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February 13, 2015

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

Subject: Regulatory Capital, Implementation of Tier 1/Tier 2 Framework

Dear Mr. Mardock:

Thank you for the opportunity to comment on the Farm Credit Administration's (FCA or Agency) proposed regulatory capital rule. We appreciate FCA's effort to align the System's capital requirements to the Basel III framework applicable to other regulated financial institutions. The updated capital rules will increase transparency and understanding of the System's strong capital position by investors, rating agencies, Congress, and stockholders.

Overall, CoBank supports a tiered capital framework and FCA's general approach. Yet, we are concerned with the provisions that regulate the treatment of cooperative equities. These provisions do not properly balance the requirements of a tiered capital framework with the cooperative structure of the Farm Credit System (FCS or System). FCA is also punitive and inconsistent with U.S. banking regulators in the exclusion from Common Equity Tier 1 (CET1) of earnings retained as cooperative equities. The proposed treatment of cooperative equities discourages the formation and retention of member-held equity, thereby weakening cooperative principles and governance. Weakening the FCS cooperative members' ownership, investment, and control is contrary to the Farm Credit Act of 1971, as amended (Act).[1] We ask that FCA use its significant discretion to recognize the FCS's cooperative structure by treating cooperative equities as permanent and fully available to absorb losses during stressful periods.

We also endorse the Farm Credit Council's (FCC) comment letter on the proposed rule. FCA should fully consider the FCC's comments and adopt the suggested refinements.

Issues of Concern

CoBank's concerns share the common theme that the proposed rule undermines cooperative principles and member participation in the governance, ownership and control of FCS institutions. FCA's proposed capital requirements position cooperative equities as inferior to common shares of joint stock companies simply because cooperative shares result from a different business model with a unique set of legal and business principles.

CoBank's structure as a cooperative, by definition, is a member-owned and member-controlled business that distributes benefits to members in proportion to use. Unfortunately, the proposed regulatory capital requirements effectively incentivize reliance on unallocated retained earnings rather than cooperative equity. This proposed rule's bias incents a capital strategy of minimizing stock purchase requirements, paying only cash patronage if patronage is distributed

[1] 12 U.S.C. 2001 Sec 1.1(b) of the Farm Credit Act of 1971.

at all, and relying on unallocated retained earnings to meet capital requirements. This incentive is regrettable. We have seen numerous examples of institutions in the FCS eliminating stock in favor of unallocated retained earnings, which results in no one, except possibly the board and management, controlling the cooperative. It also demonstrates that FCA has not appropriately recognized that other cooperative capitalization strategies result in the creation and retention of high-quality cooperative equities that are permanent and available to absorb losses during stressful periods.

For CoBank, the proposed regulatory capital requirements are inappropriately harsh on cooperative equities without any corresponding benefit in safety and soundness or transparency. CoBank relies on allocated equities because of a strong belief in the strength of our cooperative business model that fully engages customers as the sole owners of the organization. These owners have a stake in CoBank's financial performance, governance processes, and mission fulfillment. Today, CoBank's customer-owners have invested in their cooperative. They understand their investment is fundamental to: (1) creating the ownership necessary for seeking credit; (2) obtaining a return in the form of patronage distributions; and (3) maintaining CoBank's financial strength to fulfill its mission through all types of agricultural, business and economic cycles. Based on these fundamentals, customer-owners expect their investment to be fully at risk and available to CoBank to absorb losses from its business operations, without question.

We ask that FCA make the following specific modifications to the proposed rule in order to align regulatory capital requirements with the precepts of Basel III, yet also support the cooperative business model.

1. Recognize earnings retained as allocated equity as CET1 without exception or application of criteria applicable to paid-in capital instruments, including the requirement for a 10-year or greater revolvement period. The proposed rule effectively treats allocated equities as capital distributions rather than earnings retained by CoBank. This treatment is inconsistent with the clear fact that CoBank has actually retained earnings rather than distributing them to member-owners as cash patronage. The allocation of current earnings as cooperative equity does not alter in any manner that they are in fact retained earnings. The allocation of earnings to a member is a construct of the cooperative business model and related principles. There is simply no evidence to suggest that allocated cooperative equites arising from retained earnings is any lower in quality than unallocated retained earnings (URE). The FCS has consistently used allocated cooperative equity to absorb losses without question, even during the agricultural credit crisis of the 1980s.[2]

   From a financial strength and risk-buffer standpoint, there is no difference between allocated cooperative equities and URE. The proposal's different treatment of allocated equities and URE fails to recognize the high-quality, at-risk, and permanent nature of cooperative equities within the context of a cooperative financial institution. The characteristics of allocated cooperative equities as currently employed in CoBank's capital plan are entirely consistent with Basel III's principles that CET1 be permanently available to absorb losses during periods of stress. Allocated retained earnings also do not possess the features

[2] During the stressful period of the 1980s, FCS institutions relied on allocated retained earnings (i.e., allocated cooperative equities) and unallocated retained earnings to absorb losses. The loss absorbing capacity of allocated cooperative equities never came into question. Congress also recognized that allocated surplus was fully at-risk and therefore never took action to protect such equity as it did for paid-in borrower stock.

identified in Basel III as having the effect of reducing loss absorbency (e.g., cumulative dividends) during periods of economic or market stress. In the absence of any data or features that bring into question the loss absorbing capacity of allocated retained earnings, the FCA should follow the U.S. banking regulators' lead in implementing Basel III by including all retained earnings in CET1 regardless if such earnings are retained as unallocated or allocated to members.

While we believe it is unnecessary to impose minimum revolvement periods, we recognize that FCA may wish to retain criteria currently applicable to allocated cooperative equity relating to revolvement cycles. Conceptually, FCA could retain the current regulatory capital revolvement periods that differentiate among allocated equities.[3] Following current requirements would rectify FCA's overly harsh interpretation of Basel III and narrow the gap between the System's Basel III requirements and the U.S. banking regulator's implementation of Basel III. If FCA ultimately decides not to drop the proposed revolvement requirement or not to follow current regulatory revolvement cycles, a 7-year revolvement requirement for CET1 treatment of allocated equities would be more reasonable and workable from a cooperative structure perspective. However, we want to emphasize that a revolvement period does not affect in any manner the availability of cooperative equities to absorb losses. The revolvement period is simply not relevant and does not create an expectation or legal right relative to member-owners, particularly. The proposed rule also imposes strict limitations over the dissipation of capital without FCA prior approval, thereby making revolvement requirements redundant and unnecessary.

2. Drop the proposed capitalization bylaw provisions given they are fundamentally unworkable and legally problematic. The proposed rule requires numerous capitalization bylaw changes before a FCS institution may count cooperative equities in CET1 or Tier 2 capital. The bylaw requirements result in a meaningless vote that puts the FCS institution and its member-owners at considerable implementation risk. Member-owners effectively have no option but to approve bylaw changes required to ensure compliance with the proposed rule. Member-owners would understand that a "no" vote on the required bylaw change could put lending capacity and mission fulfillment at risk, clearly an unacceptable result. Therefore, the required vote is not a reasonable business choice for member-owners to consider, but a compelled affirmative vote for the sole purpose of meeting an unnecessary regulatory requirement. There is no logical or legal reason to force member-owners in a false-choice bylaw vote.

   FCS institution bylaws provide the board of directors with significant authority for ensuring ongoing compliance with regulatory capital requirements. The boards manage this compliance through the adoption of a capital plan as required by §615.5200. Rather than requiring a bylaw change, FCA could simply require System institutions, including CoBank, to distinguish between the treatment of retained and allocated cooperative equities through the regulatory capital-planning requirement and/or a board resolution. FCA could require by regulation modifications to the capital plan adopted by the board and/or board resolution for the sole purpose of implementing the proposed regulatory capital requirements.

[3] Based on current requirements, a logical approach would be to allow allocated equities with a 5-year or greater revolvement period to count as CET1, while such equities with a 3 year or greater but less than 5-year revolvement period would count as additional tier 1 capital. All remaining allocated equities would count as tier 2 capital.

3. Do not include the proposed 1.5% URE requirement in the new capital framework for the FCS. The proposed URE requirement creates a “super” CET1 subclass on the basis that URE “shields” member-owners’ cooperative equity from losses given priority upon liquidation requirements per § 615.5220(a)(2). The liquidation priority concept used by cooperative entities in no way diminishes the loss absorbing capacity of cooperative equities included in CET1. In fact, commercial banks and other financial institutions follow a similar priority where URE is impacted by losses before paid-in capital or par value of stock. U.S. banking regulators, however, did not implement a “super” subclass of CET1 in its Basel III framework. FCA should recognize that there is no basis for a URE requirement within Basel III either directly or in the context of a minimum URE standard embedded within CET1. Basel III did not see a safety and soundness need to establish URE as a “superior” class of CET1, and FCA has no quantifiable or logical theoretical basis not to come to the same conclusion given the at-risk and permanent nature of cooperative equities. 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.

   The proposed minimum URE requirement unnecessarily infringes on a System institution’s duty to implement governance processes that best support member-owners’ ownership and control as well as engagement in their entities. To the best of our knowledge, FCA’s current regulatory requirements are the only instance globally of a regulatory URE capital requirement relating to cooperative financial institutions. There simply is no factual or logical basis for FCA to continue to impose this requirement, let alone expand its impact on FCS institutions. As an alternative, FCA could remove the proposed, specific URE minimum requirement and replace it with a general requirement that FCS institutions manage the components of CET1, including retaining a sufficient amount of URE, as appropriate for the effective business operations through economic/business cycles. If FCA ultimately decides to maintain the URE requirement, it should do so only on a risk-adjusted basis consistent with FCA’s current regulatory requirements, which minimizes unintended consequences for System institutions operating as cooperative financial institutions.

4. Maintain the 50% and 20% risk-weight treatments of exposures to electric cooperative assets consistent with the treatment under the current regulations.[4] There has been no change in the unique characteristics and low risk profile of these loans. 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 institution that provides financing to this segment, other than CoBank and the U.S. government, is not regulated and utilizes Farmer Mac as a

[4] Under BL-053, FCA permitted the 50% risk-weight based on certain conditions and 20% risk-weight based on AAA or AA rating by an NRSRO. We recognize that FCA is not able to rely on NRSRO ratings in regulatory capital provisions. Regardless, it is still clear that high-quality rural electric cooperatives should still be able to qualify for a 20% risk-weight based on their strong financial profile. One approach may be to rely on the FCS institution’s internal ratings for this specific industry.

key risk counterparty and source of liquidity. This change would further the capital advantage Farmer Mac already has in competition with CoBank for the same loans and increase Farmer Mac's exposure to one counterparty. Therefore, it is critical to the rural areas served 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 CoBank is to be a dependable source of credit and financial services for these cooperatives. For these reasons, the FCA should continue the 50% and 20% risk-weight treatments to ensure that CoBank can continue to competitively meet its mission to serve the rural electric industry as it does today. In the event FCA is unwilling to change the proposed regulatory language, we ask that the final rule reaffirm the current treatment that is established by Bookletter-53 and permissible under the provisions of the proposed rule.

5. Revise the capital distribution "safe harbor" to provide for greater flexibility in distributing current earnings in the form of cash patronage. The proposed "safe harbor" provision is unnecessarily strict and limiting. Limiting capital distributions to the past year's net retained income and not allowing for any reductions in CET1 capital from the prior year-end provides no reasonable room to manage CoBank's cooperative capital without constantly seeking FCA prior approval. This burdensome requirement is far more restrictive than the implementation of Basel III by foreign and U.S. bank regulators. Foreign bank regulators allow up to at least a 2% reduction in CET1 as long as regulatory capital ratios remain above the conservation buffer and all other requirements. Under 12 CFR 208.5(c), U.S. banking regulators allow commercial banks to distribute up to the sum of their current year net income, plus retained net income for the prior two years if the capital conservation buffer requirement is met and there is no outstanding supervisory action. FCA should be consistent with other regulators and provide FCS greater flexibility to distribute capital.

6. Clarify the treatment of High Volatility Commercial Real Estate (HVCRE) as it pertains to traditional eligible project-like finance transactions of agribusiness or rural infrastructure entities.[5] The proposed definition of HVCRE and the associated 150% risk weight is unclear with respect to eligible project-like finance transactions. We are concerned that FCA examiners will conclude that transactions to build processing and marketing facilities or rural infrastructure qualify as HVCRE. Any such determination would undermine CoBank's lending mission going forward. FCA should specifically exclude traditional eligible project-like finance transactions from the definition of HVCRE given such transactions present no greater risk relative to other retail loans as demonstrated by CoBank's loan performance history.

7. Implement a 4% Tier 1 leverage ratio requirement, consistent with the Basel III framework applicable to all other regulated financial institutions globally. FCA's proposed 5% Tier 1 leverage ratio requirement is not supported based on quantified analysis or actual risk exposures. CoBank is not any riskier compared to commercial banks or other financial institutions. In fact, CoBank has consistently been recognized as one of the safest banks globally.[6] Adding to CoBank's financial strength is the geographic and industry diversification of its loan portfolio that spans all 50 states and ranges from agribusiness to

[5] CoBank makes loans to agricultural marketing and processing cooperatives and rural infrastructure entities in the energy, water system, and communication sectors. These loans often involve specific projects for building new or expanding existing facilities, a core aspect of CoBank's mission fulfillment.

[6] As recognized by Global Finance Magazine in its annual "World's 50 Safest Banks" listing.

rural infrastructure to wholesale lending. There simply is no data to support that a 25% higher minimum leverage ratio is required for CoBank to be adequately capitalized. FCA should follow U.S. banking regulators' implementation of Basel III by imposing a 4% Tier 1 leverage ratio requirement rather than the proposed 5% minimum.

8. Recognize statutory provisions that provide for the allotment of allocated investments between FCS banks and affiliated associations within the proposed Tiered regulatory framework. FCA's proposed approach is to ignore Section 4.3A(a)(1)(B) of the Act. FCA should not disregard clear statutory provisions with respect to the allotment of capital within the regulatory capital framework. To respect Congressional intent and statutory direction, FCA should allow for the application of allotment agreements in the proposed CET1, Tier 1, and total capital framework. If FCA decides not to allow agreements for the allotment of allocated investments between FCS banks and affiliated associations, there would be an immediate and significant negative impact on institutions within the CoBank district. At a minimum, the FCA should provide for a 5-year transition period for the allotment of allocated investments within proposed Basel III framework, consistent with the treatment permitted under existing regulatory capital requirements.

Responses to FCA's Questions

As requested by FCA, CoBank is providing specific responses to three of FCA's questions. We did not provide a response to all questions given we fully support the appropriate and thorough responses the FCC provided in its letter to all of FCA's questions.

Alternatives to Including Common Cooperative Equities in CET1 or Tier 2 Capital

We seek comment on using alternative terms or conditions that FCA could apply to common cooperative equities. Is a 10-year revolvement cycle long enough to reduce the expectation of redemption and increase the permanence of such equity instruments so that they may be included in CET1 capital?

As discussed previously, CoBank finds the 10-year or any regulatory-imposed revolvement cycle unnecessary under Basel III and irrelevant to cooperative equities' availability to absorb losses during stressful periods. FCA should drop all proposed revolvement period requirements relating to cooperative equities resulting from the allocation of earnings to member-owners. If FCA decides to retain a revolvement requirement, it should recognize different approaches for demonstrating compliance with such a requirement. A requirement to date stamp individual common equity instruments at issuance and hold the instrument for a set period is overly restrictive and burdensome. FCA should recognize the portfolio nature of cooperative equities and permit loan-based approaches (e.g., average loan balance outstanding over some period). CoBank has successfully used a loan-based approach for a number of years. Our approach has resulted in member-owners having a stable and predictable level of investment related to their business activity. Our member-owners understand that they must maintain this investment commitment and they do so in a permanent fashion as long as they maintain their business relationship with CoBank. If a member-owner is no longer a customer, a loan-based plan ensures their capital investment can be retained by CoBank if needed to protect against losses or retired in a predictable manner over a reasonable period of time, subject to board approval. FCA should allow a loan-based approach, as it does in the existing regulatory capital regulations, if the Agency retains a revolvement requirement. There is simply no financial or logical justification for implementing a prescriptive and restrictive "date-stamped" approach to revolvement requirements.

Third-Party Capital Limits
We seek comment on alternative third-party limits to ensure that System institutions remain capitalized primarily by their member borrowers.

CoBank needs flexible access to third-party capital to supplement member capital. This access is critical for our ability to fulfill our mission and meet the credit needs of our member-owners during periods of growth or commodity price volatility. FCA has proposed two formulas to limit third-party capital that are overly restrictive and unnecessary. We ask that FCA drop its proposed limits. The level of third-party capital is a matter for the member-owners to manage and control. FCA should not take actions that would compromise member-owner control without well-defined safety and soundness reasons. Moreover, third-party capital limits are unnecessary given the proposed CET1 requirements effectively create capital diversification with respect to retained earnings and capital instruments other than preferred stock. Therefore, FCA should not retain the third-party capital limit formulas. Rather, FCA should allow member-owners and System institution boards of directors 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 Agency should significantly increase the limits to allow greater flexibility for member-owners to direct the capital structure of their institutions and ensure CoBank can access third-party capital when needed to support mission fulfillment and financial strength.

Accounting for Defined Benefit Pension Fund Assets
Given System institutions' differing methods of reporting defined benefit pension fund assets, what is the best way to require adjustments for defined benefit pension fund assets in the CET1 capital computation?

The Federal Deposit Insurance Corporation determined that it has access to insured depository institutions' prepaid pension assets in the event of receivership.[7] As a result, the U.S. banking regulators do not require insured depository institutions to deduct pension fund assets from CET1. The Farm Credit System Insurance Corporation (FCSIC) has similar significant authority to carry out its receivership mandate to take control of all assets of a FCS institution and repudiate various contracts, including defined benefit pension fund assets recorded on the books of a FCS institution. The FCSIC has the capacity to make a claim on the excess contributions at the point of receivership when it makes the final accounting with respect to the FCS institution's business activities. FCA should modify the proposed rule so that defined benefit pension fund assets recorded on the books of a System institution be risk-weighted at 100% rather than deducted from CET1. This modification would align FCA's treatment with that of FDIC-insured depository institutions.

Conclusion
CoBank supports implementation of a regulatory capital framework comparable to the standards applied to other regulated financial institutions under Basel III. As discussed in our comment letter, the proposed rule is a good start but clearly needs refinement to make it workable for the FCS's cooperative structure and mission. CoBank also fully supports the FCC's comment letter with respect to the threshold issues, responses to FCA's questions, and section-by-section analysis.

[7] Regulatory Capital Rules, Interim Rule, 78 Fed. Reg. 55340-55598 (September 10, 2013) page 55375, footnote 78.

We would be happy to provide additional information on any of the topics discussed or otherwise be helpful to FCA as it addresses this far-reaching and materially impactful rulemaking effort. If you have questions or require additional information, please do not hesitate to contact us.

Sincerely,

Robert B. Engel

Robert B. Engel
Chief Executive Officer