THE FARM CREDIT COUNCIL

November 16, 2011

Mr. Gary K. Van Meter
Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Subject: Proposed Rule – Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Management – 76 FR 51289

Dear Mr. Van Meter:

We appreciate the opportunity to comment on the Farm Credit Administration's (FCA) proposed rule on investment management. We respect FCA's perspective and responsibilities as a safety and soundness regulator. We understand that the proposed rule is intended to enhance safety and soundness across the Farm Credit System (System or FCS), especially in light of experiences from the recent financial crisis.

As you know, the FCS Presidents Planning Committee has established a Treasurers' Workgroup (Workgroup) that includes financial officers from several associations throughout the System and all of the System Banks and the Federal Farm Credit Banks Funding Corporation. The comments provided herein were developed with input from that Workgroup. Nonetheless, we anticipate that several System institutions will submit their own comments. We offer the FCA the following general and section by section comments on the proposed rule.

General Comments
The rule proposes several provisions that would enhance many aspects of investment management at System institutions. As an example, the proposed provisions relating to investment divestiture are a welcome refinement to current regulatory requirements. On the other hand, there are areas of the proposed rule where we would like to request further clarification. These include the proposed provisions relating to the maximum portfolio limit.

There are additional areas where we have significant concerns with the proposed provisions, including new requirements for investment management. Of particular concern is the proposed inclusion of language that states we must comply with other FCA policies and guidance not articulated in the proposed rule (see proposed § 615.5133(c)(2)). In many ways, this concern captures our overall observations that the proposed rule is inordinately and unnecessarily prescriptive. The recent Bookletter on investment management (see BL-064 dated December 9, 2010) causes much of the regulation to be especially unnecessary.

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We are providing comments on the proposed investment management rule based on existing regulatory requirements pertaining to liquidity and funding management. We note, however, that the FCA Board approved at its November 9 2011, meeting a proposed rule on liquidity and funding. We have not had an opportunity to review this proposed rule. Depending on the proposed revisions contained in this rulemaking, the comments we are submitting in this letter may need revision. Therefore, FCA should provide an opportunity to revise comments submitted on the investment management rule after there has been a chance for the public to fully evaluate the liquidity and funding proposed rule.

While we are supportive of the proposed rule overall, we do think that much of the specificity and prescriptive language results in an excessive regulatory burden and inappropriate regulator involvement in the management of System institutions. While we understand that the recent financial crisis has highlighted opportunities for enhancing some aspects of existing regulatory requirements, we believe the existing regulations were effective and safeguarded the System from excessive losses during the most recent financial crisis. We ask that FCA revise the proposed regulatory language to eliminate the prescriptive and unnecessary requirements as discussed more fully in our section by section comments.

Comments by Proposed Regulatory Section

We provide the following specific comments on each regulatory section of the proposed rule:

§ 615.5131 Definitions

We appreciate and recognize the value of FCA's proposal to add definitions for Government agency and Government-sponsored agency investments to Subpart E of Part 615. We see this additional clarity as beneficial for ensuring consistency and transparency of investment holdings across the System. We note, however, that FCA has already defined these terms in § 625.5 pertaining to regulatory capital requirements. Our review indicates that FCA and the banking regulators essentially define these terms identically for regulatory capital purposes. Therefore, we suggest that FCA conform to the capital definition to ensure regulatory consistency when defining the terms Government agency and Government-sponsored agency. Conceptually, it may be effective to simply add these defined terms to Part 619.

§ 615.5132 Investment Purposes

We support the concept of excluding investments pledged to derivative transactions from the 35 percent investment portfolio limit given it supports sound risk and liquidity management. The proposed exclusion permits System institutions to effectively and efficiently use interest rate swaps and other derivatives to manage interest rate risk while still maintaining a strong liquidity position. We applaud FCA for its proposal to achieve a balanced approach to implementing the 35 percent investment portfolio limit.

In considering this proposal, we conclude that the full realization of the balance envisioned in the proposal requires additional refinement. The first refinement would be to recognize the risk of the System's large "net receive" position in interest rate swaps. This creates the real possibility of large collateral positions being returned to System institutions, thereby resulting in possible violations of the 35 percent limit. To overcome this risk and uncertainty, FCA should provide an exclusion of securities purchased and designated for the primary purpose of posting collateral to derivative positions. The amount of securities designated for this purpose should be based on a System institution's expected derivative positions needed for risk management purposes and related potential collateral posting exposure. If FCA allows for the prudent management of this collateral posting risk, the Agency should do so through a flexible and general regulatory requirement rather than a prescriptive and formulaic approach.

The second refinement would be to exclude U.S. Treasury (Treasury) securities from the 35 percent limit. We disagree with FCA's conclusion that the current limit provides sufficient flexibility for maintaining adequate liquidity. As the System has enhanced both the quality and quantity of its liquidity position, the 35 percent limit creates a very real economic constraint and disincentive to holding Treasury securities. We also believe that the recent financial crisis has demonstrated that in uncertain economic times Treasury securities remain the most liquid and marketable investment held by financial institutions. Therefore, we see inclusion of Treasury securities in the 35 percent limit as inconsistent with prudent risk management practices. In response to FCA's questions, Treasury securities should be excluded from the 35 percent limit and no discount should be applied to such security positions. We further see the inclusion of Treasury securities as an indirect way of further limiting and reducing other types of investment holdings already limited by regulation. When Treasury securities are included in the limit, they crowd out other higher-yielding, high-quality liquid investments. As FCA has increased its expectations for the quality and quantity of the System liquidity position with a particular preference for holding Treasury securities, it should also provide a better balance in its overall position by excluding Treasury securities from the 35 percent limit. Overall, such exclusion fundamentally enhances the System's safety and soundness, especially during economic downturns.

Third, investment securities pledged in secured borrowing relationships should be excluded from the calculations of the 35 percent limit. Examples of these secured borrowing arrangements are State Ag-Linked lending programs and repurchase agreements. Under both arrangements, the pledging of securities acts as an alternative that provides cash for operations without the issuance of new Federal Farm Credit Banks (FFCB) debt obligations. Under existing regulation, these investments are not considered liquid assets under the FCA liquidity regulations since they are not unencumbered. Excluding pledged securities from the 35 percent limit would be consistent with use of the securities as an alternative method to secure financing and their treatment under the FCA regulatory liquidity measurement.

§ 615.5133 Investment Management

The FCA has proposed substantial additional requirements for investment management. We will comment on each paragraph of this section in turn.

Responsibilities of the board of directors: We agree with strong board oversight of the investment function. We also agree with the proposed regulatory flexibility permitting the board to designate a committee to provide this oversight as the designation of a special board committee is not viewed as a necessary requirement to ensure sound oversight. The proposed language, however, that the board must "affirmatively validate the sufficiency of investment policies" permits an overly prescriptive and burdensome implementation by FCA. Specifically, it is unclear what FCA will require as sufficient affirmative validation of investment policies by the board. In our view, the existing regulatory language already requires the appropriate level of board oversight and the proposed regulatory change is unnecessary. Nothing in the current risk environment, emerging best practices, business failures, or existing System investment management disciplines supports the proposed regulatory revision on board oversight responsibilities. We ask that FCA drop the words "and affirmatively validate" from the proposed regulatory text as both unnecessary and redundant to the already existing board responsibility to review the sufficiency of investment policies at least annually.

Investment policies—general: While exceedingly detailed and comprehensive, this proposed new paragraph, which outlines general expectations for the investment policies, appears reasonable overall. The proposed requirement, however, to suggest "board minutes" as a place to document any analysis in formulating policies is burdensome and does not enhance the investment management process. Analysis is maintained and contained elsewhere and available to the board. Putting this analysis in the board minutes is redundant and clutters the document in a manner that is not helpful. For this reason, FCA should delete the "or board minutes" language from the proposed regulatory text of this paragraph.

Investment policies—risk: The proposed revisions to this paragraph require that System institutions establish risk and concentration limits for each type, class, and sector of eligible investments. The preamble recognized that these proposed changes significantly replicate the existing regulatory requirements for diversification of the investment portfolio. Therefore, the preamble states that FCA proposes to delete the existing diversification requirement. The proposed regulatory text, however, includes this existing regulatory language. Therefore, FCA should delete the following sentence: "These policies must ensure that you maintain appropriate and prudent diversification of your investment portfolio." Alternatively, FCA could simply revert to existing regulatory language given it accomplishes diversification just as effectively and efficiently as what is proposed by this regulatory revision.

Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations: Fundamentally, the proposed revisions are essentially identical to existing regulatory requirements. Therefore, we have no concerns with the clarification of the regulatory text. We disagree, however, with FCA's preamble assertion that the change will result in a more thorough consideration of investment portfolio diversification, given the System already thoroughly considers and effectively addresses investment portfolio diversification.

Criteria for selecting brokers, dealers, and investment bankers: We find the proposed revision is unworkable from a practical perspective and creates unnecessary burden without enhancing prudent investment management practices or board oversight. While it is appropriate for the board to approve criteria for the selection of brokers, the concept of board approval of any existing relationships is entirely unnecessary. It also remains unclear how the proposed revision would treat new relationships, which presumably would be allowed under board approved criteria but not require board review until the new relationships became existing relationships. Overall, the proposed revision is confusing, creates an excessive burden and results in an unnecessary distraction for the board. We see no reason for this prescriptive requirement that essentially dictates in an area that the board of directors should have responsibility for oversight.

Collateral margin requirements on repurchase agreements: The proposed regulatory requirements for regularly marking-to-market and safeguarding collateral positions for repurchase agreements are logical and prudent business practices. Additionally, the requirements are consistent with the System banks' existing business practices.

Market risk: The proposed revision adds to existing regulations the requirement that market risk limits must be consistent with risk limits required by regulations for the management of interest rate risk and the stress testing of investments. We think it is unnecessary to create such a specific linkage in the regulation given it does not appear to create a new requirement. Today, System institutions ensure that investment purchases comply with market risk limits, interest rate risk limits, and stress test requirements. We are concerned, however, that FCA will use the proposed regulatory linkage as a basis for requiring excessive granularity and complex market risk limits that duplicate interest rate risk and stress test requirements. Given that potential, as alluded to in the preamble to the proposed rule, FCA should drop the proposed revision since existing requirements already create effective and efficient market risk, stress test, and interest rate risk controls over the investment portfolio. In addition, the proposed and existing regulation text includes a requirement that other FCA policies and guidance must be followed. We vigorously object to this regulatory language. Such language is inappropriate since it appears to give policies and other guidance the full weight of law even though they have not been subject to notice and comment rulemaking as required by the Administrative Procedures Act. FCA should remove this inappropriate regulatory reference to other policies and guidance.

Liquidity risk: We have no comment regarding the liquidity risk paragraph given it essentially replicates existing regulatory requirements.

Operational risk: We have no comment regarding the operational risk paragraph given it essentially replicates existing regulatory requirements.

Delegation of authority: We have no comment regarding the delegation of authority paragraph given it essentially replicates existing regulatory requirements.

Internal controls: FCA proposes additional requirements for the separation of duties among staff who execute investment transactions and those responsible for investment accounting, policy compliance, approvals, valuation, and supervision. While this basic internal control is a standard business practice, we caution that the concept of separation of duties not be taken to the extreme beyond what may be appropriate or necessary for the type and scale of investment activities of individual System institutions. The specificity within the proposed regulations of personnel whose duties and supervision should be segregated from personnel who execute investment transactions is excessively detailed, overreaching, and contravenes management discretion to rely on compensating controls when appropriate for the risk involved. For instance, it may be sufficient to have one individual execute investment transactions and a second individual perform the other functions listed in the regulation. In other instances, it may be appropriate to separate the functions further if the volume, complexity, and other investment activities require a higher level of controls. The proposed regulatory provision for internal controls should allow for this flexibility when applied and implemented at individual System institutions.

The FCA also proposes a new internal control requirement for internal audit to review investment controls at least annually including ensuring that <u>all</u> investments at time of purchase are eligible and suitable for purchase. Rather than prescribing specific requirements that internal audit must address, the FCA should provide flexibility for internal audit to develop its own risk-based approach. Therefore, the proposed regulatory language should be modified to generalize the requirement. For instance, the language could simply require an annual internal audit over investment controls based on its risk assessment and sufficient testing to ensure compliance with policy requirements. A more generalized requirement would eliminate the potential for excessive internal audit activities and cost beyond what is needed to effectively control risk. We conclude that a generalized regulation in conjunction with the existing Bookletter guidance for investment management is sufficient for ensuring effective internal audit review of the investment function.

Due diligence to determine eligibility, suitability, and value of investments: The addition of this FCA proposed revision significantly consolidates and refines existing requirements as well as adds extensive new policy requirements for eligibility and suitability analysis and expanded stress testing. We will address each sub-paragraph of this proposed revision in turn.

Eligibility and suitability for purchase: The proposed revision requires sufficient due diligence to ensure an investment is eligible and suitable under a System institution's policy. We see this aspect of the proposal as a current and appropriate business practice. However, eligibility and suitability are often established for a class or segment of securities by specifying the criteria (credit risk, liquidity, market risk, etc.) which makes this class of securities suitable and eligible per se. The regulations should be clear that eligibility and suitability may be defined for segments or classes of securities which meet appropriate criteria rather than a security-by-security basis. We also note that FCA has included existing regulatory requirements for verifying the value when purchasing investments. The verification of value from an independent source is simply not realistic for investments in tranches of collateralized mortgage obligations (CMO), including planned amortization class (PAC) bonds, purchased in the primary market. These securities are generally unique in nature and purchases of newly created securities will be impossible to verify with a third party prior to purchase. For such eligible investments, the System generally complies with current requirements by calculating security values using various pricing models. We ask that the FCA include sufficient regulatory flexibility to ensure continuation of current effective and efficient investment valuation practices.

FCA also proposes significant additional due diligence for the purchase of any investment with respect to credit risk, liquidity risk, market risk, cash flow analysis, and underlying collateral risk. While this level of investment due diligence and documentation is appropriate for certain types of investments such as mortgage-backed securities (MBS), we conclude it is excessive and burdensome for Treasury securities, federal funds investments, short-term commercial paper, discount notes, bullet bonds, and other less complex securities. For this reason, FCA should carve out lower risk and less complex investments where the proposed comprehensive due diligence analysis creates burden without any appreciable enhancement in investment management practices.

Pre-purchase and quarterly stress test: The FCA proposes to require stress testing of interest rate and market value risks for individual investments at the time of purchase and quarterly thereafter. Beyond individual investments, the proposal requires the stress testing of the entire investment portfolio and development of a plan if the portfolio exceeds board established stress test parameters. It is inappropriate to require pre-purchase stress testing of short-term money market investments; specifically, non-amortizing fixed and floating rate securities maturing within one year. Only more complex securities should require pre-purchase stress testing. An appropriately structured and documented quarterly stress test of the entire portfolio, which is built up from stress tests of each individual investment as required by 615.5133(f)(2), provides useful information on capital, earnings, and liquidity risks relative to changes in the market value of the investment portfolio. Similarly, individual investment stress testing of mortgage securities, asset-backed securities, and other complex securities may be helpful in identifying which positions may be most problematic from a risk perspective and require mitigation action by management.

In response to FCA's first preamble question regarding stress testing, we conclude that FCA should not retain the standardized stress-testing option. We believe that System banks have the capability and sophistication to develop their own stress test processes depending on the complexity and characteristics of the investment class. In response to the second and third questions, we believe allowing System institutions to develop their own stress test standards will not lead to different risk profiles or an inappropriate amount of risk in some portfolios. We see the risk profile of the investment portfolio as a function of the investment decision and not the specification of the stress test. We also believe that each System bank has already demonstrated the capability to create and maintain stress tests that accurately and consistently measure various investment portfolio risks. In response to the fourth and fifth questions, stress testing of all securities at the time of purchase is not an appropriate investment and risk management practice, but rather the analysis needs to be reflective of the complexity and characteristics of the class of investments. For relatively simple securities, this would create additional work with no commensurate value. Consistent with existing practice at System banks, pre-purchase stress testing should only be required for MBS and other complex instruments. In response to the sixth and final question, quarterly stress testing of the investment portfolio is a common investment and risk management practice of System banks.

Ongoing value determination: We have no comment regarding the ongoing value determination paragraph. We see the proposed requirement as being essentially the same as the existing regulatory requirements even with the clarification that fair market value must be determined for individual investments as well as the entire portfolio. Fundamentally, the fair market value of the investment portfolio is determined by calculating the fair value of each individual investment which is done today by each System bank on a monthly basis.

Presale value verification: We have no comment regarding the presale value verification paragraph given it essentially replicates existing regulatory requirements.

Reports to the board: We see the board reporting requirements as exceedingly prescriptive and limiting the authority of the board to direct management on ongoing reporting requirements. We recommend that this provision be generalized and simply require that the boards receive a quarterly report containing information on the investment portfolio as the board deems appropriate. We see no reason for FCA to regulate board reporting to this level of detail, which we see as burdensome and inflexible since reporting needs to be adjusted as market and institutional situations change.

Special: This provision proposes to require the immediate notification of the board or a designated committee when the investment portfolio stress test exceeds board defined parameters. We ask that FCA drop the word "immediate" from the proposed language. While the term "immediate" appears specific, it is actually vague. Based on the proposed language, it is difficult to know if FCA would conclude that one day, 12 hours, or one hour would be considered immediate notification. In our view, notifications should be completed in a reasonable manner which the board may direct in investment policies and procedures.

Investment plan and investment management committee: In the preamble of the proposed rule, FCA states that each System institution should establish a formal investment plan and a formal investment management committee. We respect that FCA further recognized that this is not a regulatory requirement. While we appreciate FCA's perspective, there is simply no evidence to support that an investment plan would enhance investment management practices particularly considering the extensive regulatory investment policy requirements. Similarly, there is no evidence to suggest that a formal investment committee would be superior to the asset/liability management committee and other controls used by System institutions to manage investment activities. In fact, the individuals who serve on the Asset-Liability Management Committee (ALCO) would essentially be the same ones who would serve on the FCA suggested investment committee. Essentially, the ALCO and investment committee members would overlap given the required expertise, particularly considering stress testing is a core foundation for the regulatory investment management practices.

§ 615.5135 Management of interest rate risk

The proposed rule contains several new provisions for the management of interest rate risk. The majority of the proposed revisions are mostly refinements to current policy and procedure requirements. These refinements appear designed to capture investment stress test results, exception parameters, quarterly board reporting requirements, and derivative exposures, including counterparty risk thresholds and limits. We find the proposed provision prescriptive and not supported by any identified weaknesses in current System interest rate risk management practices. We are concerned that the additional requirements will be implemented by FCA in a way that results in additional burden in an area that has functioned exceedingly well over the years including throughout the recent financial market crisis. While we generally support the proposed changes, we ask that FCA recognize the effectiveness of the System's existing interest rate risk management practices.

§ 615.5136 Emergencies impeding normal access of Farm Credit banks to capital markets
We applaud FCA's proposal to provide additional flexibility in regulatory requirements to allow for the use of liquidity investments during periods of a financial market, economic, agricultural industry, and national defense crisis. Therefore, we support the proposed revisions to § 615.5136.

§ 615.5140 Eligible investments
The rule proposes several provisions affecting existing eligible investments, including when to determine eligibility, lowering portfolio limits for private label mortgage and asset-backed securities, eliminating commercial MBS (CMBS), and making other technical modifications. We will comment on each of the proposed revisions in turn.

FCA proposes that investments must only satisfy regulatory eligibility criteria at the time of purchase and subsequent ineligibility be managed in accordance with revised § 615.5143. We see this proposed revision and conforming changes in the investment eligibility criteria table as providing regulatory certainty for the purchase and ongoing management of securities that no longer satisfy eligibility criteria after purchase. This proposed revision is a welcome and appropriate refinement that FCA should finalize as proposed.

Investment Eligibility Criteria Table
The first revision proposes a new category for the senior debt securities of Government-sponsored agencies. This will clarify the difference in the treatment of such obligations from the treatment of obligations of the U.S. government. We appreciate this clarification and view it as a technical refinement.

The second proposed revision imposes a 15 percent investment portfolio limit for general obligation municipal securities. While the System has not traditionally purchased such securities, the imposition of a 15 percent limit is overly restrictive and redundant considering concentration risk requirements proposed in § 615.5133(c). Highly rated general obligation municipal securities are relatively liquid during economic slowdowns compared to other investment categories such as corporate bonds and private-label mortgage-backed securities. Similarly, general obligation municipal securities could prove to be a valuable future investment for diversifying the investment portfolio and managing interest rate risk, particularly given they are recognized as low-risk obligations in FCA's regulatory capital standards. For these reasons, FCA should not impose this proposed limit and should continue with the existing regulatory requirement. If FCA concludes a limit is necessary, we ask that it be increased to at least 25 percent to provide flexibility for potential future marketplace investment opportunities.

The third proposed revision imposes a 10 year maturity limit and a 15 percent investment portfolio limit on international and multilateral development bank obligations. We see the imposition of these limits as unnecessary and redundant to other regulatory requirements, particularly given the System has not traditionally purchased such obligations. Therefore, we ask that FCA revert back to current regulatory requirements as they have worked extremely well over the years. If FCA concludes a maturity limit and an investment portfolio limit are necessary, we ask that the maturity limit be increased to at least 15 years and the portfolio limit be increased to at least 20 percent. This would provide System institutions additional flexibility for investing in such obligations if appropriate opportunities arise in the future.

The fourth proposed group of revisions affects the treatment of MBS investments. The rule would reduce the investment portfolio limit for non-agency MBS to 10 percent. It would limit non-agency MBS to the senior most position within the securitization structure. Finally it would also eliminate commercial MBS as an eligible investment. Collectively, we see these revisions as unnecessarily and significantly limiting the System's ability to manage its investment portfolio through time in an economically efficient and effective manner. We are particularly concerned that in restricting non-agency MBS investments the FCA did not offset it with an increase in the limits for Fannie Mae and Freddie Mac guaranteed securities. Fannie Mae and Freddie Mac guaranteed securities have performed exceedingly well overall throughout the majority of the financial crisis. Therefore, we ask that FCA remove the investment portfolio limit for Fannie Mae and Freddie Mac guaranteed MBS allowing System banks' to hold up to 100 percent in Fannie Mae and Freddie Mac guaranteed MBS.

We also ask that FCA revise or clarify the proposed language requiring the purchase of only senior most positions of non-agency MBS. The proposed language appears to effectively limit System institutions to only purchasing the "money market" tranche created in most non-agency MBS investments. It appears FCA is interpreting the term "senior most" in a manner that may not be consistent with the liquidation priority of the tranche or the general market usage of the term "senior position."[1] In market usage, "senior position" refers to liquidation and loss allocation and not the payment window. We would ask FCA to adopt this interpretation of "senior position". By directing cash flows within a securitization structure, a more consistent and less variable cash flow can be created which may be a more suitable security. Therefore, we further ask that FCA not limit the System's ability to purchase MBS that have anticipated principal cash flows scheduled for a future time period. The System has successfully purchased such investments in a manner that has enhanced the overall quality and performance of the investment portfolio through time. Similarly, FCA should not reduce the existing 15 percent investment portfolio limit as proposed. It is essential that System institutions not be unduly constrained from flexibly managing their overall investment portfolio through business cycles that occur in the general economy, financial markets, and the agricultural industry. Overwhelming evidence demonstrates that the current investment portfolio limit was effective and safeguarded the System from excessive losses during the recent financial market crisis.

FCA's preamble suggests that it may further restrict Fannie Mae and Freddie Mac MBS investments depending on what happens to the GSEs in the future. We see this suggestion as somewhat one-sided. FCA should be open to considering flexibility and the reduction of restriction on such MBS investments if the resolution of Freddie Mac and Fannie Mae results in enhanced quality and liquidity. This may also be the case for non-agency MBS depending on the outcome of pending credit risk retention requirements proposed by other regulators.

The final comment on the fourth group of proposed revisions is that FCA should not eliminate the CMBS asset class in its entirety. Rather, we recommend placing a low investment portfolio limit on the asset class of 5 percent. While the System has not invested in CMBS since few transactions meet very restrictive existing "Other Requirements" provisions, future innovations in the financial markets may result in new and refined CMBS investment structures that are high-quality, liquid investments. Conceptually, FCA's regulations should provide for a broad range of asset classes so System institutions can effectively and flexibly manage their investment portfolios within the comprehensive policy and procedure controls required by regulations. In

[1] For example, as referenced in the preamble, PAC bonds technically may not be the first tranche to receive principal and interest cash flows in a collateralized mortgage obligation securitization and therefore appear to be ineligible investments under FCA's definition of "senior most" tranche.

our view, the limits contained in the regulatory eligible investment table are largely redundant to current regulatory safety and soundness requirements for investment management.

The fifth proposed revision reduces the investment portfolio limit for asset-backed securities (ABS) to 15 percent with no more than 5 percent of the portfolio invested in any one type of collateral. This proposed change is too restrictive and does not permit the effective management of the return performance for the overall investment portfolio. Managing overall return is critical given the costs associated with maintaining greater levels of high-quality liquidity. FCA should ensure the System has appropriate flexibility to manage the overall performance by retaining the existing regulatory investment portfolio limit of 20 percent. We also believe that the 5 percent single collateral limit forces unnecessary ABS investment diversification when put into context of the entire investment portfolio. Moreover, it creates the potential that System institutions would be forced to purchase less desirable and potentially higher-risk collateral types to remain compliant with regulatory ABS portfolio limits. We also recognize, however, the proposed rule's emphasis on the importance of diversification. Therefore, to balance the diversification objective and collateral risk trade-offs, FCA should increase the proposed single collateral type limit to 10 percent. A 10 percent collateral type limit in combination with a 20 percent portfolio limit would provide the best balance of risk versus return in the context of the entire investment portfolio.

The sixth proposed revision requires that investments in corporate debt securities must be senior debt securities with no more than 10 percent of the entire investment portfolio in any one of the 10 industry sectors defined by the Global Industry Classification Standard. While slightly more restrictive then current requirements, the proposed revisions provide a reasonable approach for diversification of corporate debt securities that System institutions may purchase for investment purposes.

The seventh proposed and final revision to the Investment Eligibility Criteria Table imposes two significant new restrictions on investments in diversified investment funds. The first restriction limits investments in diversified investment funds to open-end funds only. The second restriction limits investments in such funds up to 50 percent of the total investment portfolio. The proposed restrictions on diversified investment funds are unnecessary given the existing restrictions requiring that securities held in diversified funds must be solely eligible investments. As a result, the universe of funds eligible for System institutions' investment activities is essentially limited to fixed income funds that invest in U.S. Treasury securities. In this small eligible segment of the mutual fund market the distinction between close-end and open-end funds does not matter given there is no reasonable opportunity for speculation. Moreover, speculation is not a permitted purpose for a System institution's purchase of an investment, which further supports that the proposed revision is unnecessary. For these same reasons, the FCA should revert to existing regulatory requirements and not impose a 50 percent investment portfolio limit on diversified investment funds.

Denomination
We have no comment on FCA's proposed technical revision to move the existing requirement that investments be denominated in U.S. dollars to proposed § 615.5140 (b).

Rating of foreign countries
We have no comment on FCA's proposed re-designation of existing § 615.5140(b) to § 615.5140(c) given the technical change to move the U.S. dollar denomination requirement and proposed elimination of the existing paragraph relating to *marketable securities*. We also have no comment on the proposed elimination of the existing *marketable securities* regulatory

requirement. The current provision can be confusing to consistently apply in different financial market environments.

Obligor limits
FCA's proposed revisions would lower the obligor limit for single obligors to 15 percent from the existing 20 percent limit, clarify the exception language, and impose new limits on investment company holdings. While there are already significant regulatory controls over System institution investment purchases, the proposed lowering of the obligor limit appears reasonable, particularly given the exception relating to Government and Government-sponsored agency securities. We believe that the clarifications to the exception language are not substantive in nature. We also find the obligor limit on diversified investment funds confusing and burdensome. The proposed limit requires that individual diversified investment holdings in excess of 5 percent must be aggregated with other similar investment holdings when applying the obligor limit. Given the diversified nature of such funds, imposing this additional burden does not reduce risk and confuses investment concepts of a fund verses single obligor investments. Under no circumstances would a diversified fund that includes a particular single investment of greater than 5 percent expose a System institution to the same level of risk as holding that single investment directly. Aggregating these exposures as if they represent the same exposure is technically incorrect and overstates obligor risk. We ask FCA to drop this confusing and technically inconsistent proposed revision.

Other Issues Raised by FCA pertaining to § 615.5140
FCA also asked if it would be appropriate to establish an overall portfolio limit including all obligations except for money market, Government securities, and Government-sponsored agencies. We are not certain what FCA is asking by posing this question. Given the current portfolio limit of 35 percent, FCA seems to be suggesting a sub-limit on portfolio investments other than the exceptions listed. We see any imposition of such additional limits as potentially burdensome and restrictive particularly given the investment portfolio limit already creates effective sub-limit by investment class. Unless such a sub-limit provides System institutions additional flexibility in managing their investment portfolio, we see no need for such a limit. The current regulatory requirements already provide excessive regulatory controls over investment purchases and investment management.

The FCA further asks if it should impose a limit on the housing sector. We see no need for such a limit given existing and proposed regulatory requirements over investment purchases and investment management. An overall limit on the housing sector would be unduly restrictive and significantly compromise a System institution's ability to effectively manage the risk and return performance of its investment portfolio. We also see such a limit as a potentially indirect way to restrict investments in Government-sponsored agency MBS which would be problematic for System institutions to maintain sufficient liquidity without incurring excessive costs. We believe that a housing sector limit would not reduce risk, but could potentially force System institutions into less liquid investments and potentially riskier investments over time (e.g., more corporate debt, ABS, and municipal securities). Additionally, this proposal seems inconsistent with other proposals such as to eliminate CMBS as an eligible investment sector and the reduction of the allowed percentage of other non-housing related investment classes. Overall, we see no basis for imposing an overall housing sector limit for the investment portfolio particularly given existing regulatory requirements coupled with FCA's examination oversight which proved effective during the recent financial market crisis.

§ 615.5142 Association investments
We disagree with FCA's characterization that a Farm Credit bank is required by Section 2.2(10) or 2.12(18) of the Act to supervise investment activities of affiliated associations when in fact the

Act requires approval.[2] In regard to association investments, the Act specifically states that a Farm Credit bank may approve association investments under authorized FCA regulations. While the bank may approve an affiliated association's investment activities, we agree with FCA that bank approval does not absolve an association from its fiduciary duty to manage investments in a safe and sound manner. We also recognize that the current regulatory requirements require banks to review the investment portfolio of every association it funds on an annual basis. The proposed review requirement is unnecessary and goes beyond the requirements the Act places on Farm Credit banks with respect to association investments. We see the Farm Credit bank's oversight of an affiliated association as a debtor-creditor matter addressed in the general financing agreement (GFA). In prior rulemakings FCA determined that it does not have statutory authority to approve GFAs and removed such regulatory requirements. For this reason, FCA should be consistent and eliminate the investment review requirement thereby allowing Farm Credit banks to manage this matter through the GFA.

FCA characterizes associations as having minimal interest rate risk given Farm Credit banks generally ensure cash flows are matched between liabilities and assets. FCA, however, also determined in § 615.5182, BL-012 and Examination Manual (EM) Section 425 that associations may be exposed to interest rate risk and therefore requires associations to adopt appropriate asset-liability management practices. Even for Tier I associations, as defined in EM 425, that have very limited exposure to interest rate risk, FCA states:

> "However, these associations may still have some IRR in the form of potential compression of net interest income. This could arise from sources including, but not limited to, lag risk caused by failure to properly administer retail loan rates in response to changes in funding costs, adjustments in loan spreads, the impact of interest rate movements on an institution's loanable funds position, or other unique loan products where the IRR is managed locally."

We agree with FCA that there is potential interest rate risk at the association level. For this reason, it is essential that associations have the regulatory flexibility to purchase investments to help mitigate and guard against this risk. We take exception to FCA's preamble clarification that an association's use of investments should be commensurate with its actual interest rate risk. This clarification is extremely vague, unnecessary, and inappropriately involves FCA in association decision-making. The clarification is vague given "commensurate with its actual interest rate exposure" is essentially undefined. For instance, an association may have minimal exposure if rates move 100 basis points but experience significant exposure if rates move by 200 basis points particularly to its loanable funds position. Given the clarification, what exposure should be used to determine "actual" and what is "commensurate"? Rather than define these terms or provide additional clarification, FCA should rely on existing regulatory requirements for the management of interest rate risk since they have been highly effective and efficient over the years and during the recent financial crisis. Given the adequacy of current requirements, the additional clarification is unnecessary.

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[2] Section 2.2(10) invest funds of the association as <u>may be approved by the Farm Credit Bank under regulations of the Farm Credit Administration</u> and deposit the current funds and securities of such with the Farm Credit Bank, a member bank of the Federal Reserve System, or any bank insured under the Federal Deposit Insurance Corporation, and may pay fees therefor and receive interest thereon as may be agreed (emphasis added). Section 2.12(18) invest association funds in such obligations as <u>may be authorized in regulations of the Farm Credit Administration and approved by the bank</u> and deposit securities and current funds of the association with any member bank of the Federal Reserve System, with the Farm Credit Bank, or with any bank insured by the Federal Deposit Insurance Corporation, and pay fees therefor and receive interest thereon as may be agreed (emphasis added).

Current regulatory requirements also make unnecessary and overly restrictive the proposed limitation on association investments for managing short-term funds. Considering existing regulatory requirements, the concern that borrowing short from the bank to invest in longer-term investments is unfounded. FCA's stated concern is that if an association were to engage in this practice it would be exposed to interest rate risk. Interest rate risk at the association level, however, is already fully regulated which makes the proposed provision an unnecessary, regulatory burden. We ask that FCA drop this proposed revision in its entirety.

FCA asked for comment on whether it should define surplus short-term funds. We do not believe that FCA should attempt to define surplus short-term funds. Any definition would inherently be imprecise and venture into the area of institution management. Rather, System institutions should be free to define surplus short-term funds on their own. FCA can then evaluate an association's determination as part of the routine examination function. We believe this approach is more appropriate and ensures that surplus short-term funds are determined within the context of the unique circumstances for each System institution.

FCA also asked about the appropriateness of its position that association surplus short-term funds should only be invested in overnight securities or securities maturing in 30 days or less. We find this position inconsistent with the proposed limitation for matching the maturity and repricing characteristics of such surplus short-term funds with investments purchased. We also feel that FCA's position is an indirect approach for defining surplus short-term funds considering this limitation which is inappropriate. We conclude that there is no financial safeguard need for FCA to take this position particularly given the current extensive and restrictive regulatory requirements over investments. We are concerned that FCA's question will lead to unnecessary and additional complex restrictions resulting in regulatory burden.

FCA's final question asks if the proposed limitation on permissible characteristics is appropriate or unreasonably restrictive. We previously responded to this question in our comment on the proposed revision. We find it restrictive and unnecessary given existing regulatory requirements for investments. We see no reason for additional regulatory limitations on association investments.

§ 615.5143 Management of ineligible and unsuitable investments

The FCA is proposing major revisions to the disposal of investments that are ineligible at purchase or no longer satisfy eligibility criteria after purchase. Overall, the proposed revisions are a significant improvement over existing requirements given they reduce regulatory burden and uncertainty.

Investments ineligible when purchased

The proposed revision which addresses the purchase of ineligible investments should be eliminated. Investments ineligible when purchased should be treated in the same manner as an investment that becomes ineligible after purchase. While we understand that FCA's proposal is meant to provide a disincentive to purchase ineligible investments, the proposal is entirely unnecessary given it would be a regulatory violation to purchase ineligible investments. FCA would be able to address the regulatory violation using its existing supervisory authorities. Despite the statements made in the preamble of the proposed rule, we also see this proposed revision as essentially authorizing System institutions to purchase ineligible investments that could be held for 60 calendar days under specific regulatory requirements. Therefore, FCA should drop this proposed revision.

Investments that no longer satisfy eligibility criteria or are unsuitable
We find the proposed revisions consistent with the lessons learned during the recent financial crisis and FCA's appropriate approval of System institution divestiture plans. The proposed regulatory conditions for the treatment of investments that no longer satisfy eligibility requirements are appropriate and likewise mirror the conditions placed on approved divestiture plans. Our only concern is with the requirement to promptly notify FCA in writing. We are unsure what "prompt" means in the context of this regulation. The concept of notifying FCA so it can evaluate if an institution is responding appropriately seems redundant and unnecessary given the specific requirements of the regulation and the ongoing nature of its examination function. If FCA decides to retain this requirement, it should provide for a 60 calendar day notice period.

Board reporting requirements
The specificity of the board reporting requirement is unnecessary and redundant given similar, prescriptive requirements proposed in § 615.5133(g). We see § 615.5133(g) as already requiring both a report on the status of each investment and their impact on capital, earnings, liquidity, and collateral position. We see the proposed requirement in § 615.5143(c) as a regulatory burden and creating additional reporting that adds no benefit for board reporting. FCA should drop the language of the proposed provision and replace it with a simple reference to § 615.5133(g).

§ 615.5174 Famer Mac securities
We see the proposed revisions as an improvement to existing requirements which require the stress testing of Farmer Mac mortgage securities. FCA is proposing that a stress test is not required if the Farmer Mac mortgage securities held by a System institution are backed by loans the System institution originated. We see this proposed revision as an appropriate improvement to existing requirements.

Dodd-Frank ACT (DFA) Compliance
FCA has also asked a series of questions on possible approaches for eliminating the use of Nationally Recognized Statistical Rating Organizations' (NRSRO) ratings from investment regulations. In the place of NRSRO ratings, FCA is required by the DFA to establish standards of creditworthiness it deems appropriate. In the preamble of the proposed rule, FCA suggests four possible approaches for establishing a creditworthiness standard to replace NRSRO ratings. Before we comment on the four approaches, we want to provide an overall observation on the removal of NRSRO ratings from investment regulations.

Our overall comment is the FCA should be careful to stay in step with the banking regulators on the removal of credit ratings. We think it is critically important that FCA consider what the other regulators propose for a creditworthiness standard before proposing a standard for FCS institutions. The actions by the other regulators may prove valuable and informative as FCA considers this matter for FCS institutions. We also believe that FCA should support efforts to work with Congress on the significant impact and costs associated with this DFA requirement including providing information that Congress may need to implement legislative refinements to this requirement.

Along with waiting for the banking regulators to complete their rulemaking, we see the FCA investments regulations as a special case with respect to section 939A of the DFA. While these regulations include the use of ratings, they do not rely solely on ratings for determining investment eligibility. We think that FCA could make a case that the references to NRSRO ratings in the investment regulations are just one of several data points used to determine investment eligibility as part of the proposed regulatory due diligence requirement placed on

System institutions. While DFA does indicate that all references to NRSRO ratings should be removed, the column header "NRSRO credit rating" of the investment eligibility table found in the regulations could be generalized to "credit score." The other guidance would specify that the "credit score" should be determined by both a System institution using available information including external ratings to inform the mapping of the internal "credit score" as well as using the existing 14 point scale used by most System institutions. We believe that this would be a simple, workable, and logical approach to complying with Section 939A of the DFA.

Financial measurements, benchmark indexes, and other measurable criteria
FCA's first suggested approach is to establish a creditworthiness standard based on a myriad of criteria, including credit spreads, default statistics, inclusion in an index, priorities, enhancements, price, yield, volume, and asset class-specific factors. We find this suggested approach as entirely unworkable, overly complex, and not reflective of the risks of an individual investment. To be effective and efficient, creditworthiness should be security specific and reflect the potential historical and current experiences of an individual security within an investment class. This contemplated approach simply does not evaluate an individual security but seems to compare it to other criteria derived from marketplace data, which is not appropriate given market data is influenced by a variety of factors beyond simply credit. Moreover, determining the appropriate criteria to apply, and the appropriate algorithm for aggregating this information into a measure of creditworthiness would be extremely complex and likely need to be adjusted over time; making this potential approach expensive, problematic, and inefficient. It would be difficult for FCA to identify criteria that would remain valid predictors of creditworthiness over time. In addition, once these criteria were written into regulations, they could not be changed in a timely manner in response to changes in market conditions. Therefore, FCA should reject this approach as well as any combination thereof. Further, FCA should not attempt to establish standards for probability of default or loss given default because these are not static measures but fluctuate in complex ways over time.

Internal Models
FCA's second suggested approach is to establish a creditworthiness standard based on a System institution's internal model. We believe that this approach offers the greatest potential for pursuing. As discussed previously, System institutions already have an effective and efficient internal loan rating model that can be adapted and applied in a consistent manner to the investment portfolio. In fact, the System already uses this model to evaluate the creditworthiness of mission-related investments based on FCA's approval criteria for pilot program investments. We think the System's current model used for classifying loans is already applicable to investments. As part of ongoing due diligence, however, we think that an investment rating using the internal model should also be evaluated against the investment's external NRSRO ratings so that there is consistent consideration and analysis of credit risk. We think that the criteria for investment eligibility under the existing rating system would map directly to the existing characterization of credit risk in the Investment Eligibility Criteria Table (e.g., "highest," and "one of the two highest"). While such an approach could conceptually result in slight differences in ratings among System institutions, we believe that such differences would be very few and effectively reviewed by FCA as part of its ongoing examination process. Therefore, the use of internal models based on the existing asset classification system is the best standalone overall approach. We believe this approach should not be combined with other approaches suggested by FCA given it would create greater complexity

Third-party assessments
The third approach suggested by FCA is to require System institutions to use third-party assessments, other than NRSRO ratings, to determine creditworthiness. FCA should not require the use of third-party ratings that would essentially duplicate the same creditworthiness

information obtained from NRSRO ratings. FCA has determined that Section 939A of the DFA does not prohibit the use of NRSRO ratings as a tool for assessing creditworthiness. We think that use of NRSRO ratings is appropriate as a tool when applying an internal model approach as previously discussed. However, there should be confidence that NRSROs are appropriately regulated to ensure conflicts of interest do not result in inappropriate ratings and that the ratings methodologies are validated consistent with best practices for measuring credit risk, encompassing not merely historically derived statistical probabilities but appropriate scenario analysis and stress testing as well. Conversely, we agree with FCA that third-party ratings have been shown to be problematic in the recent financial crisis and no better than NRSRO ratings. Therefore, FCA should not consider the approach of requiring third-party ratings, but should certainly permit reliance on third party ratings as a component of a broad system for credit risk evaluation. Overall, non-NRSRO third-party assessment requirements could just add costs and may not provide a corresponding benefit for creditworthiness assessments made as part of investment management decision-making. For these reasons, use of non-NRSRO third-party assessments of credit risk should be permitted but not be required by regulation.

FCA defined criteria
The fourth approach suggested is to have FCA establish a set of clearly defined criteria for creditworthiness and require System institution's due diligence to ensure compliance with that criterion. The FCA further outlined sample definitions for two criteria called the "highest standard" and "high standard." In reviewing this approach, the FCA-defined criteria would be difficult to apply in a consistent manner. Moreover, it substitutes already well defined criteria established in System institutions' rating models previously discussed with relatively vague and broad definitions prescribed by FCA. Therefore, the suggested approach is overly burdensome and problematic given it would be difficult to implement. Reconciling FCA specified criteria to external NRSRO ratings and internal models when performing due diligence on investment purchases would prove particularly difficult to implement. We think that this approach should not be pursued or combined with other approaches suggested by FCA.

General Questions
FCA also asked a series of general questions regarding the requirements of the DFA and suggested approaches. The first question asks if the approach allows for too much subjectivity and inconsistency. We addressed this question in our specific responses to the individual suggested approaches. In summary, the internal models approach appears the most realistic for providing sufficient objectivity and consistency for investment management purposes. FCA's second question asks if there is an alternative approach to those FCA suggested. We think it is premature to identify alternative approaches until the banking regulators complete their rulemaking efforts in this area. We have no additional alternative approaches to offer FCA at this time. Finally, FCA also asked about specific methods and standards for assessing political and economic stability of a foreign country that hosts the obligor or issues of an eligible investment. FCA should not provide any specific regulatory requirements relating to country risk for the investment portfolio. Country risk should be assessed as part of the overall due diligence associated with investment decisions. We believe that assessment of country risk is inherently expected by FCA and therefore does not need to be addressed specifically, particularly given the System's strong track record in managing this risk.

Conclusion
We appreciate the FCA's role as a safety and soundness regulator in promulgating the investment management proposed rule. We fully support, to the extent necessary, FCA's measures to protect the safety and soundness of System institutions. The proposed rule, however, goes beyond this level of protection and enters the realm of institution management. We find portions of the rule excessively prescriptive, burdensome, and unnecessary given the

effectiveness of current regulatory requirements. Therefore, we request that FCA revise this proposed rule in a manner consistent with the comments we have provided.

Again, we appreciate the opportunity to comment on this rulemaking. Please do not hesitate to contact us if you have any questions regarding our comments.

Sincerely,

Charles Dana
Sr. V.P., General Counsel