Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 9, 2003

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Institutions

From: Roland E. Smith, Director
Office of Examination

Subject: Issuance of Preferred Stock

The Farm Credit Administration (FCA or agency) has recently experienced a marked increase in requests from Farm Credit System (FCS) institutions to review their preferred stock issuance programs (program). In reviewing specific requests, the FCA has a number of regulatory and supervisory responsibilities including:

- Determining whether the stock issuance qualifies as permanent capital, total surplus, or core surplus;
- Evaluating the accuracy and completeness of the offering and disclosure material;
- Assessing whether the program may present any legal, operational, or safety and soundness issues; and
- Determining whether an FCS institution's board of directors has established appropriate policies and internal controls governing the program and the institution's overall capital levels.

In reviewing certain institution requests where preferred stock is offered to eligible borrowers, a number of policy and safety and soundness issues have surfaced that warrant a review of our capital adequacy regulations. In particular, there are questions about the permanency and quality of preferred stock that an institution plans to retire at the option or request of the stockholder with few limitations or without direct involvement or consideration by the institution's board of directors. Also, there is concern about the risk associated with managing the capital and earnings volatility that may result from fluctuations in purchases and retirements that may occur daily. These programs may be a particularly volatile source of capital under adverse credit or interest rate conditions when the likelihood of redemptions is increased.

Stock that lacks permanence and other attributes of equity is not available to absorb unforeseen losses, support growth, meet liquidity demands, and build financial strength.

Over-reliance on such programs as a source of capital may result in unsafe and unsound conditions and lessen incentives to procure more stable forms of capital. Therefore, it is necessary to take appropriate action to ensure that each FCS institution's capital continues to be fundamentally composed of equities that are of high quality and that are likely to be a permanent feature of the institution's capital base. For this reason, the agency is evaluating the need to establish additional regulatory parameters and limits on certain types of preferred stock programs.

Further, the term "permanent capital" has achieved broad-based recognition and acceptance throughout the FCS as a measure of an FCS institution's financial stability. Including certain types of preferred stock in an institution's permanent capital ratio that lack qualities of "permanence" may give stockholders an inaccurate or misleading impression about an FCS institution's true financial condition. Therefore, additional guidance or regulatory amendments may be needed to ensure that stockholders receive complete information regarding the components of their institution's capital base and the long-term stability of those components.

Fair, accurate, and complete disclosure in all written information (including marketing materials, Web page advertisements, and other written information) referencing preferred stock programs is another critical issue of concern for FCA. Uniform guidance in this area may be helpful in ensuring that all written information accessible to potential purchasers is appropriate and not misleading. While the agency will continue to expeditiously review each application for adequacy of disclosure, it is often necessary to request additional information, which may delay the processing of your requests.

There are also several other regulatory and policy issues regarding preferred stock programs that FCA plans to evaluate as it considers future amendments to its regulations, including the potential for conflicts of interest. Specifically, the agency is concerned that board and management may not treat all preferred stockholders equitably regarding stock retirement, or that insiders could become aware of financial difficulties of the FCS institutions and retire their stock before other shareholders. FCA's Standards of Conduct regulations (set forth in §§ 612.2130-612.2270), apply to preferred stock issuances and require directors, employees, agents, and the institution itself to maintain high standards of integrity and impartiality and prohibit directors and employees from using their position or information to obtain a personal benefit. Nevertheless, the agency is considering the need for additional conflict of interest provisions specifically directed to stock issuances.

Lastly, the agency hopes further regulatory guidance will help ensure consistent treatment for all FCS institutions seeking to issue preferred stock. If you have any questions regarding the agency's future plans to issue guidance or regulations on this subject, please contact Roland E. Smith, Director, Office of Examination at (703) 883-4160, Michael V. Dunn, Director, Office of Policy and Analysis at (703) 883-4414 or S. Robert Coleman, Director, Regulation and Policy Division at (703) 883-4498.