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January 3, 2005

S. Robert Coleman
Director
Regulation and Policy Division, Office of Policy and Analysis
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Re: Proposed Rule: Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investments, Liquidity, and Divestiture; 12 CFR 615; 69 Federal Register 67070, November 16, 2004.

Dear Mr. Coleman:

The American Bankers Association (“ABA”) appreciates this opportunity to comment on the above referenced proposed rule. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

In the proposed rule, the Farm Credit Administration (“FCA”) makes four substantive proposals for modifications to the loan, funding, investments, liquidity and divestiture polices of the Farm Credit System (“System”) and seeks comment on a fifth issue, relating to divestiture of ineligible investments. ABA’s comments on each of these items follows.

Proposal 1: Increase the regulatory liquidity reserve requirement of the System to 90 days. ABA believes that increasing the liquidity reserve of the System is both reasonable and prudent, for the reasons detailed in the proposed rule, including following industry trends to increase reserves to offset the risks, post Sept. 11, 2001, of potential market disruptions resulting from terrorist acts or other unforeseen circumstances.

Proposal 2: Apply discounts on assets used to fund the liquidity reserve. Again, ABA believes this to be a prudent measure. Under the proposal, Farm Credit Banks would only be able to use cash and eligible investments to fund the liquidity reserve. We concur with the FCA that investments used to fund the liquidity reserve must be readily marketable. We also concur with FCA’s definition of readily marketable as being investments that can quickly be converted into cash at a reasonable cost and in a timely manner.

S. Robert Coleman
January 3, 2005
Page 2

Proposal 3: Change the eligible investment limit from 30 percent of total outstanding loans to 35 percent of total outstanding loans.

ABA strongly disagrees with the FCA regarding this proposal. The present limit on System investments as a percentage of outstanding loans should not be increased, for four reasons. First, the cash-and-investments/loan percentage for the System as a whole fell in the 25% range during 2004, based on quarter-end data. This suggests that the present 30% ceiling is not constraining System investments and liquidity.

Second, the present 30% limit permits the System to engage in excessive on-balance-sheet maturity mismatching because the System can use its investments, along with derivatives, to bridge timing differences between the maturities or repricing dates on System assets and liabilities. Worse, this capacity for maturity mismatching creates the potential for System gambling on interest-rate swings while making it highly dependent on a handful of counterparties (just 19 on September 30, 2004) to partially hedge those mismatches with interest-rate swaps and other derivatives. While the FCA's request for comment expresses concerns about System liquidity risk, a far greater risk lies in the capacity of the System's counterparties to supply reasonably priced hedges in a time of systemic strain. At September 30, 2004, interest rate swaps and other derivatives transformed longer-term System debt into short-term debt funding 30% of System assets in the 0-to-6 months repricing interval; on that same date, transformed debt accounted for one-third the debt funding assets in the 0-to-6 month repricing interval. Nearly the reverse situation occurred in the 1-to-5 years repricing interval. Half the System debt in that interval (equal to 77% of System assets in that interval) was transformed out of that interval into other repricing intervals, largely the 0-to-6 months repricing interval. Raising the investment limit to 35% would give the System even more room to engage in more extreme maturity mismatching and become even more dependent upon a few hedge counterparties. Instead of raising the investment limit, the FCA should take steps to reduce the amount of on-balance-sheet maturity mismatching the System engages in so as to reduce the System's dependence on hedge counterparties.

Third, as the request for comment notes, the "investment limit prevents Farm Credit banks from using their GSE status to borrow favorably from the capital markets and accumulate large investment portfolios for arbitrage activities." This arbitraging already generates upwards of \$100 million of arbitrage profits annually, based on a conservative arbitrage profit of 40 basis points per investment dollar. Such a dramatic increase does not appear to be necessary for safety and soundness. Raising the investment percentage to 35% would permit the System to generate even more in unjustified, unneeded, and unconscionable arbitrage profits

Fourth, an increase in minimum liquidity reserve days, as proposed in the proposed rule, does not justify an increase in the investment percentage to 35%. The System's financial stress during the 1980s does not offer a sufficient rationale for a higher percentage since the FCA should not allow the System to approach insolvency again, as it did in the 1980s. Fortunately, the System has an extremely strong capital position today. Further, as the aftermath of the Russian debt crisis in 1998

S. Robert Coleman
January 3, 2005
Page 3

demonstrated, there was an investor flight to quality, making it relatively easier for GSEs to fund themselves, relative to their private-sector competitors, due to the implicit federal guarantee of GSE debt, an implicit guarantee strengthened by the System's taxpayer bailout in 1987.

Fifth, increasing the investment limit for System institutions will divert resources away from the farmers, ranchers and rural homeowners the System was chartered to serve.

Proposal 4: Require the Farm Credit Banks to establish and maintain a liquidity contingency fund. We agree with the FCA that liquidity contingency plans are prudent and within the proper responses of the System regulator in addressing the potential for market disruptions due to terrorism or other unforeseen occurrences.

Other Issues: Disposing of ineligible investments. ABA strongly believes that the procedure for disposing of ineligible investments should not be altered as the present regulation already gives the FCA sufficient latitude to grant a System institution a disposal period longer than six months when circumstances specific to that investment so warrant. The request by a Farm Credit bank for "investment flexibility" suggests that the bank wants to retain ownership of an ineligible investment indefinitely, most likely with the foolish hope that it will eventually become an eligible investment. This is especially true in situations where a supposedly eligible investment, or loan, in fact never was an eligible investment or loan.

Conclusion:

ABA commends the Farm Credit Administration for its efforts to strengthen the System by ensuring adequate liquidity. In light of recent events and potential threats to our financial system, regulators need to react in a timely and thoughtful manner. While we agree that liquidity requirements should be increased for the System, we do not share the FCA's view that increasing the investment authority of the System is necessary to meet new liquidity requirements. To the contrary, we believe that increasing the investment authority will only lead to greater speculation and arbitrage by System members which does nothing to enhance safety and soundness or to better the System's ability to serve its members.

Thank you for the opportunity to comment on these proposals. If you would like to discuss them further, please contact the undersigned at 202-663-5480 or via email at JPigg@aba.com.

Sincerely,

Joseph Pigg
Senior Counsel