Revised
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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.

Paid In Capital Surplus (Due to Acquisition) – ***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 – ***<u>Tier 1</u>***

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

Unprotected Stock – ***<u>Tier 1</u>***

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 – ***<u>Tier 2</u>***

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 – ***<u>Tier 1 or Tier 2</u>***

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 – ***<u>Tier 2</u>***

The allowance for loan losses including the Reserve for Unfunded Commitments 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 Surplus (or Retained Earnings) – ***Tier 1***

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

Qualified Allocated Stock to Cooperatives – ***Tier 1***

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

Additional Paid In Capital Surplus (Due to Acquisition) – ***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***

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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.