POLICY IN MANAGEMENT ISSUES SURROUNDING SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

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I appreciate the opportunity to visit with you today and I'm particularly pleased that you've chosen to focus your program as you have because the need to exchange new information and ideas concerning financing agriculture has never been greater. I emphasize the word "exchange" because I look forward most to hearing new ideas and perspectives from you as well.

We are all aware of the tremendous frustration and helplessness every-one associated with the agricultural complex has been experiencing. Globalized markets, disinflation, de-regulation of financial services, a myriad of environmental and consumer pressures, on top of agriculture's traditional cost/price cycles, have indeed caused massive financial adjustments. Moreover, these changes probably have not yet played out their entire impact in terms of recapitalization of asset values and allocation of both farm and financial resources.

Despite the problems, Wells Fargo is convinced that agricultural business will be good business, if it is done with the right people, in the right way and with the right tools.

But now, more than ever, the financial, political and university communities must join together to create an environment where agriculture's potential can be realized. In addition to new techniques and technologies, new coalitions must be formed.

The need for a viable secondary market for farm real estate loans, available to <u>all</u> farm borrowers, is a prime example of the need for a new approach and equally new spirit of cooperation.

Unfortunately, recent signals from Washington, D.C. indicate that a focus on self-serving politics, rather than the well-being of farmers, may prevent establishment of this much-needed product. So it's incumbent upon each of us to become involved in the political process on behalf of the farmers upon whom we depend so totally.

Since your meeting is to focus on "macro, market and policy issues," I plan to concentrate on the conceptual framework for this secondary market and focus on specifics in whatever depth you indicate through your questions.

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Hopefully everyone here today recognizes that the need for capital in agriculture is greatest when the cost/price squeeze is at its worst, as it has been in recent years. Only through capital investment in new equipment and new technologies will the U.S. agricultural complex be able to compete in today's globalized market place. But the only way capital markets will turn to agriculture in a quality way and at reasonable cost is if substantive proof can be provided that long-term policies and products are being put in place.

This was a primary conclusion of the American Bankers Associations' research project titled "Transition In Agriculture" conducted by Hopkin and Associates and released last year. While I would like very much to share all of its results and recommendations with you, I'll just invite you to obtain your own copy through the Washington office of the American Bankers Association and I'll limit my references today to its major conclusions that relate directly to the need for a secondary market. Let me quote from the report which was based upon extensive research into the new realities of rural economics and financial markets: "banks will need to materially increase their capacity and willingness to make farm real estate loans ... they can no longer depend upon a local deposit base to provide long-term funds ... and securitization of agricultural credit provides a means of access to the nation's capital markets." In other words, a secondary market for farm real estate loans is considered an essential ingredient for the long-term commitment commercial banks must have if they are to prudently finance agriculture.

Everyone agrees that a farmer's present long-term financing opportunities are extremely limited. According to the Federal Reserve Board's 1985 estimates, the Federal Land bank holds over 44% of farm real estate debt and commercial banks hold only 9.01% simply because the latter does not have access to a long-term source of funds. Traditionally, commercial banks have extended operating loans to farm customers who had their farm mortgages with the Land Banks. As long as the Land Banks were financially healthy and worked as distinct organizations, and as long as farm real estate values continued to escalate, the system seemed to work relatively well and a need for a secondary market was obscured.

Now, the financial problems being experienced by the Farm Credit System and the obvious move toward consolidation of Land Banks and Production Credit Associations render a secondary market available to borrowers and lenders outside the System essential.

Moreover, we have experience after which we can pattern our efforts. "Securitizing" has served the home mortgage market well (which currently has 30 percent of its outstandings converted to securities), and is now quickly spreading to commercial and industrial loans. Advantages of securitizing over traditional funding methods for lenders include (1) it is cheaper and saves insurance, reserve and many excess capital cost; (2) it is more liquid, thus allowing banks to adjust more quickly to changing conditions; (3) it avoids concentration of credit risk by geography (and commodity in the case of agriculture); and (4) it allocates interest-risk to those better equipped than rural banks.

In addition to putting all lenders on an equal competitive level, a secondary market would accomplish a number of other goals crucial to recovery in agriculture. Generally, it would help the farm sector make the transition to a debt structure supported by earnings, vs. only equity. It would increase farm borrowers' access to national capital markets at reduced, fixed interest rates, thus enhancing their financial planning. Then, increased liquidity for purchasers of farm land will help avoid a further drop in land values below long-term equilibrium levels. Finally, and perhaps most importantly, it would signal our government's priorities, letting farmers know they deserve the same long-term support overseas farmers enjoy and the same assistance as our nation's home buyers who have benefited greatly from secondary markets.

The American Bankers Association recognized the need for a secondary market over two years ago and formed a task force of agricultural lenders and investment bankers to address the very complex issues surrounding its development. I've been encouraged over the partnership approach commercial bankers, insurance companies and the Farm Credit System have demonstrated in this effort, focusing upon the ultimate farm borrower, rather than only certain financial intermediaries. Results have been well documented in congressional testimony and are certainly available to you.

I also invite you to review the "Economic Analysis provided for the American Council of Life Insurance" by Farm Sector Economics Associates. It contains, in addition to the macro advantages I've just covered, a good summary of a secondary market's specific advantages. Briefly it reports:

- From the primary mortgage lender's perspective:
  - higher yields as portfolios are turned over more rapidly;
  - increased loan originations as up to 100 percent can be recaptured for reinvestment in new mortgages;
  - increased profits from origination and loan servicing fees; and
  - improved efficiencies through larger loan portfolios.
- From the investors perspective:
  - guaranteed cash flow;
  - liquidity since securities can be traded as part of an overall portfolio strategy; and
  - hedging against future rates.

- From the borrowers perspective:
  - access to new sources of funds;
  - lower rates (between 1/2 & 1% experienced in the home loan market);
  - better service through increased competition.

It should be obvious that we now need all the resources we can muster to provide the quantity and quality of credit agriculture needs to survive these difficult times. But for this to become reality, old barriers must be broken. No longer can we afford the traditional conflicts between (1) the private and public sectors, (2) bankers and borrowers, and (3) the Farm Credit System and commercial banks. And no longer can industry and the university community operate independently. All our human and financial resources and energies must be directed instead toward competitors outside our national borders.

Now let me quote from the recently released Farm Income Study Report released by the American Farm Bureau. "The financial problems of many farmers today are a direct negative result of the inflation euphoria of the 1970s which, in tandem with the widespread practice of collateral lending by agricultural lenders, produced the problem of excess debt." Clearly, simply providing more debt capital to all segments of agriculture is not the answer, even if it is subsidized. Capital must come with a proper blend of debt and equity and, most importantly, must be structured in a quality way with repayment coming primarily from cash flow, vs. total reliance upon equity. The term "creative financing" has become common place in most other industries, especially real estate, and is resulting in innovative debt/equity packages. I'm hopeful the university community will help agriculture follow suit.

This effort takes on special importance since, in an era of de-regulation for the financial community, disincentives such as Chapter 12 Bankruptcy, mandatory mediation and exorbitant lender liability settlements will undoubtedly increase the cost and restrict the availability of debt capital to those who need it most. So a failure to develop all possible originators of quality long-term real estate loans clearly sends the wrong signals to the private sector which needs incentives, vs. disincentives, for providing agriculture's financial needs. Again, you can help add credibility by emphasizing that we need new tools to deal with new realities in bringing much needed capital to agriculture.

Last month Warren T. Brookes published some startling statistics. He reported that "federally subsidized credit", to include the Farm Credit System and Farmers Home Administration, as a percentage of total farm debt, grew from 21 percent in 1970 to over 55 percent in 1987. Is this the direction we should be headed is a transition toward privatization of agricultural credit sources in the best interest of farmers, all their related businesses and the U.S. taxpayer?

It's important to note that the underlying concept and objective is to privatize the farm loan secondary market as soon as possible. Again, experience in the securitization of the home loan market indicates potential.

While it's difficult to simplify such a complex process, let me briefly summarize how the concept would work, as I understand it: I'm told many of you are well versed on the process, but some are not. So I will start with the basics to ensure we're all on the same foundation for our discussion:

- Farmers and ranchers apply to local lenders for loans to buy or re-finance farmland.

- Lenders, following the strict underwriting standards established by the governing body of the secondary market check, with various certified poolers of farm mortgages to get the best terms for their qualified borrowers. The loan originators then sell those loans to the loan pooler while retaining the right to service the loans and maintain their relationship with the farm borrowers.

- Poolers of farm mortgages will be insurance companies, commercial banks, Farm Credit System institutions or any other entities that meet the certification standards of the secondary market governing body. The mortgage poolers will:
  - Purchase loans on a non-recourse basis from loan originators and package loans into loan "pools" to serve as collateral backing securities to be sold to investors;
  - Establish a 10 percent reserve against losses for each pool of loans. This reserve must be depleted before any claim can be made by a pooler against the credit enhancement purchased from the Farm Credit System. It should be noted that recent data indicates, even in today's troubled ag industry, a 10 percent reserve would be adequate to prevent triggering government assistance;
  - Apply for approval of the credit enhancement which will give the securities issued by the poolers the same "agency status" as the securities issues by the Farm Credit System;
  - Sell securities to investors.

I purposely have not talked in great detail about the specific mechanisms of how the secondary market would work. Recognizing that each of you are at different levels of awareness on the subject, I would rather handle that by responding to your individual questions and/or referring you to the specific appraisal and underwriting standards developed by representatives of commercial banks, insurance companies and the Farm Credit System, and reviewed by the American Society of Farm Managers and Rural Appraisers. But more importantly, we have not yet crossed the first hurdle of agreeing that this product is essential for the well-being of agriculture. Let me emphasize that the capitalization and reserve requirements, in combination with the highest quality appraisal and underwriting standards, are designed to provide quality capital for agriculture of the future, not to bail lenders out of existing problems.

Now let me just briefly suggest some other areas in which the university community can be of help. First, at the risk of sounding simplistic, I want to emphasize that only a profitable agriculture will be a bankable agriculture over the long run, While it seems so elementary to most of us, only people like you and me can convince Congress and the Administration that farm asset values are particularly vulnerable to mis-directed monetary and fiscal policy. Thus, the financial and university communities have a clear obligation to educate and advise federal policy makers on behalf of agriculture. So, if I were to identify the major area in which the university community could be of most help to agriculture, it would be in development of new ways in which we can become more proactive in the political process, convert misconceptions and emotions into facts and reason, and develop more creative and effective ways of elevating the viability of agriculture to the top of our national priorities.

As I travel throughout the world, it is increasingly apparent to me that the key to our agricultural success has been our unique research and extension services. I am hopeful that today will mark a re-vitalization of the creativity, innovation and applied research/extension that has solved so many problems for us in the past. With that re-vitalization, there is simply no end to what can be accomplished. So I invite you to join with the banking community in taking an important first step making a secondary market for farm real estate loans a reality.