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FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Conditions May Slow Development of Secondary Markets

Statement of
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Before the
Subcommittee on Conservation, Credit, and Rural Development
Committee on Agriculture
House of Representatives

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the secondary market programs that the Federal Agricultural Mortgage Corporatio (Farmer Mac) is sponsoring to increase the availability of rural credit. Our testimony is based on ongoing work we are doing for this Subcommittee and others regarding Farmer Mac I--the secondar market program for agricultural real estate and rural housing loans--as well as Farmer Mac II--the secondary market program for Farmers Home Administration (FmHA) guaranteed loans.

In summary, we found that Farmer Mac has established standards, guidelines, and other mechanisms for operating both programs. However, these actions in themselves will not guarante the success of either program. Rather, economic and other factor: that are in large part beyond Farmer Mac's control continue to play a major role in determining the viability of the programs. More specifically:

-- Although Farmer Mac I program guidance has been in place for over a year, participation in the program has been limited. In fact, Farmer Mac has not yet guaranteed any securities under this program. Under the Farmer Mac II program, Farmer Mac has not yet been able to form any pools of loans. As a result, it has issued securities backed by individual loans and may have to continue to do so. This approach may not provide the benefits that the program was intended to offer.

-- Factors constraining the volume of loans sold through Farmer Mac I include (1) a decline in the demand for agricultural credit; (2) uncertainty about the competitiveness of loans originated for sale through the program; (3) new regulatory constraints that make participation less advantageous for poolers and originators than anticipated; and (4) lack of lender incentives to use a secondary market. Most of these factors will also affect the development of the Farmer Ma II program. Changes in any of these factors could affect the development of either program.

Farmer Mac is in the process of developing new approaches to both programs that are designed to increase participation and stimulate more secondary market activity. Under the Farmer Mac I program, Farmer Mac is buying the FmHA guaranteed portions of loans using unsecured debt, and is holding these loans in its own investment portfolio. To fund its Farmer Mac II operations, on M 2, 1991, Farmer Mac made its first public offering of unsecured debt--for $50 million in short-term notes. With regard to the Farmer Mac I program, Farmer Mac is considering establishing a separate corporation to buy, also using unsecured debt, and hold Farmer Mac guaranteed securities issued by poolers. The new approaches have not yet been finalized. It is too early to predict whether or not they will in fact significantly increase participation in either of Farmer Mac's programs. We understand that the Farm Credit Administration (FCA) is presently reviewing Farmer Mac's authority to make public offerings of unsecured debt

BACKGROUND ON FARMER MAC PROGRAMS

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) created Farmer Mac to promote the development of a secondar market for agricultural real estate and rural housing loans, through a program now known as Farmer Mac I, under which it would guarantee securities issued by private poolers. Expectations wer that (1) a secondary market for buying and selling these loans--i the form of securities guaranteed by Farmer Mac--would help make additional long-term credit available to farmers, ranchers, and rural homeowners and (2) the new secondary market would develop quickly. In this program, poolers--such as investment banks and insurance companies--are to buy agricultural real estate and rura housing loans originated at the local level, assemble them into pools, and issue securities backed by these pools. Farmer Mac is to guarantee timely payment of principal and interest to investor who purchase these securities. The program deals with two types loans--agricultural real estate and rural housing--that will probably not be commingled in the same pools because of the significant differences between the loan types. Consequently, within Farmer Mac I, there may be two separate programs, one for each type of loan.

The Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624, Nov. 28, 1990) authorized Farmer Mac to facilitate creation of a secondary market for the guaranteed portion of FmHA guaranteed loans. These loans, made by private lenders, are backed by FmHA's promise to reimburse the lender for up to 90 percent of lost principal and interest and for loan liquidation costs if the borrower defaults. With this secondary market program, known as Farmer Mac II, Farmer Mac was to assemble the guaranteed portions of FmHA guaranteed loans into pools, and sell them as securities to investors. It was also to guarantee the timely payment of principal and interest on these securities. Overall, the Congress expected that this market would make more funds available to small agricultural lenders.

FARMER MAC I HAS BEEN SLOW TO DEVELOP AND ITS FUTURE IS UNCERTAIN

Farmer Mac announced in January 1990 that it was ready to certify poolers and guarantee securities for Farmer Mac I. It has had its operating guidelines in place for over a year. As of May 29, 1991, Farmer Mac had certified two poolers; one other financial institution had applied for certification. However, no securities have been guaranteed by Farmer Mac. Only 1 other financial institution--of the 46 that were eligible in December 1988 to apply for certification as Farmer Mac poolers--has plans to apply within the next 2 years. Potential poolers are reluctant to participate because they are concerned that there may be an insufficient volume of loans; interest rates to borrowers may not be competitive; newly instituted banking regulations make participation less advantageous to originators and poolers; and there is little pressing need for additional funds to meet agricultural credit demand at this time.

Steps Taken to Establish the Farmer Mac I Program

Farmer Mac has essentially completed the legislatively required steps to establish the Farmer Mac I program. It raised $22.8 million in its initial public offering of stock in December 1988. At that time, 46 stockholders purchased a sufficient number of shares to apply for certification as poolers. Over 1,700 stockholders bought enough shares to become originators, including about 1,100 small banks. These originators are located predominantly in the Midwest.

The board of directors appointed a president and chief executive officer in June 1989, and shortly thereafter, within the legislated time frames, Farmer Mac submitted loan underwriting and other standards for congressional review. In late December 1989, Farmer Mac published the Securities Guide, a manual containing its operating guidelines for both agricultural real estate and rural housing loans. By January 1990, Farmer Mac had announced that it was ready to certify poolers and guarantee securities.

In establishing its operating guidelines for rural housing loans, Farmer Mac has interpreted its authorizing legislation to allow it to accept loans for residential dwellings having a purchase price of up to $100,000 and associated land valued at up to 50 percent of the appraised value of the combined land and dwelling. Essentially, by separating the value of the land from the purchase price of the house, this interpretation allows rural housing loans for properties valued up to $200,000 into Farmer Mac I pools. However, in our view, Farmer Mac's authorizing legislation cannot be construed to authorize a rural housing loan secured by a property in excess of $100,000, adjusted for inflation.

Few Poolers Are Participating

Of the 46 financial institutions that were eligible to apply for certification as Farmer Mac poolers in December 1988, only 3 had applied as of May 29, 1991. Farmer Mac had certified two--Manufacturers Hanover Securities Corporation and Goldman Sachs Mortgage Company--by January 1991. Neither pooler has issued any securities guaranteed by Farmer Mac. We surveyed all other eligible institutions and found that only one of them plans to apply for certification within the next 2 years, and most of the remainder have no plans to ever be certified.

Factors That Have Constrained Development of Farmer Mac I

Potential poolers and originators are reluctant to participate in Farmer Mac I for a number of reasons, most of which are beyond Farmer Mac's control. In general, potential poolers are concerned that there might not be a sufficient number of loans originated for sale through the Farmer Mac I program to justify their commitment to the program or to support a viable secondary market. In particular, they expressed concern that enough loan volume may not be generated for three reasons. First, overall demand for agricultural credit has declined significantly since the early 1980s, and no large increases in farm borrowing are forecast for next year. Agricultural lenders are also hesitant to make commitments to the Farmer Mac I program because of the uncertainty of demand for long-term, fixed-rate loans for both agricultural real estate and rural housing.

Second, potential poolers and originators are concerned that the interest rates on loans originated for sale through the Farmer Mac program might not be competitive. Estimates of the interest rates borrowers would pay on these long-term, fixed-rate loans vary widely, from Farmer Mac's estimates of 10.25 to 10.65 percent to other financial experts' estimates of 10.75 to 12.90 percent. According to these financial experts, at the upper end of the range of estimates, the interest rates on such loans would not be competitive with other available rates.

Third, new regulatory constraints make participation in the Farmer Mac I program less advantageous than originally anticipated. Under new risk-based capital standards, banks and Farm Credit System (FCS) institutions that retain a subordinated participation interest[1] in a loan or pool of loans will have to, in effect, retain capital as if they continued to hold the entire loan, not just the subordinated participation interest. In other words, the loans will effectively remain on the lender's balance sheet as if they had not been sold. As a result, the lender may not have incentives to sell loans through Farmer Mac I. Furthermore, regulations generally will not permit banks or FCS institutions to hold subordinated participation interests in loans or pools of loans made by other financial institutions. According to poolers and originators, this makes it more difficult to find buyers for

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[1]Subordinated participation interests represent the right to receive a portion of the principal and interest payments on a loan or pool of loans, but only after investors in the Farmer Mac guaranteed securities backed by these pools have received all payments due to them. Farmer Mac may not guarantee any security under the Farmer Mac I program unless either a subordinated participation interest or a cash reserve is established to cover at least a 10-percent loss on each loan.

the subordinated participation interests and, therefore, less profitable to participate in Farmer Mac I.

Additionally, agricultural lenders we spoke with currently lack incentives to participate in a secondary market for several reasons. First of all, they currently do not need the additional lending capacity that a secondary market is designed to provide. For example, an Independent Bankers Association of America spokesman recently said that agricultural banks "have money to lend." Second, these lenders believe that demand for fixed-rate loans for agricultural real estate and rural housing has not been demonstrated, even though these types of loans are typical for the home mortgage market and may indeed be desirable for rural housing. Third, many lenders do not now participate in secondary markets to a large extent, and they state that participation will require additional administrative burdens, such as staff dedicated to understanding the complexities of regulations and forms that accompany secondary markets. Fourth, these lenders cite the difficulties in meeting legislative requirements for geographically diverse pools of loans.

STATUS OF AND ISSUES FACING FARMER MAC II

By February 1991, within 3 months of being authorized to do so, Farmer Mac had established the infrastructure and policy that will guide operations of a secondary market for FmHA guaranteed loans. However, Farmer Mac has not yet been able to form any pools of loans. As a result, it has issued securities backed by individual loans, and may have to continue to do so. This practice may not offer the benefits that Farmer Mac II was intended to offer. On April 5, 1991, Farmer Mac issued five securities under this program, each one backed by an individual loan, totaling approximately $700,000. On May 29, 1991, Farmer Mac issued a second group of securities--backed by approximately $1.5 million of guaranteed loans. As with the first issuance, each security was backed by an individual loan. Farmer Mac's first "swap transaction" also occurred on April 5, 1991. Zions First National Bank in Salt Lake City, Utah, traded approximately $250,000 in FmHA loan guarantees for Farmer Mac securities, each security backed by an individual loan.

Farmer Mac Faces Several Challenges in Facilitating the Market

While there has been some activity in the Farmer Mac II program, its future development may be constrained by many of the same factors facing Farmer Mac I.

-- First, it is unclear whether the volume of FmHA guaranteed loans will be large enough to support a market in securities backed by pools of these loans.

-- Second, while most specialized secondary markets were created in part to address a perceived credit shortage, many lenders currently have adequate funding to meet loan demand.

-- Third, while most loans sold in secondary markets have common loan characteristics--such as maturity dates, interest rates, and payment dates--current FmHA guaranteed loans do not.

-- Finally, Farmer Mac's strategy for establishing its price for purchasing guaranteed loans may place Farmer Mac II at a competitive disadvantage with the existing secondary market in which FmHA guaranteed loans are traded on an ad hoc basis.

Overall, the success of Farmer Mac II is likely to depend on advantages it will offer that do not already exist in the current ad hoc market for FmHA guaranteed loans, such as providing (1) a uniform infrastructure for selling FmHA guaranteed loans and securities and (2) a guarantee of the timely payment of principal and interest to investors.

Farmer Mac II May Increase Risks to the Government Caused by the Underlying FmHA Loan Program

GAO has previously reported that two principal problems exist within the FmHA guaranteed loan program that may increase the government's exposure to risk. First, lenders use the program to refinance loans of existing customers who are financially stressed; and second, FmHA has improperly managed the program, thereby contributing to guaranteed loan losses absorbed by the federal government. The intention of Farmer Mac II is to provide lenders with incentives to increase the number of FmHA guaranteed loans. When this number increases, a corresponding increase in financial risk to the government could result. If not properly monitored, practices such as refinancing loans of financially stressed customers, may be continued or expanded if lenders can generate funds by selling loans into the secondary market. However, we recognize that the expansion of the guaranteed loan program is a public policy issue and that the risks of such expansion should be considered in conjunction with planned reductions in FmHA's direct lending program.

NEW APPROACHES TO FARMER MAC PROGRAMS INVOLVE NEW RISKS

On May 2, 1991, Farmer Mac made its first public offering of unsecured debt--in the amount of $50 million--in connection with the Farmer Mac II program. On May 6, Farmer Mac announced that it would purchase FmHA guaranteed portions of a new type of loan, one with an interest rate that varies based on changes in the "Farmer Mac Cost of Funds Index." This index will reflect changes in the rates Farmer Mac expects to pay on future issues of unsecured debt. Subsequently, Farmer Mac clarified that it intended to make direct investments in these loans--that it planned to buy and hold them in its own investment portfolio--rather than sell them to investors as Farmer Mac guaranteed securities. Farmer Mac may also adopt a similar approach for the Farmer Mac I program. This would involve establishing a separate corporation to buy and hold securities backed by qualifying pools of loans issued by poolers and guaranteed by Farmer Mac. In effect, under the new approaches, Farmer Mac would operate as a portfolio manager as well as a guarantor, much as Fannie Mae and Freddie Mac do.

It is too early to predict whether or not the new initiatives will in fact increase participation in either of Farmer Mac's programs to a significant degree. The new plans address only one of the factors we identified as constraints on the secondary market's development--the uncertainty of the competitiveness of the interest rates lenders will be able to offer on loans originated for sale through the Farmer Mac programs. Further, it is not certain that these new approaches will have the effect of inducing lenders to sell loans or offer more competitive interest rates to borrowers.

The issuance of unsecured debt in connection with the Farmer Mac II program, and, potentially, for the Farmer Mac I program as well, raises concerns about the new and different risks facing Farmer Mac and the government. These risks would not arise if Farmer Mac continued to operate exclusively as a guarantor. We believe this reaffirms the need to establish minimum capital standards for Farmer Mac, as we recently recommended in our testimony on government-sponsored enterprises.[2] We understand that FCA is presently reviewing Farmer Mac's authority to make public offerings of unsecured debt. We are also reviewing this question.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

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[2] Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises (GAO/T-GGD-91-28, May 10, 1991).