AgStar
Financial Services, ACA

October 23, 2014

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

Re: Investment Eligibility Requirements

Dear Deputy Director Mardock,

AgStar Financial Services, ACA ("AgStar") appreciates the opportunity to comment on the proposed changes to the Farm Credit Administration's ("FCA") regulations found at 12 CFR, Parts 611 and 615 as outlined in the Federal Register, Vol. 79, No. 143. AgStar supports comments being submitted by AgriBank, FCB and provides these additional comments to encourage FCA to modify certain additional provisions of the proposed changes to the investment regulations. In particular, we provide comments on the proposed changes as they relate to Sections 615.5140 and 615.5142 of the FCA regulations, which govern the investment activities of associations.

We agree with FCA's assessment that the risks Farm Credit Banks and their respective associations face are multifaceted, and the current requirements are too restrictive and do not provide associations the flexibility to manage the full array of risks in today's environment. FCA acknowledges associations may need to hold investments for purposes other than managing surplus short-term funds and reducing interest rate risk, which currently are the only purposes authorized under on the existing regulations. Therefore, the proposed amendments grant associations greater flexibility to hold investments for other risk management purposes. We concur that such modernization is in the best interest of the System as a whole.

Consistent with the rest of the System, the risks AgStar faces are numerous and include, but are not limited to, interest rate risk, duration risk, prepayment risk, concentration risk, spread risk and market disruption risk. The Asset Class list defined in Section 615.5140 can be effectively and appropriately utilized to manage most of the risks the System faces, however, the proposed amendments would now only allow the System Banks to utilize current authorized investments. AgStar believes that reducing the types of investments associations can hold will make association-based risk management difficult at best.

The Farm Credit Act does not prohibit associations from managing these risks themselves, and there are associations that today do not rely completely on their funding bank for risk management. Nevertheless, as a matter of practicality, many associations do currently rely on their district bank for their risk management, particularly managing interest rate risk. However, as FCA notes in the preamble to the proposed changes, "a few larger associations now have the capacity to manage interest rate risk separately from their funding bank." The Farm Credit Act of 1971 (Sec. 2.2(10) and (11), and Sec. 2.12(17) and (18)) specifically authorizes System associations to make investments as may be approved

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by their respective funding banks, a concept endorsed by the existing investment regulations. The FCA recognizes that most System associations have increased in size and complexity over the past two decades, offer a diversity of products and face new risks. Many associations have sophisticated and experienced professionals, and in fact, there are two associations which are larger than two Farm Credit Banks. Under current regulations, with district bank approval and FCA supervision, associations have the ability to manage some or all of their own risks through the prudent use of the current investment authorities. District bank approval and oversight is a strength of the current regulations and a benefit to both the System and the System's stakeholders. We believe that the types of investments associations should be permitted to hold include those listed as eligible investments in Section 615.5140(a), and that association investments should continue to be subject to review and approval by their district banks in terms of portfolio size and constitution – as currently required under Section 615.5142. Limiting association investments to instruments issued or fully guaranteed by the U.S. Government, as discussed more fully below, will not appropriately reduce risk within System investment portfolios but rather will limit the flexibility for associations to manage risk in an uncertain future. We urge FCA to eliminate this limitation when it publishes its final rule.

**<u>Size Limit of Investment Portfolio</u>**

FCA suggests in the preamble that, "our regulations authorize Farm Credit banks to hold significantly larger investment portfolios because the banks maintain liquidity and manage interest rate risk for all system institutions operating in the district, and associations borrow exclusively from their funding banks." Given AgStar's current use of funding from non-district bank sources as well as our knowledge of other association practices, this statement is neither entirely accurate nor is it a requirement of the Farm Credit Act or the current regulations.

As previously stated, although not a requirement, most associations currently allow their district banks to manage their interest rate risk and that risk management is done out of convenience and economies of scale. While the 10% limitation may be sufficient for associations who rely solely on their funding bank to manage risks, it will almost certainly be insufficient for those associations who choose to manage risks (such as IRR) independent of their funding bank now or in the future. It is also more restrictive than what FCA acknowledges is a common limit that currently exists within many associations of 15%.

An example of where a 10% limitation is likely to be too restrictive relates to associations who choose to partially fund with third-party capital. Although until recently no association had raised third-party capital, associations do have that authority and AgStar has chosen to secure permanent third-party capital. The amount of outside capital held by an association may significantly influence the need for risk management tools. The proposed 10% limit appears unnecessarily restrictive for an association that utilizes existing authorities like raising third-party capital that others, for whatever reason, may not choose to pursue. Risk exposure of an association funded with a significant amount of third-party capital (the current regulations permit an association to have up to 40%), is materially different from one with 90% match funding, and a 10% limit may simply be too restrictive to effectively manage risks, especially during a crisis or significant downturn in the agriculture industry.

We remain confident that the district banks are the best suited and most informed about the sophistication and needs of any particular association. In light of this, we urge FCA to reconsider the size limit of an association's investment portfolio. While a 15% limitation is likely sufficient for an association that relies primarily on its funding bank to manage risks, it may prove too restrictive in other situations. Our suggestion is to create a baseline 15% authorized limit for associations, with the ability to increase that authorization up to 35% with specified sublimits upon district bank approval. In all situations, we expect to remain in compliance with the strong FCA standards around investment management.

AgStar is not seeking unfettered approval to invest in a range of capital market instruments. Rather, we are only seeking the authority for associations to retain the ability to manage risk with a full array of appropriate tools so long as we identify and evaluate how such investment contributes to the management of risk and are pre-approved by the district bank. Although we are open to commenting on a more limited set of investments than those offered to district banks, many of the securities that have been eliminated from investment eligibility under the proposed changes are appropriate tools for prudent risk management across the financial industry.

**Limitation of Instruments**

AgStar also has concerns about the proposed limitation of instruments eligible for investment purposes. Although the proposed regulations rightfully acknowledge a greater flexibility in managing risks, the proposed regulations take away the preponderance of tools with which to manage risk. Beyond even traditional investment management practices (discussed in the following paragraphs), there are some nuanced, practical applications that fall outside of the proposed approved investment asset classes.

The proposed Section 615.5142(a) authorizes associations to solely and exclusively purchase unconditionally guaranteed obligations of the United States on the basis that they pose virtually no credit risk. However, FCA acknowledges in its discussion related to eligible bank investments that not all risks in a particular investment need to be minimal. Rather, risks need to be consistent with purpose. We believe these same principles should be applied to associations as it relates to credit and instrument risk.

At a basic level, the proposed rules could be interpreted to exclude associations from utilizing simple liquidity/cash management options such as money market instruments and certificates of deposit. Going forward, associations will be subject to the willingness of their district banks to create a pass-through program for even the most common tasks rather than being able to execute a program on its own, and thereby be subject to the respective costs associated with such an arrangement. Such a model creates unnecessary economic inefficiencies given the size and sophistication of many associations and concentrates risk in a few large entities.

As an example, AgStar operates its RuraLiving home mortgage program that ultimately securitizes pools of home loans with Farmer Mac. AgStar warehouses these loans on its balance sheet until a critical mass can be reached for securitization. Consequently, AgStar currently maintains an interest rate hedging program under the approval and monitoring of AgriBank. The program utilizes Fannie Mae securities to mitigate against short-term fluctuations. If Section 615.5142(a) were to be made final as proposed, AgStar may no longer be able to execute this effective internal program. The same program hedged with Treasury securities would expose AgStar to basis and market-implied prepayment risks.

AgStar urges FCA to allow associations the ability to hold the same types of investment instruments it allows district banks to hold, so long as the association obtains prior approval from its district bank and follows board and FCA prescribed investment management practices.

**Prudent Investment Management Framework**

Used appropriately, investments can enable associations to manage the risks they confront, and FCA seeks and appropriately requires "prudent investment management" policies from all System entities. Perhaps the most universally accepted precept of a prudent framework is the concept of diversification. Diversification minimizes systematic risk by allocating investments among various financial instruments, industries and other categories. Most investment professionals agree that, although it does not guarantee against loss, diversification is the most important component for minimizing risk. As such, a combination of asset classes will reduce a portfolio's sensitivity to idiosyncratic risk.

Fluctuating macroeconomic factors affect asset classes differently, and instruments within the same asset class would be expected to have an extremely high degree of correlation particularly to systematic risks. Best practices in modern portfolio management, including those established as far back as 50 years ago by Nobel laureate Harry Markowitz and others, highly weigh asset correlation in their risk management decisions. As noted by FCA, an asset class is "a group of securities that exhibit similar characteristics and behave similarly in the marketplace." Fully and unconditionally guaranteed obligations of the United States – no matter the ultimate issuer - are appropriately designated in the proposed regulations as a single asset class since those securities will move together as a class and will be distinctively non-diverse.

The language in the current proposal observes, "portfolio diversification is a key concept in ensuring the safety and soundness of investors such as Farm Credit Banks." In fact, FCA goes on to propose diversification **requirements** for covered investments. "Under the proposal, a well-diversified investment portfolio would mean that, at a minimum, covered investments are comprised of different assets classes, maturities, industries, geographic areas and obligors . . . No more than 15 percent of the investment portfolio may be invested in any one asset class." Yet, contrary to the recognition by FCA of the role of diversification, the proposed changes to Section 615.5142 would require associations to manage their risk profile solely with a single asset class – a highly undiversified approach. For this reason and those discussed below, we request that FCA reconsider the proposal that limits association investments to fully and unconditionally guaranteed US securities.

**Alternative Instruments for Managing Risk**

AgStar, like every other association, is a credit lender. Credit and risk evaluation is our expertise. AgStar believes there are associations in the System who have the resources and expertise necessary to appropriately evaluate investments beyond fully and unconditionally guaranteed US securities for managing risks. With the oversight of the district banks and examination authorities of FCA, we believe associations should have the tools necessary to diversify their investment portfolios.

Consequently, we believe it would be appropriate for associations to have additional, uncorrelated tools for managing risk and obtaining prudent diversification in their investment portfolios. Although not necessarily an exhaustive list, we provide the following comments to FCA on agency mortgage-backed securities, corporate debt and municipals, as examples of how and why such tools could be used to achieve the goal of diversification. Additionally, these investments, included under eligible investments for Farm Credit Banks in Section 615.5140(a)(2)(i), can be used to manage four distinct risk categories: prepayment or contraction risk, credit risk, liquidity risk and yield risk.

*Agency Mortgage-backed Securities*

Mortgage-backed securities (MBS) issued by government GSE's Fannie Mae and Freddie Mac are eligible investments for Farm Credit Banks under Section 615.5140(a)(2)(iv), and constitute a large portion of the U.S. investment-grade taxable bond market. MBS liquidity is extremely high as it represents 29% of the investment grade bond sector, only slightly behind Treasuries in total issuance. Yet, MBS' distinct characteristics differentiate them from other fixed income bonds with a correlation of 0.86 to U.S. Government securities, and 0.88 to U.S. investment grade corporate debt. The diversification properties of MBS owing their differentiated duration and convexity characteristics make them worthy of consideration for a diversified risk management portfolio.

MBS provides a potential buffer in the form of a somewhat differentiated pattern of returns. For example, a surge in refinancing applications in mid-1992 was a driver of MBS underperformance, whereas default and liquidity worries near the end of 2008 enabled MBS to outperform traditional credits. Although both scenarios would have a direct effect on the Farm Credit system, only MBS would deliver potential differentiated returns without material exposure to market or liquidity risk. In fact, traditional MBS securities backed by Fannie Mae and Freddie Mac outperformed U.S. Treasuries during the combined years 2008 and 2009, and has a better Sharpe Ratio (a measurement of return divided by risk) than Treasuries for the 5- and 10-year periods ending 2013.

*Corporate Bonds*

While we fully expect the hurdle set by district banks or FCA for using corporate bonds in risk management to be high, the practice itself should not be prohibited altogether based on principle alone. Corporate bonds can provide further diversification for convexity, interest rate, and credit risks. Historically, credit risk tends to be diversifying relative to interest rate moves, assuming that increases in interest rates occur because economic conditions are improving, lowering credit risk, and tightening spreads. Investors are exposed to the idiosyncratic risk of the issuers within a credit portfolio, but this can be mitigated with qualified credit professionals.

In fact, many associations already perform the necessary credit analysis that would be required for a portfolio of non-convertible senior debt corporate bonds. The same skills and analysis currently being applied to capital markets transactions would be utilized in analyzing corporate bonds for an investment portfolio.

*Municipal Securities*

The returns of municipal bonds over the past 20 years have not been closely correlated with those of other types of fixed income securities. As an asset class, municipals have only a 0.47 correlation to U.S. Treasuries, and over the past 20 years (1994-2013) have lower volatility and higher average returns (tax-effective) than a portfolio of 100% Treasury securities.

Although not utilized by associations currently, municipal securities could be effective in mitigating risk from certain rural investments and are among the eligible investments currently permitted by Section 615.5140 of the regulations. AgStar has significant commitments through its Rural Capital Network program to community infrastructure. Often times those mission related investments are reliant upon certain municipalities and revenues from the community. Prohibiting the use of municipal securities would unnecessarily limit a potential tool for risk management.

**Consistency with Industry Regulation**

We appreciate FCA's efforts to transition the Farm Credit regulatory environment to one more closely aligned to the banking system's BASEL framework. However, the proposed limitation on investment asset classes has no BASEL or other regulatory counterpart. Commercial and community banks face many of the same risks as System associations, but do not have nearly the investment restrictions being proposed.

Much like FCA's proposed rulemaking here, regulators of other banking institutions have previously addressed investment management including their compliance with Section 939A of the Dodd-Frank Act. Although the resulting regulations require a stringent review of credit risk, there remains no prohibition by security type for investment grade securities. For example, the Office of the Comptroller of the Currency issued a final rule to implement Section 939A, effective January 1, 2013, to the national banks and federal savings associations supervised by the OCC (the rule became the standard for all banks and savings associations because the Federal Reserve Board's Regulation H3 and the FDIC's regulations on activities of insured state banks and insured savings associations require mirrored compliance). Originally published in the Federal Reserve Board SR Letter 12-15, investments are judged upon an issuer's capacity to meet financial commitments, not the specific instrument. They note that this standard is consistent with sound loan underwriting standards and requires a bank to analyze and verify repayment ability.

In particular, the Federal Reserve Board in its third quarter 2013 edition of Community Banker Connections noted, "credit risk is credit risk, whether in a loan portfolio or an investment portfolio. Bankers are comfortable underwriting loans and should be able to use those skills in developing an oversight process for identifying and monitoring credit risk in investment securities and portfolios. . . . The board of directors is ultimately responsible for the risk acceptance of a bank by establishing appropriate policies and limits, but management is responsible for implementing the board's restrictions."

Accordingly, many of our community banking peers have prudently diverse portfolios which include many of the assets discussed above. According to SNL.com, small banks and thrifts (between $20 and $100 million in assets) have 6% of total assets on average invested in MBS alone. Medium-sized banks (between $100 million and $1 billion in assets) are closer to 9% - one third of which are in private market (non-agency) MBS. Of the almost 900 banks tracked by SNL with loans between $100 million and $10 billion, their average securities investments total 32.8% of gross loans, of which less than 1% was in U.S. Treasury securities. An average of 15.8% of gross loans was invested in MBS and another 13.6% on other security types.

Although we acknowledge our commercial banking peers operate outside of GSE status, we share similar characteristics for the balance of risk and portfolio management. The other regulatory agencies have grappled with the same issues we face in the Farm Credit system, including wide variety of institution size and sophistication, and none have imposed limitations on either portfolio size or investment type. Rather they have maintained the standard for investments to be similar to that of loans – prudence. Modifying the proposed regulations as we have suggested above would more closely align the System with other regulated financial institutions while still maintaining some limitations designed to ensure association practices are consistent with our GSE status.

**Conclusion**

FCA correctly recognizes that the risks Farm Credit banks and their respective associations face are multifaceted, and that the current requirements are too restrictive and do not provide associations the flexibility to manage the full array of risks in today's environment. The current restriction of risk management to interest rate risk and short-term liquidity was too narrow, and FCA's acknowledgement of that is an important step forward for the Farm Credit System.

However, in the proposal to limit the size and tools for implementation, FCA suggests that associations can create and develop "robust strategies" to manage risk. We contend there is an inconsistency between managing for a wider variety of risk with a single asset class.

As such, we propose:

(1) FCA not limit the investment portfolio to solely securities issued or guaranteed by the U.S. Government or its wholly-owned agencies.
(2) Modifying Section 615.5142(a) to be more consistent with the original language of Section 615.5142 that allows Farm Credit associations the authority to hold eligible investments listed in Section 615.5140, with the approval of its funding bank.
(3) Managing the size of an investment portfolio to be consistent with the risk exposure of that portfolio. Consequently, we suggest a 15% baseline based on staying consistent with other FCA regulations and the current practices of many associations around IRR management, but the

ability to match the maximum exposure of the funding banks (35%) with their approval and supervision.

Additionally, separate and distinct from these suggestions, we wish to reiterate the importance of defining eligible investments included under any proposed limitation as discussed in the comment letter submitted by AgriBank, FCB:

(4) We urge FCA to clarify that certain balance sheet components are to be excluded from the investment limit. FCA should ensure that the limit does not unintentionally detract from authorized business practices appropriate to our mission. Specifically, FCA should clarify that the language pertaining to the proposed limit is aimed at investments <u>used for the purpose of risk management</u>, and explicitly excludes other specific investment items, such as investments in Farmer Mac (FMAC) mortgage-backed securities (MBS), Agriculture and Rural Community (ARC) bonds/Rural America Bonds (RAB), investments in Rural Business Investment Companies (RBICs), and investments in Unincorporated Business Entities (UBEs).

(5) Finally, the proposed calculation of an investment limit is the 30-day average balance of investments divided by the 30-day average balance of loans. Loans are defined in Section 615.5131, which provides that loans are calculated <u>quarterly</u> at quarter end using <u>quarterly</u> ADB (including accrued interest and excluding allowance for loan loss adjustments). Therefore, in this case, using the <u>quarterly</u> average daily balances for investments and loans is more appropriate because it limits distortions caused by seasonal fluctuations in loans and remains consistent with the definition in Section 615.5131. Nonetheless, we believe that total loans outstanding is an inappropriate benchmark for investments used in risk management. If an association were to transform "loans" into an "investment" (e.g., via securitization through Farmer Mac), any limit with loans as a denominator would be inadvertently restrictive. More appropriate options include (a) Earning Assets, (b) Loans Plus Mission-related Investments Plus UBEs Plus RBICs Plus FMAC MBS, or (c) Total Assets.

AgStar appreciates the opportunity to comment on the proposed changes and encourages FCA to consider our perspective as it affects how risk is managed particularly in future years.

Sincerely,

Jase Wagner
Chief Financial Officer

William H. Moore, CFA
Director of Capital Management