FARMER MAC

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October 23, 2014

Via Electronic Mail to reg-comm@fca.gov
Barry F. Mardock
Deputy Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Notice of Proposed Rulemaking: "Organization; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Eligibility"
12 CFR Parts 611 and 615, RIN 3052-AC84, July 25, 2014

Dear Mr. Mardock:

The Federal Agricultural Mortgage Corporation ("Farmer Mac") appreciates the opportunity to respond to the request for public comment on the above-referenced proposed rule (the "Proposed Rule")[1] published by the Farm Credit Administration (the "FCA") regarding the eligibility of investments held by Farm Credit banks and the removal of references to credit ratings. Although the Proposed Rule does not apply to Farmer Mac, Farmer Mac understands that the FCA intends to issue a notice of proposed rulemaking in the near future related to the regulations governing the eligibility of investments held by Farmer Mac (12 C.F.R. Part 652). To the extent that the proposed rulemaking related to Farmer Mac is intended to be similar to the Proposed Rule, Farmer Mac believes that its observations on the Proposed Rule will be constructive. Farmer Mac has comments on three specific areas of the Proposed Rule, as described below.

1. Definition of "Collateralized Debt Obligation"

Farmer Mac recognizes that the FCA's proposed prohibition on the investment in collateralized debt obligations ("CDOs") by Farm Credit banks in the Proposed Rule[2] stems from the adverse experience encountered by some CDO investors during the recent financial crisis. However, Farmer Mac believes that the proposed definition of a CDO[3] does not fully align with the FCA's intent of eliminating unacceptable risk to Farm Credit banks. The CDO structure in concept was not implicated as one of the triggers of the recent financial crisis, but rather, it was

[1] 79 Fed. Reg. 43301 (July 25, 2014).

[2] Proposed Rule at 43306 (proposed 12 C.F.R. § 615.5140(c)).

[3] Proposed Rule at 43303 (proposed definition under 12 C.F.R. § 615.5131). Under the Proposed Rule, the definition of a CDO would include a debt security collateralized by mortgage-backed securities ("MBS"), asset-backed securities ("ABS"), or trust-preferred securities.

the misunderstanding by investment banks, rating agencies, and investors alike of the benefits intended to be provided by the CDO structure.[4] This misunderstanding appears to have been carried into the FCA's proposed definition of a CDO, as it assumes that all CDO structures are unsuitable without according due consideration to the true objectives of a CDO structure.

In addition, the proposed definition of a CDO cannot be reconciled with the definitions in the existing investment regulations applicable to Farm Credit banks (the "Investment Regulations") of MBS[5] and ABS,[6] which the FCA has not proposed to substantively revise.[7] The definition of a CDO, as currently proposed, could also capture a security that would be classified as an MBS or ABS, and an investment in such a security would consequently be prohibited. By contrast, the Proposed Rule would simultaneously permit a Farm Credit bank to invest in the same security under the definition of MBS (or ABS), whether or not guaranteed by a U.S Government agency,[8] by defining them in part as securities that may be collateralized by an MBS (or ABS). A direct conflict exists, therefore, between the operational provisions of the Investment Regulations permitting investments in MBS or ABS and the proposed operational provision prohibiting investments in CDOs. For example, a pass-through security backed by residential mortgage loans subsequently restructured into a multiclass real estate mortgage

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[4] Specifically, some market participants incorrectly assumed that the credit quality of an obligation backed by pooled assets was superior to the average credit quality of the pool itself, and it appears that this assumption allowed for the widespread financial engineering of credit risk. However, in a true CDO structure, there should be no financial engineering of credit risk. For example, a security backed by a pool of multiple corporate debt instruments allows investors to gain exposure to a diverse set of corporate issuers with differing credit profiles through one liquid security without having to invest in each corporate issuer separately, and typically the credit quality of the pool is equivalent to the average credit quality of all of the corporate issuers included in the pool.

[5] "Mortgage securities" are defined under the Investment Regulations, in relevant part, as "a multiclass security (including collateralized mortgage obligations and real estate mortgage investment conduits) that is backed by a pool of residential, multifamily or commercial real estate mortgages, pass-through mortgage securities, or other multiclass mortgage securities." 12 C.F.R. § 615.5131.

[6] "Asset-backed securities" are defined under the Investment Regulations as "investment securities that provide for ownership of a fractional undivided interest or collateral interests in specific assets of a trust that are sold and traded in the capital markets." 12 C.F.R. § 615.5131.

[7] Although the Proposed Rule proposes to replace the defined term "mortgage securities" in the Investment Regulations with the term "mortgage-backed securities" or "MBS" and make conforming changes to the definition of "ABS" in the Investment Regulations, these changes are not intended to have any substantive effect. Farmer Mac has assumed that these technical changes will be made and therefore uses the new terminology in this letter. *See* Proposed Rule at 43303.

[8] The Proposed Rule proposes to replace the existing defined terms "Government sponsored agency" and "Government agency" in the Investment Regulations at 12 C.F.R. § 615.5131 with the terms "Government-sponsored enterprise (GSE)" and "United States (U.S.) Government agency," respectively. The Proposed Rule also proposes to slightly alter the definitions of these terms, but these changes are not intended to have any substantive effect. Farmer Mac has assumed that these changes will be made and therefore uses the new terminology and definitions in this letter. *See* Proposed Rule at 43303.

investment conduit (REMIC) would be labeled as both a CDO and an MBS simultaneously, with the same investment prohibited and permitted by the Proposed Rule simultaneously. This inconsistency should be clarified.

Farmer Mac understands that the motivation for the FCA's proposed definition of a CDO stems from the financial crisis experienced in 2008-2009 and is intended to monitor and limit a Farm Credit bank's exposure to the financial engineering of credit risk. However, Farmer Mac believes that the FCA should refine the types of risks that are captured within the definition of CDOs because debt obligations backed by different types of collateral generate differing risk profiles, and the FCA should not attempt to altogether prohibit a beneficial securitization methodology (the pooling of securities of diverse issuers). To ensure that it is appropriately limiting a Farm Credit bank's investment in a financially engineered credit instrument while also encouraging liquidity through investments in eligible, high credit quality structured securities, Farmer Mac believes that the FCA should refine the concept of a CDO to include only those MBS (or ABS) that materially alter the credit characteristics of the underlying MBS (or ABS), and not those MBS (or ABS) that primarily alter the scheduled cash flows of the underlying MBS (or ABS). For example, if an MBS obligation is fully guaranteed by a U.S. Government agency, restructuring its cash flows into another security should be perfectly acceptable from a credit perspective (as already provided for in the definition of MBS). In addition, even if the MBS obligation is not fully guaranteed by a U.S. Government agency, a restructured security should still be acceptable from a credit perspective if there is no material change in the credit characteristics of the new security as compared to the original security (as described in the example provided in footnote 4 above). Thus, it would logically follow that if the credit risk of the original security is acceptable by virtue of that security constituting an eligible investment, then the credit risk of the new security should similarly be acceptable and the new security itself should likewise be considered an eligible investment. Stated another way, to the extent that any MBS or ABS under the Proposed Rule constitutes an eligible investment, then any debt obligation backed by such MBS or ABS should be excluded from the definition of a CDO. Using a less prescriptive approach to the definition of a CDO is consistent with the FCA's desire to eliminate the risks related to the financial engineering that can be used to mask the real credit risk of collateral backing the MBS or ABS. Therefore, the FCA should focus on revising the definition of a CDO to better identify those CDOs that materially alter credit risk through the securitization of diverse credits rather than listing blanket asset classes.

2. Obligor's Capacity to Meet Financial Commitment

Farmer Mac understands that Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the FCA to revise all of its regulations that reference or require reliance upon credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") to assess the creditworthiness of a security by removing such references or requirements and substituting them with other appropriate creditworthiness standards. In the Proposed Rule, the FCA has proposed that the existing criteria for the eligibility of all Farm Credit bank investments, including those referencing or relying upon credit ratings,[9] be replaced with the following standard: "at least one obligor (whether debtor or guarantor) must have *very strong capacity* to meet its financial commitment for the expected life of the investment [and obligors] that exhibit very strong capacity to meet financial commitments generally have *very low probability of default*."[10]

Farmer Mac believes that while the new standard of creditworthiness proposed by the FCA provides a feasible alternative to the use of credit ratings in determining investment eligibility, it still requires further clarification and interpretation. Specifically, the Proposed Rule remains unclear as to what may permissibly constitute a "very low" probability of default and how this probability of default should be calculated or measured. The FCA should provide additional clarification and guidance on either threshold levels of defaults or the types of factors that would be appropriate to consider in determining whether an obligor has a "very low" probability of default and when an obligor would be considered to have slightly more than a "very low" probability of default, and thereby have a less than "very strong" capacity to meet its financial commitment for the expected life of the investment.

Although a threshold limit on the probability of default standard might be challenging to implement in view of varying facts and circumstances surrounding any particular investment, Farmer Mac believes that the FCA should provide additional guidance as to the new creditworthiness standard it proposes. This is especially true because the FCA's proposed creditworthiness standard appears to be stricter than the creditworthiness standards implemented by the Office of the Comptroller of the Currency ("OCC")[11] and the Federal Deposit Insurance Corporation ("FDIC").[12] Specifically, the OCC and the FDIC refer to an "adequate capacity" of the issuer to meet its financial commitments, which is defined in part as a "low" risk of default by the obligor, while the FCA indicates that an obligor must have a "very strong capacity" to meet financial commitments, which is defined in part as having a "very low" probability of default. Because the FCA's creditworthiness standard appears to be stricter than those promulgated by the OCC or FDIC, Farm Credit banks would not necessarily be able to look to

[9] Under the existing Investment Regulations, to be eligible, Farm Credit bank investments generally must meet the highest or second highest NRSRO rating, depending on the asset class. *See* 12 C.F.R. § 615.5140.

[10] *See* Proposed Rule at 43305 (emphasis added).

[11] *See* 77 Fed. Reg. 35253 (June 13, 2012) (Alternatives to the Use of External Credit Ratings in the Regulations of the OCC). The creditworthiness standard adopted by the OCC in its final rule states that an "issuer of the security has an *adequate capacity* to meet financial commitments under the security for the projected life of the asset or exposure" if it is determined that "the *risk of default by the obligor is low* and the full and timely repayment of principal and interest is expected" (emphasis added).

[12] *See* 77 Fed. Reg. 43151 (July 24, 2012) (Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities). The creditworthiness standard adopted by the FDIC in its final rule is substantially similar to the creditworthiness standard adopted by the OCC.

the guidance provided by the OCC or FDIC[13] in conducting an analysis as to whether a particular security was eligible for investment. Thus, it would be helpful for the FCA to provide additional guidance on the application of its revised creditworthiness standard.

3. Investment Portfolio Diversification Requirements and Farm Credit Bank Obligor Limit

Under the Proposed Rule, the FCA will require Farm Credit banks to diversify their investment portfolios among various non-exempt asset classes and obligors, with no more than 15% and 3% permitted to be invested in any one asset class or obligor, respectively (hereinafter referred to as the "Diversification Limits").[14] Farmer Mac agrees that requiring an investment portfolio to be diversified is appropriate and represents a fundamental aspect of risk management. However, Farmer Mac believes that the proposed thresholds for the Diversification Limits do not allow sufficient flexibility for a Farm Credit bank to manage its investment portfolio based upon existing or unanticipated market conditions. Furthermore, the Proposed Rule provides little reasoning as to why these specific Diversification Limits were chosen.

The Investment Regulations already reflect a careful approach to asset class limits based upon differing credit and risk characteristics of distinct asset classes. The FCA notes that it proposes a 15% limit on investments in each asset class "to simplify the rule."[15] Farmer Mac believes that this blanket 15% limit across all asset classes, imposed for simplicity's sake, does not make allowance for the nuances that may arise in the management of an investment portfolio consisting of various asset classes. Additionally, imposing the same limitation across all asset classes may have the unintended consequence of impairing a Farm Credit bank's ability to effectively manage its operations and the diversification of risks it faces. Indeed, because investment portfolios are carefully designed to manage various types of risks, including interest rate, credit, investment, and liquidity risk, it may be prudent for an institution to increase its exposure to a specific type of asset class at certain times.

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[13] *See* 77 Fed. Reg. 35259 (June 13, 2012) (OCC Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment) and 77 Fed. Reg. 43155 (July 24, 2012) (FDIC Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment).

[14] *See* Proposed Rule at 43308 (proposed 12 C.F.R. § 615.5133(f)(3)). Under proposed 12 C.F.R. § 615.5133(f)(2), the following investments will be exempt from the Diversification Limits: (i) investments that are fully guaranteed as to the timely payment of principal and interest by a U.S. Government agency; and (2) investments that are fully and explicitly guaranteed as to the timely payment of principal and interest by a GSE, except that no more than 50% of the investment portfolio may be comprised of GSE MBS. Farmer Mac agrees with the FCA's determination that these types of investments are of the highest quality and therefore should not be subject to the Diversification Limits.

[15] *See* Proposed Rule at 43308.

The FCA could still ensure the safety and soundness of Farm Credit banks by setting broader diversification limits at the regulatory level and deferring to the business judgment of a Farm Credit bank's board of directors to set appropriate investment limits that fall within the broader regulatory parameters. Almost all portfolio managers will also set their own internal triggers within the investment policy limits established by the board of directors to manage the investment portfolio prudently. In setting tight limits at the regulatory level, the FCA appears to be trying to perform the function of a portfolio manager without the benefit of knowing all of the nuances of a Farm Credit bank's day-to-day operations. Another possible unintended effect of unnecessarily tightening portfolio limits is that it may actually *decrease* an investment portfolio's diversification in direct contravention of sound risk management principles, thereby undermining safety and soundness.[16] Indeed, the Diversification Limits may unintentionally increase the other types of risks that Farm Credit banks may encounter while simultaneously eliminating the flexibility and ability to manage such risks. Therefore, Farmer Mac recommends that the Investment Regulations with the current asset class diversification limits remain in place to provide sufficient flexibility in managing an investment portfolio and to allow a Farm Credit bank's board of directors to manage the business through the adoption of investment policies with specified diversification limits appropriate for that Farm Credit bank.

For many of the same reasons cited above, Farmer Mac also does not believe that the proposed 3% limit in a single obligor provides for sufficient flexibility in the management of an investment portfolio. Farmer Mac appreciates the FCA's rationale that obligor limits would prevent concentration among obligors that could lead to significant risk, but the Proposed Rule does not explain why a 3% limit in a single obligor, as opposed to a 5% or 7% limit, is the threshold over which obligor risk cannot be managed or provides the requisite flexibility in managing an investment portfolio.

Another issue raised by the Proposed Rule relates to the calculation of the proposed Diversification Limits. The Proposed Rule indicates that the Diversification Limits would be calculated based on the entire investment portfolio "valued at amortized cost."[17] Farmer Mac believes that valuing an investment portfolio at amortized cost does not take into consideration the length of time an asset has been held in a portfolio and the changes in value an investment may experience over the course of its life. Farmer Mac recommends that the value of an investment portfolio be based upon its market value on a daily basis to ensure compliance with specified diversification limits.

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[16] For example, an investment portfolio in which 20% is invested in a broad set of corporate debt instruments and 10% is invested in non-U.S. Government agency residential MBS may be a higher quality and more liquid investment portfolio than a portfolio in which 15% is invested in each of those asset classes because corporate debt can be highly diversified across industries, while residential MBS are highly concentrated in a specific sector of the economy and thus less diversified.

[17] *See id.*

Farmer Mac also encourages the FCA to reconsider the new proposed limit of 10% of total capital that Farm Credit banks may invest in any one obligor (the "Capital Obligor Limit"),[18] which is half of the current limit of 20% under the Investment Regulations. Although the FCA indicates that it believes that this lower obligor limit would enhance safety and soundness by ensuring that only a small portion of capital would be at risk if an obligor were to default,[19] it still remains unclear as to why a reduction by half in the amount of capital permitted to be invested in a single obligor would accomplish this purpose. The FCA is able to validate and enhance the safety and soundness of Farm Credit banks in a number of ways already, separate and apart from reducing the amount of a Farm Credit bank's total capital that may be invested in a single obligor, particularly in light of the new Diversification Limits related to a single obligor being proposed by the FCA. Specifically, the substantial requirements regarding the due diligence that must be met prior to the purchase of an investment and the investment purposes which must be satisfied, as well as the investment policies that a Farm Credit bank's board of directors must implement as part of its enterprise risk management process, provide more than adequate safeguards to ensure the safety and soundness of Farm Credit banks.

Generally, Farmer Mac believes that the Diversification Limits and the Capital Obligor Limit proposed by the FCA are not required to ensure the safety and soundness of Farm Credit banks and unnecessarily supplant the judgment of a Farm Credit bank's board of directors and management. The implementation of the proposed Diversification Limits and Capital Obligor Limit would practically have the effect of preventing Farm Credit banks from making otherwise eligible investments that could be highly attractive from a risk management perspective. Farmer Mac recommends that the FCA continue to provide flexibility to Farm Credit banks to manage their investment portfolios in light of real-time changes in market forces, which Farmer Mac believes is also consistent with ensuring the safety and soundness of Farm Credit banks.

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[18] *See* Proposed Rule at 43309 (proposed 12 C.F.R. § 615.5133(g)). The Capital Obligor Limit would not apply to investments in obligations that are fully guaranteed as to the payment of principal and interest by a U.S. Government agency or fully and explicitly guaranteed as to the payment of principal and interest by a GSE.

[19] *See* Proposed Rule at 43309.

We encourage the FCA to consider the comments contained in this letter as the FCA formulates its final regulations related to the eligibility of investments made by Farm Credit banks and its proposed regulations related to the eligibility of investments made by Farmer Mac. Farmer Mac appreciates the FCA's consideration of these comments and would be pleased to discuss these matters further at the FCA's request.

Very truly yours,

R. Dale Lynch
Senior Vice President – Chief Financial Officer