FARM CREDIT BANK OF TEXAS

November 16, 2011

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

Re: Proposed Rule – Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations: Investment Management – 76 FR 51290

Dear Mr. Van Meter:

We thank you for the opportunity to submit comments on the proposed rule on investment management the Farm Credit Administration (FCA) published in the August 18, 2011 edition of the Federal Register. Although we have participated in the development of the comments to this proposed rule submitted by the Farm Credit Council and, with the exception noted below, fully support those comments, the significance of the proposed rule is such that we wish to add our individual comments on certain sections.

§ 615.5132 – Investment Purposes

Treasury Securities and the 35% Limit:

In the preamble to the proposed rule, FCA states its belief that the current 35% limit would continue to provide sufficient flexibility for System institutions to maintain adequate liquidity. We agree with the Farm Credit Council's comments in that we think that the 35% limit would be sufficiently flexible if Treasury securities are excluded from the calculation of the 35% limit. During times of economic stress, Treasury securities have proven to be the most liquid and marketable assets next to cash. However, there is a natural disincentive to hold excess levels of cash and Treasuries given the relative cost of this form of liquidity. During periods of economic stress, System institutions should have the flexibility to increase their liquidity positions as deemed necessary without having to forgo other high quality, better yielding investments. Therefore, it is the bank's position that Treasury securities should be treated in a manner similar to cash and excluded from the 35% investment limit.

§ 615.5133 Investment Management

§ 615.5133(a) - Responsibilities of the board of directors:

We agree with the requirement for strong board oversight of the investment function; however, we do not feel the designation of a special board committee is necessary to ensure sound oversight. We understand FCA's intent to be simply to allow the creation of such a committee rather than to recommend the creation of a special board committee as a best practice. We support granting System institutions the flexibility to create a designated board committee, but do not support any requirement to create such committees.

§ 615.5133(c) - Investment Policies – Risk Tolerance:

The sections covering investment policies and risk tolerance are extremely prescriptive and detailed. While most sections represent reasonable expectations of which most are currently standard practice for the system institutions, a few items require special comment:

§ 615.5133(c)(1)(ii) - Criteria for selecting securities firms:

As with § 615.5133(a), this provision also makes reference to a designated board committee. We reiterate our understanding that FCA merely intends to permit special board committees to perform these functions, but does not intend to require the creation of such committees.

§ 615.5133(e) - Internal Controls:

We believe that the proposed regulations are overly prescriptive with respect to certain internal controls. For example, while the increased detail that has been proposed in regards to segregation of duties and specific personnel is most likely representative of the practices already in place at System institutions, there are instances where the level of simplicity of the investment, or composition of staff, could warrant the overlapping of functions. Instead of prescribing additional specific categories of employees who must be separated from the execution of investment transactions, the regulations should include a broader requirement stating the institution's need to evaluate and adopt policies and procedures that reflect "best practices" for segregation of duties appropriate to the complexity and risk of the institution's investment operations. Management should then be responsible for ensuring day-to-day operational aspects are governed through these policies and procedures. Also, the proposed requirement for annual review by internal audit is too prescriptive and may be unnecessary in some circumstances. The proposed requirement for annual audits should be replaced with a general requirement for audits to be performed periodically, as deemed necessary, based on internal audit's development of its own internal risk-based approach. Depending upon the nature and extent of an institution's investment activities, an annual audit may not actually be warranted.

§ 615.5133(f) - Due diligence to determine eligibility, suitability and value of investments:

The proposed regulatory requirements in regards to eligibility, suitability and value of investments should consider the type of security evaluated. For some types of securities, depending on the complexity and type of investment, an adequate level of due diligence can be performed at the sector level of the security as opposed to the individual level of each security. While credit risk, market risk, liquidity risk, cash flow analysis and underlying collateral risk should be evaluated for certain investments, such as mortgage-backed securities; we believe that this level of analysis would be excessive and unduly burdensome for other security types with minimal price sensitivity due to their short term structures and readily determinable cash flows, such as, Treasuries, commercial paper, and fed funds.

We would recommend excluding these types of securities with low price sensitivity from the requirement for pre-purchase stress testing of all individual investments. While we agree that pre-purchase stress testing of certain types of individual investments may be helpful in identifying which particular investments may be the primary drivers of potential risk, non-amortizing, bullet-type structures with maturities of 1 year or less do not present the level of risk that warrants the burden of individual investment stress testing analysis prior to purchase. We do not believe that a robust testing environment requires stress testing of all individual investments if it would increase compliance cost without creating information that is actually useful to risk management decision-making.

We do agree that an appropriately structured and documented quarterly stress test can provide useful information on capital, earnings and liquidity risk relative to changes in the market value of the entire portfolio of investments. Further, the parameters an individual System institution sets for the quarterly stress testing analysis of its entire investment portfolio as a whole should be sufficient to analyze the level of risk contributed by investments.

§ 615.5133(g) - Reports to the Board of Directors:

This area of the proposed regulations adds new prescriptive requirements to the already overly detailed requirements of the existing regulations. Because it encourages a "check-list" approach to compliance, an unduly prescriptive regulation can result in over-reporting of unnecessary or duplicative information or the omission of important information. While more detailed reporting is appropriate at the level of the Asset Liability Management Committee (ALCO), it should be up to the board and management to determine the type of reporting that is made to the board. Reporting to the board needs to be flexible enough to encompass emerging best practices and the identification of risk as markets change.

Investment Plan and Investment Oversight Committee: While we realize it is not a regulatory requirement, the FCA's recommendation that each System institution should develop an investment plan and establish a formal investment oversight committee is unnecessary. FCA has cited no evidence supporting superior benefits of a detailed investment plan implemented by an investment management committee compared to current processes in place in most System institutions. FCA asserts that such a committee would provide additional expertise, but from our bank's perspective, the individuals who would serve on the formal investment oversight committee would be the same individuals currently serving on the bank's ALCO. The fact that the individuals on the proposed committee would most likely be the same ones as are currently performing investment operations calls into question whether the committee would actually provide much benefit in terms of separation of duties. In addition, while many of the FCA's recommendations in regards to a formulated plan are already in practice and addressed in the bank's current ALCO and board reporting practice, the recommendations regarding portfolio performance, specifically as it relates to spread targets, is inappropriate. Spread levels are going to be dynamic and based on risk tolerance levels specific to each bank's strategy as well as heavily dependent upon market conditions.

§ 615.5140 – Eligible Investments:

Given the FCA's proposal to increase requirements in regards to due diligence and the overwhelming evidence demonstrating that the current investment portfolio limitations were effective at mitigating excessive losses during the recent financial market crisis, some of the proposed changes in portfolio sector limits are unnecessary and unduly restrict the flexibility System institutions have in managing the overall investment portfolio.

§ 615.5140(a) - Treatment of Mortgage Securities:

The proposed recommendations to reduce the non-agency mortgage-backed securities (MBS) limit to 10% from 15%, reduce the ABS limit from 20% to 15% and eliminate commercial MBS entirely are arbitrary. System institutions need the ability to diversify their portfolios to manage risk. Further, the recent financial crisis has led to the market availability of additional protection from both a credit enhancement and overall structure design perspective that could represent potential purchase opportunities in high quality, liquid, non-agency MBSs, commercial MBSs and ABSs.

The bank does not support FCA's proposed collateral-type limitations on ABS securities. The bank needs the ability to manage its portfolio based on risk and current market conditions. There will be times when particular sectors are more favorable than others based on structure and/or the nature of the underlying collateral. A good illustration of such a time is when, during the recent financial crisis, the mortgage market was experiencing high defaults, prime auto ABSs performed well because borrowers were willing to pay their auto loans rather than make mortgage payments on property that had lost significant value. By imposing additional diversification limits within the ABS sector by collateral type, the proposed regulation could drive System institutions to invest in less pristine collateral types, which would be counter-productive from a regulatory perspective.

In light of these considerations, we believe that FCA's regulations should continue to provide for a broad range of asset classes to be available to the System for purchase, provided that all due diligence requirements are met in evaluating purchases. Therefore, we recommend that FCA leave the existing non-agency MBS and CMBS, as well as the existing ABS limits at their current levels, allowing System institutions the necessary flexibility to manage their overall portfolio risk while still adhering to guidelines that have proven effective during a time of financial market stress.

We also recommend that the proposed regulatory language in regards to the "senior-most" position be refined. While the language specific to "no other remaining position in the securitization has priority in liquidation" would be an acceptable means to identify a senior position; the FCA's second requirement for determining a senior position in contractual cash flows should be removed. Investors in the marketplace, including System institutions, typically seek to match the timing of the cash flows of their assets and liabilities. Consequently, there are times when a second pay sequential, or a PAC bond, may not be the first priority in regards to contractual cash flows, but meets the investor's preferred target structure even with planned cash flows scheduled for a future period. From this standpoint, what is important to an investor seeking a senior position is not whether its contractual cash flows are paid first in the ordinary course of business, but rather whether, in the event that credit support is depleted, or the issuer/borrower defaults, the investor receives a pro-rata share of cash-flows compared to all other investors in the same senior position. This is why the market understands the term "senior-most" position as relating to liquidation and loss allocation and not the scheduled payment window. System institutions should not be constrained in their flexibility to manage the timing of their overall cash flows.

Finally, the portfolio limitation with respect to Fannie/Freddie exposure should not be maintained at 50%, but rather should be expanded to 100% to match the permissible exposure to Ginnie Mae securities, since these agencies are under conservatorship with the U.S. Government. Arguably, Fannie, Freddie and Ginnie Mae securities are the safest investments from a credit perspective in this economic environment. Banks' should have sufficient flexibility to purchase the safest, most liquid, yet appropriately yielding, products available in the given market at that time while adhering to sound risk management practices.

§ 615.5140(d) - Obligor limits:

FCA's proposed revisions would lower the investment limit for single obligors to 15% from the existing 20% limit. The Farm Credit Council's position is that this reduced limit is reasonable in light of FCA's exclusion of Government and GSE obligors. Our view is that, since there are already significant regulatory controls over System institution investment purchases, and are likely to be even tighter controls under the proposed regulation, the reduced single obligor limit seems unnecessary, and furthermore, would restrict the flexibility System institutions have in managing their investment risk. The Bank's current policy calls for the aggregate investment exposure to any one obligor, excluding overnight investments, to not exceed 10% of the bank's permanent capital. The aggregate investment exposure to any one obligor, including overnight investments shall not exceed 20% of the bank's permanent capital. During the credit crisis, there were times when the Bank's confidence level in counterparties was limited to a handful of names, making compliance with this requirement extremely difficult. Compliance with a reduced limit would be even more challenging.

§ 615.5142(b) - Association Investments:

In contrast to the comments of the Farm Credit Council on this point, we believe that some kind of bank review of association investments is consistent with the Act and do not object to the bank's performing this role. We do believe, however, that for the bank to perform such reviews in a meaningful way, it is necessary that FCA clarify both what types of investments an association may purchase pursuant to its mission-related and non-mission-related investment authorities and what elements FCA expects the bank's review to include. As FCA has continued to issue guidance on investment activities in recent years, from the Informational Memoranda dated June 25, 2004 and January 11, 2005 on mission-related investments, to the Informational Memoranda on USDA guaranteed investments dated March 22, 2011 and June 30, 2011, to the Bookletter No. 64 on investment management, the scope of the associations' authorities and the nature of the bank's role have become somewhat more uncertain. As a result, before our bank can provide any specific meaningful supervision or guidance to associations in regards to their investments, we feel that additional clarification in regards to the proper scope of association investments needs to be provided by FCA.

We agree with the Council that the requirement that FCA has proposed with respect to matching an investment's repricing and maturity characteristics to the characteristics of the short-term funds to be invested is unnecessary and could even limit the ability of associations to manage interest rate risk effectively. The same could also be said of the proposal to limit investments of short term funds to overnight investments or investment with maturities of 30 days or less on which FCA has solicited comment. For example, it is true that an association's direct loan balance fluctuates daily, but restricting eligible investments to overnight investments may not in fact match the association's true excess funds position over time.

§ 615.5143 - Management of ineligible and unsuitable investments:

On the whole, we are in favor of the changes FCA has proposed for the management of ineligible and unsuitable investments under § 615.5143. We believe that these revisions represent a reasonable approach that does not force System institutions to recognize unnecessary losses and incur unnecessary expenses on ineligible investments. We agree with the Farm Credit Council that all ineligible investments should be treated the same way. Although the purchase of an ineligible investment is an unauthorized act, if this were to occur, it does not seem appropriate to unnecessarily penalize the institution and its stockholders by applying a more onerous disposal requirement to purchases of ineligible investments as opposed to investments that were eligible when purchased, but which later become ineligible.

Dodd Frank Act Compliance:

We are in full agreement with the comments of the Farm Credit Counsel in response to FCA's questions regarding possible approaches for eliminating the use of Nationally Recognized Statistical Rating Organizations' (NRSRO) ratings from FCA's investment regulations. While we think that the approach of establishing a credit-worthiness standard based upon the System's current 14-point internal credit classification model may have the best potential for success, we think it is premature to draw definitive conclusions before the other federal financial regulators have issued their own rulemakings on this subject, and we strongly urge FCA to delay its rulemaking on this subject until the approaches of the other financial regulators have been determined.

Once again, we appreciate the opportunity to submit our comments on these important proposed regulations. If you have any questions regarding our views expressed in these comments, please do not hesitate to contact me by e-mail or call me at (512) 465-0736.

Sincerely,

Amie Pala

Amie Pala
Chief Financial Officer