THE FARM CREDIT COUNCIL

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RE: Investment Eligibility – RIN 3052-AC84 / *Federal Register* 79 (July 25, 2014) 43301

The Farm Credit Council, on behalf of its membership, appreciates the opportunity to comment on the Farm Credit Administration's (FCA's) proposed rule regarding the investment authorities for the Banks and Associations of the Farm Credit System.

The following comments were developed after soliciting input from all System Banks. A workgroup consisting of individuals from the finance departments of each Bank provided initial input for these comments. Each Bank obtained additional comments from their affiliated Associations. Following receipt of comments, System representatives held a conference call to discuss specific concerns. A draft letter was then circulated for further review and comment. The following comments represent the consensus view of System institutions regarding the proposed rule as it applies to System Banks.

Due to the significant variance in both current and anticipated use of the investment authority by System Associations, both within each Bank's district as well as across the System, System institutions will submit their own comments on various aspects of the proposed Association Investment portion of the rule.

Specific Comments

1) In Section 615.5134 – *Liquidity Reserve*, the proposed regulation clarifies that mortgage-backed securities must be fully guaranteed by a U.S. government agency to qualify for Level 2 liquidity and fully guaranteed by a government sponsored enterprise (GSE) to qualify for Level 3 liquidity (p. 43303).

Comment 1: While the housing GSEs have been in conservatorship, they have received support from the U.S. government and have paid dividends on that support to the U.S. Treasury. The relationship is analogous to the budget and appropriations process of payments to and from the U.S. government departments that have direct U.S. government guarantees. We therefore request that the treatment in terms of liquidity classification of both Fannie Mae and Freddie Mac, while they remain within the conservatorship governance of the U.S. Treasury, be equal to Ginnie Mae.

2) In Section 615.5140 (a)(1) - *Purpose*, each Bank is required to be able to identify the authorized purpose or purposes for which each investment is held (p. 43303).

Comment 2: Requiring an additional, formal designation of investment purpose is unnecessary and does not add incremental value to the existing pre-purchase due diligence requirements that are designed to assess eligibility at the asset level. Each Bank is responsible for managing the liquidity for its district. As such, the primary purpose of each Bank's investment portfolio is to manage that risk. It would be ineffective, as well as overly burdensome, to designate at a type or CUSIP level to support purposes of liquidity, interest rate risk or management of surplus funds. Each such determination would not necessarily be mutually exclusive. FCA proposes to allow Associations to "hold investments to manage risk" (p. 43310). However, System Banks are not afforded the same flexibility with respect to managing risk. Instead, they are asked to designate a specific purpose for each investment. Given FCA's proposed "eligible" investment classes, it has clearly established security classes designed to meet an authorized purpose for the Bank investment portfolios, regardless if that purpose is to manage liquidity risk, interest rate risk or short-term surplus funds.

In addition, the recently released final rule on the liquidity coverage ratio from other financial regulators has recognized the ability of securities to serve multiple purposes. On page 107 of the final rule on Liquidity Coverage Ratio: Liquidity Risk Measurement Standards issued by prudential regulators effective January 1, 2015, "If HQLA (high quality liquid assets) had been used as a general macro hedge, such as interest rate risk of the covered company's portfolio; it could still have been included as eligible HQLA." We believe this acknowledgement by other financial regulators, as well as the FCA's proposed approach for Associations' use of investment assets, support our request for the FCA to drop this requirement for System Banks.

3) In Section 615.5140 (a)(3) - *Obligors' Capacity to Meet Financial Commitment*, the FCA proposed at least one obligor must have a very strong capacity to meet its financial commitment (p. 43305).

Comment 3: We request replacing the standard "very strong" with "strong," which will allow flexibility while maintaining the high credit quality standard for the portfolio. This will allow System institutions to purchase corporate debt falling within the investment grade standard currently allowed by other banking regulators for their regulated institutions.

Comment 4: The Farm Credit Banks request clarification on the application of obligor capacity definition to all investments and suggest U.S. government, government sponsored agencies and GSEs be excluded from this requirement.

4) With respect to Section 615.5140 (a)(4) – *Credit and Other Risk in the Investment*, the FCA proposes Banks identify the purpose for which each investment is held.

Comment 5: We repeat our request that FCA remove the requirement to identify a specific purpose for which particular investments are held, as investments may be held for more than one purpose. The design of the liquidity reserve, the buffer and the definition of corresponding assets that may be purchased within each of the regulatory requirements sufficiently ensure safety and soundness for each investment purchased.

Additionally, price volatility does not indicate marketability or measure liquidity risk. The market value of each investment is used in measuring liquidity. As the price moves, the liquidity valuation is adjusted. Also, determining volatility requires measuring against a history. We suggest a close proxy be allowed for determining the initial purchase price for a type or class that lacks adequate price history. Price movements may come from interest rate or credit spread moves on different kinds of investment instruments. Therefore, price volatility, depending on its cause, is not necessarily a valid measure of liquidity in the marketplace. Rather, price volatility is simply the valuation of liquidity amounts via pricing adjustments.

5) In Section 615.5133 (f)(3)(i) – *Asset Class Diversification*, the proposed regulation requires the Farm Credit Banks to diversify their investment portfolios among various asset classes; no more than 15 percent of their investment portfolios can be invested in any one asset class (p. 43308). The existing rule imposes portfolio limits of 15 percent, 20 percent or 50 percent, depending on the asset class. The FCA proposal simplifies the rule with a 15 percent limit for all asset classes (p. 43308). The comments note that, because the vast majority of System investments are in exempt securities, a 15 percent limit on investments in each asset class should provide sufficient flexibility for institutions to manage their investment portfolios (p. 43308).

Comment 6: We propose money market investments continue to remain exempt from the asset class portfolio diversification limit. The addition of a 15 percent cap per asset class poses undue restriction on money market investments and limits their use as an effective investment vehicle for liquidity risk management.

The Farm Credit Banks place a high importance on the risk-reducing benefits of money market investments. The short-term maturities make these investments self-liquidating, which provide the Banks with a reliable source of liquidity during periods of market stress. Self-liquidating means money market securities do not rely on the capital markets or the repo market for the ability to convert to cash, which provides diversification in the source of liquidity. In the post-crisis market and corresponding reduction in the size of dealer Bank balance sheets, money market investments makes relying on dealers for liquidity less important. Furthermore, the level of risk of concentration is low [(f) – Farm Credit Bank Portfolio Diversification, p. 43307].

The addition of this proposed new limit creates an unnecessary burden which also may result in unintended consequences during times of market stress, when it would be prudent to increase highly liquid federal funds or other money market positions. If the money market asset class were limited to 15 percent, Banks might have to diversify into less liquid assets or assets with more market risk, or increase certain other concentrations such as housing or U.S. government.

In addition, requiring a cap on covered investments is inconsistent with current liquidity objectives. Instruments in the Level 1 liquidity category should not be limited as a source of liquidity. Their positioning and availability provides safe liquidity and acts as an effective cash management tool, both of which are directly tied to authorized purposes to hold investments.

In 615.5133, the regulation describes the requirement to diversify across asset classes, geography, industries, and obligors, as well as maturities and collateral. Money market investments offer an efficient and most affordable way to diversify across geography, industry, maturities, and companies. They also offer an alternative to, or a reduction in, U.S. government exposures and housing collateral concentrations.

The Farm Credit Banks also believe the 15 percent limit on money market investments is unreasonable, because it would increase both price and liquidity risk in the portfolio while providing no commensurate benefit. In the existing regulation, there is no investment portfolio limit on money market investments, except non-callable term fed funds and master notes (both at 20 percent), given their importance in efficient cash management.

Due to the requirements for and concentration of U,S, government and Ginnie Mae investments in the liquidity reserve definition, a cap of 20 percent for the remaining non money market asset classes does not increase risk or create undue burden to reallocate investments.

6) Section 615.5133 (f)(3)(ii) and (g) - *Obligor Diversification, Farm Credit Bank Obligor Limit*, proposes to limit, with certain exceptions, to no more than 3 percent, the amount of the investment portfolio invested in any one obligor. In (g), the proposed regulation limits the amount of capital a Bank may invest in any one obligor to an amount equal to no more than 10 percent of total capital, with certain exceptions (p. 43308-43309).

Comment 7: We propose the amount of capital Banks may invest in one obligor should be maintained as a percentage of total capital without the additional limit of 3 percent of total investment portfolio per obligor. The 3 percent limit is unnecessary in light of the proposed regulatory obligor reduction from 20 percent to 10 percent of the total capital concentration. Maintaining obligor exposure limits based on a percentage of capital provides sufficient protection for the Banks. Adding an additional layer of measurement against a moving target, given that investment portfolio balance fluctuates daily, and depending on pay-downs, purchases, maturities etc., creates an unnecessary layer of operational reporting. It does not add substantial value from a risk management perspective, given protection is already in place with the 10 percent limit.

Measuring obligor risk against total capital can be meaningful. However, if a Bank chooses to reduce its overall investment holdings to a lower level or increase its holdings temporarily, the 3 percent of portfolio limitation would effectively require an adjustment in individual obligor exposures, from an operational limitation standpoint, when in fact there may have been no change to the Bank's overall risk profile.

7) In 615.5133 (i) – *Reports to the Board of Directors*, the proposed regulation adds the word "risk" to the reporting requirements (p. 43309).

Comment 8: The Farm Credit Banks fully support effective communication to their respective boards regarding the risks within their investment portfolios. Specifically, the due diligence requirement for board reporting sets a high threshold for detail. Refining the reporting obligation to be targeted to managing risks versus detailed lists of requirements seems more reasonable. The existing regulation and additional proposal encourage a "check-list" approach to compliance, which can result in over-reporting of unnecessary or duplicative information, or the omission of important information. While more detailed reporting is appropriate at the level of the Asset Liability Committee (ALCO), the board and management should determine the type of board reporting. The reporting to the Board needs to be flexible enough to encompass emerging best practices and also provide the identification and implications of risk as markets change.

8) IV - *Compliance Date*, FCA invites comments on whether the delayed compliance timeframe is appropriate (p. 43313).

Comment 9: We ask the FCA to consider the impact of the specific changes made in the final regulations on each Bank's existing portfolio. For example, if the final regulation requires a reduction in certain asset classes and changes in composition, then additional time may be required to achieve compliance. In that instance, we request up to 12 months from effective date to comply with the new rules. The specific impact to those Banks that hold a higher percentage of money market investments and the corresponding compositional changes would be significant and substantial. Allowing for a natural transition by incorporating maturity dates up to one year would minimize the economic cost of compliance. Additionally, by permitting a 12-month implementation, the cycle of annual strategic plan presentation and approval at the board level would be easily maintained.

Conclusion

Thank you again for the opportunity to comment on this proposed rule. We recognize the need to revise the rule to comply with applicable provisions of the Dodd Frank Act and are therefore supportive of the overall concept underlying the proposed rule as it applies to System Banks. However, we ask FCA to consider and address our comments before issuing a final rule.

We trust our comments and those of other System institutions will assist the Agency. If you have any questions, please contact me.

Respectfully submitted,

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