United States General Accounting Office 133488

GAO

Briefing Report to the Honorable Richard H. Lehman, House of Representatives

July 1987

FARM FINANCE

Secondary Markets for Agricultural Real Estate Loans

133488

039493

GAO/RCED-87-149BR

GAO United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-220507

July 17, 1987

The Honorable Richard H. Lehman
House of Representatives

Dear Mr. Lehman:

As requested in your November 6, 1986, letter and modified in subsequent discussions with your office, we are providing you with information on (1) secondary markets, in general, including the purposes such markets have served in the past; (2) existing agricultural real estate secondary markets; (3) formal proposals for a national-scope secondary market for agricultural real estate loans and the major provisions of each; and (4) the major issues meriting further attention in determining the potential effects of a secondary market for agricultural real estate loans on farmers, lenders, and the federal government. Also as agreed with your office, we have limited our work to the nine legislative proposals listed in our testimony on Issues Surrounding a Secondary Market for Agricultural Real Estate Loans (GAO/T-RCED-87-29, June 3, 1987) and subsequently included in our fact sheet entitled Farm Finance: Legislative Proposals for Secondary Markets for Farm Real Estate Loans (GAO/RCED-87-172FS, July 2, 1987). This briefing report presents the final results of our work.

A secondary market is a market in which existing, rather than new, products are bought and sold. A secondary mortgage market is a market for the sale of mortgage loans or securities backed by mortgage loans. The sale of the individual loans or mortgage-backed securities returns funds to the loan originator, creating liquidity and allowing the originator to make additional loans or use the funds for other purposes.

In summary, currently only limited secondary markets exist for farm real estate loans. No organized national-scope secondary markets exist, but several small, organized regional-scope markets operate primarily in heavily agricultural states.

We have identified nine proposals, introduced in the 100th Congress, to create an active national-scope secondary market for farm real estate loans. We met with industry experts and discussed the types of information that should be considered to obtain a better understanding of each proposal's potential impact on farmers, lenders, and the federal government. Not all of this information is available in each proposal. Some of it is not typically included in legislation, and can be fleshed out and refined by the administering agency within broad legislative guidelines. Appendix I of this report contains a comparative summary of the nine proposals.

We have divided this briefing report into three sections. The first provides general information on secondary markets, purposes they have served, and existing agricultural real estate secondary markets. The second section provides information on the formal proposals for secondary markets for agricultural real estate loans, including an overview of each proposal's major provisions. The third section raises issues that merit further attention in the ongoing congressional debate on secondary markets for agricultural real estate loans.

HOW WE DID OUR STUDY

Our study consisted primarily of interviewing individuals and officials from the private sector and the government concerned with both secondary markets, in general, and a national-scope secondary market for agricultural real estate loans in particular. We reviewed legislation introduced during the 99th and 100th Congresses and examined agricultural and financial periodicals and magazines. In addition, we held discussions with industry officials to identify (1) formal proposals for national-scope secondary markets for agricultural real estate loans and (2) any such existing markets. As agreed with your office, because our work was focused on proposals for such a market, we did not perform detailed audit work on existing markets but rather relied on readily available information.

We interviewed agricultural economists, bankers, and investment house and investment rating agency representatives familiar with secondary market and farm credit issues. We also interviewed officials at the Department of Agriculture, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration (FCA), the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae), the Farm Credit System (FCS), the American Bankers Association, the Independent Bankers Association of America, and the American Council of Life Insurance. We also reviewed research literature, legislation, and publications concerning secondary markets in general.

We plan to send copies of this briefing report to the Chairman, House Committee on Agriculture; the Chairman, Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture; the Secretary of Agriculture; the Director, Office of Management and Budget; and other interested parties. Copies will be available to others upon request. If we can be of further assistance, please contact me at (202) 275-5138.

Major contributors are listed in appendix II.

Sincerely yours,

Wm E Gahr
for

Brian P. Crowley
Senior Associate Director

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ABBREVIATIONS

Fannie Mae	Federal National Mortgage Association
FCA	Farm Credit Administration
FCS	Farm Credit System
FHA	Federal Housing Authority
FmHA	Farmers Home Administration
Freddie Mac	Federal Home Loan Mortgage Corporation
GAO	General Accounting Office
Ginnie Mae	Government National Mortgage Association
MABSCO	Mid-America Bankers Service Company
MASI	MABSCO Agricultural Services, Incorporated
RCED	Resources, Community, and Economic Development Division
SEC	Securities and Exchange Commission
VA	Veterans Administration
WHEDA	Wisconsin Housing and Economic Development Authority

SECTION 1

SECONDARY MARKETS: A PRIMER

EXISTING SECONDARY MARKETS: FORMAT, FACTORS, AND FUNCTIONS

Format of a secondary market:

- -- Lender makes loan to borrower (primary market).
- -- Loan or securities backed by the loan are sold to investors.
- -- Lender can use proceeds of loans to make new loans or for other purposes.

Factors that assist the development of a secondary market:

- -- Ability to issue securities based on loans.
- -- Homogeneity of loans/securities.
- -- Improved marketability of securities through high-quality collateral, insurance, government backing, or other means.

Functions of a secondary market:

- -- Provide liquidity.
- -- Moderate cyclical flow of funds.
- -- Assist regional flows of capital.
- -- Reduce geographical spread in interest rates and allow for portfolio diversification.

Existing (regional) farm secondary markets:

- -- State markets.
- -- Private market (operating in three states).
- -- FCS performs economic functions of a secondary market.

WHAT IS A SECONDARY MARKET?

The investment market is usually defined in terms of primary and secondary markets. A primary market exists at the point that an original debt or ownership interest is created, for example, when a lender makes a loan directly to a borrower or a company sells a new issue of stock. In its simplest form, a secondary market transaction occurs when a loan is sold by the original lender or a stock is resold by an investor. Thus, essentially a secondary mortgage market involves the buying and selling of existing rather than new products.

Many types of financial instruments--stocks, corporate bonds, treasury securities, and home mortgages--have their own well-developed secondary markets. Perhaps one of the best-developed secondary markets is the New York Stock Exchange, where every week several hundred million shares of existing stock certificates are bought and sold by investors. Less-developed secondary markets exist for car loans, credit card debt, and manufacturers' notes receivable.

The success of obtaining large amounts of funds directly from individual lenders or investors can be attributed largely to active secondary markets for those financial instruments, that is, markets that provide the holders of those financial instruments the ability to sell them quickly, creating liquidity. The financial community has been successful in packaging, or pooling, many financial instruments for sale, such as loans of relatively small denominations, and selling a financial instrument representing an interest in the underlying loans. For example, lenders have packaged individual mortgage loans, with similar characteristics, and sold them as mortgage-backed securities.

The issuance of securities not backed by individual financial instruments, such as loans, has also had significant success in attracting funds to mortgage markets. For example, one of the home mortgage market entities sells general obligation bonds and uses the proceeds to, among other things, buy home mortgages. General obligation bonds are backed by the full faith and credit of the issuing organization and are not backed by loans or specific collateral.

The Home Mortgage Secondary Market

A secondary mortgage market is a market for the sale of securities backed by loans or for the sale of individual loans. The home mortgage secondary market is the most widely recognized and developed secondary mortgage market. It is comprised of government and private organizations that make it possible for a large secondary market to exist for home mortgages. In 1986, $383.8 billion in home mortgages were sold. A closer look at the home mortgage secondary market will provide a better understanding of secondary market development, the different secondary market entities, market operations, and financial instruments used in the secondary mortgage market.

<u>How Did the Market Develop?</u>

Several factors played key roles in facilitating the development of the secondary market for home real estate loans. Probably most important were the development of securities backed by mortgages, the homogeneity of the mortgages underlying the securities, and the improvement of the securities' marketability by risk reduction mechanisms known as credit enhancements. One such mechanism is a guarantee that investors will receive certain returns on their investments. The government played an important role in all of these secondary market developments. It is unlikely that the home mortgage secondary market would have become so well developed if these factors had not been adequately considered and appropriately incorporated.

<u>Mortgage-backed Securities</u> -- As the housing finance industry developed, it increasingly obtained funds for home mortgage loans through sales of securities. Traditionally, lenders had made home mortgages by relying on customer deposits. As the secondary market developed, lenders increasingly obtained funds to support their home mortgage lending through government-sponsored entities, charged with ensuring access to capital for the housing market. These organizations, discussed later, sold general obligation bonds, bought loans from lenders, and held the loans in their portfolios. As the market developed further, the organizations issued securities backed by pools of mortgage loans. These mortgage-backed securities are the leading source of funds for home mortgages today.

The increasing use of securities has enabled lenders to make more loans and has provided investors with an attractive investment. The ability to sell loans directly or indirectly to investors has provided lenders with an additional source of funding for long-term mortgages, not provided through relatively short-term customer deposits. The investors' ability to place large investments with relative ease and quickly convert them to cash has greatly increased the attractiveness of home mortgages as investments. Those factors reduce both the lenders' and investors' transaction costs.

<u>Homogeneity of Mortgages</u> -- Standardization of home mortgages greatly facilitated pooling of home mortgages for securities and, therefore, development of the home mortgage secondary market. Development of the fixed-rate 30-year mortgage, home construction standards, and standard loan criteria sowed the seeds of secondary market growth. Traditionally, the ability to create loan pools with similar risks and terms has been desirable. Such

standardization provides for ease of marketing and reduces administrative costs.

Improved Securities Marketability -- Investor confidence in the integrity of the financial instrument is crucial to its marketability. Several types of credit enhancement mechanisms can be used to improve the marketability of an instrument including (1) insuring or guaranteeing certain returns to investors in the event of default by the borrowers, (2) requiring high levels of collateral, and (3) providing recourse to the original lender in the event of borrower default. These enhancement tools can be used singularly or in concert to obtain the desired level of product marketability.

Federal government backing of mortgages was a major element in the growth of the home mortgage secondary market by improving the marketability of securities. In the early stages of the market, Federal Housing Authority (FHA)-insured and Veterans Administration (VA)-guaranteed loans were the backbone of the market. Federal government guarantees of timely payment of principal and interest on certain securities, backed by FHA and VA loans, dramatically enhanced the acceptance of home mortgages by the investment community. With the increasing use of securities, the percentage of home loans sold has grown dramatically from about 30 percent of all home loans originated in 1978 to about 78 percent in 1986. Later, use of conventional-mortgage-backed securities gained acceptance as quasi-governmental organizations issued securities with guarantees on principal and interest payments, coupled with private mortgage insurance requirements. Secondary market entities, also, require certain levels of collateralization, or loan-to-value ratios, for loans they purchase.

What Entities Exist?

Organizations most often associated with the secondary home mortgage market are Ginnie Mae, Fannie Mae, and the Federal Home Loan Mortgage Corporation (Freddie Mac). Other organizations, such as large banks, mortgage bankers, and state and local governments, are also active participants in the secondary home mortgage market. All of these organizations differ somewhat in the role they play in the secondary market for home loans, but all make it possible for the existence of a large, active investment market for home loans.

Because Ginnie Mae, Fannie Mae, and Freddie Mac were chartered by the federal government and have "agency status," the financial community perceives that their securities are backed by the government.[1] In reality, Ginnie Mae is a federal agency, and its

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[1]This perceived government backing has not been tested for Fannie Mae and Freddie Mac.

debt is backed by the full faith and credit of the federal government. However, Fannie Mae and Freddie Mac are private organizations without explicit federal government guarantees.

These organizations do share a common characteristic of encouraging investors to buy mortgages or securities representing a pool of mortgages, by assuming risks that would otherwise be borne by the original lender or the investor. This is done by providing a guarantee to investors that the principal and interest derived from the underlying mortgage payments will be paid in case of borrower default.

In 1986 mortgage-backed securities issued by these organizations totaled $259.8 billion, or about 79 percent of all mortgage-backed securities issued publicly. During the same year, private firms and state and local governments accounted for about $53 billion, or about 16 percent, and about $14 billion, or about 4 percent, respectively, of all publicly issued mortgage-backed securities.

How Does the Market Operate?

Many different players can become involved in a secondary mortgage market transaction, but key activities occur in the process: a loan is made; the loan is sold or securities representing a pool of the loans are sold, often to securities dealers; and the securities are then sold to investors. It is not unusual for one entity to perform several of these activities. For example, a mortgage banker may make the loan, pool it with other loans, and sell the security representing the loans to investors. Many other variations on this theme have developed.

Ginnie Mae, Fannie Mae, and Freddie Mac have established financial criteria and standardized mortgage applications that are used by most participants in the home secondary market. Freddie Mac purchases loans that meet its prescribed criteria, providing cash to the lender to make new loans or for other purposes. The lender receives income by (1) charging the borrower a loan origination fee and (2) receiving servicing fees for collecting the payments and forwarding them to the purchaser or designated agent. Fannie Mae also buys loans, but most of its activity is conducted through its "swap" program through which it issues securities to holders of loans and takes the loans in exchange. The holders can then hold the securities or sell them. Ginnie Mae does not buy loans; rather, it charges a fee to guarantee loan pools, which are packaged by financial institutions to sell to investors.

Once loans are purchased or guaranteed by a "secondary market" organization, they can be held in portfolio or packaged with other loans to form a pool that becomes the collateral for a securities issue. This issue is then sold to securities dealers, who, in turn, earn fees by selling the securities to investors. The investors in such securities include commercial banks; savings and loan associations; mutual savings banks; state and local government agencies; pension funds; and private citizens, either individually or through mutual funds.

What Types of Financial Instruments Are Used?

The innovative use of securities to better match the investors' cash-flow and risk needs has been a major factor in the development of the secondary market for home mortgages. The securities that promoted this development are generically referred to as mortgage-backed securities. These securities are issued as both ownership and debt and are named for their cash-flow characteristics. They are issued with and without government or implied-government backing.

The most commonly known ownership issues are called "pass-through" certificates, which represent a pool of mortgages assembled by a mortgage lender. Once the pool has been sold to investors, the ownership of the pool lies with the investors. Although the investors own the mortgages, the loan originator collects all payments, both principal and interest; and all payments, less a servicing fee, are "passed through" to the investors--hence the name "pass-throughs."

The most commonly known debt securities are called mortgage-backed bonds and pay-through bonds. A mortgage-backed bond is a debt obligation of a mortgage lending institution and is collateralized by mortgage loans. The bonds' payment characteristics are much like other bonds, having stated maturities and interest paid at regular intervals. The pay-through bond is also a debt of the mortgage lender and is collateralized by the underlying mortgages. However, its cash-flow stream is like that of a pass-through security, in that investors receive payments each month as monthly payments are passed through to them. Several variations on those types of mortgage securities have developed in recent years to respond to specific investor requirements.

FUNCTIONS PERFORMED BY A SECONDARY MARKET

Historically, secondary markets, especially the home mortgage secondary market, have been credited with performing the following economic functions that promote efficiency and equity in lending markets.

Provide Liquidity

A secondary market for a particular type of financial instrument improves the ability to convert it into cash, or create liquidity, and reduces transaction costs associated with selling the instrument. This enhances the value of the instrument and attracts a broader range of potential investors wishing to buy it.

Moderate Cyclical Flow of Funds

Traditionally, during periods of general capital shortages, the funds available for mortgages generally decreased; and real estate activity slowed down. For example, funds available for home mortgages were severely affected during the general capital shortages of 1969-70, 1974, and 1979-80, as depositors withdrew their funds from deposit accounts at savings and loan associations (thrifts) to seek higher returns on their money. This deposit flight occurred because deposit accounts at the thrifts had interest rate ceilings imposed on them by Federal Reserve Regulation Q.[1] As a result, when general interest rates went up in the economy, depositors withdrew their funds to invest them in unregulated financial instruments. To some extent, the financial institutions operating in the secondary market helped to alleviate the severity of the shortage by purchasing mortgages from the thrifts and, therefore, providing funds for additional lending. In recent years, since general deregulation of interest rates, moderating cyclical flows of funds has not been a major function performed by the home secondary mortgage market.

Assist Regional Flows of Capital

Secondary markets stimulate the flow of funds from capital-surplus to capital-deficit areas. During the last decade the home mortgage secondary market ensured that mortgage funds flowed to rapidly growing areas needing capital, such as the South and West, from capital-surplus areas of the Northeast.

Reduce Geographical Spread in Interest Rates and Allow Portfolio Diversification

As capital becomes more mobile, a geographical moderation in interest rates results because capital will flow to areas of high interest rates, thereby placing downward pressure on those rates. Because a strong secondary market broadens the geographical base of investors, it can spread the risk of a single region, such as the Midwest, to a geographically broader range of investors, potentially lessening its effects.

FARM REAL ESTATE SECONDARY MARKETS

Currently no organized national-scope secondary market exists for farm real estate loans. Through readily available information, however, we have identified several organized markets that are regional in scope and operate primarily in heavily agricultural states. Most of them are state-sponsored programs, but one is a

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[1]Regulation Q prescribes the maximum rates of interest that may be paid by Federal Reserve System member banks on time and savings deposits.

private market, which has been established to operate in three states. In addition, both formal and informal secondary markets exist for Farmers Home Administration (FmHA)-guaranteed farm real estate loans. Examples of formal markets for FmHA loans include the state and private markets discussed below. The informal market reportedly operates throughout the nation. We could not determine, from available information, the number or volume of real estate loans traded in these markets. However, limited audit work has provided some insights into one state market and the private market. Furthermore, one national organization, FCS, appears to perform many of the economic functions associated with an organized secondary market, although it does not buy or sell real estate loans.

State Secondary Markets

Several heavily agricultural states have reacted to financial stress in agriculture by establishing programs to help farmers obtain financing for both operating and real estate loans. During the last decade, at least four states--Nebraska, North Dakota, Wisconsin, and Wyoming--have operated secondary markets for farm operating and real estate loans. Readily available information indicates that loan volume in most of these markets is relatively small--under $50 million--and real estate loans are a small portion of those markets. A brief description of the Wisconsin program will highlight how one of these state-wide secondary markets operates.

In 1986 the Wisconsin Housing and Economic Development Authority (WHEDA) initiated a $10 million pilot program to buy the guaranteed portion of FmHA loans, usually 90 percent, from commercial lenders. WHEDA is a private, state-chartered agency and funds the pilot program through its own investment capital. To qualify for the program, borrowers must be Wisconsin residents engaged in farming in the state. The real estate loans qualifying for purchase must have a maximum loan term of 10 years; a loan repayment schedule computed as if the loan had a 25- to 40-year term, with a balloon payment at the end of the 10-year period; a fixed interest rate; and a maximum of a 1-percent servicing fee built into the interest rate.

The program has purchased one FmHA-guaranteed real estate loan worth $223,200. An additional 16 loans worth about $2.3 million are pending approval. The 17 loans average about $150,500 per loan and range from about $73,800 to $230,400. The program also purchases real estate loans through purchases of combined-purpose loans for real estate and operations. Currently 11 combined-purpose loans worth about $2 million are pending approval. They average about $178,600 and range from about $99,000 to $360,000.

Private Secondary Market

The Mid-America Bankers Service Company (MABSCO) Agricultural Services, Incorporated, or MASI, is a private agricultural credit corporation developed by bankers to create a program to keep community banks competitive and make loans to individuals and companies engaged in production agriculture or agribusiness industries. MASI is a wholly owned subsidiary of MABSCO Bankers Services Inc., a joint effort of 15 state bankers' associations (Arkansas, Colorado, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Montana, North Dakota, Oklahoma, Oregon, South Dakota, and Wisconsin). Currently over 175 banks participate in the program.

In 1983 MASI contracted with Rabobank Nederland--a Dutch bank with $40 billion in assets that ranks among the world's 35 largest and finances 90 percent of Dutch agriculture--to purchase portions of loans made by participating banks. These sales of portions of loans can range up to 80 percent of conventional loans or 100 percent of the FmHA-guaranteed loan portion. MASI currently has about $38 million in outstanding production loan participations with Rabobank.

MASI has recently developed a program to sell participations in real estate loans made by its banks and guaranteed by the FmHA to Rabobank. These loans are to be sold under the same arrangements discussed above. Since September 1986 MASI has approved Iowa's, North Dakota's, and South Dakota's participating banks to sell real estate loans under the program. As of July 8, 1987, no real estate loan participations have been sold under this program.

Secondary Market Functions Performed by the Farm Credit System

FCS is a private national network of lenders that has been chartered by the Congress to make loans to the farm sector. It is the largest institutional farm real estate lender, holding about $40 billion, or about 55 percent, of outstanding farm real estate debt held by institutional lenders as of December 31, 1986. It obtains funds to make those loans through sales of general obligation bonds and holds those loans in its portfolio.

FCS is composed of 12 farm credit districts. Each district has a Federal Land Bank that makes farm mortgage loans through Federal Land Bank Associations; a Federal Intermediate Credit Bank that provides production and equipment loan funds to Production Credit Associations and to other financial institutions that, in turn, lend to farmers; and a Bank for Cooperatives that makes loans to agricultural cooperatives.

FCS issues notes and bonds, which represent the joint and several obligations of all its banks, through its Federal Farm Credit Banks Funding Corporation in New York City. Because the FCS, like Fannie Mae and Freddie Mac, has "agency status," its bonds have traditionally sold at or near rates on similar Department of the Treasury issues. As a result, these sales have provided FCS with relatively low-cost funds, especially for making long-term real estate loans. In addition, because the FCS securities have been desired by many organizations and investors seeking safe investments, FCS has traditionally been able to return to the market often to sell its securities, giving it a stable source of funding.

FCS differs from a secondary mortgage market entity in that it is a primary lender that does not buy or sell mortgage loans. However, its economic effect is similar to that of a secondary mortgage market entity in that it has created liquidity and attracted a wide range of investors, insulated its borrowers from cyclical fund flows, enhanced the regional flow of funds, and reduced regional differences in interest rates.

Created Liquidity

Because of its "agency status," FCS' favored access to the capital market has enhanced its ability to raise cash. This has broadened its range of investors and added liquidity to the farm real estate market.

Insulated Borrowers Against Effects of Cyclical Flow of Funds

FCS has also had the effect of insulating its borrowers against adverse effects caused by outflow of funds during periods of general capital shortages. Because FCS is not a depository institution and relies primarily on sales of securities for its funds, aside from customer demand, proceeds from securities sales are the main determinant of how many loans it can make. Because of its "agency status," FCS bonds have been traditionally treated as favored investments by the investment community and, as a result, have provided FCS with a stable source of funds.

Enhanced Regional Flow of Funds

FCS' ability to return to the national capital markets to borrow large amounts of funds from a broad range of investors and funnel those funds through a national network of mortgage lenders has enhanced the regional flows of funds and FCS' ability to make long-term loans.

Reduced Regional Differences in Interest Rates

FCS has also provided the basis to reduce regional differences in interest rates. Because FCS issues consolidated securities, proceeds of which are distributed to its banks, the cost of money for all banks for any one issue is the same. A review of interest rates charged on FCS farm real estate loans, across FCS districts, indicates that this benefit has been passed through to borrowers. Historically, interest rates have been roughly equal in all FCS districts. It is not expected that the rates would be exactly equal, because individual banks obtain varying amounts of funds at different times and the rates on FCS securities, like other securities, vary for different issues, depending on economic conditions. In addition, each district has different operating costs.

SECTION 2

LEGISLATIVE PROPOSALS FOR A SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

LEGISLATIVE PROPOSALS

Nine legislative proposals were introduced in the 100th Congress for national-scope farm real estate secondary markets:

- -- Farm Mortgage Marketing Corporation Act of 1987, S. 234.
- -- Farm Mortgage Marketing Corporation Act of 1987, H.R. 497.
- -- Farm Credit Enhancement Act of 1987, H.R. 575.
- -- Farm Mortgage Guarantee Act of 1987, S. 427.
- -- Agricultural Mortgage Marketing Act of 1987, S. 848.
- -- Farmers Home Administration Guaranteed Loan Improvements Act of 1987, H.R. 2179.
- -- Agricultural Mortgage Marketing Act of 1987, S. 1172.
- -- Agricultural Mortgage Marketing Act of 1987, H.R. 2435.
- -- Federal Farm Credit Mortgage Corporation Act of 1987 (Title IV, Farm Credit Borrower Stock Protection and System Restoration Act of 1987), S. 1219.

We identified nine legislative proposals, introduced in the 100th Congress, to create an active national-scope secondary market for farm real estate loans. The nine bills represent seven basic proposals. Some of the bills are essentially reintroductions of bills from the 99th Congress, while others have resulted from the current debate about creating an active national secondary market for agricultural real estate loans. Although several proposals have the same titles, all have some differences. However, S. 1172 and H.R. 2435, both titled the Agricultural Mortgage Marketing Act of 1987, are substantially the same. S. 234 and H.R. 497, both titled the Farm Mortgage Marketing Corporation Act of 1987, are also very similar.

We identified the major provisions of each proposal and met with officials of two home mortgage secondary market entities --Ginnie Mae and Fannie Mae. We discussed with them the elements that should be considered to obtain a better understanding of each proposal's potential impact on farmers, lenders, and the federal government. The elements we selected to include in this report are the following: purpose of the market, market organization and operation, sources of funding for the market, cost to establish and operate the market, eligibility criteria for lenders, loan and underwriting criteria, market volume, regulatory oversight body and cost, targeted investors, risk bearers, and market duration.

Not all of this information is available in each proposal to permit an understanding of a secondary market's potential impacts on farmers, lenders, and the federal government. Some of the elements, such as cost to operate or volume of activity, are not typically present in legislation. Others, such as eligibility criteria, may be left to the determination of the administering agency within broad legislative guidelines. Even when elements are present in the proposals, they may not lend themselves to a complete understanding of the potential impact each proposal may have on farmers, lenders, and the government. To permit such an understanding, most elements would have to be fleshed out and refined as the proposals go through the legislative process. Even then, some uncertainty could remain.

The nine proposals would all require some level of government involvement. For example, three proposals would vest the responsibility of making a secondary market in farm real estate loans with the Secretary of Agriculture. The other six would establish a federally chartered corporation as the secondary market institution. Of these, four would create such a corporation within the FCS, and two would create it outside the FCS.

The government could incur direct and immediate financial liability ranging from providing initial funding to the market to guarantees on the loans and mortgage-backed securities traded in the market. For example, S. 234, the Farm Mortgage Marketing Corporation Act of 1987, would provide initial funding through appropriated funds for the Secretary of the Treasury to purchase $200 million of the secondary market corporation's stock. The corporation could retire this stock at any time. H.R. 575, the Farm Credit Enhancement Act of 1987, would provide for government loan guarantees of up to $4 billion to be outstanding at any time. Although many of the bills disclaim any government guarantee on the securities traded in the market, questions loom over the government's potential implied backing as a result of the federal charter.

Profiles for each proposal follow. Appendix I of this report contains a comparative summary of the nine proposals to highlight the key provisions of each proposal.

Farm Mortgage Marketing Corporation Act of 1987,

S. 234

Date introduced

January 6, 1987, 100th Congress.

Sponsor

Senator Cranston.

Date to be established

Date of enactment.

Purpose

The purpose of the proposal is to establish a quasi-private corporation chartered by the federal government that would purchase and insure agricultural mortgages and sell pools of such mortgages in order to do the following: facilitate the availability of long-term credit for agricultural borrowers, provide liquidity for financial institutions and other agricultural lenders, and provide an institutional mechanism to allow capital markets to invest in and provide funding for agricultural loans.

Organizational structure/market operation

The proposal would create a mixed-ownership government corporation, to be called the Farm Mortgage Marketing Corporation. The powers of the corporation initially would be vested in a five-member Board of Directors that would consist of the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and three members appointed by the President with the advice and consent of the Senate. The three presidentially appointed members would be representatives of agricultural lending institutions who have substantial experience and expertise in the fields of agricultural lending and mortgage investments.

Common stock in the corporation with voting rights would be issued to those selling mortgages to it, in return for capital contributions, and then would be freely transferable. When the President determined that sufficient common stock of the corporation had been sold to qualified agricultural lenders, the interim board would turn over the affairs of the corporation to regular board members elected by and from holders of common stock. The chairperson of the board would be designated by the members of the board.

The corporation's earnings would be transferred annually to a general surplus account from which dividends on the common stock would be paid. The board would have discretion to transfer funds from the surplus account to a reserve account.

The corporation would purchase farm mortgage loans from any agricultural lender that it deems qualified; sell securities backed by the mortgages, which it would hold in portfolio; and insure the timely payment of principal and interest payments to purchasers of the securities, either itself or by purchasing insurance from private sources. The corporation would set the term and interest rate on the mortgage-backed securities subject to approval of the Secretary of the Treasury. The corporation would be permitted to apply different regulations or fees to different classes of sellers or lenders.

Funding of the market

Mortgage sellers could be required to make a nonrefundable capital contribution of not more than 2 percent of the unpaid principal amounts of mortgages sold to the corporation and would get common stock in return. In addition, charges or fees could be imposed to meet all costs incurred in carrying out the act, and the corporation could issue additional common stock.

Cost to establish

The Secretary of the Treasury would subscribe to $200 million of the corporation's capital stock, to be funded by appropriated funds. The corporation could retire the stock purchased by the Treasury at any time.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The corporation would establish criteria for determining the eligibility of an agricultural lender and approve applications from lenders applying for certification as qualified agricultural lenders. Participating agricultural lenders would include any bank, business and industrial development company, savings and loan institution, commercial finance company, trust company, credit union, insurance company, or other person approved by the corporation.

Lending criteria/underwriting standards

The proposal defines a farm mortgage as any loan to an agricultural producer that would be (1) originated after the bill's date of enactment, (2) an obligation of a U.S. citizen (or if the borrower is not an individual, a majority interest in the borrower is held by a U.S. citizen), (3) secured by a fee simple or leasehold mortgage with status as a first lien on agricultural real estate located in the United States, and (4) to borrowers whose training or farming experience would assure a reasonable likelihood of repayment. The mortgaged property would have to be land, used for the production of agricultural commodities and of a minimum annual acreage or producing minimum annual receipts established by the corporation.

The loans to be purchased by the corporation would have a loan-to-value ratio of less than 80 percent or have the amount over 80 percent guaranteed or insured by a qualified insurer. Before the corporation could purchase a loan, the lender would be required to agree either to retain a 10-percent participation in the mortgage or to repurchase or replace the loan upon demand if the borrower defaults and no reserves are established to cover losses on such mortgages.

The securities issued by the corporation would be non-bank eligible for purposes of underwriting, selling, and distributing those securities. The term non-bank eligible is not defined in the act.

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

The securities issued by the Farm Mortgage Marketing Corporation would be regulated under federal securities laws administered by the Securities and Exchange Commission (SEC), including the Securities Act of 1933 and the Securities Exchange Act of 1934. The cost of regulation is not discussed in the proposal.

Because it would be a mixed-ownership government corporation, we, the U.S. General Accounting Office, would be required to audit the corporation's financial transactions at least every 3 years, as long as federal government capital was invested in the corporation.

Targeted investors

The proposal does not discuss potential investors targeted.

Risk bearers

The securities would not be guaranteed by or represent an obligation of the United States. The corporation would insure the timely payment of principal and interest for the securities either itself or through private insurance.

Market duration

The proposal does not contain a termination date but states that the corporation would continue until dissolved by an act of Congress.

Farm Mortgage Marketing Corporation Act of 1987,

H.R. 497

Date introduced

January 7, 1987, 100th Congress.

Sponsors

Congressman Lehman (California),
Congressman Bereuter,
Congressman Fauntroy,
Congressman Wortley,
Congressman Torres,
Congressman Kleczka,
Congressman Martinez, and
Congressman Jones (Tennessee).

Companion legislation

H.R. 497 is a companion bill to S. 234, the Farm Mortgage Marketing Corporation Act of 1987. (See p. 22.) The only differences between the two bills relate to the eligibility of banks to participate in the secondary market and the sellers' commitment to repurchase loans in default. H.R. 497 is silent on which market participants may underwrite, sell, and distribute securities created by the new secondary market entity. S. 234 states that the securities would be non-bank eligible for those purposes but does not define the term. On the issue of the sellers' commitment to repurchase mortgages in default, S. 234 would require the sellers to agree either to retain a 10-percent interest in the mortgage or to repurchase or replace the loan upon demand if the borrower defaults and no reserves are established to cover losses on such mortgages. H.R. 497 is silent with respect to the use of reserves.

Farm Credit Enhancement Act of 1987,

H.R. 575

Date introduced

January 8, 1987, 100th Congress.

Sponsor

Congressman Lightfoot.

Date to be established

Date of enactment.

Purpose

The purpose of the proposal is to increase availability of agricultural mortgage credit by authorizing the Secretary of Agriculture to guarantee pools of qualified agricultural mortgage loans and to provide for issuance by approved agricultural loan facilities of securities representing interests in such pools.

Organizational structure/market operation

The Secretary of Agriculture would certify approved agricultural loan facilities. These facilities would then be authorized to issue secondary market securities backed by pools of agricultural mortgage loans.

Each facility would maintain a reserve of U.S. Treasury securities, initially equal to 10 percent of the principal amount of loans comprising each pool, as security for payment of principal and interest to owners of the pool securities. The Secretary, if he concurred in the facilities' certifications of pooled loans, would guarantee timely payment of principal and interest on the securities backed by the pools after the 10-percent reserve was exhausted.

The government guarantee would not be available to any pool in which a single loan constituted more than 5 percent of the pool at the time of the loan guarantee application. Any proceeds from the liquidation of collateral or from judgments, settlements, or guarantees with respect to a loan in the pool would first be used, less costs of collection, to reimburse the Secretary for any guarantee payments made on the pool.

Funding of the market

The Secretary of Agriculture would be authorized to borrow from the Treasury to finance outstanding loan guarantees, on terms approved by the Secretary of the Treasury. In addition, a guarantee fee not greater than one-half of 1 percent of the principal amount of the loan pools would be charged the loan facilities for guaranteeing the pools. Entities applying to be approved agricultural lending facilities would be charged a "reasonable" certification fee to cover costs incurred in processing and evaluating the applications.

Cost to establish

The proposal does not estimate or limit cost to establish. However, the total amount of guarantees outstanding at any time would not exceed $4 billion.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The proposal does not provide criteria as to which lenders may sell loans in the market. However, it discusses eligibility criteria for organizations approved to purchase and pool the loans. An approved agricultural loan facility is defined as (1) a corporation, association, or trust under state or District of Columbia law having as its primary business purpose the sale or resale of securities backed by pools guaranteed by the Secretary of Agriculture and (2) being certified by the Secretary. To be certified under rules prescribed by the Secretary, such facilities would be required to have capitalization of at least $25 million, acceptable managerial ability in relevant areas, adequate agricultural mortgage loan underwriting and servicing procedures, and prior agricultural mortgage origination experience of $25 million or more during each of 3 preceding years. Certification would be good for 5 years but could be revoked after notice and hearing for noncompliance with rules. Guarantees would not be affected by the revocation.

Lending criteria/underwriting standards

A qualified loan would be the following: an obligation of a U.S. citizen or a private corporation or partnership whose owners holding a majority interest in that organization are U.S. citizens; originated after enactment of this proposal; secured by a fee simple or leasehold first-lien mortgage on agricultural real estate located in the United States; an obligation not exceeding $2 million in total principal; made to borrowers whose training or farming experience assure a reasonable likelihood of repayment; and certified by an approved agricultural loan facility as meeting underwriting, security, and repayment standards established by the Secretary in consultation with agricultural mortgage loan originators. The mortgaged property would have to be land, used for the production of agricultural commodities and of a minimum acreage or producing minimum annual receipts established by the Secretary.

Volume of activity

The proposal does not estimate volume of activity. It specifies, however, that the total amount of guarantees outstanding at any time would not exceed $4 billion.

Regulatory oversight body and cost

The Secretary of Agriculture would be authorized to examine the books, records, and loan files of the approved agricultural loan facilities. Securities under this proposal would be exempt from the federal securities laws administered by the SEC to the same extent as securities that are obligations of or guaranteed by the United States. If the securities are rated among the four highest categories, they would also be exempt from state regulation to the same extent. States could pass laws to override this exemption. The cost of regulation is not discussed in the proposal.

Targeted investors

Targeted investors are not specifically discussed in the proposal. The proposal would require that the securities be authorized investments under federal or state law of any person, trust, corporation, partnership, association, business trust, or business entity to the same extent as federally issued or federally guaranteed obligations, provided the pool securities are rated in one of the four highest rating categories. States could pass laws to override this provision.

Risk bearers

The securities would not be guaranteed by the United States. The approved loan facilities would have to exhaust the reserve equal to 10 percent of the pool principal before the government guarantee would be activated. Then the government's risk exposure would be the amount of the default, less amounts recouped by the facility on all defaulted loans in the pool.

Market duration

The Secretary of Agriculture's authority to guarantee new pools of loans would terminate 5 years after enactment.

Farm Mortgage Guarantee Act of 1987,

S. 427

Date introduced

February 2, 1987, 100th Congress.

Sponsor

Senator Grassley.

Date to be established

Date of enactment.

Purpose

The purpose of the proposal is to encourage agricultural lenders to provide long-term financing for the purchase of agricultural land by providing a secondary market for sound mortgages adequately secured by farm real estate and guaranteed by the FmHA.

Organizational structure/market operation

The Secretary of Agriculture or his agent would purchase qualifying farm real estate mortgages or interests in such mortgages. The Secretary would guarantee principal and interest payments on purchased loans on terms and conditions that he finds to be prudent and that will assure an adequate market for the loans. The guarantee could not be extended to any loan if at the time of the guarantee the amount borrowed exceeded 70 percent of the "most probable" purchase price of the property securing the loan; the price to be established by the Secretary of Agriculture.

The Secretary, acting for himself or through designated agents, would assure a secondary market for guaranteed loans by selling, reselling, purchasing, and repurchasing the loans or securities backed by the loans. The Secretary would promulgate regulations necessary to carry out the act.

Funding of the market

The market would be funded through two funds created by the bill, the Farm Mortgage Revolving Fund and the Farm Real Estate Insurance Fund. The revolving fund would be used to buy loans and pay costs of administering the law. It would be credited for funds received by the Secretary of Agriculture from the sale of loans, interest earned from the investments of the revolving fund, and principal and interest payments on loans held for resale.

The insurance fund would receive up to a $100-million appropriation and earnings on investments of its assets in federally guaranteed obligations. It would be used, to the extent permitted in appropriation acts, to discharge obligations associated with loan guarantees.

In addition, the Secretary could transfer funds from the revolving fund to the insurance fund as necessary to pay obligations associated with loan guarantees. Fees imposed by the Secretary on sellers and buyers of loans would be allocated between the revolving fund and the insurance fund at the Secretary's discretion. When the insurance fund exceeds 5 percent of the aggregate value of loans and interest on loans for which a guarantee is in effect, the Secretary would use receipts that would otherwise go to the insurance fund to repay the appropriated amounts.

Cost to establish

No initial capitalization is specified for the revolving fund. An appropriation of $100 million would be authorized for the insurance fund for the purpose of guaranteeing loans purchased and then resold in the secondary market.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The proposal indicates that federally or state-chartered commercial banks, savings and loan associations, credit unions, mutual savings banks, mortgage bankers, cooperative lending agencies, or other legally organized lending agencies, including institutions of the FCS or insurance companies, could be approved to sell loans they have originated. Loans held by FmHA would be eligible to participate.

Lending criteria/underwriting standards

To qualify, farm real estate loans not held by FmHA would have to be (1) initiated by an approved legally organized lending agency, including FCS institutions and insurance companies, (2) secured by farm land adequate to ensure low risk of loss of principal, (3) made to a borrower with sufficient resources or cash flow to ensure a high probability of repayment, (4) secured at the time of the loan guarantee by property having a loan-to-value ratio of no more than 70 percent, based on the "most probable" price of the property, and (5) in accordance with such other requirements as the Secretary of Agriculture would impose. If the loans are held by

FmHA, they need meet only the second, third, and fourth requirements.

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

The Secretary of Agriculture would promulgate regulations to carry out the act and could delegate his authority to oversee secondary market operations to FmHA. The cost of regulation is not discussed in the proposal.

Targeted investors

The proposal does not discuss potential investors targeted.

Risk bearers

The government would assume risks according to the terms of the loan guarantee. Depending on the terms of any securities issued, the government could also assume additional risks. Lenders and/or investors would assume risks not covered by the government.

Market duration

The Secretary's authority to guarantee a loan under provisions of the act would terminate on December 31, 1991. A guarantee made prior to that date would remain in effect for the life of the loan.

Agricultural Mortgage Marketing Act of 1987, S. 848

Date introduced

March 26, 1987, 100th Congress.

Sponsors

Senator Exon and
Senator Grassley.

Date to be established

Not later than 60 days after date of enactment.

Purpose

The purpose of the proposal is to establish the Agricultural Mortgage Enhancement Corporation as an institution of the FCS. The purposes of the corporation would be to certify agricultural mortgage marketing entities and provide for a secondary marketing arrangement for farm real estate mortgages in order to increase the availability of long-term agricultural credit at a stable interest rate, provide greater liquidity and lending capacity for agricultural lenders, and facilitate the funding of long-term agricultural investments.

Organizational structure/market operation

Not later than 60 days after enactment, the FCA would organize and grant a charter to the Agricultural Mortgage Enhancement Corporation. The Board of Directors of the corporation would consist of nine members appointed by the Chairman of the FCA Board. Of these nine members, three would be representatives of agricultural lending institutions outside the FCS that have substantial experience in agricultural lending; three would be representatives of agricultural lending institutions within the FCS that have substantial experience in agricultural mortgage lending; and three would be representatives of the general public recognized as experts in agricultural lending and mortgage investment, one of whom would be designated by the Chairman of the FCA Board as Chairman of the Board of Directors.

The corporation would certify private agricultural mortgage marketing entities that, in turn, would purchase qualified agricultural real estate mortgage loans from originating lenders. The agricultural mortgage market entities would package the loans into pools and issue securities, backed by the pools and guaranteed by the corporation, to the investing public. The corporation would not discriminate between or against FCS and non-FCS applicants desiring to become certified agricultural mortgage marketing entities.

To be eligible for certification, an entity would be required to (1) have adequate capitalization, (2) have as its primary business purpose the sale or resale of the agricultural mortgage-backed securities, (3) demonstrate acceptable managerial ability, (4) adopt appropriate underwriting and other standards required by the corporation, (5) permit the corporation to examine the entity's books, records, and loan files, and (6) be a corporation, association, or trust under state or District of Columbia law. Certification would be for 5 years or less and could be revoked after notice and hearings for failure to continue to meet eligibility criteria.

The corporation would be authorized to provide credit enhancement, defined as the assurance of timely payment of principal and interest on the securities representing interests in the pools of qualified agricultural real estate mortgage loans purchased by the entities. Credit enhancement would not be provided unless: the amount of any single loan would not exceed 5 percent of the total principal amount of the pool; the mortgage loan originator would retain the servicing of the loan; and the loans would be purchased by the entity without recourse to the mortgage loan originator. Each certified mortgage marketing entity would be required to maintain for the benefit of the holders of its securities a reserve in U.S. Treasury securities equal to 10 percent of the principal amount of the loans comprising each pool. Before the corporation would pay on its guarantee of principal and interest to security holders, the individual mortgage marketing entity would have to exhaust the 10-percent reserve. Funds for the reserve would come from both the certified entity and the loan originator. Any proceeds received by an entity from the liquidation of collateral or from judgments, settlements, or other guarantees with respect to a loan in the pool, less costs of collection, would first be used to reimburse the corporation for any guarantee payment made on the pool.

Funding of the market

The FCA would provide initial capitalization for the corporation through a revolving fund established by existing law (12 U.S.C. 2151) to fund the Farm Credit System Capital Corporation. The FCA would commit any other funds necessary to meet the corporation's responsibilities that are available to it, including funds originating outside FCS.

The corporation would also have authority with the approval of FCA to borrow from any source. The corporation would be authorized to charge a fee for credit enhancement that would not exceed one-half of 1 percent of the principal amount of the guaranteed mortgage loans comprising the pool. The corporation also would be authorized to collect a reasonable fee to recover costs incurred for processing applications for certification as agricultural mortgage marketing entities.

Cost to establish

The proposal does not state the amount of initial capitalization.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The proposal defines an agricultural mortgage loan originator to be any bank, business and industrial development company, savings and loan association, commercial finance company, trust company, credit union, insurance company, or other entity that originates and services agricultural mortgage loans.

Lending criteria/underwriting standards

The proposal defines a qualified agricultural mortgage loan to mean an obligation (1) originated after date of enactment of the bill and secured by a fee simple or leasehold mortgage with status as a first lien on agricultural real estate located in the United States, (2) not exceeding $2 million in total principal, with a loan-to-value ratio not exceeding 65 percent, (3) approved by a certified agricultural mortgage marketing entity, and (4) of a U.S. citizen, or a corporation or partnership of which a majority interest is held by U.S. citizens, who has training or farming experience that is sufficient to assure a reasonable likelihood of repayment. The bill defines agricultural real estate to mean a parcel or parcels of land, used for the production of one or more agricultural commodities or products, consisting of a minimum acreage or producing minimum annual receipts as determined by the corporation. The corporation would establish uniform underwriting, security appraisal, and repayment standards for qualified loans. The proposal requires that the standards would not discriminate against small agricultural mortgage loan originators or small agricultural mortgage loans of at least $50,000.

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

The corporation would be an institution of the FCS subject to the regulations and oversight of the FCA. The securities guaranteed by the corporation would be exempt from federal securities laws administered by the SEC, to the same extent as securities that are obligations of or guaranteed by the United States. They would also be exempt from state securities laws if rated in one of the four highest rating categories. States could pass laws to override this exemption. The cost of regulation is not discussed in the proposal.

Targeted investors

Securities guaranteed by the corporation would be designated as qualified investments under state or federal law for any person, trust, corporation, partnership, association, business trust, or business entity, provided such securities are rated in one of the four highest rating categories. States could pass laws to override this provision.

Risk bearers

The securities would carry a statement that they are not guaranteed by or an obligation of the United States. The 10-percent reserve funded by the certified mortgage marketing entities and the loan originators would be looked to first for the timely payment of principal and interest. When drawing on the reserve to meet losses, except for the portion of losses absorbed by the certified entity's contributions to the reserve, losses would be charged first to the total contribution to the reserve of the originator of the loan in default, before charging the contributions of other originators. The corporation would guarantee the timely payment of the remaining principal and interest for the securities comprising guaranteed pools of agricultural mortgage loans.

Market duration

The authority of the corporation to provide guarantees for new pools of qualified agricultural mortgage loans would terminate 5 years after date of enactment.

Farmers Home Administration Guaranteed Loan Improvements Act of 1987,

H.R. 2179

Date introduced

April 27, 1987, 100th Congress.

Sponsor

Congressman Thomas (Georgia).

Date to be established

Upon issuance of final regulations by the Secretary of Agriculture.

Purpose

The purpose of the proposal is to improve the operation of the secondary market for loans guaranteed by FmHA, including agricultural real estate loans.

Organizational structure/market operation

The proposal applies generally to loans guaranteed by the FmHA under Title III of the Consolidated Farm and Rural Development Act, including real estate, operating, and rural development loans. The portion of such loans made by private-sector lenders that is guaranteed by the FmHA may be sold by the lender, and by any subsequent holder, in accordance with regulations on such sales issued by the Secretary of Agriculture, provided (1) all fees due the Secretary with respect to a guaranteed loan are paid in full before any sale and (2) the loan is fully disbursed to the borrower before the sale. After a loan is sold in the secondary market, the lender remains obligated under the guarantee agreement with FmHA and is required to continue to service the loan according to the guarantee agreement. The Secretary is to develop the necessary procedures for the facilitation, administration, and promotion of secondary market operations and for assessing the increase of farmers' access to capital at reasonable rates and terms as a result of secondary market operations.

The Secretary may issue pool certificates representing ownership of part or all of the guaranteed portion of any loan guaranteed by the FmHA under Title III. Such certificates are to be backed by a pool composed solely of the entire FmHA-guaranteed portion of such loans. The Secretary may permit approved market makers to issue pool certificates on his behalf and may guarantee the timely payment of the principal and interest on such certificates. Such guarantee is limited to the extent of principal and interest on the guaranteed portions of loans that comprise the pools. The full faith and credit of the United States is pledged to the payment of all amounts required to be paid under any guarantee of pool certificates issued by approved market makers.

On the adoption of final regulations, the Secretary would (1) provide for the central collection of registration information from all participating market makers for all loans and pool certificates sold by them; (2) before any sale of pool certificates, require the seller to disclose to each prospective purchaser information on the terms, conditions, and yield; (3) require each market maker to service all pools formed and participations sold and to provide specific information to the Secretary relating to collection and disbursement of funds; and (4) regulate market makers with regard to pool certificates sold. The Secretary can charge fees for these functions.

Funding of the market

The proposal speaks of a reserve fund, to be established by the Secretary to enable the guarantee to be self-funding, but does not explain the mechanism for the reserve fund. The Secretary is authorized to collect fees for the functions he is to perform after the adoption of final regulations, provided that he is not to collect any fee for the guarantee of a pool certificate. The fees are not available to finance the program. Two existing revolving funds, the Agricultural Credit Insurance Fund and the Rural Development Insurance Fund, both currently available to meet the Secretary's obligations on guaranteed loans under Title III, would apparently also be available to satisfy guarantees of pool certificates.

Cost to establish

The proposal does not discuss the cost to establish the various provisions.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The proposal does not discuss eligibility criteria for participating market makers. For lenders, existing law provides that the Secretary may guarantee loans by any federally or state-chartered bank, savings and loan association, cooperative lending agency, or other legally organized lending agency. (See 7 U.S.C. 1928(h).)

Lending criteria/underwriting standards

The proposal does not discuss lending criteria/underwriting standards for participating market makers. Generally, borrowers must be farmers or ranchers in the United States who are citizens with training or experience that the Secretary judges assures reasonable prospects of success, who are operating a family farm, and who cannot get credit elsewhere at reasonable rates and terms. (See 7 U.S.C. 1922.)

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

The Secretary of Agriculture would be required to issue regulations governing the operations of a secondary market for FmHA-guaranteed loans. The Secretary would be required to transmit an annual report to the Senate and House Committees on Agriculture including specific information on the operations of the secondary market. The cost of regulation is not discussed in the proposal.

Targeted investors

The proposal does not discuss potential targeted investors.

Risk bearers

The United States bears the credit, or default, risk of pool certificates issued by approved market makers and guaranteed by the Secretary of Agriculture. Such guarantee is limited to the extent of principal and interest on the guaranteed portions of loans that comprise the pools. Since the unguaranteed portion of a loan is not included in a pool, it appears that the owner of the unguaranteed portion, whoever that is, bears the credit risk.

Market duration

The proposal does not contain a termination provision.

Agricultural Mortgage Marketing Act of 1987,

S. 1172

Date introduced

May 8, 1987, 100th Congress.

Sponsors

Senator Pryor,
Senator Cochran,
Senator Exon,
Senator Grassley,
Senator Simpson,
Senator McClure,
Senator Baucus,
Senator Harkin,
Senator Symms, and
Senator Durenberger.

Date to be established

Not later than 60 days after date of enactment.

Purpose

The purpose of the proposal is to establish the Federal Agricultural Mortgage Corporation as an institution of the FCS. The purposes of the corporation would be to certify agricultural mortgage marketing facilities and to provide for a secondary marketing arrangement for farm real estate mortgages in order to increase the availability of long-term agricultural credit at a stable interest rate, provide greater liquidity and lending capacity for agricultural lenders, and facilitate capital market investment in long-term agricultural funding.

Organizational structure/market operation

Within 60 days of enactment, the President would appoint a nine-member interim board of directors and designate one of them as interim chairman. Of the nine interim directors, three would be representatives of banks, other financial institutions, or insurance companies; three would be representatives of the FCS; two would be farmers; and one would be a representative of the general public. The interim board's primary duty would be to arrange for an initial offering of the corporation's voting common stock to banks, other financial institutions, life insurance companies, and members of the FCS on an equitable and nondiscriminating basis so that no institution or group of institutions acquires a disproportionate amount. Stock may be issued only to agricultural mortgage loan originators or certified agricultural mortgage marketing facilities. However, the stock is fully transferable. The voting common stock would be divided equally between member institutions of the FCS and nonmember institutions. The interim board would also be authorized to take whatever actions are necessary for the corporation to proceed with its operations.

After $20 million of initially offered voting common stock was purchased and fully paid, a 15-member permanent board of directors would be chosen. Six members would be elected by the banks, other financial institutions, and insurance companies; six members would be elected by FCS institutions; and three members would be appointed by the President. The FCS stockholders and the non-FCS stockholders would each vote as a class. Two of the presidentially appointed directors would be farmers, and one would be a representative of the general public.

Not later than 120 days after the permanent Board of Directors is chosen, the corporation would be required to issue standards for certification of agricultural mortgage marketing facilities, including eligibility standards. The certified facilities in turn would purchase qualified agricultural real estate mortgage loans from originating lenders and package the loans into pools that would serve as collateral for securities purchased by the investing public. The corporation would not discriminate between or against FCS and non-FCS applicants desiring to become certified agricultural mortgage marketing facilities.

A certified facility would be required to do the following: (1) be an affiliate of an institution of the FCS or a corporation, association, or trust under state or District of Columbia law; (2) have adequate capitalization; (3) have as one of its purposes the sale or resale of securities representing interests in pools of qualified agricultural mortgage loans that have been provided credit enhancement by the corporation; (4) demonstrate acceptable managerial ability; (5) adopt appropriate agricultural mortgage loan underwriting, appraisal, and servicing standards in conformity with those established by the corporation; and (6) permit the corporation to examine the facility's books, records, and loan files. Certification would be for 5 years or less and could be revoked after notice and hearings for failure to continue to meet eligibility criteria.

The corporation would be authorized to provide credit enhancement --the assurance of timely payment of principal and interest--on securities representing interests in pools of qualified agricultural mortgage loans, on application by certified agricultural mortgage marketing facilities. Credit enhancement would be provided through agreement with the existing Federal Farm Credit Banks Funding Corporation (Funding Corporation). The maximum liability of the Funding Corporation with respect to credit enhancement would not exceed a total amount of $500 million.

The issuance of any credit enhancement would be subject to provisions among which are the following: (1) the credit enhancement would be issued to cover an individual pool of qualified mortgage loans pursuant to the application of a certified agricultural mortgage marketing facility; (2) the amount of any single loan could not exceed 5 percent of the total principal amount of the pool; (3) the mortgage loan originator would retain the servicing of the loan; (4) the loans would be purchased by the facility without recourse to the mortgage loan originator; (5) a reserve equal to 10 percent of the principal amount of the loans comprising each pool would be established by the certified mortgage marketing facility, with optional participation by agricultural mortgage loan originators; (6) the individual mortgage marketing facility would have to exhaust its 10-percent reserve, before the Funding Corporation's credit enhancement for the timely payment of principal and interest to security holders would be activated; and (7) any proceeds received by a facility from the liquidation of collateral, judgments, settlements, or guarantees with respect to a loan in the pool, less costs of collection, would first be used to reimburse the Funding Corporation for any credit enhancement payment made on the pool. With regard to the 10-percent reserve, agricultural mortgage loan originators that exercise their option to contribute to the pool would be paid semiannually any earnings on their contributions to the reserve, to the extent the distribution would not cause the reserve to fall below 10 percent of the outstanding aggregate principal and accrued interest of loans remaining in the pool. The reserve would have to be exhausted first before any payments were made to security holders.

Agricultural loans by loan originators or certified facilities pursuant to this act would be exempt from state laws or constitutions limiting interest, discount points, finance charges, or other charges. States could pass laws to override this exemption.

<u>Funding of the market</u>

In addition to the initial $20 million of common stock sold, the corporation would be authorized to require each agricultural mortgage loan originator and each certified mortgage marketing facility to make nonrefundable capital contributions, in exchange for stock, that are reasonable and necessary to carry out the purposes of the act. The corporation could issue additional common stock but only to mortgage loan originators or certified agricultural mortgage facilities.

Further, at the time a Funding Corporation credit enhancement would be issued, the corporation would impose a fee on the certified agricultural mortgage marketing facility not greater than one-half of 1 percent of the initial principal amount of securities backed by each pool of qualified loans covered by the Funding Corporation's credit enhancement. The corporation would also impose additional charges or fees in reasonable amounts to recover its administrative costs.

Cost to establish

An initial capitalization of $20 million is to be provided from purchase of stock by banks, other financial institutions, insurance companies, and FCS institutions.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The proposal defines an agricultural mortgage loan originator to be any FCS institution, bank, insurance company, business and industrial development company, savings and loan association, commercial finance company, trust company, credit union, or other entity that originates and services agricultural mortgage loans.

Lending criteria/underwriting standards

The proposal defines a qualified agricultural mortgage loan to mean, among other things, an obligation (1) secured by a fee simple or leasehold mortgage with status as a first lien on agricultural real estate located in the United States; (2) approved by a certified agricultural mortgage marketing facility as meeting the underwriting, security appraisal, and repayment standards established by the corporation in consultation with agricultural mortgage loan originators; and (3) of a U.S. citizen (or a corporation or partnership the majority of which is held by U.S. citizens) that has training or farming experience sufficient to assure a reasonable likelihood that the loan will be repaid according to its terms. The bill defines agricultural real estate to mean a parcel or parcels of land, used for the production of one or more agricultural commodities or products and consisting of a minimum acreage or producing minimum annual receipts as determined by the corporation. These standards established by the corporation are not to be used to discriminate against small agricultural mortgage loan originators or small agricultural mortgage loans of at least $50,000.

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

The corporation would be an institution of the FCS and subject to the regulatory authority of the FCA. However, that authority would be confined to providing for examination of the condition of the corporation and to the general regulation of the safe and sound performance of the powers, functions, and duties vested in the corporation. The corporation would have to publish an annual report containing financial statements prepared in accordance with generally accepted accounting principles and audited by an independent public accountant, as well as any other information required by the FCA. The FCA would be required to audit the financial transactions of the corporation at least annually. The securities representing an interest in a pool of qualified agricultural mortgage loans for which credit enhancement had been provided by the Funding Corporation would be exempt from federal securities laws administered by the SEC and from state securities laws to the same extent as U.S.-issued or -guaranteed securities. States could pass laws to override the exemption. The cost of regulation is not discussed in the proposal.

Targeted investors

Securities representing an interest in pools of qualified agricultural loans, for which the Funding Corporation has provided credit enhancement, would be designated as qualified investments for any person, trust, corporation, partnership, association, business trust, or business entity to the same extent as U.S.-issued or -guaranteed securities. States could enact laws to override the provision. The securities would be eligible for unlimited purchase, sale, and underwriting by national banks.

Risk bearers

Securities issued would carry a statement that they are not guaranteed by or an obligation of the United States. The 10-percent reserve created by the certified mortgage marketing facilities would be looked to first for the timely payment of principal and interest. When drawing on the reserve to meet losses, except for the portion of losses absorbed by the certified facility's contribution to the reserve, losses would be charged first to the contribution to the reserve of the originator of the defaulted loan before charging the contributions of other originators. The Funding Corporation's credit enhancement would provide for the timely payment of the remaining principal and interest for the securities backed by pools of qualified agricultural mortgage loans.

Market duration

The proposal does not contain a termination provision. The proposal states that the corporation would continue until dissolved by an act of Congress.

Agricultural Mortgage Marketing Act of 1987,

H.R. 2435

Date introduced

May 14, 1987, 100th Congress.

Sponsors

Congressman Stallings,
Congressman Gunderson,
Congressman English,
Congressman Bereuter,
Congressman Lehman (California),
Congressman Craig,
Congressman Penny,
Congressman Jontz,
Congressman Lightfoot,
Congressman Morrison (Washington),
Congressman Weber,
Congressman Nagle,
Congressman Evans, and
Congressman Roberts.

Companion legislation

H.R. 2435 is a companion bill to S. 1172, the Agricultural Mortgage Marketing Act of 1987. (See p. 40.) Although the wording of the bills differs slightly, they are in substance identical.

Federal Farm Credit Mortgage Corporation Act of 1987 (Title IV, Farm Credit Borrower Stock Protection and System Restoration Act of 1987),

S. 1219

Date introduced

May 15, 1987, 100th Congress.

Sponsors

Senator Leahy and
Senator Lugar.

Date to be established

Date of enactment.

Purpose

The purposes of the proposal are to (1) increase the availability of agricultural credit; (2) stimulate the flow of investment capital into the agricultural sector; and (3) increase the liquidity and lending capacity of agricultural lenders by creating the Federal Farm Credit Mortgage Corporation, which would foster, develop, and maintain a nationwide secondary market for agricultural loans.

Organizational structure/market operation

The proposal would amend the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.) to create the Federal Farm Credit Mortgage Corporation. The corporation would be a federally chartered instrumentality of the United States and an institution of the FCS. The corporation would have an initial Board of Directors consisting of nine members: six elected by FCS banks to represent FCS, and three elected by the other six to represent non-FCS institutions that sold agricultural loans to the corporation or that issued securities guaranteed by the corporation. When the board determines that voting rights are sufficiently dispersed to permit representative elections of non-FCS directors, non-FCS institutions will be allowed to elect directors to represent them. The board would be authorized to increase the number of directors to 12 or 15, provided that the ratio of 2 directors elected by FCS banks for each director elected by non-FCS institutions was maintained. The board would elect, on an annual basis, a chairman from among the members of the board.

The corporation would have Class A voting common stock, which would be issued to and held only by FCS banks. The initial capitalization of the corporation, which would be determined by the board, would be provided by each FCS bank, with each bank required to purchase an equal number of shares of Class A common stock at a price set by the board. The FCS banks that sell loans to the corporation or issue securities guaranteed by the corporation may be required to buy additional Class A stock, on the basis of the nature and volume of their transactions with the corporation. The corporation would be authorized to issue additional Class A stock to FCS banks and to issue additional classes of nonvoting common stock and nonvoting preferred stock.

The corporation would be authorized to purchase, service, sell, or lend on the security of, or otherwise deal in, agricultural loans. The corporation would require, as far as is practicable, equal access to full participation in its programs by each type of eligible seller.

The operations of the corporation would be confined so far as practicable to agricultural loans of such quality, type, and class as to meet standards imposed by private institutional agricultural loan investors. The corporation would establish underwriting standards as it deems appropriate to implement this requirement. The corporation would not be authorized to require recourse to the loan seller as a prerequisite to buying a loan but would be authorized to consider the extent of recourse and the nature of the seller's guarantees as an element of pricing.

The corporation would be authorized to guarantee timely payment of principal and interest on securities (1) issued by any issuer approved by the corporation and (2) backed by a trust or pool of eligible agricultural loans. The corporation's guarantee would be limited to pools containing only loans of such quality, type, and class that meet purchase standards imposed by private institutional agricultural loan investors.

The corporation would make payments to holders of guaranteed securities when the issuer defaults and would be empowered to contract with issuers so that in the event of the issuer's default, the loans would become property of the corporation, subject only to the unsatisfied rights of the holders of the securities. State law could not override this provision.

Funding of the market

The initial capitalization of the corporation would be provided by each FCS bank, as determined by the board. Each FCS bank would purchase an equal number of shares of Class A voting common stock at a price set by the board. FCS banks selling loans to or issuing securities guaranteed by the corporation could be required to buy additional Class A stock. The board also would be authorized to issue additional classes of nonvoting common stock and nonvoting preferred stock.

The corporation would impose a reasonable guarantee fee and make other charges to recover costs of its loan and security review and analysis. The corporation could also impose different fees for different classes of sellers or services as long as the distinction was related to the purposes of the act. Fee requirements could not discriminate solely on the basis of FCS membership.

Cost to establish

The proposal does not specifically discuss the amount it would cost to establish the corporation and to implement its secondary market operations. However, the corporation could not exercise its powers to retire any of the Class A stock if the necessary payment reduced capital, reserves, and surplus of the corporation below $100 million.

Cost to operate

The proposal does not estimate or limit operating cost.

Eligibility criteria for participating lenders

The corporation would purchase an agricultural loan from any FCS bank, regulated insurance company, financial institution whose deposits are insured by an agency of the United States, and any other class of institutional agricultural lenders that the board may deem appropriate. The corporation would establish requirements for sellers consistent with the purposes of the act. Among other factors that the corporation could take into account would be minimum net worth, supervisory mechanisms, warranty compensation mechanisms, prior approval of facilities, and prior experience.

Lending criteria/underwriting standards

The proposal defines an agricultural loan to either mean an obligation secured by a fee simple or leasehold mortgage with status as a first lien on agricultural real estate located in the United States, which is used for the production of one or more agricultural commodities or products and which consists of minimum acreage or produces minimum annual receipts, as determined by the corporation and meeting any other requirements as to amount, term, repayment provisions, status prescribed by the corporation or alternatively to mean any loan originated or purchased by an FCS member under the Farm Credit Act or that was not originated by an FCS member but could have been, except for the requirement to purchase stock in the originating institution as a condition of the loan. On the basis of its requirements, the corporation would determine if an institution would be eligible to sell agricultural loans to the corporation.

The corporation would buy or guarantee only agricultural loans of such quality, type, and class that meet purchase standards imposed by private institutional agricultural investors. The corporation would be required to establish underwriting standards it deems appropriate to implement this requirement.

Volume of activity

The proposal does not estimate or limit volume of activity.

Regulatory oversight body and cost

All securities issued or guaranteed by the corporation would be exempt from federal securities laws administered by the SEC and from state law to the same extent as U.S. government-issued or -guaranteed securities. States could pass laws to override this exemption.

The regulatory authority of the FCA with respect to the Federal Farm Credit Mortgage Corporation would be confined to providing for the examination of the condition and the general regulation of the safe and sound performance of the powers, functions, and duties vested in the corporation.

The corporation's financial transactions would be audited at least annually by FCA, and FCA would report the results to the Congress. The corporation would prepare an annual report of its condition, including financial statements prepared in accordance with generally accepted accounting principles, and audited by an independent public accountant.

FCA may order the corporation to cease and desist from practices that FCA considers unsafe or unsound and may remove directors or officers of the corporation that it finds have violated a cease-and-desist order, engaged in an unsafe or unsound practice, or committed a breach of fiduciary duty (if certain other conditions are met). Judicial review of these actions is available. Civil penalties can also be imposed for unsafe or unsound practices. The cost of regulation is not discussed in the proposal.

Targeted investors

Any person, trust, or organization created under the laws of the United States or any state would be authorized to purchase, hold, and invest in agricultural loans, obligations, or other securities that are issued, sold, or guaranteed by the corporation to the same extent as securities issued or guaranteed by the United States. States could pass laws to override this provision.

Risk bearers

Securities issued by the corporation or by issuers approved by the corporation and backed by pools of eligible agricultural loans would be guaranteed by the corporation with respect to the timely payment of principal and interest. The FCS banks would be required, to the extent prescribed by the corporation's board, to guarantee the corporation's obligations with respect to any agricultural loan or security.

Market duration

The proposal does not contain a termination provision.

SECTION 3

KEY ISSUES IN THE SECONDARY MARKET DEBATE

KEY SECONDARY MARKET ISSUES

Questions for further consideration in the secondary market debate:

-- Is federal government involvement needed to develop a large national-scope secondary market for farm real estate loans?

-- What impact would a large national-scope secondary market for farm real estate loans have on FCS and other lenders?

-- Should FCS be given powers to operate as the secondary market for all lenders?

-- Could a new secondary market entity coexist with the FCS?

-- What loans should be eligible to be sold in the secondary market?

On the basis of our examination of the legislative proposals in section 2 of this report and our discussions with individuals and officials, from both the private sector and government, we believe that several issues merit additional consideration in the secondary market debate. Our observations on the following questions should help highlight the issues involved.

IS FEDERAL GOVERNMENT INVOLVEMENT NEEDED TO DEVELOP A LARGE NATIONAL-SCOPE SECONDARY MARKET FOR FARM REAL ESTATE LOANS?

Given the historical experience with farm real estate lending, it is unlikely that a large national-scope secondary market for farm real estate loans can be established without federal government involvement. Historically, the federal government has encouraged FCS' role in providing farm real estate loans on reasonable terms because it had determined that such credit was not adequately provided through other lenders. FCS' "agency status" has historically enabled it to obtain a stable source of funds from the capital markets to make long-term farm real estate loans. Wall Street investment house representatives told us that a large secondary market for farm real estate loans could not exist without some degree of government involvement. Given the current financial stress in the farm sector--combined with the economic, weather, geographic, and political environments normally facing the sector--potential risks faced by investors are great.

The private sector has not, of its own accord, developed a large national-scope farm real estate secondary market. The legislative proposals all provide some degree of government involvement to, at a minimum, get such a market off the ground. The major consideration in this area is to what extent federal backing is needed to stimulate or sustain secondary market development. Will the federal government have to be involved in the short or long term to ensure the long-term existence of such a secondary market? Will the federal government have to provide some level of credit enhancement, such as a guarantee or insurance, or would a federal charter be adequate?

Direct federal involvement in the secondary market for home mortgages was critical to the development of that market and still plays a major role today. In the early years federal insurance and guarantees of mortgages and mortgage-backed securities helped accelerate secondary market development. Today, a significant amount of the home secondary market activity is supported by a federally owned organization--Ginnie Mae--and two other federally chartered organizations--Fannie Mae and Freddie Mac. The federal government does not guarantee or insure Fannie Mae's or Freddie Mac's securities, but the organizations have "agency status" and investors assume the government stands behind their securities. The three agencies accounted for about 79 percent of all mortgage-backed securities issued in 1986. Fannie Mae and Freddie Mac accounted for about 49 percent.

Like the home mortgage market, a federally chartered agency (the FCS) supports the lion's share of farm real estate lending today. If the home mortgage secondary market offers any answers as to the need for government involvement to establish a large secondary market for agricultural real estate loans, the answer is probably yes.

WHAT IMPACT WOULD A LARGE NATIONAL-SCOPE SECONDARY MARKET FOR FARM REAL ESTATE LOANS HAVE ON FCS AND OTHER LENDERS?

The Congress is currently concerned about the health of FCS because it has lost billions of dollars in the last few years and is expected to need federal assistance in the future. The Congress is also concerned about the health of commercial banks that serve agriculture because they have been failing at unusually high rates during the same period. We believe that a secondary market is not a short-term solution to the current financial stress in the agricultural sector, but it does have major long-term implications.

Development of a national secondary market for agricultural real estate loans could strengthen, weaken, or leave unchanged the fates of FCS and other lenders to agriculture. However, the current legislative proposals do not provide enough information to allow a complete understanding of how farmers, lenders, or the government would be potentially affected.

Because of its access to a stable source of credit through the capital markets that other lenders could not match, FCS has dominated farm mortgage lending. Commercial banks, generally, have obtained competitively priced, short-term funds from customer deposits, which has allowed them to maintain a substantial market share for short-term agricultural loans. However, because these funds are short-term deposits, large percentages of them cannot prudently be committed to long-term fixed-rate loans. Commercial banks and other lenders see the ability to convert long-term mortgage loans to short-term assets (through mortgage loan sales) as positive.

If commercial banks could, without restriction, access the same source of funds at the same cost as FCS, they could potentially increase their market share of total farm lending. Conversely, FCS could potentially lose market share and, all other things being equal, lose a proportionate amount of interest income.

However, the potential impact of a secondary market on FCS and other lenders could be better understood if we knew what organization would operate the market, what fees would be charged, what loan volume might be expected, and what restrictions would be placed on participation. If total farm lending increased substantially and FCS operated a secondary market that all lenders could access without restriction and for which it charged fees to lenders, including the FCS, to provide credit enhancement, it might improve its financial position, even if it lost market share as a primary lender.

On the other hand, if a secondary market for farm real estate loans were to be controlled by any particular lender group, that group could use its control to improve its fee income or market share at the expense of other lenders. In addition, entry to the market could be restricted by qualifying lender and loan criteria. For example, if only lenders with an asset size of $40 million or more would be able to participate, most "agricultural banks," as defined by the Federal Reserve Board, would be precluded from participating. As of December 31, 1986, the average asset size of agricultural banks was about $33 million.

Some commercial agricultural lenders are already concerned about FCS' market share because of the recent changes FCS made in response to the need to be more efficient and minimize operating losses, coupled with its favored access to the capital markets. Prior to the early 1980's, FCS' organizational structure was decentralized down to the local level, with separate locations and management for production credit and real estate credit activities. The commercial banking sector's concern about losing market share flows from reorganizations of FCS at the local level that have taken place since the early 1980's. For example, FCS production lending and real estate lending facilities have consolidated in some areas and colocated in others. The commercial banking sector sees the convenience of "one-stop banking" at FCS, for both production and real estate loans, as a catalyst that could eventually shift market share of short-term loans from commercial banks to FCS.

SHOULD FCS BE GIVEN POWERS TO OPERATE AS THE SECONDARY MARKET FOR ALL LENDERS?

Arguments for making FCS the secondary market for farm real estate loans are that FCS already performs some secondary market functions, operates in all states, and needs an infusion of capital. It provides liquidity and attracts a wide range of investors; insulates its borrowers against the effects of cyclical flows of funds; enhances regional flows of funds to farmers; and reduces regional differences in interest rates by allowing money to flow to areas of higher interest rates, thereby exerting downward pressure on those rates. FCS has been able to perform these functions largely because of its "agency status" that has traditionally enabled it to access the capital markets routinely for funds. In addition, its charter has permitted it to operate as a national lending agency enabling it to perform the cross-region functions normally attributed to secondary markets.

On the other hand, arguments can be made against FCS being the secondary market. With the changing face of agricultural lending, if the market is not structured in such a way as to allow agricultural lenders, other than FCS, equal access to the capital markets for farm real estate lending, the agricultural credit delivery network as a whole may become too vulnerable to financial stress. Commercial "agricultural banks" may become less able to compete with FCS.

Furthermore, the implications for managing the government's risk exposure to the national agricultural credit portfolio may be unacceptable if one lender--FCS--increases its market share of farm lending. A GAO report entitled Financial Condition of American Agriculture (GAO/RCED-86-09; Oct. 10, 1985) pointed out that farm lenders with loan portfolios more concentrated in agricultural lending were more vulnerable to financial stress in the sector. One solution to this problem may be to develop short-range and long-range plans for agricultural lending that would encourage as many lenders as possible to compete for farm lending, spreading the risk of lending to one sector, as much as possible, throughout the lender and investor community. This strategy could possibly incorporate a plan for FCS to operate the secondary market, thereby deriving more of its future income from secondary market activities rather than from primary lending.

COULD A NEW SECONDARY MARKET ENTITY COEXIST WITH THE FCS?

FCS' favored status in the capital markets raises questions as to whether a new secondary market entity could also compete as well for funds. The issue most related to this question is whether the new entity could attract funds at an interest rate that would allow lenders to make loans at competitive rates.

A related question is how well the investment community would accept another agricultural lending entity, especially when the agricultural sector is still experiencing financial stress and FCS is losing billions of dollars. Wall Street brokerage house representatives told us that if a new secondary market were to be established, it would require at least the same level of government backing perceived by investors for FCS and possibly more to initially establish the market.

WHAT LOANS SHOULD BE ELIGIBLE TO BE SOLD IN THE SECONDARY MARKET?

Probably the most important issue to determining the potential impacts of a secondary market on farmers, lenders, and the government is underwriting criteria that embody specific loan criteria. This single element can determine such factors as market volume; expected loss experience; likely costs to risk bearers, such as investors and credit enhancers; and social benefits to the farm community. For example, underwriting criteria that allowed virtually all farm loans to be sold in the secondary market would result in a high expected loss experience and high risk to investors and others who have provided credit enhancements.

Another component of this eligibility question is whether land-based agricultural loans can be adequately standardized to be included in a national-scope secondary market. While it is possible to develop a standardized loan application that will go a long way to understanding risks associated with the farm sector and individual farm operations, it will likely be more difficult to develop large pools of loans with substantially homogeneous characteristics. For example, Midwest grain farms have much different cash-flow characteristics than West-coast ranches with tree crops and vineyards.

SUMMARY OF LEGISLATIVE PROPOSALS FOR A SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

ELEMENT IN PROPOSAL	S. 234 and H.R. 497	H.R. 575	S. 427
PURPOSE	To create a secondary market for farm mortgages to facilitate the availability of long-term mortgage credit to agriculture, provide liquidity, and allow capital markets to fund agricultural loans.	To increase availability of agricultural mortgage credit through operation of a secondary market.	To provide long-term financing for the purchase of agricultural land through the operation of a secondary market.
ORGANIZATIONAL STRUCTURE/MARKET OPERATION	An independent federally chartered corporation, initially run by a board comprised of government officials and presidential appointees, would buy and pool agricultural loans. Sellers of mortgages to the corporation would make capital contributions in return for common stock, which could also be sold to others. Initial government investment of $200 million could be repaid. Ultimately, the stockholders would control the corporation.	Secretary of Agriculture would certify private entities to make a market by pooling loans. Entities would establish a reserve (initially equal to 10 percent of the pool's principal) to assure payment of principal and interest to investors in the pooled loans. The Secretary would guarantee amounts not covered by the reserve.	Secretary of Agriculture would make a market in securities representing loans which he would buy, guarantee, and pool. Loans would include those held by FmHA, as well as others bought by the Secretary.
FUNDING OF THE MARKET	Congress would appropriate initial capital. Additional capital contributions could be required of mortgage sellers, stock could be sold, and fees could be charged.	Secretary of Agriculture would borrow from Treasury and would charge fees.	Funds would be provided through appropriations by the Congress, fees charged to sellers or buyers of loans, and earnings from investments.
COST TO ESTABLISH	$200 million appropriation.	Not specified.	$100 million appropriation.
COST TO OPERATE	Not estimated.	Not estimated.	Not estimated.
ELIGIBILITY CRITERIA FOR PARTICIPATING LENDERS	Any lender approved under criteria established by the corporation.	At the discretion of Secretary of Agriculture; no statutory restrictions.	Legally organized lending agency (expressly includes FCS institutions) approved by the Secretary.

S. 848	H.R. 2179	S. 1172 and H.R. 2435	S. 1219
To create a secondary market for farm mortgages to increase the availability of long-term agricultural credit at a stable interest rate, provide liquidity, and facilitate funding of long-term agricultural investments.	To improve the secondary market for FmHA-guaranteed loans.	To create a secondary market for farm mortgages to increase availability of long-term agricultural credit at a stable interest rate, provide liquidity, and facilitate funding of long-term agricultural investments.	To create a secondary market for farm mortgages to increase availability of agricultural credit, increase liquidity, and stimulate flow of investment capital to the agricultural sector.
A federally chartered corporation within FCS would certify private entities to make a secondary market by buying and pooling agricultural loans. The certified entities and loan originators would contribute to a reserve (equal to 10 percent of the pool's principal) to assure payment of principal and interest to pool investors. The corporation would guarantee amounts not covered by the reserve. The corporation would have a 9-member board of directors appointed by the Chairman of the FCA Board--3 from FCS, 3 from non-FCS lenders, and 3 from the general public.	Secretary of Agriculture, either himself or through regulated private market makers, would issue and guarantee payment of principal and interest on pool securities backed by the guaranteed portion of FmHA-guaranteed loans.	A federally chartered corporation within FCS would certify private entities to make a secondary market by buying and pooling agricultural loans. Entities would establish a reserve (equal to 10 percent of the pool principal), with optional participation by loan originators, to assure payment of principal and interest on pool securities. The corporation would guarantee amounts not covered by the reserve. A 15-member permanent board would have 6 elected by and from non-FCS members, 6 elected by and from FCS members, and 3 appointed by the President.	A federally chartered corporation within and controlled by FCS would make a secondary market by buying and pooling agricultural loans and guaranteeing pool securities. Voting stock would be required to be bought and held by FCS banks. The corporation would have an initial 9-member board of directors--6 elected by FCS banks and 3 elected by the newly elected FCS directors to represent non-FCS institutions. The board could be expanded to 12 or 15, but with the ratio of 2 FCS directors to 1 non-FCS director maintained.
FCA would provide funds, and the corporation could charge fees for credit enhancement and certification and borrow from any source with FCA approval.	Secretary would establish a reserve fund (source not specified). FmHA existing revolving funds could be used to meet pool certificate guarantees.	Funds would be provided by sale of stock to and capital contributions from lenders and marketing entities, and fees.	Funding would be provided by sale of voting stock to FCS and nonvoting stock to others and by fees for services.
Not specified.	Not specified.	$20 million from stock.	Not specified.
Not estimated.	Not estimated.	Not estimated.	Not estimated.
Any entity that originates and services agricultural mortgage loans.	Any legally organized lending agency.	Any entity that originates and services agricultural mortgage loans (expressly includes insurance companies, banks, FCS institutions, and others).	Any class of institutional agricultural lenders (expressly includes insurance companies, federally insured depository institutions, and FCS banks).

ELEMENT IN PROPOSAL	S. 234 and H.R. 497	H.R. 575	S. 427
LENDING CRITERIA/UNDERWRITING STANDARDS	Loans must be to U.S. citizen-farmers, who are likely to repay; be secured by a first lien on farmland; and have less than an 80-percent loan-to-value ratio. Lender must retain at least a 10- percent risk. Under S. 234, securities issued would be non-bank eligible for purposes of underwriting, selling, and distributing those securities.	Loans must be to U.S. citizens; be secured by a first lien on farmland; be less than $2 million; and meet underwriting standards set by the Secretary of Agriculture.	FmHA-held loans must be only to a borrower with a high likelihood to repay and secured by property with a loan-to-value ratio of no more than 70 percent. Non-FmHA loans must also meet additional requirements set by the Secretary.
VOLUME OF ACTIVITY	Not estimated.	Not estimated.	Not estimated.
REGULATORY OVERSIGHT BODY AND COST	Securities would be subject to federal securities laws. The corporation would be subject to GAO audit.	Secretary of Agriculture would oversee approved loan facilities. Securities would be exempt from federal securities laws.	Secretary of Agriculture would oversee market operations.
INVESTORS TARGETED	Not specified.	Securities would be authorized investments to the same extent as federal obligations, unless restricted by state law.	Not specified.
RISK BEARERS	The corporation would insure timely payment of principal and interest on the securities. No government guarantee.	The securities would not be obligations of the U.S., but the Secretary would guarantee timely payment of principal and interest not covered by the issuer's 10-percent reserve. There would be a $4 billion limit on the outstanding guarantees.	Secretary would be liable according to the terms of the guarantee. The lenders and/or investors would assume the nonguaranteed portion of the risk.
MARKET DURATION	Until dissolved by law.	Secretary of Agriculture's authority to guarantee new pools of loans would terminate 5 years after enactment.	Secretary of Agriculture's authority to guarantee a loan would terminate on 12/31/91. Guarantees made prior to that date would remain in effect for the life of the loan.

S. 848	H.R. 2179	S. 1172 and H.R. 2435	S. 1219
Loans must be to U.S. citizens; secured by a first lien on farmland; have a loan-to-value ratio of no more than 65-percent; be less than $2 million; and meet underwriting standards set by the corporation. Discrimination against loans of at least $50,000 would be prohibited.	Loans must be to U.S. citizen-farmers operating family farms, who have reasonable prospects of success and who cannot get credit elsewhere at reasonable rates and terms.	Loans must be to U.S. citizens likely to repay; be secured by a first lien on U.S. farmland; and meet underwriting standards set by the corporation. The standards may not discriminate against small loans of at least $50,000.	Loans must be either (1) on U.S. farmland secured by a first lien and meeting requirements established by the corporation <u>or</u> (2) originated or could have been originated or purchased by FCS members. All loans must meet private investment standards.
Not estimated.	Not estimated.	Not estimated.	Not estimated.
FCA would oversee secondary market operations. Securities would be exempt from federal securities laws.	Secretary of Agriculture would issue regulations and report to the Congress annually.	FCA would oversee operation of the market. The securities would be exempt from federal securities laws.	FCA would oversee operation of the market. The securities would be exempt from federal securites laws.
The securities would be authorized investments to the same extent as federal obligations if rated in one of four highest catergories unless restricted by state law.	Not specified.	The securities would be authorized investments to the same extent as federal obligations unless restricted by state law.	The securities would be authorized investments to the same extent as federal obligations unless restricted by state law.
The corporation would guarantee timely payment of principal and interest not covered by the 10-percent reserve. The guarantee would not obligate the government.	The government would guarantee timely payment of principal and interest on the FmHA-guaranteed portion of the loans.	The corporation would guarantee the timely payment of principal and interest not covered by the 10-percent reserve. The guarantee would not obligate the government. Credit enhancement would not exceed $500 million.	The corporation, backed by FCS banks as required, would guarantee the timely payment of principal and interest. The guarantee would not obligate the government.
The authority of the corporation to issue loan guarantees would terminate 5 years after date of enactment.	Contains no market duration provision.	Until dissolved by law.	Contains no market duration provision.

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