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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

Re: Proposed Rule: Regulatory Capital, Implementation of Tier 1/Tier2 framework;
79 Fed. Reg. 52813 (September 4, 2014)

Dear Mr. Mardock:

The Farm Credit Bank of Texas ("FCBT") deeply appreciates the opportunity to comment on the Farm Credit Administration's ("FCA's") proposed rule on regulatory capital and the implementation of a two-tiered approach similar to the Basel III framework as well as the agency's extension of the deadline for submitting these comments. The FCBT has actively participated in the development of the comments submitted by the Farm Credit Council ("Council") on behalf the System and fully supports those comments. Because of the profound importance of these regulations, and the very troubling implications of the approach FCA has taken, we wish to submit our own comments.

While we remain supportive of the general concept of modernizing FCA's capital adequacy regulations, and acknowledge that FCA has made a significant effort to take the System's views into account, we think the proposed rule falls dramatically short of the kind of modernization that the System actually needs. We are prepared to follow the capital disciplines embodied in the Basel III framework assuming, as Basel III allows, that appropriate adjustments are made in the FCA regulations to accommodate the System's unique cooperative structure. As it is currently written, however, the proposed rule contains a number of requirements that bear no reasonable relationship to the requirements or objectives of either the Basel III framework or the regulations adopted by the Federal banking regulators. These departures from Basel III requirements appear to have been made, not in order to accommodate the System's cooperative structure and make the System's capital requirements comparable to Basel III, but rather, quite the opposite.

Specifically, we are deeply concerned that the proposed rule, whether by design or not, would undermine the System's ability to operate on a cooperative basis in the following critical respects: the treatment of allocated equities and the associations' investment in the funding bank in the definitions of regulatory capital, the requirement to amend capitalization bylaws, the limitations on the safe harbor for equity retirements, the 30% haircut penalty for equity retirements made without prior approval, the requirement that 1.5% of Tier 1 capital consist as unallocated retained earnings (URE) for purposes of calculating the leverage ratio, and the capitalization of an association's excess borrowing base in its direct loan with its Farm Credit banks, and in addition to all those burdens, the imposition of a unique capital burden on the System through a leverage ratio 25% higher than what Basel III provides.

We question the wisdom of the FCA's proposed approach to the reconciliation of Basel III requirements with the System's cooperative structure, since the likely effect of these proposed changes over time will be to weaken the System's ability to fulfill its mission to serve farmers and ranchers. As a prime example, the higher Tier 1 leverage ratio, given that it is not related to risk, simply imposes a surtax on System loans that is not levied on non-System institutions. Furthermore, because cooperative operation is the most distinctive part of the value proposition the System brings to its borrowers, to the extent that the capital rules restrict the ability of System institutions to operate on a cooperative basis, we fear that over time the System will become less relevant in the marketplace. In both cases, the result would be that the System will become less competitive and less effective in serving the farmers and ranchers it was created to serve. We do not think that this is a necessary outcome. As discussed below and in the Council's comments, we continue to believe that it is possible to achieve a more reasonable and appropriate reconciliation of Basel III requirements and System cooperative principles, and respectfully urge FCA to reconsider and modify the proposed rule accordingly.

CRITICAL ISSUES:

1. <u>Regulatory Capital Definitions.</u>

a. <u>Treatment of Allocated Equities.</u>

(i). Allocated equities are essential to cooperative principles.

Although § 628.20(b) of the proposed rule nominally includes allocated equities as a component of common equity Tier 1 ("CET1") capital, as the System requested, we are concerned that the overly severe constraints FCA has placed on the use of these equities as regulatory capital will effectively discourage System institutions from allocating retained earnings to their borrowers at all. Because the Act establishes the System as a cooperative system, and because the allocation and revolvement of retained earnings to members constitute the essence of operating under cooperative principles, any regulatory capital requirement that unnecessarily limits the System's practice of allocating and retiring allocated retained earnings would, in our view, subvert the clear intent of the Act.

We do not think that it is necessary to sacrifice cooperative principles in order to make the System's regulatory requirements comparable to Basel III. We believe that the treatment of allocated equities in the proposed rule rests on a fundamental misunderstanding of the requirements of the Basel III framework. Based on the FCA's commentary explaining its approach to common cooperative equities, including allocated equities, FCA apparently assumes that Basel III requires System allocated equities to be analogized to common shares in a joint stock company, because the commentary goes on to explain its application of the 14 criteria for common shares in Basel III to common cooperative equities. The FCA's assumption overlooks the fact that the definition of "Common Equity Tier 1" in the Basel III framework also includes retained earnings as the equivalent of common shares without regard to compliance with the 14 criteria.

We think that FCA's assumption ignores the very different circumstances under which allocated equities in a cooperative are created compared to the issuance of common shares in a joint stock company. In the case of allocated equities, the cooperative first receives earnings from the business it does with its members, and then, after paying expenses and setting aside necessary reserves (such as, allowance for loan losses), it allocates those earnings to its current members on the basis of their patronage business with the cooperative. This allocation gives the member a contingent right to distribution of these equities, subject to the sole discretion of the cooperative's board to authorize it, but the character of the funds as the retained earnings of the cooperative does not change just because ownership of a contingent right to distribution has been assigned to a particular member. Allocated retained earnings remain on the cooperative's books to capitalize its risks and absorb losses until the board determines that they are no longer needed and authorizes redemption of them. These allocated equities have no dividend or redemption rights that would cause their capital value to the cooperative to diminish over time. As new allocations are made, older allocations are redeemed. This revolvement practice ensures, in keeping with the cooperative principle of equitable treatment of each equity holder, that current risks in the cooperative are being capitalized by its current members, rather than by past members who are no longer doing business with the cooperative.

In contrast, common shares in a joint stock company are issued in a transaction that transfers a unit of legal and economic rights to an investor in return for payment of a specific consideration. The proceeds of a common stock issuance constitute the capital of the company, but they are not its retained earnings from its business operations. The quality of this capital depends upon the contractual terms surrounding the issuance transaction. The investor may have rights to receive a return on the investment in the form of dividends or a stock split paid from the company's retained earnings, or by realizing upon any appreciation of the company's value by selling the security at an increased price to other investors. Normally, while the identity of the investors bearing the risks of the company may change through market transactions that do not involve the company, the share itself and the capital it represents is not repurchased or redeemed. The stock may have features, however, that would give the company legal obligations or rights or economic incentives, such as a put or call option, cumulative dividends, or step-up in dividend rates, or changes in distribution priorities, that would call into question the company's ability to meet the terms of the stock and maintain its value in the company. This is the concern of Basel III, that common shares not carry features that might lessen their availability to absorb losses.

The central and irreducible difference between the operations of a System institution that allocates equities on a patronage basis and a bank operating as a joint stock company is that the primary source of capital for the joint stock bank is contributed capital, while in the System institution with allocated equities, it is retained earnings. A cooperative, in order to treat all members on an equitable basis that results in each member receiving a fair (proportionate) share of the cooperative's earnings and paying a fair share of its expenses, should ensure that the cost of capitalizing current risks presented by the business done with current members is borne by those members and not by past members. To do otherwise puts a disproportionate burden on past members, which is contrary to pure cooperative principles. In a joint stock company, on the other hand, there simply is no concept of user-ownership and user-benefit. The business risks of the company are always borne by current stockholders, who may freely sell their shares when they no longer wish to bear those risks.

(ii). Allocated equities are retained earnings under Basel III, but also meet the "permanence" and "expectation" criteria for common shares.

A proper reconciliation of the Basel III framework to the System's cooperative structure requires a classification of allocated equities as retained earnings rather than as common shares subject to the 14 criteria. When seen in this light, the revolvement of allocated equities by System institutions from their retained surplus closely resembles the payment of dividends from retained surplus by a commercial bank. Payment of dividends is subject to regulator approval and limitations in amount, but does not change the loss absorption capacity or the characterization of the remainder of the bank's retained surplus as CET1 when the dividend is actually declared and paid, even if the dividends are paid on a regular basis. By the same token, the regular revolvement of allocated equities, subject to board discretion and regulator approval, should not taint remaining allocated equities or make them less available to absorb losses. Most, if not all, of the many burdensome complexities of the proposed rule, such as the need to differentiate categories of allocated equities on the basis of revolvement periods and to provide a contractual basis for doing so in amended bylaws, could be eliminated if this fundamental mischaracterization of allocated equities were to be corrected.

System allocated equities represent real, tangible capital in the institution. From a legal perspective, these allocated equities have no maturity date, carry no dividend rights, and grant no redemption rights to holders or other features that would in any way weaken their ability to absorb losses in the event an institution experiences financial stress. Instead, System allocated equities are at all times subject to retirement or redemption only at the discretion of the institution's board of directors and in compliance with regulatory requirements. Consequently, System allocated equities are fully available to absorb losses in times of financial stress, the characteristic which is the central focus of Basel III in defining CET1 as the highest quality of capital.

Even if it is assumed that the 14 criteria of Basel III for common shares should be applied to System allocated equities, the requirements of the proposed rule with respect to the criteria of permanence of capital and expectations of redemption are far more restrictive than what any reasonable interpretation of Basel III actually requires and do not adequately take into account the differences between a joint stock company and a cooperative organization. In the commentary explaining the application of the 14 criteria to System cooperative equities, FCA notes that System institutions, through the practice of routinely and frequently redeeming cooperative equities, "can create expectations on the part of their members that these purchased and allocated equities will be redeemed," and therefore, "that the 'expectation' requirement of Basel III and the Federal regulatory banking agencies could reasonably be interpreted to disallow common cooperative equities redeemed by System institutions from CET1." We think that FCA has misinterpreted what Basel III actually requires.

According to the "expectation" criterion of the Basel III, in order for an instrument to be classified as common shares included in CET1, the issuing bank must do "nothing to create an expectation *at issuance* that the instrument will be bought back, redeemed or cancelled nor [can] the statutory or contractual terms provide any feature that might give rise to such an expectation." (Emphasis added). The fact that this criterion specifically refers to expectations created at the time of issuance is significant. It indicates that what the Basel III framework is really concerned about are the terms of the instrument, such as a step-up or call feature, and the circumstances that relate to the terms of the transaction in which an investor originally acquires an instrument, such as an explicit or implicit promise to redeem upon the occurrence of a future event, which could create an economic incentive for the company to redeem the instrument or give rise to a legal claim against the issuer that could diminish the availability of the instrument to absorb losses.

That Basel III's "expectation" criterion does not address actions taken by an issuer *following* the issuance of an instrument is illustrated by the "permanence" criterion which, after stating that the principal of the instrument must be perpetual and never repaid outside of liquidation, expressly goes on to permit "discretionary repurchases or other means of reducing capital in a discretionary manner allowable under relevant law." If a history of discretionary repurchases were indeed to give rise to an expectation of redemption at the time of subsequent issuance of another instrument, then the "permanence" and "expectation" criteria would be inconsistent with each other, but the text of the Basel III framework does not actually say that. It is worth noting that the proposed rule in adopting the permanence and expectation criteria omits from the "permanence" criterion the Basel III language allowing for discretionary repurchases, instead making any redemption subject to board discretion and regulatory approval, while omitting from the "expectation" criterion the words "at issuance."

Since the practice of periodically redeeming allocated equities when a System institution meets its regulatory capital ratio requirements constitutes a discretionary reduction of capital allowable under the Act and cooperative principles, it would appear to be consistent with the "permanence" criterion of Basel III for CET1 capital. Similarly, as long as a System institution's bylaws and disclosures allow redemption of cooperative equities only at the discretion of the board subject to the institution's compliance with capital adequacy requirements, and the institution does not make an explicit or implicit promise at the time of issuance of the equities to redeem them in the future, periodic redemption would appear to be consistent with Basel III's "expectation" criterion. Consequently, it is far from clear that these Basel III criteria can be *reasonably* interpreted to disallow System allocated equities from CET1.

(iii). The proposed minimum revolvement periods are too long because they break the link between the cooperative principles of user-ownership and user-benefit

We acknowledge and appreciate that the definitions of CET1 and Tier 2 capital in the proposed rule do in fact include cooperative common equities, including allocated equities subject to redemption. We think that FCA's approach in establishing the minimum revolvement periods for CET1 and Tier 2 capital, however, is misguided. We agree with the Council that minimum revolvement periods create difficult administrative complexities and are unnecessary to the permanence of allocated equities for purposes of Basel III. Even if minimum revolvement periods are retained, the minimums established in the proposed rule are overly long and do not have a compelling policy justification.

The FCA's commentary admits that it is important for the current members of a cooperative to capitalize it and for current and former members to eventually receive a return of their capital, but suggests that somehow the Basel III "permanence" and "expectation" criteria now demand even greater limitations on a System institution's reliance on redeemable allocated equities as regulatory capital than exist today. As justification for requiring a 10-year holding period for allocated equities to qualify as CET1 and 5 years to qualify as Tier 2, FCA states in the commentary its belief that, because member expectations of redemption may put stress on System institutions to continue to redeem equities even when the institution's financial health is deteriorating, and because shorter revolvement periods would be expected to have higher member expectations of redemption than longer ones, a longer revolvement period would have the effect of "moderating" member expectations, causing members to be less likely to count on the cash redemption of those equities in their own capital planning.

We believe FCA's reasoning is mistaken in assuming that, as a matter of policy, member expectations of redemption should be "moderated" at all in any cooperative organization that issues allocated equities. First, all cooperatives are intended and designed for the very purpose of creating member expectations about the return of the cooperative's net profits on a patronage basis. According to FCA's own statement on its website, "The Cooperative Way", there are three core inter-connected cooperative principles that provide the foundation of the System's operation as a cooperative system: user-ownership, user-control, and user-benefit. Under the principle of user-benefit, a cooperative returns the profits of its operations to its members net of any expenses and necessary reserves. Through utilization of the benefits of single taxation provided under subchapter T or the tax-exempt status of long-term mortgage lending, the profits of a System institution operating on a cooperative basis are intended to flow to the member, in effect making the cooperative an extension of the member's own operations. Ultimately, the cooperative's earnings are considered to be the same as the member's earnings, as illustrated by the fact that when a cooperative issues a qualified notice of allocation, the member must pay taxes on the amount allocated, and in the event the qualified allocated equities are impaired, it is the member who receives the tax deduction. In this way, the principle of user-ownership is logically tied to the principle of user-benefit.

Under the cooperative principles of user-ownership and user-control, a member-user can ensure that the operations of the cooperative continue to follow the user-benefit principle. Member expectations about the redemption of allocated equities should be encouraged rather than discouraged because they enhance the links between the principles of user-benefit, user-ownership, and user-control, and thereby promote member participation in the governance of System institutions. The expressed policy of Congress in the Act is to provide for a "farmer-owned cooperative Farm Credit System" that will "encourage farmer- and rancher-borrowers to participate in the management, control, and ownership of a permanent system of credit for agriculture." Since the inception of the System, borrowers have always been required to have an at-risk investment in their institutions. In other words, having "skin in the game" has always been perceived as necessary for System borrowers to draw the connection between realizing the benefits of ownership and being engaged in the governance of their institutions. Whenever this requirement has been questioned, Congress has re-affirmed the need for at-risk, borrower-ownership to ensure the safe and sound operation of System institutions.

The FCA specifically solicited comments on whether "a 10-year revolvement cycle would be '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." It is quite clear that FCA's purpose in proposing the 10-year minimum revolvement period was to reduce the value of allocated equities so much that any link between member's ownership of the equities and the member's economic benefit from them would effectively be broken. We believe that is precisely what the capital rules should not do if the System is to operate under cooperative principles as the Act provides.

FCA overlooks the role of member expectations of redemption in holding boards accountable when a System institution experiences financial distress. Since a member has no legal right to enforce redemption of allocated equities, which always remains subject to board discretion and compliance with regulatory requirements, refinancing with another lender will not put the member in a stronger position to demand payment or an offset against a loan. Consequently, interruption of a redemption cycle is itself unlikely to lead to borrower flight and a downward spiral. Instead, members with disappointed redemption expectations must exercise their right as user-owners to elect a board that will respond appropriately. Contrary to what FCA suggests, boards responding to member dissatisfaction are not more likely to make imprudent retirement decisions that violate regulatory requirements and violate their fiduciary duties. Rather, experience has shown that when redemption expectations are not met, boards have responded by taking actions that improve the institution's financial performance so that redemptions can resume in a safe and sound manner. That is simply the way that all cooperatives, including System institutions, should operate.

Since we do not think that it would be appropriate for capital regulations to break the link between member-benefit and member-ownership, we recommend that all minimum revolvement periods to qualify allocated equities as regulatory capital be eliminated. If they are to be retained at all, the 10-year period for CET1 and the 5-year period for Tier 2 be replaced by minimum periods that reflect prevailing business practices in cooperative organizations generally and that are consistent with the operational needs of System institutions that choose to allocate their retained earnings. We agree that the alternative proposals made in the Council's comments, while unnecessary, would be less burdensome to System institutions and their members that wish to follow cooperative principles. We also ask the FCA to consider that a 10-year revolvement period is so long that it makes it that much more likely that System institutions will lose contact with some holders whose loans are repaid before revolvement occurs, with the result that the investment of these System patrons will escheat to the state, thus depriving them of the user-benefit they should have received.

b. <u>Other Definitional Issues</u>

(i), Status of attributed surplus in the banks

In addition to these general concerns, there are some other aspects of the proposed definitions of regulatory capital that need clarification. The definition of "CET1 capital" includes any "common cooperative equity" meeting the specified criteria in §626.20(b)(1). The term "common cooperative equity" includes "allocated equities" which are specifically defined at § 628.2 with reference to retained patronage refunds that have been distributed to a borrower by means of qualified and nonqualified notices of allocation. The definition of CET1 at § 628.20(b)(2) also includes "unallocated retained earnings (URE)," which is defined at § 628.2 as "accumulated net income that a System institution has not allocated as patronage refunds." Taken together, these two definitions appear to include in URE surplus that is attributed to borrowers on a patronage basis through "memo accounting," but that is not actually allocated under Subchapter T using qualified or nonqualified written notices of allocation. Even so, the definition of "unallocated retained earnings (URE) equivalents" at § 628.2, which term is not actually included in the definition of CET1 capital, includes only "nonqualified allocated surplus not subject to retirement except on dissolution or liquidation," and would appear to exclude attributed surplus. FCA's commentary discussing the current capital structure of the System mentions attributed surplus, but does not indicate that it is making a change to its capital treatment. We think the definition of "URE equivalents" should be amended to include attributed surplus for which written notices of allocation have not been given, and that the definition of "URE" should be amended to include "URE equivalents." In addition, it should be noted that while the FCA commentary discussing calculation of the leverage ratio mentions including "URE equivalents" in the calculation, the regulation itself does not given the way that "Tier 1 capital" is currently defined.

(ii). Exclusion of common cooperative equities from Additional Tier1 capital.

In addition, in the event FCA retains the proposed requirements for minimum revolvement periods for allocated equities in order to qualify as regulatory capital (and we do not think it should), FCA should modify the classification of allocated equities that do not satisfy the minimum 10-year period for CET1 from Tier 2 capital to Additional Tier 1 ("AT1") capital. FCA has not explained the reason why it specifically excluded common cooperative equities from the definition of AT1 capital at § 628.20(c). As noted above and in the Council's comments, allocated equities redeemed on a cycle of less than 10 years are really no less permanent than those on a cycle of more than 10 years because all allocated equities are subject to board approval and regulatory compliance and are available to absorb losses. The member expectations raised by a revolvement period between 5 and 10 years should not be greater than an AT1 instrument in a joint-stock company, which under Basel III's criteria, may be callable after 5 years. Consequently, these non-CET1 equities should meet the Basel III criteria for AT1.

The practical effect of the exclusion of common cooperative equities from the definition of AT1 capital, appears to be primarily to make it more difficult for institutions that do issue allocated equities to satisfy the Tier 1 leverage ratio and maintain the capital conservation buffer. The only conceivable purpose for the exclusion of these equities is to penalize System institutions that choose to operate on a cooperative basis from issuing allocated equities that have revolvement periods of less than 10 years and to force them instead to increase their revolvement periods or to rely on URE or URE equivalents in order to satisfy the leverage ratio and maintain the capital conservation buffer. As we have previously said, no capital requirements for the System should discourage institutions from issuing and redeeming allocated retained earnings to its members in accordance with cooperative principles.

2. Treatment of Association Direct Loan with its Funding Bank.

a. Treatment of Association Investment in the Bank.

(i) Interpretation of "minimum borrower stock requirement."

The capital treatment of an association's investment in its funding bank is extremely problematic for several reasons. One such reason is the way the proposed rule appears to interpret the term, "minimum borrower stock requirement," in the definition of CET1 at § 628.20(b) in connection with allowing inclusion in CET1 of equities that are purchased for the purpose of allowing borrowers to become members of the institution and are financed by the member's loan. While we agree with FCA's determination to include in CET1 the minimum amount of stock required to be purchased as a condition of obtaining a loan, we disagree with FCA's statement in the commentary that this amount is the lesser of $1,000 or 2 percent of the member's loan or loans. Under the Act, each System institution is required to adopt capitalization bylaws that (1) provide for the manner in which stock shall be issued (including the amount that is issued), (2) enable the institution to meet capital adequacy standards, and (3) require as a condition to borrowing from the institution that borrowers acquire stock in an amount not less than $1,000 or 2 percent of the amount of the loan, whichever is less. In other words, what the Act effectively provides is that borrowers must purchase the minimum amount of stock that an institution's bylaws require, which cannot be less than the lesser of $1000, or 2 percent of the loan amount. The Act does not say, and has never been understood to say, that borrowers are only required to purchase $1000 or 2 percent of the loan amount. Accordingly, we think the language in the regulation referring to the minimum stock purchase should be changed to the "minimum borrower stock requirement *under bylaws adopted* under section 4.3A of the Act.

Practically speaking, most if not all association's bylaws do in fact allow boards to set the bylaw minimum to the lesser of $1000, or 2 percent of the loan amount, but the System banks' bylaws all require a higher percentage based on the amount of the association's direct loan. In effect, this means that the proposed rule does not give required stock in System banks the same capital treatment as association borrower stock. Although as currently written, the actual language of proposed rule does not clearly provide for this exception, the FCA commentary concerning the treatment of purchased member stock states that the minimum amount of required stock would not have to obtain FCA prior approval before redemption and would not be required to be held for the minimum 10-year period. If association stock in the funding bank cannot be treated in the same manner as membership stock in an association, then it follows that a minimum redemption period must be established for bank stock and that FCA prior approval must be obtained for any redemption. If adopted as proposed, this rule will create a very costly and completely unnecessary administrative burden on the federated cooperative relationship between the funding bank and its associations.[1]

Although FCA has not explained its reasons for excluding the excess amount of member required stock over the statutory floor, or for the differential treatment of System banks in this respect, we presume its proposal is based on the fact that the European Banking Authority's regulatory standards for capital requirements permit cooperatives to include directly or indirectly funded member stock where the stock is not "material in amount", in addition to being purchased to qualify the member for a loan that is not made for the purpose of purchasing the stock, and because, as FCA notes in its commentary on the System's capital structure, while member stock "is not a significant source of association capital," member stock purchased by associations "plays an important role in capitalizing System banks."

We do not think that it is appropriate to apply the EBA's "material amount" limitation to member stock purchased in System banks because, as FCA has itself noted, the European financial cooperatives operate differently than the System does, and therefore, certain rules that might make sense in the European context cannot be directly analogized to the System's federated cooperative structure, which is evidently unique in the world. The Act clearly creates the banks for the purpose of providing funding and services to the associations, which in turn, the Act requires to own and capitalize their funding bank. This statutory federated cooperative structure should be appropriately accommodated as contemplated by footnote 12 of the Basel III framework. Given that the associations' purchased stock investment in the bank is required by the Act, the amount of that investment in itself should not affect its capital treatment.

(ii) Periodic equalization.

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[1] Although our comments object to the differential capital treatment of purchased stock in the bank, and the Council's comments advocate different capital definitions for banks and associations, in fact, there is no inconsistency. We and the Council both object to the same problem, which is the application of prior approval requirements for equalization and application of the bylaw requirements establishing minimum revolvement periods to required stock held by associations in the bank. There may be more than one way to address this problem.

FCA's commentary, in describing how stock balances in the bank are adjusted as the indebtedness under the direct loan increases or decreases, correctly notes that "[t]ying the amount of the required investment to the amount of the loan results in each association's bearing the cost and risks of bank capital relative to the association's share of bank debt." Thus the FCA recognizes that the equalization process is vital to a bank's ability to operate in accordance with cooperative principles with respect to its associations. It follows that any capital rule that restricts a bank's ability to retire an association's stock investment would impose unnecessary capitalization costs on associations that cannot receive redemptions that they would otherwise receive, and would be contrary to the Act's intent that the System operate as a federated cooperative. FCA's commentary goes on to state, however, that the practice of equalization "also makes the stock less permanent because the bank routinely issues or redeems the stock." If this statement is intended to justify differential and more burdensome treatment of association purchased stock in the bank, then FCA has not only misunderstood the "permanence" requirement under Basel III, but has failed to comprehend the nature of the bank and association relationship in a federated cooperative structure.

As the Council's comments clearly explain, the permanence of the association stock investment in the bank is a function of the permanence of the association-bank relationship under the Act. The Act authorizes the banks to fund only the associations in its district, and correspondingly authorizes associations to obtain funding only from the district bank, except with bank approval, and obligates them to purchase stock in the bank to capitalize their indebtedness to the district bank. The Basel III permanence criterion should be satisfied under this relationship because stock in the required percentage of the direct loan will always be available to absorb losses in the bank. Regardless of any discretionary periodic adjustments in the amount of stock to reflect increases or decreases in the direct loan, the stock has no maturity date, the association is required to own the stock, has no legal right to demand redemption, and cannot readily reaffiliate or terminate System status to repay the direct loan without bank and regulator approval, and the bank board at all times retains discretion to suspend or extend the equalization period.

As the System has evolved over the nearly 100 years of its existence, the administration of the direct loan and the related stock balances in the banks has become very efficient. The FCA commentary acknowledges that System banks and associations accounting systems and wire transfer systems are highly coordinated. This coordination and efficiency allow the banks to optimize their capital positions and thus improve the profitability of the associations. In this way the banks function in the federated cooperative structure as an extension of the operations of the associations, just as associations operating as cooperatives, function as an extension of their members' operations. The treatment of the associations' required investment in the bank under the proposed rule would threaten to upend the efficiency of the bank-association relationship by introducing a totally alien and unnecessary concept, that is, the assignment of a 10-year minimum holding period for any required stock subject to the need to FCA prior approval of any equalization of this stock.

The proposed rule raises many questions about how existing bank stock, which is currently treated as fungible, would be treated. The rule appears to require that whatever stock balances exist at the time of the effective date of the regulation would have to be maintained for 10 years before any equalization whatsoever could take place. This delay could create a heavy drag on an association that experiences a decline in loan volume. The minimum holding period would also restrict the ability of bank boards of directors to manage the bank's capital position to accommodate unusual events by reducing the equalization period. In addition, the banks would have to expend considerable effort to modify their accounting systems in a reliable way in order to be able to classify and track required stock by date, and avoid errors that could trigger the 30% haircut penalty. Furthermore, as the Council's comments note, the classification of bank required stock by date issuance or allocation will create tax consequences that would not otherwise exist, unnecessarily creating additional complexity in bank operations, and increasing the effective cost of bank capital to associations. These issues have nothing to do with the actual availability of the association's investment in the bank to absorb losses, and so, are not required by the Basel III framework. We urge FCA to eliminate these issues by modifying the proposed rule to allow all association investment in the bank required to be held under the bank's bylaws, whether purchased or allocated, to be included in CET1 without regard to any minimum holding period, and should allow that investment to be equalized at the bank' board's discretion in accordance with those bylaws without prior FCA approval.

b. Capitalization of Excess Borrowing Base as Unfunded Commitment

FCA has invited comment on its proposed requirement under § 628.33 for the bank to capitalize as an unfunded commitment the amount by which the maximum credit limit under the bank's general financing agreement with an association exceeds the association's outstanding indebtedness. In its commentary to this provision, FCA argues that this treatment is consistent with the way that loan exposures are treated and does not result in double capitalization because the bank's commitment exposures and the association's commitment exposures are separate risks due to the possibility that an association could conceivably use the excess commitment to fund operations or investments. For the reasons set forth below, we think that the risk to an association in an unfunded commitment to a borrower is really not at all comparable to the risk to the bank in its excess commitment in a direct loan to an association and should not have to be capitalized in the same way. We believe that capitalization of the bank's excess commitment under the direct loan would in fact result in double capitalization of risks that are already being mitigated in other ways. That would only increase the cost of bank operations that the associations and their members must ultimately bear.

In a typical lending relationship, such as what an association could be expected to have with its borrowers, the debt is evidenced by a note that establishes the definitive amount of the obligation. In the case of the bank-association direct loan, the general financing agreement (GFA) is open ended, providing for continued funding with no limit on the amount so long as all terms and conditions of the GFA are met. Thus, there is no specific amount of unused commitment from the bank to the association in the traditional sense. This arrangement evolved from the symbiotic nature of the federated cooperative relationship between the banks and associations, and allows for growth of the associations without the necessity for administrative burdens such as numerous amendments to promissory notes and loan documents.

Another difference is that when an association's unfunded commitments to its borrowers are drawn down, the association typically does not have the ability to require a performing borrower to purchase more capital, comply with additional covenants, or except in the case of some revolving lines of credit loans, provide more collateral. In contrast, the district bank's lending relationship with the associations via the direct note, including the excess amount over the borrowing base, is protected by the totality of the associations' assets, earnings, capital and allowance. First, the System banks' general financing agreements with their associations typically are secured by all of an association's assets but provide funding to the associations controlled by a borrowing base that discounts or excludes certain types of assets, such as loans on which there is a disagreement between the bank and association about loan classification. Thus, at the outset, the bank's collateral position in the direct loan exceeds what is reflected in the borrowing base. In addition, the general financing agreement contains a liquidity covenant that effectively limits the association's ability to borrow in excess of a percentage below the actual borrowing base without the bank's approval, which serves as an equity buffer to absorb losses in the event of credit adversity. This liquidity percentage can also be increased if the association has an internal review program unacceptable to the bank. It is also true that to the extent than an association draws on its commitment under the GFA, it does so in order to fund an additional loan or other asset that then increases the bank's collateral and liquidity margin.

FCA's argues that bank commitments and association commitments are separate risks because "an association could use money it borrows from the bank not only to establish and expand commitments and loans to borrowers, but also to invest, hedge risk, replace equipment, or fund new facilities and services." While in theory, this argument appears plausible, it overlooks a number of facts about the direct loan relationship which make this supposed risk of advances not backed by collateral much less likely. The GFA between FCBT and its associations, similar to the GFAs of the other district banks, contains numerous covenants that ensure that an association's ability to continue to draw on its direct note line is based upon the association's having adequate financial performance and capitalization, as well as sufficient collateral to support the direct note relationship.

One such covenant is the requirement to maintain a minimum return on assets ratio of 1%. Typically, the first event of default by an association is the failure to meet the minimum ROA requirement of 1%. This covenant severely reduces any incentive that an association might otherwise have to use borrowed funds to pay for activities or assets that will not earn a return that covers the interest cost of the loan, rather than pay for them from its earnings. Another important covenant is the requirement to submit a corrective action plan if an association's adverse assets to risk funds ratio exceeds 50% and to maintain a ratio of adversely classified assets to risk funds of less than 75%. In the event of a default of either the ROA or the Adverse Assets to Risk Funds ratios, the GFA gives the bank the right to take a wide variety of actions that could control the risk that the association would use its excess liquidity to fund imprudent activities or transactions that would weaken that bank's collateral position in the direct loan, such as imposing limitations on capital purchases, restricting distributions of capital, and reducing association delegated authorities and lending limits, requiring bank approval of budgets and business plans. If defaults are not satisfactorily corrected, the bank can control its risk by terminating the association's loan, refusing to make additional disbursements, charging a default interest rate or even requesting that FCA appoint a receiver.

The GFA also provides controls for early identification of potential events of default for associations with credit issues. For example, The bank is entitled to receive: association audit reports and correspondence, quarterly financial reports, strategic business plans, monthly borrowing bases, internal credit reviews, FCA examinations, FCBT credit reviews, association allowance for loan loss write ups, a report of each association's ten largest aggregate exposures, board minutes, policies, procedures and other reports reasonable required. This provides the bank with an early warning of association credit problems and documents how the association is dealing with them. In addition, the FCBT prior approves each association's ten largest exposures along with loans over some established level, usually approximately 10% of capital.

The history in our district also supports the conclusion that the terms of the GFA require associations to maintain adequate capital. For example, prior to the merger of Ag Credit of South Texas (ACST) with Texas Ag Finance, the FCBT performed a liquidation analysis on ACST. The analysis was conducted long after ACST defaulted under the GFA. That analysis concluded that, even if the association was liquidated, the FCBT would not suffer a loss. As a result, liquidation was not required, since the association still had sufficient equity and assets to be an attractive merger partner.

We believe that the covenants of the GFA governing the lending relationship between the bank and the associations, contain the necessary safeguards so that the bank does not need to hold additional capital to support unfunded commitments to an association. If the funding bank were also required to capitalize the unused portion of direct notes, it would be a case of "gilding the lily," effectively doubling up on capital to cover what is essentially the same risk that has already been capitalized by the association. Furthermore, there is no financial risk for the bank to capitalize since the association's financial performance is dictating the amount the association can borrow on the direct note. Given the safeguards that are in place, there is no need to require the bank to capitalize the excess borrowing base under the direct loan. That would merely reduce the efficiency of the bank-association relationship without contributing materially to its safety and soundness, while it would impose unnecessary burdens on the associations.

We believe that FCA should not treat the excess borrowing base of the direct loan as an unfunded commitment, but if FCA retains this requirement, we agree with the Council that FCA should clarify what the applicable credit conversion factor and risk-weighting category are for the bank's excess commitment amount. We presume that FCA intended the 50 percent credit conversion factor to be applied to the excess commitment because the GFA is usually a multi-year agreement, and that amount should then be risk-weighted at 20 percent. We also seek clarification on how frequently this calculation should be performed and how the excess amount should be calculated, since the excess amount of the borrowing base will change on a daily basis.

3. Capitalization Bylaws Amendments

The definition of regulatory capital at § 628.20(b)(xiv) proposes to require, as a condition for any instrument to be included in CET1, other than the minimum statutory borrower stock requirement under 4.3A of the Act, that the System institution's capitalization bylaws provide that the institution will not offset the instrument against a member loan in default, and will not redeem the instrument less than 10 years after issuance or allocation, or reduce the original revolvement period, without FCA approval. Similarly, the proposed definition of AT1 capital at § 628.20(c)((xiv) requires that the capitalization bylaws will not allow redemption of the instrument without FCA approval, and the proposed definition of Tier 2 capital at § 628.20(d)(xi) requires capitalization bylaws to prohibit redemption of the equity for at least 5 years after allocation without FCA approval. FCA has not explained why it proposed these requirements for capitalization bylaw amendments, but the reason appears to be based on its fundamental assumption that System allocated equities should be analogized to instruments of common shares in a joint stock company rather than as retained earnings.

For the reasons explained above in the discussion of the treatment of allocated equities, we believe that System allocated equities should be classified as retained earnings rather than as common shares. Since the Basel III framework confers CET1 status to retained earnings without regard to the 14 criteria applied to common shares, footnote 12 of the Basel III framework does not actually require application of these criteria to allocated equities in System institutions. In choosing to apply the 14 criteria to allocated equities in its approach to reconciliation of Basel III to System capital requirements, FCA has actually departed from the principles of Basel III.

Because FCA's existing capital regulations currently differentiate the capital treatment of allocated equities based on the length of the revolvement period, FCA was predisposed to find in Basel III a justification for continuing this differentiation, which it did through the "permanence" and "expectation" criteria for common shares included in CET1. This approach has led FCA down a rabbit hole of unnecessary administrative and conceptual complexity in order to make allocated equities look more like common shares in a joint stock company. Currently, all System allocated equities are not divided into classes based on revolvement periods. Consequently, without a change in the legal rights associated with these allocated equities, they cannot be assigned to different categories of regulatory capital. FCA's solution is to require stockholders to approve capitalization bylaw amendments that alter the legal rights of members in these equities in order to create classes of allocated equities based on a minimum revolvement period.

As the Council's comments rightly point out, these bylaw amendment provisions raise a significant number of vexing issues. First, in contrast to the stockholder vote required by the 1987 Act to place borrower stock at risk, where the consequences of a failure of stockholders to approve new capitalization bylaws was simply that the stock remained in protected status, the proposed bylaw requirements offer no palatable alternative to stockholders considering whether to approve the bylaws required by the proposed rule. These members will face a Hobson's choice: if the stockholders disapprove the bylaws, their institution will possibly fail to meet regulatory capital standards and be placed in liquidation, or if they approve the bylaws, they will be voting to limit their institution's ability to operate on a cooperative basis in the future and to reduce the value of the investment they currently hold in the institution. Another problem is that, because members would be voting to approve amendments that adversely affect the rights holders of allocated equities who have repaid their loans and are no longer members with a right to vote, there would likely be legal challenges to any action that changes the rights of these non-member holders.

It is also concerning that the proposed rule, by requiring the bylaws to prohibit the offset of equities against a defaulted loan, appears to directly contradict Section 4.3A(g) of the Act, which preserves the right of System institutions to retire stock or other equities against a defaulted or restructured loan. While the minimum statutory stock requirement is excluded from this provision of the proposed rule, it would affect any required equities that happen to exceed the statutory floor and other allocated equities. The requirement is unclear in that it appears to prohibit offset against a defaulted loan altogether in perpetuity. Presumably, FCA intended to make this provision subject to the minimum revolvement period and allow offset against defaulted loans beginning 10 years after allocation or issuance, but the proposed rule does not actually say that. Also, the proposed rule does not make clear that the prohibition of offset against a loan in default does not apply to the minimum statutory stock requirement. In addition, as discussed previously, we think that the term minimum statutory borrower stock requirement should be modified to include any stock or allocations are required by an institution's bylaws to be held as a condition to obtaining a loan so that these equities will be encompassed by the exception from the minimum holding period and offset prohibition.

In addition, insofar as the proposed AT1 definition would include the System's existing third party preferred stock, the requirement for a bylaw that provides for FCA prior approval of redemptions is also problematic. Under the FCBT bylaws and the terms of the preferred stock currently issued by the FCBT, and presumably those of other System banks as well, these preferred stockholders would be required to approve amendments to capitalization bylaws that materially change the terms of their stock by a majority vote of all shares currently entitled to vote. It is uncertain whether a requirement for FCA prior approval for redemptions would constitute a material change in terms, triggering this voting right. This uncertainty puts the bank in a dilemma: if the bank concludes that the amendment is not a material change and does not include the preferred stockholders, the bank may invite legal action by preferred stockholders; on the other hand, if the bank includes the preferred stockholders in the vote, and a majority of the preferred stockholders does not approve the amendment, the amendment will fail and the preferred stock will not qualify as AT1. This would be a significant amount of Tier 1 capital for the FCBT. If the vote were to fail, it is also unclear whether this would actually qualify as a regulatory event under the terms of the stock, and as a result, the bank could be faced with preferred stock that it can neither redeem nor count in its regulatory capital.

We believe that these troublesome issues could be completely eliminated if FCA were simply to characterize allocated equities as retained earnings, as they should be characterized, instead of characterizing them as instruments to be treated like common shares in a joint stock company. That change of approach would avoid altogether any perceived necessity to alter members' legal rights in existing and future allocations in order to create classes of instruments subject to differing capital treatment. If FCA does not modify its fundamental approach, then we agree with the Council's recommendation that FCA should eliminate from the proposed rule any requirement that System institution amend their capitalization bylaws, in favor of a requirement of a board resolution creating different classes of allocated equities adopted as part of the capital planning process.

4. Regulator Prior Approval of Capital Distributions.

a. Safe Harbor.

Section 628.20(f) of the proposed rule would adopt a new requirement for FCA prior approval of cash patronage and dividend payments and retirements or redemptions of common cooperative equities, except for the minimum member stock requirement of $1,000 or 2 percent of the loan, whichever is less. In its commentary on this provision, FCA states that it is necessary to include these prior approval requirements in order to make the System's regulatory capital framework comparable to the regulatory capital framework that applies to U.S. banking organizations. We agree that the addition of this type of requirement would be appropriate to the extent that it is actually comparable to the requirements applicable to non-System banking organizations.

In fact, the safe harbor in the proposed rule for System institutions is actually much more restrictive than those in the regulations applicable non-System financial institutions. The Federal financial institution regulators generally permit U.S. financial institutions to make capital distributions in an amount that does not exceed net income for the year to date (less declared capital distributions) plus retained net earnings for the preceding two years. The FCA proposed rule, in contrast, would only permit capital distributions to the extent that, after the distributions, the institution's CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date in the previous calendar year. In the commentary, FCA offers no explanation why it imposed such a tighter limit on the amount of allowable capital distributions than did the Federal banking regulators.

We think that the proposed rule is an unwarranted limitation on the ability of System institution boards to manage their institution's capital positions. There may be any number of sound reasons for a board to authorize distributions in excess of current year earnings. For example, assuming that an institution allocates roughly the same amount of earnings every year, an institution that decides to issue qualified allocated equities from current year earnings and pay a cash patronage of 20 percent, as Subchapter T requires it to do, would find itself unable under the safe harbor to revolve a series of non-qualified allocated equities issued 10 years before. Assuming that the institution's regulatory capital exceeds the capital conservation buffer limits, and no other supervisory limitations apply, there would appear to be little to be gained from a safety and soundness perspective in requiring FCA prior approval in this kind of situation.

Although the proposed rule does contemplate that FCA could grant approval for this kind of distribution, the prior approval process appears to be more cumbersome that what the Federal banking regulators follow. We agree with the Council's suggestion that FCA consider allowing, as the Federal banking regulators do, for a more expedited approval process for institutions that operate above the capital conservation buffer. Waiting until the full 30 days FCA has required for consideration of a request does not allow enough time for an institution to respond if the request is not granted or new conditions are imposed.

In addition, the prior approval process that the FCA has outlined in the proposed rule needs some clarification. Although the proposed definitions of regulatory capital exclude the minimum member stock requirement from the provisions imposing minimum holding periods, nothing in the safe harbor provision appears to mention that it includes the minimum member stock requirement. As we have discussed in other contexts, the term, "minimum statutory borrower stock requirement," should be clarified to include any stock a borrower is required to purchase or hold as a condition to obtaining a loan under the institution's capitalization bylaws. All such stock should be redeemable without prior FCA approval.

We also think it is important for FCA to include in the safe harbor incidental redemptions of allocated equities held by the estates of deceased members. The retirement of allocated equities in this situation is a common practice in cooperatives generally, and has historically been followed in the System subject to bylaw and board authorization and compliance with capital requirements. To prohibit retirement of the equities can work a financial hardship on members' families and heirs and complicate the settlement of estates. To allow retirement in these situations, on the other hand, does not affect the rights of other holders of allocated equities. In addition, FCA should consider including in the safe harbor retirements that are ordered by a bankruptcy court. To prohibit retirement in these situations would be unreasonable because the institution is subject to the court's jurisdiction and is not in a position to defy it, and refusal could delay the resolution of the bankruptcy litigation, which is ultimately in both the institution's and the member's interests.

b. Haircut for Early Redemptions Without Approval

Section 628.22(a)(8) of the proposed rule would impose a "haircut" penalty on any institution that, during the previous 12 quarters, redeems or revolves allocated or purchased equities included in CET1 capital without the required FCA prior approval if the equities were issued or allocated within the previous 10 years. In this situation, the proposed rule that the institution must deduct 30 percent of its purchased and allocated equities otherwise includable in CET1 for 3 years. We believe that this penalty is completely unnecessary and that there is utterly no possible justification for it. First, since the concept has no basis whatsoever in the Basel III framework or the capital regulations of the Federal banking regulators,, it is not required to achieve comparability with Basel III principles. Moreover, it would certainly become unnecessary if allocated equities are properly classified as retained earnings as we have recommended.

FCA states that it is proposing the haircut deduction "to ensure proper management by System institutions of their members' expectations or redemption and to ensure that institutions are vigilant in their recordkeeping of the issuance and allocation dates of CET1 capital." It is difficult to understand what relationship a 30 percent reduction of CET1 capital has with management of member expectations or member education about longer revolvement schedules. According to FCA's scheme, there must be bylaw amendments which prohibit redemptions prior to 10 years in any event. Presumably, members' expectations would be thoroughly addressed at that time. Once an institution establishes a capital structure that relies on allocated equities as CET1, it would have no incentive to reduce the revolvement schedule deliberately without agency approval. Any violations would more likely come from mistakes concerning whether particular equities are qualified for the safe harbor or from recordkeeping errors. It appears odd to punish these types of errors with such a draconian penalty regardless of the reason or the magnitude of the violation. That would be the definition of an arbitrary and capricious rule.

FCA has also given no explanation how it concluded that the 30 percent figure over a 3-year period would be appropriate. Given that the penalty applies to any redemption without required approval, which could be quite isolated and minimal, the exclusion of 30 percent of <u>all</u> purchased <u>and</u> allocated equities over a 3-year period could easily be disproportionate to the amount of the equities improperly retired and is clearly excessively harsh, and could have adverse consequences on an institution and its borrowers that FCA has not foreseen. An institution that violates the safe harbor, even inadvertently, could suddenly find itself in violation of its capital adequacy ratios and a candidate for liquidation, leaving its members high and dry.

Aside from those issues, this penalty provision is confusing as currently written. Since it applies to retirements that occur at any time during a 12-quarter look-back period, there could be multiple violations occurring at different times during that period, and it is unclear whether the 3-year exclusion period applies to each violation beginning on the date of that violation, or if it applies beginning on the discovery date of the violations in the current period. Also, although the commentary to this provision states that capital that is excluded from CET1 could be counted as Tier 2 capital if it qualifies, nothing in the regulation actually says that.

The consequences of triggering the penalty are so severe, and the circumstances in which it could be triggered are so uncertain that it appears that the penalty was designed for the very purpose of discouraging institutions from relying on allocated equities as CET1 at all. The primary effect of the proposed rule would thus be to discourage System institutions from operating on the basis of cooperative principles as the Act allows and intends for them to do. If FCA capital regulations cause System institutions to abandon operations based on a cooperative basis, these regulations clearly undermine one of the central objectives of the Act. For this reason, and because the penalty becomes moot if allocated equities are classified as retained earnings as they should be, we urge FCA to remove the 30 percent hair-cut penalty from the proposed rule completely. At a minimum, if the penalty is retained, FCA should clarify how it is to be applied, and also clarify that penalty does not apply to inadvertent or <u>de minimis</u> mistakes or to transactions that qualify for the safe harbor.

5. <u>Tier 1 Leverage Ratio</u>

a. <u>Additional 1 Percent Surtax on System Lending</u>

Section 628.10(b)(4) of the proposed minimum capital requirements include for both banks and associations a Tier 1 leverage ratio of 5 percent, of which 1.5 percent must be composed of URE or URE equivalents, calculated based on total non-risk-adjusted assets. As the FCA commentary notes, this requirement replaces the net collateral ratio in the existing regulation which applies only to System banks and is calculated on a risk-adjusted basis. We do not object to the requirement of a leverage ratio in itself. We understand that, as FCA states in the commentary to this provision, a leverage ratio acts to prevent hidden risks from reducing capital levels below a certain percentage of total assets. We strenuously object, however, to the imposition of a leverage ratio that is 1 percent higher than the 4 percent that is required by Basel III and the regulations of the Federal banking regulators.

FCA has cited no empirical evidence that supports the imposition of a leverage ratio to System institutions that is 25 percent higher than the ratio required of non-System banks and financial institutions. In its commentary, FCA provides the following justification for the higher ratio:

> The 5-percent 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 United States agriculture sector. They have a business model and risk profile that are substantially different from traditional banking organizations.
>
> The higher 5-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.

The commentary goes on to explain that, while the leverage ratio for associations would not differ significantly from their risk-adjusted Tier 1 ratio, because most of their assets are 100 percent risk-weighted, System banks have off-balance sheet items and a large portion of their assets in the form of direct loans to association risk-weighted at 20-percent, and the FCA believes a higher ratio is necessary to ensure that System banks "hold enough capital to protect against risks other than credit risk (e.g., interest rate risk, liquidity risk, premium risk, etc.)."

The FCA's rationale essentially appears to be that, because the System is unique, it is inherently more risky than non-System financial institutions. We believe this reasoning rests on a fallacy: that just because one risk is different from another, it necessarily follows that it must be a greater risk. In fact, it is just as likely, when all circumstances are taken in account, that the different risk is a lesser risk. For example, while it may be true that System institutions are financially and operationally interconnected, member-owned cooperatives, that fact may actually be a source of stability and strength as opposed to a risk factor. As the Council's comment point out, FCA ignores the fact that, with the System's two-tiered structure, it already capitalizes most credit risks at 120 percent. As a result, far from being a hidden risk concealed in a 20-percent risk-weighting, this interconnectedness is already being reflected in the System's capitalization. In addition, although it is true that the System banks are jointly and severally liable on System debt obligations, they also have in place mutual agreements such as the Market Access Agreement and Contractual Interbank Performance Agreement that provide for disciplines that control joint and several liability risks.

Similarly, while System institutions are restricted to lending to agriculture, it inaccurate to say that the System is a "monoline" lender given how System lenders manage their portfolio risks concentrations in particular commodities, industries and regions, and given the diversity in agriculture itself and the fact that adversity in one sector is often offset by prosperity in another. System institutions may actually have more real credit risk diversification than some commercial banks. Furthermore, while System institutions do have a different business model and risk profile than non-System financial institutions, that business model and risk profile served the System in good stead during the financial crisis of the last half-decade, compared to non-System financial institutions with supposedly more diverse portfolios and less inter-connectedness.

As for the System's GSE status, Congress clearly intended to promote the System's activities by conferring such GSE status on them in the Act. It is indeed odd that FCA should then impose a differential cost on the System's activities, in effect a surtax, that increases the System's operational costs and makes it less likely that the System's credit and services to farmers and ranchers will be competitive in the marketplace. This result would not appear to be consistent with the Congressional intent behind the creation of the System in the first place. As the Council's comments correctly point out, the proposed additional 1 percent leverage ratio would create a competitive disadvantage for System institutions in capitalizing loans to farmers and ranchers. The higher ratio could conceivably reduce the System's lending capacity, thereby reducing its ability to fulfill its mission to provide credit to eligible farmers and ranchers, as well as reduce its earnings, thereby weakening its safety and soundness. In our view, while some controls on leverage are appropriate, from a policy perspective, it just does not make sense to limit the System's ability to utilize leverage to make loans to eligible farmers and ranchers relative to non-System financial institutions.

We believe that FCA should not create a requirement that deviates so substantially from Basel III requirements without a sound analytical basis for doing so. FCA presented no real factual support for its proposal. Accordingly, we agree with the Council's recommendation that FCA not impose a 1 percent higher leverage ratio on System institutions until it has conducted a study that conclusively demonstrates that such differential treatment of System institutions is warranted. In addition, FCA also did not explain why 1 percent was identified as the appropriate amount. We think that such a study should also demonstrate that the additional amount imposed is actually related to the demonstrated risk that must be addressed. We therefore believe that FCA should align the System's leverage ratio with the 4 percent required by Basel III unless and until it conducts a study that shows such differential treatment to be warranted. If FCA retains the 5 percent requirement, then we agree with the Council's suggestion that the higher leverage ratio be modified to apply only as part of the capital conservation buffer.

b. URE Requirement

Section 628.10(b)(4) of the proposed rule would also require that at least 1.5 percent of the Tier 1 leverage ratio requirement consist of URE and URE equivalents. As the FCA commentary notes, this requirement is similar to the URE requirement in existing regulations, but is more burdensome in a couple of respects. First, currently, 1.5 percent of the core surplus of an institution must consist of URE and URE equivalents or perpetual noncumulative preferred stock, whereas, under the proposed rule, this same percentage must consist exclusively of URE and URE equivalents. Second, the 1.5 percent URE requirement in the current regulation is currently calculated on the basis of risk-weighted assets as a component of core surplus, whereas the proposed rule requires URE as a component of Tier 1 capital in calculating the leverage ratio compared to total assets on a non-risk adjusted basis. Consequently, the amount of URE and URE equivalents that an institution must maintain would be somewhat higher under the proposed rule than under the existing regulations. This effect is more significant for System banks than associations because the banks have issued significant amounts of preferred stock which can no longer be counted as the highest form of capital, and because banks tend to hold relatively more assets with lower risk-weightings than associations do.

According to the FCA's commentary to this provision,

> The FCA believes that it is especially important for System banks to hold sufficient URE and URE equivalents to cushion the third-party and common cooperative equities that make up the rest of tier 1 capital. URE and URE equivalents, when depleted do not result in losses to a System institution's members. URE protects against the interconnected risk that exists between System banks and associations; it protects association members against association losses, associations against bank losses, and the System against financial contagion. We are proposing to make the URE and URE equivalents a part of the leverage ratio because a URE minimum tied to risk-adjusted assets may not be sufficient for the banks, which have a greater disparity between risk-adjusted and total assets.

It is clear from this statement that FCA considers URE and URE-equivalents to be a higher quality of capital than any other form of equity an institution might have principally for the reason that it insulates a member or any association from any experience of the pain of equity impairment. While FCA may be correct that URE has this effect, it is decidedly a mixed blessing.

In a cooperative, the fact that URE by definition is not associated with any particular equity-holder breaks the link between the cooperative principles of user-benefit and user-ownership. As these comments have stated previously, the essence of operating according to cooperative principle is that the earnings of the cooperative are to be returned to the user-owners net of expenses and necessary reserves. While cooperatives may acquire URE from non-patronage business or other sources, and use them to cover expenses so that patronage distributions can be maximized, an over-accumulation of URE can result in the cooperative being found not to be operating on a cooperative basis and losing its eligibility for single taxation under Subchapter T.

Even if the institution's tax status is not at issue, an over-reliance on URE in an institution's capital structure will tend to result in the disengagement of the membership of the cooperative from its governance. Over time, if members do not experience the financial results, good or bad, of their cooperative through patronage distributions as well as impairments, they will inevitably become ignorant of and indifferent to the cooperative's operations. Ultimately, the cooperative will become in effect an organization without a real functioning owner. Instead, the operations of the cooperative will be directed by entrenched management without effective input from the members and the link between user-ownership and user-control will be broken as well. This result would be contrary to the objective of the Act "to encourage farmer- and rancher-borrowers participation in the management, control and ownership of a permanent system of credit for agriculture."

Furthermore, when an institution relies too much on URE to capitalize its operations, the commitment of the membership to the preservation of their cooperative can become so attenuated that they decide to cash in their interest in the accumulated URE by voting to merge their institution with another institution, whether System or non-System, that is willing to operate at a reduced capital level. In this scenario, the acquiring institution effectively buys the target institution with the target's own URE. This is not an idle or theoretical concern, as illustrated by the threatened take-over not so very long ago of a large System association by a large commercial bank.

While there is a legitimate role for URE in a System institution's capital structure, the proposed rule would give it a privileged position that is not warranted. This special status is not to be found in the principles of the Basel III framework which treats URE the same as any other element of CET1 capital and does not require an institution to hold any particular percentage of any particular element. We agree with the Council that requiring a specific percentage of URE in the capital structure of System institutions calls into question the adequacy of all common cooperative equities in the System, which could mislead stakeholders to lose confidence in the System's financial condition, and thereby cause damage to the System and its members.

In addition, in the context of all the onerous economic and administrative burdens that the proposed rule would impose on the practice of allocating and redeeming allocated equities, it is clear that the privileged status of URE in the FCA's eyes is yet another factor that will drive System institutions to abandon allocated equities in favor of cash patronage or no patronage at all and to rely on URE as their primary source of CET1 capital. We do not believe that FCA's capital regulations should include any requirement that creates a bias towards any particular form of operation, but it certainly should not contain a bias that discourages operating on a cooperative basis. Consequently, we agree with the Council's recommendation that the requirement for a specific percentage of URE be eliminated.

OTHER ISSUES:

1. **Higher Risk-Weighting for Rural Electric Cooperatives**

We agree with the Council that the FCA should continue the 50% and 20% risk-weighting for exposures to electric cooperatives under current regulations in consideration of the favorable risk history of this particular sector and the fact that it is a clear part of the System's mission to serve these borrowers. Our ability to purchase participations from CoBank also improves our own portfolio risk profile. Increasing the applicable risk-weight for these assets would reduce our ability to diversify our credit risk.

2. Treatment of High Volatility Commercial Real Estate

Section 628.32(j) of Tthe proposed rule would apply a higher 150-percent risk-weighting to High Volatility Commercial Real Estate exposures, defined at § 628.2 as including,

> The purchase or development of agricultural land, which includes all land known to be used or usable for agricultural purposes (such as crop and livestock productions), provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development.

(Emphasis added). Because this language appears to preclude the valuation from including any potential non-agricultural use of agricultural property for the foreseeable future, it could conceivably apply a higher risk-weight to much of the agricultural real estate that the associations in our district finance today. In our district, particularly in the state of Texas with its diversified economy and some of the largest and fastest growing metropolitan centers in the country, it is difficult to escape non-agricultural influences on valuations even where agricultural land is being used solely for agricultural purposes and there is no present intent on the owner's part to develop the land for any non-agricultural use. We agree, therefore, with the Council's comment that FCA should clarify that loans that are within the scope and eligibility requirements should not be risk-weighted more heavily under this provision just because of the possibility of some potential non-agricultural use or development at some point in the distant future. Farmers and ranchers cannot control demographic growth patterns or other non-agricultural influences that might happen to affect their land. Consequently it would be unfair to curtail their ability to obtain financing for eligible purposes merely because the valuation reflects some non-agricultural influences.

3. Third Party Capital Limits

Section 628.23 of the proposed rule would limit the amount of third party capital a system institution could include in its Tier 1 capital to 33 percent of other Tier 1 capital (i.e., 25 percent of all Tier 1 capital including third party capital), and in its total capital to the lesser of 40 percent of total capital or 100 percent of Tier 1 capital. FCA's intent in imposing these limitations, which are similar to those it has previously imposed on a case-by-case basis in approving the issuance of preferred stock by System institutions, is "to ensure that cooperative ownership continues to predominate in all System institutions, in order to maintain the status of the System as a member-controlled GSE that is owned by and primarily benefits its members."

We agree with the Council that the issuance of third party capital, whatever the amount, does not compromise the cooperative principle of user-control, because the members always exclusively retain all general voting rights, and any rights of third parties to vote on the issuance of preferred stock adversely affecting their rights or to appoint observers to the institution's board will apply regardless of the amount of stock issued. The Council also correctly observes that FCA's proposal itself limits the right of members to decide how much third party capital it is in their interest to allow the institution to issue. It is a basic fact of cooperative organizations that, because they cannot raise capital by issuing common stock to the investing public, they must either obtain capital from their users through stock subscriptions or retained earnings, or from the third party preferred stock market, assuming it is available to them. As the Council notes, if a System institution is experiencing growth because its members are growing, the members may need capital as much as the institution does. We agree with the Council that the members should be able to determine whether the potential burden on earnings from preferred stock dividends is an acceptable trade-off for not having to contribute their own capital to the institution. Consequently, we support the Council's recommendation that the FCA revise the limits to provide more flexibility.

4. <u>Disclosures</u>

We agree with the Council that FCA should eliminate its proposal at § 628.62 to require the same extensive capital disclosures that are required by the U.S. banking regulators for banks with total assets greater than $50 billion. First the four System banks are independent institutions with separate boards of directors, different charters, and diverse business models, and only two of the banks have total assets that would trigger the disclosure requirements under the regulations of the U.S. banking regulators. It is manifestly unfair to impose these requirements on the smaller System banks. Second, the application of these new extensive disclosure requirements only to the banks will complicate the process for developing consolidated district and System-wide disclosures, which is designed to result in consistency in the presentation of all System institution financial statements. We agree with the Council that the proposed disclosure requirement is excessive, and FCA should work with the System to develop appropriate modifications to current disclosures that reflect new capital requirements.

5. <u>Effective Date</u>

We agree with the Council that whatever FCA ultimately decides to do with the proposed rule, the proposed effective date should be changed from January 1, 2016 to at least January 1, 2017. As written, the proposed rule will require System institutions to make substantial modifications to their policies, capitalization bylaws, business and capital plans, business and patronage practices, member disclosures, financial disclosures, and computer systems in order accommodate the new requirements. Even if FCA made no revisions to the rule in response to public comments, it probably could not publish a final rule until well into the second half of the year, and by then, there simply would not be enough time remaining for System institutions to be in compliance by the beginning of the next year. FCA should give the System ample time, preferably close to 12 months from the publication date of the final rule, to implement the new rules whatever they may be.

CONCLUSION:

Our original request that FCA consider aligning its capital regulations with Basel III was motivated by the belief that it is essential for the System's capital requirements to be comparable to those applicable to non-System financial institutions, not only to allow the System to market its securities to investors effectively, but also to enable all other stakeholders, including Congress, rating agencies, counterparties, as well as System borrowers, to assure themselves of the financial strength of the System and its institutions in terms that are commonly recognized and understood in the business community. We also believed that Basel III principles could be reasonably adapted, under footnote 12 of the Basel III framework, to the System in a manner that would be consistent both with the principles and objective of Basel III and the distinctive cooperative structure of the Farm Credit System.

Although the proposed rule nominally includes allocated equities as a component of CET1, as the System requested FCA to do, FCA has placed many significant burdens on the use of these equities as regulatory capital that, in our view, are completely unnecessary to achieve comparability to Basel III requirements. Indeed, the burdens to which we object are all departures from the Basel III framework. We believe that the primary effect of the rule, whether intentional or not, will actually be to discourage System institutions from allocating and redeeming retained earnings to its borrowers, which is the essence of operating under cooperative principles as the Act intends. When viewed in isolation, each one of these new burdens might not appear to be that material, but their cumulative effect will be substantial. Taken as a whole, these burdens in effect represent a tax on System institutions that choose to operate on a cooperative basis.

As FCA is well aware, there are no regulatory requirements that play a more important role in setting the parameters for the strategic management decisions of System institutions than the capital regulations. The message conveyed by the proposed regulations could not be more clear: FCA prefers that System institutions do not allocate and redeem retained earnings to their members at all, under any circumstances, ever, and that instead believes that institutions should capitalize themselves exclusively with URE. We have no doubt that this message will be heard loud and clear by System institutions. Thus, despite having adopted a policy and posted a statement on its website that affirms the FCA Board's support for and commitment to, the core cooperative principles as part of the System's cooperative business model, in adopting the proposed rule as written, FCA would be effectively driving a stake through the heart of cooperative principles in the Farm Credit System.

In summary, for the reasons set forth in these comments and in order the make the proposed capital regulations consistent with the cooperative structure of the System and the principles of Basel III framework, we respectfully ask the FCA to modify the proposed rule as follows:

1. Classify allocated equities as retained earnings under the Basel III definition of CET1 capital.
2. Eliminate the 10-year minimum revolvement requirements for CET1 and the 5-year minimum requirements for Tier 2, and allow all allocated equities to be eligible to qualify as CET1 capital.

3. Include FCB attributed surplus in the definition of a URE equivalent, and include URE equivalents in the definition of URE.
4. Allow periodic equalization of the associations' investment in the bank.
5. Allow the minimum amount of stock required as a condition to borrowing under an institution's bylaws to be counted in CET1 capital, and include this amount in the safe harbor.
6. Exclude the associations' excess borrowing base in the direct loan with the bank from unfunded commitments that require capitalization.
7. Eliminate the requirement for capitalization bylaw amendments.
8. Modify the safe harbor for capital distributions to increase the amount that is distributable to a level that is more consistent with the regulations of the U.S. banking regulators.
9. Include in the safe harbor incidental redemptions for estates and pursuant to court orders.
10. Eliminate the 30 percent/3-year haircut for redemptions made without FCA approval and allow corrective actions to be case-by-case.
11. Eliminate the requirement for a specific percentage of URE and URE equivalents in Tier 1 capital for the purpose of calculating the leverage ratio in favor of a requirement that the CET1 capital should include the amount of URE and URE equivalents as an institution's board of directors determines is prudent and consistent with operating on a cooperative basis.
12. Reduce the Tier 1 leverage ratio from 5 percent to 4 percent in line with Basel III requirements.

If FCA does not make these recommend changes, then we would urge the agency to consider the other clarifications and alternative proposals set forth elsewhere in these comments and in the Council's comments on behalf of the System. These clarifications would not cure, but would help to mitigate the problems that would be generated by the proposed rule. Again, we thank you for your consideration of these comments and the extension of the deadline for submitting them.

Sincerely,

Randy Darnell
Chairman,
Panhandle Plains Land Bank, FLCA, Board of Directors

Greggory S. Lloyd

Greggory S. Lloyd
Chief Executive Officer