November 6, 2020

Mr. David P. Grahn
Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

RE: Proposed Rule – Regulatory Capital Framework: Tier 1/Tier2 Framework – RIN 3052-AD27/ Federal Register Vol. 85, No. 176 (September 10, 2020)

Dear Mr. Grahn:

The Farm Credit Council (FCC), on behalf of its membership, appreciates the opportunity to comment on the Farm Credit Administration's (FCA) Proposed Rulemaking published in the September 10, 2020 Federal Register (Proposed Rule) addressing requirements for the Tier 1/Tier 2 Regulatory Capital Framework.

The following comments and attached answers to the questions posed by FCA were developed after soliciting input from all Farm Credit System (System) institutions. The System's Capital Workgroup, which includes individuals from the finance departments of each System bank (Bank), representatives from several System associations (Associations) affiliated with each of the Banks, the Federal Farm Credit Banks Funding Corporation, and other System representatives developed initial input for these comments. We anticipate that several System institutions will submit their own comments on various aspects of the rule.

The FCC and its members generally support the proposed rule and FCA's intent to update and codify provisions of the Tier1/Tier 2 capital rule that have been addressed through Bookletter and call report instructions. However, certain aspects of this "clean up" regulation are problematic to the FCC and its members. In addition, we believe there are opportunities to address additional items of interest for System institutions which are included below.

Reconciliation of GAAP Capital to Regulatory Capital

The proposed rule clarifies requirements of 628.63(b)(4) relative to Bank disclosure of reconciliation of regulatory capital elements to the balance sheet. We support the clarification that the reconciliation occurs only at the annual audit date. We are also supportive of the requirement to reconcile the capital components as of the financial statement date as required for commercial banks in Basel III. However, we ask that FCA reconsider the requirement to impose a separate requirement to perform a similar reconciliation using 3-month-average regulatory capital components for the following reasons:

50 F Street NW, Suite 900, Washington DC 20001, 202-626-8710

- The external auditor does not audit the 3-month average daily balance as financial statements are on a point-in-time basis. As such, a reference to 'audited' average daily balance values does not exist. While we understand that FCA attempted to mirror the Basel III Pillar 3 disclosure requirements, the FCA capital ratios are inherently different in that they are on a 3-month average daily balance basis rather than point-in-time for institutions complying with Basel III.
- The concept of a reconciliation for Basel III Pillar 3 disclosures is useful for commercial banks because the capital ratios are on a point-in-time basis and the disclosure enhances a user's understanding of how the regulatory capital structure differs from the GAAP accounting capital structure. In the case of the FCA regulations, the capital ratios are based on a 3-month average daily balance, but the financial statements are on a point-in-time basis as required by GAAP.
- We believe that adding the 3-month average reconciliation is unnecessary and confusing. The audited financial reports are becoming increasingly voluminous which ultimately reduces their meaningfulness to stockholders and other users.

Deduction of Capital Invested in Service Corporations

We ask FCA to reconsider the requirement for deduction of investments in Service Corporations from CET1 capital and replace it with a 100 percent risk weighting similar to other investments. The requirement to deduct the investment in Service Corporations is excessive and not consistent with the risk profile of Service Corporations. The requirement to hold dollar for dollar capital against these Service Corporations essentially discourages the formation of these organizations. These organizations provide an efficient means for System institutions to cooperate with other System institutions in providing services to their stockholders in a cost-efficient manner and should be encouraged. Further, since all new Service Corporation formations require FCA charter approval, the appropriate capitalization can be determined and established by the agency on a case-by-case basis. This would align with the treatment afforded to Unincorporated Business Entities (UBEs) as noted in the preamble to the proposed regulations (Federal Register page 55795), where the FCA states, "With respect to the treatment of UBEs, FCA may consider the appropriate regulatory capital treatment of the UBE and apply such treatment on a case-by- case determination, as appropriate."

Treatment of Purchased Stock

By regulation, eligible customers of Farm Credit System institutions are required to acquire a minimum of $1,000 or 2% of the loan amount, whichever is less, in voting stock. While some may establish the $1,000 or 2% as the minimum, others have established $1,000 requirement for all. At origination, or as borrowers repay their loans, the amount of such stock may exceed the 2% minimum (but the dollar amount outstanding is $1,000 or less). Allowing only the lesser of 2% or $1,000 to fall within the "safe harbor" provisions results in a burdensome process to track the holding period for stock that is $1,000 or less but greater than 2%. In addition, when such stock has been held for less than the seven years required for CET1 treatment, the retirement would require System institutions to submit requests to the FCA to allow these de minimis amounts to be retired. Recognizing that such amounts are de minimis in terms of any institution's total capital, we request that FCA specifically recognize a "safe harbor" for retirements of such stock that meet the regulatory minimum requirement or are equal to or less than $1,000, provided the institution otherwise meets applicable minimum capital levels.

Treatment of Allocated Retained Earnings

In the proposed rule, under the topic "Common Equity Tier 1 Capital Eligibility Rules" FCA recognizes that allocated equities fully meet the definition of "paid-in" and therefore, as paid-in capital, allocated equities are considered Common Equity Tier 1 (CET1) capital. We fully agree and appreciate the FCA's recognition that allocated equities are the highest quality (CET1) capital. Based on this logic, we ask FCA to reconsider how allocated equities are treated within the FCA capital regulations—with particular consideration of Basel III comparability. The following paragraphs outline the specific areas where we ask FCA to reconsider how allocated equities are treated in the capital regulations:

1) <u>Minimum Unallocated Retained Earnings (URE) Requirement</u>

We ask that FCA reconsider the requirement for a separate URE component of Tier 1 capital. The URE requirement declares that URE is higher quality capital than other forms of CET1. Identifying a "super" or "superior" CET1 subclass is an unmistakable message to the marketplace that the System's CET1 does not match up with CET1 of commercial banks. The result is reduced comparability and transparency.

Implementation of the 1.5% URE standard within the Tier 1 leverage ratio requirement results in a nearly 3% URE held against each dollar of new loans made by Associations to member-owners, given the dual capitalization resulting from the System's cooperative structure. The "super" CET1 class essentially violates the cooperative principle of user-ownership whereby the owners bear the risk and reward of their cooperative institution. With respect to joint stock companies, Basel III respects the basic principle that stockholders are at-risk and bear the losses of the entity. Functionally, this ownership principle is the same for cooperatives, including FCS institutions. We ask FCA to consider putting the System on par with other regulated financial institutions and remove the "super" CET1 subclass requirement.

Historically, FCA has indicated that FCS institutions need to maintain a minimum URE due to possible variability in operating results-- that URE would buffer cooperative equities from a direct impact if minor losses occurred. Thus, FCA suggested that higher URE levels improved financial flexibility and avoided situations where member-owners may feel compelled to protect their purchased and allocated equity investments by seeking protection from Congress.

This basis for imposing a minimum URE requirement is not consistent with the Basel III framework nor is it supported by actual experience. Over a long period of years, the FCS has managed its capital resources to include an appropriate mix of different types of equity, from URE to third-party capital. History has also shown us that too much URE maintained as a "buffer" only serves to undermine the user-control and user-ownership cooperative principles, contrary to Section 1.1 of the Act, and demonstrates that allocated retained earnings are at least equal to, if not superior to unallocated retained earnings.

Accordingly, we ask FCA to reconsider the requirement for System institutions to retain URE at a specific level within a Basel III framework. We believe this requirement undermines an institution's ability to operate consistent with cooperative principles and the related IRS rules on taxation of cooperatives. The current rule also unnecessarily infringes on a System institution's flexibility to implement governance processes that best support member-owners' ownership, control and engagement. Basel III did not establish URE as a "superior" class of CET1, and given the at-risk and permanent nature of cooperative equities included in CET1 there is little basis for continuing to impose this requirement and only serves to decrease the System's Basel III comparability with other regulated financial institutions.

2) <u>Definition of URE Equivalent</u>

If the FCA retains the URE requirement, we ask the FCA to revisit its definition of URE equivalent with respect to allocated Bank stock held by Associations. Allocated Bank stock arises when a Bank declares patronage, in the form of stock, for a portion of current period earnings. Associations recognize this stock patronage in their current period earnings and accordingly, this income becomes a component of the Associations' unallocated retained earnings. The stock patronage also increases Associations' investment in their funding Bank.

In determining regulatory capital, Associations appropriately eliminate their investment in their funding Bank from assets and from capital, including from URE and URE equivalents. When an Association purchases stock it increases Bank capital. The Bank counts this capital as CET1 capital and the Association appropriately eliminates the purchased investment and an equal offset from capital in the Association's calculation of their capital ratios. With allocated stock, a portion of the Bank's current period earnings are converted into stock and distributed as patronage income to Associations. Because these earnings increase the investment in the Bank, the investment and the increased retained earnings are eliminated for regulatory capital purposes by the Associations. Under the current capital regulations, the Bank counts this capital in CET1 capital.

In the Preamble to the 2014 proposed regulations (Federal Register page 52822), the FCA stated, "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's 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 assets and total assets."

The System believes allowing the Banks to count allocated stock as URE equivalents is consistent with this concept from a regulatory capital perspective. In the worst case scenario, if the Bank incurred losses and completely impaired the allocated equities, while the Associations would take a write-off through current period earnings, their regulatory capital would not decrease. With the write-off through earnings, the investment in Bank would alsobe written down. Since the investment is eliminated from capital and assets, the write-off reflects both a lower level of capital and investment in the Bank and regulatory capital is not impacted, including the retail borrower member stock.

In addition, in the preamble to the proposed regulations (Federal Register pages 55791-55792) the FCA states, "We have reexamined the attributes of allocated equities and determined that they fully meet the definition of paid-in capital: the allocated equities are received with finality by the allocating System institution when earned and issued; their value is reliably established as the dollar value of institution net assets allocated; they are fully under the institution's control because they can be revolved only at the discretion of the System institution, with the prior approval of the FCA; and the loss-absorbing capacity of the allocated equities is not dependent on the creditworthiness of the member-borrower. We do not expect the proposed clarification to have any impact on System institution practices with respect to allocated equities."

The System agrees with the eliminations from capital for both allocated and purchased stock at the Association level. The elimination is appropriate because under the System's dual capital structure, capital should only be counted once. The System also believes the entity counting the capital should be afforded the appropriate regulatory treatment for the characteristics of that element of capital. In the case of Bank allocated stock, we believe that is "paid in capital" as clarified in the preamble referenced above. Unlike purchased stock, allocated stock is setting aside earnings at the Bank with finality by the Bank when earned and issued; their value is reliably established as the dollar value of the Bank's net assets allocated; they are fully under the Bank's control because they can be revolved only at the discretion of the Bank, with the prior approval of the FCA; and the loss-absorbing capacity of the allocated equities is not dependent on the creditworthiness of the Association. We believe it is reasonable for the counted capital to be considered an unallocated retained earnings equivalent at the Bank, consistent with certain other paid-in capital as discussed below.

In Section 628.2 of the FCA definitions, URE equivalents include paid-in capital under certain circumstances to be counted as URE equivalents. "Unallocated retained earnings (URE) equivalents means nonqualified allocated equities, other than equities allocated to other System institutions, and paid-in capital resulting from a merger of System institutions or from a repurchase of third-party capital that a System institution:

(1) Designates as URE equivalents at the time of allocation (or on or before March 31, 2017, if allocated prior to January 1, 2017) and undertakes in its capitalization bylaws or a currently effective board of directors resolution not to change the designation without prior FCA approval; and

(2) Undertakes, in its capitalization bylaws or a currently effective board of directors resolution, not to exercise its discretion to revolve except upon dissolution or liquidation and not to offset against a loan in default except as required under final order of a court of competent jurisdiction or if required under § 615.5290 of this chapter in connection with a restructuring under part 617 of this chapter."

While the existing definition of URE equivalents applies to paid-in capital resulting from a merger or repurchase of third-party capital, the System believes it is reasonable to apply this to Bank allocated stock that is distributed to its affiliated Associations. The System supports the inclusion in URE equivalents be conditioned on meeting the two criteria outlined in the definition above. The date referenced in condition (1) would be reflective of the effective date of the proposed rule or at the time of allocation.

The System agrees with the decision to treat allocated Association stock as CET1 with characteristics of purchased stock. However, we believe the relationship between the funding Bank and Associations is fundamentally different. Under the Farm Credit structure there is a permanence to the funding Bank/Association relationship. The Association investment in its funding Bank does not carry the same uncertainty that stock or allocated equities at Associations carry. There is no expectation of revolvement nor is there risk that an Association would obtain funding from another source. There is a path for reaffiliation; however, reaffiliation is a structured, complex process that has occurred on very rare occasions and has a prolonged path for approval and completion.

Given the permanence of the relationship between the funding Bank and Associations, we believe allocated stock, issued from current period earnings, recognized in current period earnings at the Associations and eliminated from their unallocated retained earnings in calculating regulatory capital, and having all the characteristics of paid-in capital, should be counted as an URE equivalent at the Bank consistent with other similar types of paid-in capital. We would further propose that the permanence of such capital would be evidenced by meeting the two criteria currently required for paid-in capital to be included in URE equivalents in section 628.2 of the regulations.

3) <u>Minimum Holding Period for Allocated Retained Equities</u>

Basel III as implemented by U.S. banking regulators includes all retained earnings and paid-in capital in CET1 for banking organizations they regulate. Basel III recognizes two broad categories of CET1: (1) retained earnings and (2) paid-in capital instruments that meet a 13-factor test.

Basel III does not establish tiers of retained earnings; it does not subtract from retained earnings the amount that a bank has announced that it plans to distribute to shareholders in the normal course of business; it does not apply a discount factor to retained earnings to reflect public market pressures to make quarterly dividend distributions (even when a bank's failure to make a dividend could ultimately increase its cost of funds or threaten its liquidity). Indeed, retained earnings are categorically included in a commercial bank's CET1 notwithstanding that the bank is generally free to distribute in a given year the sum of its total net income for that year plus its retained net income for the preceding two years.

Under FCA's current capital regulations allocated retained earnings must have a minimum term in order to be treated as CET1. While we understand the importance of "permanence" with respect to CET1, there is no basis in Basel III for a holding period for retained earnings. Moreover, an allocated equity with an express minimum term is no more permanent than an allocated equity that is perpetual on its face, particularly when a separate rule requires FCA consent when distributions result in CET1 declining year over year. Accordingly, while it may be beyond the scope of this proposed rule, we ask FCA to consider eliminating the minimum term/revolvement period for allocated equities. As discussed above, allocated equities are simply retained earnings and should be included in CET1 without qualification. In stark terms, the current rule treats an institution's "allocation" of retained earnings as a capital distribution rather than a retention of earnings in the form of capital.

We thank the FCA for the opportunity to provide comments on the proposed rule and for considering our concerns and related requests. We expect that certain other FCS institutions may present additional and supplemental comments and requests. We have included answers to the questions posed by FCA in an attachment to this letter.

Sincerely,

Charles Dana, General Counsel

Enclosure: Q&A

<u>Question 1: The FCA seeks comments on whether the new definition of "Common cooperative equity issuance date" creates a burden for System institutions due to the changes in established controls and processes that may be required. Please provide support for your position.</u>

The System supports use of the calendar quarter end for both equity issuances and dividend declarations. This will provide consistency and clarity and align with financial reporting. We suggest, however, that FCA insert "calendar" before "quarter end" to make it clear that the stock issuance date would be the calendar quarter end. FCA should also be aware that there will likely need to be a distinction recognized between the legal stock issuance date and the quarter end date used for financial reporting and regulatory capital calculations.

<u>Question 2: The FCA seeks comment on the appropriateness of removing the specific reference to Farm Credit Leasing from these provisions.</u>

We believe this change is appropriate. As FCA has noted, as a wholly owned subsidiary, FCL's financials are consolidated with those of CoBank.

<u>Question 3: The FCA seeks comment on the proposed change to the lending limit base, and the continued appropriateness of the adjustment required in § 614.4351(a)(1), and whether its removal would have any significant adverse impacts on any System institution.</u>

In general, the System supports the change to the use of total capital (from permanent capital). We also believe the elimination of stock purchased in connection with loan participations will have minimal impact and will help to simplify the calculations. (As FCA has noted, most System institutions have internal lending limit policies that set far lower limits than required by FCA regulation.)

<u>Question 4: To what extent would the QFC Rules impact System institutions as counterparties to GSIBs or to U.S. operations of foreign GSIBs? For example, if FCA did not amend these definitions, what would be the result?</u>

The System supports these proposed changes. We believe consistency with other Federal financial regulators and ratings agencies is important and simplifies comparisons with capital ratios of publicly traded companies. It will also help to align swap margin rules.

<u>Question 5: The FCA seeks comment on the appropriate deductions and adjustments that should be made to URE and URE equivalents in determining compliance with § 628.10(b)(4).</u>

In general, the System supports including the guidance provided in the Capital Bookletter on adjustments and deductions in the proposed regulatory changes. However, please refer to comments in the body of our letter regarding the capital rules for URE equivalents.

<u>Question 6: The FCA seeks comment on whether any System institution has received an allocated equity investment from a service corporation.</u>

We are unaware of any System institution having received any allocated equites from a System service corporation. Please refer to our comments in the body of the letter with respect to treatment of investments in System service corporations.

Question 7: The FCA seeks comment on the appropriateness and usefulness to internal and/or external stakeholders of completing the reconciliation using both point-in-time and average daily balance values?

The System is supportive of requiring banks to reconcile regulatory capital elements to point-in-time balance sheet values in their audited financial statements. However, the System is not supportive of requiring banks to reconcile regulatory capital elements to average daily balance values. We believe adding the 3-month average reconciliation is unnecessary for System banks and confusing to users of the financial statements while providing limited, if any, value to stakeholders. However, each of the banks would be willing to complete this reconciliation as requested by FCA on an ad hoc basis if necessary. Please refer to comments in the body of our letter for further discussion of this issue.

Question 8: What, if any, changes to the permanent capital regulations (§§ 615.5201, 615.5206, 615.5207, and 615.5208) should be made to increase their clarity and understanding?

In general, the System supports efforts to minimize use of the term "permanent capital" and the associated calculations and reporting of it. We recognize that "permanent capital" is specifically referenced in the Farm Credit Act, but believe its use can often add to confusion by third parties who understand and use the term "total capital". Accordingly, we support efforts to align the calculations for permanent capital with those of total capital to the extent possible, while minimizing the required calculations and disclosure of permanent capital and associated ratios.

Question 9: Is calculating permanent capital burdensome for System institutions? If so, are there any changes FCA could make to this calculation that would reduce this burden, considering that the definition of permanent capital in the Act precludes us from changing the components of permanent capital?

We believe the calculation of permanent capital is burdensome. We support eliminating this reporting requirement from published financial reports. To the extent it is reported, it should only be done in call reports. Disclosure of permanent capital to stockholders and other users of the financial statements is confusing and without any real benefit. It distracts from the Basel-comparability that the System and FCA seek to achieve with financial disclosures.

Question 10: Should FCA more closely align the permanent capital calculation with the total capital (tier 1 and tier 2) calculations? If so, how could FCA accomplish this, considering that for permanent capital, the Act specifies deductions related to bank and association allotment agreements?

See #8 and #9 above.