FARMERMAC
Financing Rural America

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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: Advanced Notice of Proposed Rulemaking: "Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Risk-Based Capital Stress Test, Version 5.0" 12 CFR Part 652, RIN 3052-AC70, June 16, 2011

Dear Ms. Rea:

The Federal Agricultural Mortgage Corporation ("Farmer Mac" or the "Corporation") appreciates the opportunity to respond to the request for public comment on the advance notice of proposed rulemaking (the "ANPRM") published by the Farm Credit Administration ("FCA") with respect to the risk-based capital stress test ("RBCST") applicable to Farmer Mac, as well as the possible revision of Farmer Mac's operational and strategic business planning requirements to place greater emphasis on diversity and inclusion.

1. Alternatives to the Use of Credit Ratings in Farmer Mac's RBCST

Farmer Mac recognizes the considerable task faced by FCA in developing standards of creditworthiness in place of credit ratings for use in Farmer Mac's RBCST in accordance with Section 939A of the Dodd-Frank Act. While the use of credit ratings may have contributed to recent disruptions in the U.S. financial markets, Farmer Mac believes that the prospect of employing credit ratings as a component of assessing counterparty credit risk (as part of a broader internal rating system) retains significant value, particularly for assessing counterparty risk in Farmer Mac's program assets and for assessing credit risk on certain investments held in Farmer Mac's liquidity portfolio.

As an example, Farmer Mac's RBCST currently uses counterparty credit ratings as a measure of credit risk in Farmer Mac's AgVantage® transactions. As explained in the ANPRM, FCA has "used ratings because they were readily and publicly available" and has suggested that another metric that would provide similar objectivity and transparency could be an alternative. However, Farmer Mac's AgVantage® counterparties vary widely in terms of corporate structure, business model and availability of public information. Many of Farmer Mac's AgVantage® counterparties are operating subsidiaries of publicly-held companies or are otherwise privatelyheld. Although Farmer Mac has access to all relevant information about each counterparty prior to entering into an AgVantage® transaction, some counterparties do not necessarily have the same level of financial information or market data available to the public, resulting in a lack of "sufficiently transparent" information to enable a consistent application of credit metrics.

It is also worth noting that reliance on market data for program assets and liquidity investments does not necessarily ensure the proper evaluation of credit risk. Indeed, market prices at times reflect conditions unrelated solely to credit risk, such as in market disruptions where prices may reflect limited liquidity rather than increased credit risk. Alternatively, market prices may not accurately reflect the risk inherent in an instrument, as was demonstrated by tightening spreads for certain securities through 2007. Accordingly, requiring solely the use of financial metrics or market data could actually result in unevenly applied credit standards across the spectrum of Farmer Mac's AgVantage® counterparties and the investment securities for which the RBCST currently uses credit ratings.

FCA has also suggested that an internal rating system employed by Farmer Mac in conjunction with FCA review could be an acceptable alternative to the use of credit ratings in Farmer Mac's RBCST. Farmer Mac believes that due to the inherent limitations in attempting to apply consistent and objective standards across a spectrum of counterparties and securities, as described above, FCA's suggestion for an internal rating system is a more appropriate substitute to the exclusive use of credit ratings for assessing counterparty risk. A rating system similar to the 14-point Uniform Classification System used by the Farm Credit System ("FCS") to assess borrower credit risk would be a good example from which to model an internal rating system for Farmer Mac's RBCST, which would leverage internal counterparty analysis that Farmer Mac is currently already performing. However, in instituting a system as described here, Farmer Mac believes that it is critically important that FCA's treatment of any internal rating system in its examination process be consistently applied throughout the FCS, including Farmer Mac.

Nonetheless, Farmer Mac strongly believes that credit ratings and credit agency loss methodology, such as the loss severity rates reported by Moody's,[1] should be permissible components of this internal rating system. Notwithstanding any perceived shortcomings stemming from the role of credit ratings in the recent market disruptions, credit ratings remain one of the few broadly accepted standards of measuring risk across a variety of counterparties. Properly used as one of several tools for the evaluation of credit risk, credit ratings can provide a useful, objective and consistently applied measurement of counterparty risk in Farmer Mac's RBCST. Furthermore, the appropriate use and application of an internal risk rating system could be tested as part of FCA's annual examination of Farmer Mac, just as is currently undertaken with respect to Farmer Mac's loan portfolio.

[1] *See, e.g.*, Moody's Investors Service, *Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada*, RATINGS METHODOLOGY (August 2006); and Moody's Investors Service, *Special Comment: Responses to Frequently Asked Questions about Moody's Loss-Given-Default Assessments and Probability-of-Default Ratings* (August 2006).

In the ANPRM, FCA posed several questions, two of which Farmer Mac would like to address directly. First, FCA has asked what specific creditworthiness or investment criteria should be used in the RBCST regulation. Farmer Mac believes that its RBCST is not the appropriate place to articulate creditworthiness or investment criteria, as these items are determined by other FCA regulations and Farmer Mac's internal policies and procedures. Second, FCA has asked whether different criteria should be used for different broad classes of investments or exposures and, if so, what perverse incentives or other unintended consequences that could lead to. Farmer Mac believes that any "perverse incentives" that Farmer Mac's RBCST might provide would, in reality, be limited by existing FCA regulations, as well as Farmer Mac's internal policies and procedures governing its portfolio composition and concentrations.

2. <u>Counterparty Risk on Derivatives in the RBCST</u>

The ANPRM has requested comment on whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivatives transactions. Farmer Mac believes that introducing a capital charge as a component of the RBCST is premature at this time, given the recent publication of proposed rules regulating margin and capital requirements for non-cleared swap transactions (the "Proposed Swap Rule").[2] In particular, if the Proposed Swap Rule were enacted in its proposed form, Farmer Mac (together with other entities regulated by FCA and the Federal Housing Finance Agency) would be one of only a few low-risk financial end users of derivatives to be required to collect initial and variation margin without any minimum threshold and segregate such margin with a third-party custodian, thereby aligning the counterparty risk with that of cleared swaps. However, requiring a capital charge with respect to derivatives exposure as suggested by the ANPRM, as well as requiring collection of initial and variation margin as suggested by the Proposed Swap Rule, would be duplicative and would increase costs of engaging in swap transactions with marginal (if any) additional benefit. This logic is evidenced by the current capital requirements for derivatives transactions as contemplated by the guidance from the Basel Committee on Banking Supervision (Basel II), which provides an exposure value of zero for counterparty credit risk under cleared derivatives contracts compared to derivatives without imposed margin requirements.[3]

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[2] Margin and Capital Requirements for Covered Swap Entities; Proposed Rule, 76 Fed. Reg. 27564 (2011).

[3] *See International Convergence of Capital Measurement and Capital Standards*, Basel Committee on Banking Supervision ("Basel II"), at Annex 4, paragraph 6 (June 2006) (providing for an exposure value of zero for counterparty credit risk under cleared derivatives contracts). *Cf. Capitalisation of Bank Exposures to Central Counterparties (Consultative Document)*, Basel Committee on Banking Supervision, at paragraph 9 and Annex A, paragraph 114 (December 2010) (proposing a 2% risk weight for clearinghouse exposure under cleared derivatives transaction).

Furthermore, FCA suggests in the ANPRM that Farmer Mac's RBCST may be revised to consider net replacement costs and current exposure to cash flows based on a counterparty's creditworthiness. However, the RBCST is a deterministic steady-state model, and the methodology used to address counterparty risk on derivatives should be consistent with the overall philosophy of the model. Many methods for evaluating future potential exposure rely on simulation-based models, which is not necessarily consistent with the other sections of the steady-state RBCST. Any such addition to the RBCST would likely require a separate sub-model to feed into the RBCST, as the evaluation of counterparty risk for derivatives will require unique and highly granular data elements that are not used elsewhere in the RBCST. In addition, such a sub-model would need to consider all applicable netting agreements.

If FCA proceeds with revising the RBCST to address counterparty exposure on derivatives transactions in the manner suggested, Farmer Mac recommends that FCA consider a methodology more similar to the Current Exposure Method as presented in the Basel II accord.[4] Such a methodology would consider the replacement cost as well as the potential future credit risk as a function of remaining maturity, using fairly simple inputs.

3. Business Planning Requirements to Promote Diversity and Inclusion

Farmer Mac fully supports diversity and inclusion both in its personnel and in its marketing efforts as it strives to fulfill its mission as the secondary market serving rural America. As an employer based in a large metropolitan area, Farmer Mac values the many benefits of a diverse and inclusive workforce and believes that such a workforce provides competitive advantages and promotes an environment where varying ideas and viewpoints are discussed in a way that is healthy for Farmer Mac's business. Farmer Mac also recognizes that there are borrowers in rural areas and small communities with underserved financial needs that could benefit from Farmer Mac's secondary market programs. To that end, Farmer Mac has a policy on, and sets goals for, the inclusion of loans to small farms and family farmers in the Farmer Mac I program and also is the most active participant in making a market for USDA-guaranteed portions of farm ownership loans and operating loans through the Farmer Mac II program. Indeed, Farmer Mac's business planning process already includes the development of a separate marketing plan with analysis of the Corporation's marketplace and business opportunities, as well as strategies for increasing the number of rural lenders (and, indirectly, borrowers) that benefit from Farmer Mac's programs consistent with the maintenance of sound underwriting standards and prudent risk management. Farmer Mac's goal is to reach out to any lender with qualified loans that meet Farmer Mac's standards.

Although Farmer Mac embraces the values of diversity and inclusion, the Corporation has concerns with the parts of the ANPRM related to possible revisions to existing business planning requirements to place greater emphasis on diversity and inclusion. First, the ANPRM lacks a clear articulation of FCA's authority, as the safety and soundness regulator of Farmer

[4] *See* Basel II, at paragraph 186 and Annex 4, Section VIII.

Mac, to issue regulations to promote diversity and inclusion, particularly in the absence of any finding that those issues relate to Farmer Mac's safety and soundness or compliance with applicable statutory requirements contained in the Farm Credit Act of 1971, as amended (the "Act"). Furthermore, even if FCA were authorized to issue such regulations, the commentary and questions related to diversity and inclusion in the ANPRM indicate a lack of appreciation for Farmer Mac's unique role as a secondary market compared to the primary lenders regulated by FCA, as well as the business and operational challenges posed by the types of regulatory requirements contemplated by the ANPRM.

FCA's Regulatory Authority Over Farmer Mac

Congress organized Farmer Mac as an institution of the FCS, but intended for Farmer Mac to be "unique" in terms of its "powers, corporate structure, ownership, operations, and relations with other FCS entities and [FCA]."[5] Farmer Mac, as the operator of a secondary market, is very different from primary lenders that hold portfolios of loans, most of which were originated by those lenders, such as FCS lending institutions, commercial banks, and insurance companies.[6] Farmer Mac's statutory charter, contained in Title VIII of the Act, assigns to FCA, acting through the separate Office of Secondary Market Oversight ("OSMO"), the responsibility for the examination of, and the general supervision of the safe and sound performance of the powers, functions, and duties vested in Farmer Mac by the charter and also authorizes FCA, acting through OSMO, to apply its general enforcement powers to Farmer Mac.[7] Unlike other FCS institutions, Farmer Mac is not chartered by FCA, and FCA does not possess general rulemaking authority over Farmer Mac. Accordingly, areas that do not relate to Farmer Mac's safety and soundness or compliance with applicable laws and regulations are not within FCA's purview and are properly left to Farmer Mac's board of directors and management to implement appropriate strategies. Farmer Mac believes that the promotion of diversity and inclusion, while a laudable goal, does not relate to Farmer Mac's safety and soundness or compliance with applicable laws and regulations (except to the extent already encompassed in existing nondiscrimination and affirmative action requirements) and are therefore outside of FCA's rulemaking authority.[8] It is also noteworthy that Congress has specifically mandated FCA to

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[5] S. Rep. No. 100-230, 100th Cong., 1st Sess. 48 (1987).

[6] Congress was aware that Farmer Mac's regulator would need to give special considerations to Farmer Mac's unique position, instructing FCA, in exercising its regulatory authority over Farmer Mac, to consider the purposes for which Farmer Mac was created, the practices appropriate to Farmer Mac's conduct of a secondary market in agricultural loans, and the reduced levels of risk associated with secondary market transactions. *See* 12 U.S.C. § 2279aa-11(a)(2).

[7] *See* 12 U.S.C. § 2279aa-11(a)(1).

[8] The ANPRM does not cite any statutory provision for FCA's authority to issue regulations applicable to Farmer Mac that relate to the promotion of diversity and inclusion. The proposed rule on this topic for other FCS institutions, 76 Fed. Reg. 30280, 30282 (May 25, 2011), cites Section 1.1(b) of the Act as requiring FCS institutions to be inclusionary in its lending (stating that the FCS was established as a "permanent system of credit for agriculture which will be responsive to the credit needs of *all* types of agricultural producers having a basis for credit." (emphasis added)). It should be noted that this provision cannot be read to apply to Farmer Mac because

eliminate regulations that are unnecessary, unduly burdensome or costly, or not based on law.[9] Farmer Mac does not believe that the diversity and inclusion aspects of the ANPRM are consistent with that explicit direction from Congress in 1996.

Besides lacking a clear safety and soundness justification for considering new diversity and inclusion requirements for Farmer Mac, the ANPRM also does not appear to properly distinguish the difference between mission fulfillment in accordance with statutory requirements (such as nondiscrimination in hiring and in operating secondary market programs) and general objectives dealing with broad public policy decisions and social issues that are not part of statutory requirements. These latter areas are issues properly left to Congress in the absence of direction from Congress for FCA to regulate these matters. The ANPRM seems to be focused on these general objectives rather than applicable statutory requirements and safety and soundness. It is notable that there has been no change in law that requires or even suggests that FCA should revise the business planning requirements of Farmer Mac to address diversity and inclusion as defined by FCA.[10] Farmer Mac's concern is that any FCA rulemaking in this area would exceed the provisions of current law by establishing requirements related to diversity and inclusion that do not exist in the Act or in any other provision of law that applies to Farmer Mac.

The ANPRM does not specifically define what FCA means by "diversity" and "inclusion," which creates a large degree of uncertainty about how any proposed regulations would be interpreted and applied. Nor does the ANPRM explain how Farmer Mac would determine all of the characteristics desirable in potential employees or the lenders who use Farmer Mac's programs in aspiring for more diversity and inclusion, although FCA does provide some examples of the types of groups it believes may be worthy of further outreach.[11] Farmer Mac is concerned that, in the absence of any clear direction from Congress, FCA's vision of

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Congress actually did impose, in Farmer Mac's statutory charter, restrictions on the types and quality of loans eligible within agriculture for Farmer Mac's secondary market programs. *See, e.g.*, 12 U.S.C. § 2279aa(9) (definition of "qualified loan").

9 *See* 12 U.S.C. § 2252 note ("The Farm Credit Administration shall continue the comprehensive review of regulations governing the Farm Credit System to identify and eliminate, consistent with law, safety, and soundness, all regulations that are unnecessary, unduly burdensome or costly, or not based on law.").

10 FCA cited in the proposed rule for other FCS institutions Congress's adoption of requirements related to inclusion of women and minorities for the housing GSEs as one reason why FCA believed it was empowered to issue regulations related to diversity and inclusion. Farmer Mac believes that Congress's decision not to impose these requirements on Farmer Mac and other FCS institutions is more relevant than the fact that they were imposed on other entities.

11 "We believe an integral part of promoting and achieving inclusion and diversity can be accomplished through an effective operational plan that includes strategies to seek out qualified loans from a diverse group of sources and provides rural lenders with financing products that serve a diverse array of borrowers, such as small, beginning, new, disabled, female, and minority farmers, ranchers, and rural homeowners, as well as cooperatives with diversity of ownership. We believe promotion of inclusion and diversity should also extend to non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers, and community-supported agriculture." 76 Fed. Reg. 35138, 35140 (June 16, 2011).

diversity and inclusion mixes certain categories of classes that have traditionally been "protected classes" (e.g., minority and female) with other classes that have not traditionally been protected (e.g., beginning and new[12]), as well as certain types agriculture (e.g., organic or specialty crop farmers).

Farmer Mac believes that the inclusion of specific types of agriculture in the examples of diversity and inclusion is especially worthy of further consideration by FCA because any final regulation requiring further outreach to certain agricultural producers could result in FCA influencing which types of agricultural commodities and products receive financing in a way that might not always be related to the creditworthiness of the borrower and prudent risk management. Farmer Mac's charter expressly requires that qualified agricultural loans under the Farmer Mac I program meet minimum credit and appraisal standards that represent sound loans to profitable businesses.[13] The charter also provides an explicit nondiscrimination requirement – that Farmer Mac's standards "not discriminate against small originators or small agricultural mortgage loans that are at least $50,000."[14] Farmer Mac does not believe that FCA intends to play a role in determining which types of producers within agriculture receive funding, especially within a capital-constrained sector like agriculture. A suggestion by FCA that a particular type of agriculture practiced is an example of diversity is likely to create confusion and would create an expectation for targeting more lending to a particular agricultural producer type that FCA determines adds diversity. Related to this point, Farmer Mac believes strongly that Farmer Mac's marketing plans should not be required, as contemplated by question #15 in the ANPRM, to set quantitative goals to increase the number of loans to certain types of borrowers or types of agricultural production. In any effort by FCA to encourage diversity and inclusion, it is important that FCA not require predetermined outcomes in the form of quantitative goals. Any such goals could have the unintended effect of providing incentives to reduce Farmer Mac's sound underwriting standards and provide credit concessions for certain types of borrowers or commodities in the interests of diversity or inclusion, even though those standards are intended to apply across all types of borrowers and types of agriculture to ensure prudent credit risk management.

With respect to the possibility of requiring Farmer Mac's operational and strategic plans to include strategies and actions to achieve diversity and inclusion within Farmer Mac's "workforce, management, and governance structure," Farmer Mac believes that it has already demonstrated its commitment to these values as evidenced by the diverse composition of Farmer Mac's personnel. Indeed, Farmer Mac has fully internalized the broad concepts of diversity and

[12] Section 4.19 of the Act related to young, beginning, and small farmers and ranchers does not apply to Farmer Mac, although Farmer Mac's charter contains a requirement to promote the inclusion of loans to small farms and family farmers in Farmer Mac's secondary market activities.

[13] See Section 8.8(b) of the Act, 12 U.S.C. § 2279aa-8(b).

[14] 12 U.S.C. § 2279aa-8(d). This provision, Section 8.8(d) of the Act, also provides an affirmative action provision: "The [Farmer Mac] Board shall promote and encourage the inclusion of qualified loans for small farms and family farmers in the agricultural mortgage secondary market."

inclusion as part of its corporate culture and believes that the current composition of its workforce already evidences Farmer Mac's strong commitment to diversity and inclusion in the hiring process. Farmer Mac sees no need for regulatory direction in this area that is redundant and overlapping with existing requirements such as the affirmative action plan already required of Farmer Mac and all other FCS institutions with more than twenty employees by Section 4.38 of the Act. As to diversity and inclusion in Farmer Mac's governance structure, five members of Farmer Mac's board of directors are appointed by the President of the United States and their appointment is completely out of the control of the Corporation, while the election of the remaining ten members is subject to the securities laws of the United States and not an appropriate subject of regulation by FCA.

Business and Operational Challenges as a Secondary Market

As previously discussed, Farmer Mac has a unique mission as the operator of a secondary market and is very different from the primary lenders who originate the loans that are eligible for Farmer Mac's programs. Although the Corporation does work closely with the lenders that use Farmer Mac's programs, particularly on USDA-guaranteed loans and in the development of loan products to meet the needs of agricultural and rural borrowers, Farmer Mac itself is not a primary lender. Farmer Mac believes that the ANPRM does not evidence FCA's appreciation for this distinction or the business and operational challenges that Farmer Mac would face if FCA were to establish the types of regulatory requirements contemplated by the ANPRM.

As a secondary market, Farmer Mac depends on its lender participants to bring qualified loans into Farmer Mac's programs. As such, Farmer does not have the ability to control the lending relationship and therefore cannot directly target certain types of borrowers or commodities to receive financing from the originating lenders. Indeed, if the goal is to increase service to certain types of borrowers or agricultural producers, increased volume of those loans in Farmer Mac's programs does not necessarily indicate that those specific groups will receive more financing from originating lenders. For example, Farmer Mac could bring in a large volume of loans made to women- or minority-owned operations under the standby commitment program and thereby free up more lending capacity for the originating lender, but there is no assurance that the lender will use that excess lending capacity to make further loans to women- or minority-owned operations.

Another challenge related to Farmer Mac's role as a secondary market in the context of establishing diversity and inclusion goals is the extent to which Farmer Mac relies on the originating lenders for information about the loans brought in to Farmer Mac's programs. Farmer Mac believes that much of the information that would be required to track compliance with diversity and inclusion goals is not currently readily available from lenders as meaningful and relevant market data to assist in implementing plans and measuring progress in reaching under-served market segments may be difficult to obtain. Indeed, the required data may not even be collected at all, either because the information is not relevant to the lending decision or to the extent that obtaining the requested information is not be permitted by law.

Even if FCA promulgates regulations that require FCS lending institutions to collect all the information needed to track diversity and inclusion efforts, a sizable portion of Farmer Mac's business is with non-FCS institutions. Any request of these parties from Farmer Mac to collect information that they are not required to collect or that is not particularly relevant to the lending decision could result in those participants deciding that Farmer Mac's requirements were too onerous and thus limit Farmer Mac's prospects for business with non-FCS institutions. Even though the Dodd-Frank Act does create the potential for collection of more data from lenders, the relevant provisions have not been implemented by the Consumer Financial Protection Bureau, and there currently is no timetable set for its implementation. Those provisions will require all lenders to ask potential borrowers to voluntarily self-identify as to whether their business is woman-owned, minority-owned or is a small business, which is much narrower in scope when compared to the FCA's vision of diversity and inclusion. Even if additional data is allowed to be collected, it will be many years before meaningful and measurable data is available.

Congress created Farmer Mac for very specific purposes, and Farmer Mac's activities are directed to fulfilling those purposes. The Corporation believes that it has created a successful secondary market for the types of agricultural and rural loans authorized by its statutory charter and is appropriately and effectively fulfilling its mission. Farmer Mac is committed to having a workplace that is diverse and free from discrimination and that equally serves all rural lenders who make loans that qualify for Farmer Mac's programs. In carrying out its unique mission, Farmer Mac believes it has achieved the correct balance between the needs of the rural lenders and borrowers Farmer Mac was created to serve, the oversight concerns of Congress and FCA to ensure Farmer Mac's overall safety and soundness, and the expectations of investors in Farmer Mac debt and equity securities. While Farmer Mac fully supports diversity and inclusion and recognizes the accompanying business benefits, its primary focus will always be on carrying out its public mission in compliance with applicable law and in a safe and sound manner and consistent with prudent risk management. Farmer Mac believes that any strategies related to diversity and inclusion are not related to safety and soundness and should be left to the discretion of Farmer Mac's board of directors and management, who are in the best position to fully understand Farmer Mac's business needs as it balances all of its important constituencies in furtherance of its mission, safe and sound operation, and creation of stockholder value.

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We encourage FCA to consider the comments contained in this letter as it formulates any future proposed regulations related to the RBC model and business planning requirements applicable to Farmer Mac. Farmer Mac appreciates FCA's consideration of these comments and would be pleased to discuss these matters further at your request.

Very truly yours,

Michael A. Gerber
President and Chief Executive Officer