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December 19, 2008

Mr. Gary K. Van Meter
Deputy Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Subject: Farm Credit System (FCS) Reply to the October 31, 2007 Farm Credit Administration (FCA) Advance Notice of Proposed Rulemaking (ANPR) re: Capital Adequacy – Basel Accord

Dear Mr. Van Meter:

On behalf of the FCS, the Federal Farm Credit Banks Funding Corporation (Funding Corporation) is pleased to reply to the October 31, 2007 FCA Capital ANPR and applauds the FCA for asking 17 questions to obtain advanced public input into its rulemaking process. As you know, through the FCS Presidents Planning Committee, the FCS has formed a Capital ANPR Workgroup with this letter being its formal reply to the ANPR. The Workgroup consists of representatives from numerous associations representing each district from the System and all the System banks as well as the Funding Corporation.

The FCS wishes to preface its reply to the ANPR by addressing two fundamental areas of its regulatory capital regime.

First, while the focus of the ANPR is on modifications to the risk-based capital rules for FCS institutions that are similar to the Standardized Approach delineated in the New Basel II Capital Accord, over time, we believe that an internal ratings-based (IRB) approach should be considered. Advantages of an IRB approach include:

1. It represents industry best practice.
2. It supports improved risk management.
    a. It's comprehensive, as A/L, credit, operational, and market risks are considered.
    b. Emphasizes risk identification vs. type of loan, reinforcing that not all loans represent similar risk, thereby increasing the likelihood that capital levels will reflect true risks.
    c. Produces greater sensitivity, as capital requirements based on internal ratings can be more sensitive to drivers of credit risk and economic capital.

   d. Drives off of probability of default (PD) and loss given default (LGD) for each individual exposure.
   e. A PD and LGD focus underscores and reinforces pricing loans for risk.
   f. Correlations of defaults within sectors (e.g., corn) and between sectors (e.g., rural residence vs. dairy) are key assumptions.

3. It is a flexible framework – all different assets can be accommodated.
4. An appropriately-structured IRB approach can provide a framework that encourages continued improvement in internal risk management practices.
5. As all FCS banks use the same risk rating, LGD framework and economic capital model, the FCS regulatory environment is much more consistent than that of commercial banks with this consistency supporting an IRB approach.
6. Movement in the IRB direction would make the FCS a stronger lender over the long term and strengthen basic disciplines of risk management.
7. An IRB approach would provide an option for those wanting to follow a more rigorous risk management practice. It would result in a more accurate measure of actual risk that most likely would reflect a more reasonable capital requirement than the Standardized Approach.

Accordingly, we suggest a joint IRB developmental program between the FCA and the FCS, similar to the program followed by commercial banks and their regulators. This should include the FCA considering supplementing their 5-point Uniform Classification System for loans with the FCS' 14-point risk rating system which has been adopted by all System institutions. In this manner, the goals of the FCS and the FCA are aligned. Further, the FCS and the FCA can better follow the progress of commercial banks using the IRB approach. Note that we envision this to be a 3- to 5-year endeavor once commenced.

Second, relative to the Standardized Approach, we urge development of regulations that are consistent with the approach adopted by the other Federal regulators making only modifications that are justified by unique characteristics of loans made by the System. This includes closely aligning capital regulations utilizing standardized definitions of Tier 1/Tier 2 Capital versus current definitions of Core Surplus, Total Surplus, Net Collateral and Permanent Capital utilized by FCA. This would facilitate equitable comparisons between System institutions and commercial banks by rating agencies and capital market investors relative to capital adequacy. We believe that alignment of capital definitions is extremely important to enable the System to operate on a level playing field with commercial banks in accessing the capital markets. To this end, we have enclosed a November 2008 FCS paper titled "Assignment of Capital Under a Tier1/Tier2 Structure" which explains our rationale for such assignment of FCS bank and association capital (see Exhibit I).

Precedent to adopting this two-tiered structure, most all allocated equities and purchased equities should be treated as Tier 1 Capital whether held by FCS entities or non-FCS borrowers.

Accordingly, we have enclosed a November 2008 FCS paper titled "A Discussion of Treating Allocated and Purchased Equities as Tier1 Capital" (Exhibit II) supporting this rationale.

Moreover, the other bank regulators currently have additional authority under the capital structures of the banks they regulate which is known as Prompt Corrective Action (PCA). In PCA, there are five capitalization categories ranging from Well Capitalized to Critically Undercapitalized (see chart below). Certain actions are required by banks in the lowest three categories including the development of a capital restoration plan, limitations on asset growth, restrictions on new lines of business and limits on business with affiliates, etc. If a bank's tangible equity falls below 2 percent of its assets, the regulator would appoint a receiver to liquidate the bank.

If FCA adopts the Tier 1 Capital regime as appropriate for the System, FCA should consider whether this enforcement approach along with the numerical levels used by other bank regulators, together with or in place of FCA's existing powers, should be used to address deteriorating capital adequacy issues and concerns.

Category	Total Capital	Tier 1 Capital	Leverage
Well Capitalized	10% *and*	6% *and*	5%
Adequate	8% *and*	4% *and*	4%
Undercapitalized	Under 8% *or*	Under 4% *or*	Under 4%
Significantly Undercapitalized	Under 6% *or*	Under 3% *or*	Under 3%
Critically Undercapitalized	Tangible Equity Under 2%		

As to the System's response to the individual 17 questions, these are based on the following philosophies:

1. Because the System's growth has required the use of external equity capital, the System is in regular contact with the financial community, including rating agencies and investors. Obtaining capital at competitive terms, conditions, and rates requires these parties understand the System's and individual institution's financial position, making consistency with approaches used by other regulators, rating agencies, and investment firms a requirement to enhance the capacity of the System to achieve its mission.
2. Consistent with the above statement, the System believes definitions of capital and regulatory ratios should be consistent with regulations of other regulators.
3. For the System to achieve its mission, the System must be able to compete with other lenders. Therefore, FCA's capital regulations must result in a regulatory framework that provides for a level playing field, in addition to safe and sound operations.
4. Responses to the ANPR include recommendations that are well defined and easy to measure, requiring minimal changes to information gathered or information systems.
5. Deviations from the other Federal banking regulations should be requested only when there are unique characteristics of the System's structure or nature of the loan portfolio to justify unique treatment.

With that said, the System offers the following responses by paraphrasing the question and then providing our answer.

<u>Question 1</u>: We seek comment on what additional risk-weight categories, if any, we should consider for assigning risk weights to System institutions' on- and off-balance-sheet exposures. If additional risk-weight categories are added, what assets should be included in each new risk-weight category?

Comments:

We suggest the following risk weights:

- 0% risk weight for U.S. government guaranteed portions of loans, investments, or successor-in-interest contracts backed by the full faith of the U.S. government.
- 20% risk weight for AA rated investment securities and electric cooperative loans with high investment grade ratings.
- 35% risk weight for prudently underwritten and adequately secured residential home loans and qualified residential loans (adequate FICO score – 680+, loan to value does not exceed 85%, verified income sufficient to service the loan). Also the FCA should consider a 35% risk weight for well underwritten agricultural real estate loans (see question 7).
- 50% risk weight on electric cooperative loans that meet certain criteria.
- 75% risk weight for loans that meet the specified criteria for consideration as a retail portfolio.
- 100% risk weight for all other loans except those that are troubled or have a high loan-to-value ratio.
- 150% risk weight for certain troubled loans (see Question 8).

These risk weights are in line with those of other Federal bank regulators under the Standardized Approach.

<u>Question 2</u>: We seek comments on all aspects of the appropriateness of using NRSRO ratings to assign risk weights to credit exposures. If we expand the use of external ratings, how should we align the risk-weight categories with NRSRO ratings to determine the appropriate capital charge for externally rated credit exposures? Should any externally rated positions be excluded from this new ratings-based approach? We ask commenters to consider the substantial reliance on NRSRO ratings as a means of evaluating the quality of debt investments in view of recent events in the subprime mortgage market.

Comments:

NRSRO ratings should be used for all assets where such ratings are available and mirror those in use by commercial banks. FCA should periodically review risk weight categories to ensure that risk weights remain appropriate, accurate, relevant, and consistent with other regulatory agencies. FCA regulations should also require periodic review of the NRSRO rating to ensure the external rating continues to support the appropriate risk weighting. An exposure with multiple external ratings would be assigned a risk weight consistent with the lowest external rating. Responses to the situation in the subprime markets will enhance the accuracy of the rating process as the ratings agencies face Congressional and SEC oversight. The agencies' primary asset is credibility, which must be restored if they plan to protect their franchise.

The System believes all NRSROs should be used. NRSRO is defined as an entity registered with the U.S. SEC under section 115E of the Securities Exchange Act of 1934 (15USC 780-7). We believe the SEC has established procedures for companies to earn the NRSRO designation. Congress and the administration have pressed the SEC regarding approval criteria as a result of the financial crisis related to Enron and the subprime mortgage crisis. [See President's Working Group on Financial Markets (PWG).] We do not believe that FCA should attempt to categorize these companies or duplicate the SEC's role.

Question 3: We seek comment on whether recognizing additional types of eligible collateral would improve the risk sensitivity of our risk-based capital rules without being overly burdensome. We also seek comment on what additional types of collateral, if any, we should consider and what effect the collateral should have on the risk weighting of System exposures.

Comments:

We recommend utilizing the simplified approach where the collateralized portion of the exposure is assigned a risk weight according to the external rating of the collateral. The remainder of the exposure would be assigned a risk weight appropriate to the counterparty. Collateral would be subject to a 20-percent floor, unless the collateral is cash, certain government securities, or re-purchase agreements, and the collateral would be marked-to-market and revalued every six months.

Question 4: We seek comment on what additional types of third party guarantees, if any, we should recognize and what effect such guarantees should have on the risk weighting of System exposures.

Comments:

FCA regulations should be consistent with the Standardized Approach under Basel II. Utilizing this approach, the agency would not need to forecast all of the different types of future transactions that the System may enter. Farm Credit institutions would also be on a level playing field with commercial banking institutions.

Relative to the treatment of GSEs, Fannie Mae and Freddie Mac have retained their AAA status through the recent financial crisis due to the U.S. government interceding with a capital infusion, making the "implicit guarantee," essentially "explicit." The FHLB and FCS debt remains AAA partially due to the "implicit guarantee." Alternatively, Farmer Mac debt remains unrated but was provided a recent capital infusion by its owners. According to Farmer Mac's December 3, 2007 10-K, "Farmer Mac is a government sponsored enterprise that is governed by a statutory charter controlled by the U.S. Congress and regulated by governmental agencies." Farmer Mac also discloses it has the ability, "in extreme circumstances" to issue obligations to the U.S. Treasury in a cumulative amount not to exceed $1.5 billion. Although Farmer Mac is currently experiencing certain financial difficulties, if those are adequately resolved to FCA's satisfaction, we believe that the FCA should treat Farmer Mac as a GSE. Accordingly, the System believes all GSE obligations should have the same risk weight.

Question 5: We seek comment on what evaluative criteria or methods we should use to assign risk weights to direct loans to System associations. How should the criteria be used to adjust the risk weight as the quality of the direct loan changes over time?

Comments:

The System believes that direct loans to associations should continue to be 20 percent risk weighted. This recognizes the fact that the FCA will almost certainly retain their powers embodied in Regulation 615.5210(f), Reservation of Authority, whereby FCA may judgmentally on a case-by-case basis, impose a different risk weight if conditions so warrant. The System cannot anticipate what those future negative conditions might be and accordingly offers no commensurate risk weighting.

Moreover, we suggest that this question could be readdressed after the before-mentioned joint IRB developmental program between the FCA and the FCS is completed. In this way, empirical data would be available to better assign a risk weight to direct loans to associations.

Question 6: We seek comment on what approaches we should use to improve the risk sensitivity of our risk-based capital rules for small agricultural and rural business loans. More specifically, what criteria should we use to classify an agricultural or rural business as a small business? What criteria should we use to assign risk weights of less than 100 percent to these types of loans?

Comments:

The FCA should build as much consistency into its regulations as possible. The agency has provided direction to serve young, beginning, and small farmer and rancher market segments. Most of these loans are underwritten using scorecards. Criteria for retail loans to be risk weighted 75% should include:

- Exposure is to an individual person or persons or small business.
- Total credit exposure to the borrower does not exceed $250,000.
- The exposure is a line of credit, term loan, or lease. Securities should be excluded from this category.
- No aggregate exposure to any one counterparty may exceed 1.0% of the overall regulatory retail portfolio.

A parallel to this position can be found in the other Federal regulators proposed regulatory retail exposure criteria for a 75% risk weighting:

- Aggregate exposure to a single obligor is less than $1MM.
- Exposure is part of a well-defined portfolio.

- Exposure is not to a sovereign entity, ... depository bank, construction loan, residential mortgage exposure, securitization exposure, equity exposure, or a debt security.
- 0.2% limit on aggregate exposure to one borrower.

The System's recommendation is more conservative than the other regulators proposed regulation relative to exposure to one borrower at $250,000. We believe the more conservative name concentration supports the aggregate exposure limit of 1% for any one exposure.

Note also that the System's loss experience during the 1980's supports such an approach. In addition, loss studies conducted by the System support the concept that lower losses are experienced on loans less than $250,000. This is due to a borrower's ability to seek off-farm income to support debt servicing on small loans. Repayment of loans larger than $250,000 generally requires repayment from the business enterprise and generally cannot be serviced by off-farm employment. Data to support this recommendation was embedded in information provided the agency when initial scorecard programs were implemented.

Question 7: We seek comment on all aspects of using LTV to determine the appropriate risk weight for farm real estate, qualified residential loans, or any other asset class. We also welcome comments on other methods that could be used to improve the risk sensitivity of our risk-based capital rules for these types of loans.

Comments:

Rural residence and qualified residential property – The other Federal regulators capital requirements for residential property will likely have the following criteria:

- First lien residential mortgage.
- Owner occupied or rented
- Prudent underwriting
- Not past due 90 days and not nonaccrual

Loan to Value Ratio %	Risk Weight %
<60	20
<80	35
<85	50
<90	75
<95	100
>95	150

We believe FCA should be relatively consistent with the other Federal banking regulators. Since by regulation, rural residential loans are limited to 85% L/AV, the vast majority of loans on rural residences will be risk weighted at 35% or less. FCA should consider simplifying regulations by establishing a 35% capital requirement for all rural residence loans.

In order to simplify capital calculations, we recommend that FCA utilize an approach using both funded balances and unfunded commitments to calculate the L/AV ratio. We also recommend that FCA regulations utilize principal, not principal and interest, to avoid situations where loans are in compliance at origination but become out of compliance due to interest accrual.

Absent these simplified approaches, we believe the System should operate on a level playing field with commercial banks and mirror their requirements.

The System's utilization of Private Mortgage Insurance (PMI) is limited, but we believe regulations should provide for reduction in residential mortgage exposure up to an amount covered by loan level PMI. We do not believe pool-level PMI should be used to adjust the calculation of the L/AV ratio.

Agricultural real estate – The other Federal regulators' NPR identified that most commercial banks have limited real estate loans other than residential real estate and commercial real estate. This is quite different from System institutions that primarily finance agricultural real estate. Accordingly, the other Federal regulators finalized their regulations with L/AV capital regulations only on residential real estate.

With a high percentage of System assets representing agricultural real estate (estimated at 65% of loan assets), it is important that FCA implement an L/AV approach to achieve greater risk sensitivity. This recommendation is consistent with one of the System's core philosophies regarding these capital regulations to keep the Standardized Approach simple and utilize existing data.

First lien, agricultural real estate loans typically amortize over time. Time since origination has been shown to be a meaningful indicator of risk. However, not all real estate loans amortize and/or they may amortize at different speeds. L/AV reflects both the amortization and collateral risk. We recommend that FCA utilize L/AV as a means of assigning risk weights as follows:

Loan to Value Ratio %	**Risk Weight %**
<40%	35%
<50%	50%
<65%	75%
>65%	100%

System bank and association LGD databases support reduced risk weighting for loans having a lower L/AV. For example, a district bank's database of more than 5,000 defaulted loans resolved from 1/1/02 through 12/31/07 documents average LGDs for loans in the following L/AV ranges:

Loan to Value Ratio %	Avg LGD
<50%	6.0%
<65%	8.8%
>65%	10.5%

A large association's LGD database of mortgage loans resolved since 2002 provides the following additional documentation of smaller losses on loans having a lower L/AV:

Loan to Value Ratio %	Avg LGD
<65%	0%
>65%	13.1%

<u>Question 8</u>: We seek comment on all aspects related to risk-weighting exposures that reach 90 days or more past due or are in nonaccrual status.

Comments:

Consistent with other comments herein, the Standardized Approach appears reasonable, and consistent with other regulators as a desired outcome. We see no reason to deviate from the Standardized Approach.

Under the Standardized Approach, the unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days net of specific provisions (including partial write-offs), is risk weighted as follows:

- 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan,
- 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan, and
- 100% risk weight when specific provisions are no less than 50% of the outstanding amount of the loan, but with supervisory discretion to reduce the risk weight to 50%.

We do note that the other Federal regulators may be moving toward a simplified approach whereby all loans that are 90 days or more past due or are in non accrual will be 150% risk weighted regardless of specific provisions. Alternatively, we continue to believe that risk weights should consider specific provisions as stated above.

<u>Question 9</u>: We seek comment on what approaches we should use to risk weight short- and long-term commitments that are not unconditionally cancelable.

Comments:

We recommend that the definition of a short-term commitment is less than 14 months. We believe that this definition reflects the growing/marketing season of most farm production, which the agency has recognized in current regulations. Short-term commitments less than 14 months should have a 20% percent conversion factor which is consistent with the proposal by other Federal regulators.

Long-term commitments (greater than 14 months) should continue to have a 50 percent conversion factor.

<u>Question 10</u>: We seek comment on what methods we should use to adjust the risk weight of credit exposures as the asset quality or default probability changes over time.

Comments:

The System's research (FCA has obtained this research information through their examination process) indicates that for term loans, particularly real estate loans, time from origination is a significant indicator of the probability of default, due to several factors:

- If a series of payments has been made, the demonstrated performance indicates a higher probability of financing a successful business.
- The owner's equity in the asset is likely to be higher.
- Loan balance relative to collateral value typically is lower.

The probability of default may not decline in situations involving multiple loans. Probability of loss on an individual loan may be less, but the probability of default may be driven by the borrower's total indebtedness. Recognizing these factors, we recommend utilizing the previously-described loan to appraised value approach described in our response to question 7, rather than a time from origination approach.

<u>Question 11</u>: We seek comment on what approach we should consider, if any, in determining a risk-based capital charge for operational risk.

Comments:

The other bank regulators stated that their inclusion of a factor for operational risk is driven by a desire to promote improved risk measurement processes. Accordingly, they use the Basic Indicator Approach (BIA) which is defined as 15% of the positive income over the past three years times 12.5 to calculate the risk weighted assets. The following analysis was completed to show the BIA applied to System banks only (no associations).

Basic Indicator Approach	2007	(millions $) 2006	2005
Net Interest Income	1,333	1107	1003
Non Interest Income	99	133	112
Positive Income	1,432	1,240	1,115
Three-Year Average Positive Income	1,262		
Times	15.0%		
Equals	189		
Times	12.5		
Risk-Weighted Assets for Operational Risks	2,367		
Capital for Operational Risks @ 8%	189		
Capital for Operational Risks @ 7%	166		
Capital for Operational Risks @ 12/31/07 ERisk Economic Capital Model	216		
Divided by Bank Capital	9,095		
% of Bank Capital	2.4%		

You will note that the BIA applied to System banks would generate risk weighted assets of $2.4 billion or a capital requirement of approximately $189 million utilizing an 8% OCC capital requirement against risk weighted assets and $166 million requirement utilizing the 7% FCA requirement. This compares to the bank-only economic capital requirement (calculated by our proprietary models) of $216 million for operational risks or 2.4% of combined bank capital. Therefore, we believe both the BIA and the economic capital model support our argument that operational risks represent an insignificant part of the System's risk. Additionally, we believe FCA regulations establish sufficient regulatory framework such that FCA does not need to incorporate operational risk into capital regulations to promote improved risk management processes.

In the event that FCA determines an operational risk capital factor is necessary, FCA regulations should follow the BIA, modified to recognize the unique features of the System by excluding patronage income from the banks to associations. Additionally, the FCA should also consider the comparatively smaller operating risk of the FCS since it does not have a deposit-taking business for its funding nor does it offer the broad product set of commercial banks.

Question 12: We seek comment on all aspects of the Basel II public disclosure requirements. Specifically, how would the System apply the public disclosure requirements of Pillar III given its unique cooperative structure?

Comments:

It is not necessary to identify disclosure requirements in these capital regulations because they are specifically addressed in other sections of FCA regulations, including the requirement for consistency with GAAP. We recognize that Pillar III of the Accord establishes a standard for disclosure and would expect requirements of System entities to be consistent with "best practices."

Question 13: We seek comment on whether our capital rules should include a minimum capital leverage ratio requirement for all System institutions. We also seek comment on changes, if any, that should be made to the existing regulatory minimum NCR requirement applicable to System banks that would make it more comparable to the Tier 1 ratio used by the other Federal financial regulatory agencies.

Comments:

The System wishes to be measured in a manner parallel to that of commercial banks. Accordingly, a Tier 1 unweighted leverage ratio under a Basel II Standardized Approach is appropriate for all System institutions including associations. In so doing, this would buttress FCA capital regulations from imperfection in the risk weighting of assets. The current Net Collateral Ratio (NCR) for System banks is similar to the Tier 1 leverage ratio but has two differences. First, capital invested in banks but counted by associations is deducted from bank capital. This should be continued in a Tier 1 regime. Second, pledged assets, such as collateral posted to counterparties in derivative transactions, reduces assets in the NCR calculation. This would not be the case in a Tier 1 leverage ratio calculation.

Question 14: We seek comment on revising our current capital directive regulations to include an early intervention framework. We also seek comment on potential financial thresholds, such as capital ratios or risk measures that would trigger an FCA capital directive action.

Comments:

Intra-System Agreements, such as Contractual Interbank Performance Agreement (CIPA) and Market Access Agreement (MAA), are designed such that issues are managed prior to the need for regulatory action. In addition, as an arms-length regulator, the FCA has authority to take whatever actions are necessary to prevent unsafe and unsound lending practices. However, the FCA could consider "Prompt Corrective Action" type authorities as utilized by Federal banking regulators if they feel these are helpful.

Question 15: We seek comment on the most appropriate risk-based capital framework for the System and the reasons we should implement one framework over another. Should we consider creating a uniform regulatory capital structure for the System or a multi-dimensional regulatory structure and allow each System institution the option of choosing which capital framework it will apply? How might this new risk-based capital framework increase the costs or regulatory burden to the System? Would the increased costs be justified by improved risk sensitivity, risk management, and more efficient capital allocation?

Comments:

The System is sufficiently complex today. If the System and FCA agree on a capital regulation similar to the Standardized Approach, there are merits in having all institutions regulated under the same framework, eliminating the opportunity for arbitrage.

We believe that the Standardized regulatory framework should be applied to all institutions regulated by the FCA. We note the unlevel playing field between capital regulations for Farmer Mac and other System institutions and believe capital requirements should be very similar for the same loans.

We believe, consistent with commercial bank regulators, that System institutions should be able to utilize the Internal Ratings Based approach. We believe the FCA has a unique opportunity to support advanced risk management practices that the System has developed over the past few years by providing the option to utilize the advanced approach. We believe that utilization of this approach and close regulatory monitoring of its implementation would assure safe and sound practices consistent with FCA's regulatory capital objectives. We seek FCA's commitment in these regulations to an effort to improve risk sensitivity by a joint System/FCA process of understanding economic capital and an internal rating based regulatory framework over the next 3 to 5 years, beginning in 2009.

Question 16: We seek comment on an appropriate timetable for implementing our new risk-based capital rules. Specifically, what is an appropriate time interval between the issuance of the other Federal financial regulatory agencies' final rule on the standardized approach of Basel II and ours? How long should the transition period be to allow the System to adjust to the new risk-based capital rules?

Comments:

The FCA should not be driven by concern over the issuance of rules by other financial regulatory agencies. The System is not impacted by international transactions as are institutions regulated by the OCC or FRB. As to timing, we encourage the FCA to swiftly issue the NPR on its version of Basel II Standardized Approach. Consistency with other federal banking regulators can be achieved as their NPR has already been issued. In so doing, the System will be on a level playing field with commercial banks.

While the time element is not critical, ultimate consistency with those regulators is important for competitive reasons, as well as to minimize misunderstanding of rules and regulations as employees move from commercial banks to the System.

Question 17: Additionally, we seek comment on any other methods that may be used to increase the risk sensitivity of our risk-based capital rules.

Comments:

Please see our introductory comments included in this letter.

Again, thank you for the opportunity to reply to the 17 questions in this ANPR. Note that the System would be pleased to dialogue with the FCA on this reply.

Sincerely,

Jamie B. Stewart, Jr.
President and CEO
Federal Farm Credit Banks Funding Corporation

EXHIBIT I

12/19/2008

ASSIGNMENT OF CAPITAL UNDER A "TIER 1/ TIER 2 STRUCTURE"

by the Farm Credit System Capital Adequacy Workgroup

The System recommends that FCA establish new capitalization regulations that closely follow those of commercial banking regulators. Assuming that approach, the following summarizes the System's recommended assignment of capital to the "Tier 1 / Tier 2 Structure" consistent with the Basel II Standard approach.

ASSOCIATION CAPITAL

Unallocated Retained Earnings – ***Tier 1***

Unallocated Retained Earnings are the most stable form of capital, as there is no plan, practice, or expectation of retirement.

Non-qualified Allocated Surplus not subject to revolvement – ***Tier 1***

Many associations designate a portion of their retained earnings as non-qualified allocated surplus. The "non-qualified" designation indicates the association, and not the borrower, is liable for taxes on the underlying earnings in the year of allocation. The "non-revolving" designation is an indication to the association member that no redemption is anticipated (i.e., the notice simply makes the member aware that his ownership interest in the association has increased such that, in the event of liquidation of the association, the member has a larger claim on the excess of assets over liabilities). Such notices of allocation are superior to unallocated surplus from a tax perspective because such notices of allocation preserve a tax deduction for the association in the unlikely event the allocated surplus is ever retired (i.e., they preserve single taxation).

Given that the allocation has no financial impact on the member (i.e. the member does not pay taxes on the income allocated) and the notice clearly indicates no plan of redemption, the risk-bearing capacity is very similar to that of unallocated retained earnings.

Non-qualified Allocated Surplus subject to revolvement – ***Tier 1***

Cooperatives typically capitalize themselves through allocated surplus. To ensure the cooperatives continue to be capitalized by current membership, they revolve (i.e., retire) allocated surplus on a "first in, first out" basis, to the extent the capital is not needed.

Associations may use non-qualified notices of allocation as a part of their revolvement program. As indicated above, the non-qualified notices do not trigger any tax at the member level. Rather, the member is taxed only when the allocated surplus is revolved. However, an expectation of revolvement is established with the member via the notice of allocation.

Non-qualified Allocated Surplus should qualify as Tier 1 capital because, while there is an expectation of revolvement, the timing of any revolvement is entirely at-risk and subject solely to the discretion of the association's board of directors. Further, FCA may restrict the retirement of equities of an institution if such retirement would result in the institution having insufficient capital.

Qualified Allocated Surplus – ***Tier I***

As mentioned above, cooperatives typically capitalize themselves through allocated surplus. To ensure the cooperatives continue to be capitalized by current membership, they revolve (i.e., retire) allocated surplus on a "first in, first out" basis, to the extent the capital is not needed.

Associations may use qualified notices of allocation as a part of their revolvement cycle. Unlike the non-qualified surplus discussed above, qualified notices trigger taxes at the member level and the association enjoys a tax deduction for the amount allocated. Qualified notices of allocation establish an expectation of revolvement both in terms of the associations' stated intentions and in terms of the member having paid taxes on cash that will not be received until the allocated surplus is retired.

Qualified Allocated Surplus should qualify as Tier 1 capital because they are totally at-risk and, while there is an expectation of revolvement, the timing of any revolvement is subject solely to the discretion of the association's board of directors. Also, to qualify as a deduction for the association upon allocation, a portion of the association's patronage has to be paid in cash. This cash payment generally offsets the member's current year taxes on the overall allocation, thus mitigating the tax-driven pressure to revolve the surplus in the near term. Note that in the event of a write-off of the allocated surplus by the borrower, they do benefit from a tax deduction. Further, FCA may restrict the retirement of equities of an institution if such retirement would result in the institution having insufficient capital.

Additional Paid In Capital (Due to Merger) – ***Tier 1***

This type of capital is essentially the retained earnings of the acquired entity in a merger under SFAS 141(R), which becomes effective 1/1/09. The acquired entity's retained earnings may be further increased or decreased due to changes in the fair value adjustment of acquired assets and liabilities.

Non-cumulative Perpetual Preferred Stock – ***Tier 1***

Given the perpetual nature and no obligation to accumulate dividends, such stock should be considered Tier 1.

Unprotected Stock – ***Tier 1***

Statute and regulations clearly establish unprotected common stock as "at risk". While such stock is commonly retired in conjunction with loan pay-offs, such retirement is always subject to board of director discretion. Boards commonly delegate to management and / or approve ongoing retirement programs only as long as such actions do not compromise the associations' capital adequacy. Note that this stock is most likely issued in nominal amounts.

Preferred Stock – ***Tier 2***

Preferred stock issued by associations is typically issued to members. Disclaimers inform members that retirement is subordinate to debt instruments and subject to board of director discretion. However, such stock is typically marketed as an alternative to commercial banks' money market instruments. As such, members' have a high expectation that such stock will be retired. Also, the members' investment horizons are relatively short, so the capital would be viewed as temporary. Because the preferred stock is subordinate to association debt, it should qualify as capital, but the temporary nature suggests such stock should be Tier 2.

Preferred Stock to 3rd Party Investors – ***Tier 1 or Tier 2***

Associations have discussed issuing preferred stock to outside, 3rd party investors. The characteristics of that particular issue would determine it to be classified as either Tier 1 or Tier 2 (see below the parallel treatment of preferred stock for banks).

Allowance for Loan Losses – ***Tier 2***

The allowance for loan losses is considered to be Tier 2 capital, subject to certain limits, by commercial banking regulators. These limits consist of including the general portion only of the ALL up to 1.25% of risk-weighted assets. The nature of loan loss reserves in the Farm Credit System is no different than that of other lenders. As such, capital treatment should be consistent.

Protected Stock – ***Not Counted***

Associations are required to retire protected stock at par value. Given this requirement, such stock is more akin to a liability than a capital instrument.

Subordinated Debt – ***Tier 2***

Subordinated Debt is due date paper that has certain capital characteristics. This is Tier 2 regulatory capital because of the due date.

BANK CAPITAL

Unallocated Retained Earnings – ***Tier 1***

Unallocated Retained Earnings are the most stable form of capital, as there is no plan, practice, or expectation of retirement.

Allocated Common Stock to Associations – ***Tier 1***

Treat the allocated stock as Tier 1 capital to the extent counted by the bank and associations in the capital counting agreements. Allocated stock is at-risk. Such stock is subject to capital counting agreements, whereby the Bank and Associations may enter into an agreement as to which institution "counts" the stock as regulatory capital.

Regulatory Capital Counting Agreements do not reduce the permanency of Allocated Common Stock. This capital is reflected on the District financial statements as Unallocated Retained Earnings, which is Tier 1 capital. In addition, FCA regulations currently recognize the enhanced capital characteristics of Allocated Common Stock by allowing it to be included in the Total Surplus Ratio. Also, due to the tax implications associated with Allocated Common Stock, it is unlikely to be retired in the future.

Purchased Common Stock – ***Tier 1***

Purchased Stock is at-risk. While banks typically adjust stock levels through retirements or required subscriptions as association borrowings fluctuate, any retirement is always at the discretion of the bank's board of directors.

Nonqualified Allocated Stock to Cooperatives not subject to retirement – ***Tier 1***

The same logic that applies to association Nonqualified Allocated Surplus applies to this type of capital.

Qualified Allocated Stock to Cooperatives not subject to retirement – ***Tier 1***

The same logic that applies to association Qualified Allocated Surplus applies to this type of capital.

Additional Paid In Capital (Due to Merger) – ***Tier 1***

This type of capital is essentially the retained earnings of the acquired entity in a merger under SFAS 141(R), which becomes effective 1/1/09. The acquired entity's retained earnings may be further increased or decreased due to changes in the fair value adjustment of acquired assets and liabilities.

Non-cumulative Perpetual Preferred Stock – ***Tier 1***

Given the perpetual nature and no obligation to accumulate dividends, such stock should be considered Tier 1.

Allowance for Loan Losses – ***Tier 2***

The allowance for loan losses is considered to be Tier 2 capital, subject to certain limits, by commercial banking regulators. These limits consist of including the general portion only of the ALL up to 1.25% of risk-weighted assets. The nature of loan loss reserves in the Farm Credit System is no different than that of other lenders. As such, capital treatment should be consistent.

Other Preferred Stock and Subordinated Debt – ***Tier 2***

The subordinated nature of preferred stock with cumulative dividends and/or a mandatory redemption date and subordinated debt should qualify such instruments as capital. However, the liability-like cumulative dividends and/or mandatory redemption should result in Tier 2 status.

INTRA-SYSTEM ELIMINATIONS

Generally, investment by one institution in another should be deducted from the Tier 1 capital of the investing institution and counted by the issuing institution based on the type of instrument as defined above. Common eliminations would include:

- *Bank stock purchased by association* – Stock would be Tier 1 capital of the issuing bank. Association would deduct an amount equal to its purchase from its Tier 1 capital.

- *Bank allocated stock to association* – Deduct from Tier 1 capital of the association, the amount counted by the issuing bank.

- *Bank investment in association stock* (reciprocal investment) – The bank would deduct its investment in the association from Tier 1 capital. Stock would be counted as Tier 1 capital by the issuing association.

- *Accrued Patronage* – Associations may accrue estimated bank patronage on a quarterly basis. Such accrual should be subtracted from the associations' Tier 1 capital until the patronage is declared by the bank.

EXHIBIT II

12/19/2008

"A Discussion of Treating Allocated and Purchased Equities as Tier 1 Capital"

by the Farm Credit System Capital Adequacy Workgroup
December 19, 2008

I. Overall Premise

Assuming the FCA adopts the two tiered Basel Accord regulatory regime of commercial banks, then virtually all allocated equities and purchased equities should be treated as Tier 1 Capital whether held by Farm Credit System (FCS or System) entities or non-FCS borrowers. In this manner, System institutions could be more readily compared to commercial banks relative to capital adequacy and could better access the capital markets due to higher transparency of capital.

II. Regulatory Background and Framework

It is useful to examine the current FCA regulatory background and framework because a parallel can be drawn between Core Surplus and Tier 1 Capital. Notably, however, Core Surplus does not include purchased equities and a significant portion of allocated equities while Tier 1 Capital would include these equities.

FCA adopted the current capital adequacy regime in 1997, following the lead of federal bank regulators in implementing the principles of the 1988 Basel I Accord. The regulations were adopted after extensive System dialogue with the FCA, after the receipt of recommendations from the System Capital Adequacy Workgroup in 1993 and 1994 and an extensive public comment period in 1995 and 1996.

FCA's original proposed regulation would have established a 3.5 percent Unallocated Surplus requirement and a 7 percent Total Surplus requirement. The proposed regulation defined Unallocated Surplus so as to exclude all allocated equities held by borrowers. The proposed definition of Total Surplus would have included only those allocated equities qualifying as permanent capital, which if subject to retirement, have a retirement of not less than 5 years. After considering comments questioning FCA's differentiation between allocated and unallocated capital on the ground that it created a bias against cooperative principles, FCA changed the name of the ratio from Unallocated Surplus to Core Surplus and modified its definition to include in Core Surplus, nonqualified patronage allocations to borrowers other than System institutions. In the final regulation, in response to continued debate, FCA modified the definition further to allow associations to include in Core Surplus, longer term qualified as well as nonqualified allocated equities that are includible in Totalf Surplus and are not scheduled to be retired in the next 3 years. Allocated equities issued by System banks continued to be completely excluded from the Core Surplus of either the bank or the bank's affiliated associations.

Additionally in 2008, FCA allowed by letter a certain portion of CoBank's allocated equities not held by System entities to be counted as Core Surplus with the amount being the lesser of 50 percent of Core Surplus less additional allocated equities or 70 percent of those allocated equities not held by System entities. However, they also imposed a new regulatory minimum of 3 percent for Core Surplus less the newly counted additional allocated equities.

In sum, the FCA has been willing, in some instances, to count some allocated equities (both qualified and nonqualified) as Core Surplus, which is the System's version of Tier 1 Capital.

III. Fundamental Discussion Points

The following fundamental discussion points are offered supporting the premise.

A. <u>There is no difference in the permanence between allocated equities and purchased equities.</u> A Basel regime would not make such a distinction since both are recorded on the borrowers' balance sheet either using tax paid funds for investing or paying tax on the allocations. Further, both types of equities if written down, would have the same effect on the borrowers' balance sheet. The mere act of writing a check for purchased equities does not give them more permanence than allocated equities if the rules for retirement are the same.

B. <u>There is no difference in the nature of the equity solely by its being held by a System entity or not.</u> A Basel regime would not make that distinction for a given equity. However, the Farm Credit System regulations appear to assume that the System investor has an implicit "put right" (a right to compel the issuer to redeem the equity), which is legally not the case.

C. <u>Tier 1 Capital in a FCS regime should include all allocated and purchased equities (collectively, "Stock") if its retirement is under the control of the board of directors.</u>

(1) As background, the two-tiered approach of the Basel Accord makes a distinction between Tier 1 Capital or core capital and Tier 2 Capital or supplemental capital and provides that the amount of Tier 2 Capital may not exceed the amount of Tier 1 Capital. Tier 1 Capital consists of common equities, retained earnings and noncumulative perpetual preferred stock, with stock and retained earnings considered the most permanent and reliable form of capital. Tier 2 Capital, on the other hand, consists primarily of instruments, such as, hybrid debt-equity instruments, subordinated debt, term preferred stock, cumulative perpetual preferred stock, and a portion of the allowance for loan losses, that are considered to be less permanent and of lesser quality than those included in Tier 1 because they contain certain obligations or due dates. Although FCA did not adopt the Basel framework, its Core/Permanent Capital or Total Surplus regime was largely modeled on the same distinction that the

Basel Accord made between "more permanent" and "less permanent" sources of capital. FCA's current position is most Stock has less permanence and is therefore not Core Surplus.

(2) Stock retirements do not imply impermanence since they are under the control of the board of directors who have a fiduciary duty to maintain adequate capital. As a foundation, capital retirements are allowed only if the institution is in sound financial condition. But more importantly, stock retirements would be ceased if losses were being incurred and stock was needed to absorb these losses. Note that enhanced governance structures (including a financial expert on the board) and practices serve to buttress this key control point.

(3) It is interesting to note that current FCA Core Surplus regulations exclude bank allocated equities from the Core Surplus of the recipient FCS entity. However, the bank does not receive Core Surplus treatment for these allocated equities resulting in a loss of Core Surplus treatment in the combined entities. Said another way, bank retained earnings recorded as allocated equities lose Core Surplus treatment both at the bank and the association level. This treatment imposes an unwarranted additional capitalization burden on associations.

(4) As to bank Stock held by associations, it has the highest degree of permanence. Although the associations could theoretically reaffiliate with another funding bank in a troubled bank or district situation, this would not happen since both the bank and the FCA would have to approve of the reaffiliation. Further, the association would certainly not be allowed by the FCA to voluntarily liquidate or terminate System status under a stressed bank financial scenario. Therefore, the bank has total control over its stock particularly in a troubled situation.

(5) As part of the Financial Accounting Standards Board's (FASB) liabilities and equities project, the FASB has recognized the permanence of a cooperative's capital. According to the guidance in FASB's November 2007 issuance under its Financial Accounting Series of "Preliminary Views: Financial Instruments with Characteristics of Equity", cooperative capital would continue to be classified as equity even if a portion of it is redeemable. FASB concluded that, under a basic ownership approach to the classification of instruments as liabilities or equity, only the most residual claim can be classified as equity, which they defined as those instruments with both of the following characteristics:

(a) The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and

(b) The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.

Generally speaking, cooperative Stock would satisfy these requirements. Even where it is redeemable at the option of the holder, cooperative Stock could be classified as equity under this basic ownership approach if the following additional requirements are met:

(c) The redemption amount is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on the classification date; and

(d) The terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments.

Consequently, there appears to be no reason under current accounting standards not to regard cooperative Stock as being available to absorb losses.

(6) To give further stability and permanence to Tier 1 Stock, an additional condition could be imposed by regulation. Regulations could prohibit setoff of Tier 1 Stock against a holder's loan and allow retirement only under the normal rules set forth in the capital plan. This would further buttress the fact that Stock is not included in the borrowing base or in the credit worthiness of the borrower.

D. <u>There is no legal obligation to redeem equities.</u> Systematic redemption of Stock is an essential tool for cooperatives to ensure that the obligation of providing capital remains proportionate to current patronage. Systematic redemption does not in itself change the character of patronage allocations from equity to debt. The mere existence of a regular practice or plan of retirement may indeed give rise to an expectation of retirement, but not the legal right to demand retirement. Several court cases exemplify these points.

(1) The Supreme Court of Georgia, in <u>Howard v. Eatonton Co-operative Feed Co.</u>, stated as follows:

> "Redemption of patronage allocations is a matter within the discretion of the directors of the cooperative. It is well established that equity credits allocated to a patron on the books of a cooperative do not reflect an indebtedness which is presently due and payable by the cooperative to such patron. Such equity credits represent patronage dividends which the board of directors of a cooperative, acting under statutory authority to do so, has elected to allocate to its patrons, not in cash or other medium of payments, which would immediately take such funds out of the working capital of the cooperative, but in such manner as to provide or retain capital for the cooperative and at the same time reflect the ownership interest of the patron in such retained capital. Equity credits are not an indebtedness of a cooperative which is presently due and payable to the members, but represent

an interest which will be paid to them at some unspecified later date to be determined by the board of directors. Therefore, equity credits cannot be used as a setoff against a member's present indebtedness to the association."

Id.., 226 Ga. 788, at 791-792, 177 SE2d 658, at 662 (Ga. 1970), (citing 18 Am. Jur.2d 275, Cooperative Associations, s 15.). "Accordingly, even when allocations have reached their scheduled retirement date, member-owners cannot demand retirement until the board of directors determines in the exercise of its good faith business judgment that the cooperative's financial condition will permit retirement and formally authorizes it."

(2) During 2003-2004, two large cooperatives, Agway, Inc. and Farmland Industries, Inc., representing in excess of 200,000 farmer-members, were involved in Chapter 11 bankruptcy cases. We recently reviewed the plans of reorganization and/or liquidation together with the disclosure statements filed in those cases to determine the impact of the bankruptcies on the cooperatives' farmers-members. While many classes of creditors were paid or partially paid under the plans, the equity holders (e.g. farmers-members) lost their investment (in some cases all their investment).

- In the case of Agway, Inc.:

  "Agway Class 7 (Equity Claims)...will not receive any distributions under the Plan and, as a result are conclusively presumed to have rejected the Plan."

- In the case of Farmland Industries, Inc.:

  "Under the Plan, a portion of the Industries Common Shares will be cancelled and offset against appropriate losses and available Member NOLs and Non Member NOLs (defined below). Any remaining Industries Common Shares will be reinstated on the Effective Date and shall not be cancelled or extinguished. Such Industries Common Shares however are expected to be worthless on the Effective Date."

We did not identify any attempt by the courts to introduce an equitable element to the distribution to protect farmers-members at the expense of creditors. Any attempt to do so would not have been consistent with the federal bankruptcy laws.

E. The board of directors and management have the ultimate fiduciary duty to prudently manage capital. Dissipation of capital ratios, particularly under stressed circumstances, cannot be tolerated by the board and management. Further, ratings of third-party capital (preferred stock and subordinated debt) and of the entity itself must be maintained at acceptable levels, meaning that capital must be managed in a prudent manner. Accordingly, the permanence of Stock is enhanced, not diminished, by the fiduciary responsibilities of the board and management, and particularly in a troubled situation when it is most needed.

F. Certain agreements prohibit the dissipation of capital and have minimum capital requirements. CIPA and MAA both have minimum capital requirements that, if violated, could lead to the effective liquidation of the bank. Practically speaking, a weakening capital position of a bank will certainly be addressed through the CIPA/MAA measurement process which provides early and quick enforcement triggers. We note that each bank that has intruded on CIPA/MAA measurement limits was quickly acquired by another bank despite its not being close to regulatory capital minimums and certainly far away from technical insolvency. Therefore, Stock was not dissipated in these circumstances and was available to meet the weakening financial condition. Likewise, bank GFAs require each association to maintain a satisfactory borrowing base which is also a measure of capital adequacy. Finally, third-party capital agreements (preferred stock and subordinated debt) prohibit the payment of outsized cash patronage dividends and stock retirements if regulatory capital ratios are breached. All of these factors together help ensure the availability and permanence of Stock.

G. The exclusion of Stock from Tier 1 Capital discourages operating under cooperative principles. Any new capital adequacy regime FCA establishes should accommodate the cooperative structure of the System, which is a fundamental organizing principle of the System under the Farm Credit Act. Instead of striking an appropriate balance between cooperative principles and safety and soundness objectives, excluding Stock from Tier 1 Capital arbitrarily discourages System institutions from operating on a cooperative basis as Congress explicitly authorized them to do. By limiting the inclusion of Stock in required Tier 1 ratios, FCA would unduly devalue a common form of capital maintained by cooperative organizations and give disproportionate value to a form of capital that some cooperatives do not prefer because of its unfavorable tax treatment. Any treatment by FCA of common equity as second class capital would discourage System institutions from operating in accordance with cooperative principles.

If Stock is not fully included in Tier 1 ratios, System institutions would not have an incentive to maximize non-cash patronage distributions as a component of capital management. As a result, the investment that borrowers hold in the institution would tend to remain relatively small. Without a material ownership stake in the institution, however, members are more likely to become disengaged from the processes of corporate governance and their crucial role in holding boards of directors accountable for poor performance. In this way, the exclusion of Stock actually undermines one of the key purposes of the Farm Credit Act, which is to encourage farmer-borrowers and their organizations to participate in the management, control, and ownership of the System. On the other side of the coin, where there are active retirements of Stock, the fact that borrowers may become alarmed by an interruption of a scheduled retirement does not in itself present a problem of capital impermanence, but rather it is a part of the normal process of corporate governance. If the institution's performance does not allow it to meet reasonable expectations, the members should hold the board of directors and management accountable.

Because they operate to pass earnings to users of their services on a patronage basis, cooperatives cannot attract equity from outside sources to the same extent as investor-owned businesses. The fact that user-owners of a cooperative receive patronage in proportion to their use of its services, not according to their investment, is a significant difference compared to other business forms, giving investors no incentive to make common equity available. Single tax treatment under Subchapter T helps to alleviate the problem of capital accumulation by making a greater portion of income available for reinvestment in the cooperative. Direct investment or purchased equities are usually a minor source of equity for most cooperatives. More often, cooperatives capitalize their operations from retention of patronage-sourced earnings. Single tax treatment under Subchapter T is available only for patronage-sourced earnings that are returned to the patrons as cash or retained allocated equities. When patronage-sourced earnings are not returned to patrons, such as when they are placed in an unallocated reserve, they are not eligible for single tax treatment.

At this point, it might be first argued that, as long as a taxable institution retains URE, this capital is only taxed at the institution level, and that neither the institution nor the members have been disadvantaged. This argument first of all ignores the fact that when single taxation under Subchapter T applies, the total cost of capitalizing the institution is actually lower, because Subchapter T allows earnings to be returned to the member without additional taxation, and therefore, allows more of the earnings from patronage business to be utilized to capitalize the cooperative's business at a lesser cost over time to the member. In other words, retention of allocated equities from patronage earnings is simply a more efficient method of capital accumulation.

Second, this argument also ignores the fact that the accumulation of capital from retention of earnings from patronage business is just one element of operation under cooperative principles. Another equally fundamental tenet of cooperative theory is that cooperatives will be funded to the extent possible by current patrons on the basis of patronage. If a System institution accumulates a sizeable amount of URE, it most likely will do so by retaining the earnings from patronage business. If the institution retains this URE indefinitely, over time the burden of capitalizing the institution will be borne disproportionately by patrons who have repaid their loans and have ceased to use the credit services of the institution. Current patrons will enjoy the benefit the URE affords, whether in the form of lower interest rates or larger patronage refunds than would otherwise be possible, without bearing the burden of accumulating it. Accordingly, if patrons of the cooperative choose to use allocated equities as a principal form of capitalization, then these equities deserve Tier 1 treatment.

H. <u>The exclusion of Stock from Tier 1 Capital creates a competitive disadvantage for System institutions.</u> The Basel Accord was intended to create a level playing field for international and U.S. banks by establishing a universally agreed-upon capitalization regime. By departing from the general Basel framework, FCA would put System institutions at a decided disadvantage vis-à-vis commercial banks because the capital regime System institutions must follow is not easily understood or recognized by the markets that supply external capital to financial institutions. As an example, investors and rating agencies are currently somewhat confused by our unique regulatory capital regime. They state that while we make best efforts to explain its differences, it is somewhat opaque and arcane and does not lend itself to comparisons to commercial banks. In fact, Moody's overlays the federal banking regulators capital regulations on our capital numbers in order to analyze the System. This is an imperfect way to understand the financial strength of the System. To the extent that FCA's capital adequacy regime impedes the System's access to external sources of capital and its ability to use allocated equities to meet capital adequacy standards, the System must rely instead on its borrowers to provide additional capital in the form of higher interest rates and/or reduced patronage distributions. This would make the System less able to fulfill its mission to provide adequate credit at equitable and competitive interest rates.

I. Commercial banks routinely retire their stock to optimize their leverage, however, the stock continues to be counted as Tier 1 Capital despite the bank's public announcement that a buyback program is in place. According to a recent Lehman Bros. report as of December 10, 2007, there were 54 announced share buyback programs in 2007 for U.S. depository institutions with a market capitalization of greater than $1 billion. The size of these programs average 4.8 percent of market capitalization and were as high as 10 to 14 percent of market capitalization for certain of the institutions (see Exhibit I). These discretionary purchases of their capital stock are more aggressive than System Stock retirements, which are only made when conditions warrant and must be approved by the board. Moreover, commercial banks are allowed Tier 1 treatment of stock even given a public notice to buyback such stock.

J. A Tier 1 Leverage Ratio is preferable to the current Net Collateral Ratio (NCR). More particularly, while both ratios utilize unweighted assets, the NCR penalizes banks for pledging collateral such as investments pledged in Collateral Support Annexes (CSAs) in ISDA derivative agreements because these investments are deducted from assets and decrease the NCR. In so doing, banks are implicitly disincented from using CSAs which are solid risk mitigants. The Tier 1 Leverage Ratio has no such deduction because the pledged investment is still an asset of the bank.

IV. Analogous Situations

There are certain analogous situations in treating all allocated and purchased equities as Tier 1 Capital.

A. Commercial bank stock held by a bank holding company (BHC) is treated as Tier 1 Capital by federal regulators. This treatment recognizes that the BHC has complete control over the commercial bank and could theoretically use it as a vehicle to house outsized risks or lever it to the maximum by under-capitalizing or de-capitalizing the bank, but is highly unlikely to do so due to countervailing controls embodied in regulations, implicit powers of the regulator, bond and stock market oversight, and ratings implications.

This situation is analogous to a Farm Credit Bank that is owned by a relatively small group of associations who could theoretically govern the FCB in an unsafe and unsound manner. However, associations would not engage in this type of management for all of the parallel reasons cited above.

Under current FCA regulations, however, FCB stock held by associations is not treated as Core Surplus by the FCB. Moreover, the association stock investment in the FCB is also deducted from the association's own Core Surplus and thus all core surplus treatment of FCB-allocated equities is lost. Clearly, Core Surplus treatment should be afforded to the FCB for allocated equities and for purchased stock. Note also that there is an anomalous exception to this regulation where System equities held by another FCS entity in connection with a loan participation are not deducted from the holder's own Core Surplus.

B. <u>Subchapter S commercial banks operate very similarly to Farm Credit System entities but their retained earnings are treated as Tier 1 Capital.</u> Shareholders in a Subchapter S bank are taxed at their individual income tax rates on their pro-rata share of the bank's taxable income, regardless of whether they receive a cash distribution or if the earnings are retained by the bank. Subchapter S status thus lowers the total amount of tax assessed on net income by avoiding the double taxation of corporate dividends. As of December 2006, 2356 depository institutions (or approximately 31 percent of commercial banks) had elected Subchapter S treatment.

Because Subchapter S treatment can significantly increase after-tax returns to shareholders, it can make investment in community banks more desirable, but at the same time, it can create incentives for banks to increase their cash dividend payout, which can reduce retained earnings and capital growth. Since they are taxed on the basis of their pro-rata share of the bank's income regardless of whether it is actually distributed in cash, shareholders of a Subchapter S bank would appear to have a reasonable expectation of a regular dividend distribution that is analogous to the expectations of borrowers of System institutions that allocated equities would be retired. Despite that fact, none of the federal banking regulators have created special capital adequacy rules for Subchapter S banks that exclude or discount their equities in calculating the banks' Tier 1 Capital. The federal banking regulators have acknowledged that S-corporations have a shareholder tax incentive to pay out cash dividends rather than retain earnings, and that this could mean that S-corporation banks build less capital in good economic times and continue to pay dividends in poor economic times (to allow shareholders to pay taxes) when C-corporation banks would not. This regulatory concern, however, is mitigated by the ability of regulators to order "Prompt Corrective Action" (see below) to restrict or prohibit payment of dividends if the bank would be undercapitalized after such a capital distribution. The general enforcement powers of the regulator could also be used to prevent an outsized dividend.

C. The Federal Home Loan Banks (FHLBs) are permitted to include stock in their version of Tier 1 Capital.

The FHLBs are a group of federally-chartered but privately-capitalized institutions that provide their members—which include commercial banks, thrifts, credit unions, and other entities—with access to low-cost credit for housing and community development. Similar to Farm Credit System institutions, FHLB borrower-members are required to maintain an investment in FHLB stock. However, unlike FCS institutions, FHLBs are permitted to include in their core regulatory capital [defined under Federal Housing Finance Board (FHFB) regulations as "permanent capital"] the value of capital stock issued to their borrowers regardless of whether some portion of stock of the same class has been retired or repurchased by the FHLB.

In this regard, "permanent capital" (their definition of Tier 1 Capital) is defined as "retained earnings . . . plus the amount paid-in for the Bank's Class B stock." 12 C.F.R. § 930.1. "Class B stock" is defined as stock that shall "(1) Have a par value as determined by the board of directors of the Bank and stated in the Bank's capital plan; (2) Be issued, redeemed, and repurchased only at its stated par value; (3) Be redeemable in cash only on five-years written notice to the Bank; and (4) Confer an ownership interest in the retained earnings, surplus, undivided profits, and equity reserves of the Bank." 12 C.F.R. § 931.1(b). An FHLB may, in its discretion, "repurchase from any member any outstanding Class A or Class B capital stock that is in excess of the amount . . . that the member is required to hold as a minimum investment." 12 C.F.R. § 931.7(b). Any repurchase must be in accordance with the Bank's capital plan, must follow "reasonable notice" to the borrower, and must not cause the Bank to fail to meet any minimum capital requirement. However, provided these requirements are met, an FHLB may retire a portion of its Class B stock without causing the remainder of stock of the same class to be excluded from the Bank's "permanent capital." It should be noted that FHLBs are permitted to include in their Tier 1 Capital equivalent a class of stock that can be put back to the FHLB with five years' written notice by the holder.

System entities' Stock is also subject to retirement but is treated as our version of Tier 2 Capital, that being Total Surplus. Total Surplus, rather than Permanent Capital, is being used as the analogy because Total Surplus treatment requires that the stock not be subject to retirement for a five-year period. Note also that FCS Stock cannot be put back to the FCS entity at the borrower-member's option as is the case with FHLB stock. Further, all retirements of FCS Stock must be approved by the board of directors.

D. The FCA allows a portion of association stock held by patrons to be counted as Core Surplus. The FCA has established a precedent for System institutions to count a portion of stock that has a past plan and practice of retirement as Core Surplus (our version of Tier 1 Capital). More particularly, FCA Regulation 615.5301(a)(2)(ii) allows associations to count allocated equities as Core Surplus except for those that are scheduled for revolvement or retirement during the next three years. The rationale for the three-year period is to allow an association time to address its financial situation in a stressed circumstance without disrupting its patronage or retirement plans. However, the equities within the three-year period would count as Total Surplus and not as Core Surplus. This logic implies that retirements would cease after the three-year period if the association has not rectified its financial stress, and that therefore, the equities would be frozen in a manner insuring its availability to absorb losses if needed.

E. The FCA recently allowed (by letter approval) a portion of CoBank's allocated equities held by non-System patrons to be treated as Core Surplus. The portion allowed is the lesser of 50 percent of URE or 70 percent of eligible allocated equities (purchased equities were excluded). Further, FCA required that Core Surplus less the additional allocated equities be maintained at 3 percent or higher. A five-year re-review period or a change in the capital regulations was also a condition for approval. The rationale for this treatment was the same as that for association allocated equities, that being, at least a portion of these equities has the highest level of permanence.

V. Powers and Authorities

A. Statutory and Regulatory Provisions

The Farm Credit Act of 1971, as amended, ("Act") and the FCA regulations address the ability of FCA to assure adequate capitalization at System institutions. While the Act provides the capital adequacy authority to FCA, the regulations establish the procedural requirements that apply if special capital requirements are considered. These authorities can extend in certain cases to limitations on dividends, retirements and patronage refunds depending on existing capital levels. As with other federal regulators, FCA has enforcement powers to use, if circumstances warrant.

The request that all System allocated and purchased equities be treated as Tier 1 Capital under a Basel regulatory scheme will not alter the fact that FCA has and will continue to have capital adequacy authority and enforcement powers to use within its appropriate discretion if safety and soundness is threatened.

B. A Comparison of Capital Characteristics Now Versus the 1980s

While FCA has expressed some concern with the issues experienced by System institutitions in the 1980s, those issues have been confronted methodically by both the

System and/or FCA over the last 20 years as set forth in this discussion paper. We have witnessed an effective transition of membership interests and compensating balances in an '80s framework to "at risk" stock that can only be retired at the sole discretion of the board and is subject to impairment. While expectations regarding stock retirement and patronage distributions may still remain with some customers in limited circumstances, expectations are not equivalent to legal rights. It is inescapable that an institution's bylaws, supplemented by capital plans and written disclosures to borrowers all combine to cement the treatment of System capital as Tier 1 Capital. Moreover, communications with customers have been consistent with this proposition along with the enhanced and growing knowledge of customers about their investment in System institutions solidifies its permanence. Finally, all of this is buttressed by FCA's powers and authorities to ensure the safety and soundness of a System institution.

C. Prompt Corrective Action

Moreover, other bank regulators currently have additional authority under the capital structures of the banks they regulate which is known as Prompt Corrective Action (PCA). In PCA, there are five capitalization categories ranging from Well Capitalized to Critically Undercapitalized (see chart below). Certain actions are required by banks in the lowest three categories including the development of a capital restoration plan, limitations on asset growth, restrictions on new lines of business and limits on business with affiliates, etc. If a bank's tangible equity falls below 2 percent of its assets, the regulator would appoint a receiver to liquidate the bank.

If FCA adopts the Tier 1 Capital regime as appropriate for the System for the reasons set forth in this discussion paper, FCA should consider whether this enforcement approach along with the numerical levels used by other bank regulators, together with or in place of FCA's existing powers, should be used to address deteriorating capital adequacy issues and concerns.

Category	Total Capital	Tier 1 Capital	Leverage
Well-Capitalized	10% ***and***	6% ***and***	5%
Adequate	8% ***and***	4% ***and***	4%
Undercapitalized	Under 8% ***or***	Under 4% ***or***	Under 4%
Significantly Undercapitalized	Under 6% ***or***	Under 3% ***or***	Under 3%
Critically Undercapitalized	Tangible Equity under 2%		

- **Total Capital Ratio:**
  Total Risk-Based Capital / Risk-Adjusted Assets
- **Tier 1 Capital Ratio:**
  Tier 1 Capital / Risk-Adjusted Assets

- **Leverage Ratio:**
  Tier 1 Capital / Average Assets Less Nonqualifying Intangible Assets
- **Tangible Common Ratio:**
  Common Equity Less Total Intangible Assets / Tangible Assets

D. Benefits of Alignment with Other Bank Regulators

The current FCA regulatory regime, including unique limits and conditions placed on individual System institutions, attempts to roughly parallel a Tier 1/Tier 2 regime. However, it is very difficult to draw precise analogies given the lack of parallels in the definition of common equity. This lack of comparability makes it difficult for FCA as well as the System to present clear and meaningful information about its relative financial strength and performance to interested third parties. Further, System institutions do not have as broad an access to third party capital due to the above.

If FCA had a parallel regulatory regime, then they could draw from a vast wealth of experience of other regulators—not only domestic but international. In turn, this would greatly level the playing field for System institutions relative to capital adequacy comparisons and third party capital access.

VI. SUMMARY

The overall premise of treating all allocated and purchased equities as Tier 1 Capital in a Basel regime is clearly supported by the above discussion points. Moreover, the discussion points must be viewed in their totality as all pointing to Tier 1 Capital treatment. To reiterate, the FCA has allowed certain allocated equities to be treated as Core Surplus. By comparison, analogous commercial bank and FHLB capital rules based upon parallel regulatory authorities would treat all allocated and purchased equities as Tier 1 Capital. More fundamentally, all controls and disciplines already available give stability and permanence to these equities, including statutory and regulatory requirements, board fiduciary duties, lack of legal retirement obligations, market disciplines, interbank and bank-association agreements, third-party equity agreements, and external ratings rigor. Finally, all of this is buttressed by FCA's powers and authorities to ensure the safety and soundness of a System institution.

Exhibit A

YTD Announced Depository Share Buybacks

For depositories with market capitalization greater than $1 billion

					Base Offering Size as % of:		S&P 500 - Adjusted Returns			
Announc. Date	Issuer	Market Cap ($MM)	Repurchase Size ($MM)	Repurchase Size (MM Shares)	Size as % of Mkt. Cap.	Multiple of ADTV	Annc. + 1 Day	Annc. + 1 Week	Annc. + 1 Month	Annc. + Current
1/24/07	Bank of America Corp.	$237,709	$10,700	200.7	4.5%	17.5x	(0.6%)	(1.3%)	(2.4%)	(19.4%)
4/18/07	JPMorgan Chase & Co.	171,430	10,000	199.3	5.8%	16.0x	3.9%	3.7%	0.2%	(10.4%)
3/21/07	Wells Fargo & Co.	119,821	2,591	73.0	2.2%	7.0x	(1.3%)	(2.5%)	(2.0%)	(15.5%)
8/6/07	Wells Fargo & Co.	110,314	1,705	52.0	1.5%	3.6x	5.7%	4.3%	8.2%	(5.9%)
11/7/07	Wells Fargo & Co.	102,284	2,300	74.8	2.2%	3.1x	2.4%	8.4%	1.1%	1.1%
1/31/07	US Bancorp	62,824	497	14.0	0.8%	2.5x	(0.6%)	0.3%	2.9%	(12.3%)
3/23/07	Freddie Mac	41,156	1,000	16.1	2.4%	6.7x	(0.4%)	(3.4%)	1.2%	(47.7%)
5/15/07	SunTrust Banks	31,323	1,000	11.4	3.2%	5.9x	(0.2%)	1.6%	0.9%	(21.1%)
1/18/07	The Regions Financial Corp.	26,801	1,841	50.1	6.9%	23.6x	(0.9%)	(1.7%)	(0.1%)	(33.5%)
10/4/07	PNC Financial Services Group Inc	23,553	1,747	25.0	7.4%	10.1x	1.8%	(1.5%)	0.8%	5.8%
5/21/07	Fifth Third Bancorp	22,641	1,278	31.0	5.6%	11.8x	0.7%	4.9%	1.5%	(26.3%)
4/24/07	National City Corp.	22,194	1,511	40.5	6.8%	10.5x	0.7%	(3.6%)	(9.0%)	(49.6%)
1/18/07	KeyCorp	14,952	1,133	30.2	7.6%	20.6x	0.8%	1.2%	4.1%	(38.0%)
2/22/07	M&T Bank Corp.	13,695	617	5.0	4.5%	19.6x	0.3%	(0.2%)	(4.0%)	(31.8%)
7/25/07	UnionBanCal Corp.	7,858	500	8.8	6.4%	31.2x	0.9%	0.5%	7.1%	(6.5%)
7/25/07	Hudson City Bancorp Inc.	6,169	608	52.4	9.9%	10.9x	4.7%	9.3%	26.5%	35.3%
2/6/07	Associated Banc-Corp.	4,397	70	2.0	1.6%	5.0x	1.5%	2.7%	2.0%	(22.0%)
1/24/07	Associated Banc-Corp.	4,368	219	6.5	5.0%	15.5x	0.3%	0.8%	4.3%	(22.0%)
2/23/07	PMI Group Inc.	4,190	150	3.1	3.6%	3.5x	(2.2%)	(0.9%)	(4.3%)	(73.5%)
6/11/07	Colonial BancGroup Inc.	3,760	150	6.1	4.0%	7.1x	1.5%	(1.0%)	(2.6%)	(32.1%)
8/7/07	City National Corp	3,596	76	1.0	2.1%	3.2x	1.5%	(1.9%)	(3.8%)	(14.1%)
2/2/07	Commerce Bancshares Inc.	3,478	141	3.0	4.1%	23.1x	0.9%	1.8%	2.6%	(8.0%)
4/16/07	TCF Financial Corp.	3,402	171	6.5	5.0%	7.0x	(0.7%)	(2.7%)	0.9%	(28.8%)
7/26/07	PMI Group Inc.	3,311	150	3.9	4.5%	3.5x	0.8%	(10.1%)	(20.1%)	(63.4%)
4/26/07	Cullen/Frost Bankers Inc.	3,140	131	2.5	4.2%	8.6x	(0.6%)	(2.0%)	(0.9%)	1.0%
10/16/07	First Horizon National Corp	3,099	190	7.7	6.1%	2.8x	1.9%	3.0%	(11.4%)	(4.9%)
1/18/07	Valley National Bancorp	2,931	89	3.7	3.0%	17.3x	(1.2%)	0.3%	0.3%	(25.2%)
6/5/07	Webster Financial Corp.	2,547	125	2.8	4.9%	9.2x	(0.6%)	(2.1%)	(6.5%)	(23.1%)
4/19/07	Astoria Financial Corp.	2,475	278	10.3	11.2%	18.0x	1.4%	(1.6%)	(4.7%)	(7.3%)
10/22/07	Bank of Hawaii Corp	2,422	100	2.0	4.1%	7.3x	5.5%	5.2%	4.2%	6.6%
1/24/07	East West Bancorp	2,252	30	0.8	1.3%	2.0x	5.5%	4.9%	4.0%	(24.7%)
3/21/07	East West Bancorp	2,231	50	1.4	2.2%	3.8x	0.6%	2.3%	6.4%	(24.4%)
3/21/07	BancorpSouth Inc.	1,983	74	2.9	3.7%	23.3x	(0.2%)	(0.8%)	(5.2%)	(5.5%)
5/4/07	International Bancshares Corp.	1,878	225	8.3	12.0%	70.8x	(0.4%)	(2.4%)	(1.1%)	(19.4%)
7/26/07	SVB Financial Group	1,785	250	4.8	14.0%	10.4x	3.3%	3.6%	(2.7%)	(1.0%)
5/8/07	Cathay General Bancorp	1,746	34	1.0	1.9%	4.6x	(0.0%)	(1.2%)	(1.2%)	(11.9%)
3/6/07	Cathay General Bancorp	1,734	34	1.0	1.9%	5.5x	0.2%	(1.7%)	(3.3%)	(18.0%)
8/16/07	The South Financial Group	1,663	100	4.4	6.0%	6.5x	4.3%	3.1%	0.1%	(26.6%)
4/24/07	UMB Financial Corp.	1,607	77	2.0	4.8%	16.1x	2.4%	3.1%	(2.0%)	(4.9%)
4/26/07	Investors Bancorp Inc.	1,601	161	11.3	10.0%	36.0x	1.8%	1.1%	(4.1%)	4.1%
11/29/07	First Midwest Bancorp Inc/IL	1,566	80	2.5	5.1%	5.0x	1.0%	0.6%	NA	(0.1%)
8/2/07	First Community Bancorp Inc/CA	1,531	150	3.0	9.8%	8.8x	(0.3%)	5.9%	6.2%	(13.9%)
4/19/07	Umpqua Holdings Corp.	1,520	88	3.4	5.8%	12.0x	(2.0%)	(3.7%)	(6.5%)	(39.7%)
4/20/07	First Niagara Financial Group Inc.	1,469	76	5.4	5.2%	7.5x	0.9%	(2.2%)	(4.7%)	(12.7%)
8/23/07	Westamerica Bancorporation	1,424	97	2.0	6.8%	8.0x	1.3%	2.6%	(0.6%)	(4.0%)
11/16/07	Cathay General Bancorp	1,419	29	1.0	2.0%	2.2x	(1.9%)	0.7%	NA	2.2%
6/15/07	Northwest Bancorp Inc.	1,411	29	1.0	2.0%	13.9x	1.3%	(1.8%)	(8.1%)	2.0%
4/18/07	Alabama National Bancorp	1,389	67	1.0	4.8%	14.1x	0.6%	(6.6%)	(9.9%)	13.5%
1/18/07	Chittenden Corp.	1,362	30	1.0	2.2%	7.6x	(0.7%)	(1.8%)	4.4%	11.2%
4/19/07	Chittenden Corp.	1,360	30	1.0	2.2%	6.0x	(2.1%)	(5.6%)	(7.2%)	12.8%
7/2/07	MB Financial Inc.	1,247	35	1.0	2.8%	4.5x	2.7%	(0.2%)	(0.9%)	(8.0%)
7/16/07	Park National Corp.	1,214	85	1.0	7.0%	26.2x	(2.0%)	(3.9%)	17.0%	(8.7%)
4/30/07	Wintrust Financial Corp.	1,042	46	1.1	4.4%	6.1x	6.2%	6.0%	5.1%	(18.3%)
2/27/07	CVB Financial Corp	1,038	25	2.0	2.4%	9.4x	(0.9%)	(1.4%)	(5.8%)	(13.9%)
	Average	**$20,358**	**$796**	**18.7**	**4.8%**	**11.9x**	**0.9%**	**0.2%**	**(0.4%)**	**(14.9%)**
	Median	**$2,739**	**$146**	**3.8**	**4.6%**	**8.3x**	**0.7%**	**(0.2%)**	**(0.7%)**	**(13.3%)**

Source: Lehman internal research. As of December 10, 2007.