In addition, the most frequent source of an association's financial stress is borrower adversity, whether it is the result of widespread adverse financial conditions (as it was in the mid-1980s), or the result of troubled conditions in a region or industry in which an association has a concentration of loans. As occurred in the mid-1980s, when an institution is unable to retire borrower stock because of financial stress, the institution's business and its borrower/shareholders are adversely affected.

2. ''Local'' Unallocated Retained Earnings (URE) Are Important to Institutions During Periods of Economic Adversity

Over a number of years, most associations in the System accumulated URE, in part, through non-cash earnings distributions from their affiliated banks. Since these non-cash distributions have seldom been retired, some portion of these distributions has resulted in an increase to URE on the associations' balance sheets and yet has continued to be reported as allocated equities on the bank's financial statements. Certain associations have little or no URE that is not also included in the bank's GAAP capital. This group of associations is particularly vulnerable to financial adversity at their affiliated banks because most of their capital other than borrower stock is at risk in both the bank and the association. When a bank sustains losses, all of the bank's capital is available to absorb losses, regardless of whether it is being counted as permanent capital at the association. It follows that such capital will not be available to absorb association losses, which can create a domino effect in troubled times, since adversity in one institution can cause adversity in many or all institutions in the district.

The FCA conducted a study of production credit associations (PCAs) that became financially stressed during the 1980s. The sample used represented a comparable set of financially stressed and healthy institutions. Although the number of institutions and quarters of historical financial data were limited, the FCA was able to make inferences regarding capital levels and long-term viability. The healthy associations, which had unallocated surplus net of their investments in their affiliated banks, were better able to withstand adversity and stay financially viable without assistance. However, associations with no or low surplus, after deducting the investment in the bank, generally could not independently withstand an adverse economic environment without assistance or other action to address their financial deterioration.[3]

A URE cushion that does not include the association's interdependent investment in its affiliated bank provides optimum protection for borrower/shareholders. Losses at the affiliated bank stemming from adversity in other associations or from risks borne by the bank (funding, investment, operational, etc.) could impair the investment in the bank and deplete association capital. Consequently, an association with a large URE and a high permanent capital ratio may not be adequately insulated from adversity if it relies heavily on capital that is invested in its affiliated bank. Strong local URE allows the association to remain viable even if the investment in the bank becomes impaired. The likelihood of the bank and associations sustaining losses simultaneously greatly amplifies the need for a local URE standard.

3. A Sufficient Level of Eligible Collateral Is Needed To Protect Investors in the System's Debt Instruments

The basis for funding banks within the System is the maintenance of sufficient eligible collateral. Performing agricultural loans make up the bulk of eligible collateral,[4] followed by marketable securities and cash. Nonperforming loans and acquired property also provide eligible collateral, after deducting for losses. During the 1980s, the collateral positions of the Farm Credit banks were a critical measure of survival. As an example, the collateral of one bank was exhausted, and the bank lost its ability to independently obtain funding from the marketplace before its capital was depleted.[5]

Farm Credit banks have long used a collateral ratio as a principal indicator of financial strength. Both the Market Access Agreement and the Contractual Interbank Performance Agreement (CIPA)[6] use a collateral ratio as a critical measure of bank financial viability and survivability. A bank failure within the System would have grave consequences not only for that bank and its affiliated associations, but also for the other System banks because of joint and several liability and the market perception of the System as a single entity seeking funding.

The FCA believes that a bank could be shut out of the securities markets if its collateral ratio (as defined in § 615.5050 of the regulations) dropped below 100 percent. Thus, a margin of safety above this level is reasonable, in order to protect investors and allow sufficient time for corrective action to be implemented prior to a funding crisis at an individual bank, and thus district, level. Also, the FCA believes that the net collateral position of a bank, net of its equities counted by associations as part of their permanent capital, affords better protection for both investors and shareholders.

Both the statute and the FCA's capital regulations require a permanent capital calculation that eliminates the double counting of capital shared by System institutions through the allotment agreements. Similarly, the FCA believes a collateral ratio adjusted for the allotment agreements is another appropriate measure of financial safety. This would help ensure that the bank has sufficient capital, net of any capital counted as association permanent capital, to protect investors and shareholders. Specifically, it prevents a bank from placing such equities at risk for investor protection at the same time that associations are placing them at risk for credit and other purposes.

B. Basle Accord and Capital Regulations of Other Regulators

As a part of its review, the FCA has re-examined the 1988 Basle Accord agreed to by the Committee on Banking Regulations and Supervisory Practices, which meets under the auspices of the Bank for International Settlements in Basle, Switzerland. In the existing capital regulations, the FCA incorporated the Basle Accord principles of weighting assets, including off-balance-sheet items, according to categories of risk. However, the FCA did not incorporate in the regulations the two-tiered approach of the Basle Accord, which requires that each institution have at least a minimum amount of ''core capital'' (primarily stable equity capital), which must constitute at least 50 percent of the required capital of the institution. Rather, the FCA treated all types of capital meeting the statutory definition of permanent capital as if they were of

[3] In fact, the stressed PCAs in the study generally had no ''local'' URE. The median value was actually below zero. These PCAs were subsequently merged or provided financial assistance.

[4] Such loans consist of loans made directly by the bank or, in the case of a bank's wholesale lending activities, the loans made by the direct lender associations which are pledged as security for the associations' direct loans from the bank (up to the amount of the direct loan).

[5] The bank was able to maintain access to the funding markets only after certain other System banks agreed to pledge excess collateral to the troubled bank.

[6] These are self-monitoring agreements among the Federal Farm Credit Banks Funding Corporation (Funding Corporation) and System banks that specify levels of bank financial performance, as well as the consequences of a bank's falling below such levels.