U.S. AGBANK, FCB

April 10, 2009

To: Wade Wynn, Farm Credit Administration
J.C. Floyd, Farm Credit Administration

From: David D. Janish, Senior Vice President – Finance

Subject: Capital Allocation Agreements and Tier 1 Capital

We are submitting this document to the Farm Credit Administration through the System's ANPRM Workgroup to provide input on questions FCA posed regarding the inclusion of Bank allocated stock in an Association's regulatory capital. We do so with the hope that we can contribute our insights and experiences in a constructive dialogue between the System and FCA on potential changes to FCA's capital standards. To this end, we asked McDermott Will & Emery to assist us in preparing a discussion paper, a copy of which is attached, on issues of particular importance to U.S. AgBank and its Associations; namely, the retention of counting agreements to allocate Bank patronage stock between the Bank and an Association and Tier 1 capital treatment accorded to such stock. We believe this paper provides some valuable perspectives on the development of the existing rules and how Banks have planned and adapted to them.

We believe strongly in the merits of a capital counting agreement based on the distinction between required investment (counted at the Bank level) and excess investment (counted at the Association level) and that the Bank and Association should be entitled to count patronage stock as "Tier 1" capital.

The key points are as follows:

- Capital allocation agreements have functioned smoothly ever since FCA authorized their use in 1988.

- Following Congress' codification of capital allocation agreements in 1992, they have played a constructive role in Bank capital management and, as to U.S. AgBank, were integral in the development of an agreed-upon capital plan for the merger of the Western and Wichita Districts.

- Bank allocated stock is reliable capital, and Congress made clear that such capital should be accorded that status, whether counted at the Bank level or the Association level.

ADMINISTRATIVE OFFICE: 245 N. Waco 67202 • P.O. Box 2940 67201-2940 • Wichita KS • Tel: 316-266-5100, Fax: 316-266-5121

SACRAMENTO OFFICE: 3636 American River Drive, Suite 100 • Sacramento CA, 95864-5901 • Tel: 916-973-3014, Fax: 916-973-3092

- Arguments for an owned funds approach were more persuasive previously when Congress statutorily authorized capital allocation agreements, than they are today.

- A new capital regime that would negate capital allocation agreements would ultimately reduce Bank (and possibly District) capital, and downgrading the capital weight of Bank allocated stock to something other than Tier 1 would have the same effect.

- A new capital regime that negates capital allocation agreements could have significant tax planning implications to Associations and, potentially, System borrowers.

- If a Bank experienced financial difficulties that threatened its capital position and ratios, the Bank would use existing provisions in its capitalization bylaws and capital plan to increase the Associations' required investment levels to provide additional capital. The Associations could meet the higher requirement by purchasing additional stock or reducing their excess stock positions by reallocating patronage stock to count in favor of the Bank.

We would appreciate your consideration of these points and the other matters discussed in the attached discussion paper in your ongoing evaluation of the proposed risk-based capital adequacy rules. We are prepared to address any questions you may have regarding this matter.

Attachment

c: System ANPRM Workgroup

McDermott
Will & Emery

Chicago

MEMORANDUM

Date: April 7, 2009

To: U.S. AgBank, FCB **From:** Kevin J. Feeley

Re: Discussion Paper on the Capital Treatment of Bank Allocated Stock

---

I. Introduction

In an Advance Notice of Proposed Rulemaking issued on October 31, 2007 (the "Advance Notice"), the Farm Credit Administration ("FCA") announced that it is reevaluating its capital adequacy standards and studying whether to adopt modifications to more closely align the standards to the Tier 1 and Tier 2 risk-based capital framework to which commercial banks are subject. One fixture of FCA's current capital adequacy regime is that a Bank and Association can agree on which entity counts Bank allocated stock in its regulatory capital.[1] Such agreement is known as a capital allocation or counting agreement. This paper addresses the merits of capital allocation agreements under FCA's existing regulatory capital regime and why any new regime FCA institutes should and, indeed, must allow for their continued use. It also addresses a related matter of equal importance: that Bank allocated stock continue to be accorded the same weight (i.e., equating to "Tier 1" status), whether the capital is counted at the Bank level or the Association level.

At the outset, we understand that FCA sought input on the precise issue of how Bank allocated stock is made "accessible" to an Association, particularly when the Bank is experiencing financial distress. We address this issue but feel compelled to provide a broader treatment of the subject to illustrate that the issue of accessibility is different today than it was in the late 1980s. The history is important to show both the uniqueness of the capital at issue and how Bank capital planning has evolved over the last few decades.[2]

As will be described below, Congress has declared that Bank allocated stock represents a reliable, stable form of capital and that this capital may, with the Bank's consent, be included in the owner's (i.e., Association's) capital base. This treatment of Bank allocated stock has been, to varying degrees, an underpinning of Bank capital management strategies over the past 20 years, continues to play a major role in how Associations within a District agree to bear risk at the Bank level, and has been relied upon in setting the terms of Bank mergers. Capital allocation

---

1 As used herein, the term "Banks" refers to Farm Credit Banks (or their predecessors) and Associations refer to agricultural credit associations (or their predecessors) and Federal land credit associations.

2 While many statements herein refer to Banks in general, we stress that the authors' direct, first-hand knowledge is based on the history and capital plans of U.S. AgBank and its predecessors.

agreements that count allocated stock in an Association's permanent capital up to the Association's "excess" investment in the Bank have been particularly effective in allowing the Association to use the capital to serve its members, premised on the understanding that such capital belongs to the Association and should not be leveraged by the Bank.

A capital allocation agreement is a unique approach to a unique category of capital that exists only in the System. Congress' express sanctioning of capital allocation agreements has worked well. Implementing a new capital regime that uproots this approach or otherwise degrades the capital treatment of Bank allocated stock would not only violate Congressional intent, but would also be self-defeating if the underlying objective is to build more capital at the Bank level.

II. Background

FCA's existing capital standards have special rules on how intra-System investments are treated from both the issuer's and holder's perspective. Their overarching objective is to eliminate the double counting of capital. These rules have a long history. FCA crafted them after several years of study, taking into account System input with due appreciation for the System's unique two-tier cooperative structure, the tax attributes of the involved equities, the legal rights of the holders of System equities and, most importantly, Congressional intent. The rules recognize that although each District is an economic unit inasmuch as all of its capital comes from the same source and the fortunes of a Bank and its Associations are inexorably intertwined, tensions exist on where the capital should reside. To varying degrees, depending on the District involved, Associations seek autonomy in controlling the capital furnished by their respective members, but also seek tax efficiency and bondholder approval in keeping capital invested in the Bank. Eliminating double counting while balancing the diverse and sometimes conflicting interests of the various Districts presented a difficult challenge with significant policy implications.

Deciding that Districts needed flexibility in handling this issue, Congress amended the Farm Credit Act in 1992 to allow "double duty" capital to be allocated by agreement between the Bank and its Associations. Based on this congressional directive, FCA proposed, re-proposed and finalized several sets of capital adequacy regulations imposing permanent capital and surplus requirements for Banks and Associations, in each case making sure each dollar of capital was counted only once (or not at all).

FCA's existing capital framework has not materially changed since 1997. The System, however, has undergone significant changes. Associations have merged. Greater operational efficiency and improved loan underwriting have allowed Associations to build strong capital bases supporting more diversified loan portfolios. Districts have merged, providing further cost savings and diversification at the Bank level. Larger Associations and the transition of Banks to wholesale lenders have radically changed historic dynamics. Today, Banks may routinely retire stock, pay cash patronage, and attribute their surplus so that, in many cases, each dollar of Bank earnings is either distributed or assigned a name to it. More than ever, a Bank reflects an aggregation of the interests of its Associations, much like a partnership aggregates the interests of its partners. This aggregation is reflected in the Bank's capital adequacy plan, setting forth the Associations' agreement on how loans are to be capitalized, capital raised, and losses shared at the Bank level.

III. Patronage Stock

Allocated Bank stock (also known as "patronage stock") presents a dilemma in how capital is allocated between the Bank and its Associations. Patronage stock is a unique by-product of the System's partially tax-exempt, two-tier cooperative structure. It dates back to the legislation adopted by Congress in 1956 to transition the System from government ownership to producer ownership. It was this legislation that first required Associations to purchase stock in the Banks (FICBs). It also required these Banks to distribute patronage refunds in the form of Class B stock and use the underlying earnings to retire the Class A stock owned by the government. The Banks continued this practice for several decades and long after all of the Government capital was retired (in 1969). The Class B stock is referred to as "patronage stock" or "allocated stock".

The distribution of patronage stock may have been initially compelled by Congress, but it was advantageous to Associations due to an anomalous book-tax disparity in the treatment of patronage stock. For book purposes, Associations could recognize the par value of the stock as income in the year of issuance. For tax purposes, the IRS had consistently ruled that the receipt of the stock did not create taxable income and, for stock issued prior to 1969, even the retirement of such stock did not give rise to taxable income. It made eminent sense for Banks to use patronage stock allocations to move earnings to their Associations while keeping the earnings sheltered from taxes. Issuing patronage stock became a widespread and long-standing strategy for capital management, and contributed to the Banks (FICBs) ability to withstand the downturn in the 1980s.

In 1993, the accounting treatment of patronage stock changed. For stock issued after 1993, the Associations could continue to report the par value of the stock in their book income, but would be required to record a tax expense to account for the future cash taxes that would be paid when the stock is ultimately retired. The System's external auditor and tax advisors concluded, however, that an Association should not record a tax expense if it adopted a resolution obligating itself to distribute the taxable income arising from the actual retirement of the Bank patronage stock as a patronage dividend. Such a distribution would give rise to an offsetting deduction at the time of the retirement, and effectively shift the tax burden (along with the cash or an Association allocated equity) to the farmers. This tax treatment reflected basic cooperative tax principles under which patronage earnings are subject to a single, current level of tax when distributed pursuant to a pre-existing obligation and in the manner provided for under the Internal Revenue Code. Absent the pre-existing obligation, the Associations would be required to record the receipt of patronage stock as income net of a 35% Federal tax expense.

The 1993 accounting change conformed the accounting treatment of a patronage stock allocation to an actual cash patronage distribution. In both cases, the Association had to record the tax expense, which expense dissipated District-wide capital. This accounting change did not impact most Districts because they had largely ceased issuing patronage stock in the late 1980s (due to the lack of earnings).

In at least the Western district, however, the Bank continued allocating patronage stock. To avoid recording a tax expense, many Associations in this District adopted a resolution obligating themselves to distribute any taxable income realized upon the retirement of patronage stock issued after 1993. When the Wichita and Western Banks merged, the Association stockholders agreed to a capitalization plan that continued Western's practice of distributing earnings in the form of patronage stock allocations in combination with cash patronage. Following this merger, many of the Wichita associations also adopted resolutions requiring them to distribute taxable income upon the retirement of the patronage stock that they expected to be receiving from the merged Bank.

To summarize, Association earnings were invested in the Bank through stock purchases, while Bank earnings were distributed to Associations through patronage stock allocations. The sum total of outstanding Bank stock trended upward as Associations grew and were forced to capitalize such growth. The growth in outstanding Bank stock was periodically interrupted by retirements of purchased stock (typically occurring when an Association with a shrinking loan portfolio requested a redemption or a PCA with substantial patronage stock holdings merged with an FLCA). Patronage stock, however, was rarely retired (due to the potential tax consequences). For this reason, and as further described below, several Associations today have investments in Bank stock in excess of that mandated by their Bank's capitalization plan.

IV. Capital Allocation Agreements

Patronage stock played an integral role in Bank capital management due in large part to how the Farm Credit Act and FCA regulations operate to prevent the double counting of Bank stock.

In first promulgating regulations in 1988 under the then newly imposed permanent capital requirement, FCA originally proposed that double counting be eliminated by deducting an Association's investment in Bank stock from Bank permanent capital, citing the argument that this "member funds" approach places the capital where the primary risk resides. A few months later FCA proposed for comment various other means of addressing the double counting of an Association's Bank stock investment. One idea was for the regulations to mandate a percentage allocation of the capital between the Bank and Association. Another idea was bottomed on the concept of "owned funds" – that is, the capital must be counted only at the Bank level because that is where the cash resides. FCA also introduced and sought comment on the concept of allowing a Bank and its associations to enter into a district-wide agreement specifying where the capital would be counted, intimating that the owned funds approach might be appropriate only for the purchased portion of the investment.

FCA's proposals for addressing double counting generated numerous comments from across the System, many with opposing viewpoints. After considerable deliberation, FCA adopted final regulations in 1988, rejecting both an allocation approach and its original member funds approach in favor of the owned funds approach. However, FCA provided a transition period in which capital allocation agreements would be allowed. Specifically, until 1993, a Bank and its Associations could adopt a district-wide agreement on the allocation of the Bank stock investment. After 1993, all purchased stock had to be included in the Bank capital. Allocated stock, on the other hand, would be gradually transitioned from Association capital to Bank capital in 20% increments over five years (the "phase-in rule"). While this compromise demonstrated a policy preference for an owned funds approach, FCA did not articulate any specific objections to capital allocation agreements that were then being put in place.

Notwithstanding FCA's provisional acceptance of capital allocation agreements in 1988, FCA's position on where Bank allocated stock should ultimately be counted appeared to harden. In 1991, legislation was introduced to enhance the System's safety and soundness. Mark-ups of the various bills included provisions that would override FCA's phase-in rule with respect to the capital treatment of Bank patronage stock. FCA provided input to Congress on this legislation. In a letter to Representative De La Garza, Chairman of the House Agricultural Committee, FCA argued for preservation of the phase-in rule. This letter provides, in pertinent part, as follows:

> "The FCA strongly believes that, for purposes of computing regulatory capital, an association's investment in the bank should be counted as the bank's capital and not the association's capital. It is the bank, not the association, that actually has control over this capital. These funds are "good, hard cash" to the bank because the bank has complete discretion, within its operating authorities, to invest or otherwise use the funds as it sees fit. On the other hand, an association's investment in the bank is an unmarketable, non-earning asset, which can be retired only at the bank's discretion."

Congress disagreed with FCA's assessment of how Bank capital stock should be counted. In 1992, less than one year before the 5-year phase-in rule was to begin, Congress adopted and the President signed the Farm Credit Banks and Associations Safety and Soundness Act of 1992 (the "1992 amendments"). This legislation amended the definition of permanent capital to give System institutions greater flexibility to eliminate double counting. As so amended, an Association's permanent capital would include Bank patronage stock to the extent provided in a capital allocation agreement between it and the Bank. Any allocated stock included in the Association's permanent capital under such agreement would be deducted from the Bank's permanent capital. The legislation did not change the treatment of purchased stock, which continued to be included in Bank permanent capital and deducted from the Association's permanent capital.

With Congress having settled the issue of the capital treatment of Bank allocated stock, FCA suspended the regulatory provision terminating capital allocation agreements and the 5-year phase-in rule. In 1994, FCA issued final regulations approving the adoption of a capital allocation agreement between a Bank and each of its associations specifying a method for allocating Bank patronage stock between their respective capital ratios. To address potential concerns about the stability of the computation of permanent capital, FCA added a regulation providing various rules on the duration of a capital allocation agreement and when and how it can be amended. It also laid out default rules on how Bank patronage stock is allocated between a Bank and Association in the absence of an agreement. In one respect, however, the new rule was more liberal than the prior (1988) regulation in that it allowed a Bank to enter into separate capital allocation agreements with each of its Associations rather than a single District-wide capital allocation agreement covering all Associations.

As an aside, we note that during the development of the regulations on the capital treatment of Bank stock, no discussion took place on the theoretical basis for distinguishing purchased stock (financed by Association earnings) from patronage stock (funded by Bank earnings). Distinguishing the two was not an obvious compromise. From a financial accounting perspective, a patronage stock allocation was equivalent to a distribution of cash patronage to a patron followed by the patron's reinvestment of the cash in the cooperative. Further, at the time the regulations were issued, purchased stock and patronage stock had identical economic rights. Nevertheless, the distinction was created when FCA first endorsed capital counting agreements in 1988, and adopted by Congress in the 1992 amendments.

V. Surplus Requirements

In 1995, one year after FCA finalized regulations on capital allocation agreements, FCA introduced two additional risk-based capital adequacy ratios (total surplus and core surplus). These capital ratios have narrower definitions of capital, designed to compute components of retained earnings as opposed to paid-in capital. For example, the core surplus requirement does not treat outstanding stock (other than non-borrower held perpetual stock) as capital. Under the core surplus requirement, an Association's investment in Bank is not only subtracted from the Association's core surplus but also excluded from the Bank's core surplus. Since neither entity counts Bank patronage stock in core surplus, no allocation agreement is needed to eliminate double counting.

However, capital allocation agreements continued to have effect for both the statutory permanent capital requirement and the new FCA-imposed total surplus requirement. That is, in computing both permanent capital and total surplus, a Bank and Association must deduct the amount of Bank equities counted in the other's permanent capital pursuant to a capital allocation agreement or under the default rules. Furthermore, FCA allowed the Bank to not reduce its collateral, for purposes of computing its net collateral ratio, by patronage stock included in Bank capital pursuant to a capital allocation agreement.

VI. Owned Funds Approach is Not Appropriate to Excess Investments

In connection with the Advance Notice, FCA sought input from the System's capital workgroup on several questions, including the issue of how readily Associations can, if the need arises, liquidate Bank stock that is allocated to them under a capital allocation agreement. This line of inquiry suggests that a new or modified capital regime might not necessarily confer the same treatment on intra-System investments, the most significant of which is Bank allocated stock. For the past 17 years, the treatment accorded to Bank allocated stock has proved successful. Reverting to an owned funds approach would be somewhat unsettling, as it would vitiate the capital allocation agreements in place since 1988, endorsed by Congress in 1992, and relied upon since that date in Bank capital planning. We also believe that preserving capital allocation agreements while downgrading the capital weight of Bank allocated stock would be equally unsettling and would thwart the purpose and intent of well functioning statutory and regulatory rules.

We appreciate the logic of the argument that an owned funds approach counts the capital where the cash resides. The argument goes that if an Association cannot legally compel a retirement of the patronage stock and cannot otherwise monetize the stock to pay down its debts, it cannot be assumed that the Association will be able to use the stock to absorb its own losses. This argument would be much more compelling if the stock at issue was not an investment in the Association's (sole) creditor. The purpose of maintaining capital is to provide the equity cushion that a lender requires. Here, the Association does not need to liquidate the Bank stock investment to satisfy its creditor because the funds are already held by the creditor. Since the Bank-creditor's position is secure, its agreement to allow the Association-borrower to count and use the capital is really nothing more than an expansion of the line of credit.

The question, then, is what if a Bank experiences a loss from lending to Association A, and Association B wants its allocated stock retired. The question assumes a motivation on the part of Association B that, at least under the U.S. AgBank District's capital plan, would not likely exist, at least to the degree that FCA might presume. As described in the following paragraphs, developments in Bank capital plans over the past several years weaken the theory of an owned funds approach relative to the timeframe Congress last addressed it.

At its most fundamental and basic level, a wholesale Bank's capital plan is a loss sharing agreement. Under the typical capital plan, the Associations agree that they will maintain an investment in Bank stock equal to a specified percentage of their borrowings. If an Association must further invest in Bank stock to capitalize growth, such additional stock becomes part of the Bank's capital (and cannot be leveraged by the Association for further loan growth). The rather simple premise underlying each capital plan is that Associations bear losses in proportion to usage – a cooperative principle that is uniformly understood and accepted.

Some Banks had to consider how to remain true to this cooperative principle in light of the continuing growth of patronage stock. The Western and Wichita Banks negotiated this precise issue in setting terms for the formation of U.S. AgBank. In reliance on the 1992 amendments and the existing capital adequacy regulations, the two Banks and their Associations agreed that the merged Bank would continue Western's practice of issuing patronage dividends in the form of stock. They did so even though many of the Associations had (or would eventually have) an investment in Bank stock above the minimum required under the Merged Bank's proposed capital adequacy plan. The receipt of additional Bank patronage stock following the merger would simply increase the excess investments.

Under the U.S. AgBank capital plan, a distinction is drawn between patronage stock and "excess patronage stock." Excess patronage stock is an amount of patronage stock equal to the amount by which the Association's investment in Bank equities exceeds its required investment. Excess patronage stock inures to the benefit of the Association holding such stock in several ways. First, an Association is allowed to count excess patronage stock in its permanent capital (which amount is then deducted from the Bank's permanent capital). <u>This capital allocation agreement reflects a shared understanding of the Bank and Associations that the excess investment is "owned" by the Associations</u>. It is treated as such because it reflects an investment above and beyond the amount a patron ideally would have at risk in a cooperative based on its usage. Second, excess patronage stock for a particular calendar quarter is subtracted from the Association's direct note in determining the Association's investment requirement for the following quarter. This places the Association in the same position as if the excess patronage stock had been redeemed through an offsetting reduction in the direct note. Third, and most importantly, Associations receive a return on their excess patronage stock through a priority allocation of patronage. Associations that do not have excess investments receive no patronage (in cash or stock) until the priority patronage return for the current year and past years has been fully distributed to the Associations with excess investments. Although the excess patronage stock is not a deposit with the Bank, it is treated that way both economically and in the perception of the Associations.

In assessing the "accessibility" of Bank stock, thoughtful consideration must be given to the level of an Association's stock investment in the Bank. Certainly, treating Bank stock as Bank capital is warranted where the holder owns only the minimum required investment in the Bank. To that degree, the stock is not accessible to the Association. An excess investment is, at least under U.S. AgBank's capital plan, a different type of asset. It is backed by capital that the Bank does not leverage and does not view as risk bearing. The holder earns a priority return on the excess investment that largely negates any earnings the Bank derives from having such stock outstanding. Thus, the Bank does not materially benefit from keeping the stock outstanding and, for this reason, presumably would have no basis to reject a redemption request.[3]

In light of the developments in Bank capital plans in general and the U.S. AgBank capital plan in particular, the argument underlying an owned fund approach loses strength. Although excess patronage stock like all Bank stock can be retired only at the Bank Board's complete discretion, it is not a "non-earning asset" as it was so characterized in the quotation above from the legislative history to the 1992 amendments. To the contrary, excess stock generates a return solely for the benefit of the Association that owns it. The Bank does not extract the earnings on the excess stock for its own benefit (i.e., the benefit of all Associations proportionately). The capital counting agreement allows the Association to leverage the capital to serve its members. Also, the argument that Bank stock is a pool of "good, hard cash" because the "bank has complete discretion … to invest or otherwise use as it sees fit" is not indicative of how Banks operate today (or even back in 1991). A Bank is a closed cooperative. The Bank's capital is deployed for the singular purpose of serving the mission of its member Associations.

In sum, the U.S. AgBank District believes strongly in the merits of a capital allocation agreement premised on the distinction between required investments (counted at the Bank level) and excess investments (counted at the Association level to the extent of the Association's patronage stock). More specifically, if an Association has more than the required investment in Bank stock, the Bank and Association should be entitled to agree to count patronage stock up to the excess amount as Association "Tier 1" capital. Allowing such an agreement respects the Bank's determination of the aggregate amount of capital it requires and that Associations should not be penalized for having more capital <u>theoretically</u> (and temporarily) at risk than what their borrowings from the Bank warrant.

---

[3] It is also noteworthy that, under U.S. AgBank's bylaws, a Bank loss impairs the stock that comprises the Association's required investment in the Bank before it impairs the excess patronage stock.

VII. Adverse Impact of a Strict Owned Funds Approach.

If a new capital regime imposes a strict owned funds approach, Associations with excess investments in Bank stock would take a substantial capital hit and a consequential reduction in their lending limit. Such an Association would likely feel compelled to request a retirement of the excess stock to reclaim its members' capital. The problem is that the retirement may generate a tax liability, preventing the transaction from fully replenishing its capital. Alternatively, if the Association is under a standing resolution obligating itself to distribute the retirement proceeds as a patronage dividend, the Association would be forced to shift the taxable income to its members. An Association could do so by either distributing cash, in which case the capital leaves the System, or by issuing qualified allocated equities, in which case an allocated equity in the Bank becomes an allocated equity in the Association. In either case, if the capital allocation agreement is eliminated, the members will directly or indirectly pay tax and the District loses some amount of capital.

It can be argued that the reluctance of retiring patronage stock to avoid potential adverse tax consequences demonstrates that the stock is inaccessible. However, a material tax impediment is not likely to exist in any scenario where the Association truly needed the capital. That is, net operating losses resulting from charge-offs precipitating the need for capital would likely be available to offset the taxable income. Also, as noted above, Associations would have some ability to retain the capital by allocating the taxable income to its members in the form of allocated surplus. The bottom line is that if the Association truly needs the capital, the tax issues could be managed in a way to preserve the capital.

VIII. Contrast to the FHLB System

That capital allocation agreements lack precedent in the regulations of the other banking agencies is not a persuasive argument to discard them. The Banks and Association are integrated and mutually dependent like no other GSE or banking structure with which we are familiar. The Farm Credit Act structurally separates retail credit risk and wholesale funding risk, and FCA rightly imposes a capital requirement at each level. The wholesale funding risk, however, is a function of the retail loan volumes and is shared by the Associations on that basis through their required investments in Bank stock. The excess stock is not a side pocket of capital meant to bear wholesale funding risk or generate a return to reduce a Bank's marginal cost of funding.

In this regard, the Federal Home Loan Bank System provides an interesting and instructive contrast to the System. In certain districts of the HLB system, the member institutions own "excess stock" in their district Home Loan Bank ("HLB"). The regulator of that system (today known as the Federal Housing Finance Agency) grappled with the consequences of allowing HLBs to use this capital. The Finance Agency saw considerable downside in allowing an HLB to leverage excess stock. As described in the following paragraphs, from a capital management perspective, System Banks compare quite favorably to HLBs, in part due to capital allocation agreements which allow the Associations to utilize the excess stock.

HLBs, like Farm Credit Banks, are tax-exempt cooperatives. A mortgage lender seeking an advance from an HLB must buy stock in and become a member of its district HLB. Each HLB has a capital plan that requires its member banks to hold stock in the HLB equal to a percentage of its advances. Another similarity to the System is that many HLBs have the practice of distributing earnings to its members in the form of their own common shares, but with the distinction that these dividend shares are issued based on existing stock ownership and not on a patronage basis. From the member's perspective, the receipt of these stock dividends gave rise to book income but not taxable income. As is the case with System Banks issuing patronage stock, the underlying earnings remained sheltered in the HLB.

For many HLBs, the continuous issuance of stock dividends resulted in member banks owning stock in excess of the requirement established in the HLB's capital plan. The HLBs counted all outstanding stock (including the excess amounts) in their permanent capital, and the excess stock rose year after year. The Federal Housing Finance Agency saw this as problematic and issued proposed regulations in 2006 to prohibit the issuance of dividends that an HLB could issue in the form of stock. In the preamble, the regulator stated as follows: "These changes are being proposed for prudential reasons to address the Finance [Agency's] concerns that some Banks increasingly use excess stock to capitalize assets that are long term in nature and not readily salable, such as [a member's mortgage loans], or that are not mission related …."[4]

The Finance Agency clearly perceived a risk in unabated growth in excess stock, fueled by the statutory tax shelter that the HLBs provided their members. The Finance Agency was circumspect in its language, but the insinuation was clear -- HLBs were, to use FCA's vernacular, "using the funds as it sees fit" or, more precisely, making questionable investments in defiance of its cooperative mission. The implication was that eliminating excess stock from an HLB's capital base would force it to hew more closely to its core function and mission.

This is not to imply that the Farm Credit Banks would drift into new areas or investments if they counted excess patronage stock in their permanent capital. Quite the contrary: because of its smaller membership and the industry it serves, Associations demand that Banks adhere to the cooperative principle. The allegiance to that principle and the accountability it creates does not exist to the same degree in the HLB system. The capital allocation agreement, which allows Associations to use the excess capital to serve the ultimate owners of the System, reflects and reinforces the responsibility of a Bank to serves its Associations on a cooperative basis.

Actually, the issue of how a Bank would use excess stock in the absence of a capital allocation agreement is academic. The Associations would eventually (if not immediately) withdraw the capital, not based on a fear that the Banks would, if given the chance, undertake risky trading strategies, but rather because the Associations could better use the capital to serve their own members. An HLB's members might be willing to continuously roll over their dividends for more HLB stock (or at least they were two years ago). System Associations would not. A more important distinction, however, is that the excess stock in the HLBs was growing and allegedly encouraging greater risk taking. To the extent the excess patronage stock in a System Bank poses a prudential concern, it is a quantifiable concern. In this connection, U.S. AgBank ceased issuing patronage stock in late 2006 and does not anticipate resuming the practice. Any safety and soundness concern of a capital allocation agreement for today's patronage stock will ameliorate over time.

IX. Conclusions

The position of this paper is that excess Bank patronage stock should be included in the Association's regulatory capital if the Bank and Association so agree. Congress determined that Bank patronage stock was quality capital and sanctioned capital allocation agreements to determine the level at which it should be counted. If a new capital regime is put in place, the Bank patronage stock should be accorded no less status in the Association's capital base than it has today. Counting all patronage stock at the Bank level or relegating the status of this capital in the Association's capital ratios would clearly contravene Congressional intent and be highly disruptive to Bank capital management plans that were built under the assumption that this issue was settled back in 1992. We understand the simplicity of a rule that treats Bank stock as Bank capital because that is where it is most accessible. The logic of such a rule fails, however, when applied to a category of investment that exceeds the cooperative ownership level dictated by usage and that, as a result, all involved treat as belonging to the Association.

We would also like to stress there is nothing inconsistent in treating a category of Bank allocated equities as excluded from Bank permanent capital while allowing an Association to treat the full amount of its allocated equities as permanent capital. We strongly believe that an Association (or Bank) should be able to include allocated equities in its Tier 1 capital if a two-tier system is instituted. As noted above, if excess patronage stock is retired at a time that the Association needs the capital, the Association is likely to turn around and issue an allocated equity to its members with the expectation that doing so would leave its regulatory capital position largely unchanged.

Finally, it must be emphasized that the amount of patronage stock that is currently allocated to the permanent capital of the U.S. AgBank Associations is a finite amount. The stock was accumulated based on the rules that existed at the time the earnings were generated and settled expectations on the capital treatment. As an Association grows, this category of stock will only shrink over time. Importantly, disciplines exist today that did not exist in the 1980s. Banks are held accountable to Associations in the efficiency of their operations. A Bank operates on a premise that all Bank capital belongs to its Associations. The Associations view this capital as the means by which they share wholesale funding losses. Excess patronage stock, however, is not intended to absorb Bank losses. Allowing such stock to be counted at the Association level is meant to preserve (but not expand) an historic tax/accounting benefit so that the Associations are better positioned to serve their members.

cc: Michael R. Fayhee

---

[4] See Federal Register, Vol. 71, No. 50, at pages 13306-13316 (March 15, 2006).