FARM CREDIT BANK OF TEXAS

February 27, 2012

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

Re: Proposed Rule on Liquidity and Funding – RIN 3052-AC54; as published in the December 27, 2011 Federal Register.

Dear Mr. Van Meter:

The Farm Credit Bank of Texas appreciates the opportunity to submit these comments on the agency's proposed rule amending its liquidity regulations as published in the Federal Register December 27, 2011. We participated in the development of the comments submitted by the Farm Credit Council on behalf of its membership and strongly support those comments. Because of the importance of these proposed regulations, we are submitting these separate comments to emphasize several issues that give us particular concern.

General Comments

First, from a general perspective, we believe that the proposed liquidity regulations are simply too detailed and prescriptive compared to the more principles-based approach taken by the other bank regulators. We agree that liquidity is an extremely important topic and that an institution's liquidity position needs to be continually reviewed and updated to ensure that appropriate risk management strategies and controls are in place. The proposed regulations, however, by striving to anticipate a wide range of risks and prescribing specific content for policies and new board responsibilities to address those risks, do not account for the fluid and changing nature of the financial markets in which System institutions must manage their liquidity positions. For that reason, if these regulations are adopted as currently written, they are likely to prove unwieldy, or even unworkable and counterproductive to FCA's stated objective of bolstering the ability of System banks to fund their obligations and continue their operations during times of economic, financial or market adversity.

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We urge FCA to reconsider its overall approach given that the existing regulatory framework, together with the System banks' voluntary efforts to revamp liquidity practices, allowed the System as a whole to weather the liquidity/market crisis of the last several years with relatively small losses on investments. During the most recent crisis, the Farm Credit banks, which had already maintained relatively high levels of liquidity compared to other financial institutions, responded by adjusting their strategies on a variety of fronts to further enhance their liquidity. For example, debt maturities were adjusted; loan pricing was increased to reflect reduced ability to issue longer term debt; high quality cash and Treasury securities were added to the liquidity portfolio, and the overall amount of liquid assets was increased. It was this flexibility that allowed the banks to manage liquidity effectively without being burdened with multiple layers of regulations. In a future crisis, different actions may need to be taken, and the flexibility to change strategies as circumstances warrant will best be provided by a principles-based approach to liquidity regulation.

Liquidity Policy Content

Generally speaking, we believe that liquidity strategies must be dynamic in that management needs to be able to address changes in strategy without board approval as long as management remains within the risk tolerance guidelines established by the board. The detailed content of the policy section of the proposed regulation and responsibilities imposed on the board seem to be inappropriately merging the responsibilities of the board to set policy parameters and the responsibilities of management to establish daily best practices and operational procedures. This becomes especially apparent when the proposed regulation is read together with the agency's commentary in the preamble. For example, the regulation simply requires the policy to address diversification requirements for the liquidity portfolio. In describing this requirement, however, the commentary explicitly states that the policy must address the board's desired mix of cash and investments that the bank should hold under a variety of scenarios and must establish criteria for diversifying assets based on issuers, maturity, and other factors. These are the sort of specific matters that can and do change on a daily basis requiring management to respond. They should not be embedded in a policy that cannot be changed in a timely manner as an adverse scenario unfolds, yet the commentary seems to contemplate that the policy should be detailed enough to eliminate the need for management to exercise judgment in any particular situation. Instead, we feel the board should establish the bank's risk appetite and approve appropriate policy limits, while management should develop procedures and strategies to implement the board's policy.

We also take issue with FCA's commentary concerning the purpose and objectives section of the liquidity reserve. The FCA's commentary suggests that it is inappropriate for GSEs to generate positive earnings from a liquidity portfolio. While maintaining high levels of liquidity has its costs, we believe that a liquidity portfolio should not be designed to lose money. Certainly, the first priority is to build a front-line defense of the highest quality, and most likely lowest-earning, liquid investments as an emergency source of funding. Even so, generating positive earnings from the portfolio is a complementary and necessary part of the overall liquidity strategy. Once the first two tiers of protection are established, banks should have the flexibility to manage the supplemental liquidity buffer as they see fit, potentially accepting incremental risk for return, while remaining within the eligible asset guidelines, in order to offset the costs of holding the pristine liquid assets in tiers 1 and 2 as proposed by FCA. This flexibility is necessary to ensure that holding high levels of pristine liquidity will be sustainable over the long term. Furthermore, FCA has not explained why the generation of earnings is not appropriate for System banks when it has allowed Farmer Mac to maintain an investment portfolio for the purpose of generating earnings.

The regulation's requirements that the liquidity policy address diversification, composition, maturity limits and credit quality standards for the liquidity portfolio are redundant to the requirements laid out in the proposed investment management regulations. In addition, while it is appropriate to establish a policy with a days-of-liquidity target, the recommendations centered around developing the target, specifically in regards to identifying an adverse scenario, are unnecessary. The core liquidity guidelines are already developed with the mindset of withstanding an adverse scenario, thereby making it unproductive and unnecessary to spend additional time to try to identify other random and unlikely adverse scenarios. Even more inappropriate is the assignment of this task to the board. Management should be responsible for the development of strategies, procedures and practices to manage liquidity, with the board function centered on review and approval.

Also, the proposed language in regards to the development of a contingency funding plan (CFP), seem to require the entire CFP be documented within the liquidity policy. While the policy should require the development of an effective CFP, we believe that the detailed operational procedures should not be documented in a policy. Operational changes could be required from a best practices or practicality standpoint as seen fit by management that have no impact on the safety and soundness of the overall CFP, but if part of the overall policy, would require review and approval by the board.

Liquidity Reserve/Marketability/Supplemental Liquidity Buffer

With respect to the structure of the liquidity reserve and supplemental liquidity buffer, we believe that the voluntary internal guidelines for managing liquidity that the System banks have worked together to develop already represents a "best practice" for the Farm Credit System. For the most part, we agree that the policy limit recommendations of the proposed liquidity regulations are reasonably close to the System banks' voluntary guidelines which include a 15-day pristine liquidity component, an additional 30 days of high quality liquidity, and all other investments included to meet the current regulatory minimum of 90 days coverage with all the banks mutually agreeing to hold a minimum of 120 days and, in practice, actually holding much more. The proposed regulations, however, would introduce a significantly greater level of complexity and uncertainty to the banks' liquidity management that does not clearly contribute to the strengthening of the System bank's liquidity.

One example where the overly detailed nature of the proposed regulations may fail to contribute to the strengthening of the System banks' liquidity is the preamble statement that "FCS banks would first draw on the 15-day sub-level in the event of significant stress." The required draw-down of the 15-day sub-level of investments prior to any draw-down of other categories of investments during an event of significant stress may not necessarily be the best route for a System bank to take at the particular time. A bank may want to hold its most pristine liquidity assets in reserve in anticipation of more difficult market conditions in the future, or there may be other factors favoring sale of other investments, but the regulation would demand another course. Rather, the banks should have the flexibility to determine which assets would be the best to draw on at any specific time.

In particular, we question the proposed regulation's approach to "marketability" as the key test of the eligibility of investments for inclusion in the liquidity reserve. The FCA's commentary regarding the requirement that investments in the liquidity reserve be "marketable" speaks in terms of setting specific benchmarks for determining marketability. In fact, it is not necessarily feasible to set specific benchmarks of marketability, since the market will determine what is marketable at a given time. While we appreciate FCA's consideration of the concepts the Basel Committee articulated in the Basel III Liquidity Framework, we note that Basel III and the Federal banking agencies did not explicitly define the term "marketable" nor did they establish explicit requirements for a determination of marketability, but instead, they identified the fundamental factors and market characteristics to be considered when evaluating an asset's marketability. It is also important to note that all investments that are eligible for System banks to purchase are liquid and marketable under various economic scenarios and timeframes. Depending on the event or environment, any eligible investment categorized as "available for sale" at fair value should be available to System banks to sell as they determine necessary. Therefore, the supplemental liquidity buffer should encompass all unencumbered eligible investments, not just those that are "qualified."

Further, the proposed rule that states "each FCS bank must be able to liquidate any qualified investment in its supplemental liquidity buffer within the timeframe established in the bank's liquidity policies at no less than 80 percent of its book value" should be eliminated. The proposed 80 percent requirement is completely arbitrary, unnecessary, and inappropriate. It is important to recognize, particularly given the exceptionally low interest rate environment over the past few years, that movements in interest rates alone could cause an investment's market value to drop below 80 percent. The proposed requirement implies an asset would no longer be liquid based on a 20 percent drop in value. In fact, there may be absolutely no change in the investment's marketability relative to other available types of investments in this scenario. Under these circumstances, there would be no reasonable basis for removing the investment from the liquidity portfolio. We therefore cannot identify sound support or substantiation for this requirement and request that FCA eliminate it from the proposed regulation entirely.

With respect to FCA's solicitation of comments on whether the proposed rule should specify a time horizon for the supplemental liquidity buffer, we do not believe that a specific time horizon would be helpful. At a certain point, if the System banks cannot access the markets, the System will not be viable. Because the System is a GSE, it does not have all the same funding sources that are available to commercial banks, nor does the System have a guaranteed lender of last resort. As a result, at some point, depending on the circumstances, no amount of assets is enough to ensure the System's liquidity. Given the conservative nature of the liquidity guidelines which are already structured to prepare the System for a stress scenario, providing additional stress scenarios or specific timeframes for the supplemental liquidity buffer does not add any value to the management of the liquidity portfolio.

With respect to the contingency funding plan, although we understand the value of stress testing, we don't see a lot of added value to the proposed regulation's requirements for specific multiple stress case scenarios. These additional stress scenarios are redundant to those already required by the investment management regulations and do not add value. Additionally, the sort of cash flow analysis specifically required to be addressed in the CFP by the proposed regulation is more appropriate for commercial banks, trust banks, investment banks and similar financial institutions, and is not very valuable for Farm Credit banks. System banks' primary cash flow need is to repay debt as it comes due and to fund asset growth. As such, cash flows generated from existing assets are not generally considered to be a primary source of funds.

Reservation of Authority

While we certainly understand the FCA's concern about its responsibilities to ensure the safety and soundness of all FCS institutions, and agree that adequate liquidity is vital to that safety and soundness, we believe that the reservation of authority in the proposed section 615.5134(i) is over-broad and misconceived. As written, it appears to give the agency license to change any of its liquidity standards and requirements at any time without notice to regulated institutions. System banks would not be able to rely on the regulations to guide their liquidity practices because these regulations could effectively be changed at any time. The agency has clearly proposed this provision contemplating that there may be an emergency that calls for decisive action, but it is precisely in these circumstances where the actions FCA has described are likely to be contrary to the needs of System banks that are in the position of having to utilize their liquidity portfolios while normal market access is impossible. We urge FCA to re-think this proposal.

Conclusion

In essence, we fundamentally believe that the liquidity regulation should, first and foremost, grant System banks the flexibility they need to manage their liquidity positions effectively. While well-intentioned, we fear that the proposed regulations are overly complex and will result in a significantly greater administrative burden without a corresponding improvement in the System's ability to respond to adverse market conditions. Once again, we greatly appreciate the agency's consideration of our comments to the proposed rule.

Sincerely,

Amie Pala

Amie Pala
Chief Financial Officer