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Proceedings of
Regional Research Committee NC-161

FINANCING AGRICULTURE IN A CHANGING ENVIRONMENT: MACRO, MARKET, POLICY AND MANAGEMENT ISSUES

Denver, Colorado
October 6-7
1987

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March 1988

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J. B. Trew

Discussions within the Farm Credit System on a secondary mortgage market for farm real estate initially began with a series of meetings that took place in late 1985 and early 1986 among the Farm Credit System, the Farm Credit Administration, the Department of Agriculture, Department of Treasury, the ABA, the IBAA and the ACLI. The purpose of these meetings was to discuss the trying times in agriculture and how each of the organizations represented might be able to assist in easing the burden on the agricultural community. One of the suggestions made during these meetings concerned the potential benefits to the farm community from the existence of a secondary market in farm mortgages.

As indicated in legislation proposed by the House of Representatives for the establishment of a secondary market in farm mortgages, the purpose is to (1) increase the availability of long term credit to farmers at stable interest rates, (2) provide greater liquidity and lending capacity in extending credit to farmers and (3) provide an arrangement to facilitate capital market investments in providing long term agricultural funding, including funds at fixed rates of interest. The legislation proposes to create this market by establishing the Federal Agricultural Mortgage Corporation or Farmer Mac. It would be a federally chartered instrumentality of the United States Government and an institution of the Farm Credit System. Although it would be regulated by the Farm Credit Administration, it would not be liable for any debt or obligation of the Farm Credit System nor would the Farm Credit System be obligated for debts or obligations of Farmer Mac. To this extent it would seem that Farm Credit's relationship to Farmer Mac is one of supervision and not ownership or control.

The players in this market would be farmers, originators, poolers, Farmer Mac and the investment markets. Originators would be any qualifying financial institutions actually making loans to farmers. Poolers would be financial institutions who

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would actually purchase loans from originators, pool them, obtain a Farmer Mac guarantee for timely payment of interest and principal on pools of mortgages and then market them to the investment markets. It is anticipated that poolers will generally be some of the larger financial institutions such as regional or money center banks, investment bankers or institutions of the Farm Credit System. It is also possible that organizations pooling loans will also be originating loans themselves. Farmer Mac would operate very much like a Ginny Mae, placing its guarantee of timely payment of principal and interest on the pools of mortgages, but not actually buying mortgages for its own portfolio. Farmer Mac would also not involve itself in the marketing process with investors, but would leave this up to the individual poolers.

The House legislation proposes that an interim nine member board of directors be established concurrent with the passage of the legislation. This board would be appointed by the President within 60 days of the passage of the legislation with three representatives being chosen from the Farm Credit System, three from representatives of "other financial institutions", two being farmers that have not served as directors of any financial institution and one being a representative of the general public who has not served as a director of any financial institution. The legislation calls for a minimum initial capital requirements of $20 million to be sold to both originators and poolers and offered fairly to ensure that no institution acquires a disproportionate share of the total. It is also provided that ownership be equally divided between the Farm Credit System and "other financial institutions".

Once the $20 million minimum capital has been raised, it is proposed that a permanent 13 member board of directors be established. Six of the thirteen members would be elected and seven appointed by the President. The elected members would include three by the Farm Credit System and three by the "other financial institutions". The presidential appointees would include two farmers who have not served as a director or officer of any financial institution, one member who shall represent the interest of the general public and not have served as a director or officer of any financial institution and not more than four of the seven shall be from the same political party. It is further proposed that within 120 days of legislative approval, Farmer Mac develop standards for certifying originators and poolers and, in consultation with originators, develop uniform underwriting, property appraisal and repayment standards for qualified agricultural mortgage loans. It is proposed that as pools are formed, originators and poolers, in some negotiated proportion, will either provide a 10% reserve or keep a 10% subordinated position to meet the first losses incurred on any pool. Poolers will be required to establish this reserve in United States

Treasury securities or agency securities with the interest earned to be credited to poolers and originators as their interest may appear. Farmer Mac, for a fee to be established, will then guarantee the timely payment of principal and interest on qualifying pools of mortgages and will bear any losses after the 10% reserve has been exhausted. The pools will be sold into the marketplace by poolers and be secured by the pools of mortgages, the 10% reserve and by the Farmer Mac guarantee.

Anticipated benefits to the farm community from the establishment of this secondary market include a potentially lower cost source of funds, the availability of fixed rate money, a larger volume of available funds through an enlarged investor base, and a wider range of terms associated with the mortgages. It should be pointed out that the potential for a lower cost source of funds is a relative issue. There really is no long term fixed rate product on the market today that a farmer could expect to see the price drop on with the establishment of this market. In addition, it is likely that at any given point in time the price of a variable rate mortgage will be lower than the price of an alternative long term fixed rate mortgage. The idea is that the availability of this long term fixed rate pricing will over the life of the mortgage provide a better pricing instrument to the farmer. Because of the existence of the secondary market, the farmer can be sure that he will be obtaining a market determined rate which should be highly competitive. Investors buying pools of mortgages will have a good spread of risk afforded by the number of loans in the pool, the geographic dispersion represented by the mortgages, the crop diversification afforded, the reserve being put up by the poolers and originators and finally by the Farmer Mac guarantee.

With originators and poolers putting up only a 10% reserve, there should be significantly reduced capital and reserve requirements on the lending financial institutions which should also translate into a lower price to the farmer. Finally, the farmer can expect strong competition in the pricing of origination and closing costs as well as in the serving fees charged.

The importance of the availability of long term fixed rate financing should not be lightly discounted. This product is essentially not available to the farming community today and can provide a valuable hedge against inflationary interest rates in the future for the farmer. The farmer can also look for strong competition among originators which should translate into a wider variety of terms available to him. Today the farmer, in most cases, most go to his local Land Bank Association and accept the mortgage offered on the terms as dictated by the Land Bank Association. Now there will be numerous financial institutions potentially involved in the originating of these loans and the

farmer can look for this competition to not only produce a competitive atmosphere for the establishment of rates, but also in the determination of the quality of the service provided.

Although the advantages to the farmer seem many, there are also some potential disadvantages that could arise from the establishment of a secondary market. The first stems from the fact that it is anticipated that the availability of the secondary market will be there only for the stronger farm credits. The history of secondary market operations in other industries indicates that the investors are either only interested in the strong credits or demand very high premiums for more marginal credits. Given the continued deteriorated credit situation in the farm community today, it would seem reasonable to expect that the investing public would only accept the stronger credits or would charge very high premiums for the more marginal credits. Another potential disadvantage to farmers is a loss of flexibility which is derived from the degree of standardization that will be necessary for a secondary market to function efficiently. It may be very difficult to structure standardized mortgages that will allow the type of flexibility farmers have needed in the past to run their business organizations. This would include such things as granting rights of way, selling small partials of land, reconfiguring payment schedules, etc. Trying to build this type of operating flexibility into secondary market instruments will provide a great challenge to Farmer Mac as it establishes standards for its product.

The establishment of a secondary market offers significant potential advantages to the "other financial institutions". The most important of these are a significantly reduced capital requirement and the elimination of a potential liquidity problem for smaller lenders. In addition there will be no interest rate or prepayment risk, this being borne by the investor. The result of these beneficial changes is to open up a brand new market providing enhanced origination capability and greater flexibility. It will allow these financial institutions to better leverage their capital and create the potential for substantial fee income from origination and servicing fees.

The Farm Credit System also has the opportunity to benefit from the establishment of this market. As with its commercial counterparts, the System also has the potential for lower capital requirements for high quality assets and thus a better leveraging of its capital. It offers a new product to the System, that of a fixed rate loan without prepayment risk. This has the potential for providing stronger credits as the borrowers are then hedged against upper spiraling interest rates. There is also the potential for substantially increased fee income again from origination and servicing fees.

One of the greater potential benefits to the System is enhanced asset/liability management opportunities. The existence of a secondary market will provide a better matching of durations, better liquidity, the passing of the prepayment risk onto investors, and the potential for a new portfolio of assets. I would see the System perhaps operating somewhat like a Fanny Mae in that it could have part of its assets in mortgages and another portion of its assets in mortgage securities. The System could actually pool its own loans and/or loans purchased from other originators, obtain the Farmer Mac guarantee and then purchase its own securities. These securities would be substantially more liquid then its mortgage portfolio and although the actual return provided from interest income would probably be less, there would also be the opportunity to manage this portfolio for capital gains. Finally the existence of a secondary market offers a more advantageous risk-adjusted cost of funds at certain times. Depending on the interest rate cycle, investor perceptions and the specific characteristics of its own portfolio, at a particular point in time the System may find that secondary market funding offers advantages over its more traditional means of funding.

It should be pointed out that there are also some very serious potential disadvantages to the Farm Credit System from the establishment of this secondary market. The first of these is the loss of a very significant market share in the farm real estate market. With the potential entry of hundreds or even thousands of new originators into this market, the sheer number of increased competitors should essentially guarantee a significant loss of market share to the System. Initial discussions concerning the establishment of a secondary market had the Farm Credit System performing the Farmer Mac function in the market place and thus the System receiving the guarantee fees. This guarantee income should have largely offset the loss of net income associated with a decreased market share, but this has been lost to the System with the concept of establishing an independent Farmer Mac. In addition the System also is potentially stuck with the more marginal credits that do not qualify for the secondary market. Finally, and perhaps most importantly, the System will be forced to deal with the establishment of the secondary market at a time of great crisis within the System. With all of the other problems the System is facing today, it will also have to involve itself with preparing to effectively compete in a new market with many new competitors. In order to do this it will have to greatly increase its servicing and related back room automation functions and, for almost the first time ever, it will have to become an effective marketing organization.

I have some final thoughts on the establishment of a secondary market which I think consideration needs to be given to before this market becomes a reality. The first concerns the size of the market. Preliminary study that the Farm Credit System has done on this market indicates that the size is probably $10 billion or less today. This is not a particularly large amount of money especially when considering that minimum issue sizes are probably $100 million and at least $500 million is needed to really begin to benefit from economies of scale. It is also very important that there be regularly scheduled market issues so that investors can (1) be sure that there is enough liquidity in the market and (2) know precisely when new issues will be coming to market. With no single entity controlling the secondary market, particularly as it relates to new issues, can we expect the vast potential number of poolers to ever provide the consistency necessary in the issuing of new issues to provide really efficient markets? Another concern evolves out of the importance of originators to this whole project and a potential lack of commitment by originators from a financial standpoint. All of the credit information relative to each individual borrower will be generated by the originators and therefore all of the resulting credit decisions will only be as good as that information which is collected. It would seem very likely that poolers will end up providing the 10% reserve and that originators will then collect their origination and servicing fees, but have nothing at risk in these individual mortgages over time. This at least presents the possibility of originators being more interested in generating fees than in the competent collection of relevant credit information. We also have to realize that the financing of farm mortgages is more similar to financing business operations than in financing home mortgages. There are business cycles that have to be taken into account, cash flow streams, weather conditions, etc., will all figure into the quality of the credit being offered. Can a secondary market in this type of instrument provide the standardization necessary to realize the financial efficiencies which make this market go and at the same time provide enough flexibility to deal with an ongoing business operation?

The pricing of the guarantee should also provide a challenge to Farmer Mac. There is very little documented history of failure rates in farm mortgages and the tendency may be to place too much reliance on the 10% reserve and therefore under price this product. We can rest assured that the market will place severe restraint on over pricing of this product, but it will most certainly allow Farmer Mac to under price its guarantee. Only time will tell how good a job has been done in this area.

There has also been concern expressed as to whether or not the existence of a secondary market will not be providing too much credit to agriculture at a time when the market should

actually be shrinking. I think this is a very valid concern, but I also feel that if the credit standards and appraisal standards are properly established, they should provide restraints on the amount of credit made available to the market. One final point of interest concerns the initial capitalization of Farmer Mac. The legislation provides for an initial capitalization level of $20 million and says that no financial institution should be allow a disproportionate share of the total and further provides that the stock should equally be divided amongst the Farm Credit System and "other financial institutions". Nobody has addressed the question as to whether or not these institutions will actually want to invest in Farmer Mac stock or if they will do so in the amount of $20 million as requested. The question remains what happens if either the full $20 million is not purchased or if certain institutions should end up acquiring a disproportionate share in order for the $20 million figure to be reached?

In summary I would like to look at what I think the establishment of a secondary market in farm mortgages will mean to the Farm Credit System. In the short to intermediate term I think that the organizational effects will provide even more stress within the System and that the loss of market share will prove to be very expensive to the System. In the long term, however, I think the establishment of this market will force the Farm Credit System to better streamline itself operationally, to develop better marketing skills, to make more effective use of automation, to adopt a more service oriented business approach and in the end to become a much stronger competitor.