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Via Electronic Submission (reg-comm@fca.gov)

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

RE: ANPRM on Capital Adequacy; Capital Components – Basel Accord Tier 1 and Tier 2

Dear Mr. Van Meter

Thank you for the opportunity to comment on FCA's ANPRM for Capital Adequacy. We serve as the Senior Vice President and Chief Financial Officer and the Vice President of Capital Management for AgStar Financial Services, ACA ("AgStar").

AgStar is a $5.4 billion Association in the Farm Credit System ("FCS" or "System"). Our response to the capital adequacy ANPRM is heavily impacted by our recent issuance of third party capital. Overall, we support changes to the current capital regulations to modernize and align with other financial institutions. Throughout our response we have a few common themes in regard to the proposed regulations being contemplated. First, we view transparency of rule application as essential. Any new rules or regulations put in place regarding third party capital and capital regulations should be easily discernable by all parties as to both what the regulations are and how they will be applied. To the extent new regulations are not implemented, a better effort should be made to improve transparency of existing metrics. Second, we feel strongly that comparability to the US and world banking system is important while recognizing that the uniqueness of the Farm Credit System may require some adjustments. Efforts should be made in the process and in ongoing practices to promote comparability across US and world financial institutions whenever possible. Finally, consistency of application should be of paramount concern. As you will note in the comments below, clear and consistent application of measurement or treatment is essential to safety and soundness and the relative attractiveness of the System for third party capital. Inconsistent application of regulations or restrictions will erode the System's ability to attract competitively priced capital from the market over time.

Our responses to specific questions follow below:

1. ***Should we adopt separate and tailored regulatory capital standards for banks and associations? Why or why not?***

AgStar does not believe separate and tailored regulatory capital standards for banks and associations is beneficial for the following reasons A) complexity creates confusion in the market place B) alignment of capital standards creates alignment between institutions and reduces any possible arbitrage and C) differences between the entities can be managed through examination or surcharges similar to what is proposed in Basel III.

A) Complexity creates confusion in the market place.
We believe that a simple, logical set of capital standards for the System would promote transparency to investors and allow a greater sub-set of investors to understand the System benefits beyond of Government Sponsored Entity ("GSE") status. Similar to a reliance on a AAA rating, reliance solely on GSE status to attract competitively priced capital is a slippery slope and we believe steps should be taken to promote comparability with other financial institutions.

AgStar sought institutional capital through a process in 2009 and 2010 which ended successfully. Throughout that process, the Farm Credit System capital ratios, definitions and enforcement were discussed at length with investors. AgStar experienced a significant impediment in regard to understanding the ratios, the rationale, and how the ratios compared to other financial institutions third party investors encountered. In fact, AgStar had several investors retract from the process due to the complexity. The difficulty experienced in that process has shown us that an additional layer of capital standards for Banks and Associations would be detrimental to the view of the System from the eyes of third party capital providers. Given the inherent interdependence Associations have with Banks, investors are required to underwrite the Banks as well as an individual Association when contemplating an investment at the Association level. We believe, at a minimum, varied capital ratio's would likely raise the cost of capital due to the limited pool of investors who would be willing to understand the nature of the ratio's and other complexities the System provides. In today's market, transparency and simplicity are rewarded whereas opacity and complexity are severely discounted.

Access to third party capital for the Banks and Associations is, in our view, vital to the long term strength of Rural America and our borrower/owners. AgStar has been strongly advocating risk management to our clients for several years. Part of the risk management message is having ready access to capital at a competitive price. Streamlined capital regulations and comparability to other financial systems is one of the best ways to promote ready access to third party capital for the System.

B) Alignment of capital standards creates alignment between entities and reduces any possible arbitrage available.

If the Farm Credit Administration ("FCA") were to determine two sets of standards are best for Banks and Associations, we believe it would eventually lead to distortions that could potentially harm the System. Due to the uncertainty created by a change in capital rules, establishment of capital regulations should be intended to last for several years. While capital standards remain static, the environment around the regulations remains dynamic. A perceived sound set of rules may end up creating large distortions which were not apparent at the outset. As seen in the distortions brought on by Basel II adoption in Europe vs. US, which caused distorted investment in AAA securities as well as massive off balance sheet risks, we believe the market will evolve such that a Bank or Associations financial incentive will eventually be set up to exploit the differences and therefore cause fractions in the System. One set of rules will clearly reduce the amount of arbitrage that can take place between the two entities as the market evolves.

Also, given the structure of System reporting, different capital standards and the exploitation of those differences may become very difficult to describe/explain in the annual and quarterly statements provided to the public. A growing number of exceptions and footnotes in regularly issued financial statements does not promote transparency or trust in a system/company.

C) Differences between the entities can be managed through examination or surcharges similar to what is proposed in Basel III.

Based on the latest Basel III proposals, the international banking system is proposing differences between large and small banks and the credit environments within regions can be handled with surcharges or "capital conservation buffers". Although we do not agree with all of the suggestions put forth in Basel III, we believe that close examination and tracking are superior ways to ensure safety and soundness over individually tailored capital standards which are inherently rigid. Although we would like to understand guidelines and reasoning for implementation of "conservation buffers", and the "buffers" eventual extraction to eliminate arbitrary adoption, we would support an FCA proposal around capital conservation buffers during times of increasing risk or credit growth relative to assets. We believe this may help mitigate flight from our System Bonds when stress occurs. We believe this to be a more flexible approach and more adaptable to the changing environment over time than separate capital standards for Banks and Associations.

2. ***Should we establish an upper Tier 1 minimum standard for banks and associations? Why or why not? If so, what capital items should be included in upper Tier 1, and should bank requirements differ from association requirements?***

We believe the System should move away from the current Core Surplus ratio and implement a Tier 1 ratio in its place. This new Tier 1 ratio will represent a core comparable standard to Basel III institutions and should be similar for both Banks and Associations in the System. We believe the core defense against company or system failure is the retained earnings and permanent capital we have in our company/system. This core defense is best measured by using standard, non market based terms such as retained earnings or surplus and purchased stock (common and perpetual preferred). All other Tier 1 additions should be severely limited due to their fleeting nature or accounting dependant values. As seen in the latest Basel III statements, this view is shared by the Basel committee and is also shared by the ratings agency Moody's, which has consistently had Tangible Common Equity as a measure on their international bank rating criteria.

We believe that all stock & surplus, allocated and unallocated, that is at the discretion of the Board of Directors to maintain within the Company should be counted as Tier 1 capital. If Boards of Directors and management make poor decisions on payment of patronage during times of stress, regulatory steps can be taken to alleviate those problems. We believe strongly that our borrowers/owners can understand when/why patronage distributions or stock retirements have to be avoided for the mutual benefit of long term stability. Arguments made to the effect that regularly retired stock should not be counted as regulatory capital because they are regularly retired is similar in our view to the argument made by our customers that because we have extended credit to them in the past, they deserve extension again even though circumstances have changed. We make credit decisions every day and our customers recognize that they may not always receive credit/patronage if the circumstances have changed. We believe our borrower/owners recognize changes in the environment and that purchased stock and allocated earnings should be Tier 1 Capital.

Also, we believe scheduled patronage distributions to owners, whether they be to Associations or FCS borrowers, should always be seen as discretionary and should not be used to support baseline operations. We believe FCA should promote the goal of individual institution strength such that an entity may stand on its own without patronage support. By building entity pricing practices, organization structure and underwriting against this independent model, we believe the System will reduce its interdependent weaknesses. If we promote and support the patronage dependence, we will inherently create a more unstable/correlated system which can have domino effects once stress is felt at the Bank level. Stronger links in the chain support a stronger overall system and eventually a more consistent level of patronage to our customers.

3. ***Should we establish specific regulatory restrictions on third-party capital? Why or why not? If so, should there be different restrictions for banks and associations?***

Although philosophically we don't view restrictions on third-party capital as necessary, we understand the need for some restrictions in order to fulfill and maintain our mission as a GSE and cooperative owned system.

AgStar believes specific regulatory restrictions on third party capital are in the best interests of System institutions vs. the current system of ad hoc application. Keeping with our theme of transparency, we believe specific regulatory restrictions are beneficial to increase certainty of rule application. Certainty can smooth transaction execution and eliminate potentially harmful/arbitrary steps, which can impact the attractiveness of an investment in FCS institutions.

As noted above, AgStar recently embarked on an effort to raise third party capital, which proved successful. Despite the success, there was significant consternation around the ability of the deal structure to fit within the guidance FCA provided to Associations and Banks in February of 2009. The lack of clarity as to what is allowed or qualifies caused pricing of the transaction to fluctuate within a range and may have caused the transaction to fall apart if long term treasury rates had moved significantly. It also proved very difficult for AgStar to finalize the diligence process with the investor because they were not able to commit to a price/transaction until they knew the extent of the qualifications presented by FCA. AgStar board members and the potential investors were sensitive to the cost and terms of the transaction and were unwilling to move forward if terms changed significantly. Transparency on the restrictions and rules being applied would have provided a smoother overall transaction process.

While the traditional, investment bank led transaction completed by the Banks in various instances alleviates most of the problems mentioned above due to the "take or leave it" or "best efforts" terms presented to investors, the current system is not ideal for a privately negotiated transaction such as what AgStar completed in March of 2010. While an investment bank led transaction was available to us, we believe we were able to execute better eventual pricing and terms and save significantly on fees by completing a private transaction. We believe well defined regulatory restrictions will allow all types of transactions, with or without an investment bank or agent, to be completed without the uncertainty that transpired in our transaction.

The clarity in regulations will also help with advance planning and understanding by other stakeholders. We will cite one transaction which outlines the point, a System Bank issuance of third party capital. In our view, the primary reason an entity raises third party capital is to provide a "cushion" to the minimum capital standards. Due to FCA regulations regarding the issuance of third party capital, the cushion to the Net Collateral Ratio actually decreased from pre to post issuance.

NCR Pre Issuance	104.80%
Capital Standard	103.00%
Cushion	1.80%
Est. NCR Post Issuance	105.59%
Capital Standard	104.00%
Cushion	1.59%
Reduction in Cushion	0.21%

Associations in the District were now deeper in the capital structure and had greater risk of losing patronage payments due to the issuance. Although there were other benefits to the issuance received by the Associations, set FCA regulations would have allowed borrower/owners to forecast the potential risks and weigh the consequences much easier. The medley of restrictions/conditions instituted by FCA does not facilitate advance planning that is beneficial to any capital issuance.

4. ***Should we replace any regulatory limits and/or restrictions based on permanent capital with a new limit based on Tier 1 or total capital? If so, what should the new limits and/or restrictions be? Also, we ask for comments on how, or whether, to reconcile the sum of Tier 1 and Tier 2(eg total capital with permanent capital).***

Please See Appendix II for an alternative recommendation to all capital ratio calculations that we believe would be transparent, similar to other financial entities and promote consistency.

Current Ratio	Changes To	Proposed Ratio
Core Surplus	→	Tier I
Total Surplus	→	Permanent Capital (redefined)
Permanent Capital	→	Total Capital

Given Permanent Capital's statutory nature, we recognize its permanence and believe the ratio now defined as Total Surplus can be redefined as Permanent Capital and a new capital standard which specifically includes allowance for loan loss ("ALL") and other Tier II capital components can be implemented and named Total Capital. We believe migrating Total Surplus to Permanent Capital is appropriate today in part due to the reduction of purchased common stock as a component of capital within the System. This reduction has taken place over the past 20 years to the point where purchased stock rarely accounts for more than 0.25% of Association risk adjusted capital levels. Overall, at 12/31/10, capital stock and participation certificates accounted for only 4.6% of total system capital and only 2.4% of Association capital. AgStar is generally comfortable with the current regulations centered on Permanent Capital and feel the alternative recommendation more properly strengthens the role Permanent Capital may play in System Institutions, especially Associations, in the future.

Permanent Capital (Redefined)	**Total Surplus**
Purchased Common Equity	
Unallocated & Allocated Surplus	Unallocated & Allocated Surplus (except allocated with <5 yr revolvement)
Plus: Qual. Outstanding Subdebt	Plus: Qual. Outstanding Subdebt
Plus: Qual. Term Preferred Stock	Plus: Qual. Term Preferred Stock
Plus: Qual. Cum Perpetual Preferred Stock	Plus: Qual. Cum Perpetual Preferred Stock
Plus: Qual. Non-Cum Perpetual Preferred Stock	Plus: Qual. Non-Cum Perpetual Preferred Stock
Less: Allocated Equities counted by Bank	Less: Allocated Equities counted by Bank
Less: Reciprocal Bank Inv (100%)	Less: Reciprocal Bank Inv (100%)
Less: Allocated for Patronage Distribution (Current Year)	Less: Allocated for Patronage Distribution
Less: Investment in Farmer Mac	Less: Investment in Farmer Mac
Less: Investment in other FC Institutions	Less: Investment in other FC Institutions
Less: Goodwill	Less: Goodwill
Less: Deferred Asset Adjustment	Less: Deferred Asset Adjustment
+- Securitization-related Investment	Securitization-related Investment
Total Permanent Capital	**Total Surplus**

5. No comment

6. ***We seek comments on ways to limit reliance on noncumulative perpetual preferred stock ("NPPS") as a component included in Tier 1 capital while avoiding the downward spiral effect that can occur when other elements of Tier 1 capital decrease.***

AgStar believes the best way to limit reliance on noncumulative perpetual preferred stock ("NPPS") is to limit the structure and terms of the security before issuance while combining that with a one-time test (at issuance) as to its percentage of Tier 1. AgStar believes that properly structured NPPS is a very good instrument for Farm Credit Institutions and should be promoted as the preferred instrument for third party capital. The very nature and structure of the security allows investors to make a permanent "equity investment" into our System by one of the only means available due to the cooperative structure of the System. We do not believe the security needs further limitations post issuance and should continue to count as Tier 1 capital no matter the ultimate percentage to which it equates. Clearly, an organization would be prohibited from issuing new NPPS until they had sufficient room under the one-time test. This would eliminate the downward spiral effect and would promote this security as the preferred source of third party capital in the System.

After the precedent was set by the government in regards to Fannie and Freddie perpetual preferred stock, we do not believe, nor should others, there is any implied guarantee as to preferred stock and thus no newly issued perpetual preferred stock will carry any brand risk for the System. Further, we do not believe skipping a payment will add additional signaling risk of stress any more than the publicly available financial statements which would presumably show significant financial deterioration.

If the System is still determined to limit the overall impact, we believe a term could be inserted into the stock purchase legal documents which allows a System Institution to purchase or force the sale of the NPPS at a market price if a receivership or bankruptcy were to take place. This term would alleviate concerns about control over a System institution falling to a third party. Although we believe properly structured NPPS will carry with it a premium market price, this price is compensation for knowing that investors will experience a loss if other Tier 1 components are exhausted.

7. ***What risk metrics would be appropriate to classify a System institution as Category 1, Category 2, or category 3? What percentage ranges of specific financial ratios would be appropriate for each risk metric under each category? We also seek comments on the increased restrictions and/or reporting requirements listed in Category 2 and Category 3.***

In general, we agree that capital should be measured within an institution and subject to some level of scrutiny as the level drops. <u>The responses and charts below are operating under the assumption that Level 1, 2 and 3 equate to FIRS levels in the FCA supervisory system.</u> We will outline some restrictions and reporting needs below. FCA final determination on the levels will dictate our support for the suggestions on Category 2 reporting and Category 3 restrictions. Although we recognize agriculture is cyclical, we do not believe that capital levels and thus the restrictions that may be applied should be dramatically higher than Basel III levels as community banks lending into residential and commercial real estate industries has proven just as cyclical. Associations with very little diversity should be subject to higher standards due to the concentration risks that are likely to occur within submarkets of agriculture or geography. In order to measure this, we would urge FCA to consider institution of a concentration based metric (i.e. Top 20 borrower's concentrations as % of total Permanent Capital or sub-industry concentration (corn/soybean, swine etc) as % of total capital). While we would welcome general adoption, we believe this could also be enforced either through General Financing Agreements between Banks and Associations or through FCA exam level scrutiny.

Category 1 – No restrictions. Baseline annual capital plan and stress tests should be completed.

Category 2 – Category 2 institutions should begin to experience documentation requirements as they approach the Category 3 levels. Levels slightly below Category 1 should be noted in capital plan but no immediate steps should be taken by the regulator, if viewed in a vacuum. Should levels drop dramatically (>1.5% in 3 month period) or drop to a level approaching Level 3, specific quarterly reporting should commence. Specific reporting by management to the board upon reaching the midpoint of Level 2 and Level 3 should include an updated capital plan, presentable to the Board of Directors, which outlines 1) actionable steps to return to Category 1 levels or reasoning as to why current level of capital is appropriate and 2) review of key concentrations, growth plans, and other uses of capital to determine if they are still appropriate (including budgeted level of growth, patronage payments, and sub industry, loan and borrower concentration metrics) and 3) stress test results. Reporting on the plan should be done quarterly as well as updated stress test results until the Board is comfortable with management response and planning.

Category 3 – Category 3 reporting and restrictions should be extensive. In addition to the capital plan update and stress testing above, prohibitions on payments of patronage or stock should be placed on the Association and/or made subject to FCA approval.

To the extent FCA uses its discretion to move an Institution to a different level than the objective metrics would imply, we believe the Institution should be given a written communication to the Board outlining the specific reasons for the move down and an outline of both quantitative and qualitative metrics used in the decision. In addition, given it will be difficult to track progress toward guidelines that no longer apply, we believe FCA should provide management and the Board a written roadmap or set of guidelines which indicates how the organization will be evaluated going forward and/or how the organization can return to the process of being rated based on the established guidelines. We believe these communications will help alleviate any confusion brought on by the discretionary move, open the lines of communication between FCA and the Institution, and help the Institution set priorities going forward.

	Metric (source)	1	2	3
Capital:	Adverse Assets to Risk Funds Ratio (FCA)	<25%	<=75%	>75%
	Criticized Assets to Risk Funds Ratio (FCA)	<60%	<=125%	>125%
	TBD Concentration Metric (Moody's)	TBD	TBD	TBD
	Examples Include:			
	Top industry loans % of total	*<50%*	*<=75%*	*>75%*
	Top 20 Borrower Concentration/ Perm Cap	*<100%*	*<=200%*	*>200%*
	~~Permanent Capital Ratio(Existing)~~	~~>15%~~	~~>=10%~~	~~<10%~~
	Total Capital Ratio (Basel III)	>12.5%	>=10.5%	<10.5%
	~~Total Surplus Ratio(Existing)~~	~~>12%~~	~~>=10%~~	~~<10%~~
	Permanent Capital – Redefined	>12.0%	>=10.0%	<10.0%
	~~Core Surplus Ratio(Existing)~~	~~>9%~~	~~>=5%~~	~~<5%~~
	Tier I Capital (Basel III)	>10.5%	>=8.5%	<8.5%
	Leverage Ratio	TBD	TBD	TBD

Note: Highlighted lines are existing standards.

The categories used to rank an organization in Level 1-3 were drafted largely from existing metrics and Basel III pronouncements. Adverse Assets and Criticized Assets to Risk Funds are based on the existing CAMEL/FIRS ratings. The concentration metric, discussed above, is derived from the Moody's framework for bank financial strength.

Total Capital, which includes ALL and available for sale ("AFS") gains is measured taking the 8% minimum proposed in Basel III + a capital conservation buffer of 2.5%.

The Permanent Capital Level (redefined) is set 0.50% below the Total Capital metric due to the exclusion of ALL and AFS equity gains, and other comprehensive income ("OCI") adjustments (should they be included). Since the 2004 accounting change in regards to ALL, it is estimated System Institutions had approximately .25% of ALL as a % of risk weighted assets ("RWA") (Note only general allowances were used for this calculation). The .50% buffer would account for these differences and leave room for any impacts from AFS equity gains and losses and OCI adjustments, if any.

Finally, we believe the Tier 1 Level 2 metric should be set at 8.5% which is the same as the Basel III minimum of 6.0% plus the "capital conservation buffer" of 2.5%. Given the hoped for similarities in the definition of this metric to Basel III institutions, we believe a similar level should apply.

A leverage ratio imposed on System Institutions should be evaluated for future implementation. While AgStar has already implemented a non risk based leverage metric (Total Assets / Risk Funds), we have not sought to determine if this metric could or should apply to all FCS institutions.

SEE APPENDIX FOR BASEL III PROPOSED LEVELS, PROPOSED REDEFINITION OF TOTAL SURPLUS & MOODY'S BANK RATING PROCESS.

8. ***We seek comments on whether the FCA should count a portion of the allowance for loan losses (ALL) as regulatory capital. We also seek information on how losses for unfunded commitments equate to ALL and why they should be included as regulatory capital. We ask commenter's to take into consideration the Basel III and recent changes to FFRA regulations in relation to the amount or percentage of ALL includible in Tier 2 capital.***

AgStar believes the System should view ALL as a component of capital. While ALL only applies to credit risk, at present, credit risk is by far the dominant risk faced by System Associations and Banks. Also, FFRA has used the metric despite credit risk being a smaller part of the risk assumed by commercial banking institutions as compared to FCS institutions. The limitations imposed and the inclusion only in Tier 2 capital or Total Capital allows it to be a meaningful but not overly important component of capital which we view as appropriate.

We also believe that inclusion of ALL in capital aligns with the use of ALL in several other risk measurements currently used by FCA in examination including its main credit risk metric, Adverse Assets to Risk Funds. We believe aligning these two metrics, capital and credit risk measurement, more properly aligns the System incentives to achieve proper and conservative ALL with less apprehension on the immediate impact to capital through earnings. We believe this alignment of interests is a strong benefit to the long term safety and soundness of System institutions.

9. ***We seek comments on the treatment of cumulative perpetual and term-preferred stock as tier 2 capital subject to the same conditions imposed by the Federal banking Agencies.***

   See Question 11.

10. No Comment

11. ***We seek comments on the treatment of intermediate-term preferred stock and subordinated debt as Tier 2 capital and conditions for their inclusion in Tier 2 capital.***

Due to the similar nature of the questions, we are consolidating our comments to questions #9 and #11.

Given the limited availability FCS Institutions have to raise common equity due to their cooperative status, we feel it is vital to include properly structured types of preferred stock and subordinated debt as Permanent Capital/Tier 2 Capital or Total Capital. These securities have been tested for loss taking ability by other financial institutions and have proven their value as a loss absorption instrument.

AgStar believes the current inclusion framework established by FCA, which largely mirrors other Federal Banking Agencies to be appropriate. We would promote the adoption of exact or very similar characteristics as to what is allowed by other Federal Banking agencies in order to promote the transparency needed with third-party capital providers.

We would also generally agree with the level of inclusion allowed as to the aggregate and other limits, with a couple exceptions. SEE APPENDIX FOR REDLINE. The current limitation on term preferred stock to 25% of Permanent capital vs. no individual limit for subordinated debt does not promote the right incentives. We believe FCA should encourage the use of the most junior, longest dated capital, rather than more senior capital for System Institutions. The 25% limit, all things equal, can be seen as a limitation to raising preferred stock.

From our experience with Institutional Investors, subordinated debt issuance has a preference due to the events centered around the receivership of Fannie Mae and Freddie Mac. Thus, further limiting the ability to issue Preferred Stock makes it even more unattractive both from an issuer and investor standpoint. We believe the Term Preferred + Subordinated Debt limitation as a percentage of Tier I capital is appropriate. The Aggregate limit which included Non-Cumulative and Cumulative Perpetual Preferred Stock should be modified to remove NPPS, as discussed above, but is otherwise suitable. The current limitation of 25% of Core Surplus for NPPS should be limited to a one-time test at issuance and we believe is too restricting and would favor a limit near 50% to promote the security as the preferred source of capital and also to allow for significant sizes to be issued by Banks and Associations. A significant size issuance is important to third party capital providers who view a sizable issuance as more readily tradable which can drive down the cost of the security to Banks and Associations. As noted above, we believe formalizing the regulations around inclusion will help clarify the securities in the eyes of issuers, third party capital providers and investors in Farm Credit System Bonds. While the limitation reasoning may not be well understood, the formal rules will allow planning and certainty as to the rules being applied.

12. No Comment

13. ***We seek comments on the regulatory adjustments in our current regulations that we expect to incorporate into the new regulatory capital framework. We also seek comments on the regulatory capital treatment for positions in securitizations that are downgraded and are no longer eligible for the ratings-based approach under the new regulatory capital framework.***

    In general, we are in favor of the regulatory adjustments made to eliminate double counting and the adjustments to remove goodwill and other comprehensive income. Regardless of whether new regulations are implemented, we encourage FCA to eliminate the current regulatory adjustments made for discretionary Non-Qualified Patronage Payments in Core Surplus and the regulatory adjustment regarding payment of partial year nonqualified patronage and allocated equities.

    As expressed above, we do not believe that there should be reductions in capital ratios for "future, fully discretionary" payments. Should our Association eliminate its Patronage plan today, it will experience a windfall growth in Core Surplus Ratio. Core Surplus or a proposed Tier 1 should NOT include a discretionary component, but rather measure the risk bearing capacity in a "downside" situation whereby an ill advised patronage payment to shareholders would be eliminated either by the Board, management, or just as likely, FCA restrictions.

    Also, in order to promote transparency and consistency across the System, it is important to remove this adjustment from Core Surplus. Historically, the adjustment was in place to improve the capital quality of the Bank for Cooperatives as it was common practice to allocate all surplus to their owners. Given the consolidation of the Bank for Cooperatives into CoBank, combined with the change in capital planning by CoBank, the adjustment is no longer necessary and potentially harmful as it creates an improper incentive. FCA indicated the reason for the adjustment is because once a patronage program has been implemented, stockholders will require the payment of patronage even if the System entity is experiencing stress. While we disagree with this statement, the broader point is that patronage programs at different Associations are being applied differently in terms of the Core Surplus Ratio. Associations who take an arguably more conservative stance by paying out patronage over a period of time (5-10 years) are being penalized in the Core Surplus area while Banks and Associations who pay out patronage on a yearly basis do not get penalized. If the reasoning for the deduction is due to the expectation of patronage being paid, then shouldn't all System entities who have a regular patronage program deduct the next three years projected patronage from their core surplus as is currently required of some institutions?

The regulatory adjustment for payment of partial year nonqualified patronage and allocated equities has similar implications. Currently, the System requires institutions to deduct the full year of non-qualified patronage or allocated equities if any portion of the year is paid or revolved with exceptions for estates and distressed borrowers. The effect is to limit institutions flexibility in regards to payments of non qualified patronage and allocated equities. We believe the mechanism that is used to pay out distributions should not be of consequence as long as it is equitable, discretionary and the institution is retaining appropriate levels of capital.

Removal of these regulatory adjustments seems prudent given the inconsistent application among System entities but more importantly, due to the purely discretionary nature of patronage payments as set up in most System institutions.

Thank you for the opportunity to provide comments on this important issue. If you have any questions on the information provided, please feel free to contact either of us.

Sincerely,

Rod Hebrink
SVP, Chief Financial Officer

Jase Wagner
VP, Capital Management

Appendix I – Basel III Proposed Capital Levels

Annex 2: Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Calibration of the Capital Framework Capital requirements and buffers (all numbers in percent)			
	Common Equity (after deductions)	**Tier 1 Capital**	**Total Capital**
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

Appendix II –Recommended Capital Ratios

Proposed Capital Ratios

Tier 1

Purchased Common Equity
Unallocated & Allocated Surplus
Plus: Non-Cum Perpetual Preferred
Less: Net Investment in Bank
Add: Reciprocal Bank Inv
Less: Reciprocal Bank Inv (100%)
Less: Allocated for Patronage Distribution (Current Year)
Less: Investment in Farmer Mac
Less: Investment in other FC Institutions
Less: Goodwill
Less: Deferred Asset Adjustment
Less: Securitization-related Investment
Less: Losses on AFS equity Securities

Total Tier 1

Permanent Capital (Redefined)

Purchased Common Equity
Unallocated & Allocated Surplus
Plus: Qual. Outstanding Subdebt
Plus: Qual. Term Preferred Stock
Plus: Qual. Cum Perpetual Preferred Stock
Plus: Qual. Non-Cum Perpetual Preferred Stock
Less: Allocated Equities counted by Bank
Less: Reciprocal Bank Inv (100%)
Less: Allocated for Patronage Distribution (Current Year)
Less: Investment in Farmer Mac
Less: Investment in other FC Institutions
Less: Goodwill
Less: Deferred Asset Adjustment
+- Securitization-related Investment

Total Permanent Capital

Total Capital

Purchased Common Equity
Surplus
Plus: Qual. Outstanding Subdebt
Plus: Qual. Term Preferred Stock
Plus: Qual. Cum Perpetual Preferred Stock
Plus: Qual. Non-Cum Perpetual Preferred Stock
Plus: Up to 1.25% of Allowance for Loan Loss (Current bank regulator limit)
Less: Allocated Equities counted by Bank
Less: Reciprocal Bank Inv (100%)
Less: Investment in Farmer Mac
Less: Investment in other FC Institutions
Less: Goodwill
Less: Deferred Asset Adjustment
Less: Securitization-related Investment
+- Unrealized Gains/Losses on Level 1 AFS Securities
Less: Other Comprehensive Income
Less: Protected equities

Total Capital

Current Capital Ratios

Core Surplus:

Unallocated & Allocated Surplus (except allocated with <5 yr revolvement)
Plus: Non-Cum Perpetual Preferred
Less: Net Investment in Bank
Add: Reciprocal Bank Inv
Less: Reciprocal Bank Inv (100%)
Less: Allocated for Patronage Distribution
Less: Nonqualified Patronage Plan Distribution
Less: Investment in Farmer Mac
Less: Investment in other FC Institutions
Less: Goodwill
Less: Deferred Asset Adjustment
Less: Securitization-related Investment

Total Core Surplus

Total Surplus

Unallocated & Allocated Surplus (except allocated with <5 yr revolvement)
Plus: Qual. Outstanding Subdebt
Plus: Qual. Term Preferred Stock
Plus: Qual. Cum Perpetual Preferred Stock
Plus: Qual. Non-Cum Perpetual Preferred Stock
Less: Allocated Equities counted by Bank
Less: Reciprocal Bank Inv (100%)
Less: Allocated for Patronage Distribution
Less: Investment in Farmer Mac
Less: Investment in other FC Institutions
Less: Goodwill
Less: Deferred Asset Adjustment
Securitization-related Investment

Total Surplus

Permanent Capital

Purchased Common Equity
Unallocated Surplus
Plus: Outstanding Subdebt
Plus: Qual. Term Preferred Stock
Plus: Qual. Cum Perpetual Preferred Stock
Plus: Qual. Non-Cum Perpetual Preferred Stock
Investment counted by Bank
Reciprocal Bank Inv (100%)
Investment in Farmer Mac
Invest in other FC Inst (100%)
Goodwill
Deferred Asset Adjustment
Securitization-related Investment
Other Comprehensive Income
Less: Protected equities

Net Permanent Capital

= Change or modification

Appendix III - MOODY's Bank Financial Strength Ratio's

Summary of Factor Mapping – Financial Fundamentals

	A	B		C		D		E
Profitability	>=	>=	<	>=	<	>=	<	<
PPP % of Avg RWA	3.5%	2.4%	3.5%	1.4%	2.4%	0.5%	1.4%	0.5%
Net Income % Avg RWA	2.0%	1.7%	2.0%	1.0%	1.7%	0.3%	1.0%	0.3%
Liquidity	<	>=	<	>=	<	>=	<	>=
(Market funds - Liquid Assets) % Total Assets	-10%	-10%	0%	0%	10%	10%	20%	20%
Liquidity Management score from Risk Positioning	A	B		C		D		E
Capital Adequacy	>=	>=	<	>=	<	>=	<	<
Tier 1 ratio (%)	10%	8%	10%	6%	8%	4%	6%	4%
Tangible Common Equity % RWA	7.0%	5.5%	7.0%	4.0%	5.5%	2.5%	4.0%	2.5%
Efficiency	<	>=	<	>=	<	>=	<	>=
Cost/income ratio*	45%	45%	55%	55%	65%	65%	80%	80%
Asset Quality	<	>=	<	>=	<	>=	<	>=
Problem Loans (%) Gross Loans	0.8%	0.8%	2%	2%	5%	5%	12%	12%
Problem Loans % (Shareholders' Equity + LLR)	10%	10%	20%	20%	30%	30%	50%	50%

** Cost/income ratio = total non-interest expense as a percentage of total revenues (which is calculated as the total of net interest income plus non-interest income including the net of gains or losses on securities sales).*

	A	B	C	D	E
Credit Risk Concentration*					
Borrower Concentration **	Top 20 group exposures are the worse of < 50% of Tier 1 OR < 100% of pre-tax pre-provision income (PPI)	Top 20 group exposures are the worse of 50%-80% of Tier 1 OR 100%-200 of PPI	Top 20 group exposures are the worse of 80%-100% of Tier 1 OR 200%-350% of PPI	Top 20 group exposures are the worse of 100%-200% of Tier 1 OR 350%-750% of PPI	Top 20 group exposures are the worse of > 200% of Tier 1 OR > 750% of PPI
Industry Concentration	Largest single sector exposure is < 50% of Tier 1	Largest single sector exposure is 50%-200% of Tier 1	Largest single sector exposure is 200%-350% of Tier 1	Largest single sector exposure is 350%-500% of Tier 1	Largest single sector exposure is > 500% of Tier 1

** The overall Credit Risk Concentration score equals the lower score of Borrower Concentration or Industry Concentration.*
*** Based on the sum of the 20 largest group exposures. "Group exposure" includes the aggregate of all loans (outstanding amounts plus undrawn committed exposures), investment or trading securities, counterparty exposures, etc. to related borrowers within a group or family. Excludes advised lines or internal limits, i.e. those instances where the bank is not obligated to extend credit.outstandings. Also excludes Aaa-rated sovereign exposures, but includes all other sovereign, sub-sovereign, and other government-related exposures as well as private sector exposures.*
Industry concentration measures exposures to borrowers in specific industries or sectors of the economy; for example, Commercial Real Estate, Oil & Gas, Fishing, Ship Building, Agriculture, Mining, etc. Does not include exposure to specific product lines (e.g. residential mortgages or credit cards). Aggregate exposures to Banking or Financial Institutions is considered an industry concentration. Aggregate exposures to the "Public Sector" is not be considered an industry concentration unless the public sector entities are highly correlated.

Farm Credit System Third Party Capital – Overview

Instrument	~~CS~~ T1	~~TS~~ PC	~~PC~~ TC	Limits*	Conditions
Non-cumulative perpetual preferred stock	X	X	X	• ~~25~~50% of CS • ~~Aggregate Limit~~	FCA may require a reduction from CS if we find that the stock has characteristics or terms that diminish its contribution to an institution's ability to absorb losses. 50% of CS test is done at issuance and at no other time during the life of the security. Issuers must meet 50% max test at issuance of each series of NPPS.
Cumulative perpetual preferred stock		X	X	~~• 25% of PC~~ •Aggregate Limit	Any significant step-up (as defined by the BIS) is treated as a maturity date and effectively becomes term preferred stock.
Term preferred stock (TPS)		X	X	• TPS & SD Limit • Aggregate Limit	The amount included in Total Surplus must be reduced by 20 percent at the beginning of each of the last 5 years of the term of the instrument. Note: Mandatorily redeemable instruments are treated as a liability under GAAP.
Subordinated debt (SD)		X	X	• TPS & SD Limit • Aggregate Limit	The FCA has previously determined that SD may be included in ~~TS~~ TC and PC if it meets the following criteria: • The claims of SD investors are subordinate to the rights of all other debtholders. • Long maturity (10 years or more) with no interest rate step-ups. • Issuer has the contractual ability to defer interest payments for up to 5 years. During the deferral period, the issuer is prohibited from paying patronage or dividends. • Investor has no put option to liquidate the investment or accelerate prepayment of the principal prior to maturity. • SD cannot be sold or transferred in denominations less than $250,000. • Resales & transfers may be made only to QIBs and AIs as defined by the SEC. • Institution employees, board members & immediate family members prohibited from purchasing SD. • The amount included in Permanent Capital and Total Surplus must be reduced by 20 percent at the beginning of each of the last 5 years of the term of the instrument.

Third Party Capital Limits

TPS & SD Limit: may not exceed 50% of Tier 1~~core surplus~~. To the extent that TPS and SD exceed this limit, SD must be deducted from Total Capital ~~Permanent Capital~~, and both TPS and SD must be deducted from PC ~~Total Surplus~~. For banks, amounts includible in regulatory capital may be excluded from total liabilities when calculating the net collateral ratio.

Aggregate Limit: may not exceed an amount equal to 40% of permanent capital or 100% of Tier 1~~core surplus~~, whichever is less. All preferred stock and SD in excess of these limits may not be counted as PC ~~Total Surplus~~. SD in excess of these limits may not count as Total Capital ~~Permanent Capital~~.

Preferred stock issuances must meet the limits, conditions, and requirements of FCA regulations.
See Regulations: 614.4351, 615.5175, 615.5240, 615.5245, 615.5270, 615.5201, 615.5301, 620.21

* **Limit:** These are limits on the amount of the security that may be included in regulatory capital calculations. The limit on the amount of securities that can be issued is determined by capital bylaws authorized by the institution's shareholders.