equal value to the institution to absorb losses.

The Federal regulatory agencies for commercial banks and thrifts in this country—the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System—have all adopted capital regulations that are consistent with the Basle Accord framework. In each agency's two-tiered capital system, core or Tier 1 capital is mainly composed of common stock, surplus, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries. Supplementary or Tier 2 capital is composed of a portion of the allowance for loan losses and all other kinds of capital and capital-like instruments, up to an amount equal to the amount of Tier 1 capital. The minimum capital requirement is 8 percent. Commercial banks and thrifts also have a minimum leverage requirement, calculated as the ratio of Tier 1 capital to total (*i.e.*, not risk-adjusted) assets, to protect against risks other than credit risk.

Common shareholders' equity in commercial banks and thrifts is the most stable, permanent form of capital because it is fully paid and is rarely retired. By contrast, nearly all of the common equity capital of System associations is borrower stock, which lacks the characteristic of permanence because it is retired in the ordinary course of business of the associations.

The FCA also reviewed an FDIC staff study published in 1993 that compared the risk-based standards for commercial banks to the primary and secondary capital constraints they had replaced.[7] The previous standards differed from the current 8-percent standard in two important ways: the assets were not risk weighted, and all of the allowance for losses (ALL) was included in capital. The study concluded that the risk-based standard was a better predictor of the potential failure of a bank than the previous standards for two reasons: (1) The exclusion of ALL from Tier 1 and its only limited inclusion in Tier 2 improved the quality of the capital measure; and (2) the risk-based measure was more sensitive to credit risk.[8] But the study also concluded that using both the risk-based standard and the new Tier 1 capital-to-total-assets leverage ratio together was a better predictor of failure than either one separately, because in many cases the leverage ratio, which addressed risks other than credit risk, provided a more stringent test of capital adequacy.

[7] John P. O'Keefe, ''Risk-Based Capital Standards for Commercial Banks: Improved Capital-Adequacy Standards?'' published in the *FDIC Banking Review*, Spring-Summer 1993.

[8] ALL is already excluded from the permanent capital measure for System institutions; so the FDIC staff finding is not directly relevant with respect to the inclusion of ALL. However, the finding is important because it shows the necessity of assuring at least a minimum amount of the highest quality of capital.

C. Farm Credit System Observations

In May 1993, the System's Presidents Planning Committee appointed a capital adequacy work group (System group) with the charge of reviewing the FCA's capital adequacy regulations and making recommendations for improvements. As a result of this effort, in November 1993 the System group provided the FCA with a report of its findings and suggestions. The System group refined this report with a supplemental document submitted to the FCA in April 1994. The System group informed the FCA that the group had consulted with all the banks and a number of associations in developing its final report.

The final report recognized concerns with existing regulatory requirements similar to those identified by the FCA. The System report supported a requirement to build unallocated surplus and allocated surplus to buffer borrower stock from potential losses and to insulate an institution's capital position from the potentially volatile nature of borrower stock. The report noted the important role borrower stock plays in obtaining new loans and retaining quality business, given the cooperative structure of the System. The report also acknowledged the need to protect investors in System securities.

The System group recommended that the FCA establish regulatory standards requiring all institutions to build unallocated surplus and total surplus (*i.e.*, allocated equities and unallocated surplus) by annually retaining a portion of earnings. The System group's proposed goals of 3.5-percent unallocated surplus and 7-percent total surplus were proposed to be achieved by retaining at least 10 percent of net earnings after taxes in unallocated surplus and at least 50 percent of net earnings in unallocated and allocated equities. These objectives were based on the regulatory permanent capital framework and used risk-adjusted assets as the ratios' denominators.

The System group's report also recognized the need to protect investors in System securities. The System recommended that each bank begin reporting to the Funding Corporation its collateral position net of bank equities being counted at associations for permanent capital purposes. The System group stated that its recommendation ''effectively prevents the bank from placing such equities at risk for investor protection at the same time that associations are putting them at risk for credit and other purposes pursuant to an allotment agreement,'' and further that ''[i]t gives tangible recognition to the spirit and intent of the . . . 1992 legislation.''

Similarities and differences between the FCA's proposed regulation and the System group's suggestions are discussed below in section C of part V.

V. FCA Conclusions and Proposals for Surplus and Collateral Ratios

The FCA makes the following proposals:

A. Surplus and Collateral Requirements

Each Farm Credit institution[9] should have some minimum amount of capital in the form of unallocated surplus, allocated equities or stock not required to be purchased as a condition of obtaining a loan, in order to protect against losses. Part of the surplus should be unallocated surplus that provides a cushion for borrower stock and allocated equities and that does not also support risks in another System institution. The FCA believes that this unallocated surplus would better enable an institution to withstand its own losses and also insulate both the institution and its borrowers from adversities suffered by related System institutions.

1. Unallocated Surplus Requirement

The FCA proposes that institutions have unallocated surplus of at least 3.5 percent of risk-weighted assets. For this purpose, unallocated surplus would include common stock and noncumulative perpetual preferred stock held by non-borrowers, provided that the institution adheres to a policy of not retiring such stock. For associations, the net investment in its affiliated bank—that is, the total investment less reciprocal investments, pass-through stock, and investments related to loan participations—would be subtracted from the unallocated surplus. For both banks and associations, the risk-weighted asset base would be calculated as it is for the institution's permanent capital requirement, except

[9] ''Institution'' includes each System bank, System association, and the Farm Credit Leasing Services Corporation. It does not include other System entities, such as other service corporations. The surplus ratios for the Leasing Corporation are calculated the same way as the surplus ratios for banks. However, the Leasing Corporation would not have to maintain a net collateral standard.