FARMER MAC

1999 K Street NW, 4th Floor · Washington, DC 20006 · Phone: 800.879.3276 · Fax: 800.999.1814

April 25, 2016

Via Electronic Mail to reg-comm@fca.gov
Laurie A. Rea
Director, Office of Secondary Market Oversight
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Notice of Proposed Rulemaking: "Organization; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Farmer Mac Investment Eligibility" 12 CFR Part 652, RIN 3052-AC86, February 23, 2016

Dear Ms. Rea:

The Federal Agricultural Mortgage Corporation ("Farmer Mac") appreciates the opportunity to respond to the request for public comment on the above-referenced proposed rule (the "Proposed Rule")[1] published by the Farm Credit Administration (the "FCA"). The Proposed Rule would amend Farmer Mac's existing regulations in 12 C.F.R. Part 652 (the "Investment Regulations") to (1) replace references to credit ratings with other appropriate standards to determine the creditworthiness of investments in compliance with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and (2) revise certain concentration limits for investments. Farmer Mac has comments on four specific areas of the Proposed Rule, as described below.

1. Definition of "Obligor"

The Proposed Rule proposes adding a new definition to the Investment Regulations for "obligor," defining it as "an issuer, guarantor, or other person or entity who has an obligation to pay a debt, including interest due, by a specified date or when payment is demanded," and this definition would include "the debtor or immediate party that is obligated to pay the debt, as well as a guarantor of the debt."[2] Farmer Mac believes that the inclusion of a guarantor in the proposed definition of "obligor" does not fully align with the FCA's intent of limiting Farmer Mac's exposure to a single counterparty because Farmer Mac generally makes its investment decisions based on the creditworthiness of the issuer of a debt obligation on a standalone basis, and usually not on the creditworthiness of the guarantor. Farmer Mac believes it is customary to view a guarantor's creditworthiness and its ability to fulfill its guarantee obligations as a secondary source of protection on a debt investment upon the default of the issuer, and not as a primary source for recovery. Additionally, a single guarantor could guarantee the debt obligations of multiple issuers.

[1] 81 Fed. Reg. 8860 (February 23, 2016).

[2] Proposed Rule at 8862 (proposed definition under 12 C.F.R. § 652.5).

In this scenario, under the Proposed Rule, Farmer Mac's ability to diversify its investment portfolio, by purchasing the debt obligations of multiple issuers (on whose sole creditworthiness Farmer Mac based its investment decisions) that were also guaranteed by the same guarantor, would be unnecessarily limited and contrary to the FCA's stated goals of sound investment management through diversification.[3]

Farmer Mac believes that a guarantor should be included in the definition of an "obligor" only to the extent that the initial investment decision is based on, in whole or in part, the creditworthiness of the guarantor in providing a guarantee on the primary debt obligation. For example, when Farmer Mac purchased certain private-label residential mortgage-backed securities beginning in 2010 that were fully guaranteed by the National Credit Union Association (the "NCUA"), it based its investment decisions in part on the creditworthiness of the NCUA and its ability to guarantee full repayment of the debt obligations of the issuer should it fail to repay on time. However, when Farmer Mac purchases municipal bonds, it bases its investment decision solely upon the creditworthiness of the issuer and does not rely on any credit guarantors that the municipality may or may not have at the time of issuance or at a later date (e.g., in the form of a municipal insurer). Under the Proposed Rule, if different municipalities from which Farmer Mac purchases debt obligations have the same credit guarantor, Farmer Mac could be forced to divest some of those high credit quality investments even though it based its investment decisions solely upon the creditworthiness of each municipality. Thus, Farmer Mac requests that the FCA revise the proposed definition of "obligor" in any final rule it issues to include a guarantor of the debt obligation only to the extent that Farmer Mac bases its initial investment decision, in whole or in part, on the creditworthiness of the guarantor and its ability to fulfill its guarantee obligations.

2. <u>Obligor's Capacity to Meet Financial Commitment</u>

Farmer Mac understands that section 939A of the Dodd-Frank Act requires the FCA to revise all of its regulations that reference or require reliance upon credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") to assess the creditworthiness of a security by removing such references or requirements and substituting them with other appropriate creditworthiness standards. The Proposed Rule would replace that the existing criteria for the eligibility of all of Farmer Mac's non-program investments, including those that are not currently subject to an NRSRO credit rating requirement,[4] with the following standard: obligors (whether debtor or guarantor) must "have *strong capacity* to meet the financial commitment for the expected life of the investment."[5] The explanatory discussion in the Proposed Rule related to the revision

[3] Proposed Rule at 8862.

[4] Under the existing Investment Regulations, to be eligible, Farmer Mac investments generally must meet the highest or second highest whole-letter NRSRO rating, depending on the asset class. *See* 12 C.F.R. § 652.20.

[5] *See* Proposed Rule at 8864 (emphasis added). As discussed above in Section 1 of this Comment Letter, Farmer Mac believes that a guarantor should be included in the definition of an "obligor" only to the extent that Farmer Mac bases its investment decision, in whole or in part, on the creditworthiness of the guarantor and its ability to fulfill its guarantee obligations. Thus, Farmer Mac does not believe that it should be required to assess the creditworthiness of

of 12 C.F.R. § 652.20(b) (the "Explanatory Discussion") states that the FCA would view an investment as having met this standard "if the expected average cumulative default rate of issuers of similar credit quality is *low* based on historical default data," with reference to a potential source for this historical data entitled "Annual Default Study: Corporate Bond Default and Recovery Rates."[6] However, we note that the actual text of 12 C.F.R. § 652.20(b) of the Proposed Rule (the "Proposed Rule Text") appears to provide other criteria for investments to meet this standard which is inconsistent with the standard referenced in the Explanatory Discussion, as follows:

> "(b) Farmer Mac may only purchase those eligible investments satisfying all of the following:
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> (1) The obligor(s) of the investment have strong capacity to meet financial commitments for the life of the investment. A strong capacity to meet financial commitments exits [sic] if the risk of default by the obligor(s) is *very low*…
>
> (2) The investment must exhibit low credit risk and other risk characteristics consistent with the purpose or other purposes for which it is held. At a minimum, obligors must have strong capacity to meet financial commitments and generally have a *very low probability of default* throughout the term of the investment even under severely adverse, stressful conditions in the obligors' business environment."[7]

Both the Explanatory Discussion and the Proposed Rule Text also appear to be stricter than the creditworthiness standards implemented by the Office of the Comptroller of the Currency ("OCC")[8] and the Federal Deposit Insurance Corporation ("FDIC").[9] Specifically, the OCC and

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a guarantor based on the proposed investment eligibility criteria to the extent that it does not base its initial investment decision, in whole or in part, on the creditworthiness of such guarantor.

6 *See* Proposed Rule at 8864 (emphasis added).

7 *See* Proposed Rule at 8865 (proposed 12 C.F.R. § 652.20(b)) (emphasis added).

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

9 *See* 77 Fed. Reg. 43151 (July 24, 2012) (Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities). The creditworthiness standard adopted by the FDIC in its final rule is substantially similar to the creditworthiness standard adopted by the OCC as described in footnote 8 above.

the FDIC refer to an "adequate capacity" of the issuer to meet its financial commitments, which is defined in part as a "low" risk of default by the obligor, while the FCA indicates in both the Explanatory Discussion and the Proposed Rule Text that an obligor must have a "strong capacity" to meet financial commitments, which is defined in part as having a "very low" probability of default in the Proposed Rule Text. Because the FCA's creditworthiness standard and the criteria to meet such standard set forth in both the Explanatory Discussion (in part) and the Proposed Rule Text (in whole) appear to be stricter than those promulgated by the OCC or FDIC, and absent any further guidance from the FCA as to its standard, Farmer Mac would also not necessarily be able to consider the guidance provided by the OCC or FDIC[10] in conducting an analysis as to whether a particular security was eligible for investment.

Farmer Mac also believes that the proposed standard of creditworthiness in the Explanatory Text may provide a feasible alternative to the use of credit ratings in determining investment eligibility, if aligned with the definitions promulgated by OCC or FDIC with regard to the "adequate capacity" of the issuer to meet its financial obligations. However, Farmer Mac believes that the proposed standard and criteria to meet this standard in the Proposed Rule Text would still require further clarification and interpretation. Specifically, the criteria required to meet the creditworthiness standard set forth in the Proposed Rule Text remain unclear as to what may permissibly constitute a "very low" probability of default and how this probability of default should be calculated or measured, whereas the standard set forth in the Explanatory Discussion is somewhat more precise. If the FCA moves forward with the creditworthiness standard set forth in the Proposed Rule Text, it should provide additional clarification and guidance on either threshold levels of defaults or the types of factors that would be appropriate to consider in determining whether an obligor has a "very low" risk or probability of default and when an obligor would be considered to have slightly more than a "very low" risk or probability of default, and thereby have a less than "strong" capacity to meet its financial commitment for the life of the investment. For the reasons cited above, Farmer Mac requests that the FCA reconsider its reference to a "strong capacity" to meet financial commitments, which is referenced in both the Explanatory Discussion and the Proposed Rule Text, and replace it with an "adequate capacity" to meet financial commitments. In addition, Farmer Mac requests that, in any final rule it issues, the FCA employ criteria to meet any creditworthiness standard that are consistent with those set forth in the Explanatory Discussion and not in the Proposed Rule Text.

3. Concentration Risk: Asset Class Limits and Obligor Limit

The Proposed Rule proposes revising the Investment Regulations to address concentration risk through portfolio diversification and obligor limits.[11] Farmer Mac agrees that requiring an investment portfolio to be diversified is appropriate and represents a fundamental aspect of risk

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

[11] *See* Proposed Rule at 8862.

management. Because investment portfolios are carefully designed to manage various types of risks, including interest rate, credit, investment, concentration, diversification, and liquidity risk, it may be prudent for an institution to increase its exposure to a specific type of asset class at certain times. The Proposed Rule appears to recognize this principle by acknowledging that the Investment Regulations already require Farmer Mac to establish concentration limits for "asset classes or obligations with similar characteristics" within its investment policy.[12] The FCA further indicates in the Proposed Rule that it expects Farmer Mac to review its investment policy limits at least annually and make adjustments based on Farmer Mac's then-current risk profile and risk-bearing capacity, which may suggest lower limits than the current regulatory parameters set forth in the Investment Regulations.[13] Indeed, Farmer Mac's board of directors reviews Farmer Mac's investment policy at least annually and various asset class concentration limits in Farmer Mac's investment policy are currently set at levels below the existing regulatory limits set forth in 12 C.F.R. § 652.20.

Farmer Mac therefore agrees with the FCA's proposed approach of eliminating all of the asset class portfolio concentration limits, except for the 50-percent portfolio limit for government-sponsored enterprise-issued securities, contained in 12 C.F.R. § 652.20, (the "Existing Concentration Limits").[14] In response to the Proposed Rule's inquiry as to whether any of the Existing Concentration Limits should be retained in full or part, Farmer Mac requests that the FCA not retain the Existing Concentration Limits at all and rather, defer to the business judgment of Farmer Mac's board of directors to set appropriate concentration limits. In retaining the Existing Concentration Limits at the regulatory level, the FCA could inadvertently have the effect of supplanting its judgment with that of Farmer Mac's portfolio managers without the benefit of knowing all of the nuances of Farmer Mac's day-to-day operations on an ongoing basis. Another possible unintended effect of unnecessarily retaining the Existing Concentration Limits is that it may actually *decrease* an investment portfolio's diversification in direct contravention of sound risk management principles, thereby undermining safety and soundness. This is because retaining the Existing Concentration Limits could constrict the flexibility related to how Farmer Mac's investment portfolio is managed, as real-time changes in market forces will likely increasingly require Farmer Mac and its board of directors to act quickly in response. Indeed, the Existing Concentration Limits may unintentionally increase the other types of risks that Farmer Mac may encounter in the future while simultaneously eliminating the flexibility and ability to manage such risks. Therefore, Farmer Mac recommends that the FCA eliminate the Existing Concentration Limits in their entirety in the Investment Regulations to provide sufficient flexibility in the management of Farmer Mac's investment portfolio and allow Farmer Mac's board of directors to

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[12] *See* Proposed Rule at 8863; *see also* existing 12 C.F.R. § 652.10(c)(1)(i).

[13] *See id.*

[14] *See id.* To be clear, Farmer Mac agrees with the Proposed Rule's retention of the 50-percent portfolio limit for government-sponsored enterprise-issued securities to be set forth in new 12 C.F.R. § 652.10(c)(5)(ii).

manage the business through the periodic review and adoption of an investment policy with specified diversification limits appropriate for Farmer Mac at the time.

Farmer Mac also encourages the FCA to reconsider the new proposed limit of 10% of total regulatory capital that Farmer Mac may invest in any one obligor (the "Capital Obligor Limit"),[15] which is significantly below the current limit of 25% under the Investment Regulations. Farmer Mac acknowledges that the FCA believes that this lower obligor limit would enhance Farmer Mac's long-term safety and soundness by ensuring that only a modest portion of capital would be at risk if an obligor were to default.[16] However, Farmer Mac believes that retaining the 25% limit in the Investment Regulations and allowing Farmer Mac's board of directors the ability to establish internal concentration limits through the investment policy, as the FCA has done in the past, achieves the same result. In the Proposed Rule, the FCA maintains that the 25% limit allows Farmer Mac to invest significant capital in one obligor and default by a few such obligors would erode Farmer Mac's regulatory capital surplus.[17] While this observation may be theoretically true, reducing the limit to 10% does not necessarily accomplish the FCA's purpose of enhancing Farmer Mac's long-term safety and soundness. On the contrary, prudent risk management guidelines and limits established in Farmer Mac's investment policy adopted by its board of directors, along with auditing processes to ensure compliance with such policy, are likely to be more successful in ensuring that Farmer Mac makes investments that do not impair its safety and soundness or significantly erode its regulatory capital surplus. In addition, the FCA is able to validate and enhance the safety and soundness of Farmer Mac in a number of ways already, separate and apart from reducing the total amount of Farmer Mac's regulatory capital that may be invested in a single obligor.

In summary, Farmer Mac believes that the Capital Obligor Limit proposed by the FCA and retaining any of the Existing Concentration Limits are unlikely to automatically enhance the safety and soundness of Farmer Mac and would unnecessarily supplant the judgment of Farmer Mac's board of directors and management with that of the FCA. Therefore, Farmer Mac requests that the FCA eliminate the Existing Concentration Limits and preserve the existing Capital Obligor Limit of 25% and continue to allow Farmer Mac's board of directors to establish prudent and appropriate concentration limits through the periodic review and adoption of Farmer Mac's investment policy.

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[15] *See* Proposed Rule at 8862 (proposed 12 C.F.R. § 652.10(c)(5)(i)). The Capital Obligor Limit would not apply to investments in obligations that are backed by a U.S. Government agency or a government-sponsored enterprise (GSE).

[16] *See id*.

[17] *See id.*

4. Eligible Non-Program Investments: Private Placements

The Proposed Rule indicates that while private placements may be eligible Farmer Mac investments if they satisfy all of the proposed investment eligibility criteria, they are "generally not liquid" and would "need to be acquired for an authorized purpose unrelated to liquidity."[18] Farmer Mac does not believe that securities acquired through a private placement are generally not liquid. Farmer Mac notes that private placements are offered under exemptions from registration provided under the federal securities laws, and one such exemption is Rule 144A, promulgated under the Securities Act of 1933, as amended.[19] Under Rule 144A, non-registered securities must be sold to "qualified institutional buyers" ("QIBs"), which refers to sophisticated institutional investors meeting certain minimum net worth and minimum investment experience requirements under the federal securities laws.[20] Farmer Mac qualified as a QIB and purchases securities exempt from registration under Rule 144A. In Farmer Mac's experience, it has not observed a material difference in the liquidity of the publicly registered and privately placed securities it purchases. Any discount, if at all, based on a security's perceived liquidity is priced at the time of issuance and does not materially change after issuance solely as a result of the security's registration status. Farmer Mac generally trades in large lot sizes of $5 million or more to reduce the operational burden of executing several trades, which increases demand for privately placed securities from other QIBs capable of and seeking to trade in large size transactions, thereby increasing the liquidity of these securities. In Farmer Mac's experience, these large lots of privately placed securities trade at much tighter spreads than smaller lots of publicly registered securities purchased by the general public due to the operational efficiency achieved by these larger trades. Because of these factors, any liquidity discount that might exist when Farmer Mac purchases privately placed securities is more than offset by the premium received by Farmer Mac when it trades these securities with other QIBs. Therefore, whether a security held by Farmer Mac is privately placed or publicly traded is unlikely to impair its liquidity, which is generally readily available when needed due to Farmer Mac's status as a QIB.

Farmer Mac believes that the institutional market provides it with greater trading depth, in which large lots of privately placed securities can be traded with relative ease, thereby providing liquidity. As a result of its prior experience and from its perspective as a QIB, Farmer Mac believes the liquidity provided by securities acquired in the public markets or through a private placement is similar. Farmer Mac therefore requests the FCA to reconsider its position on whether privately placed securities may be acquired for liquidity purposes.

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[18] *See* Proposed Rule at 8864.

[19] *See* 17 C.F.R. § 230.144A.

[20] *See id.*

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

Very truly yours,

R. Dale Lynch
Executive Vice President – Chief Financial Officer