AgCountry® Farm Credit Services®

1900 44th St. S. • P.O. Box 6020 • Fargo, ND 58108-6020
(701) 282-9494 • Fax: (701) 282-9618 • www.agcountry.com

February 12, 2014

Mr. Barry F. Mardock
Deputy Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Proposed Rule – RIN 3052-AC81
Regulatory Capital Rules: Regulatory Capital, Implementation of Tier 1 / Tier 2 Framework

Dear Mr. Mardock:

On behalf of AgCountry Farm Credit Services (AgCountry), thank you for the opportunity to respond to the Farm Credit Administration's proposed rule on Regulatory Capital, 74 FR 52814, published in the *Federal Register* on September 4, 2014. AgCountry supports the Farm Credit Administration's (FCA or Agency) modernization of the FCS's regulatory capital framework to be more consistent with other regulated financial institutions and appreciates the opportunity to comment on the proposed rule on regulatory capital and the implementation of a tiered approach that is comparable to the Basel III. This modernization will help external investors and others in understanding the financial and capital capacity of the cooperative Farm Credit System (FCS or System) institutions.

We do, however, share the same concerns raised by the Farm Credit Council (FCC) and AgriBank, FCB in their comment letters regarding the proposed capital regulations. We believe FCA's proposed approach is harsher than those of other U.S. bank regulators (OCC, FRB, FDIC) in implementing the Basel III framework, placing the FCS at a competitive disadvantage. The treatment of FCS retained earnings and imposing a significantly higher Tier 1 leverage requirement are two such examples. For the reasons presented in this letter, FCA should recognize cooperative equity as CET1.

FCA should utilize the discretion provided within the Basel III framework to recognize the FCS cooperative constitution and legal structure and not place the FCS at a competitive disadvantage to banks. We ask that FCA use its discretion and authority to modify the proposed regulatory text to address our comments, as well as the comments of AgriBank and FCC, prior to issuing a final rule.

The FCC comment letter addresses nine threshold issues with the proposed regulatory capital rule that undermine cooperative principles and member participation in the management, ownership and control of FCS institutions as required by the Farm Credit Act (Act). The threshold issues demonstrate FCA has proposed capital requirements that effectively position FCS bank and association cooperative retained earnings and equities as inferior to equities of joint stock companies. FCA has provided no data or other evidence to support this inferior treatment.

The proposed regulatory capital rule disfavors the cooperative business model, penalizing institutions when they follow the distinctive cooperative principles of "user benefit", "user ownership" and "user control." We submit the following comments that, if implemented by FCA, would bring balance to the final rule and result in regulatory capital requirements that are consistent with Basel III, yet sensitive to the FCS's cooperative structure.

Threshold Issue Number 1- Treatment of System Allocated Retained Earnings

As implemented by bank regulators, Basel III includes all retained earnings in Common Equity Tier 1 (CET1) for all banking organizations, including mutual banks. We believe FCA should stay consistent with this direction and include all FCS retained earnings in CET1.

Basel III recognizes two broad categories of CET1: (1) retained earnings and (2) paid-in capital instruments that meet a 13-factor test.

As to retained earnings, Basel III CET1 includes all retained earnings. Basel III does not establish tiers of retained earnings, discount these earnings for pressure to distribute dividends or subtract from retained earnings the amount that a bank has announced that it plans to distribute to shareholders in the normal course of business. Retained earnings are specifically included in a commercial bank's CET1 although, the bank is generally free to distribute in a given year the sum of its total net income for that year plus its retained net income for the preceding two years.

FCA has proposed that allocated retained earnings must have a 10-year minimum term in order to be treated as CET1. While we understand the importance of long-term reliance on CET1, there is no basis in Basel III for a 10-year holding period. Moreover, an allocated equity with an express minimum term of 10 years is no more permanent than an allocated equity that is perpetual on its face, particularly when a separate rule requires FCA consent for distributions that exceed 12-month trailing earnings. The proposed minimum term for revolving allocated equity should be eliminated. Allocated equities are simply retained earnings and should be included in CET1 without qualification.

The proposed rule treats an institution's "allocation" of retained earnings as a capital distribution by the institution instead of retention of earnings. As a result, under most System institution bylaws, each dollar of retained earnings with a patron's name on it is automatically excluded from regulatory capital. This default exclusion applies to all forms of allocations, including Farm Credit Bank (FCB) attributed surplus, ACB patronage surplus and association written notices of allocation dating from the System's inception, in each case irrespective of retirement practices. As a result, using June 30, 2014 information, approximately $11.2 billion of these forms of capital (12% of the System's aggregate capital before eliminations for combined financial reporting) will be eliminated from regulatory capital unless effectively reissued under new bylaw amendments. This treatment is inconsistent with Basel III.

The FCS allocated retained earnings should have capital treatment consistent with the retained earnings of commercial banks. Allocated retained earnings do not have the features identified in

Basel III as reducing the ability to absorb loss (e.g., cumulative features). Allocated retained earnings do not possess any features that would reduce the ability to absorb loss, or otherwise cause financial conditions to weaken, during periods of economic or market stress. There are several examples throughout the FCS where institutions experiencing financial challenges suspended patronage distributions or significantly reduced allocated surplus redemptions with no material adverse effects to capital, liquidity or mission fulfillment further supporting allocated capital as CET1.

The pressure on FCS institutions to distribute retained earnings is not greater than the pressure on a commercial bank to make dividend payments from retained earnings. The banking regulators have addressed concerns about pressure to make distributions from retained earnings during periods of market or financial stress through specific regulatory approval requirements. FCA should accept a similar approach.

Threshold Issue Number 2 – Association Investment in its Funding Bank

FCA's proposed minimum revolvement cycle for association investment in their funding bank is unworkable, anti-cooperative and inconsistent with statutory re-affiliation provisions. The proposed CET1 requirement for a 10-year revolvement cycle for association investment in their funding bank creates challenging, bureaucratic, costly and burdensome restrictions on the capitalization of the bank with no discernable benefit in capital quality or quantity. This approach effectively requires a "first in first out" redemption approach for an association investment in the bank. If a bank wants to retire capital either to equalize investments among its associations or to provide financial support to a struggling association, it must select stock that has been outstanding for more than 10 years. This would result in costly tax consequence if the oldest stock has a zero tax basis while more recently purchased stock has a full tax basis. Contrary to the intent of capital regulations, such retirements would reduce combined bank-association capital. FCA's proposed approach is inconsistent with Congressional intent and is not needed for capital regulations to align with Basel III. In addition, it makes it functionally impossible for associations to re-affiliate as provided for in the Act.

In the cooperative structure of the FCS, an association's capital investment in its bank is legally and functionally a permanent capital contribution to the bank and is recognized as such by associations. This structure results in a permanent relationship that continues until liquidation, re-affiliation or termination of System status, all of which require FCA prior approval. The level of capital an association is obligated to contribute to its funding bank is a percentage of its outstanding direct loan balance and is perpetual in nature as long as the association has a direct loan outstanding. The ability to adjust an association's capital investment in its funding bank assures that associations proportionately share in the capitalization and risk of loss of the bank.

The proposed 10-year revolvement of allocated equities positions the bank to not be able to equalize capital contributions among affiliated associations or allow for re-affiliation in an appropriate way. It is unworkable to require an association's allocated equities that make up capital investments in their funding bank be outstanding for 10 years in order to be counted as CET1. These allocated equities are retained earnings of the bank that FCA should recognize. Furthermore, the proposed capital rule would not allow a reduction in the bank's CET1 without FCA approval. Therefore, FCA should treat the associations' stock investment in their funding bank as CET1 and exclude that capital from any minimum revolvement requirements.

The definition of capital an association invests in a FCB should differ from that of a member's investment in their association. An association's investment in a FCB results from the statutorily directed financial relationship, which is quite different from the financial relationship between an association and its members. While a member is required to capitalize an association, the member is also free to borrow from a financial institution other than the FCS. An association does not have this same flexibility and, as a result, its investment in a FCB is by statute and operation of law a permanent aspect of its capitalization regardless if a FCB periodically equalizes such investment. It is not logical or desirable to treat association member investments consistent with FCB cooperative shares from affiliated associations' investments, which are effectively eliminated when the FCS is evaluated on a combined district or System basis.

Threshold Issue Number 3 - Required Capitalization Bylaws Amendments

The proposed capitalization bylaws provisions should be eliminated. The proposal is fundamentally unsound, unnecessary, costly and legally problematic. If the members do not approve the required bylaws changes, the institution would have to exclude shareholder equities from regulatory capital, resulting in capitalization challenges. Approving the required changes to bylaws would undermine the institution's ability to function consistent with cooperative principles as expected by the Act. It is possible that institutions with modest amounts of cooperative equities may prefer to exclude their cooperative equities from regulatory capital rather than endure the cost, hassles, member confusion and uncertainty of a stockholder vote. This could lead to redemption of excluded cooperative equities, harming the overall regulatory capital position of the System.

Although we do not currently have notices of allocation, we are concerned that the proposed bylaws amendment requirement may expose FCS institutions to legal challenges under corporate law from holders of allocation notices (i.e., qualified and non-qualified) who are not voting stockholders. Not all such holders will have a right under the existing FCA regulations to vote on changes to bylaws that they may see as affecting their holder rights (e.g., retirement at the sole discretion of the board of directors). We fail to see any reason for this bylaws amendment provision. There is no basis for it in Basel III and it creates unnecessary complications, potentially for both the association and FCA. The permanence of allocated equity has already been addressed in the Act with respect to controls on capital retirements and other distributions retained by each institution's board of directors and the FCA.

We recognize the need to have clear distinctions between different holders of allocated equities to ensure they can satisfy the criteria associated with CET1, AT1 and T2. We do not agree that a bylaws change is the best or even appropriate way to accomplish this distinction. There are better means for creating a clear distinction among allocated equities than requiring a capitalization bylaws change.

Section 4.3A of the Farm Credit Act requires that the bylaws adopted by shareholder vote shall enable System institutions to meet capital adequacy standards established under regulations issued by FCA. On this basis, FCS institution bylaws provide the board of directors' discretion for the management of capital resources to achieve ongoing compliance with regulatory capital requirements. Boards manage capital adequacy compliance through the capital plan as required by §615.5200.

The FCC proposed that FCA can more appropriately and cost effectively address the expectation for a "legal distinction" within allocated retained earnings by modifying the proposed regulatory capital-planning requirement. We strongly support the FCC proposal. The modification would require the board to adopt a binding resolution on the treatment of retained and allocated equities to achieve ongoing compliance with the new capital requirements within the capital-planning requirement. The board resolution would be binding unless and only if modified by a change in the capitalization bylaws approved by all shareholders pursuant to §615.5220. FCA could require the resolution by regulation to implement the proposed regulatory capital requirements, effectively allowing all FCS institutions to comply with these requirements without having to endure the uncertainty and risk of a shareholder vote, particularly if the vote may result in technical non-compliance with minimum capital standards.

Threshold Issue Number 4 - Higher Minimum Tier 1 Leverage Ratio

The 5% Tier 1 leverage ratio requirement is excessive and unsupported, creating cost and functional limitations for our funding bank, which then transfer to associations and their members. Under Basel III, the Tier 1 leverage ratio requirement is 4%. Requiring a 5% minimum for the FCS deviates from Basel III and the requirements applicable to commercial banks and creates disadvantage to farmers and other eligible borrowers of the System. We are also concerned that this difference in minimum standards will raise questions and suspicion among members, investors and other stakeholders that the FCS is fundamentally riskier compared to other lending institutions on the basis of a higher standard.

FCA states that this standard "takes into consideration the fact that System institutions are financially and operationally interconnected, member-owned cooperatives and monoline lenders that currently provide credit to approximately 41 percent of the U.S. agricultural sector. They have a business model and risk profile that is substantially different from traditional banking organizations. The higher 5.0 percent leverage ratio also helps to ensure that System institutions continue to have sufficient systemic loss-absorbing capital to withstand a severely adverse economic event while continuing to provide a steady flow of credit to U.S. agriculture in view of the System's unique GSE mission. While System banks do have off-balance sheet items that would have to be risk weighted, especially unfunded commitments in this proposal, the banks also have a large portion of instruments in the 20 percent risk weighting category, primarily the direct loans to their affiliated associations, and the 0 percent risk weighting category. We believe it is important for System banks to hold enough capital to protect against risks other than credit risk (e.g. interest rate risk, liquidity risk, premium risk, operational risk, etc.)."

We respectfully disagree that a higher 5% minimum leverage ratio is justifiable based on this reasoning. Such documented opinions and inferences do harm to the FCS and its mission, particularly given the lack of any quantitative support for the difference. FCA's position is unsupported by recent performance during the economic downturn or recent loss experience, making both the statement in the Federal Register and this proposed requirement both arbitrary and capricious.

Basel III was a response to systemic risks that surfaced in the financial crisis, largely originating from funding practices (e.g., reliance on short-term deposits, wholesale funding, overnight re-purchase agreement and other forms of inter-bank transactions), poorly regulated subprime residential lending and rating agency practices that had the effect of correlating risk sensitivities. The inter-connections between financial institutions were revealed when losses at one institution drained capital and liquidity available to other institutions – even those with relatively high tier capital ratios. As liquidity dried up and mortgage-related losses further depleted capital, banks came under pressure to retire lower quality Tier 1 capital instruments (hybrid instruments) when they were most needed to absorb losses. To address this phenomenon, Basel III prescribed a reduction in overall leverage, as well as an increase in both the quantity of capital (higher minimums) and the quality of capital (retained earnings rather than hybrid instruments) as essential to protect the banking system and its depositor base from systemic risks and the liquidity crises they engender.

The proposed rule says nothing about how the systemic risks that led to Basel III affected System banks and associations. No association that experienced financial distress over the past 6 years had liquidity threatened, in contrast to the liquidity issues of many non-System financial institutions.

The Basel III minimum leverage requirement for banking institutions applies to specific liquidity and credit risks unique to banking and residential lending practices. The System has its own unique risks, primarily a concentration in agriculture. However, stress testing and economic capital modeling by System institutions provide evidence that System institutions "have sufficient systemic loss-absorbing capital to withstand a severely adverse economic event while continuing to provide a steady flow of credit to U.S. agriculture in view of the System's unique GSE mission." There are no facts or analysis supporting the statement that System's risks are more significant than the systemic risks that gave rise to the financial crisis and that were cited in Basel III as a justification for an increased leverage ratio. Clearly, there is no basis for a 25% higher leverage standard for the FCS.

The statement that "System institutions are financially and operationally interconnected, member-owned cooperatives, and monoline lenders that currently provide credit to approximately 41% of the U.S. agricultural sector" does not support a higher leverage ratio than for commercial banks. Interconnectedness of FCS banks and associations is in essence a strength as each tier of the two-tiered structure of the System must be capitalized independently. In addition, System Banks are interconnected by virtue of joint and several liability for System-wide debt obligations, and have implemented mechanisms (including CIPA and MAA) to ensure each bank and district remains financially healthy.

The theoretically more diverse portfolios of commercial banks did not prevent them from experiencing severe stress during the 2008-09 financial crisis, while the System remained sound. The financial crisis clearly demonstrated Basel III was needed to achieve adequate capitalization of the commercial banks. System institutions were adequately capitalized before and during the financial crisis and functioned effectively. FCA's proposed requirement for FCS institutions to hold more capital than Basel III requires of commercial banks is not supported by the facts, loss data or any reasonable analysis of risk.

The proposed 5 percent minimum leverage ratio is inappropriate for wholesale FCS banks. Although System banks have a large portion of instruments in the 20% risk weight category – primarily the direct loans to their affiliated associations – it appears FCA gives no consideration to the two-tiered System capitalization. System associations and banks must capitalize retail loans at the same risk-based minimum levels as commercial banks. In addition, System banks must capitalize wholesale loans to associations at a 20% risk weight. Due to this two-tiered capitalization of association loans, the System must effectively hold minimum capital for association loans totaling 120% of the amount required for commercial bank retail loans. Under the proposal, both associations and banks will also be subject to the capital conservation buffer, making total capital levels at both banks and associations significantly higher than regulatory minimums.

This capitalization level is more than adequate to protect not only against credit risk, but against interest rate risk, liquidity risk, operational risk and other risks as well. FCA's proposed 5% minimum Tier 1 leverage ratio requirement compared to a 4% requirement for commercial banks is inconsistent application of Basel III and provides commercial banks an advantage compared to FCS associations. FCA should not create this inequitable capital treatment, as there is no difference in risk at the loan level between a commercial bank and a FCS institution to a specific agricultural borrower, and this action fundamentally undermines the FCS's mission. We request that FCA remain consistent with Basel III and the U.S. banking regulators by imposing a 4% Tier 1 leverage ratio requirement rather than the proposed 5% minimum.

Threshold Issue Number 5 – Minimum Unallocated Retained Earnings (URE) Requirement

The 1.5 percent URE requirement in existing FCS capital regulations should not be included in the capital framework for the FCS. This requirement challenges the cooperative structure of the FCS. Implementation of the 1.5 percent URE standard within the Tier 1 leverage requirement results in a minimum 3 percent URE held against each dollar of loans made by associations to member-owners given the dual capitalization resulting from the System's cooperative structure.

The proposed rule is not necessary and infringes on a System institution's flexibility to implement governance processes that best support member-owners' ownership and control in their entities. Basel III did not establish URE as a "superior" class of CET1, and FCA has little basis to establish a minimum requirement for URE given the at-risk and permanent nature of cooperative equities included in CET1. If FCA wishes to address URE it should modify the proposal to require FCS institutions to manage the components of CET1, including retaining a sufficient amount of URE appropriate for the effective business operations through economic/business cycles.

Threshold Issue Number 6 – Safe Harbor Requirement

With cooperative equities in CET1, we recognize there must be restrictions on capital distributions; however, the proposed capital distribution "safe harbor" is overly strict. Limiting capital distributions to the past year's net retained income and not allowing for any reductions in CET1 from the prior year-end provides no reasonable room to manage capital without seeking FCA prior approval. This requirement is much more restrictive than established by foreign cooperative bank regulators and U.S. banking regulators for commercial banks. Foreign bank regulators allowed up to at least a 2 percent reduction in CET1 as long as regulatory capital ratios remain compliant with the conservation buffer and all other requirements were met. U.S. banking regulators also provide more flexibility in capital distribution restrictions for commercial banks. Under 12 CFR 208.5(c), commercial banks are permitted to distribute up to the sum of their current year net income plus retained net income for the prior two years if their capital ratios are above the capital conservation buffer requirement and they are not under supervisory remedy by a U.S. banking regulator. FCA should be consistent with foreign and U.S. banking regulators and provide FCS greater flexibility to distribute capital.

Threshold Issue Number 7 – Higher Risk Weighting for Rural Electric Cooperative Assets

FCA should maintain the 50 percent and 20 percent risk-weight treatments of exposures to electric cooperative assets consistent with the treatment under the current regulations. We support the comments made in the FCC and AgriBank letters on this issue.

Threshold Issue Number 8 – Treatment of High Volatility Commercial Real Estate

Clarification is needed on how High Volatility Commercial Real Estate (HVCRE) pertains to traditional agricultural mortgages and eligible project finance transactions. The proposed definition of HVCRE and the associated 150% risk weight is unclear with respect to agricultural mortgages where the value of the land exceeds production value. We are concerned that examiners will determine any financing that exceeds the agricultural production value needs to be risk weighted at 150%. Such a determination would essentially compromise the ability for the FCS to meets its statutory mission and would be inconsistent with the realities of today's agricultural mortgage marketplace. We are also concerned that FCA examiners will include agri-business or project finance transactions to build processing and marketing facilities or rural infrastructure as being HVCRE. This does not appears to be the intent of the provision, but we are concerned that any such determination would undermine our lending mission going forward. We are asking FCA to provide clarity in its final rule.

Threshold Issue Number 9 – Direct Loan "Unfunded Commitments"

The proposed requirement to treat FCS bank direct loans to affiliated associations as having an "unfunded commitment" amount that requires capitalization is inappropriate and not supported by the facts. We fully support the detailed response to FCA's question on this matter as documented in the FCC comment letter (see the response to question 7 in Appendix A).

CONCLUSION

We appreciate the opportunity to comment on FCA's proposed capital regulation for the FCS, and FCA's efforts in developing the proposed rule. Changes are needed to modernize the System's regulatory capital framework to be comparable to the standards applied to other regulated financial institutions. While FCA has done an admirable job of adopting a Basel III framework for the FCS, refinement is needed to meet the objective of being comparable with the standards for other regulated financial institutions and to make it workable for the cooperative structure and mission mandate of the FCS.

We ask FCA to fully consider and adopt all of our, AgriBank's and FCC's comments and suggested changes. If FCA makes these suggested changes, it will: (1) position the final rule consistent with Basel III; (2) provide for FCS capital adequacy for the future; (3) position FCS on a more level playing field with other federally regulated banks; and (4) ensure the FCS can be true to its cooperative structure in meeting its public policy mission as a GSE.

We appreciate the opportunity to comment and FCA's consideration of our comment letter. We would be happy to discuss our comments or provide any additional information that FCA may deem helpful. If you have questions or require additional information, please contact me.

Sincerely,

Robert C. Bahl, CEO