75 FR 39392, 07/08/2010

Handbook Mailing HM-10-7

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC61

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy; Capital Components—Basel Accord Tier 1 and Tier 2

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Farm Credit Administration (FCA or we) is considering the promulgation of Tier 1 and Tier 2 capital standards for Farm Credit System (FCS or System) institutions. The Tier 1/Tier 2 capital structure would be similar to the capital tiers delineated in the Basel Accord that the other Federal financial regulatory agencies have adopted for the banking organizations they regulate. We are seeking comments to facilitate the development of this regulatory capital framework, including new minimum risk-based and leverage ratio capital requirements that take into consideration both the System's cooperative structure of primarily wholesale banks owned by retail lender associations that are, in turn, owned by their member borrowers, and the System's status as a Government-sponsored enterprise.

DATES: You may send comments on or before November 5, 2010.

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act (29 U.S.C. 794d), we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Send mail to Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

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SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this advance notice of proposed rulemaking (ANPRM) is to seek public comments to help us formulate proposed regulations that would:

1. Promote safe and sound banking practices and a prudent level of regulatory capital for System institutions;
2. Minimize differences, to the extent appropriate, in regulatory capital requirements between System institutions[1] and federally regulated banking organizations;[2]
3. Improve the transparency of System capital for System stockholders, investors, and the public; and
4. Foster economic growth in agriculture and rural America through the effective allocation of System capital.

II. Summary and List of Questions

A. Introduction

In October 2007, the FCA published an ANPRM on the risk weighting of assets — the denominator in our risk-based core surplus, total surplus, and permanent capital ratios; a possible leverage ratio, and a possible early intervention framework (October 2007 ANPRM).[3] The comment letter we received in December 2008 from the Federal Farm Credit Banks Funding Corporation on behalf of the System (System Comment Letter) focused primarily on the numerators of those regulatory capital ratios.[4] The System urged us to replace the core surplus and total surplus capital standards with a "Tier 1/Tier 2" capital framework consistent with the Basel Accord (Basel I) and the other Federal financial regulatory agencies' (FFRAs[5]) guidelines to help provide a level playing field for the System in competing with commercial banks in accessing the capital markets. Furthermore, the System recommended that we replace our net collateral ratio (NCR), which is applicable only to banks, with a non-risk-based leverage ratio applicable to all System institutions. We have responded to a number of issues and comments raised in the System Comment Letter in drafting this ANPRM.

Basel I is a two-tiered capital framework for measuring capital adequacy that was first published in 1988 by the Basel Committee on Banking Supervision.[6] Tier 1 capital, or core capital, consists of the highest quality capital elements that are permanent, stable, and immediately available to absorb losses and includes common stock, noncumulative perpetual stock, and retained earnings. Tier 2 capital, or supplementary capital, includes general loan-loss reserves, hybrid instruments such as cumulative stock and perpetual debt, and subordinated debt. Basel I established a minimum 4-percent Tier 1 risk-based capital ratio and an 8-percent total risk-based capital ratio (Tier 1 + Tier 2).

In December 2009, the Basel Committee published a consultative document (Basel Consultative Proposal) that proposes fundamental reforms to the current Tier 1/Tier 2 capital framework.[7] The Basel Committee's primary aims are to improve the banking sector's ability to absorb shocks arising from financial and economic stress, to mitigate spillover risk from the financial sector to the broader economy, and to increase bank transparency and disclosures. The Basel Committee intends to develop a set of new capital and liquidity standards by the end of 2010 to be phased in by the end of 2012. Although the FFRAs have discretion whether or not to adopt the new standards, they are members of the Basel Committee and have encouraged the public to review and comment on the Basel Committee's proposals. Consequently, we believe it is important for the FCA to consider the Basel Consultative Proposal in formulating new capital standards for System institutions, and we encourage commenters on our ANPRM also to review and consider the Basel Committee's proposals.

B. <u>The Farm Credit System</u>

The Farm Credit System (FCS or System) is a federally chartered network of borrower-owned lending cooperatives and related service organizations. Cooperatives are organizations that are owned and controlled by their members who use the cooperatives' products or services. The System was created by Congress in 1916 as a farm real estate lender and was the first Government-sponsored enterprise (GSE); in subsequent years, Congress expanded the System to include production credit, cooperative, rural housing, and other types of lending. The mission of the FCS is to provide sound and dependable credit to its member borrowers, who are American farmers, ranchers, producers or harvesters of aquatic products, their cooperatives, and certain farm-related businesses and rural utility cooperatives. The FCA is the System's independent Federal regulator that examines and regulates System institutions for safety and soundness and mission compliance. The System's enabling statute is the Farm Credit Act of 1971, as amended (Act).[8]

The System is composed of 88 associations that are direct retail lenders; four Farm Credit Banks that are primarily wholesale lenders to the associations; an Agricultural Credit Bank (CoBank, ACB) that makes retail loans to cooperatives as well as wholesale loans to associations; and a few service organizations.[9] Each System bank has a district, or lending territory, which includes the territories of the affiliated associations that it funds; CoBank, in addition, lends to cooperatives nationwide. There are currently two types of System association structures: Agricultural credit associations (ACAs) that are holding companies with subsidiary production credit associations (PCAs) and Federal land credit associations (FLCAs), and stand-alone FLCAs. PCAs make short- and intermediate-term operating or production or rural housing loans, and FLCAs make real estate mortgage loans and long-term rural housing loans. ACAs have the authorities of both PCAs and FLCAs.

The five banks collectively own the Federal Farm Credit Banks Funding Corporation (Funding Corporation), which is the fiscal agent for the System banks and is responsible for issuing and marketing Systemwide debt securities in domestic and global capital markets. The proceeds from the securities are used by the banks to fund their lending and other operations, and the banks are jointly and severally liable on the debt.

C. <u>The FCA's Current Capital Regulations</u>

The FCA currently has three risk-based minimum capital standards: A 3.5-percent core surplus ratio (CSR), a 7-percent total surplus ratio (TSR), and a 7-percent permanent capital ratio (PCR).[10] Congress added a definition of "permanent capital" to the Act in 1988 and required the FCA to adopt risk-based permanent capital standards for System institutions. The FCA adopted permanent capital regulations in 1988 and, in 1997, added core surplus and total surplus capital standards for banks and associations, as well as a non-risk-based net collateral ratio (NCR) for banks.[11] Since then, we have made only minor changes to these regulations.

Permanent capital is defined primarily by statute and includes current earnings, unallocated and allocated earnings, stock (other than stock retirable on repayment of the holder's loan or at the discretion of the holder, and certain stock issued before October 1988), surplus less allowance for losses, and other debt or equity instruments that the FCA determines appropriate to be considered permanent capital. Core surplus contains the highest quality capital, similar (but not identical) to Basel I's Tier 1 capital and generally consists of unallocated retained earnings, certain allocated surplus, and noncumulative perpetual preferred stock less, for associations, the association's net investment in its affiliated bank. Total surplus generally contains most of the components of permanent capital but excludes stock held by borrowers as a condition of obtaining a loan and certain other instruments that are routinely and frequently retired by institutions.

Section IV of this ANPRM provides more detailed information for readers who are not familiar with our regulatory capital requirements; the FCA's October 2007 ANPRM and comments; and Basel I and the Basel Consultative Proposal.

D. <u>List of Questions</u>

This ANPRM poses questions on the possible promulgation of regulatory capital standards based on Basel I and the FFRAs' guidelines while keeping in mind the reforms being proposed by the Basel Committee. It is tailored to account for the member-owner cooperative structure and GSE mission of the System. The questions are listed below and followed by a full discussion in Section III.

1. We seek comments on the different ways System banks and associations retain and distribute capital, how their borrowers influence the System institution's retention and distribution of capital, and how such differences should be captured in a new regulatory capital framework. Should we adopt separate and tailored regulatory capital standards for banks and associations? Why or why not?

2. We seek comments on ways to address bank and association interdependent relationships in the new regulatory capital framework. Should we establish an upper Tier 1 minimum standard for banks and associations? Why or why not? If so, what capital items should be included in upper Tier 1, and should bank requirements differ from association requirements?

3. We seek comments on ways to ensure that the majority of Tier 1 and total capital is retained earnings and capital held by or allocated to an institution's borrowers. Should we establish specific regulatory restrictions on third-party capital? Why or why not? If so, should there be different restrictions for banks and associations?

4. We seek comments on the role that permanent capital will play in a new regulatory capital framework. Should we replace any regulatory limits and/or restrictions based on permanent capital with a new limit based on Tier 1 or total capital? If so, what should the new limits and/or restrictions be? Also, we ask for comments on how, or whether, to reconcile the sum of Tier 1 and Tier 2 (e.g., total capital) with permanent capital.

5. We seek comments on other types of allocated surplus or stock in the System that could be considered unallocated retained earnings (URE) equivalents under a new regulatory capital framework. We ask commenters to explain how these other types of allocated surplus or stock are equivalent to URE.

6. We seek comments on ways to limit reliance on noncumulative perpetual preferred stock (NPPS) as a component included in Tier 1 capital while avoiding the downward spiral effect that can occur when other elements of Tier 1 capital decrease.

7. We seek comments to help us develop a capital regulatory mechanism that would allow System institutions to include allocated surplus and member stock in Tier 1 capital. Using the table titled "System Institutions Capital Distributions Restrictions and Reporting Requirements" as an example, what risk metrics would be appropriate to classify a System institution as Category 1, Category 2, or Category 3? What percentage ranges would be appropriate for each risk metric under each category? We also seek comments on the increased restrictions and/or reporting requirements listed in Category 2 and Category 3.

8. We seek comments on whether the FCA should count a portion of the allowance for loan losses (ALL) as regulatory capital. We also seek information on how losses for unfunded commitments equate to ALL and why they should be included as regulatory capital. We ask commenters to take into consideration the Basel Consultative Proposal and any recent changes to FFRA regulations in relation to the amount or percentage of ALL includible in Tier 2 capital.

9. We seek comments on the treatment of cumulative perpetual and term-preferred stock as Tier 2 capital subject to the same conditions imposed by the FFRAs.

10. We seek comments on authorizing System institutions to include a portion of unrealized holding gains on available-for-sale (AFS) equity securities as regulatory capital. We ask commenters to provide specific examples of how this component of Tier 2 capital would be applicable to System institutions.

11. We seek comments on the treatment of intermediate-term preferred stock and subordinated debt as Tier 2 capital and conditions for their inclusion in Tier 2 capital.

12. We seek comments on how to develop a regulatory mechanism to make a type of perpetual preferred stock that can be continually redeemed (referred to as H stock by most associations that have issued it) more permanent and stable so that the stock may qualify as Tier 2 capital.

13. We seek comments on the regulatory adjustments in our current regulations that we expect to incorporate into the new regulatory capital framework. We also seek comments on the regulatory capital treatment for positions in securitizations that are downgraded and are no longer eligible for the ratings-based approach under the new regulatory capital framework.

III. <u>The Tier 1/Tier 2 Capital Framework Under Consideration by the FCA and Associated Questions</u>

The table below displays the possible treatment of the System's capital components under a framework that is consistent with the FFRAs' current Tier 1/Tier 2 capital framework. We anticipate that the Basel Consultative Proposal could lead to significant changes to this framework, and we ask commenters to take the Basel Committee's proposals into consideration when answering the questions in this ANPRM.

Tier 1 Capital

Capital Element	Comments
URE & URE Equivalents	We may create the term "URE equivalents" and ask commenters to help us

	identify types of allocated surplus and/or stock that would constitute URE equivalents.
Noncumulative Perpetual Preferred Stock (NPPS)	We may limit NPPS to an amount less than 50 percent of Tier 1 capital. We seek comments on ways to limit NPPS as Tier 1 capital while avoiding the downward spiral effect that can occur when other elements of Tier 1 capital decrease.
Allocated Surplus and Member Stock	We may treat most forms of allocated surplus and member stock as Tier 1 capital, provided System institutions are subject to a regulatory mechanism that would give the FCA the additional ability to effectively monitor and, if necessary, take actions that would restrict, suspend, or prohibit capital distributions before a System institution reaches its regulatory capital minimums. We ask commenters to help us develop this mechanism.

Tier 2 Capital

Capital Element	**Comments**
Association's Excess Investment in the Bank	We may treat the amount of an association's investment that is in excess of its bank requirement, whether counted by the bank or the association, as Tier 2 capital.
Allowance for Loan Losses (ALL)	We have not determined whether any portion of ALL should be treated as Tier 2 capital. We seek comments as to why the FCA should count a portion of ALL as regulatory capital.
Cumulative Perpetual Preferred Stock and Long-Term Preferred Stock	We may adopt the definitions, criteria and/or limits consistent with future revisions to the Basel Accord and FFRA guidelines. We also may adopt aggregate third-party capital limits that are unique to the System.
Unrealized Holding Gains on AFS Securities	This element is currently addressed in the FFRAs' guidelines but is subject to change. We seek comment on the appropriate treatment of this element and specific examples of how this application would affect System institutions.
Intermediate-term Preferred Stock and Subordinated Debt	We may adopt the definitions, criteria and/or limits consistent with future revisions to the Basel Accord and FFRA guidelines. We also may adopt aggregate third-party capital limits that are unique to the System.
Association Continuously Redeemable Preferred Stock	We view this element as a 1-day term instrument that would not currently qualify as Tier 1 or Tier 2 capital. We seek comments to help us develop a regulatory mechanism that would make the stock sufficiently permanent to be included in Tier 2 capital.

Regulatory Adjustments

We may apply most of the deductions currently in our regulations to the new regulatory capital ratios. However, in view of the Basel Consultative Proposal, we are considering reflecting the net effect of accumulated other comprehensive income in the new regulatory capital ratios.

A. The Tier 1/Tier 2 Capital Structure within a Broader Context

1. Discussion of Bank and Association Differences

We established core surplus and total surplus standards in 1997 to ensure System institutions would have a more stable capital cushion that would provide some protection to System institutions, investors, and taxpayers; reduce the volatility of capital in relation to borrower stock retirements; and ensure that the institutions always maintain a sufficient amount of URE to absorb losses. Our determinations were influenced, in part, by what we learned in the 1980s when the System experienced severe financial problems.[12] At that time, the System was employing an average-cost pricing strategy that caused System loans to be priced below rates offered by other lenders when interest rates were high (e.g., in the early 1980s) and above rates offered by other lenders when interest rates fell (e.g., in the mid-1980s). When the System's rates were no longer competitive, many higher quality borrowers who could easily find credit elsewhere began to leave the System. Those who left early in the crisis were able to have the institution retire their stock at par, which at that time was around 5 to 10 percent of the loan (or some borrowers simply paid down their loans to an amount equal to their stock), causing capital and loan portfolio quality to drop sharply at many associations.

Some association boards had the legal discretion to suspend stock retirements but did not do so, perhaps to help their borrowers in times of distress but also to avoid sending a message to remaining and potential borrowers that borrower stock was risky. The result was that, in many cases, these actions left remaining stockholders bearing the brunt of more severe association losses. We concluded from these events that associations needed to build surplus cushions to be able to continue retiring borrower stock on a routine basis and to reduce the volatility associated with borrower stock retirements, and our 1997 regulations have effectively required associations to establish such cushions. System banks and associations retain and distribute capital differently. For this reason, we will consider whether to establish separate and tailored regulatory capital standards for banks and for associations as we construct a new regulatory capital framework.

System banks do not routinely retire their stock in the ordinary course of business or revolve surplus in the same manner as associations. At the present time, each bank has established a "required investment,"[13] which may consist of both purchased stock and allocated surplus, for each of its affiliated associations.[14] This required investment, which is generally a percentage of the association's direct loan outstanding from the bank, can fluctuate within a bank board's established range depending upon the bank's capital needs. The bank's bylaws usually require an association that falls short of the required investment to purchase additional stock in the bank.[15] In most cases, the banks make little distinction between purchased stock and allocated surplus.

Associations make a greater distinction between borrower stock and the surplus they allocate to borrowers.[16] Borrower stock held by retail borrowers as a condition of obtaining a loan is routinely retired by the association at par when the borrower pays off or pays down the loan. Some associations allocate earnings, and others do not. Some associations do not have allocated equity revolvement plans and distribute patronage only in the form of cash on an annual basis.[17] Other associations do not have allocated equity revolvement plans but distribute some patronage in the form of nonqualified or qualified allocated equities on a regular basis; they generally determine how such equity will be distributed on an ad hoc or annual basis after assessing market conditions. Still other associations have equity revolvement plans and distribute earnings as either cash or nonqualified or qualified allocated equities consistent with the plan; however, they have the power to withhold or suspend cash distributions to respond to changing economic and financial conditions.

The cooperative structure and operations of System associations are significantly different from a typical corporate structure in that a borrower's expectation of patronage distributions can and does influence the permanency and stability of association stock and allocated surplus. In addition, a System bank's retention and distribution of bank stock and bank surplus are different from those of associations for a number of reasons, including the tax implications and the fact that an association cannot easily find debt financing from sources other than the bank. We are asking commenters to consider the unique structure and practices of System banks and associations, the characteristics and expectations of their borrowers, and how such characteristics and expectations can impact the stability and permanency of stock and surplus.

Question 1: We seek comments on the different ways System banks and associations retain and distribute capital, how their borrowers influence the System institution's retention and distribution of capital, and how such differences should be captured in a new regulatory capital framework. Should we adopt separate and tailored regulatory capital standards for banks and associations? Why or why not?

2. Limits and Minimums

The current regulatory capital minimums imposed by the FFRAs include a 4-percent Tier 1 risk-based capital ratio, an 8-percent minimum total risk-based capital ratio with the amount of Tier 2 components limited to the amount of Tier 1, and a 4-percent minimum Tier 1 non-risk-based leverage ratio. These standards could change as a result of efforts to revise the risk-based capital ratios and introduce a non-risk-based leverage ratio that may integrate off-balance sheet items as outlined in the Basel Consultative Proposal. We are also considering an "upper Tier 1" minimum consistent with the Basel Committee's proposed common equity standard. An upper Tier 1 minimum would ensure that the predominant form of a System institution's Tier 1 capital consists of the highest quality capital elements. Finally, we are studying third-party capital limits that take into consideration the System's GSE charter and cooperative form of organization.[18] These limits and/or minimums for System banks may differ from the limits and minimums for associations.

a. Upper Tier 1 Minimum

Upper Tier 1 in a commercial banking context is typically referred to as "tangible common equity"; it is the highest quality portion of a commercial bank's Tier 1 capital and consists of common stockholder's equity and retained earnings. A commercial bank's upper Tier 1 capital, or tangible common equity, is the most permanent and stable capital available to absorb losses to ensure it continues as a going concern. The FRB's and FDIC's regulatory guidelines state that the dominant form of Tier 1 capital should consist of common stockholder's equity and retained earnings.[19] Upper Tier 1 in a System lending institution context would not necessarily have the equivalent components of tangible common equity at a commercial bank. The FCA's position has been that borrower stock and many forms of allocated surplus are generally less permanent, stable and available to absorb losses than URE and URE equivalents[20] because suspension of patronage distributions and stock retirements can have negative effects on the institution's relationship with its existing and prospective customers. We currently restrict all forms of allocated equities includible in core surplus to 2 percentage points[21] of the 3.5-percent CSR unless a System institution has at least 1.5 percent of uncommitted, unallocated surplus and noncumulative perpetual preferred stock.[22]

As noted above, the Basel Committee is considering establishing a new common equity standard[23] and has described the characteristics that instruments must have to qualify as common equity. Instruments such as member stock and surplus in cooperative financial institutions must also have these characteristics to be included in common equity. The FCA will take into account these characteristics as it considers an upper Tier 1 standard for System institutions.

We are also considering an upper Tier 1 minimum to address interdependency risk within the System. Because of their financial and operational interdependence, financial problems at one System institution can spread to other System institutions. An upper Tier 1 capital requirement could help moderate these interdependent relationships if it contains uncommitted, high quality, loss-absorbing capital that protects the investors of a System institution from its own financial problems as well as from the financial problems of other System institutions.

A commercial bank that needs additional upper Tier 1 capital may have the ability to issue additional common stock to investors without any direct impact on its customers. System institutions have fewer options to increase their highest quality capital, and exercising these options could have negative effects on their member borrowers in adverse situations. For example, if a System bank suffers severe losses and needs to replenish capital, its only options might be to reduce or suspend patronage distributions to its affiliated associations or to increase its associations' minimum required investments in the bank, or both. Since an association depends, to some extent, on the earnings distributions it receives from its bank, the association would have less income to purchase additional capital to support its struggling bank. The association might have to use its earnings from its own operations to recapitalize the bank instead of making cash patronage distributions to its borrowers or capitalizing new loans. The bank's financial weakness could spur the association to try to reaffiliate with another System bank; however, as the System Comment Letter points out,[24] associations cannot easily reaffiliate with another funding bank or voluntarily liquidate or terminate System status under a stressed bank financial scenario. A sufficient amount of upper Tier 1 capital at the bank that consists of unallocated capital would help cushion the bank losses that can negatively impact the associations and their borrowers. It would protect the association's investment and reduce the likelihood that the bank will raise the association's capital requirement at a time when the association is least able to afford it.

Upper Tier 1 requirements at associations would also protect the borrowers' investments in the institution. Associations with financial problems might not have additional capital to meet the bank's required investment, and the bank might, in turn, try to obtain additional capital from healthier associations to ensure the bank remains adequately capitalized. Because of these interdependent relationships, it is possible that weaker associations could pull down healthier associations. An adequate amount of upper Tier 1 capital at the associations would help protect the borrower's investment from losses resulting from these interdependent relationships.

If the FCA determines that borrower stock and allocated surplus can be treated in part or in whole as Tier 1 capital (depending upon appropriate regulatory mechanisms as discussed below), we may establish an upper Tier 1 minimum at both the banks and the associations to protect against systemic risks outside the control of the System institution. The upper Tier 1 requirement for System banks might be different from the requirement for associations. For example, an upper Tier 1 minimum at the banks might include only URE and URE equivalents to protect the associations' required investments in the bank. An upper Tier 1 minimum at the associations might include some forms of allocated surplus but exclude other forms of allocated surplus and most or all borrower stock.[25]

Question 2: We seek comments on ways to address bank and association interdependent relationships in the new regulatory capital framework. Should we establish an upper Tier 1 minimum for banks

and associations? Why or why not? If so, what capital items should be included in upper Tier 1, and should bank requirements differ from association requirements?

b. Third-Party Capital Limits

System institutions capitalize themselves primarily with member stock and surplus. System institutions are also authorized to raise capital from third-party investors who are not borrowers of the System. Third-party capital may include various kinds of hybrid capital instruments such as preferred stock and subordinated debt. While diverse sources of capital improve a System institution's risk-bearing capacity and, to a certain extent, improve corporate governance through increased market discipline, the FCA believes that too much third-party capital would compromise the cooperative nature and GSE status of the System. Consequently, we have imposed limits on the amount of third-party capital that is includible in a System institution's regulatory capital.[26]

The FCA agrees with the position of the Basel Committee that the predominant form of capital should be stable, permanent, and of the highest quality. While NPPS provides loss absorbency in a going concern, it absorbs losses only after member stock and surplus have been depleted. Since member stock and surplus rank junior to NPPS, it is more difficult for a System institution to raise additional capital from its patrons during periods of adversity if it holds a significant amount of NPPS. Furthermore, while dividends can be waived and do not accumulate to future periods, System bank issuers of NPPS, like commercial banks, appear to have strong economic incentives not to waive dividends since doing so would send adverse signals to the market.[27] Additionally, unlike customers of commercial banks, the customers of System institutions are impacted when System institutions are prohibited from paying patronage because they skipped dividends on preferred stock. For these reasons, we are considering maintaining limits on third-party capital in both Tier 1 and total capital to ensure that member stock and surplus remain the predominant form of System capital.[28]

Question 3: We seek comments on ways we can ensure that the majority of Tier 1 and total capital is retained earnings and capital held by or allocated to an institution's borrowers. Should we establish specific regulatory restrictions on third-party capital? Why or why not? If so, should there be different restrictions for banks and associations?

3. The Permanent Capital Standard

Permanent capital is defined by statute to include stock issued to System borrowers and others, allocated surplus, URE, and other types of debt or equity instruments that the FCA determines is appropriate to be considered permanent capital, but expressly excludes ALL.[29] The Act imposes a permanent capital requirement and, therefore, it will remain part of the System's regulatory capital framework. The FCA will continue to enforce any restrictions or other requirements prescribed in the Act relating to the permanent capital standard. (One such restriction prohibits a System institution from distributing patronage or paying dividends (with specific exceptions) or retiring stock if the institution fails to meet its minimum permanent capital standard.[30])

Several existing FCA regulations refer to measurements of permanent capital outstanding or PCR minimums.[31] For example, § 614.4351 sets a lending and leasing base for a System institution equal to the amount of the institution's permanent capital outstanding, with certain adjustments. Section 615.5270 permits a System institution's board of directors to delegate authority to management to retire stock as long as the PCR of the institution is in excess of 9 percent after any such retirements. Section 627.2710 sets forth the grounds for the appointment of a conservator or receiver for System institutions and defines a System institution as unsafe and unsound if its PCR is less than one half of the minimum required level (3.5 percent). We could retain these regulations in their current form, but it may be more appropriate to change any or all of them to fit the new regulatory capital framework.

Question 4: We seek comments on the role that permanent capital will play in the new regulatory capital framework. Should we replace any regulatory limits and/or restrictions based on permanent capital with a new limit based on Tier 1 or total capital? If so, what should the new limits and/or restrictions be? Also, we ask for comments on how, or whether, to reconcile the sum of Tier 1 and Tier 2 (e.g., total capital) with permanent capital.

B. The Individual Components of Tier 1 and Tier 2 Capital

1. Tier 1 Capital Components

We ask commenters to consider the Basel Consultative Proposal when addressing questions 5 through 7 below. The Basel Committee's proposed Tier 1 capital would include two basic components: Common equity (including current and retained earnings) and additional going-concern capital. Common equity must be the predominant form of Tier 1 capital. Common equity is, among other things, the highest quality of capital that represents the most subordinated claim in liquidation of a bank and takes the first and, proportionately, greatest share of losses as they occur. The instrument's principal must be perpetual, and the bank must do nothing to create an expectation at issuance that the instrument will be bought back, redeemed, or canceled. Additional going-concern capital is capital that is, among other things, subordinated to depositors and/or creditors, has fully discretionary noncumulative dividends or coupons, has no maturity date, and has no incentive to redeem.[32]

a. URE and URE Equivalents

URE is current and retained earnings not allocated as stock or distributed through patronage refunds or dividends. It is free from any specific ownership claim or expectation of allocation, it absorbs losses before other forms of surplus and stock, and it represents the most subordinated claim in liquidation of a System institution. The FCA expects to propose to treat URE as Tier 1 capital under the new regulatory capital framework.

URE equivalents are other forms of surplus that have the same or very similar characteristics of permanence (i.e., low expectation of redemption) and loss absorption as URE. For example, the System Comment Letter recommends treating association and bank nonqualified allocated surplus not subject to revolvement (NQNSR) as Tier 1 capital.[33] In the comment letter, the System characterizes NQNSR as allocated equity on which the institution is liable for taxes in the year of allocation and which the institution does not anticipate redeeming. In addition, the institution has not revolved NQNSR outside of the context of liquidation, termination, or dissolution. The System explains that the "member [is] aware that his ownership interest in the [institution] has increased such that, in the event of liquidation of the [institution], the member has a larger claim on the excess of assets over liabilities." The FCA will likely consider such NQNSR to be the equivalent of URE and expects to propose to treat it as Tier 1 capital under a new regulatory capital framework.

The System recommends that the FCA treat "Paid-In Capital Surplus" resulting from an acquisition in a business combination as Tier 1 capital. Current accounting guidance for business combinations under U.S. generally accepted accounting principles (U.S. GAAP)[34] requires the acquirer in a business combination to use the acquisition method of accounting. This accounting guidance applies to System institutions and became effective for all business combinations occurring on or after January 1,

2009. For transactions accounted for under the acquisition method, the acquirer must recognize assets acquired, the liabilities assumed and any non-controlling interest in the acquired business measured at their fair value at the acquisition date. For mutual entities such as System institutions, the acquirer must recognize the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings.[35]

The System provided the FCA with three examples of potential acquisitions under FASB guidance on business combinations. In each example, the retained earnings of the acquiree are transferred to the acquirer as Paid-In Capital Surplus.[36] Under these three scenarios, Paid-In Capital Surplus functions similarly to URE and would likely be treated as Tier 1 capital under a new regulatory capital framework. However, it is equally plausible that under other scenarios, as part of the terms of the acquisition, the acquirer might allocate some or all of the acquiree's retained earnings subject to some plan or practice of revolvement or retirement. Under such scenarios, the allocated portion may or may not qualify as Tier 1 capital. The FCA would likely look at the specific acquisition before determining whether the capital transferred in the acquisition would be Tier 1 or Tier 2 capital.

Question 5: We seek comments on other types of allocated surplus or stock in the System that could be considered URE equivalents under a new regulatory capital framework. We ask commenters to explain how these other types of allocated surplus or stock are equivalent to URE.

b. Noncumulative Perpetual Preferred Stock

NPPS is perpetual preferred stock that does not accumulate dividends from one dividend period to the next and has no maturity date. The noncumulative feature means that the System institution issuer has the option to skip dividends. Undeclared dividends are not carried over to subsequent dividend periods, they do not accumulate to future periods, and they do not represent a contingent claim on the System institution issuer. The perpetual feature means that the stock has no maturity date, cannot be redeemed at the option of the holder, and has no other provisions that will require future redemption of the issue.

The FFRAs treat some, but not all, forms of NPPS as Tier 1 capital. For example, the FRB emphasizes that NPPS with credit-sensitive dividend features generally would not qualify as Tier 1 capital.[37] The FDIC views certain NPPS where the dividend rate escalates excessively as having more in common with limited life preferred stock than with Tier 1 capital instruments.[38] Furthermore, the OCC, FRB, and FDIC do not include NPPS in Tier 1 capital if an issuer is required to pay dividends other than cash (e.g., stock) when cash dividends are not or cannot be paid, and the issuer does not have the option to waive or eliminate dividends.[39]

As noted above, the Basel Committee is proposing to establish a set of criteria for including "additional going-concern capital" such as NPPS in Tier 1 capital.[40] We will consider these criteria in a future proposed rulemaking.

Consistent with the Basel Committee's position, the FCA believes that high quality member stock and surplus should be the predominant form of Tier 1 capital. We are seeking comments on how to ensure that NPPS remains the minority of Tier 1 capital under most circumstances. We note that a specific limit on the amount of NPPS that is includible in Tier 1 capital may create a downward spiral effect in adverse situations where decreases in high quality member stock and surplus also decrease the amount of NPPS includible in Tier 1 capital.

One option would be to establish a hard limit that is something less than 50 percent of Tier 1 capital at the time of issuance. If this limit is subsequently breached due to adverse circumstances, the System institution would be required to submit a capital restoration plan to the FCA that includes increasing surplus through earnings in order to bring the percentage of NPPS in Tier 1 capital back below the limit that is imposed at the time of issuance. During such adversity, the System institution may be limited in its ability to issue additional NPPS that would qualify for Tier 1 regulatory capital treatment.

Question 6: We seek comments on ways to limit reliance on NPPS as a component of Tier 1 capital while avoiding the downward spiral effect that can occur in adverse situations as described above.

c. Allocated Surplus and Member Stock

i. Overview of System Bank and Association Allocated Surplus and Member Stock

Each System bank provides its affiliated associations with a line of credit, referred to as a direct note, as the primary source of funding their operations. Each association, in turn, is required to purchase a minimum amount of equity in its affiliated bank. This required investment minimum is generally a percentage of its direct note outstanding.[41] For example, suppose a bank that has a required investment range of 2 percent to 6 percent, as set forth in its bylaws, establishes a current required investment minimum of 3 percent of an association's direct note outstanding.[42] If the association falls short of the 3-percent minimum, it would be required to purchase additional stock in the bank. If the association's investment is over the 3-percent minimum, the bank would distribute (sometimes over a long period of time through a revolvement plan) or allot, for regulatory capital purposes, the "excess investment" back to the association.

CoBank, ACB makes direct loans to System associations and is also a retail lender to agricultural cooperatives, rural energy, communications and water companies and other eligible entities. CoBank builds equity for its retail business using a "target equity level" that is similar to the required investment minimum described above.[43] The target equity level includes the statutory minimum initial borrower investment of $1,000 or 2 percent of the loan amount, whichever is less,[44] and equity that is built up over time through patronage distributions. The CoBank board annually determines an appropriate targeted equity level based on economic capital and strategic needs, internal capital ratio targets, financial and economic conditions, market expectations and other factors. CoBank does not automatically or immediately pay off the borrower's stock after the loan is paid in full. Rather, it retires the stock over a long period of time.[45]

Borrowers from System associations are statutorily required to purchase association stock as a condition of obtaining a loan. The purchase requirement is set by the association's board and, by statute, must be at least $1,000 or 2 percent of the loan amount, whichever is less. In practice over the past two decades, association boards have set the member stock (or participation certificates for individuals or entities that cannot hold voting stock) purchase requirement at the statutory minimum and routinely retire the purchased stock when the borrower pays off his or her loan.[46] Consequently, the borrower has a high expectation of stock retirement when his or her loan is paid off. Currently, member stock is not includible in core surplus or total surplus and makes up only a small portion of the association's capital base.

The majority of an association's regulatory capital base comes through retained earnings as either allocated surplus or URE. Allocated surplus is earnings that are distributed as patronage to an individual borrower but retained by the association as part of the member's equity in the institution. We do not consider allocated surplus that is subject to revolvement to be a URE equivalent, because the borrower has an expectation of distribution at some future point in time through a System association's equity revolvement program. These revolvement programs vary depending upon the unique circumstances of the association. Currently, allocated surplus that is subject to revolvement is a small part of the capital base of most associations.

ii. <u>The System Comment Letter and FCA's Responses to Treating Allocated Surplus and Member Stock as Tier 1 Capital</u>

The System Comment Letter recommends that all at-risk allocated surplus and member stock be Tier 1 capital. We have categorized the System's comments into broad arguments. We respond below after each broad argument.

The System's first argument is that various systems and agreements are in place to ensure the stability and permanency of allocated surplus and borrower stock. For example, while a regular practice or plan of retirement may give rise to an expectation of equity retirement, borrowers do not have the legal right to demand retirement. A System institution board has the sole discretion to suspend or stop equity distributions at any time if warranted by changing economic and financial conditions. Moreover, an institution's bylaws and capital plans put some restraints on capital distributions under certain conditions. The System also comments that the System banks and the Funding Corporation have entered into a Contractual Interbank Performance Agreement and a Market Access Agreement, which provide early and quick enforcement triggers to protect against a bank's weakening capital position. In addition, each bank has a General Financing Agreement (GFA) with its affiliated associations. The GFA requires each association to maintain a satisfactory borrowing base, which is a measure of capital adequacy. Third-party capital issuances (e.g., preferred stock and subordinated debt) have terms that prohibit the payment of outsized cash patronage dividends and stock retirements if regulatory capital ratios are breached.

In our 1997 final rule on System regulatory capital, we addressed similar arguments and observed that internal systems and agreements alone do not ensure that System institutions consistently maintain sufficient amounts of high quality capital.[47] At the time, we decided to exclude member stock from core surplus and limit the inclusion of allocated surplus to ensure that System institutions had an adequate amount of uncommitted, unallocated surplus that was not at risk at another institution and not subject to borrower expectations of retirement or revolvement. However, as we discuss below, in developing the new regulatory capital framework, the FCA is considering what regulatory mechanisms could be put into place to make allocated surplus and member stock more permanent and stable so as to qualify as Tier 1 capital.

The System's second argument is that other banking organizations can treat similar equities as Tier 1 capital. For example, a Federal Home Loan Bank (FHLB) is permitted to include as "permanent capital" certain stock issued to commercial banks that is redeemable in cash 5 years after a commercial bank provides written notice to its FHLB.[48] In addition, Subchapter S commercial bank corporation (Subchapter S corporation) investors have expectations of regular dividend distributions that are similar to those of System borrowers, and FFRAs permit Subchapter S corporations to treat their equities as Tier 1 capital.[49]

In response to the second argument, while the FHLBs are not directly comparable to System institutions, we are open to suggestions on how to apply a 5-year or other time horizon to allocated surplus and member stock retirements. We note, however, that the inclusion of such stock in a FHLB's capital is mandated by statute and was not a safety and soundness determination made by the FHLB's regulator.[50] As for Subchapter S corporation investors, while they may have expectations of equity distributions that may be similar to those of System borrowers, Subchapter S corporations do not depend on their investors to make up the customer base of the institution. Consequently, the borrowers' influence on the System institution's retention and distribution of its stock and surplus may be different from the investors' influence on Subchapter S corporation's retention and distribution of its stock and surplus.

The System's third argument is that no distinction should be made between allocated surplus and URE based on cooperative principles. The System believes that cooperatives should be funded to the extent possible by current patrons on the basis of patronage. The System asserts that, if we require the majority of Tier 1 capital to be URE, the burden of capitalizing the institution is borne disproportionately by patrons who have repaid their loans and have ceased to use the credit services of the institution. The result is that current patrons enjoy the benefit the URE affords without bearing a substantial part of the burden of accumulating it. The System also contends that, from a tax perspective, retention of earnings as allocated surplus is a more efficient and less costly method of capital accumulation than URE. The single tax treatment under Subchapter T enables the cooperative to capitalize its operations from retention of patronage-sourced earnings and allows such earnings to be returned to its members without additional taxation. The result is that more of the earnings derived from the patron can be utilized to capitalize the cooperative's business at a lesser cost over time to the member. The System also states its belief that limits and/or exclusions of allocated surplus from Tier 1 capital would arbitrarily discourage System institutions from operating on a cooperative basis, unduly devalue allocated surplus, and prevent System institutions from maximizing non-cash patronage distributions as a component of capital management. The investment that borrowers hold in the institution would tend to remain relatively small, and without a material ownership stake in the institution, members are more likely to become disengaged from the processes of corporate governance and their crucial role in holding boards of directors accountable for poor performance. The System believes that the FCA should include all allocated surplus as Tier 1 capital.

In response to this third argument, we agree with the System that it is important to consider cooperative principles in developing the new regulatory capital framework. However, as noted above, allocated surplus that is regularly revolved is less stable and permanent than URE because of the borrower's reasonable expectation of equity distributions. In the current regulatory capital framework, we have striven to balance cooperative principles with FCA's safety and soundness objectives by treating only certain longer-term allocated equities as core surplus and requiring that at least 1.5 percent of core surplus be composed of elements other than allocated surplus. We continue to believe that certain regulatory mechanisms are needed to ensure that allocated equities subject to revolvement qualify as Tier 1 capital. We are willing to consider approaches other than time element restrictions. Association capital retention and distribution practices have changed over time and will continue to evolve. Our regulations should be flexible enough to encompass the myriad of institutions' revolvement plans without unduly hindering patronage distribution practices.

Five System associations also submitted individual comments recommending the FCA treat all association allocated surplus as Tier 1 capital. The five commenters assert that borrower expectations of patronage distributions have little or no effect on the stability and permanency of allocated surplus. In summary, they state that extensions of established revolvement cycles or reductions or suspensions of patronage distributions have not had a negative effect on marketing efforts, growth, or income at their associations. The associations state that they price their loans to market and provide high quality service, and they say there is little or no pressure from borrowers when scheduled patronage distributions are suspended or withheld.

While borrower expectations of patronage distributions do not appear to have had a material effect on the stability and permanency of allocated surplus under current conditions, we are not certain that this would be the case under other scenarios. Since 1997, from the time core surplus and total surplus requirements were established, the System has, for the most part, enjoyed strong growth and earnings as a result of favorable agricultural and wider macroeconomic conditions. Only recently have System institutions had to extend or suspend revolvement periods for allocations and reduce cash payments in response to the current economic downturn. Prior to this downturn, System institutions have not had recent experience with the trough of a credit cycle where very adverse credit conditions require boards to make hard decisions. Consequently, it is difficult to evaluate the efficacy of our capital requirements in times of severe stress.

Currently, the predominant form of System association capital is URE. Most associations distribute the majority of their patronage in cash. Consequently, most borrowers do not have a significant amount of direct ownership in the form of allocated surplus in their respective associations. However, it is possible that the associations could at some future point be primarily capitalized by their current patrons, and the majority of the association's capital base could be allocated surplus that is subject to regular revolvement. The borrower's direct capital investment would probably have to be significantly higher, and distributions that come from scheduled revolvement plans could be large and could possibly be material to a borrower's cash flows. Under this scenario, associations could have more difficulty suspending or withholding patronage distributions during periods of adversity, especially if the borrowers are stressed and are depending on scheduled patronage distributions to meet maturing financial obligations or to remain solvent. This possible scenario is the reason why the FCA's existing regulations require associations to hold a minimum amount of URE and other high quality equity that is not allocated equity. URE provides a capital cushion that enables the association to continue making routine borrower stock retirements as well as orderly planned distributions, which are especially important in situations where borrowers need those distributions to meet their own financial obligations.

The System Comment Letter asserts that association borrower stock should be treated as Tier 1 capital, pointing out that, while association borrower stock is commonly retired in conjunction with loan pay-offs, such retirement is always at risk and subject to association board discretion. Moreover, association boards commonly delegate to management and/or approve ongoing retirement programs only as long as such actions do not compromise the associations' capital adequacy. Finally, the System notes that borrower stock is of nominal amounts.

The FCA believes that, under the current regulatory framework, there is an important difference between borrower stock issued by associations and common stock issued by commercial banks. The investors who purchase an association's borrower stock are also customers of the association, whereas investors who purchase commercial bank common stock generally are not customers of the commercial bank. This customer/investor relationship of System borrowers to their associations makes borrower stock intrinsically different from commercial bank common stock. Since associations routinely retire borrower stock, suspension of stock retirements can have negative effects on the association's relationships with its customers, prospective customers, and its investors. The effect of a suspension of stock retirements may not be material today because borrower stock is presently nominal in amount, but stock retirements can become an issue when borrower stock makes up a larger portion of association capital. For instance, if associations increased their stock purchase requirement to 5 percent or 10 percent of the loan amount (as was the case up until the end of the 1980s) and then suspended the retirements, the borrowers would be more likely to be materially affected. In addition, the suspension of such stock retirements could undermine an association's efforts to attract new borrowers.

Second, borrower stock is routinely retired when the borrower pays off his or her loan. Commercial bank common stock is rarely retired once it is issued and generally requires notice to or the prior approval of the regulator.[51] The stock may trade among investors, but an individual shareholder would have little or no success in demanding that the commercial bank retire its stock in the absence of a retirement or exchange affecting the entire class of stock. In addition, commercial bank stock buy-backs are not analogous to stock retirements in connection with the paying off of loans and are not "routine" in the way association borrower stock retirements are routine.

Third, System borrowers generally do not pay cash for association stock. Rather, the par value of the stock is added to the principal amount of a borrower's obligation, and the association retains a first lien on the stock. From a practical standpoint, the borrower could simply pay down a loan to the par value of the stock and cease making any further payments. In such cases, it is usually easier and less costly for the association simply to offset the amount of the stock against the remaining loan balance than it is to take other legal measures (such as foreclosure) against a borrower. By contrast, commercial bank investors pay cash for their stock. Since their stock must be paid in full, the stockholder has no easy opportunity to use the stock to offset a debt obligation.

The System has also commented that association allocated surplus and borrower stock are equivalent in permanency and stability and should be treated the same way under the new regulatory framework. The System states that both types of equities are at risk and can be redeemed only at the discretion of the association's board and also claims that no distinction is made from the borrower's perspective. As we have explained throughout this ANPRM, we believe a distinction can be made from a safety and soundness perspective. The very fact that association borrower stock is routinely retired when a borrower pays off a loan makes borrower stock less permanent and stable than any form of surplus.

iii. <u>FCA's Consideration of a Proposal to Treat Allocated Surplus and Member Stock as Tier 1 Capital</u>

After evaluating the comments above, the FCA has begun to formulate a regulatory mechanism that would permit: 1) System associations to treat their allocated equities subject to revolvement and borrower stock as Tier 1 capital, 2) System banks to treat their associations' required minimum investment as Tier 1 capital, and 3) CoBank to treat its retail customers' stock and surplus as Tier 1 capital. This program would give us the ability to monitor, and if necessary, take actions that would restrict, suspend or prohibit capital distributions before a System institution reaches its regulatory capital minimums. An objective of the program would be to ensure that the FCA has some control over a System institution's capital distributions when it begins to experience financial stress. In this way, we believe that allocated surplus and member stock could qualify as Tier 1 capital.

The regulatory mechanism we may propose would operate differently from the FFRAs' Prompt Corrective Action framework.[52] The Prompt Corrective Action framework was designed, in part, to protect the Federal deposit insurance fund by requiring the FFRAs to take specific corrective actions against depository institutions as soon as they fall below minimum capital standards. In contrast, the purpose of our program would be to ensure the quality, permanence and stability of allocated surplus and member stock.

Because the Prompt Corrective Action framework relies almost exclusively on regulatory capital ratios, most corrective actions are not triggered until a depository institution falls below regulatory minimum capital requirements. The program we are considering proposing would have trigger points well above regulatory capital minimum requirements that, when breached, would require System institutions to take certain actions. We also expect to include other financial measures along with the capital ratios in the program to provide earlier indicators to a System institution's financial condition and performance.

The regulatory mechanism we may propose would conceivably incorporate many of the Treasury's principles for reforming regulatory capital frameworks.[53] For example, the Treasury has noted that the capital ratios in the Prompt Corrective Action framework have often acted as lagging indicators of financial distress and "ha[ve] resulted in far too many banking firms going from well-capitalized status directly to failure." The Treasury has recommended that the FFRAs consider improving their Prompt Corrective Action frameworks by adding supplemental triggers such as measures of non-performing loans or liquidity measures.

We also note that the Prompt Corrective Action framework is mandated for all depository institutions regulated by the FFRAs. The capital regulatory mechanism we are developing would apply only to those System institutions that elect to treat their allocated surplus and/or member stock as Tier 1 capital. System institutions that choose not to participate in the regulatory program would treat their allocated surplus and/or member stock as Tier 2 capital. The following chart sets forth the broad parameters of the program we are considering:

System Institution Capital Distribution Restrictions and Reporting Requirements

System Institution Category	Risk Metrics* (e.g. capital, asset, and liquidity metrics)	Regulatory Requirements (e.g., periodic reporting, prior approval on distributions, etc.)
Category 1	Capital Ratios = high Asset Quality = strong Asset Growth = low Liquidity = high	No additional requirements
Category 2	Capital Ratios = adequate Asset Quality = fair Asset Growth = high Liquidity = adequate	Notification to FCA of any capital distributions at least 30 days before declaration of distribution Institution must report all capital ratios to the FCA on a monthly basis and explain how asset quality, asset growth and liquidity have impacted the ratios
Category 3	Capital Ratios = low Asset Quality = poor Asset Growth = high Liquidity = low	FCA prior approval of any capital distributions Possible restrictions on capital distributions** Reporting requirements of Category 2, and the FCA may increase the scope and intensity of a specific institution-related issue on more than a monthly basis
The Capital Ratio thresholds for Category 3 would be the Regulatory Capital Minimums.		

If a System institution does not meet one or more of the regulatory minimum capital requirements, the FCA could take one or more supervisory actions under its existing authorities, such as conditions imposed in writing on transactions that require FCA approval; requiring a capital restoration plan; issuing supervisory letters, cease and desist orders, or capital directives; or placing the institution in conservatorship or receivership when there are grounds for doing so.

* After the proposed capital distribution.

** This includes potential restrictions on patronage distributions, dividends, stock retirements, callable debt, and interest payments on third-party capital instruments.

The table above outlining the program we are considering displays categories we might use to determine whether or when to restrict or prohibit a System institution's capital distributions. Each participating System institution that has capital levels at or above the regulatory minimums would be assigned to one of three categories (e.g., the best performing System institutions would be assigned to Category 1 and so forth). FCA would place institutions in categories based on a variety of measures of capital adequacy, asset quality, asset growth and liquidity. These measures would have specific thresholds that would act as trigger points to require additional reporting or other action by the institution. Taken as a whole, the regulatory mechanism we are considering would assist the FCA in determining whether or when to intervene to limit or prevent a System institution's capital distributions in order to ensure the permanence and loss absorption capacity of allocated surplus and member stock.

The capital ratios we expect to use would include a Tier 1 risk-based capital ratio, a total (Tier 1 + Tier 2) risk-based capital ratio, and a Tier 1 non-risk-based leverage ratio. We are also considering a Tier 1 risk-based capital ratio or Tier 1 non-risked-based leverage ratio that includes the effects of other comprehensive income.[54] Minimum category 1 capital ratio thresholds would significantly exceed the new regulatory minimum capital requirements. Minimum category 2 capital ratio thresholds would exceed the new regulatory minimum capital requirements. Minimum category 3 capital ratio thresholds would be equal to the regulatory minimum capital requirements. For a System institution that does not meet at least one of the regulatory minimum capital requirements, the FCA could take one or more supervisory actions under our existing supervisory and enforcement authorities. As noted above, we also expect to use other financial ratios in conjunction with the regulatory capital ratios to provide earlier indicators of a System institution's financial condition and performance. We ask commenters to help us determine these other ratios and develop the thresholds.

The financial measures of the regulatory mechanism would need to reflect accurately a System institution's financial position and have appropriate thresholds to trigger a regulatory requirement so that the FCA can monitor and/or intervene to restrict capital distributions in a timely manner. For example, if a System institution dropped to Category 2, it would have to submit additional information to the FCA each month and give us prior notification of any capital distributions (as described in the table above). We are also considering requiring Category 2 institutions to submit a capital restoration plan. If a System institution drops to Category 3, it would need the FCA's prior approval of any capital distributions.[55]

Finally, the FCA would reserve the right to place a System institution in a different category if warranted by the particular circumstances of the institution and the current economic environment. We would monitor this program primarily through our examination function.

Question 7: We seek comments to help us develop a capital regulatory mechanism that would allow System institutions to include allocated surplus and member stock in Tier 1 capital. Using the table titled "System Institutions Capital Distributions Restrictions and Reporting Requirements" as an example, what risk metrics would be appropriate to classify a System institution as Category 1, Category 2, or Category 3? What percentage ranges of specific financial ratios would be appropriate for each risk metric under each category? We also seek comments on the increased restrictions and/or reporting requirements listed in Category 2 and Category 3.

2. Tier 2 Capital Components

As aforementioned, the Basel Committee is proposing changes, and we ask commenters to consider the changes to Tier 2 capital when responding to questions 8 through 12 below. At a minimum, the Basel Committee is proposing that Tier 2 capital be subordinated to depositors and general creditors and have a maturity of at least 5 years; recognition in regulatory capital will be amortized on a straight line basis during the final 5 years of maturity.[56]

a. The Association's Investment in the Bank

As explained above, each System association must maintain a minimum investment in its affiliated bank. The required investment is generally a percentage of the association's direct loan from the bank and may consist of both purchased stock and allocated surplus. If an association falls short of the required investment, it is generally required to purchase additional stock in the bank. Many associations have investments in their banks that are in excess of the bank's requirements.

Under our current capital regulations, an association's investment in its bank may be counted in whole or in part in either the bank's total surplus and permanent capital, or in the association's total surplus and permanent capital, but it may not count in both institutions' regulatory capital. This avoids the "double-duty" dollar situation of using the same dollar of capital to support risk-bearing capacity at both institutions. A capital allotment agreement between a System bank and a System association specifies which of the institutions will include the investment in its regulatory capital.[57] Even though the association is permitted to include part or all of its investment in the bank in its permanent capital and total surplus, the association's investment is retained at the bank, at risk at the bank, included on the bank's balance sheet, and retired only at the discretion of the bank board. Moreover, if the bank were to fail or to be required to make payments under its statutory joint and several liability,[58] the association might lose part or all of its investment.

One System institution commenter recommended that the FCA treat an association's investment in the bank in excess of the minimum required investment, whether counted at the bank or the association, as Tier 1 capital. The commenter stated that the capital allotment agreement reflects a shared understanding between the System bank and System association that the excess amount allotted to the association is "owned" by the association and should not be leveraged by the bank. While the commenter provides many arguments as to why the excess investment is regulatory capital, in our view the excess investment does not have the attributes of Tier 1 capital at the association level. As the commenter points out, the association cannot legally compel the bank to retire the stock or otherwise liquidate it to pay down the association's debt at a moment's notice, and the bank board retains the sole discretion as to when the stock can be retired.

b. Allowance for Loan Losses

Section 621.5(a) of our regulations requires System institutions to maintain ALL in accordance with GAAP. ALL must be adequate to absorb all probable and estimable losses that may reasonably be expected to exist in a System institution's loan portfolio. ALL is expressly excluded from the statutory definition of permanent capital in the Act Section 4.3A(a)(1)(C) of the Act[59] and will continue to be excluded from the permanent capital standard. The FCA does not currently treat any portion of ALL as either core surplus or total surplus.

Basel I defines ALL (referred to as general loan loss reserves) as reserves created against the possibility of losses not yet identified. The FFRAs, in general, define ALL as reserves to absorb future losses on loans and lease receivables. Currently, ALL can be included in Tier 2 capital up to 1.25 percent [60] of a banking organization's risk-adjusted asset base provided the institution is subject to capital rules that are based on either Basel I or the Basel II standardized approach.[61] Provisions or reserves that have been created against identified losses are not included in Tier 2 capital. Any excess amount of ALL may be deducted from the net sum of risk-weighted assets in computing the denominator of the risk-based capital ratio.

In the System Comment Letter, the System recommended that the FCA include ALL, including reserves for losses on unfunded commitments, as Tier 2 capital under the new regulatory capital framework consistent with the Basel I standards and FFRA guidelines. The FCA acknowledges that ALL is a front line defense for absorbing credit losses before capital but also believes that it may not be as loss absorbing as other components of capital because it is tied only to credit-related losses.

Question 8: We seek comments on whether the FCA should count a portion of the allowance for loan losses (ALL) as regulatory capital. We also seek information on how losses for unfunded commitments equate to ALL and why they should be included as regulatory capital. We ask commenters to take into consideration the Basel Consultative Proposal and any recent changes to FFRA regulations in relation to the amount or percentage of ALL includible in Tier 2 capital.

c. Cumulative Perpetual and Long-Term Preferred Stock

Cumulative perpetual preferred stock is preferred stock that accumulates dividends from one dividend period to the next but has no maturity date and cannot be redeemed at the option of the holder. Basel I and the FFRAs currently treat cumulative perpetual preferred stock as Tier 2 capital without limit (other than the general limitation that Tier 2 capital cannot exceed 100 percent of Tier 1 capital). The FCA expects to consider cumulative perpetual preferred stock as Tier 2 capital, provided the instrument does not have a significant step-up (as defined in Basel I) that has the practical effect of a maturity date.[62]

FCA regulations do not currently distinguish between long-term and intermediate-term preferred stock.[63] The FFRAs define long-term preferred stock as preferred stock with an original maturity of 20 years or more. Long-term preferred stock is Tier 2 capital subject to the same aggregate limits as cumulative perpetual preferred stock. In addition, the amount of long-term preferred stock that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) at the beginning of each of the last 5 years of the life of the instrument. The FCA is considering adopting the FFRAs' definition of long-term preferred stock and treating it as Tier 2 capital with similar conditions.

Question 9: We seek comments on the treatment of cumulative perpetual and term-preferred stock as Tier 2 capital subject to the same conditions imposed by the FFRAs.

d. Unrealized Holding Gains on Available-For-Sale (AFS) Equity Securities

The FCA does not currently treat any portion of a System institution's unrealized holding gains on AFS equity securities as regulatory capital. The FFRAs began treating unrealized holding gains on AFS equity securities as regulatory capital after the implementation of SFAS No. 115, which requires institutions to fair-value their AFS equity securities and reflect any changes in accumulated other comprehensive income as a separate component of equity capital.[64] This is comparable to Basel I treatment, which includes "revaluation reserves" in Tier 2 capital provided the reserves are revalued at their current value rather than at historic cost.

Basel I specifies that a bank must discount any unrealized gains by 55 percent to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that would generally be incurred if the unrealized gains were realized. Consequently, the FFRAs treat up to 45 percent of the pretax net unrealized holding gains on AFS equity securities with readily determinable fair values as Tier 2 capital. Unrealized gains on other types of assets, such as bank premises and AFS debt securities, are not included in Tier 2 capital, though the FFRAs may take these unrealized gains into consideration when assessing a bank's overall capital adequacy. In addition, the FFRAs' guidelines reserve the right to exclude all or a portion of unrealized gains from Tier 2 capital if they determine that the equity securities are not prudently valued.[65]

It is important to note that Basel I and the FFRAs' guidelines require all unrealized losses on AFS equity securities to be deducted from Tier 1 capital.

Question 10: We seek comments on authorizing System institutions to include a portion of unrealized holding gains on AFS equity securities as regulatory capital. We ask commenters to provide specific examples of how this component of Tier 2 capital would be applicable to System institutions.

e. Intermediate-Term Preferred Stock and Subordinated Debt

The FFRAs define intermediate-term preferred stock as preferred stock with an original maturity of at least 5 years but less than 20 years. Subordinated debt is generally defined as debt that is lower in priority than other debt to claims on assets or earnings. The FCA currently treats subordinated debt as regulatory capital provided it meets certain criteria.[66]

Intermediate-term preferred stock and subordinated debt are currently considered to be "lower Tier 2" capital by the FFRAs and are limited to an amount not to exceed 50 percent of Tier 1 capital after deductions. In addition, the amount of intermediate-term preferred stock and subordinated debt that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) at the beginning of each of the last 5 years of the life of the instrument. The Basel Consultative Proposal indicates that the Basel Committee may remove the limits on how much of these components may count as Tier 2 capital, but the phase-out period will be retained. The FCA is considering treating intermediate-term preferred stock and subordinated debt as Tier 2 capital with an aggregate limit of 50 percent of Tier 1 capital after deductions consistent with FFRA regulations.

Question 11: We seek comments on the treatment of intermediate-term preferred stock and subordinated debt as Tier 2 capital and conditions for their inclusion in Tier 2 capital.

f. Association-Issued Continuously Redeemable Cumulative Perpetual Preferred Stock

Some associations have issued continuously redeemable cumulative perpetual preferred stock (designated as H Stock by most associations) to existing borrowers to invest and participate in their cooperative beyond the minimum borrower stock purchases. H Stock is an "at-risk" investment and can be redeemed only at the discretion of the association's board. H Stock has some similarity to a deposit or money market account in operation, but holders of H Stock do not have an enforceable right to demand payment. The FCA has previously determined that H Stock qualifies as permanent capital because it is at risk and is redeemable solely at the discretion of the association's board. However, the H Stock is not includible in core surplus or total surplus because of the association's announced intention to redeem the stock upon the request of the holder, provided minimum regulatory capital ratios are met.

The System Comment Letter recommends treating H stock as Tier 2 capital because of its temporary nature. The System states that disclaimers inform H Stock stockholders that retirement is subordinate to debt instruments and subject to board discretion. However, the holders have a high expectation that such stock will be retired. Also, the members' investment horizons are relatively short; so the capital would be viewed as temporary.

We agree with the System that H Stock is temporary in nature. In essence, the FCA views the H Stock that is currently outstanding as similar to a 1-day term instrument because of the associations' express willingness to retire it at the request of the holder. Consequently, the FCA believes that, without some enhancement that would improve the stock's stability and permanency, H Stock could not qualify as Tier 2 capital.

Question 12: We seek comments on how to develop a regulatory mechanism to make H Stock more permanent and stable so that the stock may qualify as Tier 2 capital.

C. Regulatory Adjustments

The FCA expects to apply many of the regulatory adjustments currently in our regulations to Tier 1 and total capital. For example, we expect to require System institutions to: 1) Eliminate the double-duty dollars associated with reciprocal holdings with other System institutions, 2) deduct the amount of investments in associations that capitalize loan participations, 3) deduct amounts equal to all goodwill, whenever acquired, 4) deduct investments in the Leasing Corporation, 5) make necessary adjustments for loss-sharing agreements and deferred-tax assets and 6) exclude the net effect of all transactions covered by the definition of other comprehensive income contained in the FASB Codification. We expect to require System associations to deduct their net investments in their affiliated banks from both the numerator and denominator when computing their Tier 1 risk-based capital ratio and non-risk-based leverage ratio. We believe this is consistent with the current Basel I's requirement for unconsolidated financial entities to deduct their investments from regulatory capital to prevent the multiple use of the same capital resource and to gauge the capital adequacy of individual institutions on a stand-alone basis. However, for the purposes of computing the total risk-based capital ratio, a System association could count some or all of its investment in its affiliated bank in accordance with the terms and conditions of bank-association capital allotment agreements. We also may require System institutions to make other deductions from Tier 1 capital or total capital consistent with FFRA guidelines.[67] Finally, we expect to revise § 615.5210(c)(3) prescribing how positions in securitizations that do not qualify for the ratings-based approach affect the numerator of the new regulatory capital ratios.

We are also considering proposing some of the significant new regulatory adjustments that are discussed in the Basel Consultative Proposal. For example, financial institutions may be required to adjust the capital ratios for unrealized losses on debt and equity instruments, loans and receivables, equities, own-use properties and investment properties in our new regulatory capital ratios. The Basel Committee also proposes to deduct pension fund assets as well as fully recognize liabilities that arise from these funds. We expect to consider these regulatory adjustments in our future proposed rulemaking.

Question 13: We seek comments on the regulatory adjustments in our current regulations that we expect to incorporate into the new regulatory capital framework. We also seek comments on the regulatory capital treatment for positions in securitizations that are downgraded and are no longer eligible for the ratings-based approach under a new regulatory capital framework.

IV. Additional Background

A. The October 2007 ANPRM

In our October 2007 ANPRM, we solicited comments on the development of a proposed rule to amend our capital regulations.[68] Most of the questions posed in the October 2007 ANPRM related to the method for calculating the risk-adjusted asset base that serves as the denominator for FCA's risk-based capital ratios. The questions were designed to help us develop a risk-weighting framework consistent with the standardized approach for credit risk[69] as described in the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework"[70] (Basel II).[71] We intend to propose new risk-weighting regulations in a future rulemaking.[72]

Other questions posed in our October 2007 ANPRM related to other aspects of our risk-based regulatory capital framework. For example, we sought comments on a non-risk-based leverage ratio that would apply to all FCS institutions. We also sought comments on an early intervention framework with financial thresholds, such as capital ratios or other risk measures that, when breached, would trigger an FCA capital directive or enforcement action. Of the issues we raised in the October 2007 ANPRM, we reference only the potential addition of a non-risk-based leverage ratio in this ANPRM.

The System Comment Letter submitted in December 2008 recommended, among other things, that we replace our core surplus and total surplus standards with a "Tier 1/Tier 2 structure" consistent with Basel I and FFRA regulations.[73] The letter asserted the System's belief that such revisions would enable the System to operate on a level playing field with commercial banks in accessing the capital markets.[74] The System recommended that the FCA adopt a regulatory capital framework with a 4-percent Tier 1 risk-based capital ratio and an 8-percent total (Tier 1 + Tier 2) risk-based capital ratio. The System also recommended that the FCA replace its net collateral ratio (NCR), which is applicable only to System banks, with a Tier 1 non-risk-based leverage ratio that would be applicable to all System institutions.[75] The System Comment Letter stated that, "because the System's growth has required the use of external equity capital, the System is in regular contact with the financial community, including rating agencies and investors. Obtaining capital at competitive terms, conditions, and rates requires these parties [to] understand the System's and individual institution's financial position, making consistency with approaches used by other regulators, rating agencies, and investment firms a requirement to enhance the capacity of the System to achieve its mission. . . . For the System to achieve its mission, the System must be able to compete with other lenders. Therefore, FCA's capital regulations must result in a regulatory framework that provides for a level playing field, in addition to safe and sound operations."

The FCA believes that adoption of a Tier 1/Tier 2 capital structure (including minimum risk-based and leverage ratios), tailored to the System's structure, could improve the transparency of System capital, could reduce the costs of accessing the capital markets, could reduce the negative effects that can result from differences in regulatory capital standards, and could enhance the safety and soundness of the System.

B. Description of FCA's Current Capital Requirements

In 1985, Congress amended the Act to require the FCA to "cause System institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such System institutions and by using such other methods as the [FCA] deems appropriate."[76] Congress also authorized the FCA to impose capital directives on System institutions.[77] In the Agricultural Credit Act of 1987 (1987 Act), Congress added a definition of "permanent capital" to the Act and required FCA to adopt minimum risk-based permanent capital adequacy standards for System institutions.[78] In 1988, FCA adopted a new regulatory capital framework[79] that established a minimum permanent capital standard for System institutions that, among other things, prohibited the double counting of capital invested by associations in their affiliated banks (i.e., shared System capital).[80]

Section 4.3A of the Act[81] defines permanent capital to include stock (other than stock issued to

System borrowers that is not considered to be at risk),[82] allocated surplus,[83] URE, and other types of debt or equity instruments that the FCA determines are appropriate to be considered permanent capital. The Act explicitly excludes ALL from permanent capital. Our regulations require each System institution to maintain a ratio of at least 7 percent of permanent capital to its risk-adjusted asset base.[84] The method for calculating risk-adjusted assets (which includes both on- and off-balance sheet exposures) is based largely on Basel I and is generally consistent with the FFRAs' Basel I-based risk-weighting categories.[85] From 1988 to 1997, the only regulatory capital requirement imposed on all System banks and associations was the permanent capital standard.

In the mid-1990s, the FCA engaged in a rulemaking to ensure that System institutions held adequate capital in light of the risks undertaken. A feature of the cooperative structure of the System is retail borrowers' expectations of patronage distributions, as well as the expectation that borrower stock will generally be retired when a loan is paid down or paid off. These expectations can influence the permanency and stability of borrower stock and allocated surplus. The FCA was concerned that System associations did not have enough high quality surplus both to maintain and grow operations and at the same time to meet these borrower expectations of stock retirement. The FCA was also concerned that System associations did not have a sufficient level of surplus to buffer borrower stock from unexpected losses and to insulate such institutions from the volatility associated with recurring borrower stock retirements. It was possible for a System association to meet its permanent capital requirements solely with borrower stock. For example, it could establish a stock purchase requirement of 7 percent or more of the borrower's loan amount to meet the minimum permanent capital requirement with little or no surplus to absorb association losses.[86] Furthermore, as noted above, since borrower stock in a cooperative is generally retired in the ordinary course of business upon repayment of a borrower's loan, if the majority of association capital consists of borrower stock, then its capital base is not sufficiently permanent if stock is commonly retired when loans are repaid. The FCA concluded that a minimum surplus requirement was necessary to provide a cushion to protect the borrower's investment in the System association and also to ensure that the institution had a more stable capital base that was not subject to borrowers' expectations of retirement.[87]

The FCA was also concerned that System associations did not have a sufficient amount of what the Agency viewed as "local" surplus—that is, surplus that was completely under the control of the association and immediately available to absorb losses only at the association. Under the 1992 amendments to the Act,[88] a System bank and each of its affiliated associations can determine through a "capital allotment agreement" whether allocated surplus retained at the bank is counted as permanent capital at the bank or at the association for the purposes of computing the permanent capital ratio.[89] Over the years, many System associations had accumulated URE, in part, through non-cash surplus allocations from the bank that were retained by the bank, included in the bank's balance sheet capital, and retired only at the discretion of the bank board. The FCA was concerned that this allocated surplus under the bank's control and at risk at the bank would not always be accessible to the association if either the bank or the association (or both) were to incur losses.[90] The FCA determined that a minimum surplus requirement, which excluded a System association's investment in its affiliated bank, was necessary to: 1) Ensure that each association had a minimum amount of accessible surplus that was not at risk at the bank or at any other System institution, 2) immediately absorb losses and enable the association to continue as a going concern during periods of economic stress, and 3) improve the safety and soundness of the System as a whole.

In 1995, the FCA proposed minimum "surplus" standards to ensure that System institutions had an appropriate mixture of capital components other than borrower stock, such as URE, allocated equities and other types of stock,[91] to achieve a sound capital structure.[92] We initially proposed "unallocated surplus" and "total surplus" standards.[93] The unallocated surplus standard was designed to ensure that System institutions held a sufficient amount of URE that was not available to absorb losses at another System institution. Total surplus was designed to ensure that System institutions held a sufficient amount of capital other than borrower stock so that institutions could fulfill borrower expectations of stock retirements while continuing to hold sufficient capital to operate and grow.[94] Most comments to the 1995 proposed rule centered on the proposed unallocated surplus standard. Respondents were concerned that a high quality minimum surplus requirement that excluded allocated surplus would: 1) Convey the wrong message that allocated surplus was of lower quality than unallocated surplus, 2) create a bias against cooperative principles and 3) result in lower patronage distributions, which could create a competitive disadvantage with non-cooperative agricultural lenders. The FCA considered commenters' views and subsequently published a reproposed rule that replaced the URE standard with a "core surplus" requirement.[95]

As proposed, core surplus included the unallocated surplus (URE and certain perpetual preferred stock but not borrower stock) and NQNSR.[96] Since NQNSR has no financial impact on the borrower (e.g., the borrower does not pay tax on the allocation) and the notice sent to the borrower clearly indicates no plan of redemption, the risk-bearing capacity of NQNSR is very similar to that of URE. Respondents to the 1996 proposed rule supported the addition of NQNSR to core surplus but asserted that the definition was still too restrictive. In addition to the reasons described above, they argued that, while System associations typically establish allocated equity revolvement cycles as a matter of capital planning, the retirements are not automatic and can be reduced or withheld at any time at the board's discretion. The FCA was persuaded that certain allocated equities that are subject to revolvement, while generally not perpetual in nature, do provide important capital protection for as long as they are held. In the final rule, adopted in 1997, the FCA included certain longer-term System association qualified allocated equities in core surplus on the ground that they would help an association build a high quality capital base without discouraging patronage distribution practices.[97]

Respondents also objected to the proposed requirement that an association deduct its net investment in its affiliated bank in its core surplus calculation. We did not change this requirement from what was originally proposed. We emphasized that a measurement of capital not subject to the borrower's expectation of retirement and not available to absorb losses at another System institution was needed to ensure an association could survive independently of its funding bank.

The FCA adopted minimum "core surplus" and "total surplus" standards in 1997.[98] Since that time, the FCA has made only minor changes to the regulatory definitions of core surplus, total surplus and permanent capital.[99] Under existing regulations, core surplus[100] is the highest quality of System capital and includes the following:

(1) URE,

(2) NQNSR,[101]

(3) Perpetual common[102] (excluding borrower stock) or noncumulative perpetual preferred stock,

(4) Other functional equivalents of core surplus,[103] and

(5) For associations, certain allocated equities that are subject to a plan or practice of revolvement or retirement, provided the equities are includible in total surplus and are not intended to be revolved or retired during the next 3 years.[104]

In calculating their core surplus ratio, System associations must deduct their net investment in their affiliated bank.[105] Each System institution must maintain a ratio of at least 3.5 percent of core surplus to its risk-adjusted asset base.[106] Furthermore, allocated equities, including NQNSR, may constitute up to 2 percentage points of the 3.5-percent CSR minimum. This means that at least 1.5 percent of core surplus to risk-adjusted assets must consist of components other than allocated equities.

Total surplus is the next highest form of System institution capital.[107] It includes the following:

(1) Core surplus,
(2) Allocated equities (including allocated surplus and stock), other than those equities subject to a plan or practice of revolvement of 5 years or less,
(3) Common and perpetual preferred stock that is not purchased or held as a condition of obtaining a loan, provided that the institution has no established plan or practice of retiring such stock,
(4) Term preferred stock with an original term of at least 5 years,[108] and
(5) Any other capital instrument, balance sheet entry, or account the FCA determines to be the functional equivalent of total surplus.[109]

Total surplus excludes ALL as well as stock purchased or held by borrowers as a condition of obtaining a loan. Each System institution must maintain a ratio of at least 7 percent of total surplus to its risk-adjusted asset base.[110] The FCA's purpose for adopting the total surplus requirement was to ensure that System institutions, particularly associations, do not rely heavily on borrower stock as a capital cushion. Associations have continued their practice of retiring borrower stock when the borrower's loan is repaid.

Each System bank must maintain a 103-percent minimum NCR requirement that functions as a leverage ratio.[111] The NCR is, generally, available collateral as defined in § 615.5050, less an amount equal to the portion of affiliated associations' investments in the bank that is not counted in the bank's permanent capital, divided by total liabilities. Total liabilities are GAAP liabilities with certain specified adjustments.[112]

C. Overview of the Tier 1/Tier 2 Capital Framework

In 1988, the Basel Committee published Basel I, a two-tiered capital framework for measuring capital adequacy at internationally active banking organizations.[113] Tier 1 capital, or core capital, is composed primarily of equity capital and disclosed reserves (i.e., retained earnings), the highest quality capital elements that are permanent and stable. Tier 2 capital, or supplementary capital, comprises less secure sources of capital and hybrid or debt instruments.[114] Basel I established two minimum risk-based capital ratios: a 4-percent Tier 1 risk-based capital ratio and an 8-percent total (Tier 1 + Tier 2) risk-based capital ratio. For discussion purposes, FCA's core surplus is more similar to Tier 1 capital, whereas total surplus is more similar to total capital. (FCA regulations do not include a ratio similar to Tier 2 capital.)

The Basel Consultative Proposal published in December 2009 proposes many significant changes to the current Tier 1/Tier 2 capital framework.[115] The changes are intended to strengthen global capital regulations with the goal of promoting a more resilient banking sector. The Basel Committee also announced a plan to conduct an impact assessment on the proposed changes in the first half of 2010 and develop a fully calibrated set of standards by the end of 2010. These changes will be phased in as financial conditions improve and the economic recovery is assured, with the aim of full implementation by the end of 2012. We describe the current Tier 1/Tier 2 capital framework and summarize the Basel Committee's proposed changes below.

1. The Current Tier 1/Tier 2 Capital Framework

Tier 1 capital in Basel I consists primarily of equity capital and disclosed reserves. Equity capital is issued and fully paid ordinary shares of common stock and noncumulative perpetual preferred stock. Disclosed reserves are primarily reserves created or increased by appropriations of retained earnings.[116] Disclosed reserves also include general funds that must meet the following criteria: 1) Allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential liabilities; 2) the funds, including movements into or out of the funds, must be disclosed separately in the bank's published accounts; 3) the funds must be unrestricted and accessible and immediately available to absorb losses; and 4) losses cannot be charged directly to the funds but must be taken through the profit and loss account. In October 1998, the Basel Committee determined that up to 15 percent of Tier 1 capital could include "innovative instruments," provided such instruments met certain criteria.[117]

Tier 2 capital is undisclosed reserves,[118] revaluation reserves, general loan loss reserves, hybrid capital instruments and subordinated debt. Revaluation reserves are reserves that are revalued at their current value (or closer to the current value) rather than at historic cost. The bank must discount any unrealized gains by 55 percent to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that would generally be incurred if the unrealized gains were realized. General loan loss reserves are reserves created against the possibility of losses not yet identified. General loan loss reserves can be included in Tier 2 capital up to 1.25 percentage points of risk-weighted assets.[119] Hybrid capital instruments are instruments that have certain characteristics of both equity and debt, such as cumulative preferred stock, and must meet certain criteria to be treated as Tier 2 capital. Subordinated debt and term preferred stock must also meet certain criteria to be treated as Tier 2 capital. This last category is also referred to as "lower Tier 2" capital since subordinated debt and term preferred stock are not normally available to participate in the losses of a bank and are therefore limited to an aggregate amount not to exceed 50 percent of Tier 1 capital (after deductions).

Goodwill and any increases in equity capital resulting from a securitization exposure must be deducted from Tier 1 capital prior to computing the Tier 1 risk-based capital ratio. Investments in unconsolidated financial entities must also be deducted from regulatory capital (as well as from assets): 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. Such deductions prevent multiple uses of the same capital resources by entities that are not consolidated (based on national accounting and/or regulatory systems) and to gauge the capital adequacy of individual institutions on a stand-alone basis. The Basel Committee explained that such deductions are necessary to prevent the double gearing (or double-leveraging) of capital, which can have negative systemic effects for the banking system by making it more vulnerable to the rapid transmission of problems from one institution to another.

In 1989, the FFRAs adopted the Basel I Tier 1 and Tier 2 capital framework with some variations to correspond to the characteristics of the financial institutions they regulate. All FFRAs treat common stockholders' equity (including retained earnings), noncumulative perpetual preferred stock and certain minority interests in equity accounts of subsidiaries[120] as Tier 1 capital.[121] The FRB and FDIC also emphasize in their guidelines that common stockholders' equity should be the predominant form of Tier 1 capital. Tier 2 capital includes a certain portion of qualifying ALL and unrealized holding gains of available-for-sale equity securities, cumulative perpetual and term preferred stock, subordinated debt and other kinds of hybrid capital instruments.[122] Tier 2 capital is limited to 100 percent of Tier 1 capital. Certain Tier 2 capital elements, such as intermediate-term preferred stock and subordinated debt, are limited to 50 percent of Tier 1 capital. The FFRAs' regulations include a 4-percent Tier 1 risk-based capital ratio, an 8-percent total risk-based capital ratio and a 3- or 4-percent minimum leverage ratio requirement.[123] The FFRAs also require certain deductions to be made prior to computing the risk-based capital ratios.

2. Proposed Changes to the Current Tier 1/Tier 2 Framework

In December 2009, the Basel Committee described a number of possible fundamental reforms to the Tier 1/Tier 2 capital framework in its Basel Consultative Proposal. The reforms proposed in the Basel Consultative Proposal would strengthen bank-level, or micro-prudential, regulation, which will help increase the resilience of individual banking institutions during periods of stress. The Basel Committee is also considering a macro-prudential overlay to address procyclicality and systemic risk. The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress and reduce the risk of spillover from the financial sector to the real economy. The Basel Committee also aims to improve risk management and governance as well as strengthen banks' transparency and disclosures.

The Basel Committee proposes to improve the quality and consistency of Tier 1 capital. The new standards would place greater emphasis on common equity as the predominant form of Tier 1 capital. Common equity means common shares plus retained earnings and other comprehensive income, net of the regulatory adjustments (which can be significant).[124] The Basel Committee has also identified a Tier 1 element it calls "additional going-concern capital," which would be all capital included in Tier 1 that is not common equity.[125] Certain instruments with innovative features that do not meet the criteria of common equity and additional going-concern capital would be phased out of Tier 1 capital over time.

The Basel Consultative Proposal defines Tier 2 capital as capital that provides loss absorption on a gone-concern basis.[126] The criteria that instruments must meet for inclusion in Tier 2 capital would be simplified from the Basel I criteria. All limits and subcategories related to Tier 2 capital would be removed.

The Basel Committee plans to revise the Tier 1 risk-based and total risk-based capital ratios. Since common equity would be the predominant form of Tier 1 capital, the Basel Committee would establish a common equity risk-based minimum to ensure that it equates to a greater portion of Tier 1 capital. The data collected in the impact assessment will be used to calibrate the new minimum required levels and ensure a consistent interpretation of the predominant standard. The regulatory adjustments that are applied to capital, including the new common equity component, would also change.[127]

The Basel Committee is also introducing a non-risk-based leverage ratio as a supplementary "backstop" measure based on gross exposure.[128] A Tier 1 and/or common equity leverage ratio will be considered as possible measures. The leverage ratio would be harmonized internationally, fully adjusting for material differences in accounting, and, unlike the current leverage ratios of the FFRAs, would appropriately integrate off-balance sheet items.

The Basel Committee has included a proposal for capital conservation standards that would reduce the discretion of banks to distribute earnings in certain situations.[129] A Tier 1 capital buffer range would be established above the regulatory minimum capital requirement. When the Tier 1 capital level falls within this range, a bank would be required to conserve a certain percentage of its earnings in the subsequent financial year. Regulators would have the discretion to impose time limits on banks operating within the buffer range on a case-by-case basis. The Basel Committee will use the impact assessment to calibrate the buffer and restrictions of this regulatory capital conservation framework.

Finally, the Basel Committee proposes to improve the transparency of capital. Banks would be required to: 1) Reconcile all regulatory capital elements back to the balance sheet in the audited financial statements; 2) separately disclose all regulatory adjustments; 3) describe all limits and minimums, identifying the positive and negative elements of capital to which the limits and minimums apply; 4) describe the main features of capital instruments issued; and 5) comprehensively explain how the capital ratios are calculated. In addition to the above, banks would be required to make available on their Web sites the full terms and conditions of all instruments included in regulatory capital.[130]

The FFRAs have not yet announced or proposed these recommended changes to their regulatory capital frameworks. However, we note that the FFRAs used higher capital standards consistent with the Basel Consultative Proposal in their "Supervisory Capital Assessment Program" (SCAP) conducted between February and April 2009 to assess the capital adequacy of 19 of the largest U.S. bank holding companies.[131] We also note that the U.S. Treasury's core principles for reforming the U.S. and international regulatory capital framework are consistent with the Basel Committee's recent proposal.[132] Finally, we note that the National Credit Union Administration (NCUA) issued a proposed rule to propose changes to its regulation that would improve the quality of capital at corporate credit unions.[133] Among the regulations the NCUA is proposing is a retained earnings minimum to ensure that a corporate credit union's capital base does not consist of entirely contributed capital. This should provide a cushion to protect against the downstreaming of corporate credit union losses to its natural person credit unions when those institutions could least afford those losses.[134]

The comment period for the Basel Consultative Proposal closed on April 16, 2010. As noted above, the Basel Committee has indicated it plans to issue a "fully calibrated, comprehensive set of proposals' covering all elements discussed in the consultative document. It is expected that Basel Committee member countries will phase in the new standards as their economies improve, with an aim of full implementation by the end of 2012.

Date: June 30, 2010

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

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[1]For the purposes of this ANPRM, "System institutions" include System banks and associations but do not include service organizations or the Federal Agricultural Mortgage Corporation (Farmer Mac).

[2]Banking organizations include commercial banks, savings associations, and their respective holding companies.

[3]72 FR 61568 (October 31, 2007).

[4]Comment letter dated December 19, 2008, from Jamie Stewart, President and CEO, Federal Farm Credit Banks Funding Corporation, on behalf of the System. This letter and its attachments are available in the "Public Comments" section under "Capital Adequacy—Basel Accord—ANPRM" at www.fca.gov.

[5]We refer collectively to the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of

Thrift Supervision (OTS) as the other "Federal financial regulatory agencies" or FFRAs.

[6]Basel I has been updated several times since 1988. The Basel Committee's documents are available at www.bis.org/bcbs/index/htm.

[7]"Basel Consultative Proposals to Strengthen the Resilience of the Banking Sector," December 17, 2009. The document is available at http://www.bis.org/publ/bcbs164.htm.

[8]12 U.S.C. 2001-2279cc. The Act is available at www.fca.gov under "FCA Handbook."

[9]This is the System's structure as of April 30, 2010. Farmer Mac, which is a corporation and federally chartered instrumentality, is also an institution in the System. The FCA has a separate set of capital regulations that apply to Farmer Mac, and the questions in this ANPRM do not pertain to Farmer Mac's regulations.

[10]See 12 CFR 615.5201-5216 and 615.5301-5336.

[11] See 53 FR 39229 (October 6, 1988) and 63 FR 39229 (July 22, 1998).

[12]This discussion presents a simplified explanation of the System's financial problems in the 1980s. See 60 FR 38521 (July 27, 1995) and 61 FR 42092 (August 13, 1996) for a more comprehensive discussion. These Federal Register documents are available at www.fca.gov. To find them, go to the home page and click on "Law & Regulations," then "FCA Regulations," then "Public Comments," then "View Federal Register Documents."

[13]See Section III.B.1.c. for a more detailed discussion of the bank's required investment.

[14]We are generalizing about how banks retain and distribute capital. In practice, each bank has its own unique policies and practices for retaining and distributing capital. For example, one bank distributes patronage to its associations in the form of either cash or stock, and the associations' investments consist only of bank stock. This bank retires its stock over a long period of time, depending upon its capital needs.

[15]See Section III.B.2.a. for a more detailed discussion of the excess investment.

[16]See Section III.B.1.c. for a more detailed discussion of association borrower stock and allocated surplus.

[17]All associations are required to have capital plans, but these plans may or may not include regular allocated equity revolvement plans.

[18]Third-party capital is capital issued to parties who are not borrowers of the System institution and are not other System institutions. Existing third-party regulatory capital in System institutions includes both preferred stock and subordinated debt.

[19]FRB guidelines for state member banks are in 12 CFR Part 208, App. A, II.A.1. FRB guidelines for bank holding companies (BHCs) are in 12 CFR Part 225, App. A, II.A.1.c(3). FDIC guidelines for state non-member banks are in 12 CFR Part 325, App. A, I.A.1(b).

[20]URE is earnings not allocated as stock or distributed through patronage refunds or dividends. URE equivalents are other forms of surplus that have the same or very similar characteristics of permanence (i.e., low expectation of redemption), stability and availability to absorb losses as URE.

[21]In other words, if an institution has at least 1.5 percent of uncommitted, unallocated surplus and noncumulative perpetual preferred stock, it may include qualifying allocated equities in core surplus in excess of 2 percentage points.

[22]The NCUA has taken a similar position as it considers adopting a Tier 1/Tier 2 regulatory capital framework for the institutions it regulates. The NCUA has also proposed a retained earnings minimum for corporate credit unions to help prevent the downstreaming of the losses to the credit unions they serve. See 74 FR 65209 (December 9, 2009).

[23]See paragraph 87 of the Basel Consultative Proposal.

[24]See footnote 4 above.

[25]We discuss the individual components of System capital in more detail below in Section III.B.

[26]The FCA currently limits NPPS to 25 percent of core surplus outstanding and imposes aggregate third-party regulatory capital limits of the lesser of 40 percent of permanent capital outstanding or 100 percent of core surplus outstanding. We also limit the inclusion of term preferred stock and subordinated debt to 50 percent of core surplus outstanding. (Institutions can issue third-party stock or subordinated debt in excess of these limits but cannot count it in their regulatory capital.)

[27]Market analysts might perceive a financial institution to be in worse financial condition when it waives preferred stock dividends, because it implies that the institution has previously eliminated its common stock dividends (or, in the case of a cooperative, its patronage).

[28]See also the discussion in Section III.B.1.b.

[29]Section 4.3A(a) of the Act (12 U.S.C. 2154a(a)).

[30]Section 4.3A(d) of the Act (12 U.S.C. 2154a(d)). Any System institution subject to Federal income tax may pay patronage refunds partially in cash as long as the cash portion of the refund is the minimum amount required to qualify the refund as a deductible patronage distribution for Federal income tax purposes and the remaining portion of the refund paid qualifies as permanent capital.

[31]The FCA's regulations are set forth in chapter VI, title 12 of the Code of Federal Regulations and available on the FCA's Web site under "Laws & Regulations."

[32]See paragraph 89 of the Basel Consultative Proposal.

[33]The associations refer to NQNSR in various ways such as "nonqualified retained earnings" or "nonqualified retained surplus." The System Comment Letter refers to bank NQNSR as "nonqualified allocated stock to cooperatives not subject to revolvement."

[34]On June 30, 2009, the Financial Accounting Standards Board (FASB) established the FASB Accounting

Standards Codification™ (FASB Codification or ASC) as the single source of authoritative nongovernmental U.S. GAAP. In doing so, the FASB Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters. More information about the FASB Codification is available at http://asc.fasb.org/home.

[35]This guidance was formerly included in pre-codification reference Statement of Financial Accounting Standards (SFAS) No. 141(R), Business Combinations, and is now incorporated into the FASB Codification at ASC Topic 805, Business Combinations.

[36]Since the System submitted its comment letter in December 2008, there have been several System mergers that were accounted for under the acquisition method and resulted in recording additional paid-in capital similar to the System's examples.

[37]See 12 CFR Part 225, App. A, II.A.1.c.ii(2) for BHCs and Part 208, App. A, II.A.1.b for state member banks. If the dividend rate is reset periodically based, in whole or in part, on the institution's current credit standing, it is not treated as Tier 1 capital. However, adjustable rate NPPS where the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates may be included in Tier 1 capital.

[38]See 12 CFR Part 325, App. B, IV.B. This is an issuance with a low initial rate that is scheduled to escalate to much higher rates in subsequent periods and become so onerous that the bank is effectively forced to call the issue.

[39]The OTS may allow this type of NPPS to qualify as Tier 1. See 73 FR 50326 (August 26, 2008), "Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies; Report to the Congressional Basel Committees."

[40]See paragraphs 88 and 89 of the Basel Consultative Proposal.

[41]The minimum may not be lower than the statutory minimum stock purchase requirement of $1,000 or 2 percent of the loan amount, whichever is less (section 4.3A (c)(1)(E) of the Act). The banks also have other programs in which associations and other lenders participate that require investment in the bank. We collectively refer to these investments as the bank's required minimum investment.

[42]The bank board may increase or decrease this minimum within the required investment range from time to time, depending upon the capital needs of the bank.

[43]For more detail on CoBank's target equity level, see CoBank's 2008 Annual Report. This document is available at www.cobank.com.

[44]Section 4.3A(c)(1)(E) of the Act (12 U.S.C. 2154a(c)(1)(E)).

[45]CoBank stated in its 2008 annual report that the target equity level is expected to be 8 percent of the 10-year historical average loan volume for 2009 and remain at that level thereafter.

[46]Under section 4.3A(c)(1)(I) of the Act (12 U.S.C. 2154a(c)(1)(I)), this stock is retired at the discretion of the association.

[47]62 FR 4429 (January 30, 1997).

[48]The System indicates in its comment that it views FHLB "permanent capital" as the equivalent of Tier 1 capital.

[49]The System also noted that the FASB has recognized cooperative capital as equity even if a portion of it is redeemable. While this is true, it does not support the argument that allocated surplus and member stock should be treated as Tier 1 capital rather than Tier 2 capital.

[50]See 12 U.S.C. 1426.

[51]U.S. commercial banks and savings associations must, in many cases, notify or seek the prior approval of their primary FFRA before making a capital distribution (stock retirements or dividends in the form of cash). The notification requirements and/or restrictions enhance the permanence and stability of Tier 1 capital elements for such entities. For national banks, see 12 U.S.C. 59, 60; 12 CFR 5.46, 5.60-5.67. For state banks, see 12 CFR 208.5; 12 U.S.C. 1828(i), 12 CFR 303.203, 303.241. For savings associations, see 12 U.S.C. 1467a(f); 12 CFR 563.140-563.146.

[52]Congress established the Prompt Corrective Action framework in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 with the objective to prevent a reoccurrence of the large-scale failures of bank and thrift institutions that depleted the Federal deposit insurance funds in the 1980s. For information about the use and effectiveness of the Prompt Corrective Action framework see GAO, Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions, GAO/GGD-97-18 (Washington, D.C.: Nov. 21, 1996), and GAO, Deposit Insurance: Assessment of Regulators Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System, GAO-07-242 (Washington D.C.: February 2007).

[53]"Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" (September 3, 2009). This document is available at http://www.ustreas.gov/.

[54]Other comprehensive income (OCI) is the difference between net income and comprehensive income and represents certain gains and losses of an enterprise. OCI generally refers to revenues, expenses, gains, and losses that under U.S. GAAP are included in comprehensive income but excluded from net income. For System institutions, the most common items in OCI have recently been pension liability adjustments, unrealized gains or losses on available-for-sale securities, and other-than-temporary impairment on investments available-for-sale. The accumulated balances of those items are required by those respective standards to be reported in a separate component of equity in a company's balance sheet. The principal source of guidance on comprehensive income and OCI under U.S. GAAP is at ASC Topic 220, Comprehensive Income.

[55]We note that the Basel Consultative Proposal has a similar concept to limit capital distributions, including limits on dividend payments and share buybacks, to ensure that banking organizations hold higher amounts of high quality capital during good economic situations so as to be drawn down during periods of stress. See paragraphs 39 and 40 of the Basel Consultative Proposal.

[56]The Basel Committee will determine the amount of allowance for loan losses to be included in Tier 2 capital after conducting its mid-year 2010 impact assessment.

[57]See 12 CFR 615.5207-5208.

[58] See section 4.4(a)(2)(A) of the Act (12 U.S.C. 2155(a)(2)(A)).

[59] (12 U.S.C. 2154a(a)(1)(C).

[60] The Basel Committee may remove or modify this percentage after conducting its mid-year 2010 impact assessment.

[61] The more advanced approaches of Basel II have a different formula for determining the amount of general loan loss reserves that can be included in Tier 2 capital. Basel II is discussed briefly in Section IV of this document.

[62] For descriptions of cumulative perpetual preferred stock and long-term stock, see the OCC's guidelines at 12 CFR Part 3, App. A, 1(c)(26) and 2(b)(2). See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2.b and 12 CFR Part 208, App. A, II.A.2.b. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2.ii and I.A.2.b. See the OTS's guidelines (for cumulative perpetual preferred stock) at 12 CFR 567.5(b)(1).

[63] FCA defines "term preferred stock" in § 615.5201 as stock with an original maturity date of at least 5 years and on which, if cumulative, the board of directors has the option to defer dividends, provided that, at the beginning of each of the last 5 years of the term of the stock, the amount that is eligible to be counted as permanent capital is reduced by 20 percent of the original amount of the stock (net of redemptions).

[64] Pre-codification reference: SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, was issued in May 1993 and effective for fiscal years beginning after December 15, 1993. This statement is now incorporated into ASC Topic 320, Investments—Debt and Equity Securities. See 63 FR 46518 (September 1, 1998).

[65] See the OCC's guidelines at 12 CFR Part 3, App. A, 2.b.5. See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2(v) and II.A.e; and 12 CFR Part 208, App. A, II.A.2(v) and II.A.e. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2(iv) and I.A.2.f. See the OTS's guidelines at 12 CFR 567.5(b)(5).

[66] See the OCC's guidelines at 12 CFR Part 3, App. A, 2.b.5. See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2(iv) and II.A.2.d; and 12 CFR Part 208, App. A, II.A.2(iv) and II.A.2.d. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2(v) and I.A.2.d. See the OTS's guidelines at 12 CFR 567.5(b)(1)(vi) and (b)(2)(ii).

[67] See the OCC's guidelines at 12 CFR Part 3, App. A, 2.c. See the FRB's guidelines at 12 CFR Part 225, App. A, II.B. and 12 CFR Part 208, App. A, II.B. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.B. See the OTS's guidelines at 12 CFR 567.5(a)(2).

[68] See 72 FR 61568 (October 31, 2007). The original comment period of 150 days was later extended to December 31, 2008. We note that, in the October 2007 ANPRM, FCA withdrew a previous ANPRM published in June 2007 (72 FR 34191, June 21, 2007) in which we had sought comments to questions based on a proposed regulatory capital rulemaking (referred to as Basel IA) published by the FFRAs in December 2006. The FFRAs later withdrew the Basel IA proposal. For that reason, we withdrew the June 2007 ANPRM and published the October 2007 ANPRM. The FFRAs replaced the Basel 1A

rulemaking with the July 2008 proposal based on the Basel II standardized approach.

[69]We also asked for comments on what approach we should consider in determining a risk-based capital charge for operational risk.

[70]See www.bis.org/publ/bcbsca.htm for the 2004 Basel II Accord as well as updates in 2005 and 2006.

[71]The Basel Committee on Banking Supervision was established in 1974 by central banks with bank supervisory authorities in major industrialized countries. The Basel Committee formulates standards and guidelines related to banking and recommends them for adoption by member countries and others. All Basel Committee documents are available at http://www.bis.org.

[72]The FFRAs are in the process of implementing multiple sets of capital rules for the financial institutions they regulate. In December 2007, the FFRAs adopted a regulatory capital framework consistent with the advanced approaches of Basel II that is applicable to only a few internationally active banking organizations. See 72 FR 69288 (December 7, 2007). In July 2008, the FFRAs proposed a regulatory capital framework consistent with the standardized approach for credit risk and basic indicator approach for operational risk under Basel II to help minimize the potential differences in the regulatory minimum capital requirements of those banks applying the advanced approaches and those banks applying the more simplified approaches. See 73 FR 43982 (July 29, 2008). The FFRAs have not yet acted on this proposal.

[73]See footnote 4 above.

[74]The FCA also received six comment letters from individual System institutions pertaining to the treatment of certain capital components as Tier 1 capital. We address these comments below.

[75]The System also recommended many changes to our risk-weighting regulations, which we will address in a future rulemaking.

[76]Section 4.3(a) of the Act (12 U.S.C. 2154(a)).

[77]Section 4.3(b) of the Act (12 U.S.C. 2154(b)). This provision is nearly identical to legislation enacted in 1983 with respect to the other FFRAs. See 12 U.S.C. 3097.

[78]Section 4.3A of the Act; section 301(a) of Pub. L. 100-233, as amended by the Agricultural Credit Technical Corrections Act of 1988, Pub. L. 100-399, title III, section 301(a), August 17, 1988, 102 Stat. 93.

[79]See 53 FR 39229 (October 6, 1988). The FCA's objective at this time was to develop a permanent capital standard consistent with the statute. We determined not to adopt the two-tiered capital structure of Basel I because of significant differences between statutory permanent capital and Tier 2 capital.

[80]The 1988 regulation required an association to deduct the full amount of its investment in its affiliated bank before computing its PCR. This requirement had a phase-in period that was to begin in 1993. In 1992, Congress amended the statutory definition of permanent capital to permit System banks and associations to specify by mutual agreement the amount of allocated equities that would be considered bank or association equity for the purpose of calculating the PCR. In July 1994, the FCA amended the regulations to implement this statutory change. See 59 FR 37400 (July 22, 1994).

[81]Section 4.3A(a)(1) of the Act (12 U.S.C. 2154a(a)(1)).

[82]Borrower stock is common shareholder equity that is purchased as a condition of obtaining a loan with a System institution. We include in this category participation certificates, which are a form of equity issued to persons or entities that are ineligible to own borrower voting stock, such as rural home borrowers. To be counted as permanent capital, stock must be at risk and retireable only at the discretion of an institution's board of directors. Any stock that may be retired by the holder of the stock on repayment of the holder's loan, or otherwise at the option or request of the holder, or stock that is protected under section 4.9A of the Act or is otherwise not at risk, is excluded from permanent capital. Stock protected by section 4.9A of the Act was issued prior to October 1988, and nearly all such stock has been retired.

[83]Allocated surplus is earnings allocated but not paid in cash to a System institution borrower. Allocated surplus is counted as permanent capital provided the bylaws of a System institution clearly specify that there is no express or implied right for such capital to be retired at the end of the revolvement cycle or at any other time. In addition, the institution must clearly state in the notice of allocation that such capital may be retired only at the sole discretion of the board of directors in accordance with statutory and regulatory requirements and that no express or implied right to have such capital retired at the end of the revolvement cycle or at any other time is thereby granted.

[84]See § 615.5205. Before making this computation, each System institution is required to make certain adjustments and/or deductions to permanent capital and/or the risk-adjusted asset base.

[85]See §§ 615.5211-615.5212. Under the current framework, each on- and off-balance sheet credit exposure is assigned to one of five broad risk-weighting categories (0, 20, 50, 100, and 200 percent) or dollar-for-dollar deduction) to determine the risk-adjusted asset base, which is the denominator for all of FCA's risk-based capital ratios.

[86]Before the 1987 Act took effect, the FLBAs had authority to set a borrower stock requirement of not less than 5 percent nor more than 10 percent of the amount of the loan, and the associations were required to retire the stock upon full repayment of the loan. The PCAs had a statutory minimum borrower stock requirement of 5 percent, and such stock could be canceled or retired on repayment of the loan as provided by the association's bylaws; in addition, an association could also require borrowers to purchase stock or provide an equity reserve in an amount up to another 5 percent of the loan. The 1987 Act changed these provisions by eliminating the mandatory stock retirements when long-term real estate loans were repaid and by allowing System institutions to choose their stock purchase requirement as long as it was not below the lesser of $1,000 or 2 percent of the loan.

[87]At the time, the System generally supported the FCA's position and recommended that we establish regulatory standards requiring all System institutions to build unallocated surplus and total surplus (e.g., both allocated and unallocated surplus). To meet these new standards, the FCS suggested that each System institution retain a portion of its net earnings after taxes to achieve and maintain at least 3.5 percent in unallocated surplus and 7.0 percent in total surplus of the institution's risk-adjusted assets. The FCA chose instead to establish fixed minimums but permitted institutions with capital below the minimums to achieve compliance initially by submitting capital restoration plans.

[88]Farm Credit Banks and Associations Safety and Soundness Act of 1992, Pub. L. 102-552, 106 Stat. 4102 (October 28, 1992).

[89]See §§ 615.5207(b)(2) and 615.5208 for the provisions regarding the capital allotment agreements.

[90]It is important to distinguish the terms "allocated surplus" and "allotted surplus." From a bank perspective, allocated surplus is earnings allocated to an association and retained at the bank. It is counted in either the bank's regulatory capital or the association's regulatory capital. "Allotted surplus" is the term we use to describe how the allocated surplus is counted according to an allotment agreement when calculating regulatory capital ratios. We describe the System banks' retention and distribution of capital in Section III.A.1. and Section III.B.1.c.

[91]This is stock that is not required to be purchased as a condition of obtaining a loan and that is not routinely retired.

[92]We also proposed a minimum NCR requirement (a type of leverage ratio) for System banks above the statutory minimum collateral requirement to protect investors and allow sufficient time for corrective action to be implemented prior to a funding crisis at an individual bank (see below). See 60 FR 38521 (July 27, 1995).

[93]The proposed definition of unallocated surplus included URE and common and noncumulative perpetual preferred stock held by non-borrowers but excluded allocated surplus, borrower stock and ALL. System associations also had to deduct their net investments in their affiliated bank before computing the unallocated surplus ratio. The proposed definition of total surplus included both unallocated and allocated surplus, including allotted surplus, as well as various types of common and preferred stock, but excluded borrower stock and ALL.

[94]In the final rule, adopted in 1997, the total surplus requirement remained mostly unchanged from what was originally proposed. See 62 FR 4429 (January 30, 1997).

[95]See 61 FR 42092 (August 13, 1996).

[96]NQNSR (nonqualified allocated equities not subject to revolvement) is equity retained by a cooperative institution from after-tax earnings. The System institution pays the tax on earnings and issues a notice of allocation to its members specifying the amount that has been earmarked for potential distribution. The "non-revolvement" feature indicates that no redemption is anticipated in the near future.

[97]See 62 FR 4429 (January 30, 1997). We determined at the time not to include System bank allocated equities in core surplus. This primarily affected CoBank, which operates a significant retail operation (the other System banks are primarily wholesale operations). However, since March 2008, we have temporarily permitted CoBank to include a portion of its allocated equities in core surplus consistent with our treatment of association allocated equities until this issue could be addressed through a rulemaking.

[98]See 62 FR 4429 (January 30, 1997).

[99]In 1998 we made minor wording changes to the total surplus and core surplus definitions to clarify certain terms and phrases. See 63 FR 39219 (July 22, 1998). In 2003, we changed the definition of permanent capital to reflect a 1992 statutory change to section 4.3A of the Act and added a restriction to the amount of term preferred stock includible in total surplus. See 68 FR 18532 (April 16, 2003).

[100]Core surplus is defined in § 615.5301(b).

[101]In the event that NQNSR are distributed, other than as required by section 4.14B of the Act (statutory restructuring of a loan), or in connection with a loan default or the death of an equityholder whose loan has been repaid (to the extent provided for in the institution's capital adequacy plan), any remaining NQNSR that were allocated in the same year will be excluded from core surplus.

[102]Certain classes of common stock issued by System institutions are typically never retired except in the event of liquidation or merger. However, there is only a small amount of these classes of stock currently outstanding. In the event that such stock is retired, other than as required by section 4.14B of the Act, or in connection with a loan default to the extent provided for in the institution's capital adequacy plan, any remaining common stock of the same class or series has to be excluded from core surplus.

[103]The FCA may permit an institution to include all or a portion of any instrument, entry, or account it deems to be the functional equivalent of core surplus, permanently or on a temporary basis.

[104]We explained in the 1997 final rule our belief that 3 years should be sufficient time for a System association experiencing adversity to adjust its allocation plans and take other protective measures while continuing to be able to make planned patronage distributions. The rule further provides that, in the event that such allocated equities included in core surplus are retired, other than in connection with a loan default or restructuring or the death of an equityholder whose loan has been repaid (to the extent provided for in the institution's capital adequacy plan), any remaining such allocated equities that were allocated in the same year must be excluded from core surplus.

[105]System banks cannot include their affiliated associations' investments in core surplus. The net investment is the total investment by an association in its affiliated bank, less reciprocal investments and investments resulting from a loan originating/service agency relationship, such as participation loans. See § 615.5301(e).

[106]Each System institution is also required to make certain other deductions and/or adjustments before computing its core surplus ratio. See 12 CFR 615.5301(e).

[107]Total surplus is defined in § 615.5301(i).

[108]Term preferred stock is limited to a maximum of 25 percent of the institution's permanent capital (as calculated after deductions required in the PCR computation). The amount of includible term stock must be reduced by 20 percent (net of redemptions) at the beginning of each of the last 5 years of the term of the instrument.

[109]The FCA may permit one or more institutions to include all or a portion of such instrument, entry, or account as total surplus, permanently or on a temporary basis.

[110]As with the other capital ratios, each System institution is also required to make certain other deductions and/or adjustments before computing its total surplus ratio.

[111]See § 615.5301(c) and (d) and § 615.5335.

[112]See § 615.5301(j).

[113]In 1996, the Basel Committee added a third capital tier to support market risk, commodities risk and foreign currency risk in relation to trading book activities. However, in the Basel Consultative Proposal, the Basel Committee has proposed to abolish Tier 3 to ensure that market risks are supported by the same quality of capital as credit and operational risk.

[114]Total capital is the sum of Tier 1 and Tier 2 capital. Currently, Tier 2 capital may not account for more than 50 percent of a commercial bank's total capital.

[115]See footnote 7 above.

[116]The Basel Committee has emphasized over the years that the predominant form of Tier 1 capital should be voting common stockholder's equity and disclosed reserves. Common shareholders' funds allow a bank to absorb losses on an ongoing basis and are permanently available for this purpose. It best allows banks to conserve resources when they are under stress because it provides a bank with full discretion as to the amount and timing of distributions. It is also the basis on which most market judgments of capital adequacy are made. The voting rights attached to common stock provide an important source of market discipline over a commercial bank's management.

[117]The Basel Committee determined that all Tier 1 capital elements, including these instruments, must have the following characteristics: 1) Issued and fully paid, 2) noncumulative, 3) able to absorb losses within a bank on a going-concern basis, 4) junior to depositors, general creditors, and subordinated debt of the bank, 5) permanent, 6) neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors and 7) callable at the initiative of the issuer only after a minimum of 5 years with supervisory approval and under the condition that it will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks. See "Instruments eligible for inclusion in Tier 1 capital" (October 27, 1998). This document is available at www.bis.org.

[118]Although Basel I includes them in Tier 2 capital, the FCA would likely not recognize undisclosed reserves as Tier 2 capital under a new regulatory capital framework.

[119]This is applicable to capital rules that are based on either Basel I or the Basel II standardized approach. The advanced approaches of Basel II have a different formula for determining the amount of general loan loss reserves in Tier 2 capital.

[120]Minority interests in equity accounts of subsidiaries represent stockholders' equity associated with common or noncumulative perpetual preferred equity instruments issued by an institution's consolidated subsidiary that are held by investors other than the institution. They typically are not available to absorb losses in the consolidated institution as a whole, but they are included in Tier 1 capital because they represent equity that is freely available to absorb losses in the issuing subsidiary. Some of the FFRAs restrict these minority interests to 25 percent of Tier 1 capital.

[121]The OTS and FRB have additional elements in Tier 1 capital. For example, the OTS permits some of its institutions to include nonwithdrawable accounts and pledged deposits in Tier 1 capital to the extent that such accounts have no fixed maturity date, cannot be withdrawn at the option of the accountholder and do not earn interest that carries over to subsequent periods. The FRB permits certain BHCs to treat certain "restricted core capital elements" (restricted elements) as Tier 1 capital. Restricted elements include qualifying cumulative perpetual preferred stock and cumulative trust preferred securities, which are limited to 25 percent of Tier 1 capital. The FRB has recently decreased this limit to 15 percent of Tier 1

capital for certain internationally active BHCs but has delayed the effective date to March 31, 2011. See 70 FR 11827 (March 10, 2005) and 74 FR 12076 (March 23, 2009).

[122] The FFRA's elements of Tier 2 capital are discussed in more detail below.

[123] The minimum leverage ratio requirement depends on the type of institution and a regulatory assessment of the strength of its management and controls. Banks holding the highest supervisory rating and not growing significantly have a minimum leverage ratio of 3 percent; all other banks must meet a leverage ratio of at least 4 percent.

[124] Common shares must meet a set of criteria to be included in Tier 1 capital. See paragraph 87 of the Basel Consultative Proposal.

[125] Additional going concern capital must meet a set of criteria to be included in Tier 1 capital. See paragraphs 88 and 89 of the Basel Consultative Proposal.

[126] Instruments must meet or exceed a set of criteria to be included in Tier 2 capital. See paragraph 90 of the Basel Consultative Proposal.

[127] A description of the regulatory adjustments can be found in paragraphs 93 through 108 of the Basel Consultative Proposal.

[128] See paragraphs 202 through 207 of the Basel Consultative Proposal.

[129] See paragraphs 247 through 259 of the Basel Consultative Proposal.

[130] See paragraphs 80 and 81 of the Basel Consultative Proposal.

[131] A detailed white paper on the SCAP data and methodology was published in April 2009, and the results were published in May 2009. See "The Supervisory Capital Assessment Program: Design and Implementation" (April 24, 2009) and "The Supervisory Capital Assessment Program: Overview of Results" (May 7, 2009). These documents are available at www.federalreserve.gov.

[132] See "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," (September 3, 2009). This document is available at http://www.ustreas.gov.

[133] See 74 FR 65209 (December 9, 2009).

[134] See also Statement of Michael E. Fryzel, Chairman of NCUA, on "H.R. 2351: The Credit Union Share Insurance Stabilization Act" before the U.S. House of Representatives, Basel Committee on Financial Services, SubBasel Committee on Financial Institutions and Consumer Credit (May 20, 2009). This document is available at: www.ncua.gov.