1st FARM CREDIT SERVICES.
YOUR FIRST CHOICE

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October 23, 2014

Mr. Barry F. Mardock
Deputy Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Re: Proposed Rule – RIN 3052-AC84
Organization; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Eligibility

Dear Mr. Mardock:

On behalf of 1st Farm Credit Services, thank you for the opportunity to respond to the Farm Credit Administration's proposed rule on Investment Eligibility, 79 FR 43301, published in the *Federal Register* on July 25, 2014. 1st Farm Credit Services fully supports and agrees with the comments submitted on this matter by AgriBank, FCB and encourages the Farm Credit Administration ("FCA" or "Agency") to adopt the suggested revisions proposed in the comments submitted by institutions in the AgriBank District. In addition to the comments provided by AgriBank, we urge FCA to consider the following comments.

General Comments

We appreciate the Farm Credit Administration's (FCA's) proposal to update and modernize the investment regulations and to address association investment and risk management practices. The Agency's comments in the Federal Register properly suggest the proposal be viewed as part of a "comprehensive set of rules guiding the System's liquidity and investment management." We concur that the investment and risk management rules should work in tandem, and offer our comments designed to further this purpose. Our comments focus primarily on proposed Section 615.5142 (a), which would authorize each System Association, with the approval of its funding Bank, to manage risk by purchasing and holding obligations that are issued by, or are fully guaranteed or insured as to the timely payment of principal and interest by, the United States or any of its agencies in an amount that does not exceed 10 percent of its total outstanding loans.

We applaud FCA's recognition that the risks Farm Credit Banks and their respective Associations face are multifaceted, and agree that current requirements for Association investments—which specify only the two purposes of reducing interest rate risk (IRR) and managing surplus short-term funds — are too restrictive and do not provide Associations the flexibility to manage our risks in today's environment. The proposed rule would provide Associations greater flexibility to hold investments for other risk management purposes, including concentration risk. We agree that such modernization is in the best interest of the System. Our comments generally support this change. Given that investments can and do benefit Associations, we urge FCA to clarify that the proposed limit on Association investment portfolio size does not apply to certain investments authorized under other sections of FCA regulations. In addition, we ask FCA to reconsider the definition of the portfolio size limit for Associations by specifying the limit as a percent of either earning assets or total assets, rather than as a percentage of loans. Our rationale for these requests is provided in the following paragraphs.

Eligible Purposes
First, FCA requested comments on whether the proposed rule should identify specific purposes for Associations to purchase and hold investments. We believe that this proposed rule should not identify specific purposes for Associations to purchase and hold investments.

As noted in the Agency's Federal Register comments, U.S. government issued or guaranteed investments are generally liquid and pose virtually no credit risk, although they do pose market risk. Investments "should help associations manage concentration risk as single-industry lenders." Associations must maintain the flexibility to use investments to manage a broad array of risks to enhance their safety and soundness without limitation.

In general, FCA has identified that the purpose of Association investments is "to appropriately manage and diversify risks while serving their primary mission of funding agriculture and rural America." We believe any attempt to further enumerate the specific purposes for which Associations may purchase and hold investments beyond this general description will prove to be inflexible and unnecessarily restrictive, particularly in future years.

Calculating 10 Percent of Total Loans
The Agency states that a limit on Association investment portfolio size will ensure "that loans to eligible borrowers always constitute the vast majority of System assets, which is consistent with the mission of each Association." We agree and seek to clarify how such a limit would be defined and administered.

In particular, we urge FCA to clarify that certain balance sheet components will be excluded from the 10 percent of total outstanding loans investment limit. This limit must not unintentionally detract from authorized business practices appropriate to our mission. For this reason, FCA should clarify that the language pertaining to the proposed 10 percent limit is aimed at investments used for the purpose of risk management, and explicitly excludes other investments authorized in specific FCA regulations, including:

- **Unincorporated Business Entities (UBE)**
  The size limitation should exclude investments in UBEs. UBEs are generally created to manage complex workout situations or to efficiently structure programs that allow Associations to collaborate on customer-oriented programs and services in the fulfillment of our mission. UBE investments are already limited under Section 611.1153 (h) to 1 percent of loans, unless otherwise approved by FCA. These equity investments are mostly operational in nature and should not be included when calculating risk management investments.

- **Farmer Mac (FMAC) Mortgage-Backed Securities:**
  The size limitation should exclude investments in FMAC mortgage-backed securities, which are authorized under Section 615.5174, "for the purposes of managing credit and interest rate risk, and furthering your mission to finance agriculture." Section 615.5174(a) limits the total size of Farmer Mac securities investments to "your total outstanding loans" and provides other guidance for appropriate controls. An Association's use of FMAC for credit or capital purposes should not create limits in other risk management areas.

- **Rural Business Investment Corporation (RBIC)**
  The investment portfolio limitation should exclude investments in RBICs, whose authority stems from Title VI of the Farm Security and Rural Investment Act of 2002 and regulations issued by USDA (7 CFR 4290.10 through 4290.3099). These investments support the System's mission, and FCA currently exercises the authority to ensure that a System institution's investment in a RBIC is safe and sound, and that it operates the RBIC in accordance with applicable laws and regulations.

- **Agriculture and Rural Community/Rural America Bonds (ARC/RAB Bonds)**
  The 10% of total loans limit should exclude ARC/RAB bonds, which should continue to be authorized under new Sections 615.5140 (b) and 615.5142(d). Although some bonds may include partial or conditional government guarantees, these mission-related securities are often treated as loans under GAAP accounting, and fulfill our mission to agriculture and rural America. Such mission-related investment activities should be excluded from the limit on investments for risk management purposes.

- **Investments in USDA Guaranteed Loans**
  As noted in the Agency's published comments (footnote 33), the Farm Credit Act (Act) authorizes System institutions to buy and sell obligations of, or insured by, the United States or any agency thereof. Consistent with the Act, the current Section 615.5140(a) lists "obligations fully insured or guaranteed" by the United States or its agencies among eligible investments for banks and associations, which includes investments in loans guaranteed by the USDA under its various programs. In its Informational Memorandum (IM) dated March 22, 2011, FCA discusses at length the purchase of USDA guaranteed loans, citing both Section 615.5140(a) and 615.5140(e) as authority for these investments. The IM lists several important mission-related benefits to the purchase of USDA guarantees, such as increased credit availability to Farm Credit eligible borrowers, improved liquidity for agricultural lenders and providing capital for agricultural investments and rural homes. Investments in USDA guaranteed loans occupy the rare position of being authorized under multiple sections and being recognized by FCA as mission-related and "of the highest quality". As such, we suggest FCA include in Section 615.5142 a specific exemption for investments in USDA guaranteed loans from the association 10% limit for investments. Such an exemption would be consistent with the exemption for these investments from portfolio diversification requirements for Farm Credit banks under proposed Section 615.5133(f)(2)(i). More importantly, this exemption would ensure continuing benefits to agriculture and rural America through Farm Credit's participation in USDA guaranteed loan programs.

Frequency of Loan Calculation

The proposed rule would calculate the investment limit using the 30-day average balance of investments divided by the 30-day average balance of loans. However, the proposed language refers to the definition of loans in Section 615.5131, which provides that loans are calculated quarterly at quarter end using quarterly ADB (including accrued interest and excluding allowance for loan loss adjustments). This discrepancy sets up a potential conflict in the regulations and undermines the Agency's goal of providing a comprehensive regulatory framework for Association investments. We recommend FCA modify this provision to use the quarterly average daily balances for investments and loans, which will limit distortions caused by seasonal fluctuations in loans and remain consistent with the definition in Section 615.5131.

Total Outstanding Loans

Using an Association's total outstanding loans is an inappropriate benchmark for investments used in risk management. More appropriate options include (1) Earning Assets; or (2) Loans plus other enumerated assets, including mission-related investments, UBEs, RBICs and FMAC MBS; or (3) Total Assets.

For example, if an Association were to transform "loans" into an "investment" (e.g., via securitization through Farmer Mac), any limit with loans as denominator would be inadvertently restrictive. System entities may utilize securitizations for liquidity, credit risk and capital management purposes, and therefore, converting loans into investment securities should not cause a tighter constraint to be imposed on any other investment purpose. The potential denominators mentioned above would alleviate this predicament. Accordingly, we request FCA specify the limit as 10 percent of either earning assets or total assets, rather than 10 percent of total outstanding loans. This specification will avoid inappropriately restricting investments when loans are converted to investments.

Risk Management Requirements

Section 615.5142(b) as proposed would require an Association to evaluate its investment management policies and determine and document how its investment activities are conducted in accordance with the risk management processes and procedures identified in proposed subsections (b)(1), (b)(2), and (b)(3). In general, these proposed requirements are reasonable, as they require appropriate policies, controls and practices, and also require an Association's investment management process to be appropriate for the size, risk, and complexity of the Association and its investment portfolio.

As to this section, FCA requested comments on how to structure the documentation requirements so they do not impose undue regulatory burden on funding Banks or Associations. To accomplish this goal, much of the documentation for each specific investment program (e.g., SBA, USDA or other guaranteed loans) should be at the program level, rather than the individual security level, and that program documentation should address concentration limits, interest rate risk characteristics, investment process, and liquidity characteristics. Associations could document asset class diversification, although this is probably unnecessary in that the current proposal would limit Associations to a single asset class that poses no credit risk.

Funding Bank Supervision of Association Investments
Proposed 615.5142 (c) specifies that an Association must request approval to buy and hold investments from its funding Bank.

We request FCA to clarify that approval should be sought for specific investment programs (e.g., SBA, USDA or other loans), rather than on an individual investment basis. The funding Bank oversight should include, at a program level, whether an Association has complied with Section 615.5142 (b) in that it has adequate policies, procedures, internal controls, and accounting and reporting systems for investments, as well as whether it has the capability to effectively manage risks. These determinations made on a program basis, coupled with the funding Bank's annual evaluation of whether investments mitigate and manage Association risks, provide ample oversight to assure Associations comply with the regulations and appropriately manage any risks related to an investment portfolio.

Conclusion
FCA's diligent review has resulted in improvements to the investment regulations governing System institutions. As with any substantive change, there are some areas that require further consideration. We support FCA's efforts to modernize the investment regulations and request that the Agency clarify certain provisions and consider the additional modifications as detailed in this comment letter. We appreciate the opportunity to provide input on this proposed regulation. If you have any questions about our Association's position, please contact me.

Respectfully submitted,

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1st Farm Credit Services

CC: Board of Directors
Gary Ash, CEO