

Fact Sheet

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Fact Sheet on Tier 1/Tier 2 Regulatory Capital Framework Notice of Proposed Rulemaking

Today the Farm Credit Administration Board adopted a proposed rule to add a new part 628 to FCA's regulations and amend part 615, subpart H, to modify the regulatory capital requirements for Farm Credit System (FCS or System) banks and associations (institutions).

FCA's objectives in proposing this rule are as follows:

- To modernize capital requirements while ensuring that institutions continue to hold sufficient regulatory capital to fulfill their mission as a government-sponsored enterprise.
- To ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the federal banking regulatory agencies have adopted, but also to ensure that the rules recognize the cooperative structure and the organization of the System.
- To make System regulatory capital requirements more transparent.
- To meet the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Summary of Changes

The proposal would replace core surplus and total surplus requirements with common equity tier 1 (CET1), tier 1 and total capital (tier 1 + tier 2) risk-based capital ratio requirements. The proposal would add a tier 1 leverage ratio for all System institutions, which would replace the existing net collateral ratio for System banks.

In addition, the proposal would establish a capital conservation buffer, enhance the sensitivity of risk weightings, and, for System banks only, require additional public disclosure requirements. The revisions to the risk weightings would include alternatives to the use of credit ratings, as required by section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

§ 628.1 – Purpose, applicability, and reservations of authority: This provision explains the purpose of the proposed rule, its applicability, and FCA’s reservations of authority.

§ 628.2 – Definitions: This provision defines the terms that are used in the rule.

§ 628.3 – Operational requirements for certain exposures: This provision establishes operational requirements for calculating risk-weighted assets for certain exposures.

§ 628.10 – Minimum Capital Requirements: This provision sets the following minimum risk-based requirements:

- A CET1 capital ratio of 4.5 percent.
- A tier 1 capital ratio (CET1 capital plus additional tier 1 capital (AT1)) of 6 percent.
- A total capital ratio (tier 1 plus tier 2) of 8 percent.

This provision also sets a minimum tier 1 leverage ratio (tier 1 divided by total assets) of 5 percent, of which at least 1.5 percent must consist of unallocated retained earnings (URE) and nonqualified allocated equities with certain characteristics of URE (URE equivalents).

§ 628.11 – Capital Conservation Buffer: This provision establishes a capital cushion of 2.5 percent above the risk-based CET1, tier 1, and total capital requirements, below which capital distributions (e.g., equity redemptions, dividends, and patronage) and discretionary bonuses are restricted or prohibited without prior FCA approval.

§ 628.20 – Capital Components and Eligibility Criteria for Regulatory Capital Instruments: This provision sets forth the criteria an institution must meet to be able to include capital instruments in CET1 capital, AT1 capital, and tier 2 capital. The criteria are as follows:

- **CET1 Capital** consists of URE plus common cooperative equities (purchased member stock, purchased participation certificates, and allocated equities) that meet the following key criteria (among others):
 - Borrower stock (regardless of redemption or revolvment period) up to the lesser of the statutory minimum of \$1000 or 2 percent of the loan amount (statutory minimum borrower stock).
 - Equities are perpetual and represent claims in liquidation subordinated to all preferred stock, subordinated debt, and liabilities of the institution.
 - Equities subject to revolvment or redemption are not retired for at least 10 years after issuance.
 - Equities can be redeemed or revolved only with FCA prior approval (unless it is the statutory minimum borrower stock requirement or unless the distribution meets “safe harbor” standards described below).
 - A System institution must adopt a capitalization bylaw providing it will seek prior FCA approval before redeeming or revolving any equities it includes in CET1 before the end of the 10-year period (other than the statutory minimum borrower stock).
- **AT1 Capital** consists of equities other than common cooperative equities that meet most of the CET1 criteria, except that AT1 capital equities represent a claim that ranks senior to all common cooperative equities in a receivership, liquidation, or similar proceeding. AT1 capital would consist primarily of noncumulative perpetual preferred stock that has been issued primarily by System banks to investors outside of the System.
- **Tier 2 Capital** consists of equities, which may be either common cooperative equities or equities held by third parties, not includable in tier 1 capital. These equities must meet the following key criteria:
 - The equities are perpetual or have an original maturity of at least five years.
 - Equities subject to revolvment or redemption are not retired for at least five years after issuance.
 - The equities may not be redeemed or revolved prior to maturity or the end of the stated revolvment period without FCA prior approval.
 - A System institution must adopt a capitalization bylaw providing it will seek prior FCA approval before retiring any equities it includes in tier 2 before the end of the five-year period.

This provision contains procedural requirements for a System institution to request approval for patronage and equity redemptions, as well as dividends and cash patronage. It also contains a safe harbor for cash redemptions, dividends, and patronage under certain conditions.

§ 628.22 – Regulatory Capital Adjustments and Deductions: This provision requires a System institution to deduct the following from CET1 capital:

- Goodwill, intangible assets, gains-on-sale in connection with a securitization exposure, and defined benefit pension fund net assets, all of which are net of associated deferred tax liabilities.
- A System institution's allocated equity investments in another System institution.

In addition, if an institution redeems equities (other than the minimum borrower stock amount) included in CET1 capital that it issued or distributed less than 10 years prior to the redemption, it must deduct 30 percent of purchased and allocated equities from CET1 capital for the subsequent three years after the redemption. The deduction does not apply to the minimum borrower stock requirement, nor does it apply to allocated equities that are URE equivalents unless the equities redeemed early were URE equivalents.

This provision also applies a corresponding deduction approach to a System institution's purchased investment in another System institution. This means that a System institution makes deductions from the component of capital for which the underlying instrument would qualify if it were issued by the System institution itself.

§ 628.23 – Limits on Third-Party Capital: This provision caps the amount of stock issued to third-party investors that a System institution can include in regulatory capital. The limits would be on tier 1 capital and total capital and would be similar to existing limits on third-party capital that FCA has imposed on System institutions' core surplus and total surplus on a case-by-case basis.

§§ 628.30–628.53 – Risk-Weighted Assets – Standardized Approach: These provisions establish the risk weights for the following asset exposures:

- General exposures, including exposures to
 - the United States and foreign sovereigns,
 - supranational entities and multilateral development banks,
 - government-sponsored enterprises,
 - depository institutions or credit unions, including those that are “other financing institutions” (OFIs),
 - public sector entities such as states and municipalities,
 - corporate entities (including exposures to agricultural borrowers and OFIs that are not affiliated with depository institutions or credit unions),
 - residential mortgage borrowers,
 - high-volatility commercial real estate,
 - past-due exposures,
 - servicing assets, and
 - deferred tax assets.
- Off-balance-sheet exposures.
- Over-the-counter derivative contracts.
- Cleared transactions.
- Guarantees and credit derivatives.
- Collateralized transactions.
- Unsettled transactions.
- Securitization exposures.
- Equity exposures.

Changes in risk weighting between the existing rule and the proposed rule include the following:

- As required by the Dodd-Frank Act, credit ratings would no longer be used to determine creditworthiness of an exposure. Instead, other risk-sensitive approaches would be used.
- The 50 percent intermediate risk weighting for exposures to OFIs would be eliminated; all OFI exposures would be risk-weighted at 100 percent, except for OFIs affiliated with a depository institution or credit union.
- High-volatility commercial real estate exposures increase in risk weighting from 100 percent to 150 percent. (These exposures may overlap with exposures to land in transition.)
- Currently, risk weights do not increase when an exposure becomes past due, except for residential mortgage exposures. Under the proposed rule, all past-due exposures would be risk-weighted at 150 percent, except for any portion that is guaranteed or secured by financial collateral (real estate and chattel are not financial collateral).
- Short-term commitments (14 months or less) that are not unconditionally cancellable increase from zero percent to 20 percent.

The net effect of these changes on an institution’s risk-adjusted asset base should be small. The risk weighting for many System assets, such as agricultural loans and direct notes, will remain unchanged. And although the risk-weightings of some assets (like short-term commitments) will go up, the risk-weightings of other assets (like derivatives) will go down.

§§ 628.61–628.63 – Disclosures: These provisions would require Farm Credit banks to make public disclosures comparable to those required of banking organizations with over \$50 billion in assets that are regulated by the federal banking regulatory agencies. Meaningful public disclosures encourage market discipline and aid market participants in their assessments. Disclosure requirements are appropriate for all Farm Credit banks—even those with less than \$50 billion in assets—because of their joint and several liability for the Systemwide debt obligations that they issue. To avoid duplicating other reporting requirements, the rule would give Farm Credit banks discretion in how they present the required disclosures.

§ 628.300 – Transitions: This provision would establish a three-year phase-in of the capital conservation buffer, beginning January 1, 2016.

§ 628.301 – Initial Compliance and Reporting Requirements: This provision would require a System institution not meeting all minimum regulatory capital requirements on the effective date of the rule to notify FCA of its noncompliance and to submit a capital restoration plan. If FCA approves the plan and the institution complies with the plan, FCA would consider the institution complying with the regulatory capital requirements.

Other Regulatory Provisions: As required by the Farm Credit Act of 1971, as amended, the regulatory provisions in subpart H of part 615 pertaining to permanent capital would be retained for the numerator, but the denominator would be calculated using the risk weighting in proposed part 628. Numerous technical and conforming changes are made throughout part 615 and in other FCA regulations.

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