
INFORMATIONAL MEMORANDUM



November 10, 2016

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

From: Samuel R. Coleman, Director and Chief Examiner
Office of Examination

Subject: Implementation of the Tier 1/Tier 2 Capital Framework

As noted in the Office of Examination's National Oversight Plan for Fiscal Year 2017, one of the risk topics that we will focus on is implementation of the new Tier 1/Tier 2 capital regulations. These regulations become effective on January 1, 2017. This Informational Memorandum communicates our expectations for effective implementation of these regulations and contains a request for related information.

Operational and Control Considerations: Each board should establish a clearly defined plan to ensure compliance with the new regulations. This plan should, at a minimum, contain action steps and timelines that address:

- ***Measurement and Reporting Processes:*** Ensure processes are in place for accurately calculating and reporting the new capital measures. Although your service provider or district bank may provide the information system platforms or processes to calculate the new capital ratios, the board and management of each institution are responsible for the accuracy of information reported to FCA. Accordingly, you should develop your own validation and control processes to ensure capital measures are calculated in accordance with the new regulations and accurately reported. These processes should be rigorously tested before implementation, provide a sufficient audit trail for independent testing of capital calculations, and include ongoing internal validation of reported regulatory capital amounts and ratios.
- ***FCA Prior Approval Requirements:*** Ensure capital distributions (including equity retirements) comply with FCA Regulation § 628.20(f). This regulation requires institutions to obtain FCA approval prior to making any capital distributions. You should have robust internal controls that alert the board and management before taking actions that require FCA prior approval and ensure approval is requested when required.

We anticipate the need for prior approval requests to the FCA under paragraphs (f)(1)-(4) of § 628.20 will be rare and typically associated with capital restructuring or third-party capital redemptions. In general, under the “safe harbor” provision in paragraphs (f)(5)-(6) of § 628.20, capital distributions that are cash dividends, cash patronage, or redemptions or revolvments of common cooperatives equities are deemed to already have FCA prior approval so long as:

- the equities meet minimum holding period requirements;
- the dollar amount of common equity tier 1 (CET1) capital does not decline compared to the same date in the previous year; and,
- the institution complies with all regulatory capital requirements after distributions.

In other words, capital distributions that fall within the “safe harbor” do not require a request to FCA for prior approval. Requests for exceptions to these “safe harbor” provisions could indicate that your capital management is inconsistent with the spirit of the new regulations.

- ***Policies and Procedures:*** Revise or adopt policies and procedures that comply with and implement the new capital regulations. In particular, policies or procedures should address controls over capital calculations, patronage programs, allocated equity revolvment cycles, internal and external reporting, audit, compliance with FCA prior approval requirements, and bylaw revisions/annual board resolutions (as applicable).
- ***Training:*** Ensure training on the new capital regulations is provided to the board, management, and personnel responsible for calculating, reporting, and validating regulatory capital measures.
- ***Audit and Review:*** Ensure the 2017 audit scope (and subsequent risk assessments and audit rotation schedule) includes compliance with the new capital regulations, calculation of regulatory capital measures, FCA call reporting, and related processes, policies, and procedures. In addition, this audit should be completed by a qualified auditor with the necessary expertise.

Strategic Considerations: Each board must ensure it develops an understanding of the impact of these regulations on its institution. Strategic considerations should be incorporated into 2017 business and capital plans. Key areas to consider include:

- ***Capital Adequacy and Capital Plans:*** Your capital plan and internal assessment of capital needs must comply with FCA Regulations § 628.10(e) and § 615.5200. Regulation § 628.10(e) requires that each institution assess capital adequacy in relation to its risk profile, maintain capital commensurate with the level and nature of all risk exposures, and establish comprehensive strategies for maintaining an appropriate level of capital. Regulation § 615.5200 requires the institution to establish capital goals that will assure continued financial viability. Goals must be established for the CET1, Tier 1, Total Capital,

Tier 1 Leverage, Unallocated Retained Earnings (URE) and URE Equivalents, and Permanent Capital ratios. Strategies must be established for achieving those goals. This regulation contains several additional requirements that must also be considered in the capital needs assessment and incorporated into the capital plan. When establishing capital goals, the board should also consider FCA's new FIRS rating benchmarks for capital (see Attachment).

- **Patronage Programs:** The new capital regulations may cause you to change your practices for distributing patronage refunds, tracking the life of common cooperative equities, and retiring allocated equities. Your business and capital plan must address whether such changes are needed to achieve capital goals and ensure common cooperative equities qualify for inclusion in regulatory capital. If changes to patronage programs are needed, your business plan should also address the strategies and communications necessary to manage member expectations.
- **Bylaw Revisions or Annual Board Resolutions:** Ensure bylaws or annual board resolutions comply with FCA Regulations § 628.20 and § 615.5200. Specifically, to include common cooperative equities and third-party equities in regulatory capital, each institution must either amend its bylaws or its board must adopt a resolution that in effect ensures equity holding periods, redemptions, and revolvments will comply with regulatory requirements, including the requirement for FCA prior approval of capital distributions. This resolution must be reaffirmed by the board annually and included as a separate resolution in the capital plan. FCA Regulation § 615.5200 addresses the specific requirements.

Information Request: Our examination activities will assess strategies and internal controls that promote accurate capital reporting and compliance with the new capital regulations. To assist our examinations, each System institution should submit the following information to FCA via the FCS Data Portal:

- A documented implementation plan that includes the items listed below. This plan should be submitted to FCA by December 31, 2016.
 - Action steps and timelines addressing the *Operational and Control Considerations* discussed in this Informational Memorandum;
 - Primary contact person(s) at your institution responsible for implementing the new capital regulations; and,
 - If applicable, the name of your service provider that provides the information system platforms or processes to calculate your new capital ratios.
- Your 2017 business and capital plan, which addresses the *Strategic Considerations* discussed in this IM. Consistent with § 618.8440(a), institutions will submit this plan by January 30, 2017.

Please direct questions about this Informational Memorandum to your designated Examiner-In-Charge or Curtis Bednarz, Capital Market Specialist Program Manager, Office of Examination, at (469) 359-4110 or bednarzc@fca.gov.

Attachment

FIRS Capital Benchmarks

The new FIRS benchmarks for capital are summarized in the table below. These benchmarks are intended to apply to both associations and banks. We plan to publish these benchmarks in our Examination Manual (section EM-1.3) after the new Tier 1/Tier 2 capital regulations become effective on January 1, 2017. Our FIRS analyses and ratings as of March 31, 2017, will be based on these new benchmarks. We plan to study the impact of these benchmarks over the next couple years to determine if they need to be recalibrated and adjusted.

New Benchmark Ratios	Regulatory Requirement		FIRS Capital Benchmarks		
	Minimum	+ Buffer	1 Rating	2 Rating	3+ Rating
TRC ratio	8.0	10.5	≥15.5	≥11.0	<11.0
T1 ratio	6.0	8.5	≥13.5	≥ 9.0	< 9.0
CET1 ratio	4.5	7.0	≥12.0	≥ 7.5	< 7.5
T1 Leverage ratio	4.0	5.0	≥ 6.0	≥ 5.35	< 5.35
UREE Leverage ratio	1.5		≥ 2.5	≥ 2.0	< 2.0
Adverse Assets/TRC			≤25.0	≤75.0	>75.0
Criticized Assets/TRC			≤60.0	≤125.0	>125.0

TRC - Total Regulatory Capital

T1 - Tier 1 Capital

CET1 - Common Equity Tier 1 Capital

UREE - Unallocated Retained Earnings (URE) and URE equivalents

Buffer - Conservation or leverage buffer established by regulations