

**FARM CREDIT ADMINISTRATION****12 CFR Parts 607, 611, 614, 615, 620, 624, 627 and 628****RIN 3052-AC81****Regulatory Capital Rules: Regulatory Capital, Implementation of Tier 1/Tier 2 Framework****AGENCY:** Farm Credit Administration.**ACTION:** Final rule.

**SUMMARY:** The Farm Credit Administration (FCA or we) is adopting a final rule that revises our regulatory capital requirements for Farm Credit System (System) institutions to include tier 1 and tier 2 risk-based capital ratio requirements (replacing core surplus and total surplus requirements), a tier 1 leverage requirement (replacing a net collateral requirement for System banks), a capital conservation buffer and a leverage buffer, revised risk weightings, and additional public disclosure requirements. The revisions to the risk weightings include alternatives to the use of credit ratings, as required by section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

**DATES:** *Effective date:* January 1, 2017.

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**I. Introduction***A. Objectives of the Final Rule*

The FCA's objectives in adopting this final rule are:

- To modernize capital requirements while ensuring that institutions continue to hold enough regulatory capital to fulfill their mission as a Government-sponsored enterprise (GSE);
- 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 take into account the cooperative structure and the organization of the System;
- To make System regulatory capital requirements more transparent; and
- To meet the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

*B. Summary of the Proposed Rule*

On September 4, 2014, the FCA published in the **Federal Register** a notice of proposed rulemaking seeking public comment on revisions to our regulatory capital requirements governing System banks,<sup>1</sup> System associations, the Farm Credit Leasing Services Corporation, and any other FCA-chartered institution the FCA determines should be subject to this rule (collectively, System institutions).<sup>2</sup> The proposed rule, where appropriate, was comparable to the capital rules

<sup>1</sup> For purposes of this preamble and part 628, as well as some of the regulations in which there are conforming changes and other existing regulations, the term "System bank" includes Farm Credit Banks, agricultural credit banks, and banks for cooperatives. It has the same meaning as "Farm Credit bank", which is defined in § 619.9140 and will continue to be used in some of the regulations in which there are conforming changes as well as in other existing regulations. The Farm Credit Act of 1971, as amended (Farm Credit Act or Act), uses the term "System bank" in a number of its provisions.

<sup>2</sup> 79 FR 52814 (September 4, 2014).

published in October 2013 and April 2014 by the Federal banking regulatory agencies<sup>3</sup> for the banking organizations they regulate (U.S. rule).<sup>4</sup> Those rules follow the Basel Committee on Banking Supervision's (BCBS or Basel Committee) document entitled "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III), including subsequent changes to the BCBS's capital standards and BCBS consultative papers, and our proposed rule followed Basel III as appropriate for cooperatives.<sup>5</sup>

The proposed rule was intended to:

- Improve the quality and quantity of System institutions' capital and enhance risk sensitivity in calculating risk weighted assets,

- Provide a more transparent picture of System institutions' capital to the investment-banking sector, which could facilitate System institutions' securities offerings to third-party investors, and

- Comply with section 939A of the Dodd-Frank Act<sup>6</sup> by proposing alternatives to credit ratings for calculating risk weighted assets for certain exposures that are currently based on the ratings of nationally recognized statistical rating organizations (NRSROs).

After the worldwide financial crisis that began in 2008, the BCBS issued the Basel III framework and has continued to issue additional standards, with the goal of strengthening financial organizations' capital. The U.S. rule reflects Basel III as well as aspects of Basel II and other BCBS standards. The provisions of the U.S. rule that are not specifically included in the Basel III framework are generally consistent with the goals of the framework.

The FCA's proposed rule was comparable to the standardized approach rules of the Federal banking regulatory agencies to the extent appropriate for the System's cooperative

structure and status as a GSE with a mission to provide a dependable source of credit and related services for agriculture and rural America. Consistent with the U.S. rule, the FCA's proposed rule incorporated key aspects of the Basel III tier 1 and tier 2 framework and included the following minimum risk-based ratios:

- CET1 capital of 4.5 percent;
- Tier 1 capital of 6 percent; and
- Total capital of 8 percent.

The risk-based minimum ratios are identical to the ratios in the U.S. rule. In contrast to Basel III and the U.S. rule, we did not include all accumulated other comprehensive income (loss) (AOCI) in CET1. We note, however, that under the final U.S. rule, qualifying commercial banks can elect to opt-out of including AOCI in their regulatory capital ratios. We also proposed a tier 1 leverage ratio of 5 percent, of which at least 1.5 percent must be unallocated retained earnings (URE) and URE equivalents (nonqualified allocated surplus that is never revolved). Our proposal differed from the U.S. rule's minimum tier 1 leverage ratio of 4 percent with no minimum URE requirement.

We proposed a capital conservation buffer of 2.5 percent to enhance the resilience of System institutions, the same capital conservation buffer as in the U.S. rule. Our proposed capital conservation buffer similarly had a phase-in period of 3 years, but we did not propose to incorporate any of the other transition periods in Basel III and the U.S. rule.

The proposed rule imposed some new patronage refund and equity redemption requirements, including FCA prior approvals, on System institutions to provide comparability with the U.S. rule and also to ensure the stability and permanence of the capital includable in the tier 1 and tier 2 capital ratios. We proposed that System institutions must retain equities included in CET1 capital for at least 10 years and retain equities included in tier 2 capital for at least 5 years, unless the FCA grants prior approval to redeem or revolve at an earlier date. We proposed to require institutions to adopt a bylaw committing the institutions to the minimum redemption and revolvement periods. We provided a "safe harbor," or deemed prior approval, for cash patronage refund payments and equity redemptions and revolvments as long as the dollar amount of the institution's CET1 capital was equal to or above the dollar amount of the institution's CET1 on the same date of the previous year. Both the Basel III framework and the

U.S. rule and applicable law have similar prior approval requirements, but we adapted these requirements to the System's cooperative structure and operations.

The proposed rule contained regulatory deductions and adjustments in the capital ratio calculations that are comparable in purpose to those required in Basel III and the U.S. rule. However, we modified the deductions and adjustments in consideration of the two-tiered, financially interdependent, cooperative structure of the System. We proposed to require deductions from CET1 of goodwill and other intangibles and of allocated equity investments in other System institutions, service corporations, and the Funding Corporation. We also proposed to require System institutions that have purchased equity investments in other System institutions to deduct the investment using the corresponding deduction approach. A "haircut" deduction of a portion of allocated equities was required if an institution redeemed or revolved equities before the end of the applicable minimum redemption or revolvement period.

We proposed a limit on how much third-party capital—capital held by investors other than other System institutions or their member-borrowers—could count in the regulatory capital ratios. The proposed limit was similar to the limit the FCA had previously imposed on System institutions on a case-by-case basis.

The FCA also proposed changes to its risk-based capital rules for determining risk weighted assets—that is, the calculation of the denominator of a System institution's risk-based capital ratios. We proposed to eliminate the credit ratings of NRSROs from risk weights for certain exposures, consistent with section 939A of the Dodd-Frank Act. As an alternative, FCA proposed to include methodologies for determining risk weighted assets for exposures to sovereigns, foreign banks, and public sector entities, securitization exposures, and counterparty credit risk. We proposed an increased risk-weight for high-volatility commercial real estate (HVCRE) exposures and for past due and nonaccrual exposures. We did not propose to alter FCA Bookletter BL-053, which since 2007 has permitted lower risk weights for certain exposures to generation and transmission and electric distribution cooperatives (electric cooperatives), but we also did not propose to include the lower risk weights in the rule. We proposed to increase the credit conversion factors (CCF) that apply to unused commitments, including commitments

<sup>3</sup> The Federal banking regulatory agencies are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC).

<sup>4</sup> 78 FR 62018 (October 11, 2013) (final rule of the OCC and the FRB); 79 FR 20754 (April 14, 2014) (final rule of the FDIC).

<sup>5</sup> Basel III was published in December 2010 and revised in June 2011. The text is available at <http://www.bis.org/publ/bcbs189.htm>. The BCBS was established in 1974 by central banks with bank supervisory authorities in major industrial countries. The BCBS develops banking guidelines and recommends them for adoption by member countries and others. BCBS documents are available at <http://www.bis.org>. The FCA does not have representation on the Basel Committee, as do the Federal banking regulatory agencies, and is not required by law to follow the Basel standards.

<sup>6</sup> Public Law 111-203, 124 Stat. 1376 (2010).

from System banks to associations to fund direct loans. We proposed to eliminate the existing 50-percent risk weight for certain other financing institutions (OFIs). We proposed certain due diligence requirements in connection with securitization exposures. The proposed rule included new risk weights for cleared transactions, guarantees including credit derivatives, collateralized financial transactions, unsettled transactions, and securitization exposures.

We generally did not propose risk weightings for exposures that System institutions have no authority to acquire.<sup>7</sup> In some but not all cases, we discussed in the preamble this variance from the rules of the Federal banking regulatory agencies. In addition, we did not propose risk weightings for certain exposures that are both complex and unlikely; we stated that we would determine the treatment on a case-by-case basis using our regulatory reservation of authority. We generally discussed these exposures in the preamble. We reminded System institutions that the presence of a particular risk weighting does not itself provide authority for a System institution to have an exposure to that asset or item. System authorities to acquire exposures are contained in other provisions of our regulations and in the Farm Credit Act.

We did not propose to adopt the “advanced approaches” regulatory capital rules because no System institution has the volume of assets or foreign exposures that would subject it to those approaches if it were regulated by a Federal banking regulatory agency.<sup>8</sup> We also did not propose the market risk requirements, because no System institution has significant exposure to market risk.

The proposed rule also required additional recordkeeping and disclosures by System banks, comparable to the required disclosures in the U.S. rule for commercial banks with assets of \$50 billion and above. It was our belief that the benefits to the System of these proposed rules would more than outweigh the requirements and additional responsibilities we would require.

We proposed to: (1) Place the tier 1 and tier 2 risk weighted and leverage capital requirements in a new part 628 of FCA regulations in title 12 of the Code of Federal Regulations; (2) rescind the risk-weighting provisions in subpart

H of part 615 and the core surplus, total surplus, and net collateral requirements in subpart K of part 615; (3) retain in part 615 the requirements for the numerator of the permanent capital ratio, a measure that is mandated by the Farm Credit Act, but make the risk weightings for the denominator of the permanent capital ratio the risk weightings in new part 628; and (4) make conforming changes in other FCA regulations.

In the proposed rule, we used the general format and the section and paragraph numbering system of the U.S. rule to the extent possible. In many cases, we retained the numbering system by reserving sections and paragraphs where we did not propose parallel provisions. We did so in order to facilitate the comparison of the proposal with the U.S. rules.

### C. Summary of the Final Rule

The final rule replaces the FCA’s core surplus, total surplus, and net collateral rules with common equity tier 1 (CET1), tier 1, total capital, capital conservation buffer, and leverage buffer rules as described below. The final rule also revises the risk weightings in the existing rule and makes minor adjustments to the permanent capital calculation. In addition, it expands public disclosure requirements for System banks. After considering the comments we received, we have made changes in the final rule to address policy, technical, and compliance concerns raised by commenters.

In the final rule, we have adopted the minimum CET1, tier 1, and total risk-based capital ratios as set forth in the proposed rule. We have adopted a lower tier 1 leverage ratio of 4 percent in the final rule but have retained the URE and URE equivalents requirement of 1.5 percent, and we have added a tier 1 leverage buffer of 1 percent.

We have adopted the capital conservation buffer of 2.5 percent as proposed and have provided a phase-in period of 3 years that will end on December 31, 2019.

We have revised a number of the proposed patronage refund and equity redemption or revolvment requirements:

- We have revised the minimum CET1 redemption or revolvment period to 7 years from 10 years in the proposal but have adopted the other minimum periods as proposed.

- We have provided that institution boards may adopt a resolution annually

that commits the institutions to comply with the minimum redemption and revolvment periods, as an alternative to adopting a capital bylaw.

- We have expanded the “safe harbor” to exempt 3 types of equity redemptions or revolvments from the applicable minimum holding periods: (1) Equities mandated to be redeemed or retired by a final order of a court of competent jurisdiction; (2) equities belonging to the estate of a deceased former borrower; and (3) equities that the institution is required to cancel under § 615.5290 of our regulations.

We have adopted the regulatory deductions and adjustments in the final rule as proposed, with several exceptions. We have revised the 30-percent mandatory “haircut” for noncompliance with the minimum revolvment periods and have replaced it with a provision stating that the FCA may take a supervisory or enforcement action for noncompliance with the minimum revolvment periods, which may include requiring an institution to deduct a portion of its equities from CET1 capital.

We have simplified the calculation for the third-party capital limit.

We have not finalized the proposed provisions governing HVCRE at this time. We have not included lower risk weights for exposures to electric cooperatives in the rule, but FCA Bookletter BL-053 remains in effect. We have applied a 20-percent CCF to all unused commitments from System banks to fund direct loans without regard to maturity, rather than applying a 50-percent CCF to commitments longer than 14 months, and we have clarified that this capital treatment applies to direct loan commitments to OFIs as well as associations. We have retained the existing, but not proposed, 50-percent risk weight for loans to certain OFIs, but we have eliminated the credit rating standard for this risk weight. We have retained the higher risk weight for past due and nonaccrual exposures and the due diligence requirements for securitization exposures. We have revised the definition of Government-sponsored enterprise (GSE) to include the System.

We have adopted the recordkeeping disclosure requirements for System banks as proposed.

We have adopted conforming changes to existing FCA regulations.

<sup>7</sup> However, we did propose risk weighting for exposures that System institutions are not permitted to acquire under their investment authorities, because such exposures could be

acquired through foreclosures on collateral or similar transactions.

<sup>8</sup> In general, the advanced approaches rule applies to banks with consolidated total assets of at

least \$250 billion or with foreign exposures of \$10 billion or more. Only two System institutions have total assets in excess of \$50 billion, and foreign exposures are negligible.

TABLE 1—SUMMARY OF KEY PROVISIONS OF THE TIER 1/TIER 2 CAPITAL ITEMS AND STANDARDIZED APPROACH RISK WEIGHTS

Minimum capital ratios	Treatment in final rule
<b>Tier 1/Tier 2—Capital Items</b>	
Common equity tier 1 (CET1) capital ratio (§ 628.10) ..... Tier 1 capital ratio (§ 628.10) ..... Total capital ratio (§ 628.10) ..... Tier 1 Leverage ratio (§ 628.10) .....	A minimum requirement of 4.5 percent. A minimum requirement of 6.0 percent. A minimum requirement of 8.0 percent. A minimum tier 1 leverage ratio requirement of 4.0 percent of which at least 1.5 percent must consist of unallocated retained earnings and unallocated retained earnings equivalents. Applies to all System institutions.
Components of Capital and Eligibility Criteria for Regulatory Capital Instruments (§§ 628.20, 628.21, and 628.22). Capital Conservation Buffer and Leverage Buffer Amounts (§ 628.11) ...	Describes the eligibility criteria for regulatory capital instruments and adds certain adjustments to and deductions from regulatory capital. A 2.5-percent capital conservation buffer of CET1 capital above the minimum risk-based capital requirements and a 1-percent leverage buffer of tier 1 capital above the minimum capital requirement, both of which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments.
<b>Risk weighted Assets—Standardized Approach</b>	
Credit exposures to: U.S. government and its agencies ..... U.S. depository institutions and credit unions (including those that are OFIs). U.S. public sector entities, such as states and municipalities ..... Cash ..... Cash items in the process of collection ..... Exposures to other System institutions that are not deducted from capital. Assets not specifically assigned to a risk weight category and not deducted from capital. (§ 628.32) ..... Exposures to certain supranational entities and multilateral development banks (§ 628.32). Exposures to Government-sponsored enterprises (§ 628.32) .....	Remains unchanged from existing regulations: 0 percent. 20 percent. 20 percent—general obligations. 50 percent—revenue obligations. 0 percent. 20 percent. 100 percent. 100 percent. Assigned a 0 percent risk weight (reduced from 20 percent). Non-System exposures: Risk weight for preferred stock increased from 20 percent to 100 percent. Risk weight for all other exposures (except equity exposures, which are discussed below) remains at 20 percent. System exposures: Risk weight for direct loans remains at 20 percent. All equities, including preferred stock, deducted from capital (not risk weighted).
Credit exposures to: Foreign sovereigns; Foreign banks; Foreign public sector entities (§ 628.32) Corporate exposures (§ 628.32) ..... Residential mortgage exposures (§ 628.32) ..... High volatility commercial real estate exposures (§ 628.32) ..... Past due and nonaccrual exposures (§ 628.32) ..... Off-balance Sheet Items (§ 628.33) ..... OTC Derivative Contracts (does not include cleared transactions) (§ 628.34). Cleared Transactions (§ 628.35) ..... Guarantees and Credit Derivatives (§ 628.36) ..... Collateralized Transactions (§ 628.37) ..... Unsettled Transactions (§ 628.38) .....	Assigns risk-sensitive risk weights based on the Country Risk Classification measure produced by the Organization for Economic Cooperation and Development (risk weight no longer determined based on OECD membership status). Assigns a 100-percent risk weight to most corporate exposures, including exposures to agricultural borrowers and to OFIs that do not satisfy the criteria for a 20-percent or 50-percent risk weight. Assigns a 50-percent risk weight to non-depository institution/non-credit union OFIs that are investment grade or that meet standards similar to OFIs that qualify for a 20-percent risk weight. 50 percent for first lien residential mortgage exposures that satisfy specified underwriting criteria. 100 percent otherwise. Provisions assigning higher risk weight not adopted in this rulemaking. Additional rulemaking or guidance may take place in future. Assigns a 150-percent risk weight to exposures that are past due or in nonaccrual status, unless they are residential mortgage exposures or they are guaranteed or secured by financial collateral. Certain credit conversion factors (CCF) revised, including the CCF for unused short-term commitments that are not unconditionally cancellable, which is increased from 0 percent to 20 percent. Modifies derivative matrix table slightly. Recognizes credit risk mitigation of collateralized OTC derivative contracts. Provides preferential capital requirements for cleared derivative and repo-style transactions (as compared to requirements for non-cleared transactions) with central counterparties that meet specified standards. Provides a more comprehensive recognition of guarantees. Recognizes financial collateral. Risk weight depends on number of business days past settlement date.

TABLE 1—SUMMARY OF KEY PROVISIONS OF THE TIER 1/TIER 2 CAPITAL ITEMS AND STANDARDIZED APPROACH RISK WEIGHTS—Continued

Minimum capital ratios	Treatment in final rule
Securitization Exposures (§§ 628.41, 628.42, 628.43, 628.44, and 628.45).	Replaces the ratings-based approach with either the standardized supervisory formula approach (SSFA) or the gross-up approach for determining a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the securitization's structure.
Equity exposures (§§ 628.51, 628.52, and 628.53) .....	Establishes a more risk-sensitive treatment for equity exposures.
Disclosure Requirements (§§ 628.61, 628.62, and 628.63) .....	Establishes qualitative and quantitative disclosure requirements, including regarding regulatory capital instruments, for all System banks.
Existing FCA Regulatory Capital	
Minimum Capital Ratios:	
Permanent capital ratio (§§ 615.5201 and 615.5205) .....	Numerator calculation remains unchanged, but risk weights (denominator) are revised.
Total surplus ratio (§§ 615.5301(i) and 615.5330(a)) .....	Eliminated.
Core surplus ratio (§§ 615.5301(b) and 615.5330(b)) .....	Eliminated.
Net collateral Ratio (banks only) (§§ 615.5301(d) and 615.5335) ....	Eliminated.

*D. Comments on the Proposed Rule*

The original comment period for the proposed rule was for 120 days, ending on January 2, 2015. At the request of the System, on December 23, 2014, the FCA extended the comment period to February 16, 2015,<sup>9</sup> and on June 23, 2015 the FCA reopened the comment period for a 15-day period between June 26 and July 10, 2015.<sup>10</sup>

The FCA received approximately 2400 public comments on the proposed rule. Nearly 500 of the comments were from individual System associations and their directors and officers; the 4 System banks; and the Farm Credit Council, a trade association representing the interests of System institutions. Approximately 1800 member-borrowers of one System association submitted comments.<sup>11</sup> We also received a comment letter from a member of Congress on behalf of several of his constituents. The comment letter submitted by the Farm Credit Council (System Comment Letter) states that the System's capital workgroup developed the comments after soliciting input from all System institutions. This input was further discussed and reviewed among the institutions, after which the capital workgroup circulated a draft comment letter for further review.<sup>12</sup> The System

Comment Letter is comprehensive and detailed, covering most or all of the numerous regulatory philosophy, policy and technical issues directly and indirectly addressed in the proposed rule. Because the System Comment Letter was developed with input of all System institutions, the FCA focuses primarily on addressing those comments in this preamble. The preamble also addresses the individual comment letters of System institutions and their members and representatives, as well as those of non-System commenters, that contain substantially different arguments or discuss other issues.

In addition, 3 comments were from non-System agricultural lenders with lending relationships with System banks (other financing institutions or OFIs). Approximately 70 rural electric cooperatives and a trade association representing rural electric cooperatives submitted comments. Each of these two groups of commenters submitted a comment regarding the single issue of the proposed risk-weightings of System institutions' exposures to their particular business.

We also received comments from several educational and trade associations promoting the interests of farmers and farm businesses, cooperative businesses, rural electric cooperatives, and U.S. community bankers. The farm-related and cooperative trade associations all submitted a general comment supporting the System Comment Letter. They urged the FCA not to adopt regulations that would diminish the democratic nature of cooperatives, their identical to, or closely tracked, the System Comment Letter.

unique governance structure, and their ability to maintain financial and ethical integrity. The trade association representing community banks expressed concern about some provisions of the U.S. rule as applied to community banks and generally recommended the imposition of more strenuous capital requirements on System institutions. The trade association asserted that 1) there was an implicit government guarantee of the debt and equity of System institutions that the Basel III framework and the proposed rule failed to address, and that 2) this failure put taxpayers at risk for future bailouts, while privately-funded and well-capitalized community banks suffer with higher funding costs and absence of a government backstop. These trade association letters did not include comments on specific aspects or requirements of the proposed rule.

*E. Discussion of Threshold Issues Raised in the System Comment Letter*

This section of the preamble addresses the issues that the System Comment Letter identified as "Threshold Issues."

1. Basel III, the U.S. Rule, and Cooperative Principles

The System Comment Letter expressed strong support for modernizing the FCA's capital regulations through the adoption of a tiered framework comparable to Basel III and the U.S. rule. The System stated that such a modernization "will be helpful to external investors and others who are acquainted with the Basel III framework and understand the overall financial strength and capital capacity of individual [System] institutions as cooperative financial institutions." The

<sup>9</sup> See 79 FR 76927 (December 23, 2014).

<sup>10</sup> See 80 FR 35888 (June 23, 2015). The Farm Credit Council stated that the reason for the System's request was to give System representatives the opportunity to discuss the proposed rule with the FCA Board members that had joined the FCA Board on March 13 and 17, 2015.

<sup>11</sup> The great majority of the comments were the same form letter; however, a number of these commenters added hand-written comments to the form letter.

<sup>12</sup> A number of the comment letters from individual System institutions summarized, were

System asserted, however, that the FCA's proposed rule is "far harsher" and, in addition, "discourages the formation, retention, and distribution of member-held equity, undermining cooperative business principles that have been in place for decades." The System further asserted that, "[a]s expected by Basel III, FCA should take into account all principles specific to the constitution and legal structure of cooperatives."

The System Comment Letter is divided into three parts. The first part discusses 9 "threshold" issues important to the System, including a number identified as "undermin[ing] cooperative principles and member participation in the management, ownership, and control of System institutions as required by the Act." The second part, Appendix A, contains comments to specific questions we asked in the preamble to the proposed rule. The third part, Appendix B, identifies "various conceptual and technical issues" that are explained in a discussion of particular aspects of the regulation text. We first address the general assertion that the proposed rule is anti-cooperative as well as the issues identified in the System Comment Letter as "threshold issues." The section that follows discusses the System's remaining comments and other comments that we received.

In proposing the capital rule, it was our intention to implement capital requirements that are comparable to the Basel III framework as embodied in the U.S. rule, with adjustments to take into consideration the structure and operations of System institutions. As the System Comment Letter notes, the Basel III framework's capital components are described by the Basel Committee in terms of the capital of joint-stock banks—that is, financial institutions that issue stock to investors whose objective is to earn a profit. (We note that System institutions, like some other cooperative financial institutions, do issue stock, but they are not joint-stock banks as that term is used by the Basel Committee.) Investors with voting interests in a joint-stock bank are not required to do business with the joint-stock bank in which they own stock, and there is no connection between their ownership interests and any customer relationship they may have with such bank. Cooperatives and mutual associations, unlike joint-stock banks, are not created for the profit of investors but rather for the benefit of their member-borrowers, and there is a close connection between their equity ownership and their customer relationship with the cooperative

institution or mutual. The Basel Committee intended the criteria for joint-stock banks also to apply to other banking organizations, as explained in footnote 12 to the Basel III document:

The criteria also apply to non-joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non-joint stock companies in order to ensure consistent implementation.

The System Comment Letter appears to interpret this footnote to mean that Basel III-based regulations for cooperatives, such as the FCA's proposed rule, must take account of the "specific constitution and legal structure" of System institutions by deferring to "all cooperative principles" that are inconsistent with the Basel III criteria for joint-stock banks. Such an interpretation is not entirely without basis, given the lack of detail in the footnote, and this may have already have led to greater flexibility than intended by the Basel Committee in some banking agencies' regulatory interpretations. We note that, in December 2014, banking experts appointed by the Basel Committee to assess whether European Union pronouncements and its member countries' regulations comply with the Basel III framework raised concerns about exceptions some countries made to the framework for mutually owned institutions and suggested the Basel Committee consider issuing more specific guidance.<sup>13</sup> The Basel

<sup>13</sup> See Basel Committee on Banking Supervision, "Regulatory Consistency Assessment Program (RCAP): Assessment of Basel III regulations—European Union," December 2014. Paragraph 1.4.3 states the following, in pertinent part:

*CET1 instruments issued by mutually owned institutions:* Basel III permits some flexibility in order to accommodate the nature of capital instruments of different mutually owned banks. However, the Assessment Team is concerned that the CRR concessions from the 14 CET1 criteria for mutuals go beyond the permissible flexibility in the Basel standard, while noting that this standard does not precisely define the extent of permissible flexibility. This is an area where the BCBS could provide additional guidance on the extent of flexibility considered appropriate for CET1 issued in mutual bank structures.

In the case of one banking group, the Assessment Team observed that individual instruments of some cooperative banks were being marketed as being redeemable, non-loss absorbing in liquidation, and paying a distribution based on the face value. In the Assessment Team's view, this goes beyond the limits of permissible flexibility in Basel III. The fact

framework provides some clarity in a discussion of strengthening the global capital framework, in which the Basel Committee emphasizes the need for uniform standards for regulatory capital:

The crisis . . . revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions.

To this end, the predominant form of Tier 1 capital must be common shares and retained earnings. This standard is reinforced through a set of principles that also can be tailored to the context of non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Deductions from capital and prudential filters have been harmonized internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies.<sup>14</sup>

The FCA disagrees with the apparent interpretation in the System Comment Letter that the Basel III footnote 12 directs regulators to defer to mutual and cooperative constitutions and legal structures. There are 4 key points in the footnote, as clarified by the discussion in the text of the framework document, that we followed in the proposed rule. First, cooperative capital<sup>15</sup> that is included in CET1 or tier 2 capital must be substantively equivalent in quality to the CET1 or tier 2 capital of joint-stock banks, and that means cooperative capital must be excluded if they are not substantively equivalent. Second, cooperative capital must be excluded if it has features (including features that may be typical of cooperative operations) that weaken the capacity of the institution to continue operations during stressful times. Third, exceptions and adjustments to the criteria are in some cases necessary because of

that regulatory approval is required for redemption and that redemption may be deferred does not, in the team's opinion, mitigate the public perception that these instruments are redeemable, despite the approval requirements set out in the CRR.

While the amount of such instruments is clearly material for banks with mutual structures, the Assessment Team understands that these are well understood capital structures supported by Member State law that have proven resilient in times of stress. Moreover, some of the internationally active parts of such banking groups are capitalised by common equity in the form of publicly listed ordinary shares, which serves as an alternative source of loss-absorbing capital. This is an area where the Assessment Team believes the Basel Committee could provide additional guidance on the extent of flexibility considered appropriate for CET1 issued in mutual bank structures. As a result, this issue is noted as a deviation, but the Assessment Team has not factored this element into the grade for the definition of capital category nor into the overall assessment grade.

<sup>14</sup> Basel III Framework, paragraphs 8 and 9.

<sup>15</sup> Cooperative capital includes common cooperative equities and preferred stock issued to member-borrowers or other System institutions.

cooperative institutions' legal authorities and mandates, in order to ensure the uniform quality of the components and consistent implementation of the standards. Fourth, consistent implementation of the standards is required to enable the market to compare the quality of capital between institutions. Otherwise, the framework's goal of uniform capital standards among financial institutions would not be achieved—and the FCA could not represent our rule as comparable to Basel III and the U.S. rule. Not being able to represent our rule as comparable would eliminate a primary reason given by the System to modernize the capital regulations—to help third-party investors that are acquainted with the Basel III framework evaluate System institutions' capital.

In the proposed rule we made appropriate exceptions and adjustments related to legal authorities, structure and also traditional operations that are cooperative in nature. These include the exception for the liquidation priorities of URE and common cooperative equities; the eligibility requirements to become member-borrowers; the requirement to purchase member stock in order to obtain a loan; the restriction of association voting rights to member-borrowers in agriculture and related businesses and the restriction of bank voting rights to member associations and retail cooperative member-borrowers; the one-member, one-vote mandate for association member-borrowers; and the proportional voting mandate for associations and cooperatives that borrow from System banks. An important difference from joint-stock corporations such as commercial banks is that the voting stockholders, because they are also the customers, want both low interest rates on their loans and high amounts of patronage payments, and they are in a position to pressure the institution to provide patronage payments on a regular basis. Some institutions encourage member expectations by promoting and illustrating patronage payments as a routine “cash-back dividend” that effectively reduces the real interest rate on a member's loan as demonstrated by materials on their Web sites and in press releases.

Our proposed rule also included exceptions and adjustments to take into account non-cooperative differences between System institutions and commercial banks in legal authorities, mandates, and legal structure. Such differences include: (1) The two-tiered structure of System banks supervising and lending to the System associations that own them; (2) the joint and several

liability of System banks for almost all the general debt they issue; (3) the GSE status of the System; (4) the limitations on System associations to borrow from financial institutions other than their affiliated System bank; (5) the statutory discretion of a System institution to redeem purchased stock and retire allocated equities; and (6) the requirement that System institution voting members must approve amendments to the capitalization bylaws. Commercial banks have capital-related restrictions, some statutory and some in the U.S. rule, that the Act and our regulations have not previously imposed on System institutions, such as: (1) Restrictions on redemption of equities without both regulatory approval and stockholder approval; (2) restrictions on cash dividend payments without regulatory approval; and (3) prompt corrective action. Restrictions and adjustments in our capital rule, to the extent consistent with the System's GSE status, are also necessary in order to make our regulatory capital framework substantively comparable to the U.S. rule.

We note that the U.S. rule does not have specific provisions for mutual banking organizations.<sup>16</sup> The regulatory capital of these mutuals is made up almost entirely of retained earnings that we understand are never allocated to members; consequently, the retained earnings of mutuals have the same characteristics as the retained earnings of joint-stock banks—and, in our judgment, the URE of System institutions. Because neither joint-stock banks nor mutuals allocate equities, the U.S. rule does not take into consideration the allocation process.<sup>17</sup> In most cases, once a System institution has allocated equities to members, the members acquire ownership attributes that make the earnings stock-like and more appropriately treated like stock than like URE. The distinction is important because, if we treated

<sup>16</sup> The OCC issued a bulletin in 2014 describing the characteristics of mutuals and discussing supervisory considerations, including capital issues. See <http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-35.html>. The OCC's decision not to adopt special provisions for mutuals appears to be due to the fact that the legal authorities do not differ between commercial banks and mutuals in ways that require adjustments to the rule. According to the bulletin, mutual associations are subject to the same laws and regulations as joint-stock banks except for regulations on chartering, bylaws, combinations, and member communications.

<sup>17</sup> When a System institution pays patronage in the form of equities and retains these equities for the benefit of the cooperative institution, this is known as the allocation process in which a member-borrower's name is assigned to those equities.

allocated equities the same way we treat URE, none of the criteria that apply to equities included in tier 1 and tier 2 capital—including minimum revolvment periods and the expectation criterion discussed below—would apply.

## 2. Treatment of Allocated Equities

The System Comment Letter states that allocated equities are retained earnings and uses the term “allocated retained earnings” throughout its comment, stating that “allocated retained earnings” are the same as URE and should be treated the same way. The System makes a number of additional assertions about Basel III and the U.S. rule. These assertions include:

- Basel III does not establish tiers of retained earnings, does not require deduction from retained earnings of amounts that a commercial bank has announced it plans to distribute, and does not exclude retained earnings from CET1 to reflect market pressures to pay dividends.
- The U.S. rule includes all retained earnings in CET1 even though commercial banks are authorized to distribute retained earnings in amounts up to current year earnings plus net income for the two previous years. If the FCA does not change its position to treat retained earnings differently from the Basel III framework and the U.S. rule, it should impose only criteria applicable solely to retained earnings.
- Basel III and the U.S. rule do not apply any of the CET1 criteria to retained earnings. The FCA's proposed rule inappropriately applies the criteria to “allocated retained earnings,” including minimum revolvment periods established in capitalization bylaws.

The System Comment Letter correctly states that Basel III and the U.S. rule fully include “retained earnings” in CET1 and do not apply to retained earnings any of the CET1 criteria they apply to equities. Our treatment of URE is identical to the treatment of “retained earnings” in Basel III and the U.S. rule. In our view, equating URE with the “retained earnings” in Basel III and the U.S. rule is correct because, to our knowledge, all the retained earnings of institutions covered by Basel III and the U.S. rule are unallocated. Our research has not revealed any financial cooperatives or mutuals under the Basel III framework or the U.S. rule that allocate equities. All the System's comments about treatment of retained earnings pertain only to our treatment of earnings that have been allocated to their members. Rather than establishing tiers of retained earnings, a structure the System's comment seems to both criticize and recommend, we treat allocated equities the same way we treat purchased equities, consistent with the provisions of the Act and our existing

capital regulations. Most of the System's critical comments about our treatment of allocated equities have to do with the capitalization bylaw requirement and the requirement for prior approval of revolvments of allocated equities that do not fit within the safe harbor ("deemed prior approval") provision. We address these criteria-related comments when we discuss the bylaw and minimum holding period requirements later in this preamble.

We address here our basis for treating allocated equities the same way we treat purchased equities. We treat earnings that a System institution has allocated to a member as equities, irrespective of whether the institution calls them allocated equities, allocated stock, allocated surplus, or allocated retained earnings. "Allocated equities" is the term we use in existing capital regulations and also used in the proposed rule. The Act and existing FCA capital regulations most commonly use the term "allocated equities" and treat them as stock; in the Act and our regulations URE is consistently treated differently from stock and allocated equities.

We note that the term "allocated retained earnings" used in the System Comment Letter could potentially confuse third-party investors who are not familiar with the allocation process and may not understand the ownership attributes that attach once the earnings are allocated.<sup>18</sup> In addition, the term is not found in the Act. The closest similar term is in section 4.3A(a)(1) of the Act, which defines permanent capital to include the following: (1) "Current year retained earnings," (2) "allocated and unallocated earnings," (3) "all surplus," (4) stock that is not protected stock and that is not retireable at the discretion of the holder, and (5) other debt or equity instruments that the FCA determines appropriate to be considered permanent capital. "Allocated and unallocated earnings" may appear to be a separate and distinct category, but it overlaps with the categories of "current year retained earnings" and "surplus." "Allocated and unallocated earnings" also expressly overlaps with "stock," because paragraph (a)(2) of section 4.3A, which immediately follows the definition of permanent capital, further

defines "stock" to include "voting and nonvoting stock (including preferred stock), equivalent contributions to a guaranty fund, participation certificates, allocated equities, and other forms and types of equities." Other than the single, ambiguous reference to "allocated and unallocated earnings" in section 4.3A(a)(2) of the Act, the System's similar term "allocated retained earnings" is not a term used in the Act or our regulations. It has been rarely, if ever, used in FCA bookletters, informational memoranda, or **Federal Register** preambles.<sup>19</sup>

Many provisions of the Act treat URE and allocated equities in separate ways. Section 4.9A(d) of the Act, which defines and guarantees full repayment of "eligible borrower stock," defines borrower stock to mean "voting and nonvoting stock, equivalent contributions to a guaranty fund, participation certificates, allocated equities, and other similar equities that are subject to retirement under a revolving cycle issued by any System institution and held by any person other than any System institution." URE is not protected under section 4.9A of the Act. Sections 2.6 and 3.10 of the Act establish that associations and CoBank, ACB have liens on the stock and equities, including allocated equities, of their retail borrowers. In section 3.2(a)(2)(A)(ii) of the Act, voting by a bank for cooperatives' retail borrowers is based on a stockholder's proportional equity interest "including allocated, but not unallocated, surplus and reserves." Retirement of stock for a bank for cooperatives as provided in sections 3.5 and 3.21 of the Act treats the retirement of allocated equities the same as the retirement of "issued" equities. In section 6.4 of the Act, which pertains to the Assistance Board's certification of a System institution to obtain financial assistance by issuing preferred stock, allocated equities are treated as stock. Section 6.26(c)(1)(B) of the Act, pertaining to the repayment of financial assistance by the System, bases part of the repayment amount on an institution's amount of URE but not allocated equities.

Existing FCA capital regulations are consistent with the Act's separate treatment of URE and allocated equities.

Section 615.5330(b)(1) provides that a portion of core surplus must consist of URE and other includible equities *other than* allocated equities. A provision for banks for cooperatives that was in effect until 1997 required those banks to add at least 10 percent of their net earnings to their unallocated reserve account each year until URE equaled half the minimum permanent capital requirement (3.5 percent of risk weighted assets).<sup>20</sup>

Though the reason for treating allocated equities differently from URE is not expressly stated in the Act, the difference is likely based on the ownership attributes of allocated equities that make allocated equities stock-like in nature. The rule's treatment of allocated equities as stock and its treatment of URE as equivalent to the "retained earnings" in Basel III and the U.S. rule are consistent with the treatment of allocated equities and URE in the Act and existing FCA regulations.

### 3. Required Minimum Redemption/ Revolvment Periods

The proposed rule provided for minimum redemption and revolvment periods (holding periods) as part of the criteria for including equities in the new regulatory capital components. We proposed a minimum 10-year holding period for inclusion in CET1 capital and a minimum 5-year holding period for inclusion in tier 2 capital. In addition, consistent with Basel III and the U.S. rule, we proposed a 5-year no-call period for inclusion of equities in additional tier 1 capital and tier 2 capital, as well as a minimum 5-year term for term stock includible in tier 2 capital.

The System Comment Letter did not object to the minimum no-call periods or minimum term for term stock but expressed objections to the minimum redemption and revolvment periods as follows:

- The minimum holding period should be eliminated because there is no basis for it in Basel III.
- An allocated equity with an express minimum term of 10 years is no more permanent than an allocated equity that is perpetual on its face.
- The FCA has historically expressed a concern with member pressure on institutions for the payment of patronage or

<sup>18</sup> A review of recent financial reports shows that some System institutions refer to allocated equities as "allocated retained earnings" in the reports, some institutions use both terms, and other institutions do not use the term "allocated retained earnings." The [Federal Farm Credit Banks] Funding Corporation notably does not use the term "allocated retained earnings" in its Annual and Quarterly Statements that provide information for investors in the debt securities jointly issued by the four System banks.

<sup>19</sup> In a search of FCA databases, we found two instances of a definition of allocated equities as including "allocated retained earnings and allocated stock" in the Capital Management section of the FCA examination manual. We note that, in the preamble to the proposed rule, our Table 2 comparing cooperative capital to the capital of a joint-stock bank incorrectly categorized "allocated surplus" as comparable to retained earnings but categorized allocated stock as comparable to common stock.

<sup>20</sup> This requirement was in previous § 615.5330 and was rescinded in 1997 when the FCA adopted the net collateral ratio for banks. Under that previous regulation, we permitted CoBank, ACB to meet the URE requirement with nonqualified allocated equities, issued to its retail borrowers, that CoBank, ACB had a confirmed plan not to revolve except in liquidation. Such treatment is similar to the "URE equivalents" treatment for the capital conservation buffer in the proposed rule.

redemption of allocated retained earnings. Factually, System institutions do not face greater pressure to distribute allocated equities than the pressure on commercial banks to make dividend payments.

- Several System institutions in the years 2007–2013 suspended cash patronage payments or reduced allocated equity redemptions when they experienced credit and business issues. Loan volume declined in some instances due to more conservative lending practices but not to borrower flight. The institutions resolved their credit and business issues and resumed cash patronage payments and increased allocated equity redemptions. This demonstrates that System institution retained earnings should qualify as CET1 without application of any limiting criteria.

- If FCA remains resolute in treating allocated equities differently from URE, the agency should continue the requirements in existing FCA regulations based on minimum revolvment periods: A plan or practice not to revolve CET1 equities for at least 5 years and not to revolve additional tier 1 equities for at least 3 years, with no minimum revolvment period for tier 2 equities.

- If FCA decides to adopt minimum holding periods as set forth in the proposed rule, a minimum holding period of 7 years for inclusion in CET1 capital would be more workable and reasonable.

The System is correct that Basel III does not include a minimum redemption or revolvment period for CET1 equities or tier 2 equities. Such a minimum holding period is not necessary in the Basel framework or in the U.S. rule because commercial banks must obtain their regulator's approval before redeeming any equities, no matter how many years the equities have been outstanding. System institutions, likewise, will be able to redeem or revolve equities before the holding period ends if the institutions receive FCA approval.<sup>21</sup> What System institutions will be able to do that commercial banks cannot do is redeem and revolve equities under the safe harbor provision without submitting a request for approval to the FCA, provided the applicable minimum holding period has been completed.

We do not understand the System's comment that an allocated equity with an "express minimum term of 10 years is no more permanent than an allocated equity that is perpetual on its face." In the proposed rule, no term equities were included in CET1. On the contrary, only equities that were both perpetual "on their face" and held for at least 10 years were includible in CET1, and term (limited-life) equities were includible only in tier 2. It is true that, when an institution is placed into receivership,

equities held by the institution at that point in time are available to absorb losses of the institution, regardless of whether the equities are perpetual or term and regardless of whether they have been outstanding for 10 years or for 10 days—in a receivership, every equity is as "permanent" as every other equity. We also acknowledge that, like the water level in a bathtub, the capital level of an institution will stay constant if the amount of new capital added is equal to the amount of capital the institution redeems, revolves, or otherwise pays out in cash.<sup>22</sup> But this is not the model of "permanency" embodied in the Basel III framework or the U.S. rule. On an ongoing basis, a reliance on a constant replenishment of new "permanent" capital to replace frequently redeemed or revolved "permanent" capital is inappropriately risky in a weak economy.

The FCA believes that longer revolvment cycles benefit System institutions by enabling them to better capitalize asset growth while also improving the quality and quantity of capital, thus strengthening an institution's financial position. A System institution, like most cooperatives, has limited opportunities to raise capital other than through the direct sale of stock to member-borrowers, the sale of preferred stock to outside investors, and the retention of net income as URE or allocated equities. System associations in particular have adopted the statutory minimum borrower stock requirement of the lesser of \$1,000 or 2 percent of the loan, and only one association has issued preferred stock to outside investors. Thus, a System institution is highly dependent on its ability to generate sufficient earnings to repay its creditors, pay cash dividends to outside investors, pay cash patronage to its member-borrowers, and add to its capital base. Cooperative institutions can pay patronage to their member-borrowers in three forms: (1) Cash, which is an immediate return; (2) allocated equities that may be revolved at some future date; or (3) a combination of cash and allocated equities. Allocating equities allows the institution to use this capital for a period of time to benefit the whole cooperative membership, such as for capitalizing growth or improving the financial condition. Many boards choose to revolve allocated equities on an approved cycle, provided that the

institution can continue to meet its capital needs. Thus, capital planning assumes greater importance in the capital adequacy assessment for the System institution's long-term survival.

Academic and professional studies<sup>23</sup> conducted of agricultural cooperatives' patronage practices by the U.S. Department of Agriculture (USDA) and others have shown that longer allocated equity revolvment cycles result in stronger balance sheets and a more resilient cooperative. Institutions that maintain shorter revolvment cycles will have greater need to generate proportionally more earnings consistently to maintain the same level of capitalization. The USDA reported, "The largest cooperatives redeemed equity more recently but had a revolving length at 17 years, which was 4 years longer than the smallest cooperatives." Those cooperatives surveyed reported a range of revolvment periods from 7 to 20 years. Some cooperatives also reported retiring equities when a farmer was between 66 years and 72 years of age. Service cooperatives had the shortest revolvment periods at 6 years; and livestock, poultry, and wool cooperatives had revolvment periods of 7 years.<sup>24</sup> This study concluded that cooperatives with shorter revolvment cycles are generally more leveraged and less resilient.<sup>25</sup>

Longer revolvment periods give an institution extra flexibility when earnings are stressed, as well as help maintain stronger capital levels when membership or existing borrowers' operations grow. The FCA strongly believes that System institutions, as financial cooperatives with GSE status, must have redemption and revolvment periods that are sufficiently permanent to maintain strong capital positions in a weak economy.

On the issue of whether System institutions face greater pressure to revolve allocated equities than the pressure on commercial banks to make dividend payments, we disagree with the System. It has long been our position that members can exert more pressure on their institutions because of their dual relationship as borrowers and

<sup>23</sup> See, e.g., Robert C. Rathbone and Roger A. Wissman, *Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives*, Agricultural Cooperative Service, U.S. Department of Agriculture (USDA), ACS Research Rep. No. 124 (October 1993); Kimberly Zeuli and Robert Cropp, *Cooperatives: Principles and Practices in the 21st Century*, University of Wisconsin Center for Cooperatives (2004).

<sup>24</sup> See E. Eldon Eversull, *Cooperative Equity Redemption, Rural Business—Cooperative Programs*, USDA, Research Rep. No. 220 (June 2010) at 6–7.

<sup>25</sup> See Rathbone and Wissman at 10–11.

<sup>21</sup> We note, however, that FCA does not anticipate approving early redemptions and revolvments routinely.

<sup>22</sup> This bathtub analogy pertains to the dollar amount of a capital component. Of course, even with a constant dollar amount the capital ratio will change if the amount of risk-based assets changes or if the institution incurs losses.

voting stockholders; by contrast, the voting stockholders of a commercial bank rarely, if ever, have significant business ties with the bank. In other words, unhappy stockholders of a commercial bank do not necessarily or directly lead to a drop in the bank's business. We are particularly concerned about the circumstance of a System institution experiencing low earnings and low growth because the agricultural economy is weak and their borrowers are struggling and most need cash. We acknowledge that the pressure on System institutions to pay cash patronage payments may be comparable to the pressure on commercial banks to pay cash dividends to their stockholders, but we note that the expectation criterion in our proposed and final rule does not apply to cash patronage paid out of URE just as it does not apply to cash dividends paid out of a commercial bank's retained earnings.

Commenters asserted that they did not experience borrower flight during the years 2007–2013 even given some institutions' reductions in patronage payments. FCA staff has reviewed the patronage payment activities of a number of System associations in the years 2007–2013 leading up to and after the 2008 global financial crisis. Though the financial crisis was deep in many sectors of the U.S. economy, the agricultural economy suffered little impact. Most System institutions had little or no exposure to the "toxic" assets that crippled many financial institutions because of the System's limited lending and investment authorities. In fact, many institutions continued to grow their loan volume. Some impacted institutions did reduce or suspend cash patronage payments and planned redemptions of allocated equities. They did so for a variety of reasons, including to address financial stress and to support increased loan demand. While the experiences of 2007–2013 are useful for analysis, there were no widespread or significant changes in patronage payment practices in the System, particularly redemption or revolvement of allocated equities. Thus, we do not believe these experiences are a strong indicator of what System institutions would experience in a severely weakened agricultural economy.

In the proposed rule, we also intended the minimum holding periods to provide a way for System institutions to comply with the Basel III and U.S. rule's expectation criterion. The expectation criterion, a new concept in Basel III and the U.S. rule, is part of the criteria for all 3 capital components—CET1, AT1, and tier 2 capital. For CET1,

the U.S. rule provides that a commercial bank must not "create at issuance of the instrument, through any action or communication, an expectation that it will buy back, cancel, or redeem the instrument, and the instrument [must] not include any term or feature that might give rise to such an expectation." The criteria for AT1 and tier 2 are the same except that the expectation is with respect to exercising a call option on the instrument rather than buying back, redeeming, or canceling it. It is our understanding that this criterion is intended to curb actions like those of some commercial banks that continued to make large share buy-backs and dividend payments during the 2008 global crisis, in order not to send investors a signal of weakness.<sup>26</sup>

There are two noteworthy aspects of the expectation criterion. First, it does not pertain to the intentions—implicit or explicit—of the commercial bank to redeem the instrument, but rather to the expectations created by the bank's behavior—its "actions or communications"—and the focus is on the impact of the bank's actions on others and its communications with others that could lead the bank to redeem stock when such redemption could potentially weaken the bank. The "others" in question could be stockholders, potential investors, the market, or banking analysts and traders.

Second, all the other criteria for CET1 and the other components of capital are based on primarily objective legal rights, legal status, or accounting principles.<sup>27</sup> They cover, for example, perpetual status ("no maturity date"), liquidation priorities and claims, order of impairment, unsecured status without features that legally or economically enhance the seniority of the instrument, redemption only at the discretion of the

<sup>26</sup> The Basel III document does not specifically discuss the expectation criterion. However, in a discussion of the need for a capital conservation buffer there is an explanation that we believe applies equally to the expectation criterion: "At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. Much of this activity was driven by a collective action problem, where reductions in distributions were perceived as sending a signal of weakness. However, these actions made individual banks and the sector as a whole less resilient." Basel III Framework (December 2010, revised July 2011), paragraph 27.

<sup>27</sup> One criterion that is less objective is the requirement that the instrument does not include any term or feature that "creates an incentive to redeem." However, the Federal banking regulatory agencies have previously provided objective standards for commercial banks of the types of terms that create incentives to redeem, such as a dividend step-up term in excess of a specified percentage increase.

board and with the regulator's approval, and classification as equity under GAAP. By extension, these criteria mirror the legal rights that a commercial bank's common stockholders have or do not have. The stockholders have no legal right to require the bank to retire or redeem their stock because the stock never matures and because the commercial bank has complete discretion whether to redeem it (with regulatory approval). The expectation criterion does not pertain to legal rights regarding a stockholder's equities; the criterion pertains only to behavior or a pattern of behavior by the commercial bank that leads the stockholder or the market to expect redemption. The FCA has a similar concern regarding the expectations that System institutions may create through their behavior and communications.

The concept of a minimum holding period for System cooperative equities has been a part of FCA's existing core surplus capital regulations that have been in effect since 1997. Under that regulation, an association may include in core surplus allocated equities with an original revolvement period of at least 5 years, as long as such equities are not scheduled by the board or a board practice or expected by the members to be revolved in the next 3 years. The exclusion from core surplus in the last 3 years before revolvement focuses the board on longer-term planning to replace the soon-to-revolve allocated equities and better enables the board to revolve the allocated equities as expected, without reducing the institution's core surplus ratio. The core surplus regulation reflected the Agency's judgment that, first, member expectations of revolvement increase as the revolvement date approaches and, second, minimum revolvement periods make the equities more stable.<sup>28</sup>

The fundamental purpose of allocating equities is to build capital by retaining earnings as opposed to distributing them out as cash. As such, allocated equities need to be sufficiently permanent for the institution to include

<sup>28</sup> The FCA decided not to retain the existing regulation's plan-or-practice standard for allocated equities included in core surplus or the requirement to phase the equities out of CET1 in the 3 years before the end of the holding period. Over the years since we adopted the core surplus rule, a number of institutions have misinterpreted their yearly revolvments of allocated equities as not constituting a plan or practice of revolvement. They have erroneously included allocated equities in core surplus until revolved, rather than phasing them out. We believe eliminating the possibility of misinterpretation is the better course in the final rule, and the longer holding period will ease any concerns about including the equities in the new regulatory capital ratios until the date of revolvement.

them in capital. Equities revolved in only a 2- or 3-year period have minimal economic substance or value from a capital perspective, and revolvment periods shorter than 5 years may result in unmanageable borrower expectations and significantly reduced board flexibility to temporarily suspend or defer redemption of allocated equities. Longer revolvment periods ensure these equities are more permanent and stable forms of capital. Since 1997, System institutions have remained adequately capitalized with the existing core surplus rule's 5-year revolvment minimum. However, the agricultural economy and most System institutions have been financially healthy since that time.

As we stated above, we believe a longer minimum holding period for the highest quality capital is more appropriate to ensure adequate capital when the agricultural economy is weak. We believe the holding period for CET1 capital should be longer than the similar 5-year no-call minimum period for lower quality additional tier 1 and tier 2 capital and the minimum term of 5 years for term stock includible in tier 2 capital. The 10-year minimum holding period for CET1 capital in our proposed rule would, in our view, have both tempered member expectations of redemption or revolvment and ensured the stability of capital through the long cycle of the agricultural economy. However, we have considered the System's comments for a shorter minimum holding period for CET1 equities, in light of the rule's other provisions that ensure the retention and conservation of high quality capital, such as the safe harbor provision and FCA prior approval requirements, and the overall higher capital requirements of the rule. We have concluded that a minimum 7-year redemption and revolvment period for CET1 equities will give System institutions added flexibility to manage their capital planning without significantly impacting their resilience. As we have noted, many of the System institutions that revolve allocated equities have already extended, or begun to extend, their revolvment periods to 7 years or longer. The final rule's shorter minimum CET1 holding period, together with our change in the final rule to permit institutions to commit to the minimum holding periods through an annual board resolution, should enable institutions to comply with the new capital requirements with minimal administrative burden.

We have decided not to adopt the System's recommendations of a 3 to 5-year minimum holding period for

additional tier 1 capital and elimination of the minimum holding period for tier 2 equities. To do so would be inconsistent with the minimum no-call periods of 5 years for additional tier 1 and tier 2 capital in Basel III and the U.S. rule. Furthermore, elimination of the tier 2 minimum holding period would imprudently permit redemptions and revolvments of equities, such as the member equities issued by some System banks in connection with loan participation programs and the preferred stock issued by some associations to their members, that have been outstanding for as short a period as 1 quarter. In the final rule, we have retained the 5-year minimum holding periods for both additional tier 1 capital and tier 2 capital.

#### 4. Minimum Redemption/Revolvment Cycle for Association Investments in Their Funding Banks

The System Comment Letter objects to the proposed rule's imposition of minimum redemption and revolvment periods on associations' investments in their funding banks. The proposal provided that these investments, which consist of both purchased and allocated equities, have the same minimum redemption and revolvment periods as all other cooperative equities. The System makes the following assertions about the proposed rule's minimum holding period requirement for the association investments in their banks:

- It is challenging, bureaucratic, unworkable, anti-cooperative, costly, and burdensome without any discernible benefit in capital quality or quantity, and it is unnecessary to achieving alignment of System capital regulations with Basel III.
- It is inconsistent with statutory requirements, creates a "first in first out" redemption principle for the investment, impedes a bank's ability to help a struggling association by redeeming or revolving equities, and could create an adverse tax consequence that would necessarily dissipate combined bank-association capital.
- An association's investment in its funding bank "is legally and functionally a permanent capital contribution to the bank and is understood as such by associations," notwithstanding periodic capital equalizations by the System bank (which result in member associations' investments being adjusted, as necessary, to the same specified percentage of its outstanding borrowings from the bank).
- An association's investment in its funding bank "results from the statutorily directed financial relationship." System associations must borrow exclusively from their bank unless they have approval from the bank to borrow from another financial institution. By contrast, an association's borrowers are free to borrow outside of the System.

- The investment requirements imposed on retail borrowers by associations are unlike those imposed by a System bank on its affiliated associations, since associations do not have unilateral authority to increase the requirements. System banks have bylaws that authorize them to call, preserve, and build capital from their associations. Also, a bank's general financing agreement with its affiliated association enables it to increase spreads on outstanding direct loans immediately without association approval.

The capital rule is consistent with statutory requirements. The rule applies the same minimum redemption and revolvment cycles to all cooperative equities except for the statutorily required investment of at least \$1,000 or 2 percent of the loan amount, whichever is less. Stock or equities that meet this statutory requirement are exempt from a minimum redemption or revolvment period. We agree with the System that System banks and associations have a relationship defined by the Act that is long term and permanent except for very rare re-affiliations with another System bank or a termination of System status by one or both institutions. However, the statutory minimum required investment is the same for an association to obtain a loan from its affiliated bank as it is for a retail borrower to obtain a loan from an association or from CoBank, ACB, and the exemption from a minimum redemption or revolvment period in our rule applies only to the statutory minimum required investment.

We are not persuaded by the System's position that System banks have authority to call, preserve, and build capital from their associations that their associations lack. Associations have the same statutory and regulatory authority as banks to call, preserve, and build capital; it is the associations that have granted additional capital-building powers to their affiliated banks through bylaw provisions approved by the associations. We appreciate that associations are probably more willing to approve such bylaws because of their financial interdependence with their bank, and association retail members are probably less willing to commit themselves to purchase additional stock in the association. However, the capital-building provisions in a bank's bylaws do not eliminate the need for capital to have a minimum redemption or revolvment period.

The System Comment Letter states that the minimum holding period creates a "first in first out" redemption principle for the investment and impedes a bank's ability to help a struggling association by redeeming or revolving equities. As to the first point,

we are not certain what is meant by “first in first out” in the context of a redemption principle, unless it is merely another way to say that associations may have to pay taxes on allocated equities revolved by their banks. The minimum required holding period clearly does not impose a strict requirement that the oldest equities must be redeemed or revolved first. As to the second point, we note that a System bank may redeem or revolve equities prior to the minimum holding period if the bank receives prior approval to do so from the FCA. We believe that the FCA would have a sufficient basis to approve such a request if the bank established that its assistance was necessary or appropriate.

The FCA disagrees with the System’s assertion that an association’s investment in its affiliated bank “is legally and functionally a permanent capital contribution to the bank and is understood as such by associations.” Most System associations do clearly have very long relationships with their affiliated banks, but not all of the equities invested by an association in its affiliated bank are outstanding for lengthy periods. In fact, it appears to us that associations well understand that some of their investments in their affiliated banks are only short-term investments. System banks have discretion under section 4.3A(c)(1)(I) of the Act to redeem and revolve equities anytime, as long as the bank continues to meet the capital adequacy standards established under section 4.3(a) of the Act. By contrast, the CET1 equities issued by commercial banks are more truly permanent, because commercial banks are not permitted to retire such equities without the approval of stockholders owning two thirds of the shares (a statutory requirement) or without the prior approval of their regulator (a requirement of the U.S. rule). Similarly, tier 2 equities issued by commercial banks either are perpetual and require prior approval by their regulator to retire, or are limited-life preferred stock with a minimum term of 5 years (with no prior approval to retire on the maturity date). In our view, third-party investors, relying on an understanding that our capital rules are comparable to Basel III and the U.S. rule, would expect that System institutions’ common cooperative equity retirements are subject to substantially the same prior approval requirements as commercial banks’ equity retirements.<sup>29</sup>

<sup>29</sup> It is important to note that, if a System bank includes its affiliated associations’ investments in the bank’s CET1 capital, those investments will be the common cooperative equities of most interest to

Our proposed rule was somewhat more lenient than the restrictions on commercial banks’ equity redemptions in that we did not require banks or associations to obtain stockholder approval before each redemption or revolvement of cooperative equities. We provided additional leniency in a safe harbor provision permitting a certain level of redemptions and revolvments without FCA approval, as long as the equities had been outstanding for at least the minimum holding period. Commercial banks do not have a similar safe harbor for equity retirements, although they do have a safe harbor for cash dividends. We believed, and continue to believe, that our more lenient safe harbor for equities is appropriately comparable to Basel III and the U.S. rule because the safe harbor’s broader application to total cash dividend payments, cash patronage payments, and equity redemptions or revolvments is tempered by an overall limit that is more restrictive than commercial banks’ safe harbor to pay cash dividends.

For many associations, the greater part of their investments in their affiliated banks is long term in practice. These investments include equities the banks allocated more than 10 years ago, and the banks have stated they do not intend to revolve these allocated equities unless their associations make corresponding allocated equity revolvments to their retail borrowers. Some of these allocated equities are quite stable, due in part to the fact that they are not taxable to associations until they are revolved (System banks’ earnings derived from association business are not taxed).<sup>30</sup> As soon as the final rule becomes effective, the banks will be able to include otherwise-eligible allocated equities in CET1 that have already been outstanding at least 7 years (or tier 2 if the allocated equities have been outstanding at least 5 years), and all other allocated equities will be includible in CET1 or tier 2 if the banks adopt a bylaw or annual resolution not to redeem or revolve such equities less than the applicable 7 years or 5 years

a third-party investor in the bank and will likely be a factor, even a significant factor, in such investor’s decision whether to invest in a System bank. After all, the bank’s URE and CET1 common cooperative equities are the first line of protection for the outstanding third-party equity investments in System banks. If there were no minimum redemption or revolvement period for these cooperative equities, a third-party investor might misunderstand the level of protection these cooperative equities actually provide.

<sup>30</sup> An association’s earnings are taxable only when derived from its loans and other business conducted through the parent agricultural credit association or its production credit association subsidiary.

after issuance or allocation, as long as the equities are otherwise eligible.

However, many associations have investments in their banks that do not have the same stability and “permanence” of the long-held allocated equities. Some of these investments may be the stock purchased by associations to capitalize their direct loans from their banks; other stock is purchased by associations in order to capitalize asset loan participation program pools. Because the capital supporting these loan pools is usually equalized frequently by the bank, banks typically equalize by issuing or redeeming purchased stock because there are no tax consequences when the purchased stock is redeemed. The FCA observes that the practice of tying the investment amount to the loan amount and making frequent equalizations strongly resembles the “compensating balance” method of capitalization that both banks and associations employed in past decades—*i.e.*, the borrower capitalized its loan rather than capitalizing the institution. During the 1980s, many System associations were in such weak financial condition they could not redeem member stock; the also-struggling member-borrowers strongly objected to those associations’ not returning their investments when they paid down or paid off their loans, and Congress held a hearing to obtain the testimony of the borrowers. In the Agricultural Credit Act of 1987 (1987 Act), Congress established a statutory capitalization framework that favored capitalization of the institution, not the loan, and disfavored compensating balances, though it did not prohibit them entirely. The FCA believes, as Congress did, that capitalization of the institution rather than the loan provides a stronger and more stable capital base. At the retail level, all System institutions now require borrowers to make only the statutory minimum stock purchase, and in the nearly two decades since the enactment of the 1987 Act System institutions have taken advantage of a healthy agricultural sector to build strong capital positions of high-quality capital that remain in the institutions long term. In addition, one of the four System banks has made the decision not to equalize association investments any longer; instead, the bank pays interest to its associations who hold investments in the bank in excess of the required amount.

We acknowledge that stock equalization at the bank level can be a tool for apportioning the bank’s funding and operating costs among its affiliated associations. The FCA supports an equitable apportionment that is based

on each association's business with the bank and investment in the bank. However, short-term redemptions and revolvments of equities are not the sole way to ensure that costs are borne equitably by the associations. There are numerous other ways of apportioning the bank's operating costs, such as direct assessments or interest rate adjustments or paying interest to associations whose investments are in excess of bank's required amounts, that take into account the amount of loaned funds or other business with associations and the riskiness of that business. Should a bank prefer to apportion its funding and operating costs in part by equalizing association investments and at the same time hold most of its purchased stock for a term long enough to qualify for CET1 or tier 2 inclusion, it may consider issuing a class of common stock used solely for equalization purposes. The amount a bank might issue could be, for example, an amount equal to the average amount of equities the bank redeems in a given period for purposes of equalization. Such stock, which could be exchanged for a portion of existing outstanding common stock, could be issued and retired at the discretion of the bank and would have no minimum revolvment period, but it would be excluded from CET1 and tier 2 capital. This would by no means eliminate the minimum revolvment period for an association's investment in its affiliated bank, but having a separate class would provide more administrative clarity for the bank, the FCA, and third-party investors.

#### 5. Required Capitalization Bylaws Amendments Establishing Minimum Holding Periods

The System Comment Letter objected to the proposed rule's provision that a System institution may include cooperative equities in CET1 and tier 2 capital if the institution has adopted capitalization bylaws establishing minimum required redemption and revolvment periods. The proposed minimum redemption and revolvment periods, or minimum holding periods, were 10 years for inclusion in CET1 capital and 5 years for inclusion in tier 2 capital. Because section 4.3A(b) of the Act requires System institutions to obtain the approval of their members for changes to the bylaws, institutions would have had to exclude cooperative equities from CET1 and tier 2 capital if they had chosen not to seek member approval of the bylaw amendment or if the members had disapproved it.

The System made the following assertions about the proposed capitalization bylaw requirements:

- They are legally tantamount to a re-issuance of the cooperative equities.
- They are fundamentally unworkable, unnecessarily costly, and legally problematic, and they result in a meaningless vote that puts the System institution and its members in a Catch-22 situation.
- The bylaw changes would undermine the institution's ability to function consistent with cooperative principles as expected by the Act. Institutions with modest amounts of cooperative equities may choose to exclude their cooperative equities from regulatory capital than bear the cost, operational burdens, member confusion, and uncertainty of a member vote. If a significant number of institutions make this choice, there could be resulting harm to the overall regulatory capital position of the System.
- Holders of allocated equities that are not voting members may sue the FCA for depriving them of the right to have the institution's board forgo exercising its discretion to revolve the equities during the minimum holding periods.
- There is no basis for a minimum holding period in Basel III.
- A more cost-effective way to ensure there is a legal distinction among equities included in the various components of regulatory capital is to enhance the FCA's capital planning regulation to require boards to adopt binding resolutions regarding the minimum holding periods.

The proposed bylaw requirement to establish a minimum holding period was intended to provide a way for System institutions to comply with the Basel III and U.S. rule's "expectation" criterion. We discuss the expectation criterion under the "Required Minimum Redemption/Revolvment Periods" above.

The FCA's proposed minimum holding periods were also intended to ensure that System institutions equities are substantially comparable to the more truly permanent equities of a commercial bank that can be redeemed only with the prior approval of stockholders and the bank's regulator. Were we to apply identical requirements, System institutions would not be able to redeem or revolve any purchased or allocated equities without FCA approval and stockholder approval. As discussed under the safe harbor section below, the proposed rule would have permitted institutions to make limited redemptions and revolvments without regulator and stockholder approval. We believe that a minimum holding period lowers expectations of redemption or revolvment, and the bylaw requirement ensures both institution compliance and member buy-in regarding the minimum periods. A bylaw requirement would have explicitly established that a System institution's board had firmly committed, with its members' support, to limit its discretion under section 4.3A

of the Act to redeem or revolve equities, in exchange for being able to include the equities in tier 1 and tier 2 capital, and that the institution's members understood and supported this limit on the board's discretion. However, we have considered the System's comments on the bylaw approval process and are persuaded that requiring an institution's board to adopt a redemption and revolvment resolution that it must re-affirm in its capital plan each year would be sufficient to ensure compliance with the rule's minimum holding periods. As described below in the section-by-section discussion, we have revised the capital planning regulation in § 615.5200 to require the institution's board to establish minimum redemption and revolvment periods for specifically identified equities included in tier 1 and tier 2 capital. Any change to the minimum periods will require FCA approval. The board will also be required to re-affirm annually its intention to comply with the capital rule's minimum holding periods. We note that this annual re-affirmation is not an annual opportunity for the board to change its mind about the redemption or revolvment periods of specified equities. In addition, for institutions that prefer a capitalization bylaw to an annual board resolution, we have retained the proposed capitalization bylaw provision as another method of compliance with the minimum holding periods.

#### 6. Higher Tier 1 Leverage Ratio and Minimum URE and URE Equivalents Requirement

The System Comment Letter objected to the proposed 5 percent minimum tier 1 leverage ratio and also on the requirement that at least 1.5 percent of the tier 1 capital must consist of URE and URE equivalents. The System's objections are as follows:

- A 5-percent tier 1 leverage ratio requirement is excessive, is unsupported, is inconsistent with the 4 percent tier 1 leverage ratio of Basel III and the U.S. rule, would create an un-level playing field that gives an advantage to commercial banks in the capitalization of loans to farmers, and may raise questions and suspicion that the System is fundamentally riskier compared to other lending institutions.
- Such an inference does irreparable harm to the System and its mission achievement, given the lack of any quantifiable support for the higher minimum. The FCA has not provided "reasonable facts or data analysis" to support a higher minimum leverage requirement that could reduce institution lending capacity by over 20 percent during stressful periods. The FCA's justification is insufficient and unsupported by loss experience, making this proposed requirement arbitrary and capricious.

- The Basel III framework's minimum leverage ratio requirement, a measurement that was not required by Basel I or Basel II, was imposed in response to the "drying up" of liquidity during the financial crisis, which revealed inter-connections and inter-dependences between financial institutions and resulted in pressure on commercial banks to retire lower quality tier 1 capital instruments (hybrid instruments) when they were most needed to absorb losses. Stress-testing and economic modeling by System institutions show the System has enough loss-absorbing capital to withstand a severe adverse economic event while continuing to provide a steady flow of credit to agriculture.

- The interconnectedness of System institutions is an inherent part of the structure of the System and, despite its interconnectedness and its status as a monoline lender, the System remained "essentially unstressed" during the financial crisis.

- The proposed minimum leverage ratio is inappropriate for wholesale System banks and appears to create economic incentives for shifting ownership of loans from associations to System banks. The agency "appears not to have considered the two-tiered capitalization that exists within the System" that results in the System as a whole effectively holding minimum risk-based capital for association retail loans totaling 120 percent of the amount required for commercial banks. The risk-based capital requirements are more than adequate to protect against not only credit risk but also liquidity risk, operational risk, and other risks.

- There is no empirical evidence that the System's risks are more significant than the systemic risks that caused the financial crisis. FCA should support its higher minimum leverage ratio by conducting a study that demonstrates and quantifies that the proposed significant deviation from Basel III is justified by facts. After such a study, if the FCA remains focused on imposing a higher leverage ratio, the agency should consider a 4 percent minimum leverage ratio with an additional 1 percent leverage ratio buffer composed of tier 1 (not CET1) capital and pro-rated across the payout categories. Overall, a capital conservation buffer approach would support the objective of the proposed higher leverage ratio without unduly penalizing those System banks primarily engaged in wholesale lending to associations.

- The proposed 1.5 percent minimum URE requirement "calls into question the cooperative structure of the System" and "declares that URE is higher quality capital than CET1." This "'super' or 'superior' CET1 subclass is an unmistakable message to the marketplace that the System's CET1 does not match up with CET1 of commercial banks" and reduces comparability and transparency.

- Implementation of the URE requirement results in a minimum 3 percent of URE (1.5 percent by the bank and 1.5 percent by the association) required to be held against each dollar of loans made by associations to member-borrowers. This violates the cooperative principle that members bear the risk and reward of their institution.

- The 1.5 percent minimum URE requirement, similar to a required component

of the core surplus ratio in the FCA's existing regulations, should not be in the new capital framework. The FCA's reason for the existing URE requirement in core surplus was that higher URE levels cushioned member stock from impairment, thus minimizing the prospect of members seeking protection of their equities from Congress. Congress has already made it clear that members are at risk and will suffer the losses of the cooperative. Congress's action with respect to Fannie Mae and Freddie Mac emphasizes its resolve to allow significant shareholder losses regardless of personal impact.

The FCA disagrees with many of the System's comments and assertions. We do not believe a 5 percent minimum standard would create an "unlevel" playing field for the System that would give any appreciable advantage to commercial banks or raise suspicions that the System is fundamentally riskier than commercial banks. At the retail association level, there are so many differences between associations and commercial banks with respect to stable sources of funding, lending authorities, lending territories, tax status, and governance that we believe a higher minimum leverage ratio would not tilt the playing field. A higher leverage ratio requirement enhances the System's ability to achieve its mission by ensuring that System institutions have sufficient capital to achieve its mission, during good times as well as during periods of financial stress. More specifically, a higher leverage requirement will ensure that System institutions have sufficient amounts of capital at the height of the credit cycle so that they can continue to lend during a downturn, and thus, fulfill their mission. During a downturn, System borrowers need access to credit to ensure the continuation of their operations, and System institutions must ensure that they can continue to be a reliable source of credit to these borrowers. Moreover, we do not believe that a higher minimum leverage ratio for associations will raise suspicions in the capital markets. To our knowledge, individual association capital is not the focus of the capital markets, as we are aware of only one association that has raised equity capital from outside the System.<sup>31</sup>

At the System bank level, the banks are able to issue Systemwide debt as a single entity because they are jointly and severally liable on the debt. The System's combined assets were approximately \$300 billion as of

<sup>31</sup> In fact, market investors in System banks may prefer high capital ratios at associations on the ground that the associations' higher capital levels strengthen the banks and decrease the chances that a bank would need to provide financial assistance to an association.

December 31, 2015. By contrast, the vast majority of commercial banks subject to the 4 percent tier 1 leverage ratio requirement are considerably smaller in size than the combined size of the System.<sup>32</sup> Commercial banks subject to the "advanced approaches" Basel framework (*i.e.*, banks with more than \$250 billion in total consolidated assets) are also subject to the supplementary leverage ratio (SLR),<sup>33</sup> which has a minimum requirement of 3 percent. The SLR, which takes into account both on- and off-balance sheet exposures, could result in a higher requirement than the 4-percent tier 1 leverage ratio requirement, which includes only on-balance sheet exposures. Commercial banks with more than \$700 billion in total consolidated assets are subject to a 2-percent leverage buffer in addition to the 3-percent SLR (totaling 5 percent).<sup>34</sup> System banks, by contrast, are not constrained by a supplementary leverage ratio, yet they are able to obtain funding at low rates comparable to the rates obtained by the largest U.S. banks. We would anticipate that the capital markets and outside investors would welcome a higher leverage ratio requirement that ensures higher capital levels to absorb losses and protect outside investors, rather than "raise suspicion that the System is fundamentally riskier compared to other lending institutions."

The FCA disagrees that the Basel III framework imposed a minimum leverage ratio requirement in response to the "drying up" of commercial bank liquidity during the financial crisis. The 2008 financial crisis did begin with a severe liquidity crisis, but liquidity concerns were addressed primarily by Basel III's liquidity coverage ratio and the net stable funding ratio. The FCA updated the liquidity regulation in 2013 to incorporate the liquidity coverage principles of Basel III, as appropriate to the System.<sup>35</sup> We also plan to study Basel III's liquidity coverage ratio and the net stable funding ratio to determine what, if any, application they should have to the System.<sup>36</sup> The leverage ratio requirements in the Basel III capital framework were adopted to avoid future repetition of periods of excessive growth, resulting in excessive leveraging

<sup>32</sup> The System reported combined assets of \$303 billion including the restricted investment in the Farm Credit Insurance Fund, at December 31, 2015. See 2015 Annual Information Statement of the Farm Credit System issued March 7, 2016.

<sup>33</sup> 78 FR 62018 (October 11, 2013).

<sup>34</sup> 79 FR 57725 (September 26, 2014).

<sup>35</sup> See the amendments to § 615.5134 in 78 FR 23438 (April 18, 2013).

<sup>36</sup> See FCA's Regulatory Projects Plan at <http://www.fca.gov/Download/RegProjPlanSpring2016.pdf>.

of capital, that are followed by a sharp downturn in the economy that causes very large losses.

We agree with the System's statement that the System remained "essentially unstressed" during the financial crisis despite its status as a monoline lender and the interconnectedness of System institutions. In our view, while the cyclical nature of the agricultural economy can increase agricultural lending risk overall, the agricultural economy happened to be at a very strong point in the cycle during the financial crisis. The System's low level of agriculture loan losses during the financial crisis, together with minimal exposure to troubled residential mortgages due to legal restrictions on the loans and investments System institutions can make, enabled the System to weather the financial crisis relatively unstressed.

Contrary to another System comment, the FCA did carefully consider the two-tiered structure of the System—*i.e.*, the banks' wholesale funding of associations' retail loans—when proposing the tier 1 and tier 2 risk-based capital requirements. In fact, since the agency first proposed and adopted risk-based capital regulations in 1988, System institutions have consistently objected to the 20-percent risk weight applied to a bank's direct loan to an affiliated association and have asserted that the capital held by an association against its retail loans results in a zero risk of loss to the bank on the direct loan. Our position has been, and continues to be, that the direct loan represents a relatively small but separate and distinct credit risk to the bank, and the 20-percent risk-weight is appropriate, as well as consistent with the risk weightings for GSE securities and debt. We do not agree that the small amount of risk-based capital held by the System bank against credit risk on its direct loans, as well as the relatively small amounts of capital held against credit risks on most of its other exposures, is an adequate substitute for a tier 1 leverage ratio. As explained below, we believe that both System banks and associations need high quality minimum leverage ratios.

The FCA disagrees with the comment that a leverage ratio is inappropriate for wholesale banks. A leverage ratio can be more challenging for a wholesale System bank, since the majority of its assets are risk-weighted at 20 percent, while those of associations are risk weighted at 100 percent. However, as discussed elsewhere in this preamble, the two-tiered capitalization requirement recognizes the separate risks in the System structure and risks

that are present to each party. The capital an association holds against loans to its borrowers offsets the general risk from those loan exposures, while the bank must hold capital to offset the general risk from its loan exposure to its affiliated associations. If banks did not hold capital against these exposures, the risk in loans to association borrowers would be present to both the bank and association but only capitalized by the association. In addition, the banks and associations have levels of operational risk, such as legal risk and management risk, that do not correlate with the level of credit risk. The Basel III framework and the U.S. rule do not exempt wholesale banks from their leverage ratio requirements, and we are not convinced that we should do so. As for the System's comment that our leverage requirements appear to create an economic incentive for shifting ownership of retail loans to the System banks, banks and associations are already doing this. If a bank agrees with its associations to buy their retail loans, that is a business decision for the institutions that is probably made for business reasons in addition to regulatory capital compliance.

We also disagree with the assertion that the minimum URE requirement is anti-cooperative. The requirement ensures at least a minimum level of URE and URE equivalents, and an institution may choose to meet this requirement with URE equivalents plus current year retained earnings. URE equivalents are nonqualified allocated equities that are not revolved and generally not subject to offset against a loan in default (without prior FCA approval). In any case, the characterization of URE as anti-cooperative is inapt for most cooperatively organized financial institutions, such as mutual savings associations. Such institutions have regulatory capital that consists entirely of unallocated retained earnings. We note that the National Credit Union Administration (NCUA) issued a final rule in 2010 for corporate credit unions (which are also cooperative institutions),<sup>37</sup> which requires that their leverage ratio must consist of at least 2 percent of retained earnings to be adequately capitalized.<sup>38</sup> The NCUA's logic and belief is that a corporate credit union's capital must consist of retained earnings, which is the only form of corporate capital, that when depleted,

does not result in losses that flow downstream to natural person credit unions. Without some retained earnings, the corporate credit unions would be a continued source of instability to the credit union system as whole. FCA believes this also applies to System institutions, as discussed throughout this preamble.

We agree that Congress, in the provisions of the 1987 Act, sent a message that member stock was at risk and that members would be subject to their institutions' losses.<sup>39</sup> We also observe that Congress protected member stock outstanding at the time from loss. We believe this "helping hand" in a time of need illustrates Congress's confirmation of the importance to the entire U.S. economy of a strong agricultural sector and also of Congress's recognition that strength in the agricultural sector is inextricably linked to the personal financial stability of its farmers and ranchers. By contrast, in the case of the 2008 conservatorships of Fannie Mae and Freddie Mac, the actions of Congress and the Federal government ensured the continuing function of the secondary mortgage market for the benefit of U.S. homeowners but did not provide similar protection for the personal financial stability of the stockholders of the housing GSEs.

The 1987 Act also sent a strong message to the System not to expect Congress to provide financial assistance in the event of significant losses in the future.<sup>40</sup> We believe this reinforced the FCA's mandate under section 4.3(a) of the Act to "cause System institutions to achieve and maintain adequate capital" that will have the added benefit of protecting the institutions' members from impairment of their equities. In our view, a healthy portion of URE and nonrevolving URE equivalents reduces the possibility that those equities will be impaired during times of stress in the agricultural sector. URE protects against the risk that exists between System banks and associations: It protects association members against association losses, associations against bank losses, and the System against financial

<sup>37</sup> 75 FR 64789 (October 20, 2010).

<sup>38</sup> To our knowledge, all of the retained earnings of credit unions are unallocated. The "corporate credit unions" discussed above are cooperatives owned by natural person credit unions and provide liquidity and other services to their member owners.

<sup>39</sup> We emphasize that, before the 1987 Act, member stock was at risk, but most institutions treated it like a compensating balance, and many associations failed to advise their retail borrowers that the stock was at risk. The 1987 Act added a "guarantee" that existing outstanding member stock that was issued prior to October 1988 would be redeemed at par or face value upon repayment of the member's loan.

<sup>40</sup> Part of that message was embodied in the creation of the Farm Credit System Insurance Corporation (FCSIC) and the Insurance Fund, but the Insurance Fund primarily protects System-wide debtholders.

contagion. A minimum level of URE is needed to cushion third-party and common cooperative equities and would greatly limit the potential losses to holders of these instruments. For example, if a funding bank had a loss and there was no URE at the bank to absorb the loss, the association's stock investment in the bank would be the first line of capital to absorb the loss. The association could be required to recapitalize the bank and the bank could also increase its spread charges on the direct note to generate additional earnings to replenish its capital. If the funding bank did not have URE as the first line of defense in its capital to protect the association's investment, losses at the bank would negatively impact the association's earnings, which could further impact association patronage distributions to member-borrowers. This same argument is applicable to a member-borrower's investment in an association. Whether or not the capital markets and prospective investors conclude that URE and URE equivalents are a "superior subclass" of CET1 is, in our view, probably not going to confuse investors or make a material difference to them. What is important and clear to investors is that all of the CET1 elements will protect all of the third-party equities and sub debt issued by a System bank or association.

The System also asserted that if FCA is determined to require a minimum URE standard, then it should be based on risk-adjusted assets, which is consistent with FCA's current regulatory requirements. The URE requirement would not undermine the System's ability to manage its capital sources as this requirement is only applicable to the tier 1 leverage ratio. We also believe that the 1.5-percent URE requirement should be based on total assets rather than risk-adjusted assets, as System commenters recommended. We believe this requirement is simple, transparent, easy to understand, and reflects the true underlying risk inherent in each System institution. A URE minimum based on risk-adjusted assets benefits institutions with favorable risk weights, and this may not be sufficient to protect System borrowers against a systemic event. We note that over half of the System's capital consists of URE and URE equivalents, with all System institutions easily meeting the required 1.5 percent.

As to the System's assertion that too much URE undermines the user-control and user-ownership principles, we disagree. Section 1.1(b) of the Act encourages farmer and rancher-borrowers to participate in the management, control, and ownership of

a System institution, and the URE requirement does not undermine this section of the Act. All farmer and rancher-borrowers are allowed one vote, regardless of the amount of their investment in their System association. Moreover, the URE requirement can be fully met with nonqualified allocated surplus and stock, which supports the cooperative principle of user-ownership.

The System has asserted that the FCA has not provided reasonable facts, data analysis of loss experience, or empirical evidence to justify a 5-percent minimum leverage ratio. Much of the data the Basel Committee studied in its formulation of the Basel III framework was from the recent financial crisis. For similar data on the System, the FCA would have to go back to the 1980s, when the weakened agricultural economy in combination with the System's interest-rate model at the time resulted in borrower flight, significant losses of System capital, and eventually a Federal bailout. The scarcity and age of most of the relevant data make it of only limited use to us in formulating a leverage ratio, and both the System and financial world have changed radically since the 1980s. Another approach would be to wait until after the next crisis in the System, study the data, and formulate a new leverage ratio based on lessons learned. However, leaving the tier 1 leverage ratio out of our tier 1/tier 2 capital framework would make our capital rule far less comparable to Basel III and the U.S. rule than would a higher minimum leverage ratio.

Because of the scarcity of useful data at this time, the FCA has decided not to do a study to "demonstrate and quantify" that a 5-percent minimum leverage ratio is appropriate. However, the FCA does find considerable merit in the System's suggestion to replace the 5 percent minimum leverage ratio with a 4-percent minimum leverage ratio and a 1 percent leverage buffer, and we have revised the final rule to incorporate this suggestion. A 4-percent minimum tier 1 leverage ratio with a 1-percent tier 1 buffer will give additional flexibility to System institutions to make capital distributions and discretionary bonus payments (albeit on a more restricted basis), will appropriately address the System's concerns about a higher minimum leverage ratio giving an unwarranted negative impression about System operations to the capital markets, and will assure the FCA that System institutions will continue to hold healthy amounts of capital against all institution risks.

## 7. Safe Harbor Requirement

The System Comment Letter states the System "respect[s] in principle" the need for restrictions on capital distributions but objects to the proposed safe harbor as follows:

- Limiting capital distributions to the past year's net retained income and not allowing for any reductions in CET1 from the prior year-end makes management of regulatory capital "exceedingly challenging and inflexible" and provides no reasonable room to do so without seeking FCA prior approval.
- The safe harbor is far more restrictive than foreign cooperative bank regulators' safe harbor, allowing a reduction in CET1 of up to 2 percent without prior approval, and U.S. law that allows capital distributions equal to current year's earnings plus the retained net income for the prior 2 years.
- The 30-day approval process is burdensome and unworkable and should be streamlined for institutions with high FIRS ratings, with FCA granting approvals in as short a time as one day.

In practice, System institutions rarely pay dividends on preferred stock, make cash patronage payments, redeem or revolve equities that exceed their prior 12 months' net earnings. Associations generally pay out less than 50 percent of earnings, and only 5 System associations had payout ratios that were over 60 percent of their earnings in 2014. The 30-day approval is in effect a notification to the FCA of the intended payment, and an institution may make the payment after 30 days if the FCA has not disapproved it or not acted on the request. We expect boards to give significant thought to capital distribution decisions and how they impact overall capitalization of their institution, especially regarding a cash payment that exceeds net income over the past 12 months. The cash payments are generally made at very predictable intervals during the year (unlike, for example, funding requests), and we have not identified any situations where institutions are likely to need to make unplanned, significant capital distributions. Therefore, the FCA does not believe the safe harbor rule will be exceedingly challenging and unworkable for System institutions.

Our rule's safe harbor is different from the "advance permission" allowed by the European Bank Authority (EBA) as it is described in the System Comment Letter. The EBA has issued regulatory technical standards (RTSs) and guidelines that are binding on its member states, but it is up to the member states to promulgate regulations for their own countries. The RTS cited in the System Comment Letter regarding redemptions, reductions, and repurchases by European cooperative

financial institutions permits member states to give advance permission for redemption of predetermined amounts for a period of up to 1 year; however, the predetermined amount “shall not exceed 2% of [CET1] capital.”<sup>41</sup> We have several observations. First, it is unclear to us whether this advance permission has the same effect as our safe harbor, because the EBA has responded in its online Q&A Rulebook that an institution must deduct from capital the predetermined amount in question as soon as its regulator grants authority to make the payment.<sup>42</sup> Under our safe harbor, a System institution does not have to deduct a cash payment until declared or approved by its board. Second, we interpret the RTS merely to put a cap of 2 percent on the predetermined amount, and we do not know whether any member states have adopted the advance permission provision or, if they have, whether they have adopted a cap of 2 percent or a lower amount. Third, our safe harbor has more flexibility than the RTS in some ways. The advance permission caps all cash payments at an amount that equals 2 percent of CET1, regardless of whether CET1 declines. Our safe harbor, by contrast, does not restrict the amount of tier 2 cooperative equities that a System institution may revolve because revolvment of tier 2 equities does not reduce the dollar amount of CET1 capital.<sup>43</sup> Furthermore, it is theoretically possible under our safe harbor for a System institution’s CET1 capital ratio to decline more than 2 percent—due to a previous cash payout or simply because the institution’s risk-based assets have increased—and the institution will still be able to make a cash payout as long as the dollar amount of CET1 does not decline below the dollar amount 12 months prior to the payout.

We are aware that our safe harbor is more restrictive than the safe harbor amounts for commercial banks, in terms of cash payments for dividends, but we believe there are important reasons for the difference. First, U.S. national banks under 12 U.S.C. 60 have authority to pay cash dividends without prior regulatory approval in an amount up to current year’s net income and the retained net income of the 2 previous years, and their regulator is not

authorized to reduce that limit. With respect to cooperative System institutions, a lower limit is more prudent. We note also that our safe harbor is more permissive in several ways. It includes equity redemptions and revolvments, whereas Basel III and the U.S. rule require commercial banks to obtain prior regulatory approval before making stock redemptions. In addition, 12 U.S.C. 59 requires national banks to obtain the approval of shareholders owning two thirds of the shares of each affected class as well as OCC approval.

The System Comment Letter requested that institutions be able to redeem and revolve equities owned by the estate of a deceased former borrower and equities related to a defaulted or restructured loan without restriction. As discussed below in the section-by-section discussion, we have decided to exempt some of these redemptions and revolvments, as well as redemptions and revolvments ordered by a court, from the minimum holding period requirements in the safe harbor. This means that such cash redemptions and revolvments remain subject to the safe harbor on the amount of cash payments the institution can make.

#### 8. Risk Weighting of Electric Cooperative Assets

By FCA Bookletter BL–053, dated February 27, 2007, the FCA permitted System institutions to assign a lower risk weight than would otherwise apply to certain electrical cooperative assets, based on the unique characteristics and lower risk profile of this industry segment.<sup>44</sup> Exposures to certain electrical cooperative assets that satisfy specified conditions receive a 50-percent rather than a 100-percent risk weight. Furthermore, exposures to these assets receive a 20-percent risk weight if the assets have a AAA or AA credit rating.

We did not propose this favorable risk weighting for these exposures in this rule, but we sought comment as to whether we should retain this risk weighting. We received comments from approximately 65 electric cooperatives, in the System Comment Letter, and from several individual System institutions, all requesting that we retain a favorable risk weighting for these exposures.

The electric cooperatives specifically urged us to retain the 50-percent risk

weighting, stating that the rationale in BL–053 regarding the unique characteristics and lower risk profile of the industry segment remains valid today. These commenters also asserted that raising the risk weighting would drive up their borrowing costs and would ultimately hurt rural electric rate payers.

The System Comment Letter and the individual System institutions urged us to retain both the 50-percent and the 20-percent risk weighting. They stated that the booklet’s rationale for these risk weights remains true today. In addition, they stated that the key institutions that provide financing to this segment, other than CoBank, ACB, and the U.S. Government, are not regulated, and they asserted that it is critical that FCA’s capital rules not affect the System’s ability to compete and collaborate with other lenders in meeting the financing needs of rural electric cooperatives.

These commenters also stated, without support, that a higher risk weight for these exposures would impede the ability of CoBank, ACB to competitively meet its mission to serve this industry and would therefore also harm rural residents and businesses. In addition, several institutions stated that their ability to purchase participations from CoBank, ACB allows them to diversify their own portfolios and therefore reduces their own credit risk.

We do not include this lower risk weight for exposures to electric cooperative assets in this final rule. However, FCA Bookletter BL–053 remains in effect. We continue to evaluate the comments we have received and anticipate that we will issue further guidance on the capital treatment of these exposures in the future. As under existing FCA Bookletter BL–053, this treatment would be authorized under our reservation of authority.

#### 9. Risk Weighting of High Volatility Commercial Real Estate Exposures

Because of the increased risk in these activities when compared to other System lending, we proposed to assign a 150-percent risk weight to HVCRE exposures, unless those exposures satisfied one or more of four specified exemptions. As in the U.S. rule, our proposed rule would have defined an HVCRE exposure as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property. Also as in the U.S. rule, four types of financing would have been exempted from this definition.

<sup>41</sup> See <https://www.eba.europa.eu/documents/10180/359901/EBA-RTS-2013-01-draft-RTS-on-Own-Funds-Part-1.pdf/d1217588-ff05-4063-8d6f-5d7c81f2cc64>.

<sup>42</sup> See [http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014\\_1352](http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_1352).

<sup>43</sup> We note that the safe harbor includes redemptions and revolvments of cooperative equities only, not third-party equities.

<sup>44</sup> The FCA authorized this risk weight under our regulatory reservation of authority in § 615.5210(f), which permits us to determine the appropriate risk weight for an asset if the risk weight specified in the regulation does not appropriately reflect the asset’s level of risk. This provision will be replaced by § 628.1(d)(3) in the new rule.

The System Comment Letter and several individual System banks and associations expressed concern about some of the proposed HVCRE provisions and requested clarification of a number of issues. These commenters raised important questions that we wish to consider and analyze further. Accordingly, we are not finalizing the provisions governing HVCRE exposures at this time. We expect that we will engage in additional rulemaking or issue guidance on HVCRE exposures in the future.

As we consider these issues, we will be guided by the objectives of this rule, which include, as stated above:

- Modernizing capital requirements while ensuring that institutions continue to hold enough regulatory capital to fulfill their mission as a GSE; and
- Ensuring that the System's capital requirements are comparable to the Basel III framework and the standardized approach the Federal banking regulatory agencies have adopted, while also ensuring that the rules take into account the cooperative structure and the organization of the System.

We note that new § 628.1(d)(3), like existing § 615.5210(f), reserves the FCA's authority to require a System institution to assign a different risk weight to an exposure than the regulation otherwise provides if that risk weight is not commensurate with the risk associated with the exposure. Accordingly, under both the existing rule and the new rule, FCA has the authority, where warranted, to assign a higher risk weight to an exposure that satisfies the characteristics of HVCRE exposures, even without a specific regulatory HVCRE risk weight.

For example, FCA has recently approved requests by System institutions to purchase and hold investments pursuant to § 615.5140(e).<sup>45</sup> As part of our approval of those investments, the FCA has used our regulatory reservation of authority to impose a 150-percent risk weight on the investments, including during the time the facilities being financed are in the construction phase. The FCA expects to continue to exercise its reservation of authority as warranted to assign risk weights that are commensurate with the risks in exposures.

#### 10. Unused Commitments To Fund Direct Loans

We proposed to impose risk weight and credit conversion factor (CCF) requirements on the unused commitments from System banks to

<sup>45</sup> Section 615.5140(e) authorizes System institutions to purchase and hold investments as approved by the FCA. The FCA approves such investments on a case by case basis.

associations to fund their direct loans.<sup>46</sup> The agreement by a System bank to fund a direct loan satisfies the rule's definition of commitment, which is "any legally binding agreement that obligates a System institution to extend credit or to purchase assets."<sup>47</sup> Moreover, as discussed in the preamble to the proposed rule, we believe these commitments carry risk that warrants the holding of capital against them.

We received comments opposing this proposal in the System Comment Letter and from several individual System institutions, including both banks and associations. Their comments, and our responses, are set forth below.

The commenters stated that requiring banks to hold capital against these commitments results in the double counting of commitment exposures, because associations hold capital against their loans and commitments to retail borrowers, and the associations' funds come from their loans from the bank.

As we explained in the preamble to our proposed rule, although this treatment may be viewed as the double counting of exposures, it is consistent with the way we treat loan exposures; we require a System bank to hold capital against the outstanding balance of its loan to an association, and we also require an association to hold capital against its loans to borrowers (even though the association's loaned funds come from its loan with the System bank).

As with loan exposures, there are separate risks involved in System bank commitment exposures to associations and association commitment exposures to retail borrowers, and this treatment recognizes those separate risks. The capital an association holds against a commitment to its borrower offsets the general risk from that loan commitment, while the System bank must hold capital to offset the general risk from its loan commitment to its affiliated association. Even if the association is adequately capitalized with respect to its commitments, some risk to the System bank remains.<sup>48</sup>

The commenters also contended that this capital treatment undermines well-

<sup>46</sup> Such a commitment is not unconditionally cancelable by the System bank. Under the GFA that governs the commitment, a System bank must continue to fund the commitment as long as the association or OFI satisfies specified conditions.

<sup>47</sup> Section 628.2.

<sup>48</sup> As an illustration of why the System bank faces risk that is separate from the association's risk from its borrowers, an association could use money it borrows from the bank not only to establish and expand commitments and loans to borrowers but also to invest, hedge risk, replace equipment, or fund new facilities and services.

established capital adequacy management disciplines used within the System because it confuses the concepts of capital for growth purposes and capital needed to fund existing commitments; System banks already build additional capital in anticipation of loan growth, including commitments.

While System banks may currently capitalize their commitments to associations as part of the capital they hold for loan growth purposes, capitalization of these commitments has not been pursuant to FCA regulations. This new regulation requires System banks to hold capital specifically for the purpose of capitalizing their commitments to associations. Beyond that amount, banks should hold sufficient additional capital for loan growth purposes. If, as the commenters assert, banks already capitalize their commitments to associations, then they should not need to hold additional capital under the new rule.

The commenters also stated that commitments from System banks to associations are different from and lower risk than other commitments, such as commitments from System associations to retail borrowers, because of System interdependencies and features of the GFA.

One difference, according to the commenters, is that in contrast to a typical lending relationship, such as that between an association and a retail borrower, in which the note establishes the definitive amount of the obligation, the GFA in a bank-association direct loan is open ended, providing for continued funding with no limit on the amount, as long as all terms and conditions of the GFA are met.

Accordingly, there is no specific amount of unused commitment from the bank to the association in the traditional sense. This arrangement evolved from the symbiotic nature of the federated cooperative relationship between banks and associations, and it allows for growth of the associations without the necessity for administrative burdens such as numerous amendments to promissory notes and loan documents.

In response to this comment, we note that § 614.4125(d) requires the GFA or promissory note to establish a maximum credit limit determined by objective standards as established by the System bank. Prior to this rulemaking, FCA had never opined on whether this provision requires a specific dollar amount for the maximum credit limit in the GFA or promissory note. By proposing to determine the exposure amount of the commitment by reference to the maximum credit limit, however, FCA made clear that the regulation requires

the maximum credit limit to be a specific dollar amount. We believe that this requirement ensures that banks engage in appropriate planning so that they will always be able to fund these commitments.

We do not believe that this requirement would lead to numerous amendments to the GFA or promissory note. System banks and associations should establish a reasonable, specific dollar amount by considering the association's existing retail loans, commitments, other credit needs, and expected growth over the term of the commitment. If institutions engage in sound planning, this amount should rarely need to be changed within that term. We note that some System banks already have established a specific dollar amount for their maximum credit limits and have not identified any difficulties in doing so.

Another difference, according to the commenters, is that the GFA protects the System bank in a way that associations are not protected with respect to their retail borrowers. The GFA is typically secured by all of an association's assets, with discounts that cause the bank's collateral position to exceed the borrowing base.

In addition, according to the commenters, the GFA contains a number of covenants that provide safeguards that make it unnecessary for the bank to hold capital to support its commitments to fund direct loans. These covenants include a liquidity covenant that effectively limits the association's ability to borrow in excess of a percentage below the actual borrowing base without the bank's approval, which serves as an equity buffer to absorb losses in the event of credit adversity.

These covenants also include a requirement to maintain a minimum return on assets ratio of one percent and the requirement to submit a corrective action plan if an association's adverse assets to risk funds ratio exceeds 50 percent and to maintain a ratio of adversely classified assets to risk funds of less than 75 percent. In the event of default of either of these ratios, the bank has the right to take a wide variety of actions that could control its risk. The GFA also provides controls for early identification of potential events of default for associations with credit issues.

We are not persuaded that the GFA covenants and other provisions eliminate the need for System banks to hold capital against their commitments to fund direct loans. While these provisions do provide some protection to System banks, loan documents

governing other commitments, such as the retail commitments of associations, often contain provisions that provide similar protections.<sup>49</sup> Nevertheless, those commitments require the holding of capital. Even with these protections, the commitments still carry risk.

Moreover, we believe the relationship between System banks and affiliated associations carries risk that isn't present in most other lending relationships, such as that between associations and their retail borrowers. Although the GFA permits a bank to terminate an association's loan or to refuse to make additional disbursements in the event of default, an association can borrow only from its affiliated bank.<sup>50</sup> We believe a bank would be reluctant to terminate an association's loan or refuse to make additional disbursements, even if the association is in default, because that would leave the association with insufficient funds to carry on its operations. Accordingly, a bank has an incentive to continue to fund an affiliated association, even if that association is in default. This risk factor is not present in most other lending relationships.

Nevertheless, because of the nature of the relationship between a System bank and its associations, we believe the risk in the commitment to fund the direct loan does not increase with the term of the commitment, as it does with other commitments. Accordingly, the final rule assigns a 20-percent CCF to all unused commitments to fund direct loans, regardless of the terms of the commitments.<sup>51</sup> We are not assigning a 50-percent CCF to such commitments with original maturities greater than 14 months, as we proposed. We believe this difference in capital treatment for unused commitments on System direct loans is warranted because of the nature of the System bank-association relationship, which has no equivalent outside of the System.

## II. Minimum Regulatory Capital Ratios, Additional Capital Requirements, and Overall Capital Adequacy

### A. Minimum Risk-Based Capital Ratios and Other Regulatory Capital Provisions

The FCA proposed to adopt the following minimum capital ratios: (1) A common equity tier 1 (CET1) capital

<sup>49</sup> For example, an institution's retail loan to a large agribusiness can be collateralized by all assets of the borrower and can include financial, reporting, and negative covenants similar to those the commenters note exist in the GFA.

<sup>50</sup> The bank can authorize the association to obtain funding elsewhere. Sections 2.2(12) and 2.12(16) of the Act.

<sup>51</sup> Currently, no System GFA has a term longer than 3 years.

ratio of 4.5 percent; (2) a tier 1 capital ratio of 6 percent; (3) a total capital ratio of 8 percent; and (4) a tier 1 capital leverage ratio of 5 percent, of which at least 1.5 percent must be composed of URE and URE equivalents. Tier 1 capital equals the sum of CET1 and AT1 capital. Total capital consists of CET1, AT1, and tier 2 capital. We proposed to rescind the existing core surplus, total surplus, and net collateral regulations and proposed amendments to the permanent capital requirements. We did not propose to rescind the permanent capital regulations because the permanent capital ratio is required by the Farm Credit Act.

In addition, we proposed a capital conservation buffer in excess of the new risk-based capital requirements that imposed limitations on capital distributions and certain discretionary bonuses, as described in section II.C below. The capital conservation buffer is not considered to be a minimum capital ratio requirement.

In the final rule, we are adopting the new risk-based minimum ratios and the capital conservation buffer as proposed. However, we revised the minimum tier 1 leverage ratio requirement to 4 percent and added a 1-percent leverage buffer requirement as described in section II.B below.

Consistent with the FCA's authority under the Farm Credit Act and current capital regulations, § 628.10(d) of the final rule confirms FCA's authority to require an institution to hold a different amount of regulatory capital from what is otherwise required under the final rule, if we determine that the institution's regulatory capital is not commensurate with its credit, operational, or other risks. Therefore, the FCA will continue to hold each System institution accountable to maintain sufficient capital commensurate with the level and nature of the risks to which it is exposed. This may require capital significantly above the minimum requirements, depending on the institution's activities and risk profile. Section D below describes the requirement for overall capital adequacy of System institutions and the supervisory assessment of an institution's capital adequacy.

### B. Leverage Ratio

Consistent with Basel III and the U.S. rule, we proposed a tier 1 leverage ratio for all System institutions. We proposed a minimum leverage ratio of 5 percent, of which at least 1.5 percent of non-risk weighted total assets must be URE and

URE equivalents.<sup>52</sup> FCA's proposal differed in two respects from the leverage ratio adopted by the Federal regulatory banking agencies: There is no minimum URE and URE equivalents requirement in their leverage ratio, and their minimum requirement for the majority of commercial banks is 4 percent. We received numerous comments opposing the 5-percent tier 1 leverage ratio requirement and the 1.5-percent URE and URE equivalents minimum requirements in the System Comment Letter and from individual System banks and associations. We discuss their comments in Section I.E.6 above.

In response to the comments, we are adopting a 4-percent minimum leverage ratio, of which at least 1.5 percent must be URE and URE equivalents, and we are adding a leverage buffer of 1 percent in the final rule. We believe this revised requirement in the final rule addresses commenters' concerns, is not unduly restrictive, and will ensure that System institutions hold sufficient capital to continue to fulfill their mission as a GSE. In addition, we have revised the definition of URE equivalents to require institutions to designate equities as URE equivalents in their bylaws or board resolutions, and we have added corresponding language to paragraph (d) of the capital planning requirements in § 615.5200. We have also provided an exception to the offset prohibition for offsets required by court order and under § 615.5290.

The tier 1 leverage ratio buffer incorporates the same restrictions as the capital conservation buffer but is based on a 1-percent buffer as opposed to a 2.5-percent buffer. To avoid restrictions on cash dividend payments, cash patronage payments, and allocated equity redemptions (collectively, capital distributions) or discretionary executive bonuses, an institution's tier 1 leverage ratio must be at least 1 percent above the minimum requirement of 4 percent. The tier 1 leverage ratio buffer consists of tier 1 capital. If the institution's tier 1 leverage ratio is below the minimum requirement of 4 percent, the institution's leverage buffer is zero. There will be no phase-in for the leverage buffer as our analysis based on September 30, 2015 call reports shows that all System institutions will be above the 1 percent leverage buffer.

The maximum leverage payout ratio is the percentage of eligible retained income that a System institution would

be allowed to pay out in capital distributions and discretionary bonuses during the current calendar quarter and is determined by the amount of the tier 1 leverage ratio buffer held by the institution during the previous calendar quarter. The eligible retained income computation is the same as for the capital conservation buffer.

A System institution's maximum leverage payout amount for the current calendar quarter is equal to its eligible retained income multiplied by the applicable maximum leverage payout ratio in accordance with table 2 in § 628.11. An institution with a leverage buffer that is greater than 1 percent is not subject to a maximum leverage payout amount under this provision (although capital distributions without FCA prior approval may be restricted by other provisions in this proposed rule). If the applicable leverage buffer falls under 1 percent, the institution would remain subject to payout restrictions until it raises its leverage buffer above 1 percent. In addition, a System institution would not generally be able to make capital distributions or pay discretionary bonuses during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer is less than 2.5 percent, or its leverage buffer is less than 1 percent, as of the end of the previous quarter. In the event that a System institution's capital requirements fall below the 1-percent leverage buffer as well as the 2.5-percent capital conservation buffer, when calculating the applicable payout amount, the institution must use the lower between the maximum payout ratio and the maximum leverage payout ratio. For example, under the capital conservation buffer, if an institution's total capital regulatory ratio is 10.25 percent (fully phased-in), based on table 1 in § 628.11, the maximum payout ratio would be 60 percent. Under the leverage buffer, the same institution's tier 1 leverage ratio is 4.6 percent and based on table 2 in § 628.11, the maximum leverage payout ratio would be 40 percent. As the leverage buffer is the lower maximum payout between the two, in this example, the payout ratio the System institution must use is 40 percent.

The leverage buffer is divided into quartiles, with greater restrictions on capital distributions and discretionary bonus payments as the leverage buffer falls closer to 0. Payouts are restricted to 60 percent of eligible retained income if the buffer is above 0.75 percent but at or below 1 percent. When the buffer is above 0.50 percent but less than or equal to 0.75 percent, the payout would

be restricted to 40 percent of eligible retained income. When the buffer is above 0.25 percent but less than or equal to 0.50 percent, the payout would be restricted to 20 percent of eligible retained income. A leverage buffer of 0.25 percent or below would result in a 0 percent payout.

For the reasons discussed above, the proposed requirement of the tier 1 leverage ratio consisting of at least 1.5 percent of URE and URE equivalents is not modified in the final rule.

### C. Capital Conservation Buffer

Consistent with Basel III and the U.S. rule, we proposed a capital conservation buffer to enhance the resilience of System institutions throughout financial cycles. To avoid restrictions on cash payments for capital distributions or discretionary executive bonuses, an institution's risk weighted regulatory capital ratios must be at least 2.5 percent above the minimums when the buffer is fully phased in. The proposed buffer provided an incentive for institutions to hold capital well above the minimum required levels to ensure that they would meet the regulatory minimums even during stressful conditions.

The FCA is adopting the capital conservation buffer requirements in § 628.11 with minor modifications from the proposed rule, as described below.

The capital conservation buffer consists of tier 1 capital and is the lowest of the following risk weighted measures:

- The institution's CET1 ratio minus its minimum CET1 ratio;
- The institution's tier 1 ratio minus its minimum tier 1 ratio; and
- The institution's total capital ratio minus its minimum total capital ratio.

If any of the institution's risk weighted ratios are at or below the minimum required ratios, the institution's capital conservation buffer is zero.

The maximum payout ratio is the percentage of eligible retained income that a System institution is allowed to pay out in capital distributions and discretionary bonuses during the current calendar quarter and is determined by the amount of the capital conservation buffer held by the institution during the previous calendar quarter. Eligible retained income is defined as the institution's net income as reported in its quarterly call reports to the FCA for the four calendar quarters preceding the current calendar quarter, net of any capital distributions, certain discretionary bonus payments, and associated tax effects not already reflected in net income.

<sup>52</sup> Only System banks are subject to the net collateral ratio requirement, which has similarities to that of a leverage ratio, the tier 1 leverage ratio would replace the net collateral ratio requirement for System banks.

The System Comment Letter expressed concerns over the proposed definition of eligible retained income. The System stated that the proposed definition results in an excess deduction based on prior year distributions from current eligible retained income because the patronage distribution practices of cooperatives create a far more restrictive requirement than applicable to commercial banks. The System included an example that, to determine the eligible retained income in the first quarter of 2015, this would be based on 2014 net income, less the patronage distribution of 2013 that was paid in the first quarter of 2014. The System asserted that this is inappropriate and that deductions for patronage distributions should be aligned with when the earnings were generated.

The final rule adopts the proposed definition of eligible retained income without change. We believe that this definition of eligible retained income is appropriate and is essentially the same as the definition in the U.S. rule. We believe eligible retained income must reflect a System institution's most recent 12-month period at each quarter end, so that restrictions on capital distributions and discretionary payments to executive officers are based on the institution's most recent performance results. If a System institution declares a dividend payment or patronage payment in a specified year, the institution can recognize and accrue the dividend payment or patronage payment in the same year it was earned; that way it is reflected in that specified year's income. This could result in a change of practice for many institutions that do not recognize and accrue the patronage income in the year it was earned, but rather the following year when it is distributed. If an institution chooses not to change its patronage payment accounting practices, this treatment remains appropriate because at the declaration date, the dividend payment and patronage payment is deducted from the current year's earnings, even if it was based on the previous year's earnings. Furthermore, if the System institution wants to declare a dividend payment or patronage payment in the same quarter of every year, it will not be subject to a double deduction under the regulation.

We believe for this calculation that the declaration date determines what year the dividend payment and patronage payment are attributed. As the calculation is a rolling 12-month calculation for eligible retained income calculated each quarter, we believe institutions may decide to declare the

dividend payment or patronage dividend payments the same quarter, in order to make this calculation comparable from year to year and quarter to quarter. To do otherwise would hinder both the FCA's and the System's ability to conduct quarter to quarter comparisons.

A System institution's maximum payout amount under the capital conservation buffer for the current calendar quarter is equal to its eligible retained income multiplied by the applicable maximum payout ratio in accordance with table 1 in § 628.11. An institution with a capital conservation buffer that is greater than 2.5 percent is not subject to a maximum payout amount under this provision (although capital distributions without FCA prior approval may be restricted by other provisions in this rule). If an institution's CET1, tier 1, or total capital ratio is 2.5 percent or less above the minimum ratio, the maximum payout ratio also declines. The institution remains subject to payout restrictions until it raises its capital conservation buffer above 2.5 percent. In addition, a System institution will not generally be able to make capital distributions or pay discretionary bonuses during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer is less than 2.5 percent as of the end of the previous quarter.

The capital conservation buffer is divided into quartiles, with greater restrictions on capital distributions and discretionary bonus payments as the capital conservation buffer falls closer to 0 percent. When the buffer is fully phased in, payouts are restricted to 60 percent of eligible retained income if the buffer is above 1.875 percent but at or below 2.5 percent. When the buffer is above 1.25 percent but less than or equal to 1.875 percent, the payout is restricted to 40 percent of eligible retained income. When the buffer is above 0.625 percent but equal to or below 1.25 percent, the payout is restricted to 20 percent of eligible retained income. A capital conservation buffer of 0.625 percent or below results in a 0 percent payout.

We have made several changes to the definition of "capital distribution" to ensure the intent of the buffers—to conserve capital—is fulfilled, and to ensure comparability with the U.S. rule. In paragraphs (A) and (B) of § 628.11(a)(2)(vii), we have specified that the replacement capital instrument must be purchased capital. In paragraph (D) of § 628.11(a)(2)(vii), we have replaced the reference to "any tier 2 capital instrument" with a reference to

"any capital instrument other than a tier 1 capital instrument" to ensure inclusion of any dividend declarations or interest payments on capital instruments that are not included in tier 1 or tier 2 capital. The final rule defines a capital distribution as:

- A reduction of tier 1 capital through the repurchase or redemption of a tier 1 capital instrument or by other means, unless the redeemed capital is replaced in the same quarter by purchased tier 1 qualifying capital;
- A reduction of tier 2 capital through the repurchase, or redemption prior to maturity, of a tier 2 capital instrument or by other means, unless the redeemed capital is replaced in the same quarter by purchased qualifying tier 1 or tier 2 capital;
- A dividend declaration or payment on any tier 1 capital instrument;
- A dividend declaration or interest payment on any capital instrument other than a tier 1 capital instrument if the institution has full discretion to suspend such payments permanently or temporarily without triggering an event of default;
- A cash patronage payment declaration or payment;
- A patronage payment declaration in the form of allocated equities that do not qualify as tier 1 or tier 2 capital;<sup>53</sup> or
- Any similar transaction that the FCA determines to be in substance a capital distribution.<sup>54</sup>

The rule defines a discretionary bonus payment as a payment made to a senior officer of a System institution, where:

- The System institution retains discretion whether to pay the bonus and how much to pay until it awards the payment to the senior officer;
- The System institution determines the amount of the bonus without prior promise to, or agreement with, the senior officer; and
- The senior officer has no express or implied contractual right to the bonus payment.

The term "senior officer" is already defined in § 619.9310 as the Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer, and the General Counsel, or persons in similar positions, and any other person responsible for a major policy-making function.<sup>55</sup>

<sup>53</sup> A patronage declaration or payment in the form of allocated equities that qualify as tier 1 capital is not a reduction in tier 1 capital. It is merely a reclassification from one tier 1 capital element into a different tier 1 capital element.

<sup>54</sup> We note that the Federal regulatory banking agencies replaced the term "capital distribution" with "distribution" in their final rule. We have decided to use the term "capital distribution" to avoid potential confusion with other types of distributions that do not meet the definition for purposes of applying the capital conservation buffer.

<sup>55</sup> The FCA considers this definition substantively identical to the definition of "executive officer" used in the Federal regulatory banking agencies' rules on the capital conservation buffer.

The purpose of limiting restrictions on discretionary bonus payments to senior officers is to focus these measures on the individuals within an institution who could expose the institution to the greatest risk. We note that the institution may otherwise be subject to limitations on capital distributions under other provisions in this rule. In addition, we retain authority to approve a capital distribution or bonus payment if we determine that the payment would not be contrary to the purposes of the capital conservation buffer or the safety and soundness of the institution.

#### *D. Supervisory Assessment of Overall Capital Adequacy*

Section 628.10(d)(1) of the proposed rule required each System institution to maintain capital commensurate with the level and nature of all risks to which it was exposed and to have a process for assessing its overall capital adequacy in relation to its risk profile, as well as a comprehensive strategy for maintaining an appropriate level of capital. We did not receive any comments on this proposal and adopt it as final without modifications.

System institutions should have internal processes to assess capital adequacy that reflect a full understanding of risks and to ensure sufficient capital is held. Our supervisory assessment of capital adequacy must take account of the internal processes for capital adequacy, as well as risks and other factors that can affect an institution's financial condition, including the level and severity of problem assets and total surplus exposure to operational and interest rate risk. For this reason, a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of the institution's risk-based capital ratios.

The FCA expects System institutions generally to operate with capital levels well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the exposed risk. For example, System institutions that are growing or that anticipate growth in the near future should maintain strong capital levels substantially above the minimums and should not allow significant weakening of financial strength below such levels to fund their growth. System institutions with high levels of risk are also expected to operate with capital well above the minimum levels. The supervisory assessment also evaluates the quality and trends in an institution's capital composition, including the share

of common cooperative equities and URE and equivalents.

The supervisory assessment may include such factors as whether the institution has merged recently, entered new activities, or introduced new products. It also considers whether an institution (1) is receiving special supervisory attention from FCA, (2) has or is expected to have losses resulting in capital inadequacy, (3) has significant exposure due to risks from concentrations in credit or nontraditional activities, (4) has significant exposure to interest rate risk or operational risk, or (5) could be adversely affected by the activities or condition of an affiliated System institution.

The supervisory assessment also evaluates the comprehensiveness and effectiveness of a System institution's capital as required by § 615.5200 of existing FCA regulations.<sup>56</sup> An effective capital planning process requires a System institution to assess its risk exposures, develop strategies for mitigating those risks, and set capital adequacy goals relative to its risks and prospective economic conditions. Evaluation of an institution's capital adequacy process is commensurate with the institution's size, sophistication, and risk profile.

### **III. Definition of Capital**

#### *A. Capital Components and Eligibility Criteria for Regulatory Capital Instruments*

##### **1. Common Equity Tier 1 (CET1) Capital**

Section 628.20(b) of the proposed rule defined a System institution's CET1 as the sum of URE and common cooperative equities, minus the regulatory adjustments and deductions described in § 628.22. As discussed in Section I.E.1 of this preamble, we have adapted the criteria for the common cooperative equities in accordance with footnote 12 of Basel III, which states that the criteria for non-joint stock companies, including mutuals and cooperatives, should take into account their legal structure and constitution.<sup>57</sup>

Basel III established 14 criteria a banking organization must meet to include an instrument in CET1 capital; the U.S. rule has 13 criteria. These criteria ensure that the instrument will be available to absorb losses at the banking organization on a going-concern basis. Several of the criteria provide that

the instrument represents the most subordinated claim in liquidation, is entitled to a claim on residual assets proportional to its share of issued capital, and must take the first and proportionately greatest share of any losses as they occur.

Unlike joint-stock banks, System institutions have priorities of impairment among the various classes of member stock and allocated equities, and typically, all current and former members are entitled to the residual assets, based on historic patronage payments, in a liquidation of the institution. However, all common cooperative equities are impaired and depleted before all other instruments. Therefore, we proposed to replace some of the Basel III and U.S. rule criteria with criteria providing that the instrument must represent a claim subordinated to all other equities of an institution in liquidation, and the holder would receive payment only after all general creditors and debt holders are paid. We did not receive comments on the liquidation-related criteria and adopt them in the final rule as proposed.

Another CET1 criterion of Basel III and the U.S. rule—a criterion that also applies to additional tier 1 capital and tier 2 capital—is that the banking organization must do nothing to create an expectation at issuance that the instrument will be redeemed, nor do the statutory or contractual terms provide any feature that might give rise to such an expectation. In the System, institutions issue or allocate some cooperative equities that are never retired and that do not give rise to redemption or revolvment expectations by member-borrowers. Other cooperative equities, by contrast, are redeemed frequently and routinely. Through this practice, System institutions can create expectations on the part of their members that these purchased and allocated equities will be redeemed.

In the preamble to the proposed rule, we described our concern that the "expectation" requirement of Basel III and the U.S. rule could reasonably be interpreted to disallow cooperative equities redeemed or revolved by System institutions. We therefore proposed to permit System institutions to include cooperative equities in CET1 and tier 2 capital if they adopted bylaws committing the institution not to redeem or revolve for 10 years in the case of CET1 equities and for 5 years in the case of tier 2 equities. We also required the bylaw to state that the institution would not offset an instrument against a member-borrower's

<sup>56</sup> As discussed below, the final rule revises existing § 615.5200 to require the capital planning to include the new ratios.

<sup>57</sup> Basel III framework footnote 12 to "Criteria for classification as common shares for regulatory capital purposes."

loan in default without prior FCA approval, to ensure the permanence and stability of the included equities. The proposed rule provided an exception to the minimum redemption and revolvement periods that permitted institutions to redeem or revolve an amount of member stock equal to the minimum stock purchase requirement set forth in the Farm Credit Act. The statutory minimum is \$1,000 or 2 percent of the member's loan or loans, whichever is less. This member stock exception is similar to exceptions for member stock redemptions adopted by a number of European countries. There is a detailed discussion of this exception in the preamble to our proposed rule.<sup>58</sup>

We received extensive comments from System institutions on the 10-year minimum redemption and revolvement period for CET1 capital and the proposed bylaw requirement that we discuss in Part I.E.4 above. Commenters also asked us to provide exceptions permitting, without FCA prior approval, offsets of equities against loans in default or restructured loans and redemptions and revolvments of equities owned by the estates of former borrowers. As we described above, in the final rule we have given institution boards the option to adopt an annual resolution affirming the institution's commitment to the minimum redemption and revolvement periods as an alternative to adopting a capitalization bylaw. We have also adopted a minimum 7-year period for CET1 capital and retained the minimum 5-year period for tier capital. The final rule permits equity retirements mandated by final order of a court of competent jurisdiction and offsets mandated by § 615.5290, as well as redemptions and revolvments of the equities owned by the estate of a former borrower before the end of the minimum redemption and revolvement period. Such redemptions and revolvments may be made under the safe harbor provision in § 628.20(f) if they fit within the dollar limit.

The final rule adds new paragraph (d) to the capital planning requirements in § 615.5200, describing the requirements of the capital bylaw or board resolution an institution must adopt in order to include otherwise eligible purchased and allocated equities in CET1 and tier 2 capital. The institution must undertake or commit to obtain prior approval from the FCA under § 628.20(f) before redeeming or revolving CET1 equities less than 7 years after issuance (in the case of purchased equities) or allocation (the date of declaration in the

case of allocated equities). For additional tier 1 equities, the institution must commit itself to obtain prior FCA approval before redeeming or calling equities. For tier 2 equities, the institution must make the same commitment not to redeem or revolve the equities less than 5 years after issuance or allocation without FCA approval. In addition, the institution must commit to obtaining approval from the FCA to change the regulatory capital treatment of the equities included in the new capital ratios, as follows:

- (i) Redesignating URE equivalents as equities that the institution may exercise its discretion to redeem other than upon dissolution or liquidation;
- (ii) Removing equities or other instruments from CET1, additional tier 1, or tier 2 capital other than through repurchase, redemption or revolvement; and
- (iii) Redesignating equities included in one component of regulatory capital (CET1 capital, additional tier 1 capital, or tier 2 capital) as included in another component of regulatory capital.

The restrictions on removing or redesignating equities would, ensure that equities included in CET1 could not be redesignated by an institution as tier 2 equities so that the institution could redeem or revolve them after only 5 years. Similarly, equities cannot be removed from tier 1 and tier 2 capital without FCA prior approval and then redeemed or revolved in less than 5 years. We note that, to obtain the FCA approvals described here, the institutions must submit a request under paragraphs (f)(1) through (4) of § 628.20 and cannot rely on the deemed prior approval or "safe harbor" described in paragraph (f)(5).

The System Comment Letter objected to the rule's requirement that System institutions keep records of when they issue or allocate common cooperative equities included in CET1 and tier 2 (the comment refers to this as "date-stamping"). The System stated that date-stamping requires significant unnecessary administrative burden and is not logical because it does not "recognize the portfolio nature of cooperative equities." The System asserted that, for long-time borrowers, it does not matter whether one share of their equity is held for 2 years and another share is held for 10 years because the borrower has committed to maintain a stable and predictable level of investment related to its business with the institution. The System suggested that institutions be permitted to comply with the minimum redemption and revolvement requirements by using a "loan-based

approach" instead of a date-stamped approach.

The comment that cooperative equities have a portfolio nature is not clear to us. As for date-stamping, we disagree that it is a significant burden to keep these records. It is our understanding that the relevant software programs are available and inexpensive. Moreover, System associations have been required since 1997 to maintain records of when they issue or allocate common cooperative equities in order to include such equities in their core surplus ratios. System banks have not been required to maintain such records because they cannot include in core surplus the equities they issue or allocate to other System institutions. Currently, the System banks have various "loan-based" programs that require their borrowers to hold investments in their bank equal to a percentage of the outstanding loan amount. A bank may be able to include such equities in its CET1 and tier 2 capital ratios if its loan-based program operates so as to ensure that the equities meet the rule's applicable minimum revolvement periods and other criteria. The FCA will consider approving such requests from System institutions under § 628.1(d)(2)(ii).

As for the request to grandfather existing allocated equities for which the institution has no record of the date of allocation or issuance, we believe that most, if not all, institutions' records do contain the necessary data on when a borrower purchased or received equities. Any institution with insufficient records may submit to the FCA a request to include the equities in question along with an explanation of why the records are insufficient. We will consider whether to permit the institution to include such equities, or a portion of such equities, on a temporary basis.

The final rule requires that the common cooperative equities included in CET1 satisfy all the following criteria:

- (1) The instrument is issued directly by the System institution and represents a claim subordinated to all preferred stock, all subordinated debt, and all liabilities in a receivership, insolvency, liquidation, or similar proceeding of the System institution;
- (2) If the holder of the instrument is entitled to a claim on the residual assets of the System institution, the claim will be paid only after all general creditors, subordinated debt holders, and preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding;
- (3) The instrument has no maturity date, can be redeemed only at the

<sup>58</sup> See 79 FR 52824.

discretion of the System institution and with the prior approval of FCA, and does not contain any term or feature that creates an incentive to redeem;

(4) The System institution did not create, through any action or communication, an expectation that it will buy back, cancel, revolve, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation, except that the establishment of a minimum revolvment period of 7 years or more, or the practice of revolving or redeeming the instrument no less than 7 years after issuance or allocation, will not be considered to create such an expectation;

(5) Any cash dividend payments on the instrument are paid out of the System institution's net income or unallocated retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument;

(6) The System institution has full discretion at all times to refrain from paying any dividends without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the System institution;

(7) Dividend payments and other distributions related to the instrument may be paid only after all legal and contractual obligations of the System institution have been satisfied, including payments due on more senior claims;

(8) The holders of the instrument bear losses as they occur before any losses are borne by holders of preferred stock claims on the System institution and holders of any other claims with priority over common cooperative equity instruments in a receivership, insolvency, liquidation, or similar proceeding;

(9) The instrument is classified as equity under GAAP;

(10) The System institution, or an entity that the System institution controls, did not purchase or directly or indirectly fund the purchase of the instrument, except that where there is an obligation for a member of the institution to hold an instrument in order to receive a loan or service from the System institution, an amount of that loan equal to the minimum borrower stock requirement under section 4.3A of the Farm Credit Act will not be considered as a direct or indirect funding where:

(a) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan; and

(b) The purchase or acquisition of one or more member equities of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution;

(11) The instrument is not secured, not covered by a guarantee of the System institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(12) The instrument is issued in accordance with applicable laws and regulations and with the institution's capitalization bylaws;

(13) The instrument is reported on the System institution's regulatory financial statements separately from other capital instruments; and

(14) The System institution's capitalization bylaws or a resolution adopted by its board of directors and reaffirmed on an annual basis provides that it will not redeem or revolve the instrument for a period of at least 7 years after issuance or allocation (other than under § 615.5290), and that it will not reduce the original redemption or revolvment period to less than 7 years without the prior approval of the FCA, except that the minimum statutory borrower stock described under paragraph (b)(1)(x) of § 628.20 may be redeemed without a minimum period outstanding after issuance and without the prior approval of the FCA.

## 2. Additional Tier 1 (AT1) Capital

The criteria for AT1 are comparable to Basel III and the Federal regulatory banking agencies' rules. AT1 includes primarily noncumulative perpetual preferred stock issued by System institutions and is subject to certain adjustments and deductions. Qualifying instruments are primarily stock issued by System banks to third-party investors, though all System institutions have authority to issue such stock. AT1 does not include common cooperative equities.

The System Comment Letter and an individual affiliated with a commercial bank commented that a clause in the proposed criterion relating to distributions (paragraph (8) below and § 628.20(c)(1)(viii) in the final rule) was not part of the criterion in Basel III or the final U.S. rule. The clause in question is, "and are not subject to a limit imposed by the contractual terms governing the instrument." In the proposed rule, we mistakenly included the clause in this criterion. We have deleted it in the final rule.

The criteria for inclusion in AT1 capital are:

(1) The instrument is issued and paid-in;

(2) The instrument is subordinated to general creditors and subordinated debt holders of the System institution in a receivership, insolvency, liquidation, or similar proceeding;

(3) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(4) The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem;

(5) If callable by its terms, the instrument may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called earlier than 5 years upon the occurrence of a regulatory event that precludes the instrument from being included in AT1 capital, or a tax event. In addition:

(a) The System institution must receive prior approval from FCA to exercise a call option on the instrument.

(b) The System institution does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

(c) Prior to exercising the call option, or immediately thereafter, the System institution must either: Replace the instrument to be called with an equal amount of instruments that meet the criteria for a CET1 or AT1 capital instrument;<sup>59</sup> or demonstrate to the satisfaction of FCA that following redemption, the System institution will continue to hold capital commensurate with its risk;

(6) Redemption or repurchase of the instrument requires prior approval from FCA;

(7) The System institution has full discretion at all times to cancel dividends or other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the System institution except in relation to any capital distributions to holders of common cooperative equity instruments or other instruments that are *pari passu* with the instrument.

(8) Any capital distributions on the instrument are paid out of the System institution's net income, unallocated retained earnings, or surplus related to other AT1 capital instruments;

(9) The instrument does not have a credit-sensitive feature, such as a

<sup>59</sup> Replacement can be concurrent with redemption of existing AT1 capital instruments.

dividend rate that is reset periodically based in whole or in part on the System institution's credit quality, but may have a dividend rate that is adjusted periodically independent of the System institution's credit quality, in relation to general market interest rates or similar adjustments;

(10) The paid-in amount is classified as equity under GAAP;

(11) The System institution did not purchase or directly or indirectly fund the purchase of the instrument;

(12) The instrument does not have any features that would limit or discourage additional issuance of capital by the System institution, such as provisions that require the System institution to compensate holders of the instrument if a new instrument is issued at a lower price during a specified timeframe; and

(13) The System institution's capitalization bylaws or a resolution adopted on an annual basis by its board of directors provides that it will not call or redeem the instrument without the prior approval of the FCA.

Notwithstanding the criteria for AT1 capital instruments referenced above, an instrument with terms that provide that the instrument may be called earlier than 5 years upon the occurrence of a rating agency event does not violate the minimum 5-year issuance requirement provided that the instrument was issued and included in a System institution's core surplus capital prior to the effective date of the final rule, and that such instrument satisfies all other criteria under § 628.20(c).

### 3. Tier 2 Capital

The FCA proposed to include in tier 2 capital the sum of tier 2 capital instruments that satisfy the applicable criteria, plus ALL up to 1.25 percent of risk weighted assets, less any applicable adjustments and deductions. The criteria are similar to those in Basel III and the U.S. rule, except that common cooperative equities that are not includable in CET1 may be included in tier 2 if they meet the applicable criteria.

The System Comment Letter suggested that we eliminate the minimum 5-year period for redemptions of perpetual stock and allocated equities. As discussed above in Section I.E.3 above, we have decided to retain the minimum 5-year period as it is comparable to the tier 2 required minimum term for term stock and the 5-year no-call period for other equities.

We have revised the bylaw requirement to permit compliance by an annual board resolution, and we have added the 2 exceptions to redemption or

revolvement before the 5-year minimum period, which are the redemption or revolvement of equities owned by the estate of a former borrower and equities mandated to be retired by a court of competent jurisdiction.

The criteria for instruments (plus related surplus) included in tier 2 capital are:

(1) The instrument is issued and paid-in, is a common cooperative equity, or is member equity purchased in accordance with § 628.20(d)(1)(viii) of the proposed rule;

(2) The instrument is subordinated to general creditors of the System institution;

(3) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;

(4) The instrument has a minimum original maturity of at least 5 years. At the beginning of each of the last 5 years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when the remaining maturity is less than 1 year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the System institution to redeem the instrument prior to maturity;<sup>60</sup>

(5) The instrument, by its terms, may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, or a tax event. In addition:

(a) The System institution must receive the prior approval of FCA to exercise a call option on the instrument.

(b) The System institution does not create at issuance, through action or communication, an expectation the call option will be exercised.

(c) Prior to exercising the call option, or immediately thereafter, the System institution must either: Replace any amount called with an instrument that is of equal or higher quality regulatory capital under this section;<sup>61</sup> or demonstrate to the satisfaction of FCA

<sup>60</sup> An instrument that by its terms automatically converts into a tier 1 capital instrument prior to 5 years after issuance complies with the 5-year maturity requirement of this criterion.

<sup>61</sup> A System institution may replace tier 2 or tier 1 capital instruments concurrent with the redemption of existing tier 2 capital instruments.

that following redemption, the System institution would continue to hold an amount of capital that is commensurate with its risk;

(6) The holder of the instrument must have no contractual right to accelerate payment of principal, dividends, or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(7) The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the System institution's credit standing, but may have a dividend rate that is adjusted periodically independent of the System institution's credit standing, in relation to general market interest rates or similar adjustments;

(8) The System institution has not purchased and has not directly or indirectly funded the purchase of the instrument, except that where common cooperative equity instruments are held by a member of the institution in connection with a loan, and the institution funds the acquisition of such instruments, that loan shall not be considered as a direct or indirect funding where:

(a) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan;

(b) The purchase or acquisition of one or more capital instruments of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution; and

(c) The capital instruments are in excess of the statutory minimum stock purchase amount;

(9) Redemption of the instrument prior to maturity or repurchase is at the discretion of the System institution and requires the prior approval of the FCA; and

(10) If the instrument is a common cooperative equity, the System institution's capitalization bylaws or a resolution adopted by its board of directors and re-affirmed on an annual basis provides that it will not, except with the prior approval of the FCA, redeem such equity included in tier 2 capital for a period of at least 5 years after allocating it to a member, except that equities owned by the estate of a former borrower and equities required to be retired by final order of a court of competent jurisdiction may be redeemed without a minimum period outstanding after allocation.

### 4. FCA Approval of Capital Elements

Proposed § 628.20(e) required a System institution to obtain prior approval to include a new capital

element in its CET1 capital, AT1 capital, or tier 2 capital unless the element was equivalent, in terms of capital quality and ability to absorb losses with respect to all material terms, to a regulatory element the FCA had already determined may be included in regulatory capital. After the FCA determined that an institution could include an element in regulatory capital, it would make its decision publicly available.

We did not receive any comments on this proposal and adopt it as final without modification.

#### 5. FCA Prior Approval Requirements for Cash Patronage, Dividends, and Redemptions; Safe Harbor

As described above, the proposed rule required FCA prior approval for the redemption of equities included in tier 1 and tier 2, consistent with Basel III and the U.S. rule. The proposal also required FCA prior approval of cash dividend payments and cash patronage payments. Prior approval is not a requirement of the Basel III framework but is a requirement imposed by statute or regulation on commercial banks and other federally chartered banking organizations regulated by the Federal banking regulatory agencies.<sup>62</sup>

We also proposed a “safe harbor” provision in § 628.20(f) permitting institutions to pay cash dividend payments, cash patronage payments, and to redeem equities with “deemed” FCA prior approval if the payments were within the specified parameters. Under the proposed safe harbor, an institution had “deemed” prior approval for capital distributions to make cash dividend payments, cash patronage payments, or redemptions and revolvments of qualifying common cooperative equities provided that, after such capital distributions, the dollar amount of the System institution’s CET1 capital equaled or exceeded the dollar amount of CET1 capital on the same date in the previous calendar year and

the institution continued to comply with all regulatory capital requirements and supervisory or enforcement actions. The common cooperative equities that qualified for redemption or revolvment under the safe harbor were the minimum member stock requirement of \$1,000 or 2 percent of the loan, whichever is less; equities included in CET1 capital that were issued or allocated at least 10 years ago; and equities included in tier 2 capital that were issued or allocated at least 5 years ago.

System institutions have not generally had to obtain FCA prior approval before paying dividend payments or patronage payments or redeeming equities under current regulations, and the Farm Credit Act does not require prior approval. However, prior approval of equity redemptions is a fundamental principle of the Basel III framework and U.S. rule, and there are limits on the cash dividends commercial banks may pay without prior approval of their Federal banking regulator. In order for the regulatory capital framework of System institutions to be comparable to the regulatory capital framework of the U.S. banking organizations, it was necessary to include these prior approval requirements in our proposed rule. However, in acknowledgment of the common cooperative equity redemption and revolvment practices of System institutions, we permitted a limited amount of these redemptions and revolvments under the safe harbor “deemed” prior approval. We stated our belief that most System institutions would be able to pay cash dividend payments, cash patronage payments, and redeem equities within the safe harbor at the same levels that they pay currently.

The System Comment Letter made a number of comments, suggestions, and requests with respect to the prior approval requirements and the safe harbor provision. Two comments on the safe harbor’s cap, or maximum payment amount, are discussed above in Section I.E.7 of this preamble. With respect to the prior approval process, the System expressed concern that the 30-day approval process would be burdensome and unworkable and suggested the process be streamlined for institutions with high FIRS ratings, with FCA granting approvals in as short a time as one day. A further suggestion was that the FCA could pre-approve all contemplated capital distributions under the capital plan required by § 615.5200.

The FCA has decided to retain its 30-day review in the final rule. We expect any proposed cash dividend payments,

cash patronage payments, redemptions and revolvments that must be submitted to us will have been long planned by the institution, and we need sufficient time for our review. We note that a 30-day period is comparable to the review periods of the Federal banking regulatory agencies.

The FCA has decided not to adopt the System’s suggestion to “pre-approve” all capital distributions in an institution’s capital plan required under § 615.5200. While FCA staff reviews the capital plans submitted by institutions, we do not formally approve the plans. However, as described above in the criteria for CET1 and tier 2 capital, we have modified the criteria and the safe harbor provision to provide two additional exceptions, in response to a comment the System made with respect to the capital plan requirements in § 615.5200.

In the proposed rule, we deleted a provision in existing § 615.5200(b) pertaining to redemptions or revolvments of equities in connection with a loan default or the death of a former borrower. The deleted provisions required an institution to make a prior determination that such redemptions or revolvments were in the best interest of the institution and also required the institution to charge off an amount of the indebtedness equal to the amount of the equities that were redeemed or revolved. The System approved the deletions as eliminating a restriction on System institutions’ “absolute statutory right” to retire cooperative equities in the event of loan default and restructuring without regard to any restrictions on the equities included in tier 1 and tier 2 capital in new part 628. The System asked us to clarify whether institutions will also be able to continue to redeem or revolve equities in connection with the death of a former borrower with regard to the part 628 restrictions.

As we have discussed at some length here and in the preamble to the proposed rule, the required prior regulatory approval of equity retirements is a principle underlying the Basel III framework and the U.S. rule. Without the prior approval requirement, the new tier 1 and tier 2 framework we are adopting would not be comparable to the Basel III framework and the U.S. rule. System institutions forgo their discretion to redeem or revolve equities included in tier 1 and tier 2, and they must commit to obtain prior approval (or must rely on the safe harbor “deemed” prior approval) before redeeming or revolving the equities. The prior approval requirements apply to redemptions and revolvments related

<sup>62</sup> Before a Federal savings association declares a dividend, it must send a notice, or application for approval, of the action to the Office of the Comptroller of the Currency (OCC). Whether OCC approval is required or a mere notice will suffice depends on a number of factors. For example, an application for approval is required if the proposed declaration (together with all other capital distributions) for the applicable calendar year exceeds the savings association’s net income for the current year plus the retained net income for the 2 preceding years. A national bank must obtain OCC approval to declare a dividend if the total amount of all common and preferred dividends, including the proposed dividend, declared in any current year exceeds the total of the national bank’s net income of the current year to date, combined with the retained net income of the previous 2 years. 12 U.S.C. 60(b).

to a loan default or restructuring and to equities of a deceased former borrower. Institutions will thus have to submit a request to the FCA for prior approval or will have to redeem or revolve the equities within the safe harbor parameters. However, we are aware that the safe harbor cannot be utilized to redeem or revolve CET1 equities that have been outstanding for less than the minimum 7-year holding period or for tier 2 equities that have been outstanding for less than 5 years. Therefore, we have modified the proposed safe harbor provision to add 2 exceptions suggested by the System (with modifications) to the minimum retention periods in the safe harbor provision, as well as an exception for court orders. The new exceptions apply to:

(a) Equities mandated to be redeemed or retired by a final order of a court of competent jurisdiction;

(b) Equities held by the estate of a deceased former borrower; and

(c) Equities required by the institution to cancel under § 615.5290 in connection with a restructuring under part 617 of this chapter.

We are adding the exception for a final court order because an institution generally cannot disobey a court order. We are adding the exception for estates of former borrowers for the convenience of the estate administrator. The exception for a loan default or restructuring is limited to the required cancellation of equities under § 615.5290 and is the only offset that institutions are required to make. The other offset provisions in our regulations are permissive, not mandatory. We note that these excepted redemptions and revolvments will count in the total amount of cash payments an institution may make under the safe harbor. For payments in excess of the safe harbor cap, institutions will have to make a request to the FCA for prior approval.

We are adopting the prior approval requirements with the modifications described, including revising the reference to the minimum CET1 retention period to 7 years.

## *B. Regulatory Adjustments and Deductions*

### 1. Regulatory Deductions From CET1 Capital

In the final rule, a System institution must deduct from CET1 capital the items described in § 628.22 of the proposed rule. A System institution must also exclude these deductions from its total risk weighted assets and

leverage exposure. These deductions are:

#### a. Goodwill and Other Intangibles (Other Than Mortgage Servicing Assets)

Consistent with Basel III and the Federal regulatory banking agencies' rules, the proposed rule excluded goodwill and other intangible assets from regulatory capital because of the uncertainty that a System institution may realize value from these assets under adverse financial conditions. An institution was required to deduct goodwill and "non-mortgage" servicing assets, net of associated deferred tax liabilities (DTLs), from CET1 capital. That portion of mortgage servicing assets (MSAs) and DTAs above the threshold deductions were not risk weighted at 250 percent. Instead, the full amounts of MSAs and DTAs that arise from temporary differences relating to net operating loss carrybacks were risk weighted at 100 percent. Should the levels of MSAs held by System institutions increase significantly in the future, the FCA stated it would reconsider the appropriateness of this treatment.

The FCA did not propose the threshold deduction in Basel III and the U.S. rule for investments in other financial institutions. Instead, the proposed rule required that System institutions deduct their investments in other System institutions from their regulatory capital, as described below. Other equity investments were risk weighted according to § 628.52.

We stated that we did not believe DTAs that are risk weighted in this section would represent material items on a System institution's balance sheet because of System institutions' tax status. The FCBs and FLCAs<sup>63</sup> are exempt from Federal, state, municipal, and local taxation.<sup>64</sup> Most other System institutions' net income arises from both non-taxable and taxable sources. The production and cooperative lending business lines are taxable, but the taxable retail operations of CoBank, ACB and taxable System associations may reduce taxes by following subchapter T provisions of the Internal Revenue Code. Should the levels of DTAs held by System institutions increase significantly in the future, we stated we would reconsider the

<sup>63</sup> FLCAs are Federal land bank associations with direct long-term real estate lending authority. 12 CFR 619.9155.

<sup>64</sup> They are subject to taxes on real estate held to the same extent, according to its value, as other similar property held by other persons is taxed. See 12 U.S.C. 2023 and 2098.

appropriateness of this proposed treatment.

The System Comment Letter agreed with the FCA that the creation or purchase of MSAs is minimal and not material in the System. The System supported our proposal not to follow what it called the more complex and irrelevant Basel III deduction approach.

The FCA has decided to finalize the goodwill, other intangibles, and MSA treatment as proposed.

#### b. Gain-on-Sale Associated With a Securitization Exposure

The proposed rule required a System institution to deduct from CET1 capital any after-tax gain-on-sale associated with a securitization exposure. Under GAAP, any gain-on-sale from a traditional securitization would increase a System institution's CET1 capital. However, if a System institution received cash from the sale of the securitization exposure and the MSA, it did not deduct such amount from its CET1 capital. Any sale of loans to a securitization structure that creates a gain may include an MSA that also meets the proposed definition of "gain-on-sale." A System institution must exclude any portion of a gain-on-sale reported as an MSA on FCA's Call Report.

The FCA did not receive comments on the proposed rule and is adopting it without modification.

#### c. Defined Benefit Pension Fund Net Assets

The proposed rule required a System institution to deduct from CET1 capital a defined benefit pension fund net asset (an overfunded pension), net of any associated DTLs, because of the uncertainty of realizing any of the value from such assets. The proposed rule recognized under GAAP the amount of a defined benefit pension fund liabilities (an underfunded pension) on the balance sheet of the institution, would be the same amount included as CET1 capital. Therefore, a System institution could not increase its CET1 capital by the derecognition of these defined pension fund liabilities.

Because existing FCA regulations do not require the deduction of the defined benefit pension fund net assets in the regulatory capital calculations, our call report does not collect defined benefit pension fund net assets. In the proposed rule preamble, we stated that we would develop a call report schedule and require each System institution to report its individual year-end transactions for defined benefit pension fund net assets on their individual call report schedule.

The System Comment Letter objected to the proposed deduction in § 628.22(a)(5) of defined benefit pension fund net assets. The System stated that the FDIC has determined that it has access to commercial banks' prepaid pension assets in a receivership and, in the opinion of the System, the Farm Credit System Insurance Corporation (FCSIC) has authority to make the same determination.

It is the FCA's position that the FCSIC as receiver would be able to make such a determination; however, this is an authority not expressly granted in our regulations. The absence of express authority could lead to legal challenges to the receiver's access to the prepaid pension fund assets. We have decided to retain the deduction requirement at this time.

We note that the proposed rule preamble stated that we were proposing to permit an institution, with our prior approval, to risk-weight defined benefit pension fund net assets to which the institution had unfettered and unrestricted access.<sup>65</sup> However, this provision was not in the text of the proposed rule. In the final rule we have added it to the text. If an institution receives FCA approval to risk-weight the asset, it must risk-weight it as if it directly holds a proportional ownership share of each exposure in the defined benefit pension fund. For example, assume that: (1) The institution has a defined benefit pension fund net asset of \$10; and (2) the institution has unfettered and unrestricted access to the assets of the defined benefit pension fund. Also, assume that 20 percent of the defined benefit pension fund is risk weighted at 100 percent and 80 percent is risk weighted at 300 percent. The institution must risk weight \$2 at 100 percent and \$8 at 300 percent. This treatment is consistent with the full look-through approach described in § 628.53(b) of the final rule.

#### d. A System Institution's Allocated Equity Investment in Another System Institution

Section 628.22(a)(6) of the proposed rule would have required a System institution to deduct any allocated equity investment in another System institution<sup>66</sup> from its CET1 capital. Later in this preamble, we discuss deducting a System institution's purchased investment in another System institution using the

corresponding deduction approach in § 628.22(c).

The proposed rule had a different equity elimination method from the U.S. rule. Our method was more conservative than the Federal banking regulatory agencies' rules but consistent with the principles of Basel III and more appropriate for System institutions. It was also simpler to calculate. System associations, as member-borrowers of a cooperative network, have equity investments in their affiliated banks. System institutions also have equity investments in other System institutions but few outside the System. The investments that System institutions have in other System institutions are counted in their GAAP financial statements as equity of the issuing or allocating institution and as assets of the recipient institution. The FCA continues to believe, as we have stated numerous times previously, that equities should be counted in the regulatory capital of the institution that has control of the equities. The allocating institutions alone have discretion whether to allocate equities and when, if ever, to distribute those equities. Therefore, in the proposed rule the allocating institutions would include in their CET1 capital the equities they have allocated to their members, provided those equities meet the criteria for inclusion in CET1 capital. The institutions that have received allocated equities from other institutions would deduct those equities from their CET1 capital.

We noted that System institutions would be able to include allocated equities in CET1 capital that are excluded from core surplus under our existing regulations. These deductions applied only to investments in other System institutions because, for the most part, our investment regulations restrict equity investments outside the System.

The System Comment Letter asserted that the regulatory deductions in paragraphs (a) and (c) in new § 628.22 "ignore statutory provisions pertaining to permanent capital." The System stated its opinion that all equities categorized as tier 1 or tier 2 in the new rule must also qualify as permanent capital and must respect the allotment agreements set forth in section 4.3A(a)(1)(B). The System asserted that failure to respect the allotment agreements would have "an immediate and significant negative impact on regulatory capital ratios for some System institutions." The System requested that, because of such impact, we permit institutions to use the allotment agreements in their tier 1 and

tier 2 capital ratios calculations for the next 5 years instead of the deductions in paragraph (a)(6) of § 628.22. The System said that this phase-in period would allow System banks and their affiliated associations time "to adjust allocated investments to comport with the requirements."

The FCA disagrees with the System's apparent position that the allotment agreements in section 4.3A(a)(1)(B) of the Act must be reflected in all regulatory capital calculations, as well as the implication that no other deductions or adjustments may be made to regulatory capital ratios unless they are specified in section 4.3A of the Act.<sup>67</sup> All of our capital regulations since the enactment of the 1987 amendments to the Act<sup>68</sup> have contained eliminations of both purchased and allocated equities, as well as deductions and adjustments for such items as goodwill, that are not mentioned in the Act. Since 1997, under our statutory authority in section 4.3(a) of the Act, our capital regulations have included a core surplus ratio whose deductions and adjustments do not reflect the allotment agreements. As for the new tier 1 and tier 2 regulatory capital ratios, it is our judgment that the deductions and adjustments in § 628.22 more appropriately categorize the control of shared capital as within the discretion of the institution that allocated the equities and not the recipient institution. As stated in the preamble to the proposed rule, we strongly believe that the deductions and adjustments for the CET1 capital ratio calculation appropriately reflect that the allocated equities are within the control of, and subject to the risks in, the allocating institution and not the recipient institution. Moreover, we believe the deductions and adjustments are consistent with the intent of the Basel III framework and the U.S. rule.

Currently a small number of associations with large allocations of equities from their affiliated banks count a large portion of those equities in their permanent capital ratio calculations. The associations will, of course, be able to continue to make allotment agreements for the permanent capital ratio calculations when the new rule becomes final. Our projections of System institutions' initial compliance

<sup>67</sup> We observe that, in including up to 1.25 percent of ALL in tier 2 consistent with the Basel III framework and the U.S. rule, we are squarely deviating from the permanent capital ratio calculation because ALL is expressly excluded from the definition of permanent capital in section 4.3A(a)(1)(C).

<sup>68</sup> Agricultural Credit Act of 1987, Pub. L. 100-233, 101 Stat. 1568 (100th Cong.), January 6, 1988.

<sup>65</sup> See 79 FR 52828 (September 4, 2014).

<sup>66</sup> An example would be an association's equity investment in its System bank.

with the tier 1 and tier 2 capital requirements are discussed below in Section VII of this preamble. Those projections show that these associations' CET1 capital ratios are likely to be lower than they would have been if the calculations had included the allotment agreements. However, we do not expect the "lower" CET1 capital ratios to have a significant negative impact on those associations. Consequently, we have decided not to adopt a phase-in period for the deductions and adjustments.

We are adopting the § 628.22(a)(6) deduction of allocated equity investments without modification from the proposed rule.

#### e. Accumulated Other Comprehensive Income (AOCI) and Minority Interests

We stated in the preamble to our proposed rule that we proposed not to include the impacts of AOCI on CET1 capital. We did not receive any comments on the proposal, and this treatment is unchanged in the final rule. As we discussed in detail in the proposed rule preamble, our treatment is different from Basel III and the U.S. rule, which require banking organizations to include most elements of AOCI in CET1.<sup>69</sup> However, the U.S. rule permits banking organizations using the standardized approach to make a one-time election not to exclude most elements of AOCI in their regulatory capital. Under the FCA's AOCI treatment, the exclusion of AOCI from CET1 capital is comparable to the AOCI exclusions of the banking organizations that make an election not to include AOCI in their CET1 capital.

Our proposed rule did not include minority interests in CET1 and any other component of regulatory capital because System institutions have few or no minority equity interests in unconsolidated subsidiaries. This treatment is unchanged in the final rule.

#### f. Discretionary "Haircut" Deduction or Other FCA Supervisory Action for Redemption of Equities Included in CET1 Capital Less Than 7 Years After Issuance or Allocation

Under § 628.22(f) of the proposed rule, if a System institution redeemed or revolved CET1 equities prior to the applicable minimum revolvment period, the institution was required to exclude 30 percent of the remaining purchased and allocated equities otherwise includable in CET1 capital for 3 years (30-percent haircut).

The System Comment Letter objected to the proposed haircut as an entirely new concept, not found in Basel III or

regulations of other regulators, illogical from a policy perspective, and unclear. The System, among other criticisms, stated that a recordkeeping error or other de minimis redemptions could result in the required deduction, and that it was unclear whether the deduction was meant to be applied one time only or was cumulative or overlapping for repeated violations. The System suggested that the haircut could be a standing deduction to CET1 rather than a haircut for a violation. It is unclear to us what this suggestion means, other than perhaps, in effect, to allow institutions to apply a 30-percent haircut to their CET1 in order to eliminate the 7-year minimum redemption and revolvment period.

The FCA intended the 30-percent haircut to ensure proper management by System institutions of their member-borrowers' expectations of redemption and also to ensure that institutions are vigilant in their recordkeeping of the issuance and allocation dates of CET1. We continue to consider accurate recordkeeping to be very important under the new rule. However, in response to the comments, we have reconsidered the mandatory deduction and decided to revise it. Instead of a mandatory deduction, we have decided to identify the deduction of a portion of equities from CET1 as one of a possible range of supervisory or enforcement actions the FCA could take in response to a violation of the minimum redemption and revolvment period. Should we ever impose a haircut, we will specify the precise percentage and duration and whether the haircut could be cumulative or overlapping for repeated violations.

The final rule states that the FCA may respond to an institution's redemption or revolvment in violation of the minimum holding period by requiring such a haircut deduction or by taking other appropriate supervisory or enforcement action.

#### 2. The Corresponding Deduction Approach for Purchased Equities

Section 628.22(c) incorporated the Basel III corresponding deduction approach for a System institution's purchased equity investment in another System institution. The corresponding deduction approach did not apply to allocated equity investments in another System institution. We responded above, in Section III.B.1.d under "Regulatory Adjustments and Deductions," to the System Comment Letter's objections to the deductions of both purchased and allocated investments in other System institutions.

Under the final rule, a System institution is required to deduct an amount from the same component of capital for which the underlying instrument would qualify as if the System institution had issued the instrument itself. If a System institution does not have a sufficient amount of the specific component of regulatory capital for the entire deduction, then it must deduct the remaining portion from the next higher (more subordinated) capital component. Should a System institution not have enough AT1 capital to satisfy the required deduction, the shortfall must be deducted from CET1 capital elements.

Other than as described above, we did not receive comments on the corresponding deduction approach in the proposed rule and adopt the provision without modification.

#### 3. Netting of Deferred Tax Liabilities Against Deferred Tax Assets and Other Deductible Assets

In the proposed rule, the FCA proposed to simplify the netting of DTLs against DTAs and other deductible assets for deductions of DTAs. The proposal differed from the U.S. rule for deductions of DTAs. Rather, System institutions were required to adjust CET1 capital under § 628.22(a) net of any associated deferred tax effects. In addition, System institutions were required to deduct from CET1 capital elements under § 628.22(a) and (c) of the rule net of associated DTLs, pursuant to § 628.22(e). There is a detailed discussion of the proposal in the preamble to the proposed rule.<sup>70</sup>

We did not receive any comments on this proposed provision and adopt it without modifications.

#### C. Limits on Inclusion of Third-Party Capital

In the final rule, we continue to impose limits on the inclusion of third-party capital. However, in response to comments, in the final rule we have revised the limitations on third-party capital that we proposed. Specifically, third-party capital allowed to be included in total capital is limited to the lesser of 40 percent of total capital or 100 percent of common-equity tier 1. The final rule does not include separate limits on tier 1 capital and total capital; rather, there is one overall limit based on the aforementioned factors. However, if other capital instruments, such as unallocated retained earnings or common cooperative equities, decline in subsequent quarters causing third-party capital to exceed limits set in this final

<sup>69</sup> See 79 FR 52825.

<sup>70</sup> See 79 FR 52829–52830.

rule, an institution would still be able to include its existing level of third-party capital in its regulatory capital ratios. This limit increases the amount of third-party capital allowed in tier 1 from the proposed rule by up to 100 percent. A System institution could include third-party capital in tier 1 up to a level nearly equal to common-equity tier 1 or 40 percent of total capital, whichever is less. In the proposed rule, third-party capital allowed in tier 1 was equal to 33 percent of common-equity tier 1. We have substantially increased the amount of third-party capital allowed in tier 1 to provide member-borrowers increased flexibility to manage the affairs of their institution, which include prudent capital planning and management. The amount of third-party capital allowed in

total capital is substantially similar to that of the proposed rule (40 percent of total capital); however, we have removed the limit of an amount equal to 100 percent of its tier 1 capital outstanding. We believe it is appropriate to remove this limit given the substantial increase of third-party capital allowed to be included in tier 1 capital. Furthermore, removal of this limit would not result in a reduction of third-party capital a System institution could include in total capital.<sup>71</sup> The calculations for all limits will be based on the previous four quarters to ensure stability of the calculation and reduce the volatility associated with changes in total capital and common equity tier 1 amounts.

As previously stated, FCA believes it is prudent to set a limit on the amount

of third-party capital a System institution includes in its regulatory capital ratios. This limit ensures that unallocated retained earnings and common cooperative equities are the dominant forms of capital in the System and that the cooperative principal of user-control is not undermined. This increased limit provides increased flexibility for System institutions to manage its capital while ensuring that its member-borrowers' decisions are not heavily influenced by meeting third-party capital obligations. Commenters asserted that the applicable cooperative principle is user-benefit, and we believe that the limits do not undermine this principle.

The formulas for calculating third-party capital limits are:

$$1. \text{ CLTPC} = \min \left[ \left( \frac{\sum_{n=1}^4 (T1_n - NPPS_n)}{4} \right), \frac{2}{3} \left( \frac{\sum_{n=1}^4 (TC_n - TPC_n)}{4} \right) \right]$$

where

CLTPC = current limit on all third-party capital (noncumulative perpetual preferred stock, term preferred stock, and subordinated debt) in total capital, calculated this quarter,

T1 = tier 1 capital,

NPPS = noncumulative perpetual preferred stock included in tier 1 capital,

TC = total capital (tier 1 capital + tier 2 capital), and

TPC = third-party capital included in total capital, and

n = 4 previous quarters, 1–4

$$2. \text{ ALTPC} = \max(\text{ELTPC}, \text{CLTPC})$$

where

ALTPC = Aggregate limit on third-party capital,

ELTPC = existing limit on all third-party capital (noncumulative perpetual preferred stock, term preferred stock, and subordinated debt) in total capital, calculated the previous quarter,

CLTPC = current limit on all third-party capital (noncumulative perpetual preferred stock, term preferred stock, and subordinated debt) in total capital, calculated this quarter.

#### IV. Standardized Approach for Risk Weighted Assets

##### A. Calculation of Standardized Total Risk Weighted Assets

In general, commenters stated that they believed the risk weights we proposed were consistent with the implementation of Basel III by U.S. and foreign banking regulators, and they did not identify concerns with most of these risk weights. Commenters did request changes to or clarifications of several proposed risk-weighting provisions, however. We discuss those comments, and explain our response, in our discussion of those provisions. All provisions are generally adopted as proposed, unless a change is discussed.<sup>72</sup>

In addition to the revisions discussed below, we also adopt definitions of “qualifying master netting agreement,” “collateral agreement,” “eligible margin loan,” and “repo-style transaction” that are revised from what we proposed. The OCC and the Federal Reserve Board adopted similar revisions to these terms after they adopted their capital rules.<sup>73</sup> These revisions are designed to ensure that the regulatory treatment of certain

financial contracts is not affected by implementation of special resolution regimes in foreign jurisdictions or by the International Swaps and Derivatives Association Resolution Stay Protocol.

Similar to the FCA's current risk-based capital rules, under these new rules a System institution must calculate its total risk weighted assets by adding together its on- and off-balance sheet risk weighted asset amounts and making any relevant adjustments to incorporate required capital deductions.<sup>74</sup> Risk weighted asset amounts generally are determined by assigning on-balance sheet assets to broad risk-weight categories according to the asset type, the counterparty or, if relevant, the guarantor or collateral. Similarly, risk weighted asset amounts for off-balance sheet items are calculated using a two-step process: (1) Multiplying the amount of the off-balance sheet exposure<sup>75</sup> by a CCF to determine a credit equivalent amount; and (2) assigning the credit equivalent amount to a relevant risk-weight category.

A System institution must determine its standardized total risk weighted assets by calculating the sum of its risk

<sup>71</sup> In the proposed rule, third-party capital allowed in total capital was limited to the lesser of: 40 percent of total capital or 100 percent of tier 1 capital outstanding. FCA believes that the limiting factor in almost all cases will be the 40 percent of total capital limit. Given the System's current capital composition, the majority of capital instruments are tier 1 instruments. In order for 100 percent of tier 1 to be lower than 40 percent of total capital, System institutions would need to

substantially decrease tier 1 instruments and substantially increase tier 2 instruments. As the regulatory minimum ratios (including capital conservation buffer) are 8 percent for tier 1 and 10.5 percent for total capital, as well as the leverage ratio is based on tier 1 capital, the FCA believes it is unlikely that 100 percent of tier 1 capital will ever be lower than 40 percent of total capital.

<sup>72</sup> We do not discuss changes from the proposed rule that are minor, technical, and nonsubstantive.

<sup>73</sup> Interim final rule with request for comment, 79 FR 78287, December 30, 2014. The FDIC has proposed similar revisions, 80 FR 5063, January 30, 2015, but has not finalized them.

<sup>74</sup> See generally the FCA's regulations at part 615, subpart H.

<sup>75</sup> The term “exposure,” which is defined as an amount at risk, is used throughout the final rule and preamble.

weighted assets for general credit risk, cleared transactions, unsettled transactions, securitization exposures, and equity exposures, each as defined below, less the System institution's allowance for loan losses (ALL) that is not included in tier 2 capital (as described in § 628.20 of the rule). The sections below describe in more detail how a System institution must determine the risk weighted asset amounts for its exposures.

#### *B. Risk Weighted Assets for General Credit Risk*

Under the final rule, total risk weighted assets for general credit risk is the sum of the risk weighted asset amounts as calculated under § 628.31(a) of the rule. General credit risk exposures include a System institution's on-balance sheet exposures (other than cleared transactions, securitization exposures, and equity exposures, each as defined in § 628.2 of the final rule), exposures to over-the-counter (OTC) derivative contracts, off-balance sheet commitments, trade and transaction-related contingencies, guarantees, repo-style transactions, financial standby letters of credit, forward agreements, or other similar transactions. Section 628.32 of the final rule describes the risk weights that apply to sovereign exposures; exposures to certain supranational entities and multilateral development banks (MDBs); exposures to Government-sponsored enterprises (GSEs); exposures to depository institutions, foreign banks, and credit unions (including certain exposures to other financing institutions (OFIs) owned or controlled by these entities); exposures to public sector entities (PSEs); corporate exposures (including certain exposures to OFIs); residential mortgage exposures; past due and nonaccrual exposures; and other assets (including cash, gold bullion, and certain MSAs and DTAs).

Generally, the exposure amount for the on-balance sheet component of an exposure is the System institution's carrying value for the exposure as determined under generally accepted accounting principles (GAAP). Because all System institutions use GAAP to prepare their financial statements, we believe that using GAAP to determine the amount and nature of an exposure provides a consistent framework that System institutions can easily apply.

For purposes of the definition of exposure amount for available-for-sale (AFS) or held-to-maturity (HTM) debt securities and AFS preferred stock not classified as equity under GAAP, the exposure amount is the System institution's carrying value (including

net accrued but unpaid interest and fees) for the exposure, less any net unrealized gains, and plus any net unrealized losses. For purposes of the definition of exposure amount for AFS preferred stock classified as an equity security under GAAP, the exposure amount is the System institution's carrying value (including net accrued but unpaid interest and fees) for the exposure, less any net unrealized gains that are reflected in such carrying value but excluded from the System institution's regulatory capital.<sup>76</sup>

In most cases, the exposure amount for an off-balance sheet component of an exposure would typically be determined by multiplying the notional amount of the off-balance sheet component by the appropriate CCF as determined under § 628.33 of the final rule. The exposure amount for an OTC derivative contract or cleared transaction that is a derivative would be determined under § 628.34 of the final rule, whereas exposure amounts for collateralized OTC derivative contracts, collateralized cleared transactions that are derivatives, repo-style transactions, and eligible margin loans would be determined under § 628.37 of the final rule.

#### 1. Exposures to Sovereigns

Under the final rule, a sovereign is defined as a central government (including the U.S. Government) or an agency, department, ministry, or central bank of a central government (for the U.S. Government, the central bank is the Federal Reserve). The final rule retains the current rules' risk weights for exposures to and claims directly and unconditionally guaranteed by the U.S. Government or its agencies.<sup>77</sup> Accordingly, exposures to the U.S. Government, the Federal Reserve, or a U.S. Government agency, and the portion of an exposure that is directly and unconditionally guaranteed by the U.S. Government, the Federal Reserve, or a U.S. Government agency receive a 0-percent risk weight.<sup>78</sup> Consistent with the current risk-based capital rules, the portion of a deposit insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union

Administration (NCUA) is also assigned a 0-percent risk weight.

An exposure conditionally guaranteed by the U.S. Government, the Federal Reserve, or a U.S. Government agency receives a 20-percent risk weight. This includes an exposure that is conditionally guaranteed by the FDIC or the NCUA.<sup>79</sup>

The FCA's existing risk-based capital rules generally assign risk weights to direct exposures to sovereigns and exposures directly guaranteed by sovereigns based on whether the sovereign is a member of the Organization for Economic Cooperation and Development (OECD) and, as applicable, whether the exposure is unconditionally or conditionally guaranteed by the sovereign.<sup>80</sup>

The OECD assigns Country Risk Classifications (CRCs) to many countries as an assessment of their credit risk. CRCs are used to set interest rate charges for transactions covered by the OECD arrangement on export credits. The OECD uses a scale of 0 to 7 with 0 being the lowest possible risk and 7 being the highest possible risk. The OECD no longer assigns CRCs to certain high-income countries that are members of the OECD and that have previously received a CRC of 0. These countries exhibit a similar degree of country risk as that of a jurisdiction with a CRC of 0.<sup>81</sup>

Under the final rule, the risk weight for exposures to countries with CRCs is determined based on the CRCs. Exposures to OECD member countries that do not have CRCs are risk weighted at 0 percent. Exposures to non-OECD members with no CRC are risk weighted at 100 percent.<sup>82</sup> The OECD regularly updates CRCs and makes the assessments publicly available on its Web site. Accordingly, the FCA believes that the CRC approach should not represent undue burden to System institutions.

<sup>79</sup> Because of the issues such an exposure would raise, the FCA will determine the risk-weight of any System institution exposure that has a FCSIC guarantee, whether conditional or unconditional, on a case-by-case basis.

<sup>80</sup> Section 615.5211.

<sup>81</sup> For more information on the OECD country risk classification methodology, see generally OECD, "Country Risk Classification," available at <http://www.oecd.org/tad/xcred/crc.htm>.

<sup>82</sup> This final rule, like the U.S. rule, permits a lower risk weighting for sovereign exposures if certain conditions are met, including that the exposure is denominated in the sovereign's currency. Although the investment eligibility regulation applicable to System institutions require that all investments must be denominated in U.S. dollars (see § 615.5140(a) of our regulations), this lower risk weight could be used if a System institution were to foreclose on collateral in the form of such a sovereign exposure.

<sup>76</sup> Although System banks often classify their securities as AFS, associations almost always classify their securities, to the extent they hold any, as HTM.

<sup>77</sup> A U.S. Government agency is defined under the final rule as an instrumentality of the U.S. Government whose obligations are fully guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

<sup>78</sup> Similar to the FCA's current risk-based capital rules, a claim is not considered unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party.

The FCA believes that use of CRCs in the final rule is permissible under section 939A of the Dodd-Frank Act and that section 939A was not intended to apply to assessments of creditworthiness by organizations such as the OECD. Section 939A is part of subtitle C of title IX of the Dodd-Frank Act, which, among other things, enhances regulation by the U.S. Securities and Exchange Commission (SEC) of credit rating agencies, including Nationally Recognized Statistical Rating Organizations (NRSROs) registered with the SEC. Section 939A requires agencies to remove references to credit ratings and NRSROs from Federal regulations. In the introductory “findings” section to subtitle C, which is entitled “Improvements to the Regulation of Credit Ratings Agencies,” Congress characterized credit rating agencies as organizations that play a critical “gatekeeper” role in the debt markets and perform evaluative and analytical services on behalf of clients, and whose activities are fundamentally commercial in character.<sup>83</sup> Furthermore, the legislative history of section 939A focuses on the conflicts of interest of credit rating agencies in providing credit ratings to their clients, and the problem of government “sanctioning” of the credit rating agencies’ credit ratings by having them incorporated into Federal regulations. The OECD is not a commercial entity that produces credit assessments for fee-paying clients, nor does it provide the sort of evaluative and analytical services as credit rating agencies.

Additionally, the FCA notes that the use of the CRCs is limited in the rule. The FCA considers CRCs to be a reasonable alternative to credit ratings for sovereign exposures and the proposed CRC methodology to be more granular and risk sensitive than the current risk-weighting methodology based solely on OECD membership.

The final rule also requires a System institution to apply a 150-percent risk weight to sovereign exposures immediately upon determining that an event of sovereign default has occurred or if an event of sovereign default has occurred during the previous 5 years. Sovereign default is defined in the final rule as a noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms, as evidenced by failure to pay principal or interest fully and on a

timely basis, arrearages, or restructuring. A default includes a voluntary or involuntary restructuring that results in a sovereign not servicing an existing obligation in accordance with the obligation’s original terms.

TABLE 3—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

	Risk weight (in percent)
CRC:	
0-1 .....	0
2 .....	20
3 .....	50
4-6 .....	100
7 .....	150
OECD Member with No CRC	0
Non-OECD Member with No CRC .....	100
Sovereign Default .....	150

2. Exposures to Certain Supranational Entities and Multilateral Development Banks

Under the FCA’s existing risk-based capital rules, exposures to certain supranational entities and multilateral development banks (MDBs) receive a 20-percent risk weight. Consistent with the Basel framework’s treatment of exposures to supranational entities, the FCA’s final rule applies a 0-percent risk weight to exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund.

Similarly, the final rule applies a 0-percent risk weight to exposures to an MDB. The rule defines an MDB to include the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. Government is a shareholder or contributing member or which the FCA determines poses comparable credit risk.

The FCA believes this treatment is appropriate in light of the generally high credit quality of MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with

strong creditworthiness. Exposures to regional development banks and multilateral lending institutions that are not covered under the definition of MDB generally are treated as corporate exposures and receive a 100-percent risk weight.

3. Exposures to Government-Sponsored Enterprises

Like the Federal banking regulatory agencies, we define GSE as an entity established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. Because we believed it would make the regulations somewhat simpler, our proposed rule had excluded System institutions from this definition for the purpose of these capital rules.

The System is, however, a GSE, and the System Comment Letter asserted that our proposed definition was fundamentally incorrect and subject to misinterpretation. To alleviate any concerns about possible confusion regarding the System’s GSE status, the final rule eliminates this exclusion. Accordingly, under our final rule, as under the U.S. rule, GSEs include the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the System, the Federal Home Loan Bank System, and Farmer Mac.<sup>84</sup>

The final rule assigns a 20-percent risk weight to exposures to GSEs that are not equity exposures or preferred stock; this includes loans from System banks to associations (direct loans).<sup>85</sup>

The final rule assigns a 100-percent risk weight to preferred stock issued by a non-System GSE. This risk weighting represents a change to the FCA’s existing risk-based capital rules, which currently allow a System institution to apply a 20-percent risk weight to GSE preferred stock.<sup>86</sup>

Under final § 628.22, a System institution must deduct from regulatory capital all equity investments (including preferred stock) in another System institution, and therefore we do not provide a risk weighting for these

<sup>84</sup> As discussed above, Farmer Mac is an institution of the System, but because this regulation does not apply to Farmer Mac, it is not included in references to the System or System institutions in this regulation or preamble.

<sup>85</sup> Because System institutions were not included within the proposed rule’s definition of GSE, the proposed rule explicitly assigned a 20-percent risk weight to System bank loans to associations. In the final rule, these loans are included generally within the provision assigning a 20-percent risk weight to exposures to GSEs.

<sup>86</sup> Section 615.5211(b)(6).

<sup>83</sup> See Dodd-Frank Act, section 931 (15 U.S.C. 780-7 note).

investments. These investments could include, for example, an association's investment in a System bank and a System bank's investment in an association.<sup>87</sup>

System institutions have the authority to enter into loss-sharing agreements with other System institutions under § 614.4340. If System institutions enter into a loss-sharing agreement in the future, the FCA would assign a risk weight for any associated exposures at that time, using our regulatory reservation of authority.

4. Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The FCA's existing risk-based capital rules assign a 20-percent risk weight to all exposures to U.S. depository institutions and foreign banks incorporated in an OECD country. Short-term exposures to foreign banks incorporated in a non-OECD country receive a 20-percent risk weight and long-term exposures to such entities receive a 100-percent risk weight.

Under the final rule, exposures to U.S. depository institutions and credit unions are assigned a 20-percent risk weight.<sup>88</sup> This risk weight applies to a System bank exposure to an OFI that is owned and controlled by a U.S. or state depository institution or credit union that guarantees the exposure. If the OFI exposure does not satisfy these requirements, it is assigned a 50-percent or 100-percent risk weight as a corporate exposure pursuant to § 628.32(f).

Our existing OFI rules assign a 20-percent risk weight to a claim on an OFI that is an OECD bank or is owned and controlled by an OECD bank that guarantees the claim or if the OFI or its parent has a sufficiently high credit rating.<sup>89</sup> This final rule imposes the same risk weight for OFI exposures of the same nature, except that we eliminate the credit rating alternative in accordance with section 939A of the Dodd-Frank Act.

Under this final rule, an exposure to a foreign bank receives a risk weight one category higher than the risk weight assigned to a direct exposure to the foreign bank's home country, based on the assignment of risk weights by CRC, as discussed above.<sup>90</sup> Exposures to a

foreign bank in a country that does not have a CRC but that is a member of the OECD receive a 20-percent risk weight. A System institution must assign a 100-percent risk weight to an exposure to a foreign bank in a non-OECD member country that does not have a CRC, except that the institution may assign a 20-percent risk weight to self-liquidating, trade-related contingent items that arise from the movement of goods and that have a maturity of 3 months or less.

A System institution must assign a 150-percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign bank's home country during the previous 5 years.

TABLE 4—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight
Sovereign CRC:	
0–1 .....	20
2 .....	50
3 .....	100
4–7 .....	150
OECD Member with no CRC	20
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

Both the Basel capital framework and our existing regulation treat exposures to securities firms that meet certain requirements like exposures to depository institutions.<sup>91</sup> However, like the Federal banking regulatory agencies, the FCA no longer believes that the risk profile of these firms is sufficiently similar to depository institutions to justify that treatment. Accordingly, the final rule requires System institutions to treat exposures to securities firms as corporate exposures, with a 100-percent risk weight.

5. Exposures to Public Sector Entities

The FCA's existing risk-based capital rules assign a 20-percent risk weight to general obligations of states and other political subdivisions of OECD countries.<sup>92</sup> Exposures that rely on repayment from specific projects (for example, revenue bonds) are assigned a risk weight of 50 percent. Other

country meant the country where an entity is incorporated, chartered, or similarly established.

<sup>91</sup> See § 615.5211(b)(14) and (15).

<sup>92</sup> Political subdivisions of the United States include states, counties, cities, towns or other municipal corporations, public authorities, and generally any publicly owned entities that are instruments of a state or municipal corporation.

exposures to state and political subdivisions of OECD countries (including industrial revenue bonds) and exposures to political subdivisions of non-OECD countries receive a risk weight of 100 percent. The risk weights assigned to revenue obligations are higher than the risk weight assigned to general obligations because repayment of revenue obligations depends on specific projects, which present more risk relative to a general repayment obligation of a state or political subdivision of a sovereign.

The final rule applies the same risk weights to exposures to U.S. states and municipalities as the existing risk-based capital rules apply. Under the final rule, these political subdivisions are included in the definition of "public sector entity" (PSE). Consistent with both the current rules and the Basel capital framework, the final rule defines a PSE as a state, local authority, or other governmental subdivision below the level of a sovereign. This definition includes U.S. states and municipalities and does not include government-owned commercial companies that engage in activities involving trade, commerce, or profit that are generally conducted or performed in the private sector.

Under the final rule, a System institution would assign a 20-percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof and a 50-percent risk weight to a revenue obligation exposure to such a PSE. The final rule defines a general obligation as a bond or similar obligation that is backed by the full faith and credit of a PSE. The final rule defines a revenue obligation as a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from a specific project financed rather than general tax funds.

Similar to the Basel framework's use of home country risk weights to assign a risk weight to a PSE exposure, the final rule requires a System institution to apply a risk weight to an exposure to a non-U.S. PSE based on (1) The CRC applicable to the PSE's home country or, if the home country has no CRC, whether it is a member of the OECD, and (2) whether the exposure is a general obligation or a revenue obligation, in accordance with Table 5.

The risk weights assigned to revenue obligations are higher than the risk weights assigned to a general obligation issued by the same PSE, as set forth, for non-U.S. PSEs, in Table 5. Similar to exposures to a foreign bank, exposures

<sup>87</sup> As discussed above, Farmer Mac's preferred stock is assigned a risk weight of 100 percent.

<sup>88</sup> A depository institution is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(1)). Under this final rule, a credit union refers to an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752(7)).

<sup>89</sup> Section 615.5211(b)(16).

<sup>90</sup> Foreign bank means a foreign bank as defined in § 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2), that is not a depository institution. For purposes of this final rule, home

to a non-U.S. PSE in a country that does not have a CRC rating receive a 100-percent risk weight. Exposures to a non-U.S. PSE in a country that has defaulted on any outstanding sovereign exposure or that has defaulted on any sovereign exposure during the previous 5 years receive a 150-percent risk weight. Table 5 illustrates the risk weights for exposures to non-U.S. PSEs.

**TABLE 5—RISK WEIGHTS FOR EXPOSURES TO NON-U.S. PSE GENERAL OBLIGATIONS AND REVENUE OBLIGATIONS**

[in percent]		
	Risk weight for exposures to non-U.S. PSE general obligations	Risk weight for exposures to non-U.S. PSE revenue obligations
Sovereign CRC:		
0–1 .....	20	50
2 .....	50	100
3 .....	100	100
4–7 .....	150	150
OECD Member with No CRC ....	20	50
Non-OECD Member with No CRC .....	100	100
Sovereign Default	150	150

The final rule allows a System institution to apply a risk weight to an exposure to a non-U.S. PSE according to the risk weight that the foreign banking organization supervisor allows to be assigned to it. In no event, however, may the risk weight for an exposure to a non-U.S. PSE be lower than the risk weight assigned to direct exposures to that PSE's home country.

## 6. Corporate Exposures

Under the FCA's existing risk-based capital rules, credit exposures to companies that are not depository institutions or securitization vehicles generally are assigned to the 100-percent risk weight category. A 20-percent risk weight is assigned to claims on, or guaranteed by, a securities firm incorporated in an OECD country that satisfies certain conditions.

The requirements of the final rule are generally consistent with the existing risk-based capital rules and require System institutions generally to assign a 100-percent risk weight to all corporate exposures.<sup>93</sup> The final rule defines a

<sup>93</sup> For reasons discussed below, exposures to lower-risk OFIs that do not qualify for a 20-percent risk weight are assigned a 50-percent risk weight. The U.S. rule would assign a 100-percent risk weight to these exposures, because they satisfy the definition of corporate exposure and do not qualify for a different risk weight. The laws and regulations governing the banking organizations regulated by the Federal banking regulatory agencies do not contemplate the OFI relationship, as the Act does.

corporate exposure as an exposure to a company that is not an exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank, or a credit union, a PSE, a GSE, a residential mortgage exposure, a cleared transaction, a securitization exposure, an equity exposure, or an unsettled transaction. This definition captures all exposures that are not otherwise included in another specific exposure category and is not limited to exposures to corporations.

Accordingly, this category includes borrower loans such as agricultural loans and consumer loans, regardless of the corporate form of the borrower, unless those loans qualify for different risk weights (such as a 50-percent risk weight for residential mortgage exposures) under other provisions. This category also includes premises, fixed assets, and other real estate owned.

Because they are corporate exposures, we proposed to include in this category all OFI exposures that do not qualify for the 20-percent depository institution/credit union risk weight provided in § 628.32(d) and discussed above. Our existing rules also contain a default 100-percent risk weight category.<sup>94</sup> But our existing regulations also contain an intermediate, 50-percent risk weight category for claims on OFIs that do not satisfy the requirements for a 20-percent risk weight but that otherwise meet similar capital, risk identification and control, and operational standards or that carry an investment grade NRSRO rating.<sup>95</sup> Only if an OFI does not satisfy these standards does a claim on it receive a 100-percent risk weighting.

We proposed to eliminate the 50-percent risk weight for OFIs and to assign a 100-percent risk weight to exposures to non-depository institution/non-credit union OFIs. In our proposal, we noted that this 50-percent risk weighting for what would otherwise be a corporate exposure is inconsistent with our treatment of other corporate exposures. We also noted that the Federal banking regulatory agencies would assign a 100-percent risk weight to these exposures.

We sought comment on our proposed capital treatment of exposures to OFIs and specifically on our proposal to eliminate the 50-percent risk weight. We received comments on this proposal from several OFIs and in the System Comment Letter. All commenters urged us to retain the 50-percent risk weight.

<sup>94</sup> Section 615.5211(d)(11).

<sup>95</sup> Section 615.5211(c)(5).

Moreover, the OFIs suggested that we eliminate the 100-percent risk weight entirely.

In support of their request to retain the 50-percent risk weight, the OFIs stated that OFIs have historically been instrumental to the System and deserve recognition and fairness for their historical role. They also stated that FCA's policies have always been designed to ensure that OFIs have competitive access to System bank funding and that increasing the risk weight requirements could impair this competitive access. In addition, they stated that OFI borrowing is not risky because of the System banks' underwriting standards and loan terms and conditions and because the FCA oversees the banks' relationships with their OFIs and has the authority to examine OFIs.

The System Comment Letter asserted that the current risk weight regime has worked effectively, as evidenced by the System's low loss experience on OFI loans. According to this Letter, the underwriting requirements for OFIs found in FCA regulations at subpart P of part 614, coupled with the two levels of capital that support the exposure of System banks to OFIs (capital is held at the OFI level and at the individual OFI borrower level), make a higher risk weight inappropriate. Moreover, the Letter stated that OFIs are unique to the System and the FCA's regulations are designed not to hinder these relationships.

We believe the existing approach to risk weighting OFI exposures has worked well since it was adopted in 2004. As we said at that time, when we first adopted a 50-percent risk weight for lower-risk non-depository institution/non-credit union OFI exposures:

Lowering the capital requirements for most OFI loans will lower the operating costs of the OFI program to Farm Credit banks. This, in turn, should lower the cost of funds to well-capitalized and well-managed OFIs. Lower funding costs should enable these OFIs to reduce interest rates charged to their borrowers. These results would advance the System's public policy mission to provide affordable credit on a consistent basis to agriculture and rural America. Greater flexibility for the risk weighting of OFI loans should provide the Farm Credit banks additional incentives to expand their lending to both existing and new OFIs.<sup>96</sup>

These ideas continue to be true today. Accordingly, the final rule retains a 50-percent risk weight for exposures to non-depository institution/non-credit union OFIs that meet capital, risk

<sup>96</sup> 69 FR 29852, 29862, May 26, 2004.

identification and control, and operational standards similar to regulated depository institutions and credit unions. The final rule also retains a 50-percent risk weight for exposures to non-depository institution/non-credit union OFIs that are investment grade or are owned and controlled by an investment grade entity that guarantees the exposures.

In accordance with the Dodd-Frank Act, “investment grade” in the final rule refers to the definition in the rule rather than to NRSRO ratings. The final rule defines “investment grade,” in pertinent part, to mean that the entity to which the System institution is exposed through a loan has adequate capacity to meet financial commitments for the projected life of the exposure. Such an entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

We do not intend for the elimination of NRSRO ratings to change substantively the standards System institutions must follow when deciding whether an exposure is investment grade. A System institution may, but is not required to, consider NRSRO ratings as part of its independent investment grade determination and due diligence. An institution’s consideration of NRSRO ratings must be supplemented by the institution’s own independent analysis; an exposure does not automatically satisfy an investment grade standard by virtue of its NRSRO rating.

We decline to eliminate the 100-percent risk weight for exposures to OFIs that do not satisfy the criteria for a more favorable risk weight. The higher risk inherent in exposures to those OFIs warrants the 100-percent risk weight that is generally applicable to corporate exposures.

Finally, in contrast to the FCA’s existing risk-based capital rules, all securities firms are subject to the same treatment as corporate exposures.

#### 7. Residential Mortgage Exposures

The FCA’s existing risk-based capital rules assign “qualified residential loans” to the 50-percent risk-weight category.<sup>97</sup> Qualified residential loans include both rural home loans authorized under § 613.3030 and single-family residential loans to bona fide farmers, ranchers, and producers and harvesters of aquatic products. Qualified residential loans must have been approved in accordance with prudent underwriting standards suitable for

residential property and must not be 90 days or more past due or carried in nonaccrual status.<sup>98</sup> If the loan does not satisfy these safety and soundness standards, or the property is not characteristic of residential property, the loan receives a 100-percent risk weight.

In general, although our existing rule is structured differently, our existing safety and soundness standards are very similar to the U.S. rule’s risk-weighting requirements for residential mortgage exposures.<sup>99</sup> The major differences between the two sets of rules are the FCA’s criteria regarding the characteristics of residential property, which the U.S. rule does not have.

In the interest of consistency, we now structure our final rule the same way as the Federal banking regulatory agencies do. Moreover, we adopt the safety and soundness standards of the Federal banking regulatory agencies. As mentioned above, and as discussed below, although these standards are already very similar, there are a few changes to our rule. Finally, while we retain two of our existing requirements regarding the characteristics of residential property, the final rule eliminates the rest of these requirements as unnecessary and burdensome.<sup>100</sup>

The final rule defines a residential mortgage exposure as an exposure (other than a securitization exposure or equity exposure) that is primarily secured by a first or subsequent lien on one-to-four family residential property, provided that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien.<sup>101</sup>

<sup>98</sup> See definition of *qualified residential loan* in § 615.5201. In addition to these credit risk standards, qualified residential loans must also satisfy a number of criteria designed to ensure that the property is residential in nature. The conditions for a loan to be considered nonaccrual are set forth in § 621.6(a) of the FCA’s regulations. This final rule does not change that provision.

<sup>99</sup> These agencies retained their existing risk-weighting requirements for residential mortgage exposures when they adopted their new capital rules.

<sup>100</sup> Although the final rule deletes the specific requirements in this area, FCA examiners will continue to verify that residential property securing an exposure risk weighted as a residential mortgage exposure does in fact exhibit characteristics of residential rather than agricultural property. If examiners determine that the property is agricultural in nature, they will require appropriate adjustment of the risk-based capital treatment.

<sup>101</sup> To ensure that the collateral is primarily residential rather than agricultural in nature, the final rule revises the definition adopted in the U.S. rule to include the requirement regarding the appraised value of the dwelling relative to the value of the collateral as a whole.

The final rule assigns a residential mortgage exposure to the 50-percent risk-weight category if the property is either owner-occupied or rented<sup>102</sup> and if the exposure was made in accordance with prudent underwriting standards suitable for residential property, including standards relating to the loan amount as a percentage of the appraised value of the property;<sup>103</sup> is not 90 days or more past due or carried in non-accrual status; and is not restructured or modified.<sup>104</sup>

A System institution must assign a 100-percent risk weight to all residential mortgage exposures that do not satisfy the criteria for a 50-percent risk weight.

The final rule maintains the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. Government or U.S. Government agencies. Accordingly, residential mortgage exposures that are unconditionally guaranteed by the U.S. Government or a U.S. Government agency receive a 0-percent risk weight, and residential mortgage exposures that are conditionally guaranteed by the U.S. Government or a U.S. Government agency receive a 20-percent risk weight.

Under the final rule, a residential mortgage exposure may be assigned to the 50-percent risk-weight category only if it is not restructured or modified. We believe this new restriction on System institution risk weighting, which the Federal banking regulatory agencies adopted, is appropriate based on risk.

However, a residential mortgage exposure modified or restructured on a permanent or trial basis solely pursuant to the U.S. Treasury’s Home Affordable Mortgage Program (HAMP) is not considered to be restructured or modified and continues to receive a 50-percent risk weighting. Treating mortgage loans modified pursuant to HAMP in this manner is appropriate in light of the special and unique incentive features of HAMP, and the fact that the program is offered by the U.S. Government to achieve the public policy objective of promoting sustainable loan modifications for homeowners at risk of foreclosure in a

<sup>102</sup> The FCA’s final risk-weighting provisions do not expand the lending authorities of System institutions.

<sup>103</sup> The requirement that the underwriting standards be suitable for residential property is the other requirement the final rule adds to ensure that the collateral is primarily residential rather than agricultural in nature.

<sup>104</sup> The FCA’s existing regulation does not prohibit loans that have been restructured or modified from receiving a 50-percent risk weight. The other requirements of the final rule carry over from our existing regulation.

<sup>97</sup> Section 615.5211(c)(2).

way that balances the interests of borrowers, servicers, and lenders.<sup>105</sup>

System institutions should be mindful that the residential mortgage market is likely to change in the future, in part because of regulations the CFPB is adopting to improve the quality of mortgage underwriting and to reduce the associated credit risk and in part for market-driven or other reasons. The FCA may propose changes in the treatment of residential mortgage exposures in the future. If so, we intend to take into consideration structural and product market developments, other relevant regulations, and potential issues with implementation across various product types.

#### 8. High Volatility Commercial Real Estate Exposures

We proposed to assign a 150-percent risk weight to HVCRE exposures, unless those exposures satisfied one or more of four specified exemptions. Because the System Comment Letter identified this as one of its threshold issues, we discuss this issue above, in Section I.D.8. of this preamble. As explained in that section, we are not finalizing the provisions governing HVCRE exposures at this time, but we expect that we will engage in additional rulemaking or issue guidance on HVCRE exposures in the future.

#### 9. Past Due and Nonaccrual Exposures

Under the FCA's existing risk-based capital rules, the risk weight of a loan does not change if the loan becomes past due or enters nonaccrual status, with the exception of certain residential mortgage loans. Like the Federal banking regulatory agencies, however, the FCA believes that a higher risk weight is appropriate for past due and nonaccrual exposures (such as past due or nonaccrual agricultural or other borrower loans) to reflect the increased risk associated with such exposures. We adopt without modification the proposed treatment of past due and nonaccrual exposures, which reflects the impaired credit quality of such exposures.

The final rule requires a System institution to assign a risk weight of 150 percent to an exposure that is not guaranteed or is not secured by financial collateral (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past

due or recognized as nonaccrual.<sup>106</sup> We believe this risk weight is appropriate and that any increased capital burden, potential rise in procyclicality, or impact on lending associated with the increased risk weight is justified given the overall objective of capturing the risk associated with the impaired credit quality of these exposures.

Moreover, the increased risk weight does not double-count the risk of a past due or nonaccrual exposure, even though the ALL is already reflected in the risk-based capital numerator, because the ALL is intended to cover estimated, incurred losses as of the balance sheet date, not unexpected losses. The higher risk weight on past due and nonaccrual exposures ensures sufficient regulatory capital for the increased probability of unexpected losses on these exposures.

Rather than assigning a 150-percent risk weight under this section, a System institution is permitted to assign a risk weight pursuant to §§ 628.36 and 628.37 to the portion of a past due or nonaccrual exposure that is collateralized by financial collateral or that is guaranteed if the financial collateral, guarantee, or credit derivative meets the requirements for recognition described in those sections.<sup>107</sup>

The System Comment Letter agreed that our proposed risk weight for past due exposures was consistent with that of the Federal banking regulatory agencies, but it expressed concern that the FCA, as a matter of examination practice, has been prescriptive and slow to recognize the performance of a loan that is in past due or nonaccrual status. The Letter stated that the FCA's approach has resulted in a significant level of cash-basis nonaccrual loans, and it asked the FCA to provide improved examination direction for the movement of loans from nonaccrual to accrual.

An association commented that System institutions are much more conservative than commercial banks in their willingness to move accounts into nonaccrual status even if the loans

remain in compliance and are current, as evidenced by the high percentage of current nonaccrual loans. This association asserted that requiring 50-percent additional capital for these loans will create an incentive to loosen these conservative standards, and it recommended that we revise the rule to apply only to exposures that are both 90 days past due and nonaccrual (rather than either 90 days past due or nonaccrual, as in the proposed rule). Alternatively, the association requested that we delete the nonaccrual standard completely and retain only the 90 days past due standard.

We decline to change, in this rulemaking, either our existing regulations governing nonaccrual status or the regulation governing risk weights for past due and nonaccrual loans that we now adopt. FCA's standards for nonaccrual loans are generally similar, although not identical, to those of the Federal banking regulatory agencies.<sup>108</sup> Although there may be some differences in standards that would result in some loans being considered nonaccrual in the System but not nonaccrual by a commercial bank, we believe nonaccrual exposures have more risk and therefore that a higher risk weight is warranted.<sup>109</sup>

Nevertheless, we appreciate the comments we received on this issue. The FCA's Spring 2016 Regulatory Projects Plan, adopted by the FCA Board on February 11, 2016, indicates that we are reviewing, through April 2016, a project that would consider amendments to the criteria for reinstating nonaccrual loans under § 621.9.<sup>110</sup>

<sup>108</sup> The Federal banking regulatory agencies do not appear to define nonaccrual standards by regulation. In its Instructions for Preparation of Consolidated Reports of Condition and Income (call report instructions), however, the Federal Financial Institutions Examination Council (FFIEC) defines nonaccrual status and explains when an asset is to be reported as being in nonaccrual status. The FFIEC is a formal interagency body established by law in 1979 and empowered, among other things, to prescribe uniform principles, standards, and report forms for the Federal examination of financial institutions by the Federal banking regulatory agencies. The instructions for FFIEC 031 (filed by banks with foreign offices) and FFIEC 041 (filed by banks without foreign offices) define "nonaccrual status" in the glossary (pp. A-59—A-62) and explain when an asset is to be reported as being in nonaccrual status (pp. RC-N-2—RC-N-3). These call report instructions were last updated in June 2015.

<sup>109</sup> As discussed above, our existing capital rules assign a 50 percent risk weight to "qualified residential loans," the definition of which includes that such loans are not 90 days or more past due or carried in nonaccrual status, while all other residential loans are assigned a 100 percent risk weight.

<sup>110</sup> <http://www.fca.gov/Download/RegProjPlanSpring2016.pdf>.

<sup>105</sup> The U.S. rule establishes risk weights for "pre-sold residential construction loans" and "statutory multifamily mortgages." These are loans that are authorized by statutes that do not apply to System institutions, and therefore we do not adopt risk weights for them.

<sup>106</sup> FCA regulations at subpart C of part 621 govern loan performance and valuation assessment. A loan is considered nonaccrual if it meets any of the conditions specified in § 621.6(a). A loan may be reinstated to accrual status if it meets each of the criteria specified in § 621.9.

<sup>107</sup> Final § 628.2 defines financial collateral as collateral in the form of, in pertinent part, cash, investment grade debt instruments that are not securitization exposures, publicly traded equity securities and convertible bonds, and mutual fund (including money market fund) shares if a price is publicly quoted daily, in which the System institution has a perfected, first-priority security interest (except for cash). Financial collateral does not include collateral such as real estate (whether agricultural or not) or chattel.

## 10. Other Assets

Generally consistent with our existing risk-based capital rules, the final rule assigns the risk weights described below for the following exposures:

(1) A 0-percent risk weight to cash owned and held in all offices of the System institution, in transit, or in accounts at a depository institution or a Federal Reserve Bank; to gold bullion held in a depository institution's vaults on an allocated basis to the extent gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade;

(2) A 20-percent risk weight to cash items in the process of collection;

(3) A 100-percent risk weight to DTAs arising from temporary differences relating to net operating loss carrybacks;

(4) A 100-percent risk weight to all MSAs; and

(5) A 100-percent risk weight to all assets not specifically assigned a different risk weight under this rule (other than exposures that would be deducted from tier 1 or tier 2 capital pursuant to § 628.22).

As discussed above, the FCA's final rule, unlike the U.S. rule, requires a System institution to deduct from capital all DTAs, other than those arising from temporary differences that relating to net operating loss carrybacks. In addition, because System institutions have such little exposure to MSAs, the final rule simplifies the capital treatment that would apply under the U.S. rule. Accordingly, we risk weight DTAs and MSAs as stated above rather than adopting the capital treatment, including the 250-percent risk weight, adopted in the U.S. rule.<sup>111</sup>

## 11. Exposures to Other System Institutions

Under final § 628.22, as discussed above, a System institution must deduct from regulatory capital all equity investments (including preferred stock) in another System institution, and therefore we do not provide a risk weighting for these investments. These investments could include, for example, an association's investment in a System bank and a System bank's investment in an association.

<sup>111</sup> If a System institution were to increase significantly its exposures to MSAs, we would consider exercising our authority to require a higher risk weight.

System institutions have the authority to enter into loss-sharing agreements with other System institutions under § 614.4340. If System institutions enter into a loss-sharing agreement in the future, the FCA would assign a risk weight for any associated exposures at that time, using our regulatory reservation of authority.

## 12. Specialized Exposures

By FCA Bookletter BL-052, dated January 25, 2006, the FCA permitted loans recorded before January 1, 2006 that were supported by Tobacco Buyout assignments to be risk weighted at 20 percent.<sup>112</sup> FCA Bookletter BL-052 will remain in effect for the duration of these loans. Accordingly, this capital treatment does not need to be addressed in this final rule, and no additional guidance is necessary.

By FCA Bookletter BL-053, dated February 27, 2007, the FCA permitted System institutions to assign a lower risk weight than would otherwise apply to certain electrical cooperative assets, based on the unique characteristics and lower risk profile of this industry segment.<sup>113</sup> We did not propose this favorable risk weighting for these exposures in this rule, but we sought comment as to whether we should retain this risk weighting. Because the System Comment Letter identified this as one of its threshold issues, we discuss this issue above, in Section I.D.7. of this preamble. As explained in that section, we do not include this lower risk weight for exposures to electric cooperative assets in this final rule, but FCA Bookletter BL-053 remains in effect. We continue to evaluate the comments we have received and anticipate that we will issue further guidance on the capital treatment of these exposures in the future.

### C. Off-Balance Sheet Items

#### 1. Credit Conversion Factors (CCF)

Under this final rule, as under our existing risk-based capital rules, a System institution calculates the exposure amount of an off-balance sheet item by multiplying the off-balance sheet component, which is usually the contractual amount, by the applicable CCF. This treatment applies to off-balance sheet items, such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements.

<sup>112</sup> Such loans recorded after this date were required to be risk weighted at 100 percent.

<sup>113</sup> We authorized this treatment under our regulatory reservation of authority.

We proposed to impose the risk weight and CCF requirements on the unused commitment of a System bank to an association to fund the direct loan.<sup>114</sup> The agreement by a System bank to fund an association's direct loan satisfies the rule's definition of commitment, which is "any legally binding agreement that obligates a System institution to extend credit or to purchase assets."<sup>115</sup> Moreover, as discussed in the preamble to the proposed rule, we believe these commitments carry risk that warrants the holding of capital against them.

Because the System Comment Letter identified this as one of its threshold issues, we discuss this issue above, in Section I.D.9. of this preamble. We discuss several technical and mechanical issues in this section.

This final rule clarifies that unused commitments on bank loans to OFIs are also subject to this capital treatment. Although it was not stated explicitly in the proposed rule, it was clear from the definition of "commitment" that commitments from banks to OFIs were included in this provision.<sup>116</sup>

We provide the clarification that several commenters sought on the mechanics of the capital calculation. One commenter asked FCA to confirm that a 20-percent CCF would be applied to the wholesale unused commitment and that a 20-percent risk weight would be applied to the association obligor. With respect to associations, we confirm both of these interpretations. Under final § 628.33(b)(2)(iii), a System bank's unused commitment to an association that is not unconditionally cancelable by the System bank is assigned a 20-percent CCF, regardless of maturity. And final § 628.32(c) assigns a 20-percent risk weight to an exposure to a GSE (other than an equity exposure or preferred stock), including direct loans from System banks to associations.<sup>117</sup>

Another commenter presumed, since the GFA is usually a multi-year agreement, that a 50-percent CCF would be assigned to the commitment. As discussed above, the final rule assigns a

<sup>114</sup> Such a commitment is not unconditionally cancelable by the System bank. Under the GFA that governs the commitment, a System bank must continue to fund the direct loan as long as the association or OFI satisfies specified conditions.

<sup>115</sup> Section 628.2.

<sup>116</sup> We note that FCA regulation § 614.4560 requires System banks and OFIs to execute GFAs that are subject to the same regulations that bank-association GFAs are subject to.

<sup>117</sup> The unused commitment of a bank to an OFI that is not unconditionally cancelable by the System bank is also subject to a 20-percent CCF, regardless of maturity. As discussed above, OFI exposures are assigned a risk weight of 20 percent, 50 percent, or 100 percent, depending on the OFI.

20-percent CCF to the commitment, regardless of its term, whether it is to an association or to an OFI.

A commenter asked how the commitment amount should be calculated, since the excess amount of the borrowing base changes on a daily basis. As discussed above, FCA regulation § 614.4125(d), which requires the GFA or promissory note to establish a maximum credit limit determined by objective standards, requires the maximum credit limit to be a specific dollar amount rather than an amount based on the daily borrowing base. Final § 628.33(a)(5) provides that the exposure amount of a System bank's unused commitment to an association or OFI is the difference between the association's or OFI's maximum credit limit with the System bank (as established by the general financing agreement or promissory note, as required by § 614.4125(d)) and the amount the association or OFI has borrowed from the System bank. For example, if a System bank has a \$100 maximum credit limit to an association or OFI and the association or OFI has \$80 outstanding on its direct loan, the System bank's exposure amount on its unused commitment would be \$20.

A commenter asked how frequently this calculation should be performed. An institution must remain above the minimum capital requirements at all times, and it must therefore perform the calculation as often as is necessary to ensure compliance with these regulations.

Similar to the current risk-based capital rules, under the final rule a System institution would apply a 0-percent CCF to the unused portion of commitments that are unconditionally cancelable by the institution. Unconditionally cancelable means a commitment that a System institution may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law). In the case of an operating line of credit, a System institution is deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable law. If a System institution provides a commitment that is structured as a syndication, it is required to calculate the exposure amount only for its pro rata share of the commitment.

The final rule maintains the current 20-percent CCF for self-liquidating, trade-related contingencies with an original maturity of 14 months or

less.<sup>118</sup> In addition, the final rule increases the CCF from 0 percent to 20 percent for commitments with an original maturity of 14 months or less that are not unconditionally cancelable by a System institution.

As under our existing risk-based capital rules, under the final rule a System institution would apply a 50-percent CCF to unused commitments with an original maturity of more than 14 months that are not unconditionally cancelable by the institution (except, as discussed above, commitments of System banks to fund direct loans to associations or OFIs, which have a CCF of 20 percent) and to transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

Under this final rule, a System institution would be required to apply a 100-percent CCF to off-balance sheet guarantees, repurchase agreements, credit-enhancing representations and warranties that are not securitization exposures, securities lending and borrowing transactions, financial standby letters of credit, forward agreements, and other similar exposures. The off-balance sheet component of a repurchase agreement equals the sum of the current fair values of all positions the System institution has sold subject to repurchase. The off-balance sheet component of a securities lending transaction is the sum of the current fair values of all positions the System institution has lent under the transaction. For securities borrowing transactions, the off-balance sheet component is the sum of the current fair values of all non-cash positions the institution has posted as collateral under the transaction. In certain circumstances, a System institution may instead determine the exposure amount of the transaction as described in § 628.37 of the final rule.

In contrast to our existing risk-based capital rules, which require capital for securities lending and borrowing transactions and repurchase agreements only if they generate an on-balance sheet exposure, the final rule requires a System institution to hold risk-based capital against all repo-style transactions (that is, repurchase

<sup>118</sup> As under our existing rules, we adopt a 14-month rather than a 12-month original maturity because the agricultural production cycle and related marketing efforts typically extend beyond 12 months. A 14-month maturity allows a commitment for an operating loan to cover an entire cycle. A new commitment would be issued for the next cycle. Allowing more favorable capital treatment for a 14-month rather than a 12-month commitment does not materially raise risk in the portfolios of System institutions.

agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions), regardless of whether they generate on-balance sheet exposures, as described in § 628.37 of the final rule. For example, capital is required against the cash receivable that a System institution generates when it borrows a security and posts cash collateral to obtain the security. We adopt this approach because System institutions face counterparty credit risk when engaging in repo-style transactions, even if those transactions do not generate on-balance sheet exposures, and thus these transactions should not be exempt from risk-based capital requirements.

## 2. Credit-Enhancing Representations and Warranties

Consistent with our existing risk-based capital rules, under the final rule a System institution is subject to a risk-based capital requirement when it provides credit-enhancing representations and warranties on assets sold or otherwise transferred to third parties, as such positions are considered recourse arrangements.<sup>119</sup>

A System institution is required to hold capital only for the maximum contractual amount of its exposure under the representations and warranties, not against the value of the underlying loan. Moreover, a System institution must hold capital for the life of a credit-enhancing representation and warranty, but not after its expiration, regardless of the maturity of the underlying loan.

### D. Over-the-Counter Derivative Contracts

We proposed capital treatment that would require a System institution to hold risk-based capital for counterparty credit risk for an OTC derivative contract. We received no comments on this proposed capital treatment, and we adopt it as proposed.

As defined in final § 628.2, a derivative contract is a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. A derivative contract includes interest rate, exchange rate, equity, commodity, credit, and any other derivative contract that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular

<sup>119</sup> Sections 615.5201 and 615.5210.

instrument or 5 business days. This applies, for example, to mortgage-backed securities (MBS) transactions that the GSEs conduct in the To-Be-Announced market.

Under the final rule, an OTC derivative contract does not include a derivative contract that is a cleared transaction, which is subject to a specific treatment as described elsewhere in this preamble.

The preamble to the proposed rule explains how to determine the risk weighted asset amount for a single OTC derivative contract that is not subject to a qualifying master netting agreement and for multiple OTC derivative contracts subject to a qualifying master netting agreement.<sup>120</sup> It also explains how to recognize, in risk weighting OTC derivative contracts, the risk mitigation benefits of financial collateral and credit derivatives.<sup>121</sup>

Rather than repeating the discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>122</sup>

#### *E. Cleared Transactions*

Like the BCBS and the Federal banking regulatory agencies, the FCA supports incentives designed to encourage clearing of derivative and repo-style transactions<sup>123</sup> through a central counterparty (CCP) wherever

<sup>120</sup> The Federal banking regulatory agencies and the Federal Housing Finance Administration, together with the FCA, have adopted a rule that establishes minimum margin requirements for covered swap entities. 80 FR 74040, November 30, 2015. That margin rule permits a covered swap entity to calculate variation margin requirements on an aggregate, net basis under an eligible master netting agreement with a counterparty. In order to minimize operational burden for a covered swap entity, which otherwise would have to make a separate determination as to whether its netting agreements meet the requirements of this capital rule as well as comply with the margin rule, the definition of eligible master netting agreement in the margin rule aligns with the definition of qualifying master netting agreement in this capital rule. Like the proposed capital rule, however, this final capital rule uses the term “qualifying master netting agreement” to avoid confusion with and distinguish from the term used under the margin rules.

<sup>121</sup> Final § 628.2 defines financial collateral as collateral in the form of, in pertinent part, cash, investment grade debt instruments that are not resecuritization exposures, publicly traded equity securities and convertible bonds, and mutual fund (including money market fund) shares if a price is publicly quoted daily, in which the System institution has a perfected, first-priority security interest (except for cash). Financial collateral does not include collateral such as real estate (whether agricultural or not) or chattel.

<sup>122</sup> See Section IV.D. of the preamble to the proposed rule, 79 FR 52838–52840, September 4, 2014.

<sup>123</sup> See § 628.2 of the final rule for the definition of a repo-style transaction.

possible in order to promote transparency, multilateral netting, and robust risk management practices. Although there are some risks associated with CCPs, we believe that CCPs generally help improve the safety and soundness of the derivatives and repo-style transactions markets through the multilateral netting of exposures, establishment, and enforcement of collateral requirements, and the promotion of market transparency.

We adopt without change the capital treatment that we proposed for cleared transactions. We received one comment that supported this proposed capital treatment.<sup>124</sup>

Under the final rule, a System institution, acting as a clearing member client, is required to hold risk-based capital for all of its cleared transactions. The preamble to the proposed rule explains the definition of cleared transaction, as well as other relevant terms, such as clearing member client. It also explains that derivative transactions must satisfy additional criteria to be cleared transactions and that derivative transactions that do not meet these additional criteria are OTC derivative transactions. In addition, it explains the capital treatment for cleared transactions.

Rather than repeating the discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>125</sup>

#### *F. Credit Risk Mitigation*

System institutions use a number of techniques to mitigate credit risks. For example, a System institution may collateralize exposures with cash or securities; a third party may guarantee an exposure; a System institution may buy a credit derivative to offset an exposure’s credit risk; or a System institution may net exposures with a counterparty under a netting agreement.

<sup>124</sup> The Federal banking regulatory agencies adopted regulatory provisions contemplating that their regulated banking organizations could act as clearing members as well as clearing member clients. We did not propose comparable provisions based on our belief that System institutions would not want to act as clearing members because of the complexity, and we stated that in the absence of such regulations, we could address risk-weighting issues on a case-by-case basis. In response to our specific invitation for comment on whether we should adopt such provisions, the System Comment Letter agreed with our omission, stating that the commenters applauded FCA’s overall philosophical approach of not including complicated provisions that are not currently applicable and, as a result, are unnecessary. Accordingly, the final rule, like the proposed rule, contains no such provisions.

<sup>125</sup> See Section IV.E. of the preamble to the proposed rule, 79 FR 52840–52842, September 4, 2014.

The final rule adopts without change the proposed rule’s approach to allowing System institutions to recognize the risk-mitigation effects of guarantees, credit derivatives, and collateral for risk-based capital purposes. We received one comment that supported this proposed capital treatment.<sup>126</sup>

As the preamble to the proposed rule explains, a System institution generally may use a substitution approach to recognize the credit risk mitigation effect of an eligible guarantee from an eligible guarantor and the simple approach to recognize the credit risk mitigation effect of collateral. That preamble explains these approaches in detail.

The preamble to the proposed rule also explains that although the use of credit risk mitigants may reduce or transfer credit risk, it simultaneously may increase other risks, including operational, liquidity, or market risk. Accordingly, a System institution is expected to employ robust procedures and processes to control risks, including roll-off and concentration risks, and monitor and manage the implications of using credit risk mitigants for the institution’s overall credit risk profile.

Rather than repeating the discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>127</sup>

#### *G. Unsettled Transactions*

The final rule provides for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities

<sup>126</sup> Unlike the Federal banking regulatory agencies, we did not propose to permit System institutions to calculate market price volatility and foreign exchange volatility using their own internal estimates. We explained that we believed, due to the complexity of developing and using these estimates, that no System institution would be likely to use its own estimates of haircuts, and we noted that even without such a provision, we would be able to permit a System institution to use its own estimates in the future on a case-by-case basis, using standards similar to those contained in the U.S. rule.

In response to our request for comment on whether our regulation should permit the use of a System institution’s own estimates, the System Comment Letter stated that it saw no need for a provision of this nature. It stated that the provisions we had proposed appear currently workable for the System, and it applauded the FCA for not including provisions that are not currently applicable or expected to be needed any time soon. Accordingly, like the proposed rule, the final rule does not permit System institutions to calculate market price volatility and foreign exchange volatility using their own internal estimates.

<sup>127</sup> See Section IV.F. of the preamble to the proposed rule, 79 FR 52842–52846, September 4, 2014.

that have a risk of delayed settlement or delivery. This capital requirement does not, however, apply to certain types of transactions, including:

- (1) Cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin;
- (2) Repo-style transactions, including unsettled repo-style transactions;
- (3) One-way cash payments on OTC derivative contracts; or
- (4) Transactions with a contractual settlement period that is longer than the normal settlement period (which the rule defines as the lesser of the market standard for the particular instrument or 5 business days).<sup>128</sup>

Under the final rule, in the case of a system-wide failure of a settlement, clearing system, or central counterparty, the FCA may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

This capital treatment is unchanged from that in the proposal. We received no comments on this proposed capital treatment.

The preamble to the proposed rule explains that the rule provides separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non DvP/PvP transactions with a normal settlement period. It explains these transactions and their capital treatments.

Rather than repeating the discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>129</sup>

#### *H. Risk Weighted Assets for Securitization Exposures*

Under the FCA's existing risk-based capital rules, a System institution may use external ratings issued by NRSROs to assign risk weights to certain recourse obligations, residual interests, direct credit substitutes, asset-backed securities (ABS), and MBS. The final rule revises the risk-based capital framework for securitization exposures. These revisions include removing references to and reliance on credit ratings to determine risk weights for these exposures and using alternative standards of creditworthiness, as required by section 939A of the Dodd-Frank Act. In addition, we update the

terminology for the securitization framework, include a definition of a securitization exposure that encompasses a wider range of exposures with similar risk characteristics, and implement new due diligence requirements for securitization exposures.

The final rule adopts without change the proposed risk-based capital framework for securitization exposures. The final rule defines a securitization exposure as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure.

The preamble to the proposed rule (1) explains that the securitization framework is designed to address the credit risk of exposures that involve the tranching of the credit risk of one or more underlying financial exposures;<sup>130</sup> (2) provides an overview of the securitization framework and explains the definitions of terms used in the framework, such as traditional securitization, synthetic securitization, and resecuritization exposure; (3) explains the operational requirements for institutions using the securitization framework, including due diligence requirements; (4) explains that System institutions generally must calculate a risk weighted asset amount for a securitization exposure by applying either the simplified supervisory formula approach or a gross-up approach; (5) explains how to determine the exposure amount of a securitization exposure; and (6) explains exceptions under the securitization framework, alternative treatments for certain types of securitization exposures, and other important matters.

Rather than repeating the comprehensive discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>131</sup> We received two comments on this proposed capital treatment, which we now address.

First, we received comments on the omission of references to asset-backed commercial paper (ABCP) programs in the proposed rule. The U.S. rule excludes certain exposures to asset-backed commercial paper (ABCP) programs from the definition of resecuritization exposure. That rule defines an ABCP program as a program established primarily for the purpose of issuing commercial paper that is investment grade and backed by underlying exposures held in a bankruptcy-remote special purpose entity.

The System has access to the capital markets through the Funding Corporation; we believe it unlikely that a System institution would establish an ABCP program, because if the Funding Corporation's ability to issue debt ever was impeded, we believe the ability of an ABCP program to issue commercial paper would face the same difficulties. Accordingly, in the interest of simplifying our regulations where possible, we proposed to make no reference to ABCP programs.

In response to our specific request for comment as to whether we should include provisions in our risk-based capital rules regarding ABCP programs that are comparable to those in the U.S. rule, the System Comment Letter stated that our reason for proposing to omit ABCP provisions seemed reasonable and logical, that it seemed unlikely that either the System or an individual System bank would seek to establish an ABCP program, and that in the unlikely event they did want to establish such a program, the FCA could address it on a case-by-case basis. The Letter concluded, therefore, that ABCP provisions are unnecessary. Accordingly, the final rule, like the proposed rule, makes no reference to ABCP programs.

Second, we received comments on the due diligence requirements that we proposed for securitization exposures. Like the U.S. rule, our proposed due diligence requirements were designed to address the concern among regulators that during the recent financial crisis, many banking organizations relied exclusively on NRSRO ratings and did not perform their own credit analysis of the securitization exposures.

Our proposed rule would have required a System institution to demonstrate, to the FCA's satisfaction, a comprehensive understanding of the features of a securitization exposure that would materially affect the exposure's performance. The proposed rule would have required the System institution's analysis to be commensurate with the complexity of the exposure and the

<sup>128</sup> Such transactions are treated as derivative contracts as provided in § 628.34 or § 628.35 of the rule.

<sup>129</sup> See Section IV.G. of the preamble to the proposed rule, 79 FR 52846–52847, September 4, 2014.

<sup>130</sup> Only those MBS that involve tranching of credit risk are considered securitization exposures. Mortgage-backed pass-through securities (for example, those guaranteed by Freddie Mac or Fannie Mae) that feature various maturities but do not involve tranching of credit risk do not meet the definition of a securitization exposure. These securities are risk weighted in accordance with the general risk-weighting provisions.

<sup>131</sup> See Section IV.H. of the preamble to the proposed rule, 79 FR 52847–52854, September 4, 2014.

materiality of the exposure in relation to capital of the institution. On an on-going basis (no less frequently than quarterly), the System institution would have been required to evaluate, review, and update as appropriate the analysis required under § 628.41(c)(1) for each securitization exposure. The pre- and periodic post-acquisition analysis of the exposure's risk characteristics would have had to consider:

(1) Structural features of the securitization that would materially affect the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(2) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s);

(3) Relevant market data on the securitization, for example, bid-ask spread, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(4) For resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures.

Under the proposed rule, if the System institution was not able to meet these due diligence requirements and demonstrate a comprehensive understanding of a securitization exposure to the FCA's satisfaction, the institution would have been required to assign a risk weight of 1,250 percent to the exposure.

The System Comment Letter asserted that these due diligence requirements for "investment securities" contained in proposed § 628.41(c) significantly overlapped with the existing regulatory requirements on investment management in subpart E of part 615. The result, according to the Letter, would be significant redundancy and regulatory burden. The commenters asked us to make conforming changes to either the proposed capital rules or the existing investment management rules to eliminate duplication and potentially conflicting requirements.

We note, contrary to the assertion of the System Comment Letter, that the new due diligence requirements contained in proposed § 628.41(c) do not apply to "investment securities". Rather, this regulation applies to securitization exposures, the definition of which is discussed above. In contrast, our investment management regulations in subpart E of part 615, including the due diligence requirements at § 615.5133(f), apply only to investments that System banks and associations are authorized to hold for specified purposes. These investments must satisfy FCA's eligibility requirements or be specifically approved by FCA.<sup>132</sup>

If a System institution has a securitization exposure that is subject to our investment management regulations, then both our investment management due diligence regulation and the new securitization exposure due diligence regulation would apply. If, however, a System institution has a securitization exposure that is not subject to our investment management regulations, then only the securitization exposure due diligence regulation would apply, and not our investment management due diligence regulation. And if a System institution has an investment subject to our investment management regulations that is not a securitization exposure, then only our investment management due diligence regulation would apply, and not the new securitization exposure due diligence regulation.

Accordingly, for some exposures, only one due diligence regulation applies. Securitization exposures that are subject to our investment management regulations, however, are subject to both due diligence regulations. We do not believe these two due diligence regulations conflict with each other. Some requirements are contained in one regulation but not the other. For example, our investment management regulations require stress testing, while the securitization exposure regulation does not. Securitization exposures that are subject to our investment management regulations, therefore, like other investments, are subject to the investment management stress testing requirements.

Some requirements, such as risk analysis or value determination, are set forth in both regulations. For securitization exposures that are subject to our investment management regulations, institutions must fulfill the requirements of both regulations, but if one analysis or determination satisfies both regulations, they only need to

<sup>132</sup> See §§ 615.5132, 615.5140, and 615.5142.

perform it once, thus eliminating any potential duplication.

Because any potential overlaps can be satisfied with a single analysis or determination, we do not believe it is burdensome for an institution to have to comply with both regulations. Accordingly, we decline to change either of these regulations.

### *I. Equity Exposures*

As discussed above, under § 628.22, a System institution must deduct from regulatory capital all equity investments (including preferred stock) in another System institution. Section 628.22 also requires a System institution to deduct from regulatory capital all equity investments in a service corporation or the Funding Corporation. Accordingly, we do not assign a risk weighting for these equity investments.

This final rule revises our existing risk-based capital rules' treatment for equity exposures that are not to other System institutions, service corporations, or the Funding Corporation. Institutions could acquire such exposures, for example, by making equity investments in UBEs,<sup>133</sup> by making equity investments in rural business investment companies (RBICs),<sup>134</sup> by making equity investments that the FCA approves under § 615.5140(e), and by acquiring equity exposures pledged as collateral in a loan or derivative transaction.

The rule requires a System institution to apply the Simple Risk-Weight Approach for equity exposures that are not exposures to an investment fund and to apply certain look-through approaches to assign risk weighted asset amounts to equity exposures to an investment fund.

We received no comments on the capital treatment for equity exposures that we proposed. We adopt this capital treatment without change, except for the following. We do not adopt the provisions we proposed assigning risk weights to equity exposures authorized under FCA regulation § 615.5140(e). System institutions are authorized to acquire equity exposures under that regulation only with FCA's prior approval, and we assign a risk weight as a condition of that approval. Accordingly, it is unnecessary to assign

<sup>133</sup> System institutions have the authority to invest in UBEs under FCA regulations at subpart J of part 611.

<sup>134</sup> Authority for System institutions to invest in RBICs is governed by 7 U.S.C. 2009cc *et seq.*; these investments do not require the FCA's approval. However, a System institution that wishes to invest in a UBE organized for investing in an RBIC must comply with FCA's UBE regulations at subpart J of part 611.

a risk weight to such exposures by regulation.

The preamble to the proposed rule explains the definition of equity exposure and exposure measurement. It explains how to calculate the risk weight for various equity exposures, including those that form effective hedge pairs. It also explains the three methods of assigning risk weights to equity exposures to investment funds. Rather than repeating the discussion of this capital treatment that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion in that preamble.<sup>135</sup>

## V. Market Discipline and Disclosure Requirements

Meaningful public disclosure by banking organizations is one of the three pillars of the Basel framework. Public disclosure complements the minimum capital requirements and the supervisory review process by encouraging market discipline. The other Federal banking regulatory agencies adopted disclosure requirements for the banking organizations that they regulate with \$50 billion or more in assets.

We proposed similar disclosure requirements for System banks on a bank-only basis (not on a consolidated, district-wide basis). In our proposal, we explained that the disclosure requirements are appropriate for all System banks—even those that currently have less than \$50 billion in assets—because they are jointly and severally liable for the Systemwide debt obligations that they issue.<sup>136</sup> We further explained that a System bank's exposure to risks and the techniques that it uses to identify, measure, monitor, and control those risks are important factors that market participants consider in their assessment of the bank. We made clear that a System bank would not have to make any disclosures that do not apply to it.<sup>137</sup>

The proposal required each System bank to make these disclosures in its quarterly and annual reports to shareholders that are required in part 620 of our regulations.<sup>138</sup> We

specifically addressed potential concerns about duplicative disclosures by stating that System banks would not be required to make the disclosures in the exact format set out in the proposed regulations, or in the same location in the report, as long as they provide a summary table specifically indicating the location(s) of all disclosures.

We believed the proposal struck the proper balance between the market benefits of disclosure and the burden of providing the disclosures, and we invited comment on the appropriate application of the proposed disclosure requirements to System banks.

We received comments in the System Comment Letter and from several individual System institutions on the proposed disclosure requirements. The commenters objected to these requirements because the disclosures would not be harmonized across the System; associations would have one set of disclosures, banks would have another, combined district disclosures would be different from those of the bank, and the System-wide disclosure would be different yet again. They stated that this disclosure regime is not a good fit for the federated cooperative structure of the System. They asked the FCA to work with System banks on appropriate enhancements to the existing required disclosures in part 620 through other guidance, such as an Informational Memorandum, stating that this approach would be more flexible and not encumber the regulations with excessive requirements that apply to only four entities.

These comments do not persuade us to change the disclosure requirements we proposed. As discussed above, our existing regulations in part 620 require each System institution to prepare annual and quarterly reports. The regulations we proposed and that we now adopt without substantive change require System banks to disclose additional information that is particularly relevant to market participants as they assess the System's risk, providing a more transparent picture of System institutions' capital to the investment-banking sector.

We understand that any change in disclosure requirements may increase burden, as parties are required to disclose information they have never

previously had to disclose. We believe, however, that the benefit of these additional disclosures outweighs any burden that might result. The disclosure requirements are similar to those adopted by the Federal banking regulatory agencies. As discussed above and in the preamble to our proposed rule, the System urged the FCA to adopt a capital framework that was as similar as possible to the U.S. rule, asserting that consistency and transparency would allow investors, shareholders, and others to better understand the financial strength and risk-bearing capacity of the System. We believe this rule accomplishes that objective.

A System bank also commented that the requirement is unfair because the four System banks are independent institutions with separate boards of directors, different charters, and diverse business models, and the total assets of two of the banks are below the \$50 billion threshold that would trigger the requirement under the U.S. rule. Even though the banks are directed and managed independently of each other, we believe that all four of them—even those that currently have less than \$50 billion in assets—should be required to make these disclosures. Each bank is jointly and severally liable for the System-wide debt obligations that they issue; market participants would be unable to assess the risk in the debt without having access to this information from all four banks.

Accordingly, we adopt as final our proposal to require all System banks to make disclosures, without substantive change other than to reflect differences from the proposed capital requirements. Rather than repeating the discussion of these disclosure requirements that we provided in the preamble to the proposed rule, we invite interested persons to review the discussion that preamble.<sup>139</sup>

## VI. Conforming and Clarifying Changes

The proposed rule contained a number of conforming changes to current FCA regulations. Except for a modification of the proposed change to § 614.4351 as discussed below, we adopted the proposed changes in the final rule. We also added numerous additional nonsubstantive clarifying and conforming changes that were not in the proposed rule, primarily adding references in existing rules to the new part 628. The changes include:

In § 607.2(b), which defines “average risk-adjusted asset base” for purposes of the FCA's assessment and

<sup>135</sup> See Section IV.I. of the preamble to the proposed rule, 79 FR 52854–52857, September 4, 2014.

<sup>136</sup> Nothing in this proposed regulation or preamble would change any of our existing regulatory requirements, including those in part 620 or part 621.

<sup>137</sup> For example, Table 1 requires a System bank to make certain disclosures about subsidiaries. If a System bank has no subsidiaries, it does not have to make those disclosures.

<sup>138</sup> Sections 620.2 and 620.4 of the FCA's regulations require each System institution to

prepare, provide to the FCA and shareholders, and make available to the public an annual report after the end of each fiscal year. Sections 620.2 and 620.10 require each System institution to prepare, provide to the FCA and shareholders, and make available to the public a quarterly report after the end of each fiscal quarter (except the fiscal quarter that coincides with the end of the System institution's fiscal year).

<sup>139</sup> See Section V. of the preamble to the proposed rule, 79 FR 52857–52859, September 4, 2014.

apportionment of administrative expenses, we replaced the reference to § 615.5210 with a reference to § 615.5201.

In § 611.1265(e), which pertains to an institution in the process of terminating Farm Credit status, we deleted a reference to subpart K of part 615 and added a reference to part 628.

In proposed § 614.4351(a)(3), which describes the lending and leasing limit base for System institutions, we proposed to replace the reference to total surplus with a reference to tier 2 capital. The System Comment Letter pointed out that our proposed change had the potential effect of excluding third-party preferred stock from an institution's lending and leasing limit base if such stock is excluded under new § 628.23 from the institution's tier 1 and tier 2 capital. We agree with the System that our proposed change could have had this unintended effect. In the final rule, we have modified the language to ensure the inclusion of excess third-party capital under § 628.23 in the lending and leasing limit base, provided such preferred stock is otherwise includible in tier 1 or tier 2 capital.

In § 615.5143(a) and (b), pertaining to the management of ineligible investments, we removed references to net collateral.

In § 615.5200, which contains capital planning requirements, we removed references to total capital, surplus, core surplus, total surplus, and unallocated surplus; we added references to CET1, tier 1 capital, total capital, and tier 1 leverage ratio and made other minor nonsubstantive and technical changes. We also made a number of substantive changes in § 615.5200 that are described above in Section D.3. of this preamble.

In § 615.5201, we removed of definitions that are no longer used in revised part 615, subpart H, including "bank," "commitment," "credit conversion factor," "credit derivative," "credit-enhancing interest-only strip," "credit-enhancing representations and warranties," "deferred-tax assets that are dependent on future income or future events," "direct credit substitute," "direct lender institution," "externally rated," "face amount," "financial asset," "financial standby letter of credit," "Government agency," "Government-sponsored agency," "institution," "nationally recognized statistical rating organization," "non-OECD bank," "OECD," "OECD bank," "performance-based standby letter of credit," "qualified residential loan," "qualifying bilateral netting contract," "qualifying securities firm," "recourse," "residual interest," "risk participation,"

"Rural Business Investment Company," "securitization," "servicer cash advance," "total capital," "traded position," and "U.S. depository institution"; we revised the definitions of "permanent capital" and "risk-adjusted asset base"; and we added definitions of "deferred tax assets," "System bank," and "System institution." We also added back the definition of "allocated investment," which was inadvertently transferred to part 628 definitions in the proposed rule.

In §§ 615.5206 and 615.5208, we removed references to the defunct Farm Credit System Financial Assistance Corporation (FAC) in § 615.5206(a); we removed §§ 615.5206(d) and 615.5208(c), which pertain to the FAC; and we made other minor nonsubstantive and technical changes.

In § 615.5207, which pertains to adjustments in the permanent capital computation, we made revisions in paragraph (f) to require deduction of an investment in the Funding Corporation and in paragraph (j) to eliminate the exclusion of AOCI and to require the exclusion of any defined benefit pension fund net asset, in order to make the deductions from the numerator of the permanent capital calculation consistent with the deductions from the denominator.

We removed §§ 615.5209 through 615.5212, which pertain to risk-weighting for the permanent capital ratio. Under the final rule, the denominator of the permanent capital ratio will be computed using the risk weightings in part 628.

In § 615.5220, which pertains to the capitalization bylaws, we made minor nonsubstantive and technical changes.

In § 615.5240, which sets forth a number of permanent capital requirements, we added a reference to the regulatory capital standards in proposed part 628.

In § 615.5250, which contains disclosure requirements for borrower stock, we added references to the regulatory capital standards in part 628.

In § 615.5255, which contains disclosure and review requirements for other equities, we added a reference to the new part 628 capital standards as suggested by the System Comment Letter and made minor nonsubstantive and technical changes. We did not make other changes requested by the System. In the event a disclosure statement is deemed to be cleared 60 days after receipt by the FCA of a proposed disclosure statement under paragraph (f), we did not add a reference to new part 628 that would have permitted the institution to treat the proposed

issuance as CET1, additional tier 1, or tier 2 capital. This is consistent with the existing regulation's approach to core surplus, total surplus, and net collateral. We also did not shorten the FCA review period from 30 days to 5 days in paragraph (h) or the review period from 60 days to 30 days in paragraph (f). The suggested timeframes are not adequate for the agency's review procedures. In the case of third-party capital issuances, we are sensitive to the fact that institutions often have tight timeframes related to market expectations and timing, and we believe that we have been able to accommodate requests to expedite our review procedures whenever feasible.

We revised § 615.5270, pertaining to the retirement of equities other than eligible (protected) borrower stock, to incorporate restrictions and limits on redemptions of equities that are included in tier 1 and tier 2 capital.

In § 615.5290, pertaining to the retirement of capital stock and participation certificates in the event of restructuring, we made minor nonsubstantive and technical changes.

In § 615.5295, which pertains to the payment of dividends, we added a reference to part 628.

We removed part 615, subpart K, which contained the requirements for the core surplus, total surplus, and net collateral standards.

In §§ 615.5350, 615.5352, and 615.5355, pertaining to the establishment of minimum capital ratios for an individual institution, we replaced references to core surplus, total surplus, and net collateral with references to tier 1 and tier 2 capital.

In § 620.5, which lists the required contents of a System institution's annual report, we replaced references to core surplus, total surplus, and net collateral with references to the new part 628 regulatory capital requirements (including initial compliance plans under § 628.301) in paragraphs (d)(1)(ix), (f)(2) and (3), and (g)(4). In addition, we added a new paragraph (4) in § 620.5(f) to require disclosure of the core surplus, total surplus, and net collateral ratios in System institutions' annual reports for the years 2017–2021 for as long as these years are part of the "previous 5 fiscal years" for which disclosures are required.

We revised § 620.17, pertaining to notifying stockholders when a System institution falls below minimum capital requirements, to expand the notification requirement to include the regulatory capital standards in part 628.

In § 624.12, pertaining to the margin and capital requirements for covered

swap entities, we added a reference to part 628 in paragraph (b).

In § 627.2710, which sets forth the grounds for appointing a conservator or receiver, we deleted references to the total surplus and net collateral ratios.

## VII. Timeframe for Implementation

Our proposed rule provided for an effective date of January 1, 2016. In the final rule, we are adopting an effective date of January 1, 2017.

We also proposed a 3-year phase-in period for the capital conservation buffer but without any transition or phase-in periods for regulatory adjustments to or deductions in the regulatory capital calculations. By contrast, Basel III and the U.S. rule have, in addition to the capital conservation buffer, numerous phase-in and transition periods for the capital regulations lasting from 2014 (2015 for banking organizations not using the advanced approaches rules) until 2019 or after. Many of the transition provisions pertain to regulatory deductions and adjustments, minority interests, and temporary inclusion of non-qualifying instruments. We have determined that most of the transition and phase-in periods are not needed to give System institutions sufficient time to come into compliance with the new standards.

We have analyzed every System institution's call report data for September 30, 2015. In our analysis, we first assumed that all institutions would extend their redemption and revolvement programs to 7 years and would adopt required bylaw provisions or an annual board resolution for inclusion in CET1 capital. Under this scenario, we concluded that all System institutions would meet all the minimum amounts including the buffers for the final CET1, tier 1 and total capital risk-based ratios if those requirements were in effect today. We then assumed, alternatively, that those institutions that redeem allocated equities would not extend their revolvement periods to 7 years and could not include them under CET1. Under this scenario as well, these institutions would still exceed the minimum capital requirements. Therefore, based on current information, all System institutions should exceed the minimum regulatory ratios on the effective date of the rule. The FCA believes that most, if not all, System institutions would adopt a bylaw provision or annual board resolution to ensure that the non-qualified allocated equities they do not redeem will meet the definition of URE equivalents, and

that those equities that are routinely redeemed will be included in CET1.

For the risk weightings, we used current risk weights under FCA's existing capital regulations. For System associations, we assumed the final risk weightings would not be materially different from existing risk weightings in existing regulations. The most significant change to risk weights for associations would be past-due and non-accrual exposures, as well as the credit conversation factors for certain unused commitments. As just stated, we believe the changes in risk weights for associations would result in a negligible impact to current risk weighted asset amounts and that it is appropriate to use existing risk weights in our analysis.

For System banks, we believe that certain new risk weights or conversion factors could have a material impact. For instance, System banks will need to hold additional capital for their unconditionally cancelable unused commitments, as well as the unused commitments on the direct loans to their affiliated associations. To account for the new risk weights, our analysis increased risk-adjusted assets by 20 percent for each bank. With this increase, all banks still exceeded the minimum amounts (including the buffers) for the final CET1, tier 1 and total capital risk-based ratios. Our existing core surplus rules require both banks and associations to exclude shared capital; however, under the Tier 1/Tier 2 Capital Framework, System banks will be able to count the stock and equities they have issued or allocated to System associations in their regulatory capital ratios.

All System institutions would meet the 4.0 percent minimum tier 1 leverage ratio and 1 percent leverage buffer (including the 1.5-percent component of the ratio for URE and equivalents) if the final requirements were effective today. Our analysis indicates that the leverage ratio would not be a constraining ratio for System associations because total assets closely parallel risk-adjusted assets and the associations have strong tier 1 capital levels. The leverage ratios for associations will be similar to their tier 1 capital risk-based ratios. If the final rule were effective today, all System banks would exceed the 4.0 percent minimum tier 1 leverage ratio and 1-percent leverage buffer; however, one bank, which had a 5.4-percent tier 1 leverage ratio on September 30, 2015, would be near the leverage buffer requirement. Additionally, all System banks would significantly exceed the 1.5-percent URE and URE equivalents component of the minimum leverage ratio. This analysis assumed that System

banks would be able to include all their non-qualified allocated surplus as URE equivalents. The System banks' tier 1 leverage ratios would be significantly lower than their tier 1 risk-based ratios because a large portion of their loans are to their affiliated associations and are risk weighted at 20 percent.

The final rule includes a phase-in period for the capital conservation buffer beginning January 1, 2017, with the buffer fully phased-in beginning January 1, 2020. Unlike the U.S. rule's adjustments and deductions transitions, the calculation of our capital conservation buffer will not change over the phase-in period, and there will be no additional burden on System institutions to revise how it is calculated each year. Rather, the amount of the minimum capital conservation buffer increases every year until fully phased-in. The transition period for the U.S. rule began in 2015 and will be fully phased in as of January 1, 2019. As noted above, the FCA's final rule will become effective for the reporting periods beginning in 2017.

In the event that some System institutions do not meet the tier 1 and tier 2 minimum capital ratios as of the effective date, the final rule permits them to comply by submitting a capital restoration plan. The plan requires FCA approval, and the institution will be required to submit its proposed plan within 20 days of the quarter-end during which the new capital standards become effective—*i.e.*, March 31, 2017. The plan must describe how the institution proposes to achieve and maintain compliance with the new requirements, demonstrating progress towards meeting that goal. If the FCA does not approve the plan, the institution must revise and re-submit the plan. There is a list of factors in the final rule that the FCA will consider in evaluating a plan. They include: (1) Circumstances leading to the institution's decrease in capital and whether they were caused by the institution or by circumstances beyond the institution's control; (2) the institution's financial ratios (*e.g.*, capital, adverse assets, ALL) compared to those of its peers or industry norms; (3) the institution's previous compliance practices; and (4) the views of the institution's directors and managers regarding the plan. If the capital restoration plan is adopted by the institution and approved by the FCA within 180 days of the quarter-end in which the tier 1 and tier 2 capital requirements become effective, the

institution will be deemed to be in compliance with the requirements.<sup>140</sup>

### VIII. Abbreviations

ABCP—Asset-Backed Commercial Paper  
 ABS—Asset-backed Security  
 ADC—Acquisition, Development, or Construction  
 AFS—Available For Sale  
 ALL—Allowance for Loan Losses  
 AOCI—Accumulated Other Comprehensive Income  
 BCBS—Basel Committee on Banking Supervision  
 BHC—Bank Holding Company  
 CCF—Credit Conversion Factor  
 CCP—Central Counterparty  
 CDS—Credit Default Swap  
 CEO—Credit-Enhancing Interest-Only Strip  
 CEM—Current Exposure Method  
 CFR—Code of Federal Regulations  
 CFPB—Consumer Financial Protection Bureau  
 CFTC—Commodity Futures Trading Commission  
 CPSS—Committee on Payment and Settlement Systems  
 CRC—Country Risk Classifications  
 CUSIP—Committee on Uniform Securities Identification Procedures  
 DAC—Deferred Acquisition Cost  
 DCO—Derivatives Clearing Organizations  
 DTA—Deferred Tax Asset  
 DTL—Deferred Tax Liability  
 DvP—Delivery-versus-Payment  
 E—Measure of Effectiveness  
 EE—Expected Exposure  
 ERISA—Employee Retirement Income Security Act of 1974  
 FCA—Farm Credit Administration  
 FDIC—Federal Deposit Insurance Corporation  
 FDICIA—Federal Deposit Insurance Corporation Improvement Act of 1991  
 FFIEC—Federal Financial Institutions Examination Council  
 FHA—Federal Housing Authority  
 FHLB—Federal Home Loan Bank  
 FHLMC—Federal Home Loan Mortgage Corporation  
 FIRREA—Financial Institutions, Reform, Recovery and Enforcement Act  
 FMU—Financial Market Utility  
 FNMA—Federal National Mortgage Association  
 FR—Federal Register  
 GAAP—Generally Accepted Accounting Principles (U.S.)  
 GNMA—Government National Mortgage Association  
 GSE—Government-Sponsored Enterprise  
 HAMP—Home Affordable Mortgage Program  
 HOLA—Home Owners' Loan Act  
 HTM—Held to Maturity  
 HVCRE—High-Volatility Commercial Real Estate  
 IFRS—International Financial Reporting Standards  
 IOSCO—International Organization of Securities Commissions

LTV—Loan-to-Value Ratio  
 MBS—Mortgage-backed Security  
 MDB—Multilateral Development Bank  
 MHC—Mutual Holding Company  
 MSA—Mortgage Servicing Assets  
 NRSRO—Nationally Recognized Statistical Rating Organization  
 OCC—Office of the Comptroller of the Currency  
 OECD—Organization for Economic Cooperation and Development  
 OFI—Other Financing Institution  
 OMB—Office of Management and Budget  
 OTC—Over-the-Counter  
 OTTI—Other Than Temporary Impairment  
 PFE—Potential Future Exposure  
 PMI—Private Mortgage Insurance  
 PMSR—Purchased Mortgage Servicing Right  
 PSE—Public Sector Entities  
 PvP—Payment-versus-Payment  
 QCCP—Qualifying Central Counterparty  
 QIS—Quantitative Impact Study  
 QM—Qualified Mortgage  
 RBA—Ratings-Based Approach  
 RBC—Risk-Based Capital  
 REIT—Real Estate Investment Trust  
 Re-REMIC—Resecuritization of Real Estate Mortgage Investment Conduit  
 SAP—Statutory Accounting Principles  
 SEC—Securities and Exchange Commission  
 SFA—Supervisory Formula Approach  
 SLHC—Savings and Loan Holding Company  
 SPE—Special Purpose Entity  
 SRWA—Simple Risk-Weight Approach  
 SSFA—Simplified Supervisory Formula Approach  
 U.S.C.—United States Code  
 VA—Department of Veterans Affairs  
 VOBA—Value of Business Acquired  
 WAM—Weighted Average Maturity

### IX. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (RFA) (5 U.S.C. 601 *et seq.*), the FCA hereby certifies that the final rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not “small entities” as defined in the Regulatory Flexibility Act.<sup>141</sup>

<sup>141</sup> The System Comment Letter questioned our RFA certification. In the proposed rule, we certified that the rule would not have a significant economic impact on a large number of small entities. Our certification considered each System bank together with “its affiliated associations.” The System objected to our combining associations with System banks, stating that because each institution has to comply with the regulatory requirements each should be considered individually for purposes of identifying economic impact.

As we stated in the preamble to the final merger rule published August 24, 2015 (80 FR 51113), the RFA definition of a small entity incorporates the Small Business Administration (SBA) definition of a “small business concern,” including its size standards. A small business concern is one independently owned and operated, and not

### Addendum: Discussion of the Final Rule

#### Overview

The FCA is adopting this final rule (final rule or rule) to update the regulatory capital rules for the System to include provisions consistent with those suggested by the Basel Committee on Banking Supervision (BCBS) to the international regulatory capital framework, the U.S. rule, and the requirements of the Dodd-Frank Act. Among other things, the final rule:

- Establishes a minimum risk-based common equity tier 1 (CET1) risk-based ratio of 4.5 percent;
- Establishes a minimum tier 1 risk-based ratio of 6 percent;
- Establishes a minimum total capital risk-based ratio of 8 percent;
- Establishes a minimum tier 1 leverage ratio of 4 percent, of which at least 1.5 percent must consist of unallocated retained earnings (URE) and URE equivalents;
- Establishes a capital conservation buffer of 2.5 percent and a leverage buffer of 1 percent below which an institution’s discretionary capital distributions and bonuses would be limited or prohibited without FCA approval;
- Increases capital requirements for past-due and nonaccrual loans and certain short-term unused loan commitments;
- Expands the recognition of collateral and guarantors in determining risk weighted assets;
- Removes references to credit ratings;
- Establishes due diligence requirements for securitization exposures; and
- Increases required regulatory capital disclosures of System banks.

This addendum summarizes the final rule. The FCA intends for this addendum to act as a guide for System institutions to navigate the rule and identify the provisions that may be most relevant to them, but it is not comprehensive. The FCA expects and encourages all System institutions to review the final rule in its entirety.

We remind System institutions that the presence of a particular risk weighting does not itself provide authority for a System institution to have an exposure to that asset or item.

dominant in its field of operation. For purposes of the RFA, the interrelated ownership, supervisory control, and contractual relationship between associations and their funding banks are the basis for FCA’s conclusion to treat them as a single entity. Therefore, System institutions do not satisfy the RFA definition of “small entities.” See 80 FR 51113 (August 24, 2015).

<sup>140</sup> This final rule is modeled after current § 615.5336, which was adopted in 1997 at the time the FCA adopted the core surplus, total surplus and net collateral requirements. Several System institutions achieved initial compliance with those requirements.

## A. Capital Components

### 1. Common Equity Tier 1 Capital (CET1)

(a) Common cooperative equities (purchased member stock, purchased participation certificates, and allocated equities) with the following key criteria (among others):

- Borrower stock (regardless of redemption or revolvment period) up to the statutory minimum of \$1000 or 2 percent of the loan amount, whichever is less;

- Equities are perpetual;
- Equities subject to discretionary revolvment or redemption are not retired for at least 7 years after issuance;
- Equities can be retired only with FCA prior approval (unless it is the statutory minimum borrower stock requirement or unless the distribution meets “safe harbor” standards) and the System institution has a capitalization bylaw or board of directors resolution (which must be re-affirmed annually) providing that it must obtain FCA approval prior to redeeming or revolving any equities it includes in CET1 before the end of the 7-year period;

- Equities represent a claim subordinated to all preferred stock, all subordinated debt, and all liabilities of the institution in a receivership, liquidation, or similar proceeding;

(b) Unallocated retained earnings (URE); and

(c) Paid-in capital resulting from a merger of System institutions or repurchase of third-party capital.

In the final rule, System institutions are not required to include accumulated other comprehensive income in CET1.

### 2. Additional Tier 1 Capital (AT1)

Equities other than common cooperative equities (*i.e.*, equities issued primarily to third-party investors) 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.

### 3. Tier 2 Capital

(a) Equities, which may be common cooperative equities or equities held by third parties, not includable in Tier 1 with the following key criteria:

- Equities are perpetual or have an original maturity of at least 5 years;
- Equities subject to discretionary revolvment or redemption are not retired for at least 5 years after issuance; and

- Equities may not be redeemed or revolved prior to maturity or the end of the stated revolvment period without FCA prior approval (unless the

distribution meets “safe harbor” standards);

(b) Subordinated debt that is not callable for at least 5 years and not subject to acceleration except in the event of a receivership, liquidation, or similar proceeding; and

(c) Allowance for losses (ALL) up to 1.25 percent of total risk weighted assets.

### 4. Regulatory Adjustments and Deductions

#### (a) Deductions From CET1 Capital

- Goodwill, intangible assets, gains-on-sale in connection with a securitization exposure, defined benefit pension fund net assets, and deferred tax assets due to net operating loss carryforwards, all of which are net of associated deferred tax liabilities; and

- The System institution’s allocated equity investments in another System institution.

#### (b) Deductions From Regulatory Capital Using the Corresponding Deduction Approach

A System institution’s purchased equity investments in other System institutions must be deducted using the corresponding deduction approach. This means that a System institution would make deductions from the component of capital for which the underlying instrument qualified if it were issued by the System institution itself.

### 5. FCA Prior Approval of Cash Patronage Refunds, Cash Dividend Payments, and Allocated Equity Redemptions; “Safe Harbor” Treatment for Certain Such Payments

FCA prior approval would be required for redemption of equities included in tier 1 and tier 2, comparable to Basel III and the banking agencies’ rule. Prior approval is also required for cash dividends and cash patronage payments in excess of a specified level, comparable to U.S. banking law and regulations. Exceptions to the FCA prior approval requirement are that System institutions can redeem member stock up to an amount equal to the Farm Credit Act’s minimum member-borrower stock requirement of \$1,000 or 2 percent of the member’s loan, whichever is less. In addition, this amount of borrower stock would not have to be outstanding for a minimum period of 7 years in order for the institution to include it in CET1. However, redemptions of such amounts of stock would be included in the calculation for the “safe harbor” in proposed § 628.22(f)(5).

Under the proposed “safe harbor,” FCA prior approval is deemed to be granted (*i.e.*, a request for approval does not have to be made to the FCA) for cash distributions to pay dividend, patronage payments, or redemptions or revolvments of common cooperative equities provided that:

(a) For revolvments or redemptions of common cooperative equities included in CET1 capital, such equities were issued or allocated at least 7 years before the revolvment or redemption (except the equities are not subject to the 7-year minimum if they are held by the estate of a deceased former borrower, if the institution is required to redeem or revolve the equities under a § 615.5290 restructuring, or if a court order requires the institution to redeem or revolve the equities);

(b) For redemptions or revolvments of common cooperative equities included in Tier 2 capital, such equities were issued or allocated at least 5 years before the redemption or revolvment (except the equities are not subject to the 5-year minimum if they are held by the estate of a deceased former borrower, if the institution is required to redeem or revolve the equities under a § 615.5290 restructuring, or if a court order requires the institution to redeem or revolve the equities);

(c) After such cash payments, the dollar amount of the System institution’s CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date of the previous calendar year; and

(d) After such cash payments, the System institution continues to comply with all minimum regulatory capital requirements and supervisory or enforcement actions.

### 6. Capital Buffer Amounts

The capital conservation buffer of 2.5 percent and the leverage buffer of 1 percent provide a cushion above regulatory capital minimums. The buffers’ purpose is to restrict an institution’s discretionary capital distributions of earnings before that institution reaches the minimum capital requirements.

If a System institution’s CET1, tier 1 *and* total capital risk-based ratios exceed minimum requirements, the capital conservation buffer is the lowest of the following:

- The System institution’s CET1 capital ratio minus the System institution’s minimum CET1 capital ratio of 4.5 percent;

- The System institution’s tier 1 capital ratio minus the System institution’s minimum tier 1 capital ratio of 6 percent; and

- The System institution's total capital ratio minus the System institution's minimum total capital ratio of 8 percent.

If the CET1 ratio, tier 1 ratio, or total capital ratio does not exceed minimum requirements, then the capital conservation buffer is zero.

A System institution's leverage buffer is the institution's tier 1 leverage ratio minus the minimum tier 1 leverage ratio of 4 percent. If the tier 1 leverage ratio is below 4 percent, the leverage buffer is zero.

### B. Risk Weightings

#### 1. Zero-Percent (0%) Risk Weighted Exposures

- An exposure to the U.S. Government, its central bank, or a U.S. Government agency—§ 628.32(a)(1)(i)(A);
- 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—§ 628.32(a)(1)(i)(B);
- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
  - Exposures to certain supranational entities and multilateral development banks—§ 628.32(b);
  - Cash—§ 628.32(l);
  - Certain gold bullion—§ 628.32(l);
  - Certain exposures that arise from the settlement of cash transactions with a central counterparty—§ 628.32(l);
  - An exposure to an OTC derivative contract that meets certain criteria—§ 628.37(b)(3)(i);
  - The collateralized portion of an exposure with respect to which the financial collateral meets certain criteria—§ 628.37(b)(3)(iii); and
  - An equity exposure to any entity whose credit exposures receive a 0-percent risk weight—§ 628.52(b)(1).

#### 2. Twenty-Percent (20%) Risk Weighted Exposures

- The portion of an exposure that is conditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency—§ 628.32(a)(1)(ii);
- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
  - An exposure to a GSE, other than an equity exposure or preferred stock—§ 628.32(c)(1);
  - Most exposures to U.S.- or state-organized depository institutions or credit unions, including those that are OFIs—§ 628.32(d)(1);
  - An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;

- A general obligation exposure to a U.S. or state PSE—§ 628.32(e)(1)(i);
- An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), and (e)(4)(i) and Table 3;
  - Cash items in the process of collection—§ 628.32(l)(2);
  - A loan that a System bank makes to an association (a direct loan)—§ 628.32(m); and
  - An equity exposure to a PSE or the Federal Agricultural Mortgage Corporation (Farmer Mac)—§ 628.52(b)(2).

#### 3. Fifty-Percent (50%) Risk Weighted Exposures

- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
  - An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;
  - A revenue obligation exposure to a U.S. or state PSE—§ 628.32(e)(1)(ii);
  - An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(4)(ii) and Tables 3 and 4;
  - An exposure to an OFI that is not a depository institution or credit union but that is investment grade or that meets capital, risk identification and control, and operational standards similar to depository institutions and credit unions; and
  - First lien residential mortgage exposures that meet certain criteria—§ 628.32(g).

#### 4. One Hundred-Percent (100%) Risk Weighted Exposures

- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
- Preferred stock issued by a non-System GSE—§ 628.32(c)(2);
- An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;
  - An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(5) and Tables 3 and 4;
    - All corporate exposures—§ 628.32(f). This category would include the following:
      - Borrower loans such as agricultural loans and consumer loans, regardless of the corporate form of the borrower, unless those loans qualify for different risk weights under other risk-weighting provisions;
      - System bank exposures to OFIs that do not satisfy the criteria for a 20-percent or a 50-percent risk weight; and
      - Premises, fixed assets, and other real estate owned;

- All residential mortgage exposures that do not satisfy the criteria for a 50-percent risk weight—§ 628.32(g);
  - Deferred tax assets arising from temporary differences that could be realized through net operating loss carrybacks—§ 628.32(l)(3);
  - All mortgage servicing assets—§ 628.32(l)(4);
  - All assets that are not specifically assigned a different risk weight and that are not deducted from tier 1 or tier 2 capital pursuant to § 628.22—§ 628.32(l)(5);
  - The effective portion of a hedge pair—§ 628.52(b)(3)(ii); and
  - Non-significant equity exposures—§ 628.52(b)(3)(iii).

#### 5. One Hundred Fifty-Percent (150%) Risk Weighted Exposures

- An exposure to a sovereign entity that meet certain criteria (as discussed below)—§ 628.32(a) and Table 1;
  - A sovereign exposure, if an event of sovereign default has occurred during the previous 5 years—§ 628.32(a)(6) and Table 1;
  - An exposure to a foreign bank, if an event of sovereign default has occurred during the previous 5 years in the foreign bank's home country—§ 628.32(d)(2)(iv) and Table 2;
  - An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(5) and Tables 3 and 4;
  - An exposure to a PSE, if an event of sovereign default has occurred during the previous 5 years in the PSE's home country—§ 628.32(e)(6) and Tables 3 and 4; and
  - The portion of a past due or nonaccrual exposure that is not guaranteed or that is not secured by financial collateral (except for a sovereign exposure or a residential mortgage exposure, both risk weighted as discussed above)—§ 628.32(k).

#### 6. Six Hundred-Percent (600%) Risk Weighted Exposures

- An equity exposure to an investment firm, provided that the investment firm meets specified conditions—§ 628.52(b).

#### 7. One Thousand Two Hundred Fifty-Percent (1,250%) Risk Weighted Exposures

- Certain high-risk securitization exposures, such as CEIO strips—§§ 628.41–628.45.

#### 8. Past Due Exposures (90 Days or More Past Due or in Nonaccrual Status)

- One hundred percent (100%)—residential mortgage exposures—§ 628.32(g);

- A System institution may assign a risk weight to the guaranteed portion of a past due or nonaccrual exposure based on the risk weight that applies under § 628.36 if the guarantee or credit derivative meets the requirements of that section—§ 628.32(k)(2);

- A System institution may assign a risk weight to the portion of a past due or nonaccrual exposure that is collateralized by financial collateral based on the risk weight that applies under § 628.37 if the financial collateral meets the requirements of that section—§ 628.32(k)(3); and

- One hundred fifty percent (150%)—all other past due and nonaccrual exposures—§ 628.32(k)

#### 9. Conversion Factors for Off-Balance Sheet Items—§ 628.33

- Zero percent (0%)—commitment that is unconditionally cancellable by the System institution;

- Twenty percent (20%)—

- Commitment, other than a System bank's commitment to an association or OFI, with an original maturity of 14 months or less that is not unconditionally cancellable by the System institution;

- Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less; and

- A System bank's commitment to an association or OFI that is not unconditionally cancellable by the System bank, regardless of maturity.

- Fifty percent (50%)—

- Commitments, other than a System bank's commitment to an association or OFI, with an original maturity of more than 14 months that are not unconditionally cancellable by the System institution; and

- Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit;

- One hundred percent (100%)—

- Guarantees;

- Repurchase agreements (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has sold subject to repurchase);

- Credit-enhancing representations and warranties that are not securitization exposures;

- Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has lent under the transaction);

- Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the

sum of the current fair values of all non-cash positions the System institution has posted as collateral under the transaction);

- Financial standby letters of credit; and

- Forward agreements.

#### 10. Over-the-Counter (OTC) Derivative Contracts—§ 628.34

A System institution determines the risk-based capital requirement for a derivative contract by determining the exposure amount and then assigning a risk weight based on the counterparty or collateral. The exposure amount is the sum of current exposure plus potential future credit exposure (PFE). The current credit exposure is the greater of 0 or the mark-to-fair value of the derivative contract. The PFE is generally the notional amount of the derivative contract multiplied by a credit conversion factor for the type of derivative contract. Table 1 to § 628.34 shows the credit conversion factors for derivative contracts.

#### 11. Treatment of Cleared Transactions—§ 628.35

The rule introduces a specific capital treatment for exposures to central counterparties (CCPs), including certain transactions conducted through clearing members by System institutions that are not themselves clearing members of a CCP. Section 628.35 describes the capital treatment of cleared transactions and of default fund exposures to CCPs, including more favorable capital treatment for cleared transactions through CCPs that meet certain criteria.

#### 12. Treatment of Guarantees—§ 628.36

The rule allows a System institution to substitute the risk weight of an eligible guarantor for the risk weight otherwise applicable to the guaranteed exposure. This treatment applies only to *eligible guarantees* and *eligible credit derivatives*, and it provides certain adjustments for maturity mismatches, currency mismatches, and situations where restructuring is not treated as a credit event. To be an *eligible guarantee*, the guarantee must be from an *eligible guarantor* (as defined in the rule) and must satisfy the definitional requirements of *eligible guarantee*.

#### 13. Treatment of Collateralized Transactions—§ 628.37

The rule allows System institutions to recognize the risk-mitigating benefits of financial collateral (as defined) in risk weighted assets. In all cases, the System institution must have a perfected, first priority interest in the financial collateral.

Where the collateral satisfies specified criteria, a System institution may use the simple approach—that is, it may apply a risk weight to the portion of an exposure that is secured by the fair value of financial collateral by using the risk weight of the collateral. There is a general risk weight floor of 20 percent.

For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a System institution may instead use the collateral haircut approach—that is, it may reduce the amount of exposure to be risk weighted (rather than substituting the risk weight of the collateral).

A System institution must use the same approach for similar exposures or transactions.

#### 14. Unsettled Transactions—§ 628.38

The rule provides for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. This capital requirement does not, however, apply to certain types of transactions, including cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin. The rule contains separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period.

#### 15. Securitization Exposures—§§ 628.41–628.45

The rule introduces due diligence and other requirements for System institutions that own, originate, or purchase securitization exposures and introduces a new definition of securitization exposure. Under the rule, a System institution that originates the underlying exposures included in a securitization could have a securitization exposure and, if so, would be subject to the requirements.

Note that mortgage-backed pass-through securities (for example, those guaranteed by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association) do not meet the definition of a securitization exposure because they do not involve a tranching of credit risk. Rather, only those MBS that involve tranching of credit risk are securitization exposures.

#### 16. Equity Exposures—§§ 628.51–628.52

A System institution must apply a simple risk-weight approach (SRWA) to

determine the risk weight for equity exposures that are not exposures to an investment fund.

17. Equity Exposures to Investment Funds—§ 628.53

The approaches described in this section apply to equity exposures to investment funds such as mutual funds, but not to hedge funds or other leveraged investment funds. For exposures to investment funds, a System institution must use one of three risk-weighting approaches: The full-look through approach; the simple modified look-through approach; or the alternative modified look-through approach.

18. Foreign Exposures —§ 628.32(a), (d), and (e), and Tables 1, 2, 3, and 4

A System institution must risk weight an exposure to a foreign government, foreign public sector entity (PSE), and a foreign bank based on the Country Risk Classification (CRC) that is applicable to the foreign government, or the home country of the foreign PSE or foreign bank. If a foreign country does not have a CRC, the risk weighting for its government, PSEs, and banks depends on whether or not the country is a member of the Organization for Economic Cooperation and Development (OECD). A sovereign exposure is assigned a 150-percent risk weight immediately upon determining that an event of sovereign default has

occurred, or if an event of sovereign default has occurred during the previous 5 years.

The risk weights for foreign sovereigns, foreign banks, and foreign PSEs are shown in the tables below:

TABLE 1—RISK WEIGHTS FOR FOREIGN SOVEREIGN EXPOSURES

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	0
2 .....	20
3 .....	50
4-6 .....	100
7 .....	150
OECD Member with no CRC	0
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

TABLE 2—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
OECD Member with no CRC	20
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

TABLE 3—RISK WEIGHTS FOR FOREIGN PSE GENERAL OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
OECD Member with no CRC	20
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

TABLE 4—RISK WEIGHTS FOR FOREIGN PSE REVENUE OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	50
2-3 .....	100
4-7 .....	150
OECD Member with no CRC	50
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

19. Summary Comparison of Current Risk-Weighting Rules Versus Revised Risk-Weighting Rules

Category	Current risk weight (in general)	Revised risk weight under Final Rules	Comments
<i>Risk Weights for On-Balance Sheet Exposures Under Current and Revised Rules</i>			
Cash .....	0% .....	0%.	
Direct exposures to or unconditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency.	0% .....	0%.	
Exposures to certain supranational entities and multilateral development banks.	20% .....	0%.	
Cash items in the process of collection.	20% .....	20%.	
Conditional exposures to the U.S. Government.	20% .....	20% .....	A conditional exposure is one that requires the satisfaction of certain conditions, for example, servicing requirements.
Exposures to Government-sponsored entities (GSEs).	20% (including preferred stock).	20%—exposures other than preferred stock and equity exposures. 100%—preferred stock of non-System GSEs All System equities, including preferred stock, deducted from capital (not risk weighted).	
Most exposures to U.S. depository institutions or credit unions (including those that are OFIs).	20% .....	20%.	
Exposures to U.S. public sector entities (PSEs).	20%—general obligations ..... 50%—revenue obligations .....	20%—general obligations. 50%—revenue obligations.	

Category	Current risk weight (in general)	Revised risk weight under Final Rules	Comments
Exposures to other System institutions that are not deducted from tier 1 or tier 2 capital.	20% .....	20%.	
Corporate exposures (including exposures to agricultural borrowers and to OFIs that do not satisfy the criteria for a lower risk weight).	100%—generally ..... 50%—lower risk OFIs that do not satisfy the criteria for 20%.	100%—generally ..... 50%—lower risk OFIs that do not satisfy the criteria for 20%.	
Past due and nonaccrual exposures.	Generally no change when an exposure is past due or in nonaccrual status. Past due or nonaccrual residential loans—100%.	100%—residential mortgage exposures ..... 150%—all other exposures, for the portion that is not guaranteed or secured by financial collateral.	90 days or more past due or in nonaccrual.
Servicing assets .....	100% (not specifically addressed)—mortgage servicing assets (MSAs) and non-MSAs.	100%—MSAs ..... (Non-MSAs deducted from capital).	
Deferred tax assets .....	Certain DTAs deducted from capital. Other DTAs—100% (not specifically addressed).	100%—DTAs arising from temporary differences relating to net operating carrybacks. DTAs deducted from CET1 arise from net operating carryforwards.	
Assets not specifically assigned to a risk-weight category and not deducted from tier 1 or tier 2 capital.	100% .....	100% .....	Includes: —borrower loans such as agricultural loans and consumer loans, unless qualify for 50% risk weighting. —premises, fixed assets, and other real estate owned.
Exposures to foreign governments and their central banks.	0% for direct and unconditional claims on OECD governments. 20% for conditional claims on OECD governments. 100% for claims on non-OECD governments.	Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign. If there is no CRC, depends on OECD membership. Risk weights range between 0% and 150%. 150% for a sovereign that has defaulted within the previous 5 years.	
Exposures to foreign banks .....	20% for claims on banks in OECD countries. 20% for short-term claims on banks in non-OECD countries. 100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating. If there is no CRC, depends on OECD membership of home country. Risk weights range between 20% and 150%. 150% in the case of a sovereign default in the bank's home country.	
Claims on foreign PSEs .....	20% for general obligations of states and political subdivisions of OECD countries. 50% for revenue obligations of states and political subdivisions of OECD countries. 100% for all obligations of states and political subdivisions of non-OECD countries.	Risk weight depends on the home country's CRC. If there is no CRC, risk depends on OECD membership of home country. Risk weights range between 20% and 150% for general obligations and between 50% and 150% for revenue obligations. 150% for a PSE in a home country with a sovereign default.	
MBS, ABS, and structured securities.	Ratings-based approach .....	Deduction for the after-tax gain-on-sale of a securitization. 1,250% risk weight for a CEIO ..... 100% for interest—only MBS that are not credit-enhancing. System institutions may elect to follow a gross up approach—senior securitization tranches are assigned the risk weight associated with the underlying exposures. System institutions may instead elect to follow the simplified supervisory formula approach (SSFA)—requires various data inputs to a supervisory formula exposure. Alternatively, System institutions may apply a 1,250% risk weight to any securitization.	

Category	Current risk weight (in general)	Revised risk weight under Final Rules	Comments
Unsettled transactions .....	Not addressed .....	100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date. 1,250% for non-DvP, non-PvP transactions more than 5 days past the settlement date. The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin.	
Equity exposures .....	100% .....	0% risk weight: equity exposures to any entity whose credit exposures receive a 0% risk weight. 20%: Equity exposures to a PSE or Farmer Mac. 100%: Equity exposures to effective portions of hedge pairs and equity exposures to non-significant equity investments. 600%: Equity exposures to investment firms that satisfy certain conditions.	
Equity exposures to investment funds.	There is a 20% risk weight floor on mutual fund holdings.	Choose among three approaches: full look-through; simple modified look-through; and alternative modified look-through. <i>Full look-through:</i> Risk weight the assets of the fund (as if owned directly) multiplied by the System institution's proportional ownership in the fund. <i>Simple modified look-through:</i> Multiply the System institution's exposure by the risk weight of the highest risk weight asset in the fund. <i>Alternative modified look-through:</i> Assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus. For certain equity exposures authorized under §615.5140(e), risk weighted asset amount = adjusted carrying value.	

*Credit Conversion Factors (CCF) Under the Current and Revised Rules*

CCF for off-balance sheet items.	0% for the unused portion of a commitment with an original maturity of 14 months or less, or which is unconditionally cancellable by the System institution at any time. 20% for short-term, self-liquidating, trade-related contingent items. 50% for the unused portion of a commitment with an original maturity of more than 14 months that is not unconditionally cancellable by the System institution. 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit).	0% for the unused portion of a commitment that is unconditionally cancellable by the System institution.  20% for the unused portion of a commitment with an original maturity of 14 months or less that is not unconditionally cancellable by the System institution. 20% for self-liquidating trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less.  20% for a System bank's commitment to an association or OFI that is not unconditionally cancelable by the System bank, regardless of maturity.	
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Category	Current risk weight (in general)	Revised risk weight under Final Rules	Comments
OTC derivative contracts (except cleared transactions).	100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.	50% for the unused portion of a commitment, other than a System bank's commitment to an association or OFI, over 14 months that is not unconditionally cancellable by the System institution. 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit). 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.	
Cleared transactions .....	Calculation of off-balance sheet credit equivalents based on current exposure plus potential future exposure and a set of conversion factors. Not specifically addressed .....	Calculation of off-balance sheet credit equivalents amount based on current exposure plus potential future exposure and a revised set of conversion factors. Recognition of credit risk mitigation of collateralized OTC derivative contracts. If collateral posted with a qualified central counterparty, and subject to specific requirements, then assign 2 percent; or. If requirements not met, then assign 4 percent.	

*Credit Risk Mitigation Under the Current and Revised Rules*

Guarantees .....	Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development institutions, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.	Recognizes guarantees from eligible guarantors, as defined. Substitution treatment allows the System institution to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.	Claims conditionally guaranteed by the U.S. government receive a risk weight of 20 percent.
Collateralized transactions .....	No recognition .....	For financial collateral only, the rule provides two approaches:  1. <i>Simple approach</i> A System institution may apply a risk weight to the portion of an exposure that is secured by the fair value of collateral—with a general risk weight floor of 20%.  2. <i>Collateral haircut approach</i> A System institution may use standard supervisory haircuts for eligible margin loans, repo-style transactions, and collateralized derivative contracts.	<i>Financial collateral</i> does not include collateral such as real estate or chattel. In all cases the System institution must have a perfected, 1st priority interest.  For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral must be revalued at least every 6 months; collateral other than gold must be in the same currency.

20. Disclosure Requirements— §§ 628.61–628.63 (Including Tables 1–10)

The rule requires each System bank, generally on a quarterly basis, to make public disclosures related to its capital requirements. Disclosures are required as follows:

*Table 1—Scope of Application—* Provides the basic context underlying regulatory capital calculations.

*Table 2—Capital Structure—* Provides summary information on the terms and conditions of the main features of regulatory capital instruments. Also requires disclosure of the total amount of CET1, tier 1, and total capital, with separate disclosures for deductions and adjustments to capital.

*Table 3—Capital Adequacy—* Provides information on a System bank's approach for categorizing and risk-

weighting its exposures, as well as the amount of total risk weighted assets.

*Table 4—Capital Buffers—* Requires a System bank to disclose the capital conservation buffer and leverage buffer, the eligible retained income and any limitations on capital distributions and certain discretionary bonus payments, as applicable.

*Table 5—Credit Risk: General Disclosures—* Requires a System bank to

disclose information pertaining to its general credit risk.

Table 6—General Disclosure for Counterparty Credit Risk-Related Exposures—Requires a System bank to disclose information pertaining to its counterparty credit risk.

Table 7—Credit Risk Mitigation—Requires a System bank to disclose information pertaining to credit risk mitigation.

Table 8—Securitization—Provides information to market participants on the amount of credit risk transferred and retained by a System bank through securitization transactions, the types of products involved in the System bank’s securitizations, the risks inherent in the System bank’s securitized assets, the System bank’s policies regarding credit risk mitigation, and the names of any entities that provide external credit assessments of a securitization.<sup>142</sup> Securitization transactions in which the originating System bank does not retain any securitization exposure are shown separately and are reported only for the year of inception of the transaction.<sup>143</sup>

Table 9—Equities—Provides market participants with an understanding of the types of equity securities held by the System bank and how they are valued. Also provides information on the capital allocated to different equity products and the amount of unrealized gains and losses.

Table 10—Interest Rate Risk for Non-Trading Activities—Requires a System bank to provide certain quantitative and qualitative disclosures regarding the System bank’s management of interest rate risks.

List of Subjects

12 CFR Part 607

Accounting, Agriculture, Banks, Banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 611

Agriculture Banks, Banking, Rural areas.

12 CFR Part 614

Agriculture, Banks, Banking, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

<sup>142</sup>For purposes of these disclosures (and these capital regulations), a System bank is considered to have securitized assets if assets that it originated or purchased from third parties are included in a securitization.

<sup>143</sup>A System bank is authorized to act as an “originating System institution,” which the regulation defines as a System institution that directly or indirectly originated the underlying exposures included in a securitization.

12 CFR Part 615

Accounting, Agriculture, Banks, Banking, Government securities, Investments, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, Banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 624

Accounting, Agriculture, Banks, Banking, Capital, Cooperatives, Credit, Margin requirements, Reporting and recordkeeping requirements, Risk, Rural areas, Swaps.

12 CFR Part 627

Agriculture, Banks, Banking, Claims, Rural areas.

12 CFR Part 628

Accounting, Agriculture, Banks, Banking, Capital, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, parts 607, 611, 614, 615, 620, 624, 627, and 628 of chapter VI, title 12 of the Code of Federal Regulations are amended as follows:

PART 607—ASSESSMENT AND APPORTIONMENT OF ADMINISTRATIVE EXPENSES

■ 1. The authority citation for part 607 continues to read as follows:

Authority: Secs. 5.15, 5.17 of the Farm Credit Act (12 U.S.C. 2250, 2252) and 12 U.S.C. 3025.

■ 2. Section 607.2 is amended by revising paragraph (b) introductory text to read as follows:

§ 607.2 Definitions.

\* \* \* \* \*

(b) Average risk-adjusted asset base means the average of the risk-adjusted asset base (as defined in § 615.5201 of this chapter) of banks, associations, and designated other System entities, calculated as follows:

\* \* \* \* \*

PART 611—ORGANIZATION

■ 3. The authority citation for part 611 continues to read as follows:

Authority: Secs. 1.2, 1.3, 1.4, 1.5, 1.13, 2.0, 2.1, 2.2, 2.10, 2.11, 2.12, 3.0, 3.1, 3.2, 3.21, 4.12, 4.12A, 4.15, 4.20, 4.21, 5.9, 5.17, 6.9, 6.26, 7.0–7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2002, 2011, 2012, 2013, 2021, 2071, 2072, 2073, 2091, 2092, 2093, 2121, 2122, 2123, 2142, 2183, 2184, 2203, 2208, 2209, 2243, 2252, 2278a–9, 2278b–6, 2279a–2279f–1, 2279aa–5(e)); secs. 411 and 412 of Pub. L. 100–233, 101 Stat. 1568, 1638; sec. 414 of Pub. L. 100–399, 102 Stat. 989, 1004.

■ 4. Section 611.1265 is amended by revising paragraph (e) to read as follows:

§ 611.1265 Retirement of a terminating association’s investment in its affiliated bank.

\* \* \* \* \*

(e) Exclusion of equities from capital ratios. If another Farm Credit institution makes an agreement to retire equities you hold in that institution after termination, we may require that institution to exclude part or all of those equities from assets and capital when the institution calculates its regulatory capital under parts 615 and 628 of this chapter.

PART 614—LOAN POLICIES AND OPERATIONS

■ 5. The authority citation for part 614 continues to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a–2, 2279b, 2279c–1, 2279f, 2279f–1, 2279aa, 2279aa–5); sec. 413 of Pub. L. 100–233, 101 Stat. 1568, 1639.

■ 6. Section 614.4351 is amended by removing paragraph (a)(2), redesignating paragraph (a)(3) as paragraph (a)(2), and revising newly redesignated paragraph (a)(2) to read as follows:

§ 614.4351 Computation of lending and leasing limit base.

(a) \* \* \*

(2) Any amounts of preferred stock not eligible to be included in total capital as defined in § 628.2 of this chapter must be deducted from the lending limit base, except that otherwise eligible third-party capital that is required to be excluded from total capital under § 628.23 of this chapter may be included in the lending limit base.

\* \* \* \* \*

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

■ 7. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3,

4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a), Pub. L. 100-233, 101 Stat. 1568, 1608; sec. 939A, Pub. L. 111-203, 124 Stat. 1326, 1887 (15 U.S.C. 78o-7 note).

■ 8. Section 615.5143 is amended by revising paragraphs (a)(3) and (b)(4) to read as follows:

**§ 615.5143 Management of ineligible investments and reservation of authority to require divestiture.**

(a) \* \* \*

(3) It must be excluded as collateral under § 615.5050.

(b) \* \* \*

(4) You may continue to hold the investment as collateral under § 615.5050 at the lower of cost or market value; and

\* \* \* \* \*

■ 9. Sections 615.5200 and 615.5201 are revised to read as follows:

**§ 615.5200 Capital planning.**

(a) The Board of Directors of each System institution shall determine the amount of regulatory capital needed to assure the System institution's continued financial viability and to provide for growth necessary to meet the needs of its borrowers. The minimum capital standards specified in this part and part 628 of this chapter are not meant to be adopted as the optimal capital level in the System institution's capital adequacy plan. Rather, the standards are intended to serve as minimum levels of capital that each System institution must maintain to protect against the credit and other general risks inherent in its operations.

(b) Each Board of Directors shall establish, adopt, and maintain a formal written capital adequacy plan as a part of the financial plan required by § 618.8440 of this chapter. The plan shall include the capital targets that are necessary to achieve the System institution's capital adequacy goals as well as the minimum permanent capital, common equity tier 1 (CET1) capital, tier 1 capital, total capital, and tier 1 leverage ratios (including the unallocated retained earnings (URE) and URE equivalents minimum) standards. The plan shall address any projected dividend payments, patronage payments, equity retirements, or other action that may decrease the System institution's capital or the components thereof for which minimum amounts are required by this part and part 628 of this

chapter. The plan shall set forth the circumstances and minimum timeframes in which equities may be redeemed or revolved consistent with the System institution's applicable bylaws or board of directors resolutions. Such bylaws or resolutions must include the information described in paragraph (d) of this section.

(c) In addition to factors that must be considered in meeting the minimum standards, the board of directors shall also consider at least the following factors in developing the capital adequacy plan:

(1) Capability of management and the board of directors (the assessment of which may be a part of the assessments required in paragraphs (b)(2)(ii) and (b)(7)(i) of § 618.8440 of this chapter);

(2) Quality of operating policies, procedures, and internal controls;

(3) Quality and quantity of earnings;

(4) Asset quality and the adequacy of the allowance for losses to absorb potential loss within the loan and lease portfolios;

(5) Sufficiency of liquid funds;

(6) Needs of a System institution's customer base; and

(7) Any other risk-oriented activities, such as funding and interest rate risks, potential obligations under joint and several liability, contingent and off-balance-sheet liabilities or other conditions warranting additional capital.

(d) In order to include otherwise eligible purchased and allocated equities in tier 1 capital and tier 2 capital under part 628 of this chapter, a System institution must adopt a capitalization bylaw, or its board of directors must adopt a resolution, which resolution must be re-affirmed by the board on an annual basis in the capital adequacy plan, in which the institution undertakes the following:

(1) The institution shall obtain prior FCA approval under § 628.20(f) of this chapter before:

(i) Redeeming or revolving equities included in CET1 capital;

(ii) Redeeming or calling equities included in additional tier 1 capital; and

(iii) Redeeming, revolving, or calling instruments included in tier 2 capital other than limited life preferred stock or subordinated debt on the maturity date.

(2) The institution shall have a minimum redemption or revolvment period of 7 years for equities included in CET1 capital, a minimum no-call or redemption period of 5 years for additional tier 1 capital, and a minimum no-call, redemption, or revolvment period of 5 years for tier 2 capital.

(3) The institution shall obtain prior FCA approval before:

(i) Redesignating URE equivalents as equities that the institution may exercise its discretion to redeem other than upon dissolution or liquidation;

(ii) Removing equities or other instruments from CET1, additional tier 1, or tier 2 capital other than through repurchase, cancellation, redemption or revolvment; and

(iii) Redesignating equities included in one component of regulatory capital (CET1 capital, additional tier 1 capital, or tier 2 capital) for inclusion in another component of regulatory capital.

(4) The institution shall not exercise its discretion to revolve URE equivalents except upon dissolution or liquidation and shall not offset URE equivalents against a loan in default except as required under final order of a court of competent jurisdiction or if required under § 615.5290 in connection with a restructuring under part 617 of this chapter.

**§ 615.5201 Definitions.**

For the purpose of this subpart, the following definitions apply:

*Allocated investment* means earnings allocated but not paid in cash by a System bank to an association or other recipient.

*Deferred tax assets (DTAs)* means an amount of income taxes refundable or recoverable in future years as a result of temporary differences and net operating loss or tax credit carryforwards that exist at the reporting date. There are three types of DTAs and they arise from:

(1) A temporary difference that a System institution could realize through a net loss carryback;

(2) A temporary difference that a System institution could not realize through net loss carryback; and

(3) An operating loss and tax credit carryforward.

*Nonagreeing association* means an association that does not have an allotment agreement in effect with a Farm Credit Bank or agricultural credit bank pursuant to § 615.5207(b)(2).

*Permanent capital*, subject to adjustments as described in § 615.5207, includes:

(1) Current year earnings;

(2) Allocated and unallocated earnings (which, in the case of earnings allocated in any form by a System bank to any association or other recipient and retained by the bank, must be considered, in whole or in part, permanent capital of the bank or of any such association or other recipient as provided under an agreement between the bank and each such association or other recipient);

(3) All surplus;

(4) Stock issued by a System institution, except:

(i) Stock that may be retired by the holder of the stock on repayment of the holder's loan, or otherwise at the option or request of the holder;

(ii) Stock that is protected under section 4.9A of the Act or is otherwise not at risk;

(iii) Farm Credit Bank equities required to be purchased by Federal land bank associations in connection with stock issued to borrowers that is protected under section 4.9A of the Act;

(iv) Capital subject to revolvement, unless:

(A) The bylaws of the System institution clearly provide that there is no express or implied right for such capital to be retired at the end of the revolvement cycle or at any other time; and

(B) The System institution clearly states in the notice of allocation that such capital may only be retired at the sole discretion of the board of directors in accordance with statutory and regulatory requirements and that the institution does not grant any express or implied right to have such capital retired at the end of the revolvement cycle or at any other time;

(5) [Reserved]

(6) Financial assistance provided by the Farm Credit System Insurance Corporation that the FCA determines appropriate to be considered permanent capital; and

(7) Any other debt or equity instruments or other accounts the FCA has determined are appropriate to be considered permanent capital. The FCA may permit one or more System institutions to include all or a portion of such instrument, entry, or account as permanent capital, permanently or on a temporary basis, for purposes of this part.

*Preferred stock* means stock that is permanent capital and has dividend and/or liquidation preference over common stock.

*Risk-adjusted asset base* means "standardized total risk-weighted assets" as defined in § 628.2 of this chapter, 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.

*Stock* means stock and participation certificates.

*System bank* means a Farm Credit bank as defined in § 619.9140 of this chapter, which includes Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

*System institution* means a System bank, an association of the Farm Credit System, Farm Credit Leasing Services

Corporation, and their successors, and any other institution chartered by the FCA that the FCA determines should be considered a System institution for the purposes of this subpart.

*Term preferred stock* means preferred stock with an original maturity of at least 5 years and on which, if cumulative, the board of directors has the option to defer dividends, provided that, at the beginning of each of the last 5 years of the term of the stock, the amount that is eligible to be counted as permanent capital is reduced by 20 percent of the original amount of the stock (net of redemptions).

■ 10. Sections 615.5206, 615.5207, and 615.5208 are revised to read as follows:

**§ 615.5206 Permanent capital ratio computation.**

(a) The System institution's permanent capital ratio is determined on the basis of the financial statements of the System institution prepared in accordance with generally accepted accounting principles.

(b) The System institution's asset base and permanent capital are computed using average daily balances for the most recent 3 months.

(c) The System institution's permanent capital ratio is calculated by dividing the System institution's permanent capital, adjusted in accordance with § 615.5207 (the numerator), by the risk-adjusted asset base (the denominator) as defined in § 615.5201, to derive a ratio expressed as a percentage.

**§ 615.5207 Capital adjustments and associated reductions to assets.**

For the purpose of computing the System institution's permanent capital ratio, the following adjustments must be made prior to assigning assets to risk-weight categories and computing the ratio:

(a) Where two System institutions have stock investments in each other, such reciprocal holdings must be eliminated to the extent of the offset. If the investments are equal in amount, each System institution must deduct from its assets and its permanent capital an amount equal to the investment. If the investments are not equal in amount, each System institution must deduct from its permanent capital and its assets an amount equal to the smaller investment. The elimination of reciprocal holdings required by this paragraph must be made prior to making the other adjustments required by this section.

(b) Where an association has an equity investment in a System bank, the double

counting of capital is eliminated in the following manner:

(1) For a purchased investment, each association must deduct its investment in a System bank from its permanent capital. Each System bank will consider all purchased stock investments as its permanent capital.

(2) For an allocated investment, each System bank and each of its affiliated associations may enter into an agreement that specifies, for computing permanent capital only, a dollar amount and/or percentage allotment of the association's allocated investment between the bank and the association. Section 615.5208 provides conditions for allotment agreements or defines allotments in the absence of such agreements.

(c) A Farm Credit Bank or agricultural credit bank and a recipient, other than an affiliated association, of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with § 615.5208, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent to the allocating bank and 0 percent to the recipient. All equities of the bank that are purchased by a recipient are considered as permanent capital of the issuing bank.

(d) A bank for cooperatives and a recipient of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with § 615.5208, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent to the allocating bank and 0 percent to the recipient. All equities of a bank that are purchased by a recipient shall be considered as permanent capital of the issuing bank.

(e) Where a System institution has an equity investment in another System institution to capitalize a loan participation interest, the investing System institution must deduct from its permanent capital an amount equal to its investment in the participating System institution.

(f) Each System institution must deduct from permanent capital any equity investment in a service corporation chartered under section 4.25 of the Act or the Funding Corporation chartered under section 4.9 of the Act.

(g) Each System institution must deduct from its permanent capital an amount equal to all goodwill, whenever acquired.

(h) Each System institution must deduct from its risk-adjusted asset base any item deducted from permanent capital under this section.

(i) Where a System bank and an association have an enforceable written agreement to share losses on specifically identified assets on a predetermined quantifiable basis, such assets must be counted in each System institution's risk-adjusted asset base in the same proportion as the System institutions have agreed to share the loss.

(j) The permanent capital of a System institution must exclude any accumulated other comprehensive income (loss) as reported under GAAP.

(k) For purposes of calculating capital ratios under this part, deferred-tax assets are subject to the conditions, limitations, and restrictions described in § 628.22(a)(3) of this chapter.

(l) [Reserved]

**§ 615.5208 Allotment of allocated investments.**

(a) The following conditions apply to agreements that a System bank enters into with an affiliated association pursuant to § 615.5207(b)(2):

(1) The agreement must be for a term of 1 year or longer.

(2) The agreement must be entered into on or before its effective date.

(3) The agreement may be amended according to its terms, but no more frequently than annually except in the event that a party to the agreement is merged or reorganized.

(4) On or before the effective date of the agreement, a certified copy of the agreement, and any amendments thereto, must be sent to the field office of the Farm Credit Administration responsible for examining the System institution. A copy must also be sent within 30 calendar days of adoption to the bank's other affiliated associations.

(5) Unless the parties otherwise agree, if the System bank and the association have not entered into a new agreement on or before the expiration of an existing agreement, the existing agreement will automatically be extended for another 12 months, unless either party notifies the Farm Credit Administration in writing of its objection to the extension prior to the expiration of the existing agreement.

(b) In the absence of an agreement between a System bank and one or more associations, or in the event that an agreement expires and at least one party has timely objected to the continuation of the terms of its agreement, the

following formula applies with respect to the allocated investments held by those associations with which there is no agreement (nonagreeing associations), and does not apply to the allocated investments held by those associations with which the bank has an agreement (agreeing associations):

(1) The allotment formula must be calculated annually.

(2) The permanent capital ratio of the System bank must be computed as of the date that the existing agreement terminates, using a 3-month average daily balance, excluding the allocated investment from nonagreeing associations but including any allocated investments of agreeing associations that are allotted to the bank under applicable allocation agreements. The permanent capital ratio of each nonagreeing association must be computed as of the same date using a 3-month average daily balance, and must be computed excluding its allocated investment in the bank.

(3) If the permanent capital ratio of the System bank calculated in accordance with paragraph (b)(2) of this section is 7 percent or above, the allocated investment of each nonagreeing association whose permanent capital ratio calculated in accordance with paragraph (b)(2) of this section is 7 percent or above must be allotted 50 percent to the bank and 50 percent to the association.

(4) If the permanent capital ratio of the System bank calculated in accordance with paragraph (b)(2) of this section is 7 percent or above, the allocated investment of each nonagreeing association whose capital ratio is below 7 percent must be allotted to the association until the association's capital ratio reaches 7 percent or until all of the investment is allotted to the association, whichever occurs first. Any remaining unallotted allocated investment must be allotted 50 percent to the bank and 50 percent to the association.

(5) If the permanent capital ratio of the System bank calculated in accordance with paragraph (b)(2) of this section is less than 7 percent, the amount of additional capital needed by the bank to reach a permanent capital ratio of 7 percent must be determined, and an amount of the allocated investment of each nonagreeing association must be allotted to the System bank, as follows:

(i) If the total of the allocated investments of all nonagreeing associations is greater than the additional capital needed by the bank, the allocated investment of each nonagreeing association must be

multiplied by a fraction whose numerator is the amount of capital needed by the bank and whose denominator is the total amount of allocated investments of the nonagreeing associations, and such amount must be allotted to the bank. Next, if the permanent capital ratio of any nonagreeing association is less than 7 percent, a sufficient amount of unallotted allocated investment must then be allotted to each nonagreeing association, as necessary, to increase its permanent capital ratio to 7 percent, or until all such remaining investment is allotted to the association, whichever occurs first. Any unallotted allocated investment still remaining must be allotted 50 percent to the bank and 50 percent to the nonagreeing association.

(ii) If the additional capital needed by the bank is greater than the total of the allocated investments of the nonagreeing associations, all of the remaining allocated investments of the nonagreeing associations must be allotted to the bank.

**§§ 615.5209, 615.5210, 615.5211, and 615.5212 [Removed and reserved]**

■ 11. Sections 615.5209, 615.5210, 615.5211, and 615.5212 are removed and reserved.

■ 12. Section 615.5220 is revised to read as follows:

**§ 615.5220 Capitalization bylaws.**

(a) The board of directors of each System bank and association shall, pursuant to section 4.3A of the Farm Credit Act of 1971 (Act), adopt capitalization bylaws, subject to the approval of its voting shareholders, that set forth:

(1) Classes of equities and the manner in which they shall be issued, transferred, converted and retired;

(2) For each class of equities, a description of the class(es) of persons to whom such stock may be issued, voting rights, dividend rights and preferences, and priority upon liquidation, including rights, if any, to share in the distribution of the residual estate;

(3) The number of shares and par value of equities authorized to be issued for each class of equities. However, the bylaws need not state a number or value limit for these equities:

(i) Equities that are required to be purchased as a condition of obtaining a loan, lease, or related service.

(ii) Non-voting stock resulting from the conversion of voting stock due to repayment of a loan.

(iii) Non-voting equities that are issued to an association's funding bank in conjunction with any agreement for

a transfer of capital between the association and the bank.

(iv) Equities resulting from the distribution of earnings.

(4) For Farm Credit Banks, agricultural credit banks (with respect to loans other than to cooperatives), and associations, the percentage or dollar amount of equity investment (which may be expressed as a range within which the board of directors may from time to time determine the requirement) that will be required to be purchased as a condition for obtaining a loan, which amount shall be not less than 2 percent of the loan amount or \$1,000, whichever is less;

(5) For banks for cooperatives and agricultural credit banks (with respect to loans to cooperatives), the percentage or dollar amount of equity or guaranty fund investment (which may be expressed as a range within which the board may from time to time determine the requirement) that serves as a target level of investment in the bank for patronage-sourced business, which amount shall not be less than, 2 percent of the loan amount or \$1,000, whichever is less;

(6) The manner in which equities will be retired, including a provision stating that equities other than those protected under section 4.9A of the Act are retireable at the sole discretion of the board, provided minimum capital adequacy standards established in subpart H of this part, part 628 of this chapter, and the capital requirements established by the board of directors of the System institution, are met;

(7) The manner in which earnings will be allocated and distributed, including the basis on which patronage will be paid, which shall be in accord with cooperative principles; and

(8) For System banks, the manner in which the capitalization requirements of the Farm Credit bank shall be allocated and equalized from time to time among its owners.

(b) The board of directors of each service corporation (including the Farm Credit Leasing Services Corporation) shall adopt capitalization bylaws, subject to the approval of its voting shareholders, that set forth the requirements of paragraphs (a)(1), (2), and (3) of this section to the extent applicable. Such bylaws shall also set forth the manner in which equities will be retired and the manner in which earnings will be distributed.

■ 13. Section 615.5240 is revised to read as follows:

**§ 615.5240 Regulatory capital requirements.**

(a) The capitalization bylaws shall enable the institution to meet the capital adequacy standards established under subpart H of this part, part 628 of this chapter, and the capital requirements established by the board of directors of the System institution.

(b) In order to qualify as permanent capital, equities issued under the bylaws must meet the following requirements:

(1) Retirement must be solely at the discretion of the board of directors and not upon a date certain (other than the original maturity date of preferred stock) or upon the happening of any event, such as repayment of the loan, and not pursuant to any automatic retirement or revolvement plan;

(2) Retirement must be at not more than book value;

(3) The institution must have made the disclosures required by this subpart;

(4) For common stock and participation certificates, dividends must be noncumulative and payable only at the discretion of the board; and

(5) For cumulative preferred stock, the board of directors must have discretion to defer payment of dividends.

■ 14. Sections 615.5250 and 615.5255 are revised to read as follows:

**§ 615.5250 Disclosure requirements for sales of borrower stock.**

(a) For sales of borrower stock, which for this subpart means equities purchased as a condition for obtaining a loan, a System institution must provide a prospective borrower with the following documents prior to loan closing:

(1) The institution's most recent annual report filed under part 620 of this chapter;

(2) The institution's most recent quarterly report filed under part 620 of this chapter, if more recent than the annual report;

(3) A copy of the institution's capitalization bylaws; and

(4) A written description of the terms and conditions under which the equity is issued. In addition to specific terms and conditions, the description must disclose:

(i) That the equity is an at-risk investment and not a compensating balance;

(ii) That the equity is retireable only at the discretion of the board of directors consistent with the institution's bylaws and only if minimum capital standards established under subpart H of this part and part 628 of this chapter are met and that such retirement may also require the approval of the FCA;

(iii) Whether the institution presently meets its minimum capital standards established under subpart H of this part and part 628 of this chapter;

(iv) Whether the institution knows of any reason the institution may not meet its capital standards on the next earnings distribution date; and

(v) The rights, if any, to share in patronage payments.

(b) Notwithstanding the provisions of paragraph (a) of this section, no materials previously provided to a purchaser (except the disclosures required by paragraph (a)(4) of this section) need be provided again unless the purchaser requests such materials.

**§ 615.5255 Disclosure and review requirements for sales of other equities.**

(a) A bank, association, or service corporation must submit a proposed disclosure statement to the Farm Credit Administration (FCA) for review and clearance prior to the proposed sale of any other equities, which for this subpart means equities not purchased as a condition for obtaining a loan.

(b) An institution may not offer to sell other equities until a disclosure statement is reviewed and cleared by the FCA.

(c) A disclosure statement must include:

(1) All of the information required by parts 620 and 628 of this chapter in the annual report to shareholders as of a date within 135 days of the proposed sale. An institution may satisfy this requirement by referring to its most recent annual report to shareholders and the most recent quarterly report filed with the FCA, provided such reports contain the required information;

(2) The information required by § 615.5250(a)(3) and (4); and

(3) A discussion of the intended use of the sale proceeds.

(d) An institution is not required to provide the materials identified in paragraphs (c)(1) and (2) of this section to a purchaser who previously received them unless the purchaser requests it.

(e) For any class of stock where each purchaser and each subsequent transferee acquires at least \$250,000 of the stock and meets the definition of "accredited investor" or "qualified institutional buyer" contained in 17 CFR 230.501 and 230.144A, a disclosure statement submitted pursuant to this section is deemed reviewed and cleared by the FCA and an institution may treat stock that meets all requirements of this part as permanent capital for the purpose of meeting the minimum permanent capital standards established under subpart H of this part, unless the FCA notifies the institution to the

contrary within 30 days of receipt of a complete disclosure statement submission. A complete disclosure statement submission includes the proposed disclosure statement plus any additional materials requested by the FCA.

(f) For all other issuances, a disclosure statement submitted pursuant to this section is deemed cleared by the FCA, and an institution may treat stock that meets all requirements of this part as permanent capital for the purpose of meeting the minimum permanent capital standards established under subpart H unless the FCA notifies the institution to the contrary within 60 days of receipt of a complete disclosure statement submission. A complete disclosure statement submission includes the proposed disclosure statement plus any additional materials requested by the FCA.

(g) Upon request, the FCA will inform the institution how it will treat the proposed issuance for other regulatory capital ratios or computations.

(h) No institution, officer, director, employee, or agent shall, in connection with the sale of equities, make any disclosure, through a disclosure statement or otherwise, that is inaccurate or misleading, or omit to make any statement needed to prevent other disclosures from being misleading.

(i) Each bank and association must establish a method to disclose and make information on insider preferred stock purchases and retirements readily available to the public. At a minimum, each institution offering preferred stock must make this information available upon request.

(j) The requirements of this section do not apply to the sale of Farm Credit System institution equities to:

(1) Other Farm Credit System institutions;

(2) Other financing institutions in connection with a lending or discount relationship; or

(3) Non-Farm Credit System lenders that purchase equities in connection with a loan participation transaction.

(k) In addition to the requirements of this section, each institution is responsible for ensuring its compliance with all applicable Federal and state securities laws.

■ 15. Section 615.5270 is revised to read as follows:

**§ 615.5270 Retirement of other equities.**

(a) Equities other than eligible borrower stock shall be retired at not more than their book value.

(b) Subject to the redemption restrictions in part 628 of this chapter, no equities shall be retired, except

pursuant to §§ 615.5280 and 615.5290 or term stock at its stated maturity, unless after retirement the institution would continue to meet the minimum permanent capital standards established under subpart H of this part, part 628 of this chapter, and the capital requirements established by the board of directors of the System institution.

(c) A System bank, association, or service corporation board of directors may delegate authority to retire at-risk stock to institution management if:

(1) The board has determined that the institution's capital position is adequate;

(2) All retirements are in accordance with applicable provisions of part 628 of this chapter and the institution's capital adequacy plan or capital restoration plan;

(3) After any retirements, the institution's permanent capital ratio will be in excess of 9 percent, its capital conservation buffer set forth in § 628.11 of this chapter will be above 2.5 percent, and its leverage buffer set forth in § 628.11 of this chapter will be above 1.0 percent;

(4) The institution will continue to satisfy all applicable regulatory capital standards after any retirements; and

(5) Management reports the aggregate amount and net effect of stock purchases and retirements to the board of directors each quarter.

(d) Each board of directors of a System bank, association, or service corporation that issues preferred stock must adopt a written policy covering the retirement of preferred stock that complies with this paragraph and part 628 of this chapter. The policy must, at a minimum:

(1) Establish any delegations of authority to retire preferred stock and the conditions of delegation, which must meet the requirements of paragraph (c) of this section and include minimum levels for regulatory capital standards as applicable and commensurate with the volatility of the preferred stock.

(2) Identify limitations on the amount of stock that may be retired during a single quarterly (or shorter) time period;

(3) Ensure that all stockholder requests for retirement are treated fairly and equitably;

(4) Prohibit any insider, including institution officers, directors, employees, or agents, from retiring any preferred stock in advance of the release of material non-public information concerning the institution to other stockholders; and

(5) Establish when insiders may retire their preferred stock.

(e) The institution's board must review its policy at least annually to ensure that it continues to be appropriate for the institution's current financial condition and consistent with its long-term goals established in its capital adequacy plan.

■ 16. Section 615.5290 is revised to read as follows:

**§ 615.5290 Retirement of capital stock and participation certificates in event of restructuring.**

(a) If a Farm Credit Bank or agricultural credit bank forgives and writes off, under § 617.7415 of this chapter, any of the principal outstanding on a loan made to any borrower, where appropriate the Federal land bank association of which the borrower is a member and stockholder shall cancel the same dollar amount of borrower stock held by the borrower in respect of the loan, up to the total amount of such stock, and to the extent provided for in the bylaws of the Bank relating to its capitalization, the Farm Credit Bank or agricultural credit bank shall retire an equal amount of stock owned by the Federal land bank association.

(b) If an association forgives and writes off, under § 617.7415 of this chapter, any of the principal outstanding on a loan made to any borrower, the association shall cancel the same dollar amount of borrower stock held by the borrower in respect of the loan, up to the total amount of such loan.

(c) Notwithstanding paragraphs (a) and (b) of this section, the borrower shall be entitled to retain at least one share of stock to maintain the borrower's membership and voting interest.

■ 17. Section 615.5295 is amended by revising paragraph (c) to read as follows:

**§ 615.5295 Payment of dividends.**

\* \* \* \* \*

(c) Each System bank, association, and service corporation must exclude any accrued but unpaid dividends from regulatory capital computations under this part and part 628 of this chapter.

**Subpart K [Removed and reserved]**

■ 18. Subpart K, consisting of §§ 615.5301, 615.5330, 615.5335, and 615.5336, is removed and reserved.

■ 19. Section 615.5350 is amended by revising paragraph (a) to read as follows:

**§ 615.5350 General—Applicability.**

(a) The rules and procedures specified in this subpart are applicable to a proceeding to establish required

minimum capital ratios that would otherwise be applicable to an institution under §§ 615.5205 and 628.10 of this chapter. The Farm Credit Administration is authorized to establish such minimum capital requirements for an institution as the Farm Credit Administration, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the institution. Proceedings under this subpart also may be initiated to require an institution having capital ratios greater than those set forth in § 615.5205 or § 628.10 of this chapter to continue to maintain those higher ratios.

\* \* \* \* \*

■ 20. Section 615.5352 is amended by revising paragraph (a) to read as follows:

**§ 615.5352 Procedures.**

(a) *Notice.* When the Farm Credit Administration determines that minimum capital ratios greater than those set forth in § 615.5205 or § 628.10 of this chapter are necessary or appropriate for a particular institution, the Farm Credit Administration will notify the institution in writing of the proposed minimum capital ratios and the date by which they should be reached (if applicable) and will provide an explanation of why the ratios proposed are considered necessary or appropriate for the institution.

\* \* \* \* \*

■ 21. Section 615.5354 is revised to read as follows:

**§ 615.5354 Enforcement.**

An institution that does not have or maintain the minimum capital ratios applicable to it, whether required in subpart H of this part or part 628 of this chapter, in a decision pursuant to this subpart, in a written agreement or temporary or final order under part C of title V of the Act, or in a condition for approval of an application, or an institution that has failed to submit or comply with an acceptable plan to attain those ratios, will be subject to such administrative action or sanctions as the Farm Credit Administration considers appropriate. These sanctions may include the issuance of a capital directive pursuant to subpart M of this part or other enforcement action, assessment of civil money penalties, and/or the denial or condition of applications.

■ 22. Section 615.5355 is amended by revising paragraph (a) introductory text to read as follows:

**§ 615.5355 Purpose and scope.**

(a) This subpart is applicable to proceedings by the Farm Credit Administration to issue a capital directive under sections 4.3(b) and 4.3A(e) of the Act. A capital directive is an order issued to an institution that does not have or maintain capital at or greater than the minimum ratios set forth in § 615.5205 or § 628.10 of this chapter; or established for the institution under subpart L of this part, by a written agreement under part C of title V of the Act, or as a condition for approval of an application. A capital directive may order the institution to:

\* \* \* \* \*

**PART 620—DISCLOSURE TO SHAREHOLDERS**

■ 23. The authority citation for part 620 continues to read as follows:

**Authority:** Secs. 4.3, 4.3A, 4.19, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2154, 2154a, 2207, 2243, 2252, 2254); sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102–552, 106 Stat. 4102.

■ 24. Section 620.5 is amended by revising paragraphs (d)(1)(ix), (f)(2)(ii) through (iv), (f)(3)(ii) and (iii), and (g)(4)(ii) and adding paragraphs (f)(2)(v), (f)(3)(iv), and (f)(4) to read as follows:

**§ 620.5 Contents of the annual report to shareholders.**

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(ix) The statutory and regulatory restrictions regarding retirement of stock and distribution of earnings pursuant to § 615.5215 of this chapter, and any requirements to add capital under a plan approved by the Farm Credit Administration pursuant to § 615.5350, § 615.5351, § 615.5353, § 615.5357, or § 628.301 of this chapter.

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

- (ii) CET1 capital ratio.
- (iii) Tier 1 capital ratio.
- (iv) Total capital ratio.
- (v) Tier 1 leverage ratio.

(3) \* \* \*

- (ii) CET1 capital ratio.
- (iii) Tier 1 capital ratio.
- (iv) Total capital ratio.

(4) The annual report for each fiscal year ending in 2017 through 2021 shall also include in comparative columnar form for each fiscal year ending in 2012 through 2016, the following ratios:

- (i) Core surplus ratio.
- (ii) Total surplus ratio.
- (iii) For banks only, net collateral ratio.
- (iv) Tier 1 leverage ratio.

(g) \* \* \*

(4) \* \* \*

(ii) Describe any material trends or changes in the mix and cost of debt and capital resources. The discussion shall consider changes in permanent capital, CET1 capital, tier 1 capital, total capital, the tier 1 leverage ratio, debt, and any off-balance-sheet financial arrangements.

\* \* \* \* \*

■ 25. Section 620.17 is revised to read as follows:

**§ 620.17 Special notice provisions for events related to noncompliance with minimum regulatory capital ratios.**

(a) For purposes of this section, “regulatory capital ratios” include the capital ratios specified in § 628.10 of this chapter and the permanent capital standard prescribed under § 615.5205 of this chapter.

(b) When a Farm Credit bank or association determines that it is not in compliance with one or more applicable minimum regulatory capital ratios, that institution must prepare and provide to its shareholders and the FCA a notice stating that the institution has initially determined it is not in compliance with the minimum regulatory capital ratio or ratios. Such notice must be given within 30 days following the month end.

(c) When notice is given under paragraph (b) of this section, the institution must also notify its shareholders and the FCA when the regulatory capital ratio or ratios that are the subject of such notice decrease by one half of 1 percent or more from the level reported in the original notice, or from that reported in a subsequent notice provided under this paragraph (c). This notice must be given within 45 days following the end of every quarter at which the institution’s regulatory capital ratio or ratios decrease as specified.

(d) Each institution required to prepare a notice under paragraph (b) or (c) of this section shall provide the notice to shareholders or publish it in any publication with circulation wide enough to be reasonably assured that all of the institution’s shareholders have access to the information in a timely manner. The information required to be included in this notice must be conspicuous, easily understandable, and not misleading.

(e) A notice, at a minimum, shall include:

(1) A statement that:

(i) Briefly describes the minimum regulatory capital ratios established by the FCA and the notice requirement of paragraph (b) of this section;

(ii) Indicates the institution's current level of capital; and

(iii) Notifies shareholders that the institution's capital is below the FCA minimum regulatory capital ratio or ratios.

(2) A statement of the effect that noncompliance has had on the institution and its shareholders, including whether the institution is currently prohibited by statute or regulation from retiring stock or distributing earnings or whether the FCA has issued a capital directive or other enforcement action to the institution.

(3) A complete description of any event(s) that may have significantly contributed to the institution's noncompliance with the minimum regulatory capital ratio or ratios.

(4) A statement that the institution is required by regulation to provide another notice to shareholders within 45 days following the end of any subsequent quarter at which the regulatory capital ratio or ratios decrease by one half of 1 percent or more from the level reported in the notice.

#### **PART 624—MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES**

■ 26. The authority citation for part 624 continues to read as follows:

**Authority:** 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), 12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb-1.

■ 27. Section 624.12 is amended by revising paragraph (b) to read as follows:

##### **§ 624.12 Capital.**

\* \* \* \* \*

(b) In the case of any Farm Credit System institution other than the Federal Agricultural Mortgage Corporation, the capital regulations set forth in parts 615 and 628 of this chapter.

#### **PART 627—TITLE V CONSERVATORS, RECEIVERS, AND VOLUNTARY LIQUIDATIONS**

■ 28. The authority citation for part 627 continues to read as follows:

**Authority:** Secs. 4.2, 5.9, 5.17, 5.51, 5.58, 5.61 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2244, 2252, 2277a, 2277a-7, 2277a-10).

##### **§ 627.2710 [Amended]**

■ 29. Section 627.2710 is amended by removing and reserving paragraphs (b)(3)(i) and (iv).

■ 30. Part 628 is added to read as follows:

#### **PART 628—CAPITAL ADEQUACY OF SYSTEM INSTITUTIONS**

##### **Subpart A—General Provisions**

Sec.

628.1 Purpose, applicability, and reservations of authority.

628.2 Definitions.

628.3 Operational requirements for certain exposures.

628.4–628.9 [Reserved]

##### **Subpart B—Capital Ratio Requirements and Buffers**

628.10 Minimum capital requirements.

628.11 Capital buffer amounts.

628.12–628.19 [Reserved]

##### **Subpart C—Definition of Capital**

628.20 Capital components and eligibility criteria for tier 1 and tier 2 capital instruments.

628.21 [Reserved]

628.22 Regulatory capital adjustments and deductions.

628.23 Limit on inclusion of third-party capital in total (tier 1 and tier 2) capital.

628.24–628.29 [Reserved]

##### **Subpart D—Risk-Weighted Assets—Standardized Approach**

628.30 Applicability.

##### **Risk-Weighted Assets for General Credit Risk**

628.31 Mechanics for calculating risk-weighted assets for general credit risk.

628.32 General risk weights.

628.33 Off-balance sheet exposures.

628.34 OTC derivative contracts.

628.35 Cleared transactions.

628.36 Guarantees and credit derivatives: substitution treatment.

628.37 Collateralized transactions.

##### **Risk-Weighted Assets for Unsettled Transactions**

628.38 Unsettled transactions.

628.39 through 628.40 [Reserved]

##### **Risk-Weighted Assets for Securitization Exposures**

628.41 Operational requirements for securitization exposures.

628.42 Risk-weighted assets for securitization exposures.

628.43 Simplified supervisory formula approach (SSFA) and the gross-up approach.

628.44 Securitization exposures to which the SSFA and gross-up approach do not apply.

628.45 Recognition of credit risk mitigants for securitization exposures.

628.46–628.50 [Reserved]

##### **Risk-Weighted Assets for Equity Exposures**

628.51 Introduction and exposure measurement.

628.52 Simple risk-weight approach (SRWA).

628.53 Equity exposures to investment funds.

628.54 through 628.60 [Reserved]

##### **Disclosures**

628.61 Purpose and scope.

628.62 Disclosure requirements.

628.63 Disclosures.

628.64 through 628.99 [Reserved]

##### **Subpart E—[Reserved]**

##### **Subpart F—[Reserved]**

##### **Subpart G—Transition Provisions**

628.300 Transitions.

628.301 Initial compliance and reporting requirements.

**Authority:** Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a), Pub. L. 100-233, 101 Stat. 1568, 1608; sec. 939A, Pub. L. 111-203, 124 Stat. 1326, 1887 (15 U.S.C. 78o-7 note).

##### **Subpart A—General Provisions**

##### **§ 628.1 Purpose, applicability, and reservations of authority.**

(a) *Purpose.* This part establishes minimum capital requirements and overall capital adequacy standards for System institutions. This part includes methodologies for calculating minimum capital requirements, public disclosure requirements related to the capital requirements, and transition provisions for the application of this part.

(b) *Limitation of authority.* Nothing in this part limits the authority of FCA to take action under other provisions of law, including action to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law or regulation under part C of title V of the Farm Credit Act.

(c) *Applicability.* Subject to the requirements in paragraph (d) of this section:

(1) *Minimum capital requirements and overall capital adequacy standards.* Each System institution must calculate its minimum capital requirements and meet the overall capital adequacy standards in subpart B of this part.

(2) *Regulatory capital.* Each System institution must calculate its regulatory capital in accordance with subpart C of this part.

(3) *Risk-weighted assets.* (i) Each System institution must use the methodologies in subpart D of this part to calculate total risk-weighted assets.

(ii) [Reserved]

(4) *Disclosures.* (i) All System banks must make the public disclosures described in subpart D of this part.

(ii) [Reserved]

(iii) [Reserved]

(d) *Reservation of authority—(1) Additional capital in the aggregate.* FCA

may require a System institution to hold an amount of regulatory capital greater than otherwise required under this part if FCA determines that the System institution's capital requirements under this part are not commensurate with the System institution's credit, market, operational, or other risks according to part 615, subparts L and M, of this chapter.

(2) *Regulatory capital elements.* (i) If FCA determines that a particular common equity tier 1 (CET1), additional tier 1 (AT1), or tier 2 capital element has characteristics or terms that diminish its permanence or its ability to absorb losses, or otherwise present safety and soundness concerns, FCA may require the System institution to exclude all or a portion of such element from CET1 capital, AT1 capital, or tier 2 capital, as appropriate.

(ii) Notwithstanding the criteria for regulatory capital instruments set forth in subpart C of this part, FCA may find that a capital element may be included in a System institution's CET1 capital, AT1 capital, or tier 2 capital on a permanent or temporary basis consistent with the loss absorption capacity of the element and in accordance with § 628.20(e).

(3) *Risk-weighted asset amounts.* If FCA determines that the risk-weighted asset amount calculated under this part by the System institution for one or more exposures is not commensurate with the risks associated with those exposures, FCA may require the System institution to assign a different risk-weighted asset amount to the exposure(s) or to deduct the amount of the exposure(s) from its regulatory capital.

(4) *Total leverage.* If FCA determines that the leverage exposure amount, or the amount reflected in the System institution's reported average total consolidated assets, for a balance sheet exposure calculated by a System institution under § 628.10 is inappropriate for the exposure(s) or the circumstances of the System institution, FCA may require the System institution to adjust this exposure amount in the numerator and the denominator for purposes of the leverage ratio calculations.

(5) [Reserved]

(6) *Other reservation of authority.* With respect to any deduction or limitation required under this part, FCA may require a different deduction or limitation, provided that such alternative deduction or limitation is commensurate with the System institution's risk and consistent with safety and soundness.

(e) *Notice and response procedures.* In making a determination under this section, FCA will apply notice and response procedures in the same manner as the notice and response procedures in § 615.5352 of this chapter.

(f) [Reserved]

#### § 628.2 Definitions.

As used in this part:

*Additional tier 1 capital (AT1)* is defined in § 628.20(c).

*Allocated equities* means stock or surplus representing a patronage payment to a member-borrower that a System institution has retained for the benefit of its membership.<sup>1</sup> Allocated equities include qualified allocated equities and nonqualified allocated equities. Allocated equities are redeemable at the System institution board's discretion. Allocated equities contain no voting rights and are generally subordinated to borrower stock in receivership, insolvency, liquidation, or similar proceeding.

*Allowances for loan losses (ALL)* means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables, or other extensions of credit as determined in accordance with generally accepted accounting principles (GAAP). For purposes of this part, ALL includes allowances that have been established through a charge against earnings to cover estimated credit losses associated with off-balance sheet credit exposures as determined in accordance with GAAP.

*Bank holding company* means a bank holding company as defined in section 2 of the Bank Holding Company Act.

*Bank Holding Company Act* means the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*).

*Bankruptcy remote* means, with respect to an entity or asset, that the entity or asset would be excluded from an insolvent entity's estate in receivership, insolvency, liquidation, or similar proceeding.

*Borrower stock* means the capital investment a borrower holds in a System institution in connection with a loan.

*Call Report* means reports of condition and performance, as described in subpart D of part 621 of this chapter.

*Carrying value* means, with respect to an asset, the value of the asset on the

<sup>1</sup> System institutions as cooperatives are required to send borrowers a written notice of allocation specifying the amount of patronage payments retained as equity pursuant to the Internal Revenue Code section 1388.

balance sheet of the System institution, determined in accordance with GAAP.

*Central counterparty (CCP)* means a counterparty (for example, a clearinghouse) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts.

*CFTC* means the U.S. Commodity Futures Trading Commission.

*Clean-up call* means a contractual provision that permits an originating System institution or servicer to call securitization exposures before their stated maturity or call date.

*Cleared transaction* means an exposure associated with an outstanding derivative contract or repo-style transaction that a System institution or clearing member has entered into with a central counterparty (that is, a transaction that a central counterparty has accepted).

(1) The following transactions are cleared transactions:

(i) [Reserved]

(ii) [Reserved]

(iii) A transaction between a clearing member client System institution and a clearing member where the clearing member acts as a financial intermediary on behalf of the clearing member client and enters into an offsetting transaction with a CCP, provided that the requirements set forth in § 628.3(a) are met; or

(iv) A transaction between a clearing member client System institution and a CCP where a clearing member guarantees the performance of the clearing member client System institution to the CCP and the transaction meets the requirements of § 628.3(a)(2) and (3).

(2) [Reserved]

*Clearing member* means a member of, or direct participant in, a CCP that is entitled to enter into transactions with the CCP.

*Clearing member client* means a party to a cleared transaction associated with a CCP in which a clearing member either acts as a financial intermediary with respect to the party or guarantees the performance of the party to the CCP.

*Collateral agreement* means a legal contract that specifies the time when, and circumstances under which, a counterparty is required to pledge collateral to a System institution for a single financial contract or for all financial contracts in a netting set and confers upon the System institution a perfected, first-priority security interest (notwithstanding the prior security interest of any custodial agent), or the legal equivalent thereof, in the collateral posted by the counterparty under the agreement. This security interest must

provide the System institution with a right to close-out the financial positions and liquidate the collateral upon an event of default of, or failure to perform by, the counterparty under the collateral agreement. A contract would not satisfy this requirement if the System institution's exercise of rights under the agreement may be stayed or avoided under applicable law in the relevant jurisdictions, other than:

(1) In receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph (1) in order to facilitate the orderly resolution of the defaulting counterparty; or

(2) Where the agreement is subject by its terms to any of the laws referenced in paragraph (1) of this definition.

*Commitment* means any legally binding arrangement that obligates a System institution to extend credit or to purchase assets.

*Commodity derivative contract* means a commodity-linked swap, purchased commodity-linked option, forward commodity-linked contract, or any other instrument linked to commodities that gives rise to similar counterparty credit risks.

*Commodity Exchange Act* means the Commodity Exchange Act of 1936 (7 U.S.C. 1 *et seq.*).

*Common cooperative equity or equities* means common equities in the form of member-borrower stock, participation certificates, and allocated equities issued or allocated by a System institution to its current and former members.

*Common equity tier 1 capital (CET1)* is defined in § 628.20(b).

*Company* means a corporation, partnership, limited liability company, depository institution, business trust, special purpose entity, System institution, association, or similar organization.

*Corporate exposure* means an exposure to a company that is not:

(1) An exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multi-lateral development bank (MDB), a depository institution, a foreign bank, a credit union, or a public sector entity (PSE);

(2) An exposure to a GSE;

(3) A residential mortgage exposure;

(4) [Reserved]

(5) [Reserved]

(6) [Reserved]

(7) A cleared transaction;

(8) [Reserved]

(9) A securitization exposure;

(10) An equity exposure; or

(11) An unsettled transaction.

*Country risk classification (CRC)* with respect to a sovereign, means the most recent consensus CRC published by the Organization for Economic Cooperation and Development (OECD) as of December 31st of the prior calendar year that provides a view of the likelihood that the sovereign will service its external debt.

*Credit derivative* means a financial contract executed under standard industry credit derivative documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider) for a certain period of time.

*Credit-enhancing interest-only strip (CEIO)* means an on-balance sheet asset that, in form or in substance:

(1) Represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal due on the underlying exposures of a securitization; and

(2) Exposes the holder of the CEIO to credit risk directly or indirectly associated with the underlying exposures that exceeds a pro rata share of the holder's claim on the underlying exposures, whether through subordination provisions or other credit-enhancement techniques.

*Credit-enhancing representations and warranties* means representations and warranties that are made or assumed in connection with a transfer of underlying exposures (including loan servicing assets) and that obligate a System institution to protect another party from losses arising from the credit risk of the underlying exposures. Credit-enhancing representations and warranties include provisions to protect a party from losses resulting from the default or nonperformance of the counterparties of the underlying exposures or from an insufficiency in the value of the collateral backing the underlying exposures. Credit-enhancing representations and warranties do not include:

(1) Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans that qualify for a 50-percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

(2) Premium refund clauses that cover assets guaranteed, in whole or in part,

by the U.S. Government, a U.S. Government agency or a Government-sponsored enterprise (GSE), provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

(3) Warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation.

*Credit risk mitigant* means collateral, a credit derivative, or a guarantee.

*Credit union* means an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752 *et seq.*).

*Current exposure* means, with respect to a netting set, the larger of 0 or the fair value of a transaction or portfolio of transactions within the netting set that would be lost upon default of the counterparty, assuming no recovery on the value of the transactions. Current exposure is also called replacement cost.

*Current exposure methodology* means the method of calculating the exposure amount for over-the-counter derivative contracts in § 628.34(a).

*Custodian* means a company that has legal custody of collateral provided to a CCP.

*Depository institution* means a depository institution as defined in section 3 of the Federal Deposit Insurance Act.

*Depository institution holding company* means a bank holding company or savings and loan holding company.

*Derivative contract* means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or 5 business days.

*Dodd-Frank Act* means the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111–203, 124 Stat. 1376).

*Early amortization provision* means a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the

securitization exposures, unless the provision:

(1) Is triggered solely by events not directly related to the performance of the underlying exposures or the originating System institution (such as material changes in tax laws or regulations); or

(2) Leaves investors fully exposed to future draws by borrowers on the underlying exposures even after the provision is triggered.

*Effective notional amount* means, for an eligible guarantee or eligible credit derivative, the lesser of the contractual notional amount of the credit risk mitigant and the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant.

*Eligible clean-up call* means a clean-up call that:

(1) Is exercisable solely at the discretion of the originating System institution or servicer;

(2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and

(3)(i) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or

(ii) For a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

*Eligible credit derivative* means a credit derivative in the form of a credit default swap, n<sup>th</sup>-to-default swap, total return swap, or any other form of credit derivative approved by the FCA, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or n<sup>th</sup>-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Receivership, insolvency, liquidation, conservatorship or inability of the reference exposure issuer to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or n<sup>th</sup>-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the System institution records net payments received on the swap as net income, the System institution records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves).

*Eligible guarantee* means a guarantee from an eligible guarantor that:

(1) Is written;

(2) Is either:

(i) Unconditional; or

(ii) A contingent obligation of the U.S. Government or its agencies, the enforceability of which is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, meeting servicing requirements);

(3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;

(4) Gives the beneficiary a direct claim against the protection provider;

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) Except for a guarantee by a sovereign, is legally enforceable against the protection provider in a jurisdiction

where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(7) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment; and

(8) Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure.

*Eligible guarantor* means:

(1) A sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or

(2) An entity (other than a special purpose entity):

(i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade;

(ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and

(iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).

*Eligible margin loan* means:

(1) An extension of credit where:

(i) The extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities, or gold;

(ii) The collateral is marked-to-fair value daily, and the transaction is subject to daily margin maintenance requirements; and

(iii) The extension of credit is conducted under an agreement that provides the System institution the right to accelerate and terminate the extension of credit and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, conservatorship, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership,

conservatorship, resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs,<sup>2</sup> or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph (1)(iii) in order to facilitate the orderly resolution of the defaulting counterparty.

(2) In order to recognize an exposure as an eligible margin loan for purposes of this subpart, a System institution must comply with the requirements of § 628.3(b) with respect to that exposure.

*Eligible servicer cash advance facility* means a servicer cash advance facility in which:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not make advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

*Equity derivative contract* means an equity-linked swap, purchased equity-linked option, forward equity-linked contract, or any other instrument linked to equities that gives rise to similar counterparty credit risks.

*Equity exposure* means:

(1) A security or instrument (whether voting or non-voting) that represents a direct or an indirect ownership interest in, and is a residual claim on, the assets and income of a company, unless:

(i) The issuing company is consolidated with the System institution under GAAP;

(ii) The System institution is required to deduct the ownership interest from tier 1 or tier 2 capital under this part;

(iii) The ownership interest incorporates a payment or other similar obligation on the part of the issuing

company (such as an obligation to make periodic payments); or

(iv) The ownership interest is a securitization exposure;

(2) A security or instrument that is mandatorily convertible into a security or instrument described in paragraph (1) of this definition;

(3) An option or warrant that is exercisable for a security or instrument described in paragraph (1) of this definition; or

(4) Any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security or instrument described in paragraph (1) of this definition.

*ERISA* means the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1001 *et seq.*).

*Exchange rate derivative contract* means a cross-currency interest rate swap, forward foreign-exchange contract, currency option purchased, or any other instrument linked to exchange rates that gives rise to similar counterparty credit risks.

*Exposure* means an amount at risk.

*Exposure amount* means:

(1) For the on-balance sheet component of an exposure (other than an available-for-sale or held-to-maturity security; an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the System institution determines the exposure amount under § 628.37; a cleared transaction; or a securitization exposure), the System institution's carrying value of the exposure.

(2) For a security (that is not a securitization exposure, equity exposure, or preferred stock classified as an equity security under GAAP) classified as available-for-sale or held-to-maturity, the System institution's carrying value (including net accrued but unpaid interest and fees) for the exposure less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure.

(3) For available-for-sale preferred stock classified as an equity security under GAAP, the System institution's carrying value of the exposure less any net unrealized gains on the exposure that are reflected in such carrying value but excluded from the System institution's regulatory capital components.

(4) For the off-balance sheet component of an exposure (other than an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the System institution calculates the exposure amount under § 628.37; a cleared transaction; or a securitization exposure), the notional

amount of the off-balance sheet component multiplied by the appropriate credit conversion factor (CCF) in § 628.33.

(5) For an exposure that is an OTC derivative contract, the exposure amount determined under § 628.34.

(6) For an exposure that is a cleared transaction, the exposure amount determined under § 628.35.

(7) For an exposure that is an eligible margin loan or repo-style transaction for which the bank calculates the exposure amount as provided in § 628.37, the exposure amount determined under § 628.37.

(8) For an exposure that is a securitization exposure, the exposure amount determined under § 628.42.

*Farm Credit Act* means the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*).

*Federal Deposit Insurance Act* means the Federal Deposit Insurance Act (12 U.S.C. 1813).

*Federal Deposit Insurance Corporation Improvement Act* means the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401).

*Financial collateral* means collateral:

(1) In the form of:

(i) Cash on deposit at a depository institution or Federal Reserve Bank (including cash held for the System institution by a third-party custodian or trustee);

(ii) Gold bullion;

(iii) Long-term debt securities that are not resecuritization exposures and that are investment grade;

(iv) Short-term debt instruments that are not resecuritization exposures and that are investment grade;

(v) Equity securities that are publicly traded;

(vi) Convertible bonds that are publicly traded; or

(vii) Money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily; and

(2) In which the System institution has a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof (with the exception of cash on deposit at a depository institution or Federal Reserve Bank and notwithstanding the prior security interest of any custodial agent).

*First-lien residential mortgage exposure* means a residential mortgage exposure secured by a first lien.

*Foreign bank* means a foreign bank as defined in § 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2) (other than a depository institution).

*Forward agreement* means a legally binding contractual obligation to

<sup>2</sup> This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute "securities contracts" under section 555 of the Bankruptcy Code (11 U.S.C. 555), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act, or netting contracts between or among financial institutions under sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of the Federal Reserve Board's Regulation EE (12 CFR part 231).

purchase assets with certain drawdown at a specified future date, not including commitments to make residential mortgage loans or forward foreign exchange contracts.

*GAAP* means generally accepted accounting principles as used in the United States.

*Gain-on-sale* means an increase in the equity capital of a System institution (as reported on the Call Report) resulting from a traditional securitization (other than an increase in equity capital resulting from the System institution's receipt of cash in connection with the securitization or reporting of a mortgage servicing asset on the Call Report).

*General obligation* means a bond or similar obligation that is backed by the full faith and credit of a public sector entity (PSE).

*Government-sponsored enterprise (GSE)* means an entity established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.

*Guarantee* means a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider).

*Home country* means the country where an entity is incorporated, chartered, or similarly established.

*Insurance company* means an insurance company as defined in section 201 of the Dodd-Frank Act (12 U.S.C. 5381).

*Insurance underwriting company* means an insurance company as defined in section 201 of the Dodd-Frank Act (12 U.S.C. 5381) that engages in insurance underwriting activities.

*Insured depository institution* means an insured depository institution as defined in section 3 of the Federal Deposit Insurance Act.

*Interest rate derivative contract* means a single-currency interest rate swap, basis swap, forward rate agreement, purchased interest rate option, when-issued securities, or any other instrument linked to interest rates that gives rise to similar counterparty credit risks.

*International Lending Supervision Act* means the International Lending Supervision Act of 1983 (12 U.S.C. 3907).

*Investment fund* means a company:  
(1) Where all or substantially all of the assets of the company are financial assets; and

(2) That has no material liabilities.

*Investment grade* means that the entity to which the System institution is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

*Junior-lien residential mortgage exposure* means a residential mortgage exposure that is not a first-lien residential mortgage exposure.

*Member* means a borrower or former borrower from a System institution that holds voting or nonvoting cooperative equities of the institution.

*Money market fund* means an investment fund that is subject to 17 CFR 270.2a-7 or any foreign equivalent thereof.

*Mortgage servicing assets (MSAs)* means the contractual rights owned by a System institution to service for a fee mortgage loans that are owned by others.

*Multilateral development bank (MDB)* means the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. Government is a shareholder or contributing member or which the FCA determines poses comparable credit risk.

*National Bank Act* means the National Bank Act (12 U.S.C. 24).

*Netting set* means a group of transactions with a single counterparty that are subject to a qualifying master netting agreement or a qualifying cross-product master netting agreement. For purposes of calculating risk-based capital requirements using the internal models methodology in subpart E of this part, this term does not cover a transaction:

- (1) That is not subject to such a master netting agreement; or
- (2) Where the System institution has identified specific wrong-way risk.

*Nonqualified allocated equities* mean a patronage payment to a member-borrower in the form of stock or surplus that a System institution retains as equity for the benefit of the membership. A System institution does not deduct this patronage payment from its current taxable income according to the Internal Revenue Code sections 1382(b) and 1383. Nonqualified allocated equities also include allocated surplus in a tax-exempt institution or subsidiary. When a System institution revolves a nonqualified allocation, the System institution deducts the allocation from its taxable income, if any, and the borrower generally recognizes the tax liability, if any, as ordinary income. System institutions pay two types of nonqualified allocated equities through written notices of allocation to the borrowers:

- (1) Those subject to revolvment; and
  - (2) Those not subject to revolvment.
- The second type for GAAP purposes is generally considered an equivalent of unallocated surplus and consolidated with unallocated surplus on externally prepared shareholder reports.

*N<sup>th</sup>-to-default credit derivative* means a credit derivative that provides credit protection only for the nth-defaulting reference exposure in a group of reference exposures.

*Operating entity* means a company established to conduct business with clients with the intention of earning a profit in its own right and that generally produces goods or provides services beyond the business of investing, reinvesting, holding, or trading in financial assets. All System banks, associations, and service corporations, and all unincorporated business entities, are operating entities.

*Original maturity* with respect to an off-balance sheet commitment means the length of time between the date a commitment is issued and:

- (1) For a commitment that is not subject to extension or renewal, the stated expiration date of the commitment; or
- (2) For a commitment that is subject to extension or renewal, the earliest date on which the System institution can, at its option, unconditionally cancel the commitment.

*Originating System institution*, with respect to a securitization, means a System institution that:

- (1) Directly or indirectly originated the underlying exposures included in the securitization; or

(2) [Reserved]

*Other financing institution (OFI)* means any entity referred to in section 1.7(b)(1)(B) of the Farm Credit Act.

*Over-the-counter (OTC) derivative contract* means a derivative contract that is not a cleared transaction.

*Participation certificate* means borrower stock held by a borrower or customer of a System institution that does not have voting rights.

*Patronage payment* means a cash declaration or equity allocation to member-borrowers that pursuant to Internal Revenue Code section 1381(a) is based on a System institution's net income and allocated to borrowers based on business conducted with the institution. Patronage payments may be paid as cash, allocated equity (stock or surplus), or a combination of cash and allocated equity.

*Performance standby letter of credit (or performance bond)* means an irrevocable obligation of a System institution to pay a third-party beneficiary when a customer (account party) fails to perform on any contractual nonfinancial or commercial obligation. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things; subcontractors' and suppliers' performance, labor; and materials contracts, and construction bids.

*Protection amount (P)* means, with respect to an exposure hedged by an eligible guarantee or eligible credit derivative, the effective notional amount of the guarantee or credit derivative, reduced to reflect any currency mismatch, maturity mismatch, or lack of restructuring coverage (as provided in § 628.36).

*Publicly traded* means traded on:

(1) Any exchange registered with the Securities and Exchange Commission (SEC) as a national securities exchange under section 6 of the Securities Exchange Act; or

(2) Any non-U.S.-based securities exchange that:

(i) Is registered with, or approved by, a national securities regulatory authority; and

(ii) Provides a liquid, two-way market for the instrument in question.

*Public sector entity (PSE)* means a state, local authority, or other governmental subdivision below the sovereign level.

*Qualified allocated equities* means patronage allocated to a member-borrower, in the form of stock or surplus, that a System institution retains as equity for the benefit of the membership. A System institution can deduct this patronage from its current taxable income provided that the borrower has agreed to include the patronage in its taxable income. A System institution must pay at least 20

percent of a qualified patronage payment in cash to borrowers. A System institution must provide the borrowers with a qualified written notice of allocation when they allocate qualified patronage payments pursuant to Internal Revenue Code section 1381(b) and 1388(c). A System institution revolves qualified allocated equities according to a board-approved plan.

*Qualifying central counterparty (QCCP)* means a central counterparty that:

(1)(i) Is a designated financial market utility (FMU), as defined in section 803 of the Dodd-Frank Act;

(ii) If not located in the United States, is regulated and supervised in a manner equivalent to a designated FMU; or

(iii) Meets the following standards:

(A) The central counterparty requires all parties to contracts cleared by the counterparty to be fully collateralized on a daily basis;

(B) The System institution demonstrates to the satisfaction of the FCA that the central counterparty:

(1) Is in sound financial condition;

(2) Is subject to supervision by the Board, the CFTC, or the Securities Exchange Commission (SEC), or, if the central counterparty is not located in the United States, is subject to effective oversight by a national supervisory authority in its home country; and

(3) Meets or exceeds the risk-management standards for central counterparties set forth in regulations established by the Board, the CFTC, or the SEC under title VII or title VIII of the Dodd-Frank Act; or if the central counterparty is not located in the United States, meets or exceeds similar risk-management standards established under the law of its home country that are consistent with international standards for central counterparty risk management as established by the relevant standard setting body of the Bank of International Settlements; and

(2)(i) Provides the System institution with the central counterparty's hypothetical capital requirement or the information necessary to calculate such hypothetical capital requirement, and other information the System institution is required to obtain under § 628.35(d)(3);

(ii) Makes available to the FCA and the CCP's regulator the information described in paragraph (2)(i) of this definition; and

(iii) Has not otherwise been determined by the FCA to not be a QCCP due to its financial condition, risk profile, failure to meet supervisory risk management standards, or other weaknesses or supervisory concerns that are inconsistent with the risk weight

assigned to qualifying central counterparties under § 628.35.

(3) A QCCP that fails to meet the requirements of a QCCP in the future may still be treated as a QCCP under the conditions specified in § 628.3(f).

*Qualifying master netting agreement* means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default following any stay permitted by paragraph (2) of this definition, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the System institution the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than:

(i) In receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph (2)(i) in order to facilitate the orderly resolution of the defaulting counterparty; or

(ii) Where the agreement is subject by its terms to, or incorporates, any of the laws reference in paragraph (2)(i) of this definition;

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement); and

(4) In order to recognize an agreement as a qualifying master netting agreement for purposes of this subpart, a System institution must comply with the requirements of § 628.3(d) with respect to that agreement.

*Repo-style transaction* means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the System institution acts as agent for a customer

and indemnifies the customer against loss, provided that:

(1) The transaction is based solely on liquid and readily marketable securities, cash, or gold;

(2) The transaction is marked-to-fair value daily and subject to daily margin maintenance requirements;

(3)(i) The transaction is a “securities contract” or “repurchase agreement” under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559) or a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act; or

(ii) If the transaction does not meet the criteria set forth in paragraph (3)(i) of this definition, then either:

(A) The transaction is executed under an agreement that provides the System institution the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph (3)(ii)(A) in order to facilitate the orderly resolution of the defaulting counterparty; or

(B) The transaction is:

(1) Either overnight or unconditionally cancelable at any time by the System institution; and

(2) Executed under an agreement that provides the System institution the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set-off collateral promptly upon an event of counterparty default; and

(3) [Reserved]

(4) In order to recognize an exposure as a repo-style transaction for purposes of this subpart, a System institution must comply with the requirements of § 628.3(e) of this part with respect to that exposure.

*Resecuritization* means a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a securitization exposure.

*Resecuritization exposure* means:

(1) An on- or off-balance sheet exposure to a resecuritization; or

(2) An exposure that directly or indirectly references a resecuritization exposure.

*Residential mortgage exposure* means an exposure (other than a securitization exposure or equity exposure) that is:

(1) An exposure that is primarily secured by a first or subsequent lien on one-to-four family residential property, provided that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien; or

(2) [Reserved]

*Revenue obligation* means a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from the specific project financed rather than general tax funds.

*Savings and loan holding company* means a savings and loan holding company as defined in section 10 of the Home Owners' Loan Act (12 U.S.C. 1467a).

*Securities and Exchange Commission (SEC)* means the U.S. Securities and Exchange Commission.

*Securities Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78).

*Securitization exposure* means:

(1) An on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional securitization or synthetic securitization (including a resecuritization); or

(2) An exposure that directly or indirectly references a securitization exposure described in paragraph (1) of this definition.

*Securitization special purpose entity (securitization SPE)* means a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

*Servicer cash advance facility* means a facility under which the servicer of the underlying exposures of a securitization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures.

*Small Business Act* means the Small Business Act (15 U.S.C. 632).

*Small Business Investment Act* means the Small Business Investment Act of 1958 (15 U.S.C. 682).

*Sovereign* means a central government (including the U.S. Government) or an agency, department, ministry, or central bank of a central government.

*Sovereign default* means noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, or restructuring.

*Sovereign exposure* means:

(1) A direct exposure to a sovereign; or

(2) An exposure directly and unconditionally backed by the full faith and credit of a sovereign.

*Standardized total risk-weighted assets* means:

(1) The sum of:

(i) Total risk-weighted assets for general credit risk as calculated under § 628.31;

(ii) Total risk-weighted assets for cleared transactions as calculated under § 628.35;

(iii) Total risk-weighted assets for unsettled transactions as calculated under § 628.38;

(iv) Total risk-weighted assets for securitization exposures as calculated under § 628.42;

(v) Total risk-weighted assets for equity exposures as calculated under §§ 628.52 and 628.53; minus

(vi) [Reserved]

(2) Any amount of the System institution's allowance for loan losses that is not included in tier 2 capital.

*Subsidiary* means, with respect to a company, a company controlled by that company.

*Synthetic exposure* means an exposure whose value is linked to the value of an investment in the System institution's own capital instrument.

*Synthetic securitization* means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures; and

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).

*System bank* means a Farm Credit Bank, an agricultural credit bank, and a bank for cooperatives.

*System institution* means a System bank, an association of the Farm Credit System, Farm Credit Leasing Services Corporation, and their successors, and any other institution chartered by the FCA that the FCA determines should be considered a System institution for the purposes of this part.

*Tier 1 capital* means the sum of common equity tier 1 capital and additional tier 1 capital.

*Tier 2 capital* is defined in § 628.20(d).

*Total capital* means the sum of tier 1 capital and tier 2 capital.

*Traditional securitization* means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures;

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);

(5) The underlying exposures are not owned by an operating entity;

(6) The underlying exposures are not owned by a rural business investment company described in 7 U.S.C. 2009cc *et seq.*;

(7) [Reserved]

(8) The FCA may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction's leverage, risk profile, or economic substance;

(9) The FCA may deem a transaction that meets the definition of a traditional securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a traditional

securitization based on the transaction's leverage, risk profile, or economic substance; and

(10) The transaction is not:

(i) An investment fund;

(ii) A collective investment fund (as defined in [12 CFR 9.18 (national bank) and 12 CFR 151.40 (Federal saving association) (OCC); 12 CFR 208.34 (Board)]);

(iii) An employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of ERISA), a "governmental plan" (as defined in 29 U.S.C. 1002(32)) that complies with the tax deferral qualification requirements provided in the Internal Revenue Code, or any similar employee benefit plan established under the laws of a foreign jurisdiction;

(iv) A synthetic exposure to the capital of a System institution to the extent deducted from capital under § 628.22; or

(v) Registered with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1) or foreign equivalents thereof.

*Tranche* means all securitization exposures associated with a securitization that have the same seniority level.

*Two-way market* means a market where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within 1 day and settled at that price within a relatively short timeframe conforming to trade custom.

*Unallocated retained earnings (URE)* means accumulated net income that a System institution has not allocated to a member-borrower.

*Unallocated retained earnings (URE) equivalents* means nonqualified allocated equities, other than equities allocated to other System institutions, and paid-in capital resulting from a merger of System institutions or from a repurchase of third-party capital that a System institution:

(1) Designates as URE equivalents at the time of allocation (or on or before March 31, 2017, if allocated prior to January 1, 2017) and undertakes in its capitalization bylaws or a currently effective board of directors resolution not to change the designation without prior FCA approval; and

(2) Undertakes, in its capitalization bylaws or a currently effective board of directors resolution, not to exercise its discretion to revoke except upon dissolution or liquidation and not to offset against a loan in default except as required under final order of a court of competent jurisdiction or if required

under § 615.5290 of this chapter in connection with a restructuring under part 617 of this chapter.

*Unconditionally cancelable* means, with respect to a commitment that a System institution may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law).

*Underlying exposures* means one or more exposures that have been securitized in a securitization transaction.

*U.S. Government agency* means an instrumentality of the U.S. Government whose obligations are fully guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

### § 628.3 Operational requirements for certain exposures.

For purposes of calculating risk-weighted assets under subpart D of this part:

(a) *Cleared transaction*. In order to recognize certain exposures as cleared transactions pursuant to paragraph (1)(ii), (iii), or (iv) of the definition of "cleared transaction" in § 628.2, the exposures must meet all of the requirements set forth in this paragraph (a).

(1) The offsetting transaction must be identified by the CCP as a transaction for the clearing member client.

(2) The collateral supporting the transaction must be held in a manner that prevents the System institution from facing any loss due to an event of default, including from a liquidation, receivership, insolvency, or similar proceeding of either the clearing member or the clearing member's other clients. Omnibus accounts established under 17 CFR parts 190 and 300 satisfy the requirements of this paragraph (a).

(3) The System institution must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from a default or receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the arrangements of paragraph (a)(2) of this section to be legal, valid, binding and enforceable under the law of the relevant jurisdictions.

(4) The offsetting transaction with a clearing member must be transferable under the transaction documents and applicable laws in the relevant jurisdiction(s) to another clearing member should the clearing member default, become insolvent, or enter

receivership, insolvency, liquidation, or similar proceedings.

(b) *Eligible margin loan.* In order to recognize an exposure as an eligible margin loan as defined in § 628.2, a System institution must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement underlying the exposure:

- (1) Meets the requirements of paragraph (1)(iii) of the definition of “eligible margin loan” in § 628.2; and
- (2) Is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

(c) [Reserved]

(d) *Qualifying master netting agreement.* In order to recognize an agreement as a qualifying master netting agreement as defined in § 628.2, a System institution must:

(1) Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of the definition of “qualifying master netting agreement” in § 628.2; and

(ii) In the event of a legal challenge (including one resulting from default or from receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; and

(2) Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the definition of “qualifying master netting agreement” in § 628.2.

(e) *Repo-style transaction.* In order to recognize an exposure as a repo-style transaction as defined in § 628.2, a System institution must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement underlying the exposure:

- (1) Meets the requirements of paragraph (3) of the definition of “repo-style transaction” in § 628.2, and
- (2) Is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

(f) *Failure of a QCCP to satisfy the rule’s requirements.* If a System institution determines that a CCP ceases to be a QCCP due to the failure of the CCP to satisfy one or more of the requirements set forth in paragraph (2)(i) through (iii) of the definition of a

“QCCP” in § 628.2, the System institution may continue to treat the CCP as a QCCP for up to 3 months following the determination. If the CCP fails to remedy the relevant deficiency within 3 months after the initial determination, or the CCP fails to satisfy the requirements set forth in paragraph (2)(i) through (iii) of the definition of a QCCP continuously for a 3-month period after remedying the relevant deficiency, a System institution may not treat the CCP as a QCCP for the purposes of this part until after the System institution has determined that the CCP has satisfied the requirements in paragraph (2)(i) through (iii) of the definition of a QCCP for 3 continuous months.

#### §§ 628.4–628.9 [Reserved]

### Subpart B—Capital Ratio Requirements and Buffers

#### § 628.10 Minimum capital requirements.

(a) *Computation of regulatory capital ratios.* A System institution’s regulatory capital ratios are determined on the basis of the financial statements of the institution prepared in accordance with GAAP using average daily balances for the most recent 3 months.

(b) *Minimum capital requirements.* A System institution must maintain the following minimum capital ratios:

- (1) A common equity tier 1 (CET1) capital ratio of 4.5 percent.
- (2) A tier 1 capital ratio of 6 percent.
- (3) A total capital ratio of 8 percent.
- (4) A tier 1 leverage ratio of 4 percent, of which at least 1.5 percent must be composed of URE and URE equivalents.
- (5) [Reserved]
- (6) A permanent capital ratio of 7 percent.

(c) *Capital ratio calculations.* A System institution’s regulatory capital ratios are as follows:

- (1) *CET1 capital ratio.* A System institution’s CET1 capital ratio is the ratio of the System institution’s CET1 capital to total risk-weighted assets;
- (2) *Tier 1 capital ratio.* A System institution’s tier 1 capital ratio is the ratio of the System institution’s tier 1 capital to total risk-weighted assets;
- (3) *Total capital ratio.* A System institution’s total capital ratio is the ratio of the System institution’s total (tier 1 and tier 2) capital to total risk-weighted assets; and
- (4) *Tier 1 leverage ratio.* A System institution’s leverage ratio is the ratio of the institution’s tier 1 capital to the institution’s average total consolidated assets as reported on the institution’s Call Report minus amounts deducted from tier 1 capital under §§ 628.22(a) and (c) and 628.23.

(5) *Permanent capital ratio.* A System institution’s permanent capital ratio is the ratio of the institution’s permanent capital to its total risk-adjusted asset base as reported on the institution’s Call Report, calculated in accordance with the regulations in part 615, subpart H, of this chapter.

(d) [Reserved]

(e) *Capital adequacy.* (1) Notwithstanding the minimum requirements in this part, a System institution must maintain capital commensurate with the level and nature of all risks to which the System institution is exposed. FCA may evaluate a System institution’s capital adequacy and require the institution to maintain higher minimum regulatory capital ratios using the factors listed in § 615.5350 of this chapter.

(2) A System institution must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital under § 615.5200 of this chapter.

#### § 628.11 Capital buffer amounts.

(a) *Capital conservation buffer and leverage buffer—(1) Composition of the capital conservation buffer and leverage buffer.* (i) The capital conservation buffer for the CET1 capital ratio, tier 1 capital ratio, and total capital ratio is composed solely of CET1 capital.

(ii) The leverage buffer for the tier 1 leverage ratio is composed solely of tier 1 capital.

(2) *Definitions.* For purposes of this section, the following definitions apply:

(i) *Eligible retained income.* The eligible retained income of a System institution is the System institution’s net income for the 4 calendar quarters preceding the current calendar quarter, based on the System institution’s quarterly Call Reports, net of any capital distributions and associated tax effects not already reflected in net income.

(ii) *Maximum payout ratio.* The maximum payout ratio is the percentage of eligible retained income that a System institution can pay out in the form of capital distributions and discretionary bonus payments during the current calendar quarter. The maximum payout ratio is based on the System institution’s capital conservation buffer, calculated as of the last day of the previous calendar quarter, as set forth in Table 1 to § 628.11.

(iii) *Maximum payout amount.* A System institution’s maximum payout amount for the current calendar quarter is equal to the System institution’s eligible retained income, multiplied by

the applicable maximum payout ratio, as set forth in Table 1 to § 628.11.

(iv) [Reserved]

(v) *Maximum leverage payout ratio.*

The maximum leverage payout ratio is the percentage of eligible retained income that a System institution can pay out in the form of capital distributions and discretionary bonus payments during the current quarter. The maximum leverage payout ratio is based on the System institution's leverage buffer, calculated as of the last day of the previous quarter, as set forth in Table 2 to § 628.11.

(vi) *Maximum leverage payout amount.* A System institution's maximum leverage payout amount for the current calendar quarter is equal to the System institution's eligible retained income, multiplied by the applicable maximum leverage payout ratio, as set forth in Table 2 of § 628.11.

(vii) *Capital distribution* means:

(A) A reduction of tier 1 capital through the repurchase, redemption, or revolvement of a tier 1 capital instrument or by other means, except when a System institution, within the same quarter when the repurchase is announced, fully replaces a tier 1 capital instrument it has repurchased, redeemed, or revolved by issuing a purchased capital instrument that meets the eligibility criteria for:

(1) A CET1 capital instrument if the instrument being repurchased, redeemed, or revolved was part of the System institution's CET1 capital; or

(2) A CET1 or AT1 capital instrument if the instrument being repurchased, redeemed, or revolved was part of the System institution's tier 1 capital;

(B) A reduction of tier 2 capital through the repurchase, redemption prior to maturity, or revolvement of a tier 2 capital instrument or by other means, except when a System institution, within the same quarter when the repurchase, redemption, or revolvement is announced, fully replaces a tier 2 capital instrument it has repurchased, redeemed, or revolved by issuing a purchased capital instrument that meets the eligibility criteria for a tier 1 or tier 2 capital instrument;

(C) A dividend declaration or payment on any tier 1 capital instrument;

(D) A dividend declaration or interest payment on any capital instrument other than a tier 1 capital instrument if the System institution has full discretion to permanently or temporarily suspend such payments without triggering an event of default;

(E) A cash patronage declaration or payment;

(F) A patronage declaration in the form of allocated equities that did not qualify as tier 1 or tier 2 capital; or

(G) Any similar transaction that the FCA determines to be in substance a distribution of capital.

(viii) *Discretionary bonus payment* means a payment made to a senior officer of a System institution, where:

(A) The System institution retains discretion as to whether to make, and the amount of, the payment until the payment is awarded to the senior officer;

(B) The amount paid is determined by the System institution without prior promise to, or agreement with, the senior officer; and

(C) The senior officer has no contractual right, whether express or implied, to the bonus payment.

(ix) *Senior officer* means the Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer, the Chief Credit Officer, and the General Counsel, or persons in similar positions; and any other person responsible for a major policy-making function.

(3) *Calculation of capital conservation buffer and leverage buffer.* (i) A System institution's capital conservation buffer is equal to the lowest of paragraphs (a)(3)(i)(A), (B), and (C) of this section, and the leverage buffer is equal to paragraph (a)(3)(i)(D) of this section, calculated as of the last day of the previous calendar quarter based on the System institution's most recent Call Report:

(A) The System institution's CET1 capital ratio minus the System institution's minimum CET1 capital ratio requirement under § 628.10;

(B) The System institution's tier 1 capital ratio minus the System institution's minimum tier 1 capital ratio requirement under § 628.10;

(C) The System institution's total capital ratio minus the System institution's minimum total capital ratio requirement under § 628.10; and

(D) The System institution's tier 1 leverage ratio minus the System institution's minimum tier 1 leverage ratio requirement under § 628.10.

(ii) Notwithstanding paragraphs (a)(3)(i)(A) through (D) of this section, if the System institution's CET1 capital ratio, tier 1 capital ratio, total capital ratio or tier 1 leverage ratio is less than or equal to the System institution's minimum CET1 capital ratio, tier 1 capital ratio, total capital ratio or tier 1 leverage ratio requirement under § 628.10, respectively, the System institution's capital conservation buffer or leverage buffer is zero.

(4) *Limits on capital distributions and discretionary bonus payments.* (i) A

System institution must not make capital distributions or discretionary bonus payments or create an obligation to make such capital distributions or payments during the current calendar quarter that, in the aggregate, exceed the maximum payout amount or, as applicable, the maximum leverage payout amount.

(ii) A System institution that has a capital conservation buffer that is greater than 2.5 percent and a leverage buffer that is greater than 1.0 percent is not subject to a maximum payout amount or maximum leverage payout amount under this section.

(iii) *Negative eligible retained income.* Except as provided in paragraph (a)(4)(iv) of this section, a System institution may not make capital distributions or discretionary bonus payments during the current calendar quarter if the System institution's:

(A) Eligible retained income is negative; and

(B) Capital conservation buffer was less than 2.5 percent, or the leverage buffer was less than 1.0 percent, as of the end of the previous calendar quarter.

(iv) *Prior approval.* Notwithstanding the limitations in paragraphs (a)(4)(i) through (iii) of this section, FCA may permit a System institution to make a capital distribution or discretionary bonus payment upon a request of the System institution, if FCA determines that the capital distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the System institution. In making such a determination, FCA will consider the nature and extent of the request and the particular circumstances giving rise to the request.

TABLE 1 TO § 628.11—CALCULATION OF MAXIMUM PAYOUT AMOUNT

Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
>2.500 percent .....	No limitation.
≤2.500 percent, and >1.875 percent.	60 percent.
≤1.875 percent, and >1.250 percent.	40 percent.
≤1.250 percent, and >0.625 percent.	20 percent.
≤0.625 percent .....	0 percent.

TABLE 2 TO § 628.11—CALCULATION OF MAXIMUM LEVERAGE PAYOUT AMOUNT

Leverage buffer	Maximum leverage payout ratio (as a percentage of eligible retained income)
>1.00 percent .....	No limitation.
≤1.00 percent, and >0.75 percent.	60 percent.
≤0.75 percent, and >0.50 percent.	40 percent.
≤0.50 percent, and >0.25 percent.	20 percent.
≤0.25 percent .....	0 percent.

(v) *Other limitations on capital distributions.* Additional limitations on capital distributions may apply to a System institution under subpart C of this part and under part 615, subparts L and M, of this chapter.

(vi) A System institution is subject to the lower of the maximum payout amount as determined under paragraph (a)(2)(iii) of this section and the maximum leverage payout amount as determined under paragraph (a)(2)(vi) of this section.

(b) [Reserved]

§§ 628.12–628.19 [Reserved]

Subpart C—Definition of Capital

§ 628.20 Capital components and eligibility criteria for tier 1 and tier 2 capital instruments.

(a) *Regulatory capital components.* A System institution’s regulatory capital components are:

- (1) CET1 capital;
- (2) AT1 capital; and
- (3) Tier 2 capital.

(b) *CET1 capital.* CET1 capital is the sum of the CET1 capital elements in paragraph (b) of this section, minus regulatory adjustments and deductions in § 628.22. The CET1 capital elements are:

(1) Any common cooperative equity instrument issued by a System institution that meets all of the following criteria:

(i) The instrument is issued directly by the System institution and represents a claim subordinated to general creditors, subordinated debt holders, and preferred stock holders in a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(ii) The holder of the instrument is entitled to a claim on the residual assets of the System institution, the claim will be paid only after all creditors, subordinated debt holders, and

preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding;

(iii) The instrument has no maturity date, can be redeemed only at the discretion of the System institution and with the prior approval of FCA, and does not contain any term or feature that creates an incentive to redeem;

(iv) The System institution did not create, through any action or communication, an expectation that it will buy back, cancel, redeem, or revolve the instrument, and the instrument does not include any term or feature that might give rise to such an expectation, except that the establishment of a revolving period of 7 years or more, or the practice of redeeming or revolving the instrument no less than 7 years after issuance or allocation, will not be considered to create such an expectation;

(v) Any cash dividend payments on the instrument are paid out of the System institution’s net income or unallocated retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument;

(vi) The System institution has full discretion at all times to refrain from paying any dividends without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the System institution;

(vii) Dividend payments and other distributions related to the instrument may be paid only after all legal and contractual obligations of the System institution have been satisfied, including payments due on more senior claims;

(viii) The holders of the instrument bear losses as they occur before any losses are borne by holders of preferred stock claims on the System institution and holders of any other claims with priority over common cooperative equity instruments in a receivership, insolvency, liquidation, or similar proceeding;

(ix) The instrument is classified as equity under GAAP;

(x) The System institution, or an entity that the System institution controls, did not purchase or directly or indirectly fund the purchase of the instrument, except that where there is an obligation for a member of the institution to hold an instrument in order to receive a loan or service from the System institution, an amount of that loan equal to the minimum borrower stock requirement under section 4.3A of the Act will not be considered as a direct or indirect funding where:

(A) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan; and

(B) The purchase or acquisition of one or more member equities of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution;

(xi) The instrument is not secured, not covered by a guarantee of the System institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(xii) The instrument is issued in accordance with applicable laws and regulations and with the institution’s capitalization bylaws;

(xiii) The instrument is reported on the System institution’s regulatory financial statements separately from other capital instruments; and

(xiv) The System institution’s capitalization bylaws, or a resolution adopted by its board of directors under § 615.5200(d) of this chapter and reaffirmed by the board on an annual basis, provides that the institution:

(A) Establishes a minimum redemption or revolving period of 7 years for equities included in CET1; and

(B) Shall not redeem, revolve, cancel, or remove any equities included in CET1 without prior approval of the FCA under § 628.20(f), except that the minimum statutory borrower stock described in paragraph (b)(1)(x) of this section may be redeemed without a minimum period outstanding after issuance and without the prior approval of the FCA.

(2) Unallocated retained earnings.

(3) Paid-in capital resulting from a merger of System institutions or repurchase of third-party capital.

(4) [Reserved]

(5) [Reserved]

(c) *AT1 capital.* AT1 capital is the sum of additional tier 1 capital elements and related surplus, minus the regulatory adjustments and deductions in §§ 628.22 and 628.23. AT1 capital elements are:

(1) Instruments and related surplus, other than common cooperative equities, that meet the following criteria:

(i) The instrument is issued and paid-in;

(ii) The instrument is subordinated to general creditors and subordinated debt holders of the System institution in a receivership, insolvency, liquidation, or similar proceeding;

(iii) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(iv) The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem;

(v) If callable by its terms, the instrument may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called earlier than 5 years upon the occurrence of a regulatory event that precludes the instrument from being included in AT1 capital, or a tax event. In addition:

(A) The System institution must receive prior approval from FCA to exercise a call option on the instrument.

(B) The System institution does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

(C) Prior to exercising the call option, or immediately thereafter, the System institution must either replace the instrument to be called with an equal amount of instruments that meet the criteria under paragraph (b) of this section or this paragraph (c),<sup>3</sup> or demonstrate to the satisfaction of FCA that following redemption, the System institution will continue to hold capital commensurate with its risk;

(vi) Redemption or repurchase of the instrument requires prior approval from FCA;

(vii) The System institution has full discretion at all times to cancel dividends or other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the System institution except in relation to any distributions to holders of common cooperative equity instruments or other instruments that are *pari passu* with the instrument;

(viii) Any distributions on the instrument are paid out of the System institution's net income, unallocated retained earnings, or surplus related to other AT1 capital instruments;

(ix) The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the System institution's credit quality, but may have a dividend rate that is adjusted periodically independent of the System institution's credit quality, in relation to general market interest rates or similar adjustments;

(x) The paid-in amount is classified as equity under GAAP;

<sup>3</sup> Replacement can be concurrent with redemption of existing AT1 capital instruments.

(xi) The System institution did not purchase or directly or indirectly fund the purchase of the instrument;

(xii) The instrument does not have any features that would limit or discourage additional issuance of capital by the System institution, such as provisions that require the System institution to compensate holders of the instrument if a new instrument is issued at a lower price during a specified timeframe; and

(xiii) [Reserved]

(xiv) The System institution's capitalization bylaws, or a resolution adopted by its board of directors under § 615.5200(d) of this chapter and reaffirmed by the board on an annual basis, provides that the institution:

(A) Establishes a minimum redemption or no-call period of 5 years for equities included in additional tier 1; and

(B) Shall not redeem, revolve, cancel, or remove any equities included in additional tier 1 capital without prior approval of the FCA under § 628.20(f).

(2) [Reserved]

(3) [Reserved]

(4) Notwithstanding the criteria for AT1 capital instruments referenced in paragraph (c)(1) of this section:

(i) [Reserved]

(ii) An instrument with terms that provide that the instrument may be called earlier than 5 years upon the occurrence of a rating agency event does not violate the criterion in paragraph (c)(1)(v) of this section provided that the instrument was issued and included in a System institution's core surplus capital prior to January 1, 2017, and that such instrument satisfies all other criteria under this § 628.20(c).

(d) *Tier 2 Capital.* Tier 2 capital is the sum of tier 2 capital elements and any related surplus minus regulatory adjustments and deductions in §§ 628.22 and 628.23. Tier 2 capital elements are:

(1) Instruments (plus related surplus) that meet the following criteria:

(i) The instrument is issued and paid-in, is a common cooperative equity, or is member equity purchased in accordance with paragraph (d)(1)(viii) of this section;

(ii) The instrument is subordinated to general creditors of the System institution;

(iii) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;

(iv) The instrument has a minimum original maturity of at least 5 years. At

the beginning of each of the last 5 years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when the remaining maturity is less than 1 year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the System institution to redeem the instrument prior to maturity;<sup>4</sup>

(v) The instrument, by its terms, may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, or a tax event. In addition:

(A) The System institution must receive the prior approval of FCA to exercise a call option on the instrument.

(B) The System institution does not create at issuance, through action or communication, an expectation the call option will be exercised.

(C) Prior to exercising the call option, or immediately thereafter, the System institution must either: replace any amount called with an equivalent amount of an instrument that meets the criteria for regulatory capital under this section;<sup>5</sup> or demonstrate to the satisfaction of FCA that following redemption, the System institution would continue to hold an amount of capital that is commensurate with its risk;

(vi) The holder of the instrument must have no contractual right to accelerate payment of principal, dividends, or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(vii) The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the System institution's credit standing, but may have a dividend rate that is adjusted periodically independent of the System institution's credit standing, in relation to general market interest rates or similar adjustments;

(viii) The System institution has not purchased and has not directly or indirectly funded the purchase of the instrument, except that where common

<sup>4</sup> An instrument that by its terms automatically converts into a tier 1 capital instrument prior to five years after issuance complies with the five-year maturity requirement of this criterion.

<sup>5</sup> A System institution may replace tier 2 capital instruments concurrent with the redemption of existing tier 2 capital instruments.

cooperative equity instruments are held by a member of the institution in connection with a loan, and the institution funds the acquisition of such instruments, that loan shall not be considered as a direct or indirect funding where:

(A) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan;

(B) The purchase or acquisition of one or more capital instruments of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution; and

(C) The capital instruments are in excess of the statutory minimum stock purchase amount.

(ix) [Reserved]

(x) Redemption of the instrument prior to maturity or repurchase is at the discretion of the System institution and requires the prior approval of the FCA;

(xi) The System institution's capitalization bylaws, or a resolution adopted by its board of directors under § 615.5200(d) of this chapter and reaffirmed by the board on an annual basis, provides that the institution:

(A) Establishes a minimum call, redemption or revolvment period of 5 years for equities included in tier 2 capital; and

(B) Shall not call, redeem, revolve, cancel, or remove any equities included in tier 2 capital without prior approval of the FCA under § 628.20(f).

(2) [Reserved]

(3) ALL up to 1.25 percent of the System institution's total risk-weighted assets not including any amount of the ALL.

(4) [Reserved]

(5) [Reserved]

(6) [Reserved]

(e) *FCA approval of a capital element.*

(1) A System institution must receive FCA prior approval to include a capital element (as listed in this section) in its CET1 capital, AT1 capital, or tier 2 capital unless the element is equivalent, in terms of capital quality and ability to absorb losses with respect to all material terms, to a regulatory capital element FCA determined may be included in regulatory capital pursuant to paragraph (e)(3) of this section.

(i) [Reserved]

(ii) [Reserved]

(2) [Reserved]

(3) After determining that a regulatory capital element may be included in a System institution's CET1 capital, AT1 capital, or tier 2 capital, FCA will make its decision publicly available.

(f) *FCA prior approval of capital redemptions and dividends included in tier 1 and tier 2 capital.* (1) Subject to the provisions of paragraphs (f)(5) and

(6) of this section, a System institution must obtain the prior approval of the FCA before paying cash dividend payments, cash patronage payments, or redeeming equities included in tier 1 or tier 2 capital, other than term equities redeemed on their maturity date.

(2) At least 30 days prior to the intended action, the System institution must submit a request for approval to the FCA. The FCA's 30-day review period begins on the date on which the FCA receives the request.

(3) The request is deemed to be granted if the FCA does not notify the System institution to the contrary before the end of the 30-day review period.

(4)(i) A System institution may request advance approval to cover several anticipated cash dividend or patronage payments, or equity redemptions, provided that the institution projects sufficient current net income during those periods to support the amount of the cash dividend or patronage payments and equity redemptions. In determining whether to grant advance approval, the FCA will consider:

(A) The reasonableness of the institution's request, including its historical and projected cash dividend and patronage payments and equity redemptions;

(B) The institution's historical trends and current projections for capital growth through earnings retention;

(C) The overall condition of the institution, with particular emphasis on current and projected capital adequacy as described in § 628.10(e); and

(D) Any other information that the FCA deems pertinent to reviewing the institution's request.

(ii) After considering these standards, the FCA may grant advance prior approval of an institution's request to pay cash dividends and patronage or to redeem or revolve equity.

Notwithstanding any such approval, an institution may not declare a dividend or patronage payment or redeem or revolve equities if, after such declaration, redemption, or revolvment, the institution would not meet its regulatory capital requirements set forth in this part and part 615 of this chapter.

(5) Subject to any capital distribution restrictions specified in § 628.11, a System institution is deemed to have FCA prior approval for revolvments and redemptions of common cooperative equities, for cash dividend payments on all equities, and for cash patronage payments on all cooperative equities, provided that:

(i) For redemptions or revolvments of common cooperative equities

included in CET1 capital or tier 2 capital, other than as provided in paragraph (f)(6) of this section, the institution issued or allocated such equities at least 7 years ago for CET1 capital and at least 5 years ago for tier 2 capital;

(ii) After such cash payments, the dollar amount of the System institution's CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date in the previous calendar year; and

(iii) The System institution continues to comply with all regulatory capital requirements and supervisory or enforcement actions.

(6) The following equities are eligible to be redeemed or revolved under paragraph (f)(5)(i) of this section in less than the applicable minimum required holding period (7 years for CET1 inclusion and 5 years for tier 2 inclusion), provided that the requirements of paragraphs (f)(5)(ii) and (iii) of this section are met:

(i) Equities mandated to be redeemed or retired by a final order of a court of competent jurisdiction;

(ii) Equities held by the estate of a deceased former borrower; and

(iii) Equities that the institution is required to cancel under § 615.5290 of this chapter in connection with a restructuring under part 617 of this chapter.

#### **§ 628.21 [Reserved]**

#### **§ 628.22 Regulatory capital adjustments and deductions.**

(a) *Regulatory capital deductions from CET1 capital.* A System institution must deduct from the sum of its CET1 capital elements the items set forth in this paragraph (a):

(1) Goodwill, net of associated deferred tax liabilities (DTLs) in accordance with paragraph (e) of this section;

(2) Intangible assets, other than mortgage servicing assets (MSAs), net of associated DTLs in accordance with paragraph (e) of this section;

(3) Deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards net of any related valuation allowances and net of DTLs in accordance with paragraph (e) of this section;

(4) Any gain-on-sale in connection with a securitization exposure;

(5) Any defined benefit pension fund net asset, net of any associated DTL in accordance with paragraph (e) of this section, except that, with FCA prior approval, this deduction is not required for any defined benefit pension fund net asset to the extent the institution has

unrestricted and unfettered access to the assets in that fund;

(6) The System institution's allocated equity investment in another System institution; and

(7) [Reserved]

(8) If, without the required prior FCA approval, the System institution redeems or revokes purchased or allocated equities included in its CET1 capital that have been outstanding for less than 7 years, the FCA may take appropriate supervisory or enforcement actions against the institution, which may include requiring the institution to deduct a portion of its purchased and allocated equities from CET1 capital.

(b) [Reserved]

(c) *Deductions from regulatory capital.*<sup>6</sup> (1) [Reserved]

(2) *Corresponding deduction approach.* For purposes of subpart C of this part, the corresponding deduction approach is the methodology used for the deductions from regulatory capital related to purchased equity investments in another System institution (as described in paragraph (c)(5) of this section). Under the corresponding deduction approach, a System institution must make deductions from the component of capital for which the underlying instrument would qualify if it were issued by the System institution itself. If the System institution does not have a sufficient amount of a specific component of capital to effect the required deduction, the shortfall must be deducted according to paragraph (f) of this section.

(i) [Reserved]

(ii) [Reserved]

(iii) [Reserved]

(3) [Reserved]

(4) [Reserved]

(5) *Purchased equity investments in another System institution.* System institutions must deduct all purchased equity investments in another System institution, service corporation, or the Funding Corporation by applying the corresponding deduction approach. The deductions described in this section are net of associated DTLs in accordance with paragraph (e) of this section. With prior written approval of FCA, for the period stipulated by FCA, a System institution is not required to deduct an investment in the capital of another institution in distress if such investment is made to provide financial support to the System institution as determined by FCA.

(d) [Reserved]

<sup>6</sup> The System institution must calculate amounts deducted under paragraphs (c) through (f) of this section and § 628.23 after it calculates the amount of ALL includable in tier 2 capital under § 628.20(d)(3).

(e) *Netting of DTLs against assets subject to deduction.* (1) The netting of DTLs against assets that are subject to deduction under this section is required, if the following conditions are met:

(i) The DTL is associated with the asset; and

(ii) The DTL would be extinguished if the associated asset becomes impaired or is derecognized under GAAP.

(2) A DTL may only be netted against a single asset.

(3) [Reserved]

(4) [Reserved]

(5) A System institution must net DTLs against assets subject to deduction under this section in a consistent manner from reporting period to reporting period.

(f) *Insufficient amounts of a specific regulatory capital component to effect deductions.* Under the corresponding deduction approach, if a System institution does not have a sufficient amount of a specific component of capital to effect the required deduction after completing the deductions required under paragraph (c) of this section, the System institution must deduct the shortfall from the next higher (that is, more subordinated) component of regulatory capital.

(g) *Treatment of assets that are deducted.* A System institution must exclude from total risk-weighted assets any item deducted from regulatory capital under paragraphs (a) and (c) of this section.

(h) [Reserved]

#### § 628.23 Limit on inclusion of third-party capital in total (tier 1 and tier 2) capital.

The combined amount of third-party capital instruments that a System institution may include in total (tier 1 and tier 2) capital is equal to the greater of the following:

(a) The then existing limit, if any; or

(b) The lesser of:

(1) Forty percent of total capital, calculated by taking two thirds of the average of the previous 4 quarters of total capital reported on the institution's Call Report filed with the FCA, less any amounts of third-party capital reported in total capital; or

(2) The average of the previous 4 quarters of CET1 capital reported on its Call Report filed with the FCA.

(c) *Treatment of assets that are deducted.* A System institution must exclude from total risk-weighted assets any item deducted from regulatory capital under this section.

#### §§ 628.24–628.29 [Reserved]

### Subpart D—Risk Weighted Assets—Standardized Approach

#### § 628.30 Applicability.

(a) This subpart sets forth methodologies for determining risk-weighted assets for purposes of the generally applicable risk-based capital requirements for all System institutions.

(b) [Reserved]

#### Risk-Weighted Assets for General Credit Risk

#### § 628.31 Mechanics for calculating risk-weighted assets for general credit risk.

(a) *General risk-weighting requirements.* A System institution must apply risk weights to its exposures as follows:

(1) A System institution must determine the exposure amount of each on-balance sheet exposure, each OTC derivative contract, and each off-balance sheet commitment, trade and transaction-related contingency, guarantee, repo-style transaction, financial standby letter of credit, forward agreement, or other similar transaction that is not:

(i) An unsettled transaction subject to § 628.38;

(ii) A cleared transaction subject to § 628.35;

(iii) [Reserved]

(iv) A securitization exposure subject to §§ 628.41 through 628.45; or

(v) An equity exposure (other than an equity OTC derivative contract) subject to §§ 628.51 through 628.53.

(2) The System institution must multiply each exposure amount by the risk weight appropriate to the exposure based on the exposure type or counterparty, eligible guarantor, or financial collateral to determine the risk-weighted asset amount for each exposure.

(b) Total risk-weighted assets for general credit risk equals the sum of the risk-weighted asset amounts calculated under this section.

#### § 628.32 General risk weights.

(a) *Sovereign exposures—(1) Exposures to the U.S. Government.* (i) Notwithstanding any other requirement in this subpart, a System institution must assign a 0-percent risk weight to:

(A) An exposure to the U.S. Government, its central bank, or a U.S. Government agency; and

(B) 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 or National Credit Union Administration.

(ii) A System institution must assign a 20-percent risk weight to the portion of an exposure that is conditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency. This includes an exposure, or the portion of an exposure, that is conditionally guaranteed by the Federal Deposit Insurance Corporation or National Credit Union Administration.

(2) *Other sovereign exposures.* In accordance with Table 1 to § 628.32, a System institution must assign a risk weight to a sovereign exposure based on the Country Risk Classification (CRC) applicable to the sovereign or the sovereign's Organization for Economic Cooperation and Development (OECD) membership status if there is no CRC applicable to the sovereign.

TABLE 1 TO § 628.32—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

	Risk weight (in percent)
CRC:	
0–1 .....	0
2 .....	20
3 .....	50
4–6 .....	100
7 .....	150
OECD Member with no CRC	0
Non-OECD Member with no CRC .....	100
Sovereign Default .....	150

(3) *Certain sovereign exposures.* Notwithstanding paragraph (a)(2) of this section, a System institution may assign to a sovereign exposure a risk weight that is lower than the applicable risk weight in Table 1 to § 628.32 if:

- (i) The exposure is denominated in the sovereign's currency;
- (ii) The System institution has at least an equivalent amount of liabilities in that currency; and
- (iii) The risk weight is not lower than the risk weight that the sovereign allows banking organizations under its jurisdiction to assign to the same exposures to the sovereign.

(4) *Exposures to a non-OECD member sovereign with no CRC.* Except as provided in paragraphs (a)(3), (5), and (6) of this section, a System institution must assign a 100-percent risk weight to a sovereign exposure if the sovereign does not have a CRC.

(5) *Exposures to an OECD member sovereign with no CRC.* Except as provided in paragraph (a)(6) of this section, a System institution must assign a 0-percent risk weight to an

exposure to a sovereign that is a member of the OECD if the sovereign does not have a CRC.

(6) *Sovereign default.* A System institution must assign a 150-percent risk weight to a sovereign exposure immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous 5 years.

(b) *Certain supranational entities and multilateral development banks (MDBs).* A System institution must assign a 0-percent risk weight to an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(c) *Exposures to Government-sponsored enterprises (GSEs).* (1) A System institution must assign a 20-percent risk weight to an exposure to a GSE other than an equity exposure or preferred stock.

(2) A System institution must assign a 100-percent risk weight to preferred stock issued by a non-System GSE.

(3) Purchased equity investments (including preferred stock investments) in other System institutions do not receive a risk weight, because they are deducted from capital in accordance with § 628.22.

(d) *Exposures to depository institutions, foreign banks, and credit unions—(1) Exposures to U.S. depository institutions and credit unions.* A System institution must assign a 20-percent risk weight to an exposure to a depository institution or credit union that is organized under the laws of the United States or any state thereof, except as otherwise provided in this paragraph (d). This risk weight applies to an exposure a System bank has to another financing institution (OFI) that is a depository institution or credit union organized under the laws of the United States or any state thereof or is owned and controlled by such an entity that guarantees the exposure. If the OFI exposure does not satisfy these requirements, it must be assigned a risk weight as a corporate exposure pursuant to paragraph (f)(1)(ii) or (f)(2) of this section.

(2) *Exposures to foreign banks.* (i) Except as otherwise provided under paragraph (d)(2)(iv) of this section, a System institution must assign a risk weight to an exposure to a foreign bank, in accordance with Table 2 to § 628.32, based on the CRC rating that corresponds to the foreign bank's home country or the OECD membership status of the foreign bank's home country if there is no CRC applicable to the foreign bank's home country.

TABLE 2 TO § 628.32—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
CRC:	
0–1 .....	20
2 .....	50
3 .....	100
4–7 .....	150
OECD Member with No CRC	20
Non-OECD with No CRC .....	100
Sovereign Default .....	150

(ii) A System institution must assign a 20-percent risk weight to an exposure to a foreign bank whose home country is a member of the OECD and does not have a CRC.

(iii) A System institution must assign a 100-percent risk weight to an exposure to a foreign bank whose home country is not a member of the OECD and does not have a CRC, with the exception of self-liquidating, trade-related contingent items that arise from the movement of goods, and that have a maturity of 3 months or less, which may be assigned a 20-percent risk weight.

(iv) A System institution must assign a 150-percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign bank's home country during the previous 5 years.

(3) [Reserved]

(e) *Exposures to public sector entities (PSEs)—(1) Exposures to U.S. PSEs.* (i) A System institution must assign a 20-percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(ii) A System institution must assign a 50-percent risk weight to a revenue obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(2) *Exposures to foreign PSEs.* (i) Except as provided in paragraphs (e)(1) and (3) of this section, a System institution must assign a risk weight to a general obligation exposure to a foreign PSE, in accordance with Table 3 to § 628.32, based on the CRC that corresponds to the PSE's home country or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(ii) Except as provided in paragraphs (e)(1) and (3) of this section, a System institution must assign a risk weight to a revenue obligation exposure to a foreign PSE, in accordance with Table 4 to § 628.32, based on the CRC that

corresponds to the PSE's home country; or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(3) A System institution may assign a lower risk weight than would otherwise apply under Tables 3 and 4 to § 628.32 to an exposure to a foreign PSE if:

(i) The PSE's home country supervisor allows banks under its jurisdiction to assign a lower risk weight to such exposures; and

(ii) The risk weight is not lower than the risk weight that corresponds to the PSE's home country in accordance with Table 1 to § 628.32.

TABLE 3 TO § 628.32—RISK WEIGHTS FOR NON-U.S. PSE GENERAL OBLIGATIONS

	Risk weight (in percent)
CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
OECD Member with No CRC	20
Non-OECD Member with No CRC .....	100
Sovereign Default .....	150

TABLE 4 TO § 628.32—RISK WEIGHTS FOR NON-U.S. PSE REVENUE OBLIGATIONS

	Risk weight (in percent)
CRC:	
0-1 .....	50
2-3 .....	100
4-7 .....	150
OECD Member with No CRC	50
Non-OECD Member with No CRC .....	100
Sovereign Default .....	150

(4) *Exposures to PSEs from an OECD member sovereign with no CRC.* (i) A System institution must assign a 20-percent risk weight to a general obligation exposure to a PSE whose home country is a OECD member sovereign with no CRC.

(ii) A System institution must assign a 50-percent risk weight to a revenue obligation exposure to a PSE whose country is an OECD member sovereign with no CRC.

(5) *Exposures to PSEs whose home country is not an OECD member sovereign with no CRC.* A System institution must assign a 100-percent risk weight to an exposure to a PSE whose home country is not a member of the OECD and does not have a CRC.

(6) A System institution must assign a 150-percent risk weight to a PSE exposure immediately upon

determining that an event of sovereign default has occurred in a PSE's home country or if an event of sovereign default has occurred in the PSE's home country during the previous 5 years.

(f) *Corporate exposures*—(1) *100-percent risk weight.* Except as provided in paragraph (f)(2) of this section, a System institution must assign a 100-percent risk weight to all its corporate exposures. Assets assigned a risk weight under this provision include:

(i) Borrower loans such as agricultural loans and consumer loans, regardless of the corporate form of the borrower, unless those loans qualify for different risk weights under other provisions of this subpart D;

(ii) System bank exposures to OFIs that do not satisfy the requirements for a 20-percent risk weight pursuant to paragraph (d)(1) of this section or a 50-percent risk weight pursuant to paragraph (f)(2) of this section; and

(iii) Premises, fixed assets, and other real estate owned.

(2) *50-percent risk weight.* Unless the OFI satisfies the requirements for a 20-percent risk weight pursuant to paragraph (d)(1) of this section, a System institution must assign a 50-percent risk weight to an exposure to an OFI that satisfies at least one of the following requirements:

(i) The OFI is investment grade or is owned and controlled by an investment grade entity that guarantees the exposure; or

(ii) The OFI meets capital, risk identification and control, and operational standards similar to the OFIs identified in paragraph (d)(1) of this section.

(g) *Residential mortgage exposures.* (1) A System institution must assign a 50-percent risk weight to a first-lien residential mortgage exposure that:

(i) Is secured by a property that is either owner-occupied or rented;

(ii) Is made in accordance with prudent underwriting standards suitable for residential property, including standards relating to the loan amount as a percent of the appraised value of the property;

(iii) Is not 90 days or more past due or carried in nonaccrual status; and

(iv) Is not restructured or modified.

(2) A System institution must assign a 100-percent risk weight to a first-lien residential mortgage exposure that does not meet the criteria in paragraph (g)(1) of this section, and to junior-lien residential mortgage exposures.

(3) For the purpose of this paragraph (g), if a System institution holds the first-lien and junior-lien(s) residential mortgage exposures, and no other party holds an intervening lien, the System

institution must combine the exposures and treat them as a single first-lien residential mortgage exposure.

(4) A loan modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program is not modified or restructured for purposes of this section.

(h) [Reserved]

(i) [Reserved]

(j) [Reserved]

(k) *Past due and nonaccrual exposures.* Except for a sovereign exposure or a residential mortgage exposure, a System institution must determine a risk weight for an exposure that is 90 days or more past due or in nonaccrual status according to the requirements set forth in this paragraph (k).

(1) A System institution must assign a 150-percent risk weight to the portion of the exposure that is not guaranteed or that is not secured by financial collateral.

(2) A System institution may assign a risk weight to the guaranteed portion of a past due or nonaccrual exposure based on the risk weight that applies under § 628.36 if the guarantee or credit derivative meets the requirements of that section.

(3) A System institution may assign a risk weight to the portion of a past due or nonaccrual exposure that is collateralized by financial collateral based on the risk weight that applies under § 628.37 if the financial collateral meets the requirements of that section.

(l) *Other assets.* (1) A System institution must assign a 0-percent risk weight to cash owned and held in all offices of the System institution, in transit, or in accounts at a depository institution or a Federal Reserve Bank; to gold bullion held in a depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange (FX) and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade.

(2) A System institution must assign a 20-percent risk weight to cash items in the process of collection.

(3) A System institution must assign a 100-percent risk weight to deferred tax assets (DTAs) arising from temporary differences in relation to net operating loss carrybacks.

(4) A System institution must assign a 100-percent risk weight to all MSAs.

(5) A System institution must assign a 100-percent risk weight to all assets that are not specifically assigned a different risk weight under this subpart and that are not deducted from tier 1 or tier 2 capital pursuant to § 628.22.

(6) [Reserved]

**§ 628.33 Off-balance sheet exposures.**

(a) *General.* (1) A System institution must calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) in paragraph (b) of this section.

(2) Where a System institution commits to provide a commitment, the System institution may apply the lower of the two applicable CCFs.

(3) Where a System institution provides a commitment structured as a syndication or participation, the System institution is only required to calculate the exposure amount for its pro rata share of the commitment.

(4) Where a System institution provides a commitment, enters into a repurchase agreement, or provides a credit enhancing representation and warranty, and such commitment, repurchase agreement, or credit-enhancing representation and warranty is not a securitization exposure, the exposure amount shall be no greater than the maximum contractual amount of the commitment, repurchase agreement, or credit-enhancing representation and warranty, as applicable.

(5) The exposure amount of a System bank's commitment to an association or OFI is the difference between the association's or OFI's maximum credit limit with the System bank (as established by the general financing agreement or promissory note, as required by § 614.4125(d) of this chapter), and the amount the association or OFI has borrowed from the System bank.

(b) *Credit conversion factors—(1) Zero-percent (0%) CCF.* A System institution must apply a 0-percent CCF to a commitment that is unconditionally cancelable by the System institution.

(2) *Twenty-percent (20%) CCF.* A System institution must apply a 20-percent CCF to the amount of:

(i) Commitments, other than a System bank's commitment to an association or OFI, with an original maturity of 14 months or less that are not unconditionally cancelable by the System institution.

(ii) Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less.

(iii) A System bank's commitment to an association or OFI that is not unconditionally cancelable by the System bank, regardless of maturity.

(3) *Fifty-percent (50%) CCF.* A System institution must apply a 50-percent CCF to the amount of:

(i) Commitments, other than a System bank's commitment to an association or OFI, with an original maturity of more than 14 months that are not unconditionally cancelable by the System institution.

(ii) Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

(4) *One hundred-percent (100%) CCF.* A System institution must apply a 100-percent CCF to the following off-balance sheet items and other similar transactions:

(i) Guarantees;

(ii) Repurchase agreements (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has sold subject to repurchase);

(iii) Credit-enhancing representations and warranties that are not securitization exposures;

(iv) Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has lent under the transaction);

(v) Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current fair values of all non-cash positions the System institution has posted as collateral under the transaction);

(vi) Financial standby letters of credit; and

(vii) Forward agreements.

**§ 628.34 OTC derivative contracts.**

(a) *Exposure amount—(1) Single OTC derivative contract.* Except as modified by paragraph (b) of this section, the exposure amount for a single OTC derivative contract that is not subject to a qualifying master netting agreement is equal to the sum of the System institution's current credit exposure and potential future credit exposure (PFE) on the OTC derivative contract.

(i) *Current credit exposure.* The current credit exposure for a single OTC derivative contract is the greater of the mark-to-fair value of the OTC derivative contract or 0.

(ii) *PFE.* (A) The PFE for a single OTC derivative contract, including an OTC derivative contract with a negative mark-to-fair value, is calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor in Table 1 to § 628.34.

(B) For purposes of calculating either the PFE under this paragraph or the gross PFE under paragraph (a)(2) of this section for exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency.

(C) For an OTC derivative contract that does not fall within one of the specified categories in Table 1 to § 628.34, the PFE must be calculated using the appropriate "other" conversion factor.

(D) A System institution must use an OTC derivative contract's effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the OTC derivative contract) rather than the apparent or stated notional principal amount in calculating PFE.

(E) The PFE of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums.

TABLE 1 TO § 628.34—CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS <sup>1</sup>

Remaining maturity <sup>2</sup>	Interest rate	Foreign exchange rate and gold	Credit (investment grade reference asset) <sup>3</sup>	Credit (non-investment grade reference asset)	Equity	Precious metals (except gold)	Other
One (1) year or less .....	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Greater than one (1) year and less than or equal to five (5) years .....	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Greater than five (5) years .....	0.015	0.075	0.05	0.10	0.10	0.08	0.15

<sup>1</sup> For a derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

<sup>2</sup> For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is 0, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than 1 year that meets these criteria, the minimum conversion factor is 0.005.

<sup>3</sup> A System institution must use the column labeled "Credit (investment-grade reference asset)" for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A System institution must use the column labeled "Credit (non-investment-grade reference asset)" for all other credit derivatives.

(2) *Multiple OTC derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (b) of this section, the exposure amount for multiple OTC derivative contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement.

(i) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-fair values of the individual OTC derivative contracts subject to the qualifying master netting agreement or 0.

(ii) *Adjusted sum of the PFE amounts.* The adjusted sum of the PFE amounts,  $A_{net}$ , is calculated as:

$$A_{net} = (0.4 \times A_{gross}) + (0.6 \times NGR \times A_{gross})$$

Where:

$A_{gross}$  = the gross PFE (that is, the sum of the PFE amounts (as determined under paragraph (a)(1)(ii) of this section for each individual derivative contract subject to the qualifying master netting agreement); and

Net-to-gross Ratio (NGR) = the ratio of the net current credit exposure to the gross current credit exposure. In calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph (a)(1)(i) of this section) of all individual derivative contracts subject to the qualifying master netting agreement.

(b) *Recognition of credit risk mitigation of collateralized OTC derivative contracts.* (1) A System institution may recognize the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivative contracts subject to a qualifying master netting agreement (netting set) by using the simple approach in § 628.37(b).

(2) Alternatively, if the financial collateral securing a contract or netting set described in paragraph (b)(1) of this section is marked-to-fair value on a daily basis and subject to a daily margin maintenance requirement, a System institution may recognize the credit risk mitigation benefits of financial collateral that secures the contract or netting set by using the collateral haircut approach in § 628.37(c).

(c) *Counterparty credit risk for OTC credit derivatives—(1) Protection purchasers.* A System institution that purchases an OTC credit derivative that

is recognized under § 628.36 as a credit risk mitigant is not required to compute a separate counterparty credit risk capital requirement under § 628.32 provided that the System institution does so consistently for all such credit derivatives. The System institution must either include all or exclude all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

(2) *Protection providers.* (i) A System institution that is the protection provider under an OTC credit derivative must treat the OTC credit derivative as an exposure to the underlying reference asset. The System institution is not required to compute a counterparty credit risk capital requirement for the OTC credit derivative under § 628.32, provided that this treatment is applied consistently for all such OTC credit derivatives. The System institution must either include all or exclude all such OTC credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure.

(ii) The provisions of paragraph (c)(2) of this section apply to all relevant counterparties for risk-based capital purposes.

(d) *Counterparty credit risk for OTC equity derivatives.* (1) A System institution must treat an OTC equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the OTC equity derivative contract under §§ 628.51 through 628.53.

(2) [Reserved]

(3) If the System institution risk weights the contract under the Simple Risk-Weight Approach (SRWA) in § 628.52, the System institution may choose not to hold risk-based capital against the counterparty credit risk of the OTC equity derivative contract, as long as it does so for all such contracts. Where the OTC equity derivative contracts are subject to a qualifying master netting agreement, a System institution using the SRWA must either include all or exclude all of the contracts from any measure used to determine counterparty credit risk exposure.

(e) [Reserved]

#### § 628.35 Cleared transactions.

(a) *General requirements—(1) Clearing member clients.* A System

institution that is a clearing member client must use the methodologies described in paragraph (b) of this section to calculate risk-weighted assets for a cleared transaction.

(2) [Reserved]

(b) *Clearing member client System institutions—(1) Risk-weighted assets for cleared transactions.* (i) To determine the risk-weighted asset amount for a cleared transaction, a System institution that is a clearing member client must multiply the trade exposure amount for the cleared transaction, calculated in accordance with paragraph (b)(2) of this section, by the risk weight appropriate for the cleared transaction, determined in accordance with paragraph (b)(3) of this section.

(ii) A clearing member client System institution's total risk-weighted assets for cleared transactions is the sum of the risk-weighted asset amounts for all its cleared transactions.

(2) *Trade exposure amount.* (i) For a cleared transaction that is either a derivative contract or netting set of derivative contracts, the trade exposure amount equals:

(A) The exposure amount for the derivative contract or netting set of derivative contracts, calculated using the current exposure method (CEM) for OTC derivative contracts under § 628.34; plus

(B) The fair value of the collateral posted by the clearing member client System institution and held by the central counterparty (CCP), clearing member, or custodian in a manner that is not bankruptcy remote.

(ii) For a cleared transaction that is a repo-style transaction, the trade exposure amount equals:

(A) The exposure amount for the repo-style transaction calculated using the collateral haircut methodology under § 628.37(c); plus

(B) The fair value of the collateral posted by the clearing member client System institution and held by the CCP or a clearing member in a manner that is not bankruptcy remote.

(3) *Cleared transaction risk weights.*

(i) For a cleared transaction with a qualifying CCP (QCCP), a clearing member client System institution must apply a risk weight of:

(A) Two (2) percent if the collateral posted by the System institution to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client System institution due to the joint default or a

concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member; and the clearing member client System institution has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or from liquidation, insolvency, or receivership proceeding) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdictions; or

(B) Four (4) percent if the requirements of paragraph (b)(3)(i)(A) of this section are not met.

(ii) For a cleared transaction with a CCP that is not a QCCP, a clearing member client System institution must apply the risk weight appropriate for the CCP according to § 628.32.

(4) *Collateral.* (i) Notwithstanding any other requirements in this section, collateral posted by a clearing member client System institution that is held by a custodian (in its capacity as custodian) in a manner that is bankruptcy remote from the CCP, the custodian, clearing member and other clearing member clients of the clearing member, is not subject to a capital requirement under this section.

(ii) A clearing member client System institution must calculate a risk-weighted asset amount for any collateral provided to a CCP, clearing member, or custodian in connection with a cleared transaction in accordance with the requirements under § 628.32.

(c) [Reserved]

(d) [Reserved]

**§ 628.36 Guarantees and credit derivatives: substitution treatment.**

(a) *Scope*—(1) *General.* A System institution may recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight associated with the protection provider for the risk weight assigned to an exposure, as provided under this section.

(2) This section applies to exposures for which:

(i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or

(ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the System institution and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(3) Exposures on which there is a tranching of credit risk (reflecting at

least two different levels of seniority) generally are securitization exposures subject to §§ 628.41 through 628.45.

(4) If multiple eligible guarantees or eligible credit derivatives cover a single exposure described in this section, a System institution may treat the hedged exposure as multiple separate exposures each covered by a single eligible guarantee or eligible credit derivative and may calculate a separate risk-weighted asset amount for each separate exposure as described in paragraph (c) of this section.

(5) If a single eligible guarantee or eligible credit derivative covers multiple hedged exposures described in paragraph (a)(2) of this section, a System institution must treat each hedged exposure as covered by a separate eligible guarantee or eligible credit derivative and must calculate a separate risk-weighted asset amount for each exposure as described in paragraph (c) of this section.

(b) *Rules of recognition.* (1) A System institution may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) A System institution may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value, deliverable obligation, or occurrence of a credit event if:

(i) The reference exposure ranks *pari passu* with, or is subordinated to, the hedged exposure; and

(ii) The reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to ensure payments under the credit derivative are triggered when the obligated party of the hedged exposure fails to pay under the terms of the hedged exposure.

(c) *Substitution approach*—(1) *Full coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the exposure amount of the hedged exposure, a System institution may recognize the guarantee or credit derivative in determining the risk-weighted asset amount for the hedged exposure by substituting the risk weight applicable to the guarantor or credit derivative protection provider under § 628.32 for the risk weight assigned to the exposure.

(2) *Partial coverage.* If an eligible guarantee or eligible credit derivative

meets the conditions in §§ 628.36(a) and 628.37(b) and the protection amount (P) of the guarantee or credit derivative is less than the exposure amount of the hedged exposure, the System institution must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(i) The System institution may calculate the risk-weighted asset amount for the protected exposure under § 628.32, where the applicable risk weight is the risk weight applicable to the guarantor or credit derivative protection provider.

(ii) The System institution must calculate the risk-weighted asset amount for the unprotected exposure under § 628.32, where the applicable risk weight is that of the unprotected portion of the hedged exposure.

(iii) The treatment provided in this section is applicable when the credit risk of an exposure is covered on a partial pro rata basis and may be applicable when an adjustment is made to the effective notional amount of the guarantee or credit derivative under paragraph (d), (e), or (f) of this section.

(d) *Maturity mismatch adjustment.* (1) A System institution that recognizes an eligible guarantee or eligible credit derivative in determining the risk-weighted asset amount for a hedged exposure must adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligated party of the hedged exposure is scheduled to fulfill its obligation on the hedged exposure. If a credit risk mitigant has embedded options that may reduce its term, the System institution (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the System institution (protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the System institution to call the transaction before contractual maturity, the remaining time to the first call date is the residual maturity of the credit risk mitigant.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to 1 year and its residual maturity is greater than 3 months.

(5) When a maturity mismatch exists, the System institution must apply the following adjustment to reduce the effective notional amount of the credit risk mitigant:

$$P_m = E \times [(t - 0.25)/(T - 0.25)]$$

Where:

$P_m$  = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;

$E$  = effective notional amount of the credit risk mitigant;

$t$  = the lesser of  $T$  or the residual maturity of the credit risk mitigant, expressed in years; and

$T$  = the lesser of 5 or the residual maturity of the hedged exposure, expressed in years.

(e) *Adjustment for credit derivatives without restructuring as a credit event.* If a System institution recognizes an eligible credit derivative that does not include as a credit event a restructuring of the hedged exposure involving forgiveness or postponement of principal, interest, or fees that results in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account), the System institution must apply the following adjustment to reduce the effective notional amount of the credit derivative:

$$P_r = P_m \times 0.60$$

Where:

$P_r$  = effective notional amount of the credit risk mitigant, adjusted for lack of restructuring event (and maturity mismatch, if applicable); and

$P_m$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

(f) *Currency mismatch adjustment.* (1) If a System institution recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the System institution must apply the following formula to the effective notional amount of the guarantee or credit derivative:

$$P_c = P_r \times (1 - H_{fx})$$

Where:

$P_c$  = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);

$P_r$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and

$H_{fx}$  = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

(2) A System institution must set  $H_{fx}$  equal to 8 percent.

(3) A System institution must adjust  $H_{fx}$  calculated in paragraph (f)(2) of this section upward if the System institution revalues the guarantee or credit derivative less frequently than once every 10 business days using the following square root of time formula:

$$H_{FX} = 8\% \sqrt{\frac{T_M}{10}}$$

Where  $T_M$  equals the greater of 10 or the number of days between revaluation.

#### § 628.37 Collateralized transactions.

(a) *General.* (1) To recognize the risk-mitigating effects of financial collateral, a System institution may use:

(i) The simple approach in paragraph (b) of this section for any exposure.

(ii) The collateral haircut approach in paragraph (c) of this section for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions.

(2) A System institution may use any approach described in this section that is valid for a particular type of exposure or transaction; however, it must use the same approach for similar exposures or transactions.

(b) *The simple approach—*(1) *General requirements.* (i) A System institution may recognize the credit risk mitigation benefits of financial collateral that secures any exposure.

(ii) To qualify for the simple approach, the financial collateral must meet the following requirements:

(A) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(B) The collateral must be revalued at least every 6 months; and

(C) The collateral (other than gold) and the exposure must be denominated in the same currency.

(2) *Risk-weight substitution.* (i) A System institution may apply a risk weight to the portion of an exposure that is secured by the fair value of financial collateral (that meets the requirements of paragraph (b)(1) of this section) based on the risk weight assigned to the collateral under § 628.32. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral is the instruments, gold, and cash the System

institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. Except as provided in paragraph (b)(3) of this section, the risk weight assigned to the collateralized portion of the exposure may not be less than 20 percent.

(ii) A System institution must apply a risk weight to the unsecured portion of the exposure based on the risk weight assigned to the exposure under this subpart.

(3) *Exceptions to the 20-percent risk-weight floor and other requirements.* Notwithstanding paragraph (b)(2)(i) of this section:

(i) A System institution may assign a 0-percent risk weight to an exposure to an OTC derivative contract that is marked-to-fair on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

(ii) A System institution may assign a 10-percent risk weight to an exposure to an OTC derivative contract that is marked-to-fair value daily and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32.

(iii) A System institution may assign a 0-percent risk weight to the collateralized portion of an exposure where:

(A) The financial collateral is cash on deposit; or

(B) The financial collateral is an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32, and the System institution has discounted the fair value of the collateral by 20 percent.

(c) *Collateral haircut approach—*(1) *General.* A System institution may recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions by using the standard supervisory haircuts in paragraph (c)(3) of this section.

(2) *Exposure amount equation.* A System institution must determine the exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a single-product netting set of such transactions by setting the exposure amount equal to max:

$$\{0, [(\Sigma E - \Sigma C) + \Sigma(E_s \times H_s) + \Sigma(E_{fx} \times H_{fx})]\}$$

Where:

$\Sigma E$  = for eligible margin loans and repo-style transactions and netting sets thereof, the

value of the exposure (the sum of the current fair values of all instruments, gold, and cash the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set)); and  
 $\Sigma E$  = for collateralized derivative contracts and netting sets thereof, the exposure amount of the OTC derivative contract (or netting set) calculated under § 628.34(c) or (d).  
 $\Sigma C$  = the value of the collateral (the sum of the current fair values of all instruments, gold and cash the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));  
 $E_s$  = the absolute value of the net position in a given instrument or in gold (where the net position in the instrument or gold

equals the sum of the current fair values of the instrument or gold the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of that same instrument or gold the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty);  
 $H_s$  = the fair value price volatility haircut appropriate to the instrument or gold referenced in  $E_s$ ;  
 $E_{fx}$  = the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current fair values of any instruments or cash in the currency the System institution has lent, sold subject to

repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of any instruments or cash in the currency the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty); and  
 $H_{fx}$  = the haircut appropriate to the mismatch between the currency referenced in  $E_{fx}$  and the settlement currency.

(3) *Standard supervisory haircuts.* (i) A System institution must use the haircuts for fair value price volatility ( $H_s$ ) provided in Table 1 to § 628.37, as adjusted in certain circumstances in accordance with the requirements of paragraphs (c)(3)(iii) and (iv) of this section:

TABLE 1 TO § 628.37—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUT <sup>1</sup>

Residual maturity	Haircut (in percent) assigned based on						Investment grade securitization exposures (in percent)
	Sovereign issuers risk weight under § 628.32 <sup>2</sup>			Non-sovereign issuers risk weight under § 628.32			
	Zero	20% or – 50%	100%	20%	50%	100%	
Less than or equal to 1 year .....	0.5	1.0	15.0	1.0	2.0	25.0	4.0%
Greater than 1 years and less than and equal to 5 years .....	2.0	3.0	15.0	4.0	6.0	25.0	12.0%
Greater than 5 years .....	4.0	6.0	15.0	8.0	12.0	25.0	24.0%
Main index equities (including convertible bonds) and gold				15.0%			Highest haircut applicable to any security in which the fund can invest
Other publically traded equities (including convertible bonds)				25.0%			
Mutual funds				0%			
Cash collateral				0%			

<sup>1</sup> The market price volatility haircut in Table 1 to § 628.37 are based on 10-day holding period.

<sup>2</sup> Includes a foreign PSE that receives a 0-percent risk weight.

(ii) For currency mismatches, a System institution must use a haircut for foreign exchange rate volatility ( $H_{fx}$ ) of 8 percent, as adjusted in certain circumstances under paragraphs (c)(3)(iii) and (iv) of this section.

(iii) For repo-style transactions, a System institution may multiply the standard supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this section by the square root of 1/2 (which equals 0.707107).

(iv) If the number of trades in a netting set exceeds 5,000 at any time during a quarter, a System institution must adjust the supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this section upward on the basis of a holding period of 20 business days for the following quarter except in the calculation of the exposure amount for purposes of § 628.35. If a netting set contains one or more trades involving illiquid collateral or an OTC derivative that cannot be easily replaced, a System institution must adjust the supervisory haircuts upward on the basis of a holding period of 20 business days. If over the 2 previous quarters more than two margin disputes on a netting set have occurred that lasted more than the

holding period, then the System institution must adjust the supervisory haircuts upward for that netting set on the basis of a holding period that is at least two times the minimum holding period for that netting set. A System institution must adjust the standard supervisory haircuts upward using the following formula:

$$H_A = H_S \sqrt{\frac{T_M}{T_S}}$$

Where:

$T_M$  = a holding period of longer than 10 business days for eligible margin loans and derivative contracts or longer than 5 business days for repo-style transactions;  
 $H_S$  = the standard supervisory haircut; and  
 $T_S$  = 10 business days for eligible margin loans and derivative contracts or 5 business days for repo-style transactions.

(v) If the instrument a System institution has lent, sold subject to repurchase, or posted as collateral does not meet the definition of financial collateral in § 628.2, the System institution must use a 25-percent haircut for fair value price volatility ( $H_s$ ).

(4) [Reserved]

**Risk-Weighted Assets for Unsettled Transactions**

**§ 628.38 Unsettled transactions.**

(a) *Definitions.* For purposes of this section:

(1) Delivery-versus-payment (DvP) transaction means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

(2) Payment-versus-payment (PvP) transaction means a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

(3) A transaction has a normal settlement period if the contractual settlement period for the transaction is equal to or less than the fair value standard for the instrument underlying the transaction and equal to or less than 5 business days.

(4) Positive current exposure of a System institution for a transaction is the difference between the transaction value at the agreed settlement price and the current fair value price of the transaction, if the difference results in a credit exposure of the System institution to the counterparty.

(b) *Scope.* This section applies to all transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. This section does not apply to:

(1) Cleared transactions that are marked-to-fair value daily and subject to daily receipt and payment of variation margin;

(2) Repo-style transactions, including unsettled repo-style transactions;

(3) One-way cash payments on OTC derivative contracts; or

(4) Transactions with a contractual settlement period that is longer than the normal settlement period (which are treated as OTC derivative contracts as provided in § 628.34).

(c) *System-wide failures.* In the case of a system-wide failure of a settlement, clearing system or central counterparty, the FCA may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

(d) *Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions.* A System institution must hold risk-based capital against any DvP or PvP transaction with a normal settlement period if the System institution's counterparty has not made delivery or payment within 5 business days after the settlement date. The System institution must determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the System institution by the appropriate risk weight in Table 1 to § 628.38.

TABLE 1 TO § 628.38—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
From 5 to 15 .....	100.0
From 16 to 30 .....	625.0
From 31 to 45 .....	937.5
46 or more .....	1,250.0

(e) *Non-DvP/non-PvP (non-delivery-versus-payment/non-payment-versus-payment) transactions.* (1) A System institution must hold risk-based capital against any non-DvP/non-PvP

transaction with a normal settlement period if the System institution has delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The System institution must continue to hold risk-based capital against the transaction until the System institution has received its corresponding deliverables.

(2) From the business day after the System institution has made its delivery until 5 business days after the counterparty delivery is due, the System institution must calculate the risk-weighted asset amount for the transaction by treating the current fair value of the deliverables owed to the System institution as an exposure to the counterparty and using the applicable counterparty risk weight under § 628.32.

(3) If the System institution has not received its deliverables by the 5th business day after counterparty delivery was due, the System institution must assign a 1,250-percent risk weight to the current fair value of the deliverables owed to the System institution.

(f) *Total risk-weighted assets for unsettled transactions.* Total risk-weighted assets for unsettled transactions is the sum of the risk-weighted asset amounts of all DvP, PvP, and non-DvP/non-PvP transactions.

**§§ 628.39 through 628.40 [Reserved]**

**Risk-Weighted Assets for Securitization Exposures**

**§ 628.41 Operational requirements for securitization exposures.**

(a) *Operational criteria for traditional securitizations.* A System institution that transfers exposures it has originated or purchased to a third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if each condition in this section is satisfied. A System institution that meets these conditions must hold risk-based capital against any credit risk it retains in connection with the securitization. A System institution that fails to meet these conditions must hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from CET1 capital, pursuant to § 628.22, any after-tax gain-on-sale resulting from the transaction. The conditions are:

(1) The exposures are not reported on the System institution's consolidated balance sheet under GAAP;

(2) The System institution has transferred to one or more third parties

credit risk associated with the underlying exposures;

(3) Any clean-up calls relating to the securitization are eligible clean-up calls; and

(4) The securitization does not:

(i) Include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and

(ii) Contain an early amortization provision.

(b) *Operational criteria for synthetic securitizations.* For synthetic securitizations, a System institution may recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each condition in this paragraph is satisfied. A System institution that meets these conditions must hold risk-based capital against any credit risk of the exposures it retains in connection with the synthetic securitization. A System institution that fails to meet these conditions or chooses not to recognize the credit risk mitigant for purposes of this section must instead hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. The conditions are:

(1) The credit risk mitigant is:

(i) Financial collateral;

(ii) A guarantee that meets all criteria set forth in the definition of "eligible guarantee" in § 628.2, except for the criteria in paragraph (3) of that definition; or

(iii) A credit derivative that meets all criteria as set forth in the definition of "eligible credit derivative" in § 628.2, except for the criteria in paragraph (3) of the definition of "eligible guarantee" in § 628.2.

(2) The System institution transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:

(i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(ii) Require the System institution to alter or replace the underlying exposures to improve the credit quality of the pool of underlying exposures;

(iii) Increase the System institution's cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(iv) Increase the yield payable to parties other than the System institution in response to a deterioration in the

credit quality of the underlying exposures; or

(v) Provide for increases in a retained first loss position or credit enhancement provided by the System institution after the inception of the securitization;

(3) The System institution obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.

(c) *Due diligence requirements.* (1) Except for exposures that are deducted from CET1 capital (pursuant to § 628.22) and exposures subject to § 628.42(h), if a System institution is unable to demonstrate to the satisfaction of the FCA a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the System institution must assign the securitization exposure a risk weight of 1,250 percent. The System institution's analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to its capital.

(2) A System institution must demonstrate its comprehensive understanding of a securitization exposure under paragraph (c)(1) of this section for each securitization exposure by:

(i) Conducting an analysis of the risk characteristics of a securitization exposure prior to acquiring the exposure, and documenting such analysis within 3 business days after acquiring the exposure, considering:

(A) Structural features of the securitization that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the exposure, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value (LTV) ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the securitization, for example, bid-ask spread, most recent sales price and historic price volatility, trading volume, implied market rating, and size, depth

and concentration level of the market for the securitization; and

(D) For resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures; and

(ii) On an on-going basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under paragraph (c)(1) of this section for each securitization exposure.

#### **§ 628.42 Risk-weighted assets for securitization exposures.**

(a) *Securitization risk weight approaches.* Except as provided in this section or in § 628.41:

(1) A System institution must deduct from CET1 capital any after-tax gain-on-sale resulting from a securitization (as provided in § 628.22) and must apply a 1,250-percent risk weight to the portion of a credit-enhancing interest-only strip (CEIO) that does not constitute after-tax gain-on-sale.

(2) If a securitization exposure does not require deduction under paragraph (a)(1) of this section, a System institution may assign a risk weight to the securitization exposure using the simplified supervisory formula approach (SSFA) in accordance with § 628.43(a) through (d) and subject to the limitation under paragraph (e) of this section. Alternatively, a System institution may assign a risk weight to the purchased securitization exposure using the gross-up approach in accordance with § 628.43(e), provided however, that such System institution must apply either the SSFA or the gross-up approach consistently across all of its securitization exposures, except as provided in paragraphs (a)(1), (3), and (4) of this section.

(3) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and the System institution cannot or chooses not to apply the SSFA or the gross-up approach to the exposure, the System institution must assign a risk weight to the exposure as described in § 628.44.

(4) If a securitization exposure is a derivative contract (other than protection provided by a System institution in the form of a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a System institution may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as

determined in paragraph (c) of this section.

(b) *Total risk-weighted assets for securitization exposures.* A System institution's total risk-weighted assets for securitization exposures equals the sum of the risk-weighted asset amount for securitization exposures that the System institution risk weights under paragraph (a)(1) of this section, § 628.41(c), and § 628.43, § 628.44, or § 628.45, except as provided in paragraphs (e) through (j) of this section, as applicable.

(c) *Exposure amount of a securitization exposure.* (1) [Reserved]

(2) *On-balance sheet securitization exposures (available-for-sale or held-to-maturity securities).* The exposure amount of an on-balance sheet securitization exposure that is an available-for-sale or held-to-maturity security is the System institution's carrying value (including net accrued but unpaid interest and fees), less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure.

(3) *Off-balance sheet securitization exposures.* (i) Except as provided in paragraph (j) of this section, the exposure amount of an off-balance sheet securitization that is not a repo-style transaction, an eligible margin loan, a cleared transaction (other than a credit derivative), or an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure.

(ii) [Reserved]

(iii) [Reserved]

(4) *Repo-style transactions, eligible margin loans, and derivative contracts.* The exposure amount of a securitization exposure that is a repo-style transaction, an eligible margin loan, or a derivative contract (other than a credit derivative) is the exposure amount of the transaction as calculated under § 628.34 or § 628.37 as applicable.

(d) *Overlapping exposures.* If a System institution has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization, the System institution is not required to hold duplicative risk-based capital against the overlapping position. Instead, the System institution may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement.

(e) *Implicit support.* If a System institution provides support to a securitization in excess of the System institution's contractual obligation to provide credit support to the securitization (implicit support):

(1) The System institution must include in risk-weighted assets all of the underlying exposures associated with the securitization as if the exposures had not been securitized and must deduct from CET1 capital (pursuant to § 628.22) any after-tax gain-on-sale resulting from the securitization; and

(2) The System institution must disclose publicly:

(i) That it has provided implicit support to the securitization; and

(ii) The risk-based capital impact to the System institution of providing such implicit support.

(f) *Undrawn portion of an eligible servicer cash advance facility.* (1) Notwithstanding any other provision of this subpart, a System institution that is a servicer under an eligible servicer cash advance facility is not required to hold risk-based capital against potential future cash advance payments that it may be required to provide under the contract governing the facility.

(2) For a System institution that acts as a servicer, the exposure amount for a servicer cash advance facility that is not an eligible cash advance facility is equal to the amount of all potential future cash payments that the System institution may be contractually required to provide during the subsequent 12-month period under the governing facility.

(g) *Interest-only mortgage-backed securities.* Regardless of any other provisions of this subpart, the risk weight for a non-credit-enhancing interest-only mortgage-backed security may not be less than 100 percent.

(h) *Small-business loans and leases on personal property transferred with retained contractual exposure.* (1) Regardless of any other provisions of this subpart, a System institution that has transferred small-business loans and leases on personal property (small-business obligations) must include in risk-weighted assets only its contractual exposure to the small-business obligations if all the following conditions are met:

(i) The transaction must be treated as a sale under GAAP.

(ii) The System institution establishes and maintains, pursuant to GAAP, a non-capital reserve sufficient to meet the System institution's reasonably estimated liability under the contractual obligation.

(iii) The small business obligations are to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act.

(iv) [Reserved]

(2) The total outstanding amount of contractual exposure retained by a System institution on transfers of small-business obligations receiving the capital treatment specified in paragraph (h)(1) of this section cannot exceed 15 percent of the System institution's total capital.

(3) If a System institution exceeds the 15-percent capital limitation provided in paragraph (h)(2) of this section, the capital treatment under paragraph (h)(1) of this section will continue to apply to any transfers of small-business obligations with retained contractual exposure that occurred during the time that the System institution did not exceed the capital limit.

(4) [Reserved]

(i) [Reserved]

(ii) [Reserved]

(i) *N<sup>th</sup>-to-default credit derivatives—*

(1) *Protection provider.* A System institution must assign a risk weight to an nth-to-default credit derivative in accordance with FCA guidance.

(2) [Reserved]

(3) [Reserved]

(4) *Protection purchaser—(i) First-to-default credit derivatives.* A System institution that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative that meets the rules of recognition of § 628.36(b) must determine its risk-based capital requirement for the underlying exposures as if the System institution synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A System institution must calculate a risk-based capital requirement for counterparty credit risk according to § 628.34 for a first-to-default credit derivative that does not meet the rules of recognition of § 628.36(b).

(ii) *Second-or-subsequent-to-default credit derivatives.* (A) A System institution that obtains credit protection on a group of underlying exposures through a nth-to-default credit derivative that meets the rules of recognition of § 628.36(b) (other than a first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if:

(1) The System institution also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or

(2) If n-1 of the underlying exposures have already defaulted.

(B) If a System institution satisfies the requirements of paragraph (i)(4)(ii)(A) of this section, the System institution must

determine its risk-based capital requirement for the underlying exposures as if the System institution had only synthetically securitized the underlying exposure with the nth smallest risk-weighted asset amount and had obtained no credit risk mitigant on the underlying exposures.

(C) A System institution must calculate a risk-based capital requirement for counterparty credit risk according to § 628.34 for a nth-to-default credit derivative that does not meet the rules of recognition of § 628.36(b).

(j) *Guarantees and credit derivatives other than nth-to-default credit derivatives—(1) Protection provider.* For a guarantee or credit derivative (other than an nth-to-default credit derivative) provided by a System institution that covers the full amount or a pro rata share of a securitization exposure's principal and interest, the System institution must risk weight the guarantee or credit derivative in accordance with FCA guidance.

(2) *Protection purchaser.* (i) A System institution that purchases a guarantee or OTC credit derivative (other than an nth-to-default credit derivative) that is recognized under § 628.45 as a credit risk mitigant (including via collateral recognized under § 628.37) is not required to compute a separate credit risk capital requirement under § 628.31, in accordance with § 628.34(c).

(ii) If a System institution cannot, or chooses not to, recognize a purchased credit derivative as a credit risk mitigant under § 628.45, the System institution must determine the exposure amount of the credit derivative under § 628.34.

(A) If the System institution purchases credit protection from a counterparty that is not a securitization special purpose entity (SPE), the System institution must determine the risk weight for the exposure according to general risk weights under § 628.32.

(B) If the System institution purchases the credit protection from a counterparty that is a securitization SPE, the System institution must determine the risk weight for the exposure according to this section, including paragraph (a)(4) of this section for a credit derivative that has a first priority claim on the cash flows from the underlying exposures of the securitization SPE (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments).

**§ 628.43 Simplified supervisory formula approach (SSFA) and the gross-up approach.**

(a) *General requirements for the SSFA.* To use the SSFA to determine the

risk weight for a securitization exposure, a System institution must have data that enables it to assign accurately the parameters described in paragraph (b) of this section. Data used to assign the parameters described in paragraph (b) of this section must be the most currently available data; if the contract governing the underlying exposures of the securitization require payment on a monthly or quarterly basis, the data used to assign the parameters described in paragraph (b) of this section must be no more than 91 calendar days old. A System institution that does not have the appropriate data to assign the parameters described in paragraph (b) of this section must assign a risk weight of 1,250 percent to the exposure.

(b) *SSFA parameters.* To calculate the risk weight for a securitization exposure using the SSFA, a System institution must have accurate information on the following five inputs to the SSFA calculation:

(1)  $K_G$  is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using this subpart.  $K_G$  is expressed as a decimal value between 0 and 1 (that is, an average risk weight of 100 percent represents a value of  $K_G$  equal to .08).

(2) Parameter  $W$  is expressed as a decimal value between 0 and 1. Parameter  $W$  is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in paragraphs (b)(2)(i) through (vi) of this section to the balance, measured in dollars, of underlying exposures:

- (i) Ninety (90) days or more past due;
- (ii) Subject to a bankruptcy or insolvency proceeding;
- (iii) In the process of foreclosure;
- (iv) Held as real estate owned;
- (v) Has contractually deferred interest payments for 90 days or more, other than principal or interest payments deferred on:

(A) Federally guaranteed student loans, in accordance with the terms of those guarantee programs; or

(B) Consumer loans, including non-federally guaranteed student loans, provided that such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for periods(s) of deferral that are not initiated based on changes in the creditworthiness of the borrower; or

(vi) Is in default.

(3) Parameter  $A$  is the attachment point for the exposure, which represents the threshold at which credit losses will first be allocated to the exposure. Except as provided in § 628.42(i) for nth-to-default credit derivatives, parameter  $A$  equals the ratio of the current dollar amount of underlying exposures that are subordinated to the exposure of the System institution to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the System institution's securitization exposure may be included in the calculation of parameter  $A$  to the extent that cash is present in the account. Parameter  $A$  is expressed as a decimal value between 0 and 1.

(4) Parameter  $D$  is the detachment point for the exposure, which represents the threshold at which credit losses of principal allocated to the exposure would result in a total loss of principal. Except as provided in § 628.42(i) for nth-to-default credit derivatives, parameter  $D$  equals parameter  $A$  plus the ratio of the current dollar amount of the securitization exposures that are *pari passu* with the exposure (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter  $D$  is expressed as a decimal value between 0 and 1.

(5) A supervisory calibration parameter,  $p$ , is equal to 0.5 for

securitization exposures that are not resecuritization exposures and equal to 1.5 for resecuritization exposures.

(c) *Mechanics of the SSFA.*  $K_G$  and  $W$  are used to calculate  $K_A$ , the augmented value of  $K_G$ , which reflects the observed credit quality of the underlying pool of exposures.  $K_A$  is defined in paragraph (d) of this section. The values of parameters  $A$  and  $D$ , relative to  $K_A$  determine the risk weight assigned to a securitization exposure as described in paragraph (d) of this section. The risk weight assigned to a securitization exposure, or portion of a securitization exposure, as appropriate, is the larger of the risk weight determined in accordance with this paragraph (d) of this section and a risk weight of 20 percent.

(1) When the detachment point, parameter  $D$ , for a securitization exposure is less than or equal to  $K_A$ , the exposure must be assigned a risk weight of 1,250 percent.

(2) When the attachment point, parameter  $A$ , for a securitization exposure is greater than or equal to  $K_A$ , the System institution must calculate the risk weight in accordance with paragraph (d) of this section.

(3) When  $A$  is less than  $K_A$  and  $D$  is greater than  $K_A$ , the risk weight is a weighted average of 1,250 percent and 1,250 percent times  $K_{SSFA}$  calculated in accordance with paragraph (d) of this section. For the purpose of this weighted-average calculation:

(i) The weight assigned to 1,250 percent equals:

$$\frac{K_A - A}{D - A}$$

(ii) The weight assigned to 1,250 percent times  $K_{SSFA}$  equals:

$$\frac{D - K_A}{D - A}$$

(iii) The risk weight will be set equal to:

$$RW = \left[ \left( \frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[ \left( \frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

(d) *SSFA equation.* (1) The System institution must define the following parameters:

$$K_A = (1 - W) \times K_G \times (0.5 \times W)$$

(2) Then the System institution must calculate  $K_{SSFA}$  according to the following equation:

$$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u \times l)}$$

Where:

$$a = \frac{1}{p \times K_A},$$

$$u = D - K_A,$$

$$l = \max(A - K_A, 0), \text{ and}$$

$e = 2.71828$ , the base of the natural logarithm

(3) The risk weight for the exposure (expressed as a percent) is equal to  $K_{SSFA} \times 1,250$ .

(e) *Gross-up approach*—(1) *Applicability.* A System institution may apply the gross-up approach set forth in this section instead of the SSFA to determine the risk weight of its

securitization exposures, provided that it applies the gross-up approach to all of its securitization exposures, except as otherwise provided for certain securitization exposures in §§ 628.44 and 628.45.

(2) To use the gross-up approach, a System institution must calculate the following four inputs:

(i) Pro rata share  $A$ , which is the par value of the System institution's securitization exposure  $X$  as a percent of the par value of the tranche in which the securitization exposure resides  $Y$ :

$$A = \frac{X}{Y} \text{ expressed as a percent}$$

(ii) Enhanced amount  $B$ , which is the value of tranches that are more senior to the tranche in which the System institution's securitization resides;

(iii) Exposure amount (carrying value)  $C$  of the System institution's securitization exposure calculated under § 628.42(c); and

(iv) Risk weight ( $RW$ ), which is the weighted-average risk weight of underlying exposures in the securitization pool as calculated under this subpart. For example,  $RW$  for an asset-backed security with underlying car loans would be 100 percent.

(3) *Credit equivalent amount (CEA).* The CEA of a securitization exposure under this section equals the sum of:

(i) The exposure amount  $C$  of the System institution's securitization exposure; plus

(ii) The pro rata share  $A$  multiplied by the enhanced amount  $B$ , each calculated in accordance with paragraph (e)(2) of this section:

$$CEA = C + (A \times B)$$

(4) *Risk-weighted assets (RWA).* To calculate  $RWA$  for a securitization exposure under the gross-up approach, a System institution must apply the  $RW$  calculated under paragraph (e)(2) of this section to the  $CEA$  calculated in paragraph (e)(3) of this section:

$$RWA = RW \times CEA$$

(f) *Limitations.* Notwithstanding any other provision of this section, a System institution must assign a risk weight of not less than 20 percent to a securitization exposure.

**§ 628.44 Securitization exposures to which the SSFA and gross-up approach do not apply.**

(a) *General requirement.* A System institution must assign a 1,250-percent risk weight to all securitization exposures to which the System institution does not apply the SSFA or the gross up approach under § 628.43.

(b) [Reserved]

**§ 628.45 Recognition of credit risk mitigants for securitization exposures.**

(a) *General.* (1) An originating System institution that has obtained a credit risk mitigant to hedge its exposure to a synthetic or traditional securitization that satisfies the operational criteria provided in § 628.41 may recognize the credit risk mitigant under § 628.36 or § 628.37, but only as provided in this section.

(2) An investing System institution that has obtained a credit risk mitigant to hedge a securitization exposure may recognize the credit risk mitigant under

§ 628.36 or § 628.37, but only as provided in this section.

(b) *Mismatches.* A System institution must make any applicable adjustment to the protection amount of an eligible guarantee or credit derivative as required in § 628.36(d), (e), and (f) for any hedged securitization exposure. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the System institution must use the longest residual maturity of any of the hedged exposures as the residual maturity of all hedged exposures.

**§§ 628.46 through 628.50 [Reserved]**

**Risk-Weighted Assets for Equity Exposures**

**§ 628.51 Introduction and exposure measurement.**

(a) *General.* (1) To calculate its risk-weighted asset amounts for equity exposures that are not equity exposures to an investment fund, a System institution must use the Simple Risk-Weight Approach (SRWA) provided in § 628.52. A System institution must use the look-through approaches provided in § 628.53 to calculate its risk-weighted asset amounts for equity exposures to investment funds. Equity investments

(including preferred stock investments) in other System institutions, service corporations, and the Funding Corporation do not receive a risk weight, because they are deducted from capital in accordance with § 628.22.

(2) [Reserved]

(3) [Reserved]

(b) *Adjusted carrying value.* For purposes of §§ 628.51 through 628.53, the adjusted carrying value of an equity exposure is:

(1) For the on-balance sheet component of an equity exposure (other than an equity exposure that is classified as available-for-sale), the System institution's carrying value of the exposure;

(2) For the on-balance sheet component of an equity exposure that is classified as available-for-sale, the System institution's carrying value of the exposure less any net unrealized gains on the exposure that are reflected in such carrying value but excluded from the System institution's regulatory capital components;

(3) For the off-balance sheet component of an equity exposure that is not an equity commitment, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) given a small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure as calculated in paragraph (b)(1) of this section; and

(4) For a commitment to acquire an equity exposure (an equity commitment), the effective notional principal amount of the exposure is multiplied by the following conversion factors (CFs):

(i) Conditional equity commitments with an original maturity of 14 months or less receive a CF of 20 percent.

(ii) Conditional equity commitments with an original maturity of over 14 months receive a CF of 50 percent.

(iii) Unconditional equity commitments receive a CF of 100 percent.

#### § 628.52 Simple risk-weight approach (SRWA).

(a) *General.* Under the SRWA, a System institution's total risk-weighted assets for equity exposures equals the sum of the risk-weighted asset amounts for each of the System institution's individual equity exposures (other than equity exposures to an investment fund) as determined under this section and

the risk-weighted asset amounts for each of the System institution's individual equity exposures to an investment fund as determined under § 628.53.

(b) *SRWA computation for individual equity exposures.* A System institution must determine the risk-weighted asset amount for an individual equity exposure (other than an equity exposure to an investment fund) by multiplying the adjusted carrying value of the equity exposure or the effective portion and ineffective portion of a hedge pair (as defined in paragraph (c) of this section) by the lowest applicable risk weight in this paragraph.

(1) *Zero-percent (0%) risk weight equity exposures.* An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a 0-percent risk weight under § 628.32 may be assigned a 0-percent risk weight.

(2) *Twenty-percent (20%) risk weight equity exposures.* An equity exposure to a PSE or the Federal Agricultural Mortgage Corporation (Farmer Mac) must be assigned a 20-percent risk weight.

(3) *One hundred-percent (100%) risk weight equity exposures.* The equity exposures set forth in this paragraph (b)(3) must be assigned a 100-percent risk weight:

(i) [Reserved]

(ii) *Effective portion of hedge pairs.* The effective portion of a hedge pair.

(iii) *Non-significant equity exposures.* Equity exposures, excluding exposures to an investment firm that would meet the definition of a traditional securitization in § 628.2 were it not for the application of paragraph (8) of that definition and has greater than immaterial leverage, to the extent that aggregate adjusted carrying value of the exposures does not exceed 10 percent of the System institution's total capital.

(A) Equity exposures subject to paragraph (b)(3)(iii) of this section include:

(1) Equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611 of this chapter; and

(2) [Reserved]

(3) Equity exposures to an unconsolidated rural business investment company and equity exposures held through a consolidated rural business investment company described in 7 U.S.C. 2009cc *et seq.*

(B) To compute the aggregate adjusted carrying value of a System institution's equity exposures for purposes of this section, the System institution may exclude equity exposures described in paragraphs (b)(1) and (2) and (b)(3)(ii) of this section, the equity exposure in a hedge pair with the smaller adjusted carrying value, and a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that meet the criterion of paragraph (b)(3)(i) of this section. If a System institution does not know the actual holdings of the investment fund, the System institution may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the System institution must assume for purposes of this section that the investment fund invests to the maximum extent possible in equity exposures.

(C) When determining which of a System institution's equity exposures qualify for a 100-percent risk weight under this paragraph, a System institution first must include equity exposures to unconsolidated rural business investment companies or held through consolidated rural business investment companies described in 7 U.S.C. 2009cc *et seq.*; then must include equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611 of this chapter; then must include publicly traded equity exposures (including those held indirectly through investment funds); and then must include non-publicly traded equity exposures (including those held indirectly through investment funds).

(4) *Other equity exposures.* The risk weight for any equity exposure that does not qualify for a risk weight under paragraph (b)(1), (2), (3), or (7) of this section will be determined by the FCA.

(5) [Reserved]

(6) [Reserved]

(7) *Six hundred-percent (600%) risk weight equity exposures.* An equity exposure to an investment firm must be assigned a 600-percent risk weight, provided that the investment firm:

(i) Would meet the definition of a traditional securitization in § 628.2 were it not for the application of paragraph (8) of that definition; and

(ii) Has greater than immaterial leverage.

(c) *Hedge transactions*—(1) *Hedge pair*. A hedge pair is two equity exposures that form an effective hedge so long as each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure.

(2) *Effective hedge*. Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least 3 months; the hedge relationship is formally

documented in a prospective manner (that is, before the System institution acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the System institution will use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A System institution must measure E at least quarterly and must use one of three alternative measures of E as set forth in this paragraph (c):

(i) Under the dollar-offset method of measuring effectiveness, the System

institution must determine the ratio of value change (RVC). The RVC is the ratio of the cumulative sum of the changes in value of one equity exposure to the cumulative sum of the changes in the value of the other equity exposure. If RVC is positive, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to  $-1$  (that is, less than 0 and greater than or equal to  $-1$ ), then E equals the absolute value of RVC. If RVC is negative and less than  $-1$ , then E equals 2 plus RVC.

(ii) Under the variability-reduction method of measuring effectiveness:

$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2}$$

Where:

$X_t = A_t \times B_t$ ;

$A_t$  = the value at time t of one exposure in a hedge pair; and

$B_t$  = the value at time t of the other exposure in a hedge pair.

(iii) Under the regression method of measuring effectiveness, E equals the coefficient of determination of a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in a hedge pair is the independent variable.

However, if the estimated regression coefficient is positive, then E equals 0.

(3) The effective portion of a hedge pair is E multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

(4) The ineffective portion of a hedge pair is  $(1-E)$  multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

#### § 628.53 Equity exposures to investment funds.

(a) *Available approaches*. (1) A System institution must determine the risk-weighted asset amount of an equity exposure to an investment fund under the full look-through approach described in paragraph (b) of this section, the simple modified look-through approach described in paragraph (c) of this section, or the alternative modified look-through approach described paragraph (d) of this section, provided, however, that the minimum risk weight that may be assigned to an equity exposure under this section is 20 percent.

(2) [Reserved]

(3) If an equity exposure to an investment fund is part of a hedge pair and the System institution does not use the full look-through approach, the System institution must use the ineffective portion of the hedge pair as determined under § 628.52(c) as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value.

(b) *Full look-through approach*. A System institution that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund (as calculated under this subpart as if the proportional ownership share of the adjusted carrying value of each exposure were held directly by the System institution) may set the risk-weighted asset amount of the System institution's exposure to the fund equal to the product of:

(1) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the System institution; and

(2) The System institution's proportional ownership share of the fund.

(c) *Simple modified look-through approach*. Under the simple modified look-through approach, the risk-weighted asset amount for a System institution's equity exposure to an investment fund equals the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's

permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(d) *Alternative modified look-through approach*. Under the alternative modified look-through approach, a System institution may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under this subpart based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the System institution's equity exposure to the investment fund equals the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight under this subpart. If the sum of the investment limits for all exposure types within the fund exceeds 100 percent, the System institution must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under this subpart and continues to make investments in order of the exposure type with the next highest applicable risk weight under this subpart until the maximum total investment level is reached. If more than one exposure type applies to an exposure, the System institution must use the highest applicable risk weight. A System institution may exclude derivative contracts held by the fund that are used for hedging rather than for speculative

purposes and do not constitute a material portion of the fund's exposures.

**§§ 628.54 through 628.60 [Reserved]**

**Disclosures**

**§ 628.61 Purpose and scope.**

Sections 628.62 and 628.63 establish public disclosure requirements for each System bank related to the capital requirements contained in this part.

**§ 628.62 Disclosure requirements.**

(a) A System bank must provide timely public disclosures each calendar quarter of the information in the applicable tables in § 628.63. The System bank must make these disclosures in its quarterly and annual reports to shareholders required in part 620 of this chapter. The System bank need not make these disclosures in the format set out in the applicable tables or all in the same location in a report, as long as a summary table specifically indicating the location(s) of all such disclosures is provided. If a significant change occurs, such that the most recent reported amounts are no longer reflective of the System bank's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be disclosed as soon as practicable thereafter. This disclosure requirement may be satisfied by providing a notice under § 620.15 of this chapter. Qualitative disclosures that typically do not change each quarter (for

example, a general summary of the System bank's risk management objectives and policies, reporting system, and definitions) may be disclosed annually after the end of the 4th calendar quarter, provided that any significant changes are disclosed in the interim.

(b) A System bank must have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this subpart, and must ensure that appropriate review of the disclosures takes place. The chief executive officer, the chief financial officer, and a designated board member must attest that the disclosures meet the requirements of this subpart.

(c) If a System bank concludes that disclosure of specific proprietary or confidential commercial or financial information that it would otherwise be required to disclose under this section would compromise its position, then the System bank is not required to disclose that specific information pursuant to this section, but must disclose more general information about the subject matter of the requirement, together with

the fact that, and the reason why, the specific items of information have not been disclosed.

**§ 628.63 Disclosures.**

(a) Except as provided in § 628.62, a System bank must make the disclosures described in Tables 1 through 10 of this section. The System bank must make these disclosures publicly available for each of the last 3 years (that is, 12 quarters) or such shorter period beginning on January 1, 2017.

(b) A System bank must publicly disclose each quarter the following:

(1) CET1 capital, tier 1 capital, and total capital ratios, including all the regulatory capital elements and all the regulatory adjustments and deductions needed to calculate the numerator of such ratios;

(2) Total risk-weighted assets, including the different regulatory adjustments and deductions needed to calculate total risk-weighted assets;

(3) Regulatory capital ratios during the transition period, including a description of all the regulatory capital elements and all regulatory adjustments and deductions needed to calculate the numerator and denominator of each capital ratio during the transition period; and

(4) A reconciliation of regulatory capital elements as they relate to its balance sheet in any audited consolidated financial statements.

**TABLE 1 TO § 628.63—SCOPE OF APPLICATION**

Qualitative Disclosures .....	(a) The name of the top corporate entity in the group to which this subpart applies. <sup>1</sup> (b) A brief description of the differences in the basis for consolidating entities <sup>2</sup> for accounting and regulatory purposes, with a description of those entities: (1) That are fully consolidated; (2) That are deconsolidated and deducted from total capital; (3) For which the total capital requirement is deducted; and (4) That are neither consolidated nor deducted (for example, where the investment in the entity is assigned a risk weight in accordance with this subpart).
Quantitative Disclosures .....	(c) Any restrictions, or other major impediments, on transfer of funds or total capital within the group. (d) [Reserved] (e) The aggregate amount by which actual total capital is less than the minimum total capital requirement in all subsidiaries, with total capital requirements and the name(s) of the subsidiaries with such deficiencies.

<sup>1</sup> The System bank is the top corporate entity.

<sup>2</sup> Entities include any subsidiaries authorized by the FCA, including operating subsidiaries, service corporations, and unincorporated business entities.

**TABLE 2 TO § 628.63—CAPITAL STRUCTURE**

Qualitative Disclosures .....	(a) Summary information on the terms and conditions of the main features of all regulatory capital instruments.
Quantitative Disclosures .....	(b) The amount of common equity tier 1 capital, with separate disclosure of: (1) Common cooperative equities a. Statutory minimum purchased borrower stock; b. Other required member purchased stock; c. Allocated equities (stock or surplus): 1. Qualified allocated equities subject to retirement; 2. Nonqualified allocated equities subject to retirement; 3. Nonqualified allocated equities not subject to retirement; (2) Unallocated retained earnings (URE);

TABLE 2 TO § 628.63—CAPITAL STRUCTURE—Continued

	<ul style="list-style-type: none"> <li>(3) Paid-in capital; and</li> <li>(4) Regulatory adjustments and deductions made to common equity tier 1 capital.</li> <li>(c) The amount of tier 1 capital, with separate disclosure of:                         <ul style="list-style-type: none"> <li>(1) Additional tier 1 capital elements; and</li> <li>(2) Regulatory adjustments and deductions made to tier 1 capital.</li> </ul> </li> <li>(d) The amount of total capital, with separate disclosure of:                         <ul style="list-style-type: none"> <li>(1) Common cooperative equities not included in common equity tier 1 capital;</li> <li>(2) Tier 2 capital elements, including tier 2 capital instruments; and</li> <li>(3) Regulatory adjustments and deductions made to total capital, including deductions of third-party capital under § 628.23.</li> </ul> </li> </ul>
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TABLE 3 TO § 628.63—CAPITAL ADEQUACY

Qualitative disclosures .....	(a) A summary discussion of the System bank’s approach to assessing the adequacy of its capital to support current and future activities.
Quantitative disclosures .....	<ul style="list-style-type: none"> <li>(b) Risk-weighted assets for:                             <ul style="list-style-type: none"> <li>(1) Exposures to sovereign entities;</li> <li>(2) Exposures to certain supranational entities and MDBs;</li> <li>(3) Exposures to GSEs;</li> <li>(4) Exposures to depository institutions, foreign banks, and credit unions, including OFI exposures that are risk weighted as exposures to U.S. depository institutions and credit unions;</li> <li>(5) Exposures to PSEs;</li> <li>(6) Corporate exposures, including borrower loans (including agricultural and consumer loans) and OFI exposures that are not risk weighted as exposures to U.S. depository institutions and credit unions;</li> <li>(7) Residential mortgage exposures;</li> <li>(8) [Reserved]</li> <li>(9) Past due and nonaccrual exposures;</li> <li>(10) Exposures to other assets;</li> <li>(11) Cleared transactions;</li> <li>(12) Unsettled transactions;</li> <li>(13) Securitization exposures; and</li> <li>(14) Equity exposures.</li> </ul> </li> <li>(c) [Reserved]</li> <li>(d) Common equity tier 1, tier 1 and total risk-based capital ratios for the System bank.</li> <li>(e) Total standardized risk-weighted assets.</li> </ul>

TABLE 4 TO § 628.63—CAPITAL BUFFERS

Quantitative Disclosures .....	<ul style="list-style-type: none"> <li>(a) At least quarterly, the System bank must calculate and publicly disclose the capital conservation buffer and leverage buffer as described under § 628.11.</li> <li>(b) At least quarterly, the System bank must calculate and publicly disclose the eligible retained income of the System bank, as described under § 628.11.</li> <li>(c) At least quarterly, the System bank must calculate and publicly disclose any limitations it has on distributions and discretionary bonus payments resulting from the buffer framework described under § 628.11, including the maximum payout amount and/or maximum leverage payout amount for the quarter.</li> </ul>
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(c) *General qualitative disclosure requirement.* For each separate risk area described in Tables 5 through 10 of this section, the System bank must describe its risk management objectives and

policies, including: Strategies and processes; the structure and organization of the relevant risk management function; the scope and nature of risk reporting and/or

measurement systems; policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

TABLE 5 TO § 628.63<sup>1</sup>—CREDIT RISK: GENERAL DISCLOSURES

Qualitative Disclosures .....	<ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement with respect to credit risk (excluding counterparty credit risk disclosed in accordance with Table 6 of this section), including the:                         <ul style="list-style-type: none"> <li>(1) Policy for determining past due or delinquency status;</li> <li>(2) Policy for placing loans in nonaccrual status;</li> <li>(3) Policy for returning loans to accrual status;</li> <li>(4) Definition of and policy for identifying impaired loans (for financial accounting purposes);</li> <li>(5) Description of the methodology that the System bank uses to estimate its allowance for loan losses, including statistical methods used where applicable;</li> <li>(6) Policy for charging-off uncollectible amounts; and</li> <li>(7) Discussion of the System bank’s credit risk management policy.</li> </ul> </li> </ul>
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TABLE 5 TO § 628.63<sup>1</sup>—CREDIT RISK: GENERAL DISCLOSURES—Continued

Quantitative Disclosures .....	<p>(b) Total credit risk exposures and average credit risk exposures, after accounting offsets in accordance with GAAP, without taking into account the effects of credit risk mitigation techniques (for example, collateral and netting not permitted under GAAP), over the period categorized by major types of credit exposure. For example, System banks could use categories similar to that used for financial statement purposes. Such categories might include, for instance:</p> <ul style="list-style-type: none"> <li>(1) Loans, off-balance sheet commitments, and other non-derivative off-balance sheet exposures;</li> <li>(2) Debt securities; and</li> <li>(3) OTC derivatives.<sup>2</sup></li> </ul> <p>(c) Geographic distribution of exposures, categorized in significant areas by major types of credit exposure.<sup>3</sup></p> <p>(d) Industry or counterparty type distribution of exposures, categorized by major types of credit exposure.</p> <p>(e) By major industry or counterparty type:</p> <ul style="list-style-type: none"> <li>(1) Amount of impaired loans for which there was a related allowance under GAAP;</li> <li>(2) Amount of impaired loans for which there was no related allowance under GAAP;</li> <li>(3) Amount of loans past due 90 days and in nonaccrual status;</li> <li>(4) Amount of loans past due 90 days and still accruing;<sup>4</sup></li> <li>(5) The balance in the allowance for loan losses at the end of each period according to GAAP; and</li> <li>(6) Charge-offs during the period.</li> </ul> <p>(f) Amount of impaired loans and, if available, the amount of past due loans categorized by significant geographic areas including, if practical, the amounts of allowances related to each geographical area,<sup>5</sup> further categorized as required by GAAP.</p> <p>(g) Reconciliation of changes in allowances for loan losses.<sup>6</sup></p> <p>(h) Remaining contractual maturity delineation (for example, one year or less) of the whole portfolio, categorized by credit exposure.</p>
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<sup>1</sup> This Table 5 does not cover equity exposures, which should be reported in Table 9 of this section.

<sup>2</sup> See, for example, ASC Topic 815–10 and 210, as they may be amended from time to time.

<sup>3</sup> A System bank can satisfy this requirement by describing the geographic distribution of its loan portfolio by State or other significant geographic division, if any.

<sup>4</sup> A System bank is encouraged also to provide an analysis of the aging of past-due loans.

<sup>5</sup> The portion of the general allowance that is not allocated to a geographical area should be disclosed separately.

<sup>6</sup> The reconciliation should include the following: A description of the allowance; the opening balance of the allowance; charge-offs taken against the allowance during the period; amounts provided (or reversed) for estimated probable loan losses during the period; any other adjustments (for example, exchange rate differences, business combinations, acquisitions and disposals of subsidiaries), including transfers between allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly to the income statement should be disclosed separately.

TABLE 6 TO § 628.63—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK-RELATED EXPOSURES

Qualitative Disclosures .....	<p>(a) The general qualitative disclosure requirement with respect to OTC derivatives, eligible margin loans, and repo-style transactions, including a discussion of:</p> <ul style="list-style-type: none"> <li>(1) The methodology used to assign credit limits for counterparty credit exposures;</li> <li>Policies for securing collateral, valuing and managing collateral, and establishing credit reserves;</li> <li>(3) The primary types of collateral taken; and</li> <li>(4) The impact of the amount of collateral the System bank would have to provide given deterioration in the System bank’s own creditworthiness.</li> </ul>
Quantitative Disclosures .....	<p>(b) Gross positive fair value of contracts, collateral held (including type, for example, cash, government securities), and net unsecured credit exposure.<sup>1</sup> A System bank also must disclose the notional value of credit derivative hedges purchased for counterparty credit risk protection and the distribution of current credit exposure by exposure type.<sup>2</sup></p> <p>(c) Notional amount of purchased credit derivatives used for the System bank’s own credit portfolio.</p>

<sup>1</sup> Net unsecured credit exposure is the credit exposure after considering both the benefits from legally enforceable netting agreements and collateral arrangements without taking into account haircuts for price volatility, liquidity, etc.

<sup>2</sup> This may include interest rate derivative contracts, foreign exchange derivative contracts, equity derivative contracts, credit derivatives, commodity or other derivative contracts, repo-style transactions, and eligible margin loans.

TABLE 7 TO § 628.63—CREDIT RISK MITIGATION<sup>1 2</sup>

Qualitative Disclosures .....	<p>(a) The general qualitative disclosure requirement with respect to credit risk mitigation, including:</p> <ul style="list-style-type: none"> <li>(1) Policies and processes for collateral valuation and management;</li> <li>(2) A description of the main types of collateral taken by the System bank;</li> <li>(3) The main types of guarantors/credit derivative counterparties and their creditworthiness; and</li> <li>(4) Information about (market or credit) risk concentrations with respect to credit risk mitigation.</li> </ul>
Quantitative Disclosures .....	<p>(b) For each separately disclosed credit risk portfolio, the total exposure that is covered by eligible financial collateral, and after the application of haircuts.</p> <p>(c) For each separately disclosed portfolio, the total exposure that is covered by guarantees/credit derivatives and the risk-weighted asset amount associated with that exposure.</p>

<sup>1</sup> At a minimum, a System bank must provide the disclosures in this Table 7 in relation to credit risk mitigation that has been recognized for the purposes of reducing capital requirements under this subpart. Where relevant, System banks are encouraged to give further information about mitigants that have not been recognized for that purpose.

<sup>2</sup>Credit derivatives that are treated, for the purposes of this subpart, as synthetic securitization exposures should be excluded from the credit risk mitigation disclosures and included within those relating to securitization (Table 8 of this section).

TABLE 8 TO § 628.63—SECURITIZATION <sup>1</sup>

Qualitative Disclosures .....	<p>(a) The general qualitative disclosure requirement with respect to a securitization (including synthetic securitizations), including a discussion of:</p> <ol style="list-style-type: none"> <li>(1) The System bank's objectives for securitizing assets, including the extent to which these activities transfer credit risk of the underlying exposures away from the System bank to other entities and including the type of risks assumed and retained with resecuritization activity;<sup>2</sup></li> <li>(2) The nature of the risks (e.g. liquidity risk) inherent in the securitized assets;</li> <li>(3) The roles played by the System bank in the securitization process<sup>3</sup> and an indication of the extent of the System bank's involvement in each of them;</li> <li>(4) The processes in place to monitor changes in the credit and market risk of securitization exposures including how those processes differ for resecuritization exposures;</li> <li>(5) The System bank's policy for mitigating the credit risk retained through securitization and resecuritization exposures; and</li> <li>(6) The risk-based capital approaches that the System bank follows for its securitization exposures including the type of securitization exposure to which each approach applies.</li> </ol> <p>(b) [Reserved]</p> <p>(c) Summary of the System bank's accounting policies for securitization activities, including:</p> <ol style="list-style-type: none"> <li>(1) Whether the transactions are treated as sales or financings;</li> <li>(2) Recognition of gain-on-sale;</li> <li>(3) Methods and key assumptions applied in valuing retained or purchased interests;</li> <li>(4) Changes in methods and key assumptions from the previous period for valuing retained interests and impact of the changes;</li> <li>(5) Treatment of synthetic securitizations;</li> <li>(6) How exposures intended to be securitized are valued and whether they are recorded under subpart D of this part; and</li> <li>(7) Policies for recognizing liabilities on the balance sheet for arrangements that could require the System bank to provide financial support for securitized assets.</li> </ol> <p>(d) An explanation of significant changes to any quantitative information since the last reporting period.</p>
Quantitative Disclosures .....	<p>(e) The total outstanding exposures securitized by the System bank in securitizations that meet the operational criteria provided in § 628.41 (categorized into traditional and synthetic securitizations), by exposure type.<sup>4</sup></p> <p>(f) For exposures securitized by the System bank in securitizations that meet the operational criteria in § 628.41:</p> <ol style="list-style-type: none"> <li>(1) Amount of securitized assets that are impaired/past due categorized by exposure type;<sup>5</sup> and</li> <li>(2) Losses recognized by the System bank during the current period categorized by exposure type.<sup>6</sup></li> </ol> <p>(g) The total amount of outstanding exposures intended to be securitized categorized by exposure type.</p> <p>(h) Aggregate amount of:</p> <ol style="list-style-type: none"> <li>(1) On-balance sheet securitization exposures retained or purchased categorized by exposure type; and</li> <li>(2) Off-balance sheet securitization exposures categorized by exposure type.</li> </ol> <p>(i) (1) Aggregate amount of securitization exposures retained or purchased and the associated capital requirements for these exposures, categorized between securitization and resecuritization exposures, further categorized into a meaningful number of risk weight bands and by risk-based capital approach (e.g., SSFA); and</p> <p>(2) Exposures that have been deducted entirely from tier 1 capital, CEIOs deducted from total capital (as described in § 628.42(a)(1)), and other exposures deducted from total capital should be disclosed separately by exposure type.</p> <p>(j) Summary of current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by exposure type.</p> <p>(k) Aggregate amount of resecuritization exposures retained or purchased categorized according to:</p> <ol style="list-style-type: none"> <li>(1) Exposures to which credit risk mitigation is applied and those not applied; and</li> <li>(2) Exposures to guarantors categorized according to guarantor creditworthiness categories or guarantor name.</li> </ol>

<sup>1</sup> A System bank is not authorized to perform every role in a securitization, and nothing in these capital rules authorizes a System bank to engage in activities relating to securitizations that are not otherwise authorized.

<sup>2</sup> The System bank should describe the structure of resecuritizations in which it participates; this description should be provided for the main categories of resecuritization products in which the System bank is active.

<sup>3</sup> Roles in securitizations generally could include originator, investor, servicer, provider of credit enhancement, sponsor, liquidity provider, or swap provider. As noted in footnote 1 of this table, however, a System bank is not authorized to perform all of these roles.

<sup>4</sup> "Exposures securitized" include underlying exposures originated by the System bank, whether generated by them or purchased, and recognized in the balance sheet, from third parties, and third-party exposures included in sponsored transactions. Securitization transactions (including underlying exposures originally on the System bank's balance sheet and underlying exposures acquired by the System bank from third-party entities) in which the originating System bank (as an originating System institution) does not retain any securitization exposure should be shown separately but need only be reported for the year of inception. System banks are required to disclose exposures regardless of whether there is a capital charge under this part.

<sup>5</sup> Include credit-related other than temporary impairment (OTTI).

<sup>6</sup> For example, charge-offs/allowances (if the assets remain on the System bank's balance sheet) or credit-related OTTI of interest-only strips and other retained residual interests, as well as recognition of liabilities for probable future financial support required of the System bank with respect to securitized assets.

TABLE 9 TO § 628.63—EQUITIES

Qualitative Disclosures .....	(a) The general qualitative disclosure requirement with respect to equity risk: (1) Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons; and (2) Discussion of important policies covering the valuation of and accounting for equity. This includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.
Quantitative Disclosures .....	(b) Value disclosed on the balance sheet of investments, as well as the fair value of those investments; for securities that are publicly traded, a comparison to publicly quoted share values where the share price is materially different from fair value. (c) The types and nature of investments, including the amount that is: (1) Publicly traded; and (2) Non-publicly traded. (d) The cumulative realized gains (losses) arising from sales and liquidations in the reporting period. (e) (1) Total unrealized gains (losses). <sup>1</sup> (2) Total latent revaluation gains (losses). <sup>2</sup> (3) Any amounts of the above included in tier 1 or tier 2 capital. (f) [Reserved]

<sup>1</sup> Unrealized gains (losses) recognized on the balance sheet but not through earnings.  
<sup>2</sup> Unrealized gains (losses) not recognized either on the balance sheet or through earnings.

TABLE 10 TO § 628.63—INTEREST RATE RISK FOR NON-TRADING ACTIVITIES

Qualitative disclosures .....	(a) The general qualitative disclosure requirement, including the nature of interest rate risk for non-trading activities and key assumptions, including assumptions regarding loan prepayments and behavior of non-maturity deposits, and frequency of measurement of interest rate risk for non-trading activities.
Quantitative disclosures .....	(b) The increase (decline) in earnings or economic value (or market value of equity or other relevant measure used by management) for upward and downward rate shocks according to management's method for measuring interest rate risk for non-trading activities, categorized by currency (as appropriate).

§§ 628.64 through 628.99 [Reserved]

Subpart E—[Reserved]

Subpart F—[Reserved]

Subpart G—Transition Provisions

§ 628.300 Transitions.

(a) *Capital conservation buffer.* (1) [Reserved]

(2) Beginning January 1, 2017 through December 31, 2019 a System institution's maximum capital conservation buffer payout ratio must be determined as set forth in Table 1 to § 628.300.

TABLE 1 TO § 628.300

Transition Period	Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
Calendar year 2017 .....	>0.625 percent .....	No limitation.
	≤0.625 percent, and >0.469 percent .....	60 percent.
	≤0.469 percent, and >0.313 percent .....	40 percent.
	≤0.313 percent, and >0.156 percent .....	20 percent.
	≤0.156 percent .....	0 percent.
Calendar year 2018 .....	>1.25 percent .....	No limitation.
	≤1.25 percent, and >0.938 percent .....	60 percent.
	≤0.938 percent, and >0.625 percent .....	40 percent.
	≤0.625 percent, and >0.313 percent .....	20 percent.
	≤0.313 percent .....	0 percent.
Calendar year 2019 .....	>1.875 percent .....	No limitation.
	≤1.875 percent, and >1.406 percent .....	60 percent.
	≤1.406 percent, and >0.938 percent .....	40 percent.
	≤0.938 percent, and >0.469 percent .....	20 percent.
	≤0.469 percent .....	0 percent.

(b) through (e) [Reserved]

**§ 628.301 Initial compliance and reporting requirements.**

(a) A System institution that fails to satisfy one or more of its minimum applicable CET1, tier 1, or total risk-based capital ratios or its tier 1 leverage ratio at the end of the quarter in which these regulations become effective shall report its initial noncompliance to the FCA within 20 days following such quarterend and shall also submit a capital restoration plan for achieving and maintaining the standards, demonstrating appropriate annual progress toward meeting the goal, to the FCA within 60 days following such quarterend. If the capital restoration plan is not approved by the FCA, the FCA will inform the institution of the reasons for disapproval, and the institution shall submit a revised capital restoration plan within the time specified by the FCA.

(b) *Approval of compliance plans.* In determining whether to approve a capital restoration plan submitted under this section, the FCA shall consider the following factors, as applicable:

(1) The conditions or circumstances leading to the institution's falling below minimum levels, the exigency of those circumstances, and whether or not they were caused by actions of the institution or were beyond the institution's control;

(2) The overall condition, management strength, and future prospects of the institution and, if applicable, affiliated System institutions;

(3) The institution's capital, adverse assets (including nonaccrual and nonperforming loans), ALL, and other ratios compared to the ratios of its peers or industry norms;

(4) How far an institution's ratios are below the minimum requirements;

(5) The estimated rate at which the institution can reasonably be expected to generate additional earnings;

(6) The effect of the business changes required to increase capital;

(7) The institution's previous compliance practices, as appropriate;

(8) The views of the institution's directors and senior management regarding the plan; and

(9) Any other facts or circumstances that the FCA deems relevant.

(c) An institution shall be deemed to be in compliance with the regulatory capital requirements of this subpart if it is in compliance with a capital restoration plan that is approved by the FCA within 180 days following the end of the quarter in which these regulations become effective.

Dated: May 17, 2016.

**Dale L. Aultman,**

*Secretary, Farm Credit Administration Board.*

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