FARM CREDIT COUNCIL

November 19, 2021

Mr. Kevin Kramp
Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

RE: Farm Credit Administration's (FCA) Advanced Notice of Proposed Rulemaking: Bank Liquidity Reserve - RIN 3052–AD44/Federal Register Vol. 86, No. 123 (June 30, 2021)

Dear Mr. Kramp:

The Farm Credit Council (FCC), on behalf of its membership, appreciates the opportunity to comment on the FCA's Advanced Notice of Proposed Rulemaking (ANPRM), published in the June 30, 2021 Federal Register, addressing the Bank Liquidity Reserve regulations.

In response to the ANPRM, the Farm Credit Council engaged the Farm Credit System (FCS, System) Bank Treasurers' Workgroup (Workgroup) to collaboratively review and offer responses to the questions posed by the Agency. The Workgroup included each of the four System Bank Treasurers and individuals from each of the banks' finance departments, the Federal Farm Credit Banks Funding Corporation, and other System representatives. While other System institutions may submit their own comments on various aspects of the rule, we anticipate such comments will be limited due to the focused nature of the ANPRM on the Bank Liquidity Reserve and liquidity management at the funding bank level.

The Workgroup's comprehensive efforts not only examined the questions included in the ANPRM, but also thoroughly examined how the existing liquidity framework has guided the System banks through recent market disruptions. The comments in the following paragraphs are intended to address the major areas in question by FCA, but also provide the System Banks' unified position in regard to the regulatory liquidity framework.

<u>**Support for Maintaining the Current Framework**</u>

FCA's liquidity framework was thoughtfully crafted for the System's non-depository funding structure and remains sufficiently robust to address current and unanticipated liquidity risks. The System Workgroup members are unified in their position that the FCA's current bank liquidity reserve regulatory framework is comprehensive, working as intended, and effectively supports the safety and soundness of the System Banks. The framework incorporates the liquidity coverage principles of Basel III as appropriate to the System and provides the System banks with the appropriate capacity and flexibility to withstand market disruptions through prudent liquidity management. Specifically, the current framework has resulted in the following:

- The System banks maintain sufficient capacity to pay their obligations and fund their operations by maintaining adequate liquidity to withstand various market disruptions and adverse economic or financial conditions;
- Strong liquidity management principles are in place at all FCS banks;
- Highly liquid assets are maintained in the System banks' liquidity reserves;
- System banks maintain a three-tiered liquidity reserve-- with the first tier of the liquidity reserve consisting of a sufficient amount of cash and cash-like instruments to cover each bank's debt maturities for 15 days. The second and third tiers of the liquidity reserve contain cash and highly liquid instruments that are sufficient to cover the bank's maturing obligations for the next 15 and subsequent 60 days, respectively;
- System banks maintain a supplemental liquidity buffer that a bank can draw upon during an emergency, which is sufficient to cover the bank's liquidity needs beyond 90 days; and
- Each bank maintains a comprehensive Contingency Funding Plan that incorporates the results of liquidity stress tests.

In addition to the above, FCA's framework includes important core concepts of the other Federal financial regulators' rules, including specific policies and internal controls that mitigate liquidity risk. Accordingly, the ongoing safety and soundness of the System banks continues to be uncompromised, with sufficient levels of liquidity to fund operations through periods of temporary disruption in the funding markets.

<u>Historical Performance & Current Practices</u>

Changes to the FCA liquidity measurement framework are unnecessary given historical performance, and would be immaterial to the banks' risk profile given liquidity levels are maintained well in excess of FCA minimums. System Banks maintain a liquidity reserve in the event debt cannot be issued (i.e. a Farm Credit event). FCA's current liquidity reserve regulatory framework has performed well over many challenging market environments, including the recent market stress from the COVID pandemic and the 2008 financial crisis. The System banks' liquidity management practices ensured reserves would be available if needed. Further, the current liquidity metrics, when coupled with other stress and contingency funding analysis, have proven sufficient to measure and manage liquidity risk.

<u>Funding Bank Response to the Liquidity Event</u>

At the onset of the pandemic, the Farm Credit System Banks and the Funding Corporation were in regular dialogue to monitor and respond to the market situation. The pandemic disrupted the activities of Wall Street firms, which resulted in dislocations to the funding markets, but it lasted for a very brief period before access to the markets was restored. The Banks continued to monitor their individual liquidity needs and made strategic decisions to build excess liquidity out of an abundance of caution and due to the unique nature of the pandemic. While many commercial banks started paring back on their lending activities, the System continued to provide funds to our customers to meet their liquidity needs. Raising additional cash during the onset of the pandemic was the right strategic decision, however, the System ended up not needing any of the additional liquidity and the liquidity reserve (based on the existing liquidity framework) that the Banks had going into the pandemic was never used.

Consistency versus Applicability/Flexibility

While consistency in the regulatory measurement ratios was one of the primary reasons that FCA developed the Basel III capital framework for the System, this issue has not been raised, by System stakeholders, as a concern regarding liquidity measures. By all accounts, in dealing with System stakeholders, including the rating agencies and investors in System securities, System banks have not encountered any misunderstanding regarding the System bank's liquidity, and those stakeholders have expressed appreciation for the System's liquidity management and measurement framework.

Other Regulator's Liquidity Frameworks: Like the FCA, the other Federal financial regulators have developed liquidity frameworks unique to their regulated institutions' industries and marketplace taking into account the unique sources of liquidity risk for each type of institution. For example, the Federal Housing Finance Agency, which regulates three separate GSEs, has also established a liquidity framework tailored for the non-depository nature of those entities. Accordingly, the FCA has appropriately developed a comprehensive liquidity framework tailored for the Farm Credit System and the framework developed has been successfully tested under severe market conditions during the recent COVID pandemic related market stresses.

Consistency in Stress Testing: The stress tests required under FCA's current liquidity framework were developed by each System Bank to reflect the unique dynamics in their Districts. Unfunded commitments are considered and factored in the liquidity management practices as part of the stress testing exercise conducted by the funding Banks. Many of the assumptions, including factors applied to unfunded commitments, are conservative compared to actual draws experienced during periods of market disruptions. Further, the "standardization" of unfunded commitment factors is contradictory when you consider all of the other assumptions embedded in the banks' stress tests (ex., cash flows and prepayment speeds). Factors and other assumptions should reflect borrower characteristics and dynamics unique to the individual Bank Districts.

Analysis of the Basel Liquidity Rules

As part of Basel III financial reforms, the Basel Committee on Banking Supervision (BCBS) introduced a dual framework for global liquidity regulations:

- In 2013, the BCBS released the Liquidity Coverage Ratio (LCR) to promote "the short-term resilience of a bank's liquidity risk profile"

- In 2014, the BCBS released the Net Stable Funding Ratio (NSFR) which "requires banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities" over a 1-year time horizon

The Federal Reserve implemented LCR for U.S. banks in 2014, and finalized the NSFR in 2020.

Summary Comments: The Workgroup's analysis of the Basel Liquidity Rules identified significant problems with applying the LCR/NSFR ratios and framework, which were designed for depository institutions, to the System that has a very different funding structure. The Workgroup gave consideration to the economic, operational, and mission-related implications of adopting this framework in the Farm Credit context.

LCR: There is a great deal of conservatism built into the existing FCA Days Liquidity rule, which has a number of overlapping components with the LCR rule. The Days Liquidity framework is well understood in the System and has a long track record of ensuring the resilience of Farm Credit banks' liquidity holdings in challenging market conditions. The Workgroup questions the supervisory value of adding a second liquidity reporting requirement that has such significant overlap with our existing framework, particularly in light of the implementation challenges identified via our trial exercises.

NSFR: After applying the NSFR framework to our institutions and analyzing the results, the Workgroup concluded these rules should be set aside by FCA entirely, as it is predicated on an institution's ability to take deposits. The workgroup would further argue NSFR's focus on reducing interconnectedness and systemic risk within the banking sector need not be a focus for Farm Credit given: 1) the more limited range of our activities compared to commercial banks; and 2) our low degree of interconnectedness with commercial banks.

Additionally, given Farm Credit's lack of retail funding sources, System banks have a structural disadvantage under NSFR relative to commercial banks, and compliance could force a substantial change in our funding structure and/or loan product offerings to customers. This in turn would result in higher costs, more restrictive loan availability, or a combination of the two for Farm Credit borrowers, while providing no discernable safety and soundness benefit. Implementing NSFR may therefore undermine the System's ability to fulfill its mission over time.

LCR Evaluation: The LCR calculation examines the adequacy of an institution's available liquidity to meet short-term (30 days) obligations under stressed scenarios. Available liquidity is restricted to the highest quality and most liquid assets (termed "HQLA" under the Basel rules). Cash inflows and outflow estimates are overlaid with adverse assumptions, designed to correspond to a period of combined credit and funding stress. Also, it should be noted that the Federal Reserve recently made changes to the Applicability Thresholds for Regulatory Capital and Liquidity Requirements (published November 1, 2019), which resulted in no LCR requirement for banks with less than $250 billion in total assets and less than $50 billion in short-term wholesale funding.

Relevant Considerations for Farm Credit: While the LCR contains certain components which differ from the FCA's current Days Liquidity rule, the FCA's approach requires liquidity buffers to cover a significantly longer timeframe (>90 days versus 30 days). As a general matter, the LCR calculation requires System banks to collect and evaluate further data elements beyond those examined under Days Liquidity, and a number of these elements offset each other in the final ratio computation. Additionally, the categorization of eligible liquidity instruments differs between LCR and Days Liquidity, which would introduce further complexity to the banks' processes for managing and valuing their investment holdings over time.

Highlighted below are costs and undue regulatory burdens that the Workgroup would expect to encounter if the FCA decides to implement LCR as an additional liquidity monitoring requirement for the Farm Credit System.

1. Unique Inflow/Outflow Instruments: The Workgroup noted that Farm Credit banks and associations employ cash management programs that are unique to the System, such as Funds Held, Member Investment Bonds, Investline, H Stock, and similar instruments. These programs have bespoke provisions that constrain dollar values and inflow/outflow timing and which will prevent any "one size fits all" categorization from a regulatory perspective.
2. Secured Lending and Asset Exchange Inflows: Given that the LCR was designed for commercial and investment banks, where collateral may be in securities form, the inflow sub-categories and corresponding haircuts are not appropriate for the type of collateral that generally supports Farm Credit's secured lending transactions.
3. High-Quality Liquid Assets – Caps: The LCR rule imposes caps on aggregate holdings of Level 2A and 2B HQLA securities[1]. Given the more limited range of investment securities permitted to be held in System banks' liquidity buffers, any such caps would be difficult to manage for Farm Credit banks. FCA may need to reconsider all of the current limits on investment activities to ensure sufficient flexibility exists for System banks to manage through periods of marketplace disruption.
4. Industry and Facility Classification – Direct Notes to Associations: Because the LCR rule applies such a wide range of outflow weightings depending on the nature of undrawn facilities and borrower type, a critical decision point for Farm Credit Banks is the weighting applied to undrawn amounts under Direct Notes. The Workgroup concluded that these balances represent credit facilities to non-financial sector entities, given the economic nature of direct notes as pass-through funding conduits to each association's underlying customers. Higher weightings would have a substantial business impact and could likely cause banks to revisit General Financing Agreement (GFA) terms with their associations.
5. Disclosure: The LCR would almost certainly entail expanded disclosure requirements at both the bank and System levels. Material additions to disclosure represent further

[1] Definitions of HQLA on page 2 of https://www.govinfo.gov/content/pkg/FR-2018-08-31/pdf/2018-18610.pdf.

pressure on System resources, as they must be vetted by multiple internal and external parties.
6. Maturity Mismatch Add-On: Existing System bank technology and processes are not configured to calculate the LCR's maturity mismatch amount, adding to the operational and human capital burden associated with any potential LCR implementation.
7. Operational costs: As noted above, LCR calculations require additional data elements and a different treatment of investment holdings when evaluating each bank's liquidity buffer. In order to operationalize these calculations, banks would need to build and maintain new processes for both data capture and reporting. The banks would also have to dedicate resources to implement expanded FCA call reporting requirements and to prepare for new exam guidance and related information needs.
8. CIPA/MAA revisions: Given that System bank capital and liquidity minimums are cornerstones of the Contractual Interbank Performance and the Market Access Agreements, these Agreements would likely have to be revised again to encompass LCR.

NSFR Evaluation: The NSFR rule requires banks to maintain a minimum level of stable funding relative to the liquidity of their assets, derivatives, and commitments, over a one-year period. A covered company's Available Stable Funding (ASF) must be > 100% of its Required Stable Funding (RSF) over that time horizon. Individual asset, capital, and liability categories are assigned haircut factors based on the regulators' assessment of their relative stability. Again, it should be noted that the Federal Reserve recently made changes to the Applicability Thresholds for Regulatory Capital and Liquidity Requirements (published November 1, 2019), which resulted in no NSFR requirement for banks with less than $250 billion in total assets and less than $50 billion in short-term wholesale funding.

Relevant Considerations for Farm Credit: Many of the reasons cited for creating the NSFR are not relevant for Farm Credit given the nature of our activities, funding structure, and economic connectivity with the broader banking system. We also share a number of the concerns highlighted by the commercial banking industry in their public notes and comment letters on the NSFR[2], in particular: potential adverse effect on US loan growth; negative effects on banks' underwriting and market-making activities; lack of measurable safety and soundness benefits; and reduced incentives for inter-bank liquidity support during times of stress.

Underlined below are the rationales and goals that the Federal Reserve, FDIC, and OCC have set forth to justify the need for NSFR for commercial banks. In the observations that follow each underlined point, we note our arguments against applicability of NSFR to the Farm Credit System.

1. The NSFR is primarily designed for deposit-taking institutions and seeks to promote comparability of funding structures among depository institutions via standardized measurement and disclosure requirements. Financial institutions subject to NSFR derive

---

[2] Research note and comment letters from The Clearing House, Barclays, American Council of Life Insurers, American Bankers Association, and joint SIFMA/FSR/TCH et al submission

between 25-65% of their funding from deposits, which in turn receive 90-95% Available Stable Funding (ASF) credit under the proposed rule. Despite the System's high capital levels, Farm Credit's statutory prohibition on taking customer deposits means that our institutions would be structurally deficient in ASF relative to commercial banking peers. Further, because Farm Credit is a cooperative System and not a traditional holding company with financial operating subsidiaries, our funding structure is difficult to compare with depository institutions.

2. <u>The NSFR requirement does not apply to nonbank financial companies designated for Federal Reserve Board supervision</u>. While the Financial Stability Oversight Council retains discretion to recommend an NSFR requirement in the future for large nonbank entities, the Fed would only do so after assessing "the business model, capital structure, and risk profile of a nonbank financial company to determine whether, and if so how, the proposed NSFR requirement should apply …as appropriate"; the Fed clearly recognizes that nonbank lenders warrant tailored treatment and that NSFR may not be appropriate at all for some. We would argue that Farm Credit falls into this category.
3. <u>The NSFR requirement seeks to identify liquidity profiles that are a risk to U.S. financial stability</u>. As a cooperative network of non-bank lenders, Farm Credit is critical to its member-borrowers, but far less so to the payments, interbank lending, and deposit-taking infrastructure that together comprise the broader US financial system. Also, unlike commercial banks, Farm Credit and other Government Sponsored Enterprises (GSEs) benefit from a high level of structurally-driven <1 year funding supply, which reduces liquidity risk over that horizon; this is in part due to certain elements of regulatory reform that have prompted more investors to buy and hold high-quality debt such as ours (i.e., LCR rules; 2a-7 money market fund rules, collateral eligibility at the Federal Reserve Standing Repo Facility).
4. <u>Companies currently covered by the NSFR requirement pose greater risk to U.S. financial stability than smaller banking organizations because of their size, the scale and breadth of their activities, and their interconnectedness with the financial sector</u>. While Farm Credit is modestly large in the aggregate, System banks have little financial interconnectedness with commercial lenders (limited derivatives and repo activities; no direct borrowing/lending relationships; no operational/brokered deposits). Additionally, the range of Farm Credit's lending and investing activities is inherently constrained by both statute and regulation.
5. <u>The NSFR requirement was directed toward large and internationally active banks that were adversely impacted by the 2008 financial crisis and needed to improve planning for longer-term liquidity risks and disruptions to the organization's regular sources of funding</u>. Farm Credit banks each maintain robust Contingent Funding Plans monitored by FCA, and have now also completed testing and operational set-up to enable use of FCSIC's $10 billion contingent liquidity line with the Federal Financing Bank. Furthermore, existing FCA regulations require liquidity buffers which cover a much longer period of time than the comparable LCR rule (>90 days versus 30 days).

Use of Money Market Instruments

In our view, the current FCA regulations already appropriately address the risks of money market instruments and thus should continue to be included in the liquidity reserve. A few additional observations on money market instruments:

1. Consistent with FCA regulations, money market securities must meet eligibility requirements in order to be considered in the liquidity reserve or supplemental buffer. Any eligible investments counterparty, among other criteria, will have a very strong capacity to meet its financial commitment for the expected life of the investment and must exhibit low credit risk. Investments that at any time do not meet the eligibility criteria are excluded from the liquidity reserve calculations.
2. For liquidity reserve calculations, FCA already segments and differentiates the quality of money market instruments according to their maturity (Level 1: Overnight, Level 3 maturing within 90 days, Buffer -> money market securities with maturities greater than 90 days, but less than 1 year). Securities in each of these segments are subject to material market value discounts ranging from 1% to 10%.
3. FCA investment regulations have guidelines to reduce concentration risk within investment portfolios, including for money market instruments (although money market is exempt from the asset class limits, regulatory liquidity reserve and other investment diversification requirements – i.e. maturities, industries, geographic areas, and obligors - help limit concentration risk).
4. Historically, money market securities experienced very low credit losses during periods of liquidity crisis.
5. Money market instruments provide maturity diversification and reduces the market risk of the liquidity reserve. Their self-liquidating nature reduces reliance on sale during periods of liquidity crisis.
6. Federal Reserve acknowledges the important role of the money market instruments and considers them to be eligible collateral for their Discount Window Program.
7. Money market instruments are eligible to be pledged towards the contingency liquidity line between FCBs, FCSIC and FFB.

In addition, individual institutions have additional investment guidelines and limits to reduce the risk of this asset class within their liquidity reserves.

Summary

In summary, enhancements to the liquidity framework may be well-intended, but the workgroup consensus is that enhancements to the regulatory framework would not materially improve the System's "safety and soundness" without creating undue burden and operational inefficiencies. In general, the costs clearly outweigh the benefits of updating FCA's Bank Liquidity Reserve framework. Any needed enhancements to individual System bank's liquidity management programs can and should be handled through the examination process.

The System Workgroup members are unified in their position that the FCA's current bank liquidity reserve regulatory framework is comprehensive, working as intended, and effectively supports the safety and soundness of the System Banks. The LCR and NSFR ratios and related requirements were designed for depository institutions, are not a good fit for the System banks, and costs would greatly exceed any perceived benefit. Accordingly, we respectfully ask the FCA to maintain the current regulatory framework and work closely with this Workgroup prior to developing a proposal to change the existing bank liquidity reserve framework.

Respectfully,

Todd Van Hoose, President & CEO
Farm Credit Council