Farm Credit Administration

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BOOKLETTER

January 13, 2022

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Glen R. Smith
Board Chairman and Chief Executive Officer

Subject: Tier 1/Tier 2 Capital Framework Guidance (BL-068, Revised)

The Farm Credit Administration is issuing this revised bookletter to provide guidance to Farm Credit System (System) institutions regarding the tier 1/tier 2 capital framework. It supersedes the original version of this bookletter, which was published on December 28, 2016.

We issued the December 2016 bookletter to provide System institutions with guidance for implementing the tier 1/tier 2 capital framework final rule. Published on July 28, 2016, the rule took effect on January 1, 2017, so we refer to it here as the 2017 capital rule. The 2016 bookletter clarified and provided technical guidance on certain provisions of the 2017 capital rule.[1]

Then, on October 1, 2021, we issued amendments to the 2017 capital rule, which took effect on January 1, 2022 (the 2022 capital rule amendments).[2] The amendments clarify certain provisions in the 2017 capital rule and codify much of the guidance provided in the original version of this bookletter.

In this revised bookletter, we are retaining the guidance from the December 2016 bookletter that remains relevant. For historical reference, we've included the superseded guidance from the original bookletter in the appendix to this revised version.

1. Calculation of permanent capital – § 628.10(c)(5)

The risk-adjusted asset denominator for the permanent capital ratio is different from the risk-adjusted asset denominator for our other risk-based capital ratios. The risk-adjusted asset denominator for the common equity tier 1 (CET1), tier 1, and total capital ratios is established by the definition of *standardized total risk-weighted assets* in § 628.2, as

[1] 81 FR 49720 (July 28, 2016). The rule added a new part 628 to our regulations in Title 12 of the Code of Federal Regulations and amended existing parts 607, 611, 614, 615, 620, and 627.

[2] 86 FR 54347 (October 1, 2021).

adjusted by deductions and adjustments in accordance with § 628.22. While the permanent capital denominator calculation also begins with standardized total risk-weighted assets as defined in § 628.2, the denominator is adjusted in accordance with § 615.5207, which sets forth different regulatory deductions. We further explain the calculation of the permanent capital denominator below.

Section 628.10(c)(5) provides that a System institution's permanent capital ratio is the ratio of its permanent capital to its total risk-adjusted asset base, calculated in accordance with the regulations in part 615, subpart H, of our capital regulations. Section 615.5201 provides that *risk-adjusted asset base* means "standardized total risk-weighted assets as defined in § 628.2 of our regulations, adjusted in accordance with § 615.5207 and excluding the deduction in paragraph (2) of that definition for the amount of the System institution's allowance for loan losses that is not included in tier 2 capital."

The regulations in subpart H of part 615 that are relevant to calculating permanent capital include § 615.5206, Permanent Capital Ratio Computation, and § 615.5207, Capital Adjustments and Associated Reductions to Assets.

2. Offset of member equities against a loan in default – § 628.20(b)(1)(xiv)(B) and (d)(1)(xi)(B)

The offset of member equities against a loan in default is effectively a redemption of member equities. FCA's capital rules do not permit institutions to redeem member equities (other than specified amounts of statutory borrower stock)[3] unless the conditions outlined in § 628.20(f) are met.

As a result, your institution may not offset member equities against a loan in default without either express or deemed prior approval from FCA. Deemed prior approval would require, among other things, the member equities in question to have been outstanding for the minimum required holding period (5 or 7 years) or an applicable exception specified in § 628.20(f)(6).[4] The holding period would begin on the common cooperative equity issuance date, as defined in § 628.2.

For example, a borrower defaults on a loan and has allocated equities totaling $10,000. The institution's board resolution or bylaws state that those allocated equities will not be revolved for at least 7 years so that they can be included in CET1 capital. If the allocated equities have been outstanding for only 5 years, the institution would have to wait an additional 2 years or specifically request prior approval from FCA before offsetting the equities against the loan.[5]

[3] Under § 628.20(b)(1)(xiv)(B), your institution may retire up to $1,000 of statutory borrower stock as described in § 628.20(b)(1)(x) without a minimum period outstanding after issuance and without the prior approval of FCA, as long as your institution continues to comply with all minimum regulatory capital requirements after the redemption.

[4] For example, equities that your institution is required to cancel under § 615.5290, in connection with a restructuring under part 617, may be offset against a loan in default.

[5] This restriction on offsets applies only to equities (other than certain amounts of statutory borrower stock) that your institution plans to include in tier 1 or tier 2 capital.

3. Definition of regulatory financial statements – § 628.20(b)(1)(xiii)

Section 628.20(b)(1)(xiii) provides that an instrument included in CET1 capital must be "reported on the System institution's regulatory financial statements separately from other capital instruments…." By *regulatory financial statements*, we mean the institution's call reports required by our regulations at part 621, subpart D; we do not mean other financial reports or statements issued by the institution.

4. Tier 2 capital instruments – § 628.20(d)(1)(i)

Section 628.20(d)(1)(i) outlines criteria that an instrument must meet to be included in tier 2 capital. This provision states that "the instrument is issued and paid-in." We clarify that tier 2 capital instruments that are "issued and paid-in" include certain common cooperative equities, subordinated debt instruments, and perpetual or term preferred stock held by members or third parties that otherwise meet the tier 2 capital criteria.

5. Definition of a deceased former borrower – § 628.20(f)(6)(ii)

Section 628.20(f)(6)(ii) refers to equities held by the estate of a deceased former borrower.

A *deceased former borrower* refers only to a deceased individual. This provision does not apply to the dissolution of a corporation or other business entity.

6. Risk-weighting of funds on deposit with Federal Reserve Banks, with other System institutions, and with depository institutions – §§ 628.32(a)(1)(i)(A), 628.32(c)(1), 628.32(a)(1)(i)(B), and 628.32(d)(1)

Section 628.32(a)(1)(i)(A) requires your institution to assign a 0% risk weight to an exposure to the U.S. government, its central bank, or a U.S. government agency. Since the Federal Reserve is the central bank of the United States, this risk weight applies to deposits your institution makes with Federal Reserve Banks.

Section 628.32(c)(1) requires your institution to assign a 20% risk weight to an exposure to a government-sponsored enterprise, other than an equity exposure or preferred stock. For example, this risk weight would apply to a deposit of an association's current funds with its district bank or to a deposit of a service corporation's current funds with its district or organizing bank or association, even if the funds are ultimately deposited elsewhere.[6]

Section 628.32(a)(1)(i)(B) requires your institution to assign a 0% risk weight to the portion of an exposure that is directly and unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency. This includes a deposit or other exposure, or the portion of a deposit or other exposure, that is insured or otherwise unconditionally guaranteed by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA).

Section 628.32(d)(1) requires your institution to assign a 20% risk weight to exposures to U.S. depository institutions and credit unions that are not directly and unconditionally

[6] Section 1.5(11) of the Farm Credit Act of 1971, as amended, authorizes each System bank to accept deposits of funds from associations in its district. Sections 2.2(10) and 2.12(18) authorize an association to deposit its current funds with its district bank. FCA regulation § 611.1135(a) authorizes a System bank or association, alone or with other System banks or associations, to organize a service corporation to perform any function or service that it is authorized to perform, with two exceptions not relevant to this issue.

guaranteed. For example, when a System institution makes a deposit with an FDIC-insured institution, the 20% risk weight applies to the portion of the deposit that exceeds the deposit insurance coverage limit (currently $250,000).[7]

7. Timing of qualitative disclosures – § 628.62(a)

Section 628.62(a) requires each System bank to provide timely public disclosures at the end of each calendar quarter. The rule also notes that qualitative disclosures that typically do not change each quarter may be disclosed annually after the end of the fourth calendar quarter, provided that any significant changes are disclosed in the interim. A System bank may make these qualitative disclosures annually in its annual report to shareholders, provided it discloses any significant changes in the interim quarterly reports to shareholders.

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If you have questions on this guidance, please contact any of the following individuals:

- Jeremy R. Edelstein, Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, at 703-883-4497 or EdelsteinJ@fca.gov
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- Jennifer A. Cohn, Assistant General Counsel, Office of General Counsel, at 720-213-0440 or CohnJ@fca.gov

You may also send questions to ORPMailbox@fca.gov.

[7] As a result, a deposit at a U.S. depository institution or credit union could carry two risk weights. The portion covered by a U.S. government guarantee (FDIC or NCUA deposit insurance) would be risk-weighted at 0%. Any amounts not covered by a U.S. government guarantee would be risk-weighted at 20%.

Appendix

This Appendix (from this point to the end of the document) contains the guidance which appeared in the original version of BL-068. It has been superseded by the 2022 capital rule amendments. System institutions should no longer rely on the guidance in this appendix. We are providing it here for historical reference only.

1. First Bylaw Amendment or Board of Directors Resolution Date – § 615.5200 [Superseded]

The effective date of the final rule is January 1, 2017. The final rule does not specify the date by which the board of directors must adopt the initial annual board resolution or capitalization bylaw amendment. Therefore, FCA is giving System institutions until March 31, 2017, to adopt the bylaw amendment required under § 628.20(b)(xiv), (c)(xiv), and (d)(xi). If an institution's board of directors chooses to adopt a board resolution instead of a bylaw amendment, the board resolution must be in the capital plan submitted to the FCA by January 30, 2017.[8]

We note that the definition of "Unallocated Retained Earnings (URE) equivalents" in § 628.2 provides that institutions have until March 31, 2017, to designate as URE equivalents any nonqualified allocated equities that were allocated before January 1, 2017. However, we encourage institutions to make the designations before January 30 and include them in their capital plans.[9] Nonqualified allocated equities allocated after January 1, 2017, must be designated at the time of allocation to be considered URE equivalents.

We note further that a System institution is not required to amend its capitalization bylaws or adopt a board resolution that meets the requirements of the final rule. If a System institution does not have a board resolution in place or has not amended its bylaws to meet the regulation requirements, then no equities can count as common equity Tier 1 (CET1) or Tier 2 capital other than the statutory minimum borrower stock (2 percent of the loan or $1,000, whichever is less). As a result, CET1 capital will consist only of URE, the statutory minimum borrower stock requirement, and paid-in capital. If a System institution chooses to adopt a board resolution instead of amending its capitalization bylaws, the board resolution must be confirmed annually to include such equities under the new capital framework.

2. Capitalization Bylaw Requirement – § 615.5220(a)(6) [Superseded]

The final rule revises § 615.5220(a)(6) by requiring each System institution's capitalization bylaws to include a reference to the capital adequacy standards in new part 628. As amended, the regulation requires an institution's capitalization bylaws to include a statement that equities are retired at the sole discretion of the board, provided that minimum capital adequacy standards established in part 615 subpart H and part 628 are met (emphasis added).

[8] This is consistent with the November 10, 2016, Office of Examination Informational Memorandum – Implementation of the Tier 1/Tier 2 Capital Framework.

[9] The capital plan must be included with the institution's business plan submitted to FCA "[n]o later than 30 days after the commencement of each calendar year." See § 618.8440.

FCA has determined that a System institution may delay adding the reference to part 628 to its capitalization bylaws until the next time the institution amends its capitalization bylaws. In addition, the FCA has learned that some institution capitalization bylaws currently do not cite part 615 of FCA regulations; instead, the bylaws contain only a general reference to maintaining compliance with FCA's capital adequacy standards. We have determined that such a general reference would satisfy the requirements of § 615.5220(a)(6) and would not require a bylaw amendment.[10]

3. Tier 1 Leverage Ratio Reporting – § 620.5(f) [Superseded]

The final rule adds § 620.5(f)(4)(iv) to require System institutions, in their annual reports for each fiscal year ending in 2017-2021, to report their Tier 1 leverage ratio for the years 2012-2016 in comparative columnar form.

System institutions did not have a Tier 1 leverage ratio in the years 2012-2016. This requirement to report their leverage ratio was inadvertently placed in paragraph (f)(4) of § 620.5 and should instead be in paragraph (f)(3)(v) of § 620.5. Our intention was to require System associations to report their Tier 1 leverage ratio under § 620.5(f)(3).

System associations must report their Tier 1 leverage ratios in their annual reports to shareholders under § 620.5(f).

4. Unallocated Retained Earnings (URE) and URE Equivalents Deductions – § 628.10 [Superseded]

Section 628.10(b)(4) establishes a minimum Tier 1 leverage ratio of 4 percent, of which at least 1.5 percent must be composed of URE and URE equivalents. Section 628.10(c)(4) states that Tier 1 capital deductions required under § 628.22(a) and (c) and § 628.23 must also be deducted when calculating the Tier 1 leverage ratio. However, the rule does not specify which deductions to make when calculating the minimum URE and URE equivalents requirement.

When calculating the URE and URE equivalents requirement for the leverage ratio, a System institution must deduct from the numerator an amount equal to all the deductions required under § 628.22(a).[11] All deductions made to the denominator when calculating the Tier 1 leverage ratio must be made to the denominator when calculating the URE and URE equivalents requirement.

When a System institution allocates equities to another System institution, the URE of the System institution that receives the allocated equites will normally increase. For this reason, we are requiring an institution to deduct from its URE and URE equivalents an amount equal to any allocated investments received from another System institution.

[10] For example, an institution's capitalization bylaws may state that the institution must remain in compliance with the minimum capital adequacy standards established by FCA.

[11] Section 628.10(c)(4) requires the amounts deducted under §§ 628.22(c) and 628.23 to be deducted from Tier 1 capital when calculating the Tier 1 leverage ratio. However, the deductions under §§ 628.22(c) and 628.23 would not be applied to the numerator when calculating the URE and URE equivalents requirement as they do not increase the URE of a System institution.

5. Calculation of the Maximum Payout Ratio in the First Quarter of 2017 – § 628.11(a) [Superseded]

If a System institution falls into either the capital conservation buffer (CCB) or leverage buffer, the maximum payout ratio and maximum leverage payout ratio under § 628.11(a)(2)(ii) and (a)(2)(v) must be calculated. These ratios determine the maximum amount the institution can pay out in the form of capital distributions and discretionary bonus payments. The maximum payout ratio and maximum leverage payout ratio are determined by the institution's CCB or leverage buffer, calculated as of the last day of the previous calendar quarter (emphasis added), set forth in Tables 1 and 2, respectively, to § 628.11. If an institution falls into either the CCB or leverage buffer in the first quarter of 2017, it would be unable to determine its maximum payout ratio as there was no CCB, leverage buffer, or CET1, Tier 1 or Total capital ratios calculated on December 31, 2016.

FCA has decided not to require System institutions to calculate their maximum payout ratio and maximum leverage payout ratio until after the quarter ending March 31, 2017. FCA's estimates of all System institutions' capital levels under the new framework show that all System institutions will be above the buffer levels on January 1, 2017. If an institution's regulatory capital levels fall in the first quarter of 2017 to levels that approach the minimum regulatory capital levels, we will use our supervisory and enforcement authorities to limit distributions as we deem appropriate.

6. Determination of the Minimum Holding Periods – § 628.20 [Superseded]

The minimum holding period for purchased stock and allocated equities starts on the issuance date. The issuance date of allocated equities is defined as the date the institution segregates its "new" allocated equities (qualified and nonqualified) from its URE.[12] The issuance date could be the declaration date,[13] but there could be a short period between the declaration date and the segregation of the equities required for the issuance date. The payment date (the date on the patronage refund checks or the date on the written notices of allocation provided to the member-borrowers) typically would not be the issuance date since segregation of the equities would have already occurred. Segregating allocated equities must not be confused with the GAAP accrual of patronage refunds and allocation of equities that occur prior to the declaration date. The allocated equity segregation follows a board resolution (i.e., quarterly or annually) declaring the patronage refund in the form of cash or allocated equity.

7. Statutory Minimum Borrower Stock – § 628.20(b) [Superseded]

Section 628.20(b)(1)(xiv)(B) allows for the statutory minimum borrower stock requirement to count as CET1 capital notwithstanding the minimum 7-year holding period. The statutory minimum borrower stock requirement under section 4.3A of the Farm Credit Act of 1971, as amended (Act) is $1,000 or 2 percent of the loan amount, whichever is less.

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[12] For example, a System institution board adopts a resolution to make a patronage distribution in cash and equity on December 5. On December 10, a general ledger entry is made that moves the dollar amounts from URE to an appropriate payable account and allocated equity. On January 5 of the following year, dollar amounts are assigned to each borrower. In this example, the issuance date would be December 10.

[13] The declaration date is the date a board passes a resolution declaring a patronage refund.

FCA clarifies that the statutory minimum borrower stock includible in CET1 and the calculation of the regulatory capital ratios without a minimum holding period is the outstanding balance of the statutory minimum borrower stock.[14] If a loan is for $50,000 or more, the amount includible in CET1 capital without a minimum holding period is no more than $1,000 until such stock is retired. If a loan is for less than $50,000 at origination, the amount includible in CET1 capital is 2 percent of the original loan amount until such stock is retired. If a revolving line of credit is originated for $50,000 or more and the amount of borrower stock is retired as the loan pays down, the amount of stock remaining on the calculation date, up to $1,000, is the amount includible in CET1 without a minimum holding period. If a revolving line of credit is originated for less than $50,000 and the amount of borrower stock is retired as the loan pays down, the amount of stock remaining on the calculation date, up to 2 percent of the original loan amount, is the amount includible in CET1 without a minimum holding period.

FCA also clarifies that for any statutory borrower stock that exceeds $1,000 or 2 percent of the loan amount, whichever is less, the minimum holding periods apply if an institution plans to include the additional stock in Tier 1 or Tier 2 capital.

8. Common Equity Tier 1 Criteria – Claims on Residual Assets – § 628.20(b)(1)(ii) [Superseded]

Section 628.20(b)(1)(ii) states that one of the criteria of common cooperative equities includible in CET1 capital is that the holder of the equities is entitled to a claim on the residual assets of the institution only after all creditors, subordinated debt holders, and preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding. For allocated equities whose holders are entitled to the residual assets of the institution and for all purchased equities, § 628.20(b)(1)(ii) applies to include those equities in CET1 if the holders would be paid only after all creditors, subordinated debt holders, and preferred stock claims have been satisfied. However, the capitalization bylaws of some System institutions may provide for the issuance of allocated equities whose holders do not receive the right to the residual assets of the institution in a liquidation or similar proceeding. If such equities meet all of the other criteria for inclusion in CET1, the equities are includible in CET1.[15]

9. FCA Prior Approval (Safe Harbor) of Capital Distributions – § 628.20(f) [Superseded]

The final rule requires institutions to obtain FCA prior approval before making any distributions of capital included in Tier 1 or Tier 2 capital, other than subordinated debt or term equities redeemed on their maturity date. There are three types of FCA prior approval: (1) the 30-day "deemed" prior approval that requires institutions to submit a request to FCA; (2) the "advance" prior approval that requires institutions to submit a request to FCA; and (3) the "safe harbor" prior approval that does not require institutions to submit a request to the FCA.

[14] Both the numerator and denominator of the regulatory capital ratios continue to be calculated using a 90-day (3-month) average daily balance.

[15] This criterion was intended to start with "if" which would result in the same treatment as described above under this item.

In general, under the "safe harbor" provision in paragraphs (f)(5) and (6) of § 628.20, cash dividends, cash patronage, and cash redemptions or revolvements of common cooperative equities (including the statutory minimum borrower stock) are deemed to have FCA prior approval provided: (1) the equities meet applicable minimum holding period requirements; (2) the dollar amount of CET1 capital after the cash payments is not less than CET1 capital on the same date in the previous calendar year; and (3) the institution complies with all regulatory capital requirements after the payments.

As stated above, the "safe harbor" provision may be utilized only when, after the payments, the dollar amount of CET1 capital does not decline compared to the same date in the previous year. Because institutions will not have a CET1 capital baseline from 2016 in order to determine whether they can make 2017 distributions in cash under the safe harbor, FCA is providing an alternate standard for use only in 2017.

During 2017, cash dividends on all equities, cash patronage, and cash redemptions and revolvements of common cooperative equities may be made under the safe harbor if the amount of GAAP total capital, excluding third-party capital and the effects of accumulated other comprehensive income, is not less than GAAP capital on the same date in 2016.[16]

10. Allocated Investment Deductions from System Service Corporations – § 628.22(a)(6) [Superseded]

Section 628.22(a)(6) requires a System institution's allocated investment in another System institution to be deducted from CET1 capital.

FCA has determined that an investment allocated by a System service corporation to a System bank or association should also be deducted by the receiving bank or association under § 628.22(a)(6).

Although FCA is unaware of any service corporation that has made equity allocations to a System bank or association, allocations are permitted by some service corporations' bylaws. Because service corporations would include the equities they allocate in their permanent capital, such equities must be deducted from the CET1 capital of the receiving banks and associations in order to avoid the double counting of capital as described above under item 4.

11. Correction of Securitization Formulas – §§ 628.43(d) and 628.52(c) [Superseded]

The final rule includes four incorrect formulas – three under the simple supervisory formula approach (SSFA) under § 628.43(d) and one under the simple risk-weight approach (SRWA) under § 628.52(c). The following table shows the correct formulas that should be used when calculating the SSFA and the SRWA:

Calculation	Formula in the Final Rule	Correct Formula to be Used
SSFA - 628.43(d)	$K_A = (1 - W) \times K_G \times (0.5 \times W)$	$K_A = (1 - W) \times K_G + (0.5 \times W)$

[16] For purposes of this calculation, GAAP total capital includes all allocated equities regardless of their planned revolvement cycle.

Calculation	Formula in the Final Rule	**Correct** Formula to be Used
SSFA - 628.43(d)	$a = \frac{1}{p \times K_A}$	$a = -\frac{1}{p \times K_A}$
SSFA - 628.43(d)	$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u \times l)}$	$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u - l)}$
SRWA - 628.52(c)	$X_t = A_t \times B_t$	$X_t = A_t - B_t$