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Ms. Laurie A. Rea
Director, Office of Secondary Market Oversight
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Subject: Advance Notice of Proposed Rulemaking
Farmer Mac Risk-Based Capital Stress Test – 76 FR 35138

Dear Ms. Rea:

CoBank appreciates the opportunity to comment on the Farm Credit Administration's (FCA) Advance Notice of Proposed Rulemaking (ANPRM) on the Federal Agricultural Mortgage Corporation's (Farmer Mac) Risk-Based Capital Stress Test (RBCST). The issues identified by the FCA are critical to Farmer Mac's safety, soundness, and effective regulatory oversight. We also support the comments on this subject provided by the Farm Credit Council.

CoBank submits that the threshold issue is the required level and quality of capital at Farmer Mac. As a result, FCA needs to consider the appropriateness of Farmer Mac's overall capital standards as it works to eliminate Nationally Recognized Statistical Rating Organizations (NRSRO) ratings from the RBCST. It is critical that the amount and quality of Farmer Mac's capital reflect its inherent risks exposures in a manner consistent with the capital standards applied to other regulated investor-owned financial institutions. An appropriate way to approach Farmer Mac's capital standards is to implement a BASEL compliant capital framework.[1] We offer our comments to help identify issues and approaches for FCA's consideration as it refines Farmer Mac's RBCST, enhances business planning requirements, and safeguards agricultural and rural credit markets.

Overall Comment

The FCA must reconsider Farmer Mac's capital standards in light of statutory and RBCST requirements that allow significant leverage when compared to other lenders. While we applaud the rigor around FCA's insistence on strong capital levels at Farm Credit banks and associations to avoid adverse consequences of excess leverage, we suggest FCA take a similar approach with Farmer Mac. For this reason, FCA must reconsider current implementation of statutory and RBCST requirements that appear to allow significant leverage at Farmer Mac. Farmer Mac's capital standards should be consistent with those applied to other regulated investor-owned financial institutions. Fundamentally, Farmer Mac's risk exposures are no different than those of these lenders. For these reasons, we ask FCA to modify its regulatory requirements to implement requirements that are consistent with the capital standards applicable to regulated investor-owned banks under a BASEL compliant capital framework. We believe Section 8.11(a) of the Farm Credit Act provides FCA sufficient flexibility for implementing such a requirement. If FCA concludes otherwise, it should seek legislative authority so it can have unfettered ability to set Farmer Mac's capital standards.

[1] See Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010) at www.bis.org/publ/bcbs189.htm and 12 CFR Part 615.

Proud Member of the Farm Credit System

Under the Farm Credit Act (Act), Farmer Mac has been allowed to hold less capital under the theory that as a secondary market provider it is a lower-risk entity. Farmer Mac's evolving business practices, our observations and the recent financial market crisis do not support this conclusion. In fact, we see a fundamental misalignment of interests in Farmer Mac's hybrid Government Sponsored Enterprise (GSE) business model that incents risk taking to maximize profits in conflict with its public mission. Over time, this business model has led Farmer Mac to grow on-balance and off-balance sheet risk positions, concentrate servicer risks, offer a complex credit default product, and use highly structured third-party capital. In total, these aspects make Farmer Mac's business complex from both a risk management and capital standard perspective.

Our overall comment effectively addresses FCA's questions regarding the removal of NRSRO ratings from the RBCST. We agree that NRSRO ratings should be eliminated from the RBCST. When removing these ratings, FCA should use the principles and approaches established by the BASEL capital framework as a guide. The end result should be regulatory requirements that create parity in capital standards, both in quality and quantity, between Farmer Mac and regulated investor-owned financial institutions. This ensures that like risks are capitalized in a like manner. We will also provide suggestions for business planning and briefly highlight our concerns with Farmer Mac's current legislative proposal.

Elimination of NRSRO Rating

We generally agree that the RBCST should not rely on NRSRO ratings since they are not consistent with the spirit of a capital stress test envisioned by the Act. The statutory RBCST was meant to reflect stressful events to capture risks in an adverse economic environment. The current use of NRSRO ratings does not reflect that intent. While the current approach uses NRSRO ratings in a manner that effectively reduces earnings, the net effect results in no capital charge for investments and counterparty risks in the RBCST. Recognizing losses on investments and counterparty exposures by establishing specific capital requirements would be a more appropriate and transparent approach.

When FCA removes NRSRO ratings from the RBCST it should change the treatment of credit enhancements and investments. For credit enhancements, no benefit should be given to enhancements provided by originators, including for AgVantage bonds. The financial crisis demonstrated how quickly credit enhancements evaporate during an economic downturn. Assuming that such enhancements are available to Farmer Mac during economic downturns is not consistent with the concept of a capital stress test. For investments, reliance on NRSRO ratings proved inadequate to keep Farmer Mac from experiencing extensive losses associated preferred stock and corporate debt holdings during a significant economic downturn. We note that the NRSROs reaffirmed Lehman Brothers investment grade rating days before it failed, thereby causing significant losses for Farmer Mac. We suggest the RBCST be modified to calculate a capital charge based on the type of investment as is done under the BASEL capital framework.

Capitalization of Farmer Mac's Business Model

The recent financial crisis demonstrated that thinly capitalized financial institutions lacked the capital wherewithal to survive market disruptions and credit quality downturns. It also demonstrated the weaknesses of the hybrid GSE ownership model. A hybrid GSE ownership model is one with publicly traded common stock creating market pressures for growth and short-term returns, a long-term public policy mission to serve a target group that differs from a significant portion of the common stockholders, and specific backing by the federal government.

In the case of the housing GSEs – the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) – the U.S. Department of the Treasury (Treasury) observed their hybrid ownership model led to excess benefits to private shareholders during good times and exposed the U.S. taxpayer to significant losses during the economic recession.[2]

Farmer Mac essentially has the same hybrid GSE ownership model as Freddie Mac and Fannie Mae had before they were taken over by a conservator. Currently, Farmer Mac issues Class A voting and Class C nonvoting stock that is traded in the public equity markets.[3] A significantly larger portion of the profits Famer Mac generates accrues to these private holders of its publicly traded stock; including its board and executive management, rather than the beneficiaries targeted by its public policy purpose. Similarly, the Treasury is required to provide up to $1.5 billion to Farmer Mac if financial difficulties prevent it from honoring commitments on guaranteed securities. As a Farmer Mac shareholder, we do not believe that its hybrid GSE ownership model should be allowed to persist and FCA should seek a legislative fix. Regardless of Farmer Mac's ownership structure, FCA should hold Farmer Mac to capital standards that are compliant with the BASEL capital framework. We feel that this level of capitalization would provide the minimum level of protection owed to the U.S. taxpayer.

Capital Consideration for Balance Sheet Assets and Equity Positions

Farmer Mac's on- and off-balance sheet assets and equity positions may result in risk exposures not appropriately capitalized under the current standards. We see Farmer Mac growing its on-balance sheet positions, concentrating servicer risks, offering complex credit default products, and using highly structured third-party capital. Our perspective is that these issues collectively increase risk and, therefore, need to be addressed by FCA. We will now discuss these and other relevant factors.

Farmer Mac's original purpose was to securitize high-quality, first-lien, agricultural mortgage loans consistent with a market-based single obligor exposure limit. As a secondary market securitization entity, Farmer Mac's balance sheet and capitalization were not intended, nor structured to maintain substantial hold positions for prolonged periods. In our opinion, since its inception in 1987, Farmer Mac has not sustained an active securitization market for qualified loans it has purchased or guaranteed. More recently, it appears to us that Farmer Mac is adding exposures with uncertain marketability in a secondary market. As a result, we see Farmer Mac retaining loans, loan guarantees, and AgVantage bonds. In combination, these positions represented about 58 percent of Farmer Mac's total program business at March 31, 2011. As a result, Farmer Mac has become a portfolio lender like many other lenders in rural America, and it should be capitalized accordingly.

Farmer Mac's board has placed sensible limits on the amount of single obligor exposure, which helps reduce risk in the retained portfolio. It is reasonable from a risk management perspective to be comfortable with these hold limits for loans protected by first lien positions in agricultural land. Historically, we have viewed that these two factors, limited single obligor exposure and first lien positions on agricultural land, as key criteria in managing with Farmer Mac's risk exposures. However, Farmer Mac appears to be seeking to increase hold limits for loans not protected by such first lien mortgage positions. Any increase in hold limits or elimination of first

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[2] March 23, 2010 Secretary Timothy F. Geithner Written Testimony House Committee on Financial Services, www.treasury.gov/press-center/press-releases/Pages/tg603.aspx

[3] By law, System institutions can acquire Class B voting stock, which is not publicly traded.

lien security would be problematic given the RBCST is not designed to limit excess concentrations. For agricultural mortgages, the RBCST effectively caps losses and related capital for large loans due to the statistical boundaries inherent in the credit loss model. With respect to rural utility loans, the RBCST appears to be relatively insensitive to loan size. For investments, the ratings-based approach failed to capture significant risk concentrations resulting in losses that nearly caused Farmer Mac's failure, avoided only through an emergency capital infusion from FCS institutions and others. For these reasons, we believe that potential increases in existing hold limits would create excessive risk concentrations.

Today, nearly 19 percent of the originations and related servicing for Farmer Mac's program business is carried out by a single, unregulated financial institution. The recent financial crisis demonstrated that mistakes by loan originators can generate risks that can far exceed expected levels identified by financial models. Secondary market operators are vulnerable to servicer risk as shown by the impact on Fannie Mae and Freddie Mac when servicers went out of business and negated any "put-back" provisions. Similar provisions are currently in use at Farmer Mac. FCA should consider appropriate risk mitigating controls for servicer risk, such as concentration limits and, as already emphasized, capital standards that mirror the requirements of investor-owned regulated financial institutions.

Farmer Mac appears to be guaranteeing and participating in larger loans with more complex structures. As there is a limited market to securitize participations for sale to third parties; an expanding business focused on retaining participations on-balance sheet will merely bring increased risk exposure to Farmer Mac.[4] In addition, these types of loans are frequently subject to master and/or shared collateral and inter-creditor agreements that are far more complex to manage in the event of default and present risks unrelated to smaller, first-lien mortgage loans. Farmer Mac may also be holding a relatively small interest in overall large loans and have limited, if any, creditor voting rights and influence on the servicing. Farmer Mac's existing capital standards were not designed for these loan types, which increases the importance of establishing new capital standards for Farmer Mac.

Farmer Mac has developed a form of credit default protection known as long-term standby purchase commitments. For this product, a primary lender makes a loan and pays a fee to Farmer Mac to guarantee against borrower default. Farmer Mac's ability to provide these guarantees in a cost-effective manner is based on its low capital standards for off-balance assets. From our perspective, this situation results in a capital arbitrage opportunity that could lead to systemic undercapitalization of risk within the agricultural and rural credit markets. A simple solution is to make Farmer Mac's capital standards equivalent to those of regulated investor-owned financial institutions.

To ensure an adequate quality of capital, FCA should implement a minimum required level of retained earnings and common stock at least equal to other regulated investor-owned financial institutions of both on- and off-balance sheet assets, potentially on a risk-adjusted basis. In our view, Farmer Mac should not be permitted to continue with its existing lower quality of capital. Farmer Mac's capital position is made up of 61 percent of preferred stock, with $242 million in the form of non-controlling interest preferred stock. According to Farmer Mac's March 31, 2011, quarterly report, this preferred stock is collateralized by Farmer Mac II program assets, which are unavailable to creditors until retirement of this stock. We believe non-controlling preferred

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[4] Just like other regulated lenders, Farmer Mac's on-balance sheet program assets and loan participations expose it to variety of risks beyond credit risk, which should be capitalized in a similar manner.

stock would not be permitted to be counted as high-quality capital under the standards applicable to commercial banks or the System. In our view, Farmer Mac's capital quality should be held to the same capital quality standards of other regulated investor-owned financial institutions.

Business and Capital Planning

FCA should require that Farmer Mac's capital plans reflect the risk being undertaken by the institution rather than focusing on compliance with existing statutory and regulatory requirements. In our view, the statutory capital standards were established to support Farmer Mac's original securitization model, which anticipated the majority of risk would not remain resident on Farmer Mac's balance sheet beyond a short period of time, is no longer applicable to its current business practices and related risk exposures. On-balance sheet assets exposure Farmer Mac to risks beyond credit risk and are similar to the risk exposures of other regulated lenders. Farmer Mac is required to hold 75 cents of capital for each $100 of off-balance sheet program volume and $2.75 for each $100 of on-balance sheet volume. FCS and commercial bank lenders are required to hold much higher levels of capital to cushion against the same risks that Farmer Mac is undertaking today. For instance, FCS lenders are required to hold at least $7 of capital for each $100 of loan volume. All FCS lenders, in practice, operate at $12-$16 of capital per $100 of loan volume.

FCA business and capital planning regulations should recognize that similar risks should be capitalized at similar levels, irrespective of the type of financial institution. Therefore, it would be appropriate for Farmer Mac to calculate and disclose the capital it would be required to hold under a fully implemented BASEL compliant capital framework. At a minimum, Farmer Mac should calculate Tier 1 capital, Tier 1 common equity, leverage, and liquidity measures. From our perspective, enhanced disclosure may allow shareholder and investor groups to better understand the risks of Farmer Mac's business operations in a transparent and comparable manner. We also support FCA's efforts to enhance Farmer Mac's business planning requirements to include marketing and human capital plans that address diversity and inclusion. However, we think the regulatory requirements should be simple and flexible. In this regard, our comment letter dated July 25, 2011, on FCA's business planning proposed rule for System institutions effectively responds to the business planning question posed by the ANPRM.

Farmer Mac's Legislative Proposal

Farmer Mac has informed us that it is seeking a significant expansion of its lending authority through a legislative proposal. Farmer Mac provided the details of its legislative proposal to some FCS institutions as well as to the Administration and certain members of Congress and rural interest groups. At its core, the proposal seems to result in a dangerous accumulation of loan assets at Farmer Mac, particularly given its relatively low statutory capital standards. Here again, private investors would realize significant profits while the public, through Farmer Mac's direct credit line with the U.S. Treasury and implied government backing, would bear the burden of failure. Importantly, Farmer Mac's statutory capital standards do not reflect the risk the type of loan asset contemplated in the expanded authority proposal. As a Farmer Mac shareholder, we are opposed to the Farmer Mac legislative proposal and we encourage FCA to consider the significant risk it presents to U.S. taxpayers and to rural credit markets. If Farmer Mac is successful with its legislative proposal, FCA must have the statutory flexibility to set capital standards that are consistent with the BASEL capital framework.

Conclusion
Thank you for the opportunity to comment on this important issue. We believe FCA needs to modify its regulations, including its Farmer Mac RBCST, to accommodate the lessons learned during the recent financial crisis. FCA should adjust its Farmer Mac regulatory requirements to ensure that the risks borne by Farmer Mac are capitalized at appropriate levels. As recent experience has shown, when risks accumulates within a hybrid GSE ownership model, there is a significant increase in the likelihood for need of government support in the event of portfolio losses or an economic downturn. We are confident that no one in the Administration nor in Congress wishes to repeat the mistakes of the housing GSEs and thrust another burden on the U.S. taxpayer.

Respectfully,

Robert B. Engel

Robert B. Engel
President and Chief Executive Officer