AgStar
Financial Services, ACA

February 13, 2015

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

Re: Regulatory Capital Rules

Dear Deputy Director Mardock,

AgStar Financial Services, ACA ("AgStar") appreciates the opportunity to comment on the proposed changes to the Farm Credit Administration's ("FCA") regulatory capital rules, the implementation of a Tier 1/Tier 2 framework, and subsequent change to Part 628 – Capital Adequacy of System Institutions. Although we have some significant concerns related to several provisions of the proposed regulation, we do appreciate FCA's attempt to strike a balance between modernizing capital requirements comparable to that of a more transparent BASEL III framework and ensuring institutions continue to hold enough regulatory capital to fulfill their obligations as a cooperative and mission as a Government-sponsored enterprise (GSE). We appreciate the effort to make the Farm Credit System's regulatory structure more transparent and more easily understandable by those outside the system.

AgStar's comments below seek to highlight those provisions of the proposal that are either inconsistent with the System's cooperative structure, are materially different to the implemented rules utilizing the BASEL III framework, or both.

(1) The 10 year revolvement period criteria for including cooperative surplus in Common Equity Tier I (CETI) is unnecessarily long, inconsistent with the conservative practices FCA should encourage, inconsistent with cooperative structure, and unnecessary to eliminate retirement expectations.

A System institution's cooperative capital consists of member borrower stock, allocated equities and unallocated retained earnings. Member stock and allocated and unallocated surplus are the common equity class, carry the rights of ownership, act as the subordinated class to absorb loss in times of financial adversity, and are a cooperative's functional equivalent to common equity for commercial banks. The bulk of AgStar's cooperative equity is in the form of surplus – both allocated and unallocated. Each has no maturity and can be redeemed only at the discretion of the institution's board of directors.

In the detailed list of criteria for classification of common shares as highest quality capital for regulatory purposes, the Basel Committee was sensitive to the unique organization structure of non-joint stock companies such as a cooperative or mutual company.

"The criteria also apply to non-joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the

criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non-joint stock companies in order to ensure consistent implementation."

- Page 14; Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems

While Associations' equity balances act as a single class in loss absorption and do not possess features that cause bank weakening as described by BASEL above, FCA makes a distinction within the class regarding implementation of this principle due to the perceived waterfall of loss allocation. FCA has attempted to conform to this standard by replacing the criteria, not by categorizing all Association equity as CET1, but rather by subjugating equity classes based on the criteria that one class of equity has a claim over another class. While from an accounting perspective, losses count against unallocated retained earnings (URE) first, allocated equity second, and common stock third, if the principles of the cooperative structure are held to form, the division of losses are the equivalent of robbing Peter to pay Paul.

Despite the explicit discretionary nature of revolving allocated surplus, FCA has deemed the entire balance held by the institution to break an "expectation" criteria set by BASEL III based on the fact that the System has routinely redeemed allocated equities. FCA believes that such expectations, if not addressed, should cause allocated equities to be disallowed as CET1. As such, FCA has proposed that a revolvement period for allocated equities of no less than 10 years is necessary to be consistent with Basel III's concept of permanence. The selection of 10 years is arbitrary as it has no basis in BASEL III, is at odds with the notion of conservative capital management, and inconsistent with our experience as a cooperative. Additionally, the discretionary nature of redeeming allocated equities eliminates the expectation classification both in theory and has been proven in practice.

Incongruous with BASEL III

Commercial banks do not have allocated equities, but rather institute dividend and stock buyback programs. However, in practice, the programs are quite similar. FCA suggests there is a dilemma Associations face regarding patronage programs in times of stress,

"Such expectations may put stress on system institutions to continue to redeem equities even when the institution's financial health is deteriorating. Institutions' boards of directors generally prefer to revolve allocated equities on a regular basis. This aids in the capital planning process and can help manage the revolvement expectations of the members."

While it constitutes a true reflection of human nature, it is not a challenge solely faced by the Farm Credit System. It remains a fact of life for federally chartered banks and their own respective capital distribution plans. This exact problem was a major source of frustration for banks and their regulators in 2007 and played a key role in the establishment of the BASEL Capital Conservation Buffer. At the time, many banking institutions were too weak to pay a dividend, but such non-payment would be considered too much of a sign of weakness during the troubled times to not consider paying it. The BCBS, the body that created BASEL III, acknowledges the Catch-22 dilemma facing bank management, and admonishes against the practice of paying an expected dividend to portray financial strength. For that exact reason, they created the Capital Conservation Buffer to limit a bank's ability to pay a dividend if the underlying capital situation did not warrant it. That buffer remains the extent of the banking industry's restrictions.

Nevertheless, public investors continue to expect dividends from their banking investments. A simple search on Google will yield multiple years worth of consensus expectations for dividends for each of the major banking institutions. A few keystrokes on an investor's Bloomberg terminal will yield estimated payment dates and consensus expectations on distributions for years into the future. Yet, none of these institutions are required to deduct those future dividend payments from their capital calculations even though dividends are paid out of retained equity in the same manner as we revolve allocated equities from our surplus. In fact, dividends are only removed from the capital base when paid, "in accordance with accounting standards." Additionally, the same procedure is applied to public announced stock repurchase programs.

On March 24, 2014, JPMorgan Chase publicly announced to the market that its Board of Directors intended to increase its ongoing quarterly common stock dividend from $0.38 per quarter to $0.40, and authorized a program to repurchase $6.5 billion of common equity between April 1, 2014, and March 31, 2015. The equity repurchases are pursuant to the common equity repurchase program of $15.0 billion previously authorized by the firm's board of directors on March 13, 2012, which, at the time represented 8.5% of the firm's market capitalization. Jamie Dimon, then Chairman and CEO of JPMorgan Chase said of the announcement, "We are pleased that our Board intends to raise the dividend and has authorized us to continue our equity buyback program. We anticipate reaching a Basel III Tier I common ratio of 10% by the end of this year, taking into account these capital actions and our ongoing investments in our growing businesses." Despite setting an obvious market expectation of an on-going $0.40 per quarter dividend, as well as an equity redemption equal to 3% of the bank holding company's market cap, none of those expected distributions have been deducted from JPMorgan's CET1 capital balances until actually declared and paid.

Basel III does not establish tiers of retained earnings; it does not subtract from retained earnings the amount that a bank has announced that it plans to distribute to shareholders in the normal course of business; it does not apply a discount factor to retained earnings to reflect public market pressures to make quarterly dividend distributions (even when a bank's failure to make a dividend could ultimately increase its cost of funds or threaten its liquidity). Indeed, retained earnings are categorically included in a commercial bank's CET1 notwithstanding that 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. We acknowledge that the Farm Credit ownership structure is different, but the concepts presented here are the same, and should be treated equivalently. While we understand the importance of "permanence" with respect to CET1, there is no basis in Basel III for a 10-year holding period.

At Odds with Conservative Capital Management Practices

The concept of paying patronage allows our cooperative owners the opportunity to share in the success of their company. We allocate patronage to our stockholders based on company earnings and the amount of eligible agriculture products and services purchased during the year. AgStar's Board of Directors determines the share of earnings for distribution based on our capital and credit position, and allocated equities are only retired at the sole discretion of the Board.

Our capital structure relies greatly on equity accumulated through earnings, in addition to client purchased stock. As FCA states, such capital is a critical buffer given the economic cycles within agriculture. Given the cyclical nature of agriculture, a program utilizing a longer revolvement period for distributing patronage dividends is more conservative than a shorter one – especially when one considers the absolute discretionary nature of such payments. Although patronage may be allocated in any particular year, its payment is entirely subject to the institution's willingness to distribute it given the economic and capital circumstances at a point in time in the future. Consequently, a one year revolvement is more conservative from a capital perspective than an immediate payment. A two year revolvement is more conservative than a one-year, and each subsequent addition of time is incrementally more conservative than the one before it.

The current proposal fails to consider the benefits of holding capital over incrementally longer time periods. As currently proposed, FCA's recognition of allocated equities as CET1 capital has three categories – payment in less than five years, payment between five to ten years, and payment ten years or longer. Within each category, capital is treated equally. For example, allocated equity covered under a 9-year revolvement period is treated for capital purposes the same as allocated equity under a 6-year revolvement period – even though the 9-year program is inherently more conservative.

In stark terms, the proposed rule treats an "allocation" of retained earnings as a capital **distribution** by the institution rather than a **retention** of earnings by that institution. If anything, the proposed changes could encourage institutions to distribute capital sooner than they may have done otherwise. Institutions will be incented to move their revolvement period to the lowest level break point. For instance, an institution that may have otherwise had a four year revolvement period would receive no capital treatment for the allocated equities it held, and would therefore be incented to pay patronage dividends out immediately following their allocation. Similarly, an institution that pays on a 7-year revolvement period and thus Tier 2 capital treatment would be better served paying on a 5-year revolvement period and receiving the same Tier 2 treatment.

FCA recognizes the importance of conservative capital management as it states in the preamble to the proposed rules, "a shorter revolvement or redemption cycle places more strain than a longer revolvement or redemption cycle on an institution's ability to generate a return to stockholders and capitalize growth." However, rather than rewarding incremental holding of capital, the proposed rules will drive institutions toward one of three revolvement plans – immediate payment with no capital treatment, five year payment for Tier 2 treatment, or 10-years for CET1 treatment. Approximately $11.2 billion of these forms of capital (12% of the System's aggregate capital before eliminations for combined financial reporting) are affected, and would no-longer count as regulatory capital unless effectively reissued under new bylaw amendments.

Ten Years is Inconsistent with Cooperative Structure

Although it is unclear to us the original basis for choosing 10-years as the standard for supposedly eliminating owners expectations, holding allocated equity for such a period would be inconsistent with our cooperative structure. The patronage revolvement program provides discipline for the organization to effectively utilize stockholders' capital as well as creates a heightened sense of ownership and value for the stockholders themselves. The cognizance of ownership builds both continued loyalty and focus among existing clients that prudence is a priority within AgStar. Nevertheless, the nature of the lending business inevitably leads to client turnover and thus shareholder transition (either through uniquely new customers or, in many cases, generational or ownership change at existing customers). As such, our clients of today, and our clients of ten years ago are not mutually inclusive.

Movement towards a 10-year revolvement period on patronage would sway the equity ownership of associations away from its current client base towards owners that are no longer part of the cooperative. Our average current core business loan portfolio has an original maturity of less than nine years. Amortization, prepayments and other redemptions reduce the actual life of those loans over time. As it relates to capital distributions, in 2004 AgStar allocated patronage to approximately 10,300 clients. Of these clients, only 52% also received a patronage allocation ten years later. Similarly, in 2013, AgStar allocated patronage to approximately 16,000 clients, and only one third of them also received a patronage allocation in 2004. Allocated equity can represent a large portion of an association's equity, especially if operated under a 10-year revolvement, and therefore, could be in conflict with the cooperative structure. The longer the required equity retention, the less likely an association's stakeholders will match their customer base.

AgStar's Historical Practice

While paying patronage is relatively new to many associations, AgStar has allocated $453 million in patronage dividends since 1998 and retired over $134 million in patronage dividends to eligible stockholders. FCA notes that System institutions typically have allocated equity revolvement periods ranging from 4 to 10 years, "and perhaps longer." While we are unaware of any association with a revolvement period of 10 years or more, AgStar has targeted a 7-8 years revolvement period for its own patronage program. The program has inherently allowed AgStar to retain more capital than if it were paid within the first year, and it also has established a true sense of ownership by our cooperative client base.

Patronage allocation and distributions are made at the discretion of the Board of Directors, and evaluated at each point. AgStar's Board determines the amount of earnings to allocate at the end of each fiscal year, and again is required to approve patronage retirements at the time of distribution. Clients are informed that the exact timing of a patronage dividend retirements depend on a combination of growth, future earnings, risk in the portfolio, regulatory requirements, and the level of capital needed in the organization. Each year, the Board determines if the organization is in the position to retire any outstanding patronage dividend allocations given the economic cycles within agriculture, minimum capital standards set by the board, and regulatory minimums (and if enacted, the capital buffer) set by FCA.

Much like our banking peers, AgStar has experienced the pressure to redeem equities even when the institution's financial health was deteriorating. Indeed, AgStar has demonstrated the discretionary nature of distributions in challenging times.

Given the volatile financial and commodity markets, our capital position and risk in the portfolio, our Board of Directors delayed redeeming nonqualified patronage distributions during both fiscal 2009 and 2010, except for *de minimis* and immaterial estate retirements and distributions applied against charge-offs. While never an easy decision, the best interests of the institution drove the conclusion. These decisions were obviously made prior to any capital conservation buffer, which would only further the conservative approach taken in difficult times.

In all, we recommend FCA revisit its thought process on how allocated equities might be included as CET1, and contemplate a method that aligns more closely to BASEL III, is consistent with our cooperative structure and considers the incremental benefits of holding allocated capital each additional year.

(2) A strictly applied revolvement period does not accommodate the retirement of allocated equity to estates.

AgStar has a policy to retire patronage allocations to the estates of clients who have died. This policy is economically immaterial from a capital perspective, but we believe this is essential to allow estates to be settled in a timely manner. The current board policy is to retire estates at their "present value". This means each year's allocation is discounted to its value of paying out cash today rather than estate waiting several years to receive the dividend. The board believes this is the most equitable way of dealing with dividends for all clients and avoids any potential legal challenges by an estate and/or the court system. We currently assume an 8-year retirement cycle and use Prime as the interest rate in the present value calculation.

The proposed changes to 628.20(b)(1)(iv) and 628.20(b)(1)(xiv) require all allocated equities adhere to the proposed revolvement period to be treated as CET1 Capital without exception. Further, 628.22(a)(8) would put into jeopardy all otherwise allocated equity capital if an exception were made to any individual patronage payments.

We recommend FCA allow associations the flexibility to retire allocated equities to estates without any negative impact on the classification of other similar equities. This could be done by carving out a reasonable exception in the language of the definition of CET 1, or in the Safe Harbor provisions.

(3) Offset against Default

According to proposed § 628.20(b)(xiv), an instrument may not be considered CET1 Capital unless the institution's bylaws provide that it will not offset the instrument against a member's loan in default. Regardless of the bylaw requirement, which is addressed below, FCA should eliminate such requirement as it is both immaterial to the capital condition, yet essential for credit administration of charged-off loans. Otherwise, FCA is essentially requiring associations to charge a default against unallocated equity, while simultaneously forcing an association to repatriate capital over time to a client from which it lost money.

Note that our suggestion and current practice does not include offsetting allocated equities against delinquencies or to cure a default. We maintain that there is no right of offset by the client, and therefore allocated equities may not be considered in the negotiation for settlement. Rather, we solely seek the ability offset a charge-off after all collection efforts have been exhausted.

We support deletion of this restriction given it appears to place additional requirements on the absolute statutory right of FCS institutions to retire cooperative shares in the event of loan default and restructuring. While we understand that FCA has proposed significant restrictions on the retirement of cooperative shares, FCA still recognizes in § 615.5270 a FCS institution's right to retire cooperative equities without regard to restriction proposed in Part 628. The Act clearly intended FCS institutions to have the option of offsetting such purchased stock in the event of default or restructuring. Since our bylaws provide AgStar with a first lien on allocated equities we do have the right to apply them to charge-offs. However, as proposed we would have to track these over time and apply each retirement in succession to the charge off when paid out to other stockholders. The net effect is the same but the tracking and accounting is burdensome. We would note that under the proposed CET1, AT1 and T2 framework that respecting this statutory right of offset does not weaken in any manner the quality of capital or safety and soundness of FCS institutions.

(4) FCA's proposed treatment of revolvement of associations' stock investment in their funding bank is problematic.

FCA's application of a proposed minimum revolvement cycle to associations' 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 associations' investments in their funding bank creates challenging, bureaucratic, costly and burdensome restrictions on the capitalization of the bank without any discernable benefit in capital quality or quantity. In fact, it effectively implements a "first in first out" redemption principle for an association's investment in the bank. As a result, when 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 will result in adverse tax consequence if the oldest stock has a zero tax basis while more recently purchased stock has a full tax basis. In fact, such retirements would necessarily dissipate combined bank-association capital. FCA's proposed approach is inconsistent with Congressional intent and unnecessary to align its capital regulations with Basel III. Moreover, it functionally makes it impossible for associations to re-affiliate as provided for in the Act.

Fundamentally, in the closed, cooperative structure of the FCS, an affiliated association's capital investment is legally and functionally a permanent capital contribution to the bank and is understood 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 bank 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 ensures that affiliated associations proportionately and appropriately share in the capitalization and risk of loss of the bank.

The permanence of the association's legal obligation to contribute to bank capital is entirely unaffected by how capital contributions are equalized among affiliated associations or if capital follows the association in the event of re-affiliation. Nor does the bank stock contain any feature that would allow an association to call its investment. The proposed 10-year revolvement of allocated equities means that the bank will not be able to function as a cooperative, including the ability to equalize capital contributions among affiliated associations or allow for re-affiliation in an appropriate way. It is unnecessary and unworkable to require associations' allocated equities that make up their capital investments in their funding bank to be outstanding for 10 years in order to be counted as CET1. FCA should recognize these allocated equities as retained earnings of the bank. 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 applicable to an association's investment in a Farm Credit Bank (FCB) should differ from that of a member's investment in their association given the organizational structure of the FCS. Different capital definitions are justified for two reasons.

First, as discussed previously, the Act establishes a structure whereby an association obtains its funding from a FCB and the association has minimal opportunity to obtain funding from any other source. Regulation § 615.5000 clearly states the financial interdependence between FCBs and affiliated associations as follows: "**The System banks**, acting through the Federal Farm Credit Banks Funding Corporation (Funding Corporation), have the **primary responsibility for obtaining funds for the lending operations of the System institutions**" (emphasis added).

Second, FCS banks have rights to call, preserve and build capital from their affiliated association borrowers that association's lack. A FCS bank's capitalization bylaws give it the ability to increase the investment requirement for existing direct loan volume, as well as the ability to retain excess investments with our without paying a return (patronage or interest credit) to the over-invested association. A bank's general financing agreement (GFA) allows it to increase spreads on existing advances immediately without Association approval.

An association's investment in a FCB results from the statutorily directed financial relationship, which is simply 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 simply 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. While we had thought that treatment of cooperative equities could be identical throughout the FCS, it is clear that is not logical or desirable relative to FCB cooperative shares arising from affiliated associations' investments, which are effectively eliminated when the FCS is evaluated on a combined district or System basis.

FCA should treat the associations' stock investment in their funding bank as CET1 and exclude that capital from any holding period.

(5) The proposed bylaw provisions are unworkable, legally problematic and be an unnecessary expense.

The proposed capitalization bylaw provisions are fundamentally unworkable, unnecessarily costly, and legally problematic. The bylaw requirements result in a vote that puts the FCS institution and its member-customers in a Catch-22 situation. If the member-owners do not approve the required bylaw changes, the institution would have to exclude from regulatory capital shareholder equities under GAAP, potentially resulting in capitalization challenges. However, approving the required bylaw changes would undermine the institution's ability to function consistent with cooperative principles as expected by the Act. Moreover, institutions with modest amounts of cooperative equities may prefer to exclude their cooperative equities from regulatory capital rather than bear the cost, operational burden, member confusion, and uncertainty of a stockholder vote. Such a decision may make economic sense in isolation but could lead to redemption of excluded cooperative equities, harming the overall regulatory capital position of the System.

The proposed bylaw amendment requirement may expose FCS institutions to legal challenge under general corporate law with respect to holders of notices of allocation (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 bylaw changes that they may see as affecting their holder rights (e.g., retirement as the sole discretion of the board of directors).

We are further unsure of the reason for this bylaw amendment provision in the proposed capital rule since there is no basis for it in Basel III and creates unnecessary complications. FCA may be of the view that a bylaw change is needed to create a clear legal distinction among various holders of allocated surplus and other equity to identify what is CET1, AT1 or T2 capital. We recognize the need to ensure that allocated equities must be available to absorb losses. We submit, however, that 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 also 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, however, that a bylaw change is the best or even appropriate way to accomplish this distinction. Section 4.3A of the Act requires that the bylaws adopted by shareholder vote shall enable System institutions to meet capital adequacy standards established under regulations issued by the FCA. As a result of this requirement, FCS institution bylaws provide the board of directors significant discretion for the management of capital resources to achieve ongoing compliance with regulatory capital requirements. Boards manage this compliance by adopting a capital plan, as required by §615.5200.

The Farm Credit Council in its comment letter has 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 specifically require the board to adopt and establish 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 modified by a change in the capitalization bylaws approved by all shareholders pursuant to §615.5220. We believe that FCA could require the resolution by regulation for the sole purpose of implementing the proposed regulatory capital requirements, which would effectively allow all FCS institutions to comply with these requirements without the burden and uncertainty of a shareholder vote, particularly if the vote may result in technical non-compliance with minimum capital standards.

The direct and indirect costs of holding a vote will likely exceed the benefit sought by FCA. We anticipate that the hard cost to put forth a vote to our shareholders would likely be $50,000-$70,000. This does not include the time and expense needed to prepare materials and educate our stockholders on the purpose. While not a materially large figure in the scheme of things, it is unnecessary and wasteful when there can only be one acceptable outcome and there are more conventional methods available.

Given the proposed capital rule is a regulatory-directed change in capitalization, requiring bylaw changes and a shareholder vote is ill-advised and unnecessary.

(6) The 5% Tier 1 leverage ratio requirement is excessive and unsupported compared to commercial banks under BASEL III.

The 5% Tier 1 leverage ratio requirement is excessive and unsupported. Under Basel III, the Tier 1 leverage ratio requirement is 4%. Requiring a 5% minimum for the FCS results in an unnecessary inconsistency with Basel III and the requirements applicable to commercial banks and, would create an un-level playing field in the capitalization of loans to farmers and other eligible borrowers. Moreover, this difference in minimum standards may raise questions and suspicion that the FCS is fundamentally riskier compared to other lending institutions and thus requires a higher standard. According to FCA, the proposed 5% minimum Tier 1 leverage ratio:

> *"...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 are 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.)."[1]

We respectfully disagree that a higher 5% minimum leverage ratio is justifiable based on these considerations. We believe that left uncorrected such an inference could irreparably harm third-parties' views of the FCS and its mission, particularly given the lack of any quantitative support for the difference. FCA's justification is insufficient and unsupported by loss experience, making this proposed requirement arbitrary and capricious.

Basel III was a response to systemic risks revealed during the financial crisis, largely originating from prevalent funding practices (such as reliance on short-term deposits, wholesale funding, overnight repurchase agreement and other forms of inter-bank transactions), and poorly regulated subprime residential lending and rating agency practices, that had the effect of correlating risk sensitivities. The inter-connections and inter-dependences between financial institutions were revealed when losses at one institution drained capital and liquidity available to other institutions—even those with relatively high 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 informed Basel III bear on System banks and their associations. We note that that the System benefits from a clear division and insulation between the source of its equity capital (members) and the source of its debt funds (joint and several debt issuances). No association that experienced financial distress over the past 6 years ever had its liquidity threatened, in stark contrast to the experience of many non-System financial institutions.

Basel III increased the leverage requirement applicable to banking institutions in light of 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 "...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."[2] In short, there is no empirical basis for the assertion the System's risks are any 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. Certainly, there is no basis for a 25% higher leverage standard for the FCS.

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[1] *79 FR 52821*
[2] *ibid*

It is true 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."[3] However, it is not clear how this implies that a higher leverage ratio is needed for FCS institutions than for commercial banks. Interconnectedness of FCS banks and associations is in part a result of the two-tiered structure of the System, and each tier must be capitalized independently. System Banks are interconnected by virtue of joint and several liability for Systemwide debt obligations, and have implemented mechanisms (including CIPA and MAA) to ensure each bank and district remains financially healthy. The assertion that concentration of lending creates greater risk for the System than the banking system as a whole is simply unfounded. The more diverse portfolios of commercial banks did not prevent them from experiencing severe stress during the 2008-09 financial crisis, while the System remained essentially unstressed. The financial crisis spurred the need for Basel III and adequate capitalization of the commercial banks. The commercial banking system has been and remains considerably interconnected, and many smaller institutions are not exceedingly diverse. The Basel Committee took upon itself the considerations of interconnectedness between smaller institutions and among entities such as the FHLB, Fannie Mae and Freddie Mac, as well as the overall dependence on systematically important banking institutions with hundreds of billions in assets. For FCA to require FCS institutions to hold more capital than Basel III requires of commercial banks is unsupported by the facts, loss data, or any reasonable analysis of risk. While we respect that FCA has regulatory safety and soundness discretion, we also recognize that it should be bound and supported by appropriate analysis of relevant data. We submit that FCA has not provided reasonable facts or data analysis to support imposing the higher 5% minimum leverage ratio requirement.

Moreover, the proposed 5% minimum leverage ratio is particularly inappropriate for wholesale FCS banks, such as our District Bank, AgriBank. While it is true that System banks have a large portion of instruments in the 20% risk weight category – primarily the direct loans to their affiliated associations -- FCA appears to have not considered the two-tiered capitalization that exists within the System. System associations and banks must capitalize retail loans at the same risk-based minimum levels as commercial banks, and in addition, System banks must capitalize wholesale loans to associations at a 20% risk weight. Due to this two-tiered capitalization of association retail loans, the System must effectively hold minimum capital for association retail loans totaling 120% of the amount required for commercial banks' retail loans. In addition, both the associations and banks will be subject to the capital conservation buffer, so total capital levels at both the banks and associations will be significantly higher than regulatory minimums. This amount of capitalization is more than adequate to protect not only against credit risk, but against interest rate risk, liquidity risk, operational risk, and other risks.

Imposing a 5% minimum Tier 1 leverage ratio requirement instead of 4% as required for commercial banks under Basel III results in an inconsistent application of Basel III and inappropriately creates a situation where the FCA provides commercial banks an advantage compared to FCS institutions when offering a loan to a specific agricultural borrower. Further, the proposed higher leverage ratio requirement effectively reduces the FCS's ability to achieve its mission, particularly during stressful periods, by decreasing lending capacity by over 20 percent assuming capital positions are near or at

[3] *ibid*

regulatory minimum levels. Under such an assumption, the impact of lower loan volume would materially reduce earnings, thereby adversely affecting safety and soundness. While too much leverage is problematic for financial institutions, FCA should recognize that too little leverage is equally problematic, particularly for mission-based lenders. The Basel III 4% minimum Tier 1 leverage ratio strikes the right balance in this regard. We ask that FCA not to create an inequitable and adverse capital treatment given there is no difference in risk at the loan level between a commercial bank and a FCS institution to a specific agricultural borrower and given that doing so would fundamentally undermine the FCS's mission. We would also observe that imposing a 5% minimum leverage ratio may create strong economic incentives for shifting ownership of loans from associations to System banks.

FCA should reduce the proposed requirement to 4% to make it consistent with BASEL III and the U.S. banking regulators' requirements, especially given the wholesale funding role and capital model of the FCS banks.

(7) Counting availability under GFA between Bank and Association as an "unfunded commitment" is overly penalizing and inappropriate.

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 of such exposures. As discussed in detail in response to FCA's question on this matter (see the response to question 7 in Appendix A of the FCC comment letter), the entire concept is without merit and it is inconsistent with the FCS cooperative structure. The FCS banks and their affiliated associations closely manage commitments to extend credit made to specific borrowers and the current regulations address capital requirements for such commitments. FCA is now adding to the already multiple levels of capitalization by proposing that direct loans have an unfunded commitment aspect that requires capitalization. We strongly disagree with this premise and we believe FCA should remove the proposed requirement in its entirety and simply focus on commitments to "retail" borrowers.

(8) The 1.5% unallocated retained earnings (URE) requirement imbedded in Tier 1 standard brings into question the cooperative structure of the Farm Credit System.

The existing 1.5% URE requirement should not be included in the new capital framework for the FCS. FCA has proposed a minimum URE level in the Tier 1 leverage ratio, which we believe calls into question the cooperative structure of the FCS. The proposed URE requirement declares that URE is higher quality capital than CET1. Identifying a "super" or "superior" CET1 subclass is a message to the marketplace that the System's CET1 does not match up with CET1 of commercial banks. The result is reduced comparability and transparency. Implementation of the 1.5% URE standard within the Tier 1 leverage requirement results in a minimum 3% 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 "super" CET1 class essentially violates the cooperative principle of user-ownership, which means the owners bear the risk and reward of their cooperative institution. With respect to joint stock companies, Basel III respects the basic principle that stockholders are at-risk and bear the losses of the entity. Functionally, this ownership principle is the same for cooperatives, including FCS institutions. FCA should respect this fact and not impose a "super" CET1 subclass requirement.

FCA should not require System institutions by regulation to retain URE at a specific level within a Basel III framework. This undermines an institution's ability to operate consistent with cooperative principles and the related IRS rules on taxation of cooperatives. As proposed, the rule appears to also unnecessarily infringe on a System institution's flexibility to implement governance processes that best support member-owners' ownership, control and engagement. Basel III did not establish URE as a "superior" class of CET1, and FCA has little basis to disagree given the at-risk and permanent nature of cooperative equities included in CET1. FCA should modify the proposed URE requirement 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. If FCA remains determined to require a minimum URE standard, then it should at least apply the URE standard on a risk-adjusted basis consistent with FCA's current regulatory requirements. This approach would minimize unintended consequences for System institutions operating as cooperative financial institutions. FCA's current regulatory requirements are the only instance globally of a regulatory URE capital requirement relating to cooperative financial institutions. There is no basis for FCA to continue to impose this requirement, let alone expand its impact on FCS institutions.

(9) The distribution "safe harbor" is unnecessarily too strict and limiting.

The proposed patronage dividend limit of past year's net retained income and no reduction in capital from the prior year-end provides no reasonable room to manage capital without first seeking FCA prior approval. This burdensome requirement is far more restrictive than the implementation of BASEL III by foreign bank regulators for the cooperatives they regulate.

FCA should recognize that foreign bank regulators understood that they had flexibility to allow up to at least a 2% reduction in CET1 as long as regulatory capital ratios remain compliant with the conservation buffer and all other requirements are met. U.S. banking regulators also recognized their flexibility when implementing capital distribution restrictions applicable to 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. Importantly, §208.5(c) is applicable to commercial banks with capital ratios above the capital conservation buffer requirement and that are not otherwise under supervisory remedy imposed by a U.S. banking regulator.

FCA should follow the same standards as the foreign regulators and allow up to a 2% reduction in capital as long as regulatory capital ratios remain above the conservation buffer.

(10) FCA should maintain the risk-weight treatment of certain rural electric cooperative loans at 50% consistent with the treatment under the current regulations.

There has been no change in the unique characteristics and low risk profile of rural electric cooperative loans to warrant the change proposed by FCA. As previously acknowledged by FCA, the lower risk profile of these loans is because of: (1) the financial strength and stability of the underlying member systems; (2) the ability to establish user rates with limited third-party oversight; and (3) the exclusive service territories encompassing rural America. These unique characteristics insulate the rural electric cooperative industry from many of the credit-related risks experienced by investor-owned utilities, as demonstrated by the industry's minimal loss history and sound credit ratings through time and over many adverse business cycles. Along with the low credit risk of this rural electric industry segment, the key institutions that provide financing to this segment other than CoBank and the U.S. government are not regulated. Therefore, it is critical that FCA's capital rules not affect the FCS's ability to compete and collaborate with the other lenders in meeting the financing needs of rural electric cooperatives. In fact, the Act is clear that the FCS's mission is to be a dependable source of credit and financial services for these cooperatives.

FCA should continue the 50% risk weight treatment to ensure the FCS can continue to meet its mission to serve the rural electric industry as it does today. If FCA does not make this change, it is clear that the proposed rule will adversely affect the FCS's capital capacity to serve this industry even though there is no loss or other risk justification for the proposed change. In the event FCA is unwilling to change the regulatory language, the final rule should reaffirm the current treatment that is established by Bookletter and permissible under the provisions of the proposed rule.

(11) FCA needs to clarify the treatment of High Volatility Commercial Real Estate (HVCRE) as it pertains to traditional agricultural mortgages and eligible project finance transactions.

FCA needs to clarify the treatment of High Volatility Commercial Real Estate (HVCRE) as it 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. While we do not believe FCA intended to imply that traditional agricultural mortgages are HVCRE, 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 meet its statutory mission and would be inconsistent with the realities of today's agricultural mortgage marketplace. Similarly, we are concerned that FCA examiners will include project finance transactions to build processing and marketing facilities or rural infrastructure as being HVCRE. Again, we do not believe that this is the intent of the provision, but we are concerned that any such determination would undermine our lending mission going forward. We are therefore asking the FCA to provide the necessary clarity in its final rule.

(12) Demonstration to the satisfaction of FCA of sufficient capital to exercise a call option is both subjective and excessive.

Proposed sections 628.20(c)(v)(C) and 628.20(d)(v)(C) each require that if an institution wishes to exercise a call option, it must either replace that capital, or demonstrate to the satisfaction of FCA that following the redemption, it will continue to hold capital commensurate with its risk. While we understand the need to have appropriate capital post-redemption, the language that it needs to be "demonstrated" is quite subjective. Upon the enactment of these regulations, each institution will be subject to statutory minimums and a conservation buffer – all established by FCA. Therefore, we would expect that remaining in compliance with such regulations itself should be worthy of "demonstrating" appropriate capital, and the language regarding "demonstrate to the satisfaction of FCA" is either redundant, or too subjective.

(13) Conservative nature of the FCS in relation to nonaccruals could be counterproductive with the new 150% risk-weight for past due exposures.

Due to the subjective nature of nonaccurals and the conservative nature of FCS accounting, FCA may wish to revisit the issue of what qualifies for 150% Past Due Exposure risk weighting. The current proposed definition is similar to that of BASEL III in that it includes loans that are 90-days delinquent OR are considered in nonaccrual status. Our belief is that the FCS is much more conservative than commercial banks in our willingness to move an account into nonaccrual status even if that loan remains in compliance and current, as evidenced by the high percentage of current nonaccrual loans. Including such loans and requiring 50% additional capital will create an incentive to loosen the conservative standards. As such, we recommend that FCA reconsider past due exposures as it relates to 150% risk weight to be defined as either 90-days past due AND nonaccrual, or just 90-days past due.

(14) Seek clarification of 628.22(a)(8) Regulatory Capital Deductions

We seek additional clarity regarding § 629.22(a)(8) as it relates to regulatory capital deductions. The Language in the proposed rule reads,

"If, without the required prior FCA approval, during the 12 previous quarters, the System institution redeemed or revolved allocated equities included in its CET1 capital that it had allocated during the previous 10 years or retired purchased stock that it had issued in the previous 10 years, the institution must deduct 30 percent of its purchased and allocated equities for 3 years otherwise includable in CET1 capital. However, no deduction will be made of allocated equities that are URE equivalents unless the institution redeemed or revolved URE equivalents."

We are confused as to how there is a consequence to an institution for actions that it is prohibited from doing – redeeming allocated equities without the approval of FCA prior to the end of the designated revolvement period (potentially prohibited by both regulation and bylaw). Further clarification as to how this situation could arise would be helpful in understanding its purpose. Additionally, at what point does the 12 previous quarters clock begin? If these regulations are implemented on January 1, 2016, would the look-back period extend to actions that took place in 2013?

Further clarification as to the purpose of this subsection and its implementation would be appreciated.

(15) Third party capital limits should be flexible, and is a member-owner issue not a regulatory matter.

As the only association to both have sought a rating from one of the Nationally Recognized Statistical Rating Organizations (NRSRO) and raised third party capital from institutional investors, the flexibility of FCA rules is of particular importance to AgStar. We believe that access to third-party capital has been invaluable in supporting the FCS in serving its members and fulfilling its mission in a financially prudent manner. Although FCA would certainly express concern regarding any perceived compromise of the user-control cooperative principle, it should be clear that member-owners fundamentally retain all user-control regardless of third party capital usage. The primary difference is that third-party capital investors do not have the basic ownership rights of an owner-member.

We believe the applicable cooperative principle is user-benefit. A portion of the earnings generated by an institution that could otherwise be available to pay the member-owners is paid to third-party capital investors. While this would appear to be a concern, it is not because member-owners authorize the issuance of third-party capital and often are willing to allow their cooperative to access third-party capital when needed to support growth needs beyond what members are immediately able to contribute directly. Member-owners also understand that when a FCS institution needs additional capital it is often the time when capital is least available from member-owners or the future retention of earnings will not fully meet the capital needs while still providing an appropriate balance with respect to user-benefit. It is at this point in the management of capital adequacy that third-party capital becomes an invaluable tool for FCS institutions.

We believe that FCA's formulas limiting third-party capital are arbitrary in nature. The concept that third-party capital is limited to 25% of Tier 1 capital is far too limiting and effectively arbitrary. While we understand FCA's desire to protect user-control, the level of third-party capital issued should be a member-owner issue not a regulatory matter. By placing regulatory controls on third-party capital, FCA is essentially limiting the member-owners' control over the affairs of their FCS institution. FCS should not take such actions that compromise member-owner control without a well-defined safety and soundness reason.

Conceptually, it is logical that some level of capital diversification is financially prudent. Therefore, establishing expectations on limiting the level of third-party capital is not objectionable in and of itself. These expectations, however, should not be binding and force FCS institutions to rely more heavily on cooperative equity or unallocated retained earnings in situations where third-party capital would be preferable (e.g., the need to raise capital during periods of significant volume growth expectations). As a result, we believe that FCA should follow Basel concepts regarding limits on third party capital, and allow member-owners to determine how much of the overall capital structure may be composed of third-party capital.

If FCA decides to retain the third-party limits, the percentages should be increased to allow greater flexibility for user-owners to direct the capital structure of their institutions and ensure FCS institutions have access to needed capital during periods of growth, volatility or stress. For instance, the FCA could revise the total capital formula to allow for the inclusion of third-party capital to the max of 50% of total capital or 100% of AT1 capital. Similarly, FCA should revise the Tier 1 inclusion formula to allow third-party capital to make up 50% of Tier 1 capital. Given the criteria for CET1, we recognize that third-party capital would not be includable in CET1. Nonetheless, the overall result would increase flexibility of System institutions while maintaining diversification in the sources of capital given CET1 would effectively be 50% or greater of Tier 1 considering the various capital standards and the capital conservation buffer.

(16) Align treatment of defined benefit pension fund assets for capital computation purposes with that of insured depository institutions.

The U.S. banking regulators do not require insured depository institutions to deduct pension fund assets from CET1 based on Federal Deposit Insurance Corporation's (FDIC) determination that it has access to such institutions' prepaid pension assets in the event of receivership. We believe that the Farm Credit System Insurance Corporation (FCSIC) has authority to reach the same determination with respect to prepaid pension fund assets reported on the balance sheets of FCS institutions. While FDIC and the FCSIC have different enabling statutes, the clear intent of the law is to provide these agencies unfettered authority to resolve the affairs of an institution placed in receivership. From our perspective, the FCSIC has significant authority to carry out its receivership mandate to take control of all assets of a FCS institution and repudiate various contracts. In that regard, defined benefit pension fund assets recorded on the books of a FCS institution are reasonably available and accessible in the event of receivership. The FCSIC would have the capacity to make a claim on the excess contributions at the point of receivership when the FCSIC makes the final accounting with respect to the FCS institution's business activities. FCA could amend § 627.2725 that specifies the powers and duties of the receiver to include the authority to gain access to excess pension fund assets not required to fund the plan at the time of the receivership.

Overall, we conclude that there is sufficient basis under current law for FCA to treat prepaid pension fund assets as available to the FCSIC. For this reason, we ask FCA to modify the proposed rule so that defined benefit pension fund assets recorded on the books of a FCS institution are not required to be deducted from CET1, but rather risk-weighted at 100% as currently done under the existing capital regulations. This would also align FCA's treatment of defined benefit pension fund assets for capital computation purposes with that of insured depository institutions.

(17) FIRS Rating Metrics

While not a part of the existing proposal, FIRS ratings used by FCA play a major role in establishing capital levels for the system. We would encourage FCA to conform to banking regulations and Basel III standards when establishing FIRS levels for the system. We would also be mindful that the current high levels of systemwide capital should not be the benchmark used to establish the long-run FIRS levels.

Conclusion

We appreciate the opportunity to comment on FCA's proposed capital regulation for the FCS and we appreciate FCA's efforts in developing the proposed rule. We believe that the proposed rule is important to modernizing FCS's regulatory capital framework to make it 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, it still needs important refinement to make it workable for the cooperative structure and mission mandate of the FCS.

While many FCS institutions have high levels of retained earnings, the form of retention is either directly or indirectly allocated to members and in many cases distributed to members pursuant to a specific plan through board discretion. Moreover, FCS institutions do not follow one approach to capitalization. AgStar retains earnings in the form of allocated surplus. Under the proposed capital rules, our institutions would not be able to continue current cooperative capitalization practices, but rather would need to significantly restructure our capitalization approach. This outcome is not appropriate given there has been no indication that the current retention approach has not provided loss-absorbing capability during periods of stress consistent with Basel III's expectations.

AgStar fully supports the responses provided by AgriBank and the FCC in their comment letters, including the comments and responses provided in Appendices A and B of the FCC letter.

We respectfully ask FCA to fully consider and adopt our comments and suggested changes. We believe if FCA makes our suggested changes, it will: (1) position the final rule as consistent with Basel III in a functionally convergent way; (2) provide for FCS capital adequacy for the long run; and (3) ensure the FCS can be true to its cooperative structure in meeting its public policy mission as a GSE.

Sincerely,

Jase Wagner
SVP & Chief Financial Officer

William H. Moore
Director of Capital Management