**Fact Sheet**

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March 10, 2016

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# Fact Sheet on Tier 1/Tier 2 Regulatory Capital Framework Final Rulemaking

Today the Farm Credit Administration Board adopted a final rule that will add a new part 628 to FCA's regulations and amend part 615 and other FCA regulations to modify the regulatory capital requirements for Farm Credit System (System) banks and associations (institutions).

FCA's objectives in adopting this final rule are as follows:

- To modernize capital requirements while ensuring that System institutions continue to hold sufficient regulatory capital to fulfill the System's 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 Final Rule

The final rule replaces existing core surplus and total surplus requirements with common equity tier 1 (CET1), tier 1, and total capital (tier 1 plus tier 2) risk-based capital ratio requirements. The final rule also adds a tier 1 leverage ratio for all System institutions, which replaces the existing net collateral ratio for System banks.

In addition, the final rule establishes a capital conservation buffer and a leverage buffer; enhances the sensitivity of risk weightings; and, for System banks only, requires additional public disclosure requirements. The revisions to the risk weightings include alternatives to the

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use of credit ratings, as required by section 939A of the Dodd-Frank Act. The final rule will become effective on Jan. 1, 2017.

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

**§ 628.2 – Definitions:** This provision defines the terms that are used in the final 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) 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 4 percent, of which at least 1.5 percent must consist of unallocated retained earnings (URE) and URE equivalents, which are nonqualified allocated equities with certain characteristics of URE.

**§ 628.11 – Capital Buffer Amounts:** This provision establishes a capital cushion (capital conservation buffer) of 2.5 percent above the risk-based CET1, tier 1, and total capital requirements. This provision also establishes a leverage capital cushion (leverage buffer) of 1 percent above the tier 1 leverage ratio requirements. If capital ratios fall below these buffer amounts, capital distributions (equity redemptions, dividends, and patronage) and discretionary senior executive 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, additional tier 1 capital, and tier 2 capital. The criteria are as follows:

- **CET1 Capital** consists of unallocated retained earnings plus common cooperative equities (purchased member stock, purchased participation certificates, and allocated equities). These equities are unchanged from the proposed rule except as specified below and must meet the following criteria (among others):
    - Equities are perpetual and represent claims in liquidation subordinated to all preferred stock, subordinated debt, and liabilities of the institution.
    - Equities subject to redemption or revolvement are not retired for at least 7 years after issuance. This is a change from the proposed rule's minimum redemption or revolvement period of 10 years. An exception to this minimum period is that an institution may redeem a member-borrower's statutory minimum stock requirement (the lesser of $1,000 or 2 percent of the loan) when the loan is repaid.

  - 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 or annual board resolution providing it will seek prior FCA approval before redeeming or revolving any equities (other than the statutory minimum borrower stock) it includes in CET1 before the end of the 7-year period. This is a change from the proposed rule, which required a capitalization bylaw and did not permit compliance through an annual board resolution.

- **Additional Tier 1 Capital** consists of equities other than common cooperative equities that meet most of the CET1 criteria but represent a claim that ranks senior to all common cooperative equities in a receivership, liquidation, or similar proceeding. Additional Tier 1 capital consists 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, that do not meet the tier 1 capital criteria, as well as qualifying subordinated debt and limited-life preferred stock. These equities are unchanged from the proposed rule except as specified below and must meet the following criteria:

  - The instruments are perpetual or have an original maturity of at least 5 years.
  - Instruments subject to redemption or revolvement are not retired for at least 5 years after issuance.
  - The instruments may not be redeemed or revolved prior to maturity or the end of the stated revolvement period without FCA prior approval.
  - A System institution must adopt a capitalization bylaw or annual board resolution providing it will seek prior FCA approval before retiring any instruments it includes in tier 2 before the end of the 5-year period. This is a change from the proposed rule, which required a capitalization bylaw and did not permit compliance through an annual board resolution.

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. The safe harbor permits cash payments for dividends, patronage, and redemptions and revolvements of equities, provided that the equities have been outstanding for at least the minimum holding periods and, after the cash payments, the dollar amount of CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date in the previous year. In the final rule, FCA has provided exceptions from the minimum holding periods for equities mandated to be retired by court order, equities held by the estate of a deceased former borrower, and equities required to be canceled under § 615.5290.

**§ 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
- Accumulated other comprehensive income (loss)

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 the lesser of the following: 40 percent of total capital or 100 percent of CET1 capital.

**§§ 628.30–628.53 – Risk-Weighted Assets – Standardized Approach:** These provisions establish the risk weights and related capital treatment 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;
  - past-due and nonaccrual 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 capital treatment between existing regulations and the final rule include the following:

- As required by the Dodd-Frank Act, credit ratings are no longer used to determine creditworthiness of an exposure. Instead, other risk-sensitive approaches are used.
- Currently, risk weights do not increase when an exposure becomes past-due or nonaccrual, except for residential mortgage exposures. Under the final rule, all past-due or nonaccrual exposures are 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).
- The credit conversion factor applied to unused commitment exposures from System banks to fund direct loans to associations and OFIs is 20 percent, regardless of maturity.
- The credit conversion factor applied to other unused commitment exposures increases from zero percent to 20 percent if the commitment has a short-term maturity (14 months or less). (The credit conversion factor applied to other unused commitment exposures remains at 50 percent if the commitment has a longer-term maturity.)

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 loans, will remain unchanged.

**§§ 628.61–628.63 – Disclosures:** These provisions require System banks to make public disclosures comparable to those required of banking organizations that have over $50 billion in assets and 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 System 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 System 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 Jan. 1, 2017. There will be no phase-in of the leverage buffer.

**§ 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 to be in compliance 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 the permanent capital ratio would be retained for the numerator, but the denominator would be calculated using the risk weighting in part 628. Numerous technical and conforming changes are made throughout part 615 and in other FCA regulations.

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