FARMER MAC: STATUS AND EMERGING ISSUES

Henry Edelman

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INTRODUCTION

Mr. Chairman, distinguished members of the Subcommittee, it is a pleasure to appear before this Subcommittee to report on the progress and direction of the Federal Agricultural Mortgage Corporation-- commonly known as "Farmer Mac." My name is Henry D. Edelman, and I am the President and Chief Executive Officer of Farmer Mac. It is an honor to appear before this Subcommittee to discuss the financial means by which Farmer Mac expects to deliver the statutorily-intended benefits to the farmers and ranchers of this Nation.

Less than two years ago, the members of this subcommittee were in the middle of legislative deliberations of enormous importance to agriculture. Faced with an agricultural credit crisis of unparalleled proportions, you played a critical role in the crafting of the Agricultural Credit Act of 1987. You determined that more efficient financing of loans for agricultural real estate and rural housing were essential to the resolution of that crisis. Thus, the creation of a new secondary market for agricultural real estate and rural housing mortgages was made a part of that Act, to better secure the economic well-being American farmers and ranchers throughout this country.

The near-term credit picture for agriculture has changed in a very positive way since 1987. Still, if we are to improve the longer term view for agricultural credit, I believe the basic objectives of that Act must be pursued. Farmers and ranchers who are running sound business need-- and deserve-- the availability of long-term credit at stable interest rates, from lenders with greater liquidity and lending capacity. Access to the efficiencies of capital market funding translates to availability of lower-cost funding. So long as that access is not readily available to all who are genuinely interested in extending credit to farmers and ranchers and rural homeowners, those who <u>do</u> have such access may only price to meet the competition of those who <u>do not</u>. Notwithstanding the improved condition of the agricultural credit sector, increased liquidity, interest rate risk asset-liability management techniques, uniform credit standards and new financial products are needed for the continued viability of all who extend credit to agriculture.

As Congress contemplated in 1987, the Farmer Mac program will be critical to meeting these needs. With sound credit underwriting, loan repayment, security appraisal and diversification standards in place, Farmer Mac will be able to deliver to agricultural and rural housing borrowers those benefits the secondary markets have for so many years provided to urban residential borrowers. Farmer Mac cannot be limited to only the highest quality credits that exist in agriculture. By the same token, Farmer Mac cannot be a lender of last resort, supporting weak producers. We must, and will, operate in a manner that extends program benefits to a wide range of financially sound agricultural producers and rural homeowners, without exposing the government to significant risk of loss.

From the producer's perspective, the secondary market will soon present both near term benefits and long term opportunities. Farmers will gain immediate access to new sources of long term credit and an increasingly efficient and competitive lending environment. New products, such as long-term fixed rate loans, will be available. Community banks will benefit from the development of Farmer Mac's uniform credit underwriting and other standards, increased liquidity and -- most of all -- from the immediate opportunity to spread interest rate and credit risks that are very difficult for lenders to predict and manage.

Henry D. Edelman is the President and CEO, Federal Agricultural Mortgage Corporation (Farmer Mac). Statement to the Conservation, Credit and Rural Development Subcommittee of the Committee on Agriculture of the United States House of Representatives, September 27, 1989.

While I have so much positive news for your Subcommittee today, I cannot be blind to a few negative issues worthy only of brief dismissal. First, concerns have been voiced over the relationship that will exist between originating banks and the borrowers after loans are sold. The truth is that it will be in the mutual interest of all parties involved in Farmer Mac-guaranteed transactions to perpetuate existing customer relationships. This is the best way to minimize losses to all interested parties and, logically enough, it is just what investors really want. Second, there has been some apprehension about the nature of the relationships that might exist between originating banks and poolers. Farmer Mac will, as stated in the Eligibility Standards for Certified Facilities, require that all contracts governing the relationships they establish with originators." Moreover, Farmer Mac commits to investigate promptly each bona fide complaint of a breach of that requirement by any party or proposed party to such contracts, both at the time of contracting and throughout the life of the relationship. We are confident that our extended discussions with the principal proponents of these concerns have satisfied them, and would be pleased to provide you with additional information in that regard.

Before I proceed further, Mr. Chairman, I want to outline the contents of this statement and emphasize our objectives. Farmer Mac presents a very exciting opportunity for farmers, ranchers and those interested in the future of agricultural real estate and rural housing. The testimony you will hear from these groups will demonstrate a high level of consensus and support for what Farmer Mac has been striving to accomplish. The key to our approach has been to provide a source of new and better financing for long term fixed rate loans to those borrowers considered good credits by responsible agricultural lenders. This approach should permit Farmer Mac to succeed as a financial institution without precluding the majority of farmers and ranchers from participation in our programs.

My testimony today will focus on the critical issues that we believe go to the very heart of Farmer Mac's operation and success during the next few months. I will address: (1) qualified agricultural and rural housing loans under Farmer Mac; (2) the structure of the Farmer Mac program; (3) the senior/subordinated structure of Farmer Mac-guaranteed securities; (4) the development and synergistic character of the standards; (5) the multi-step dynamic process for assembling and evaluating loan pools for a Farmer Mac guarantee; and (6) specific major issues that have been identified and deserve individual response.

When my testimony is completed, I am confident you will conclude that both the Interim Board and the Permanent Board of Farmer Mac, proceeding in a manner that will not raise a significant risk of Farmer Mac using its Treasury "backstop," have acted with the utmost responsibility and with all deliberate speed to increase the availability of stable, long-term credit to agricultural borrowers and rural home purchasers and provide greater lending capacity to lenders for those borrowers.

PROGRAM OVERVIEW

First, I would like to recap briefly where we have been. As you know, Farmer Mac was created by Title VIII of the Farm Credit Act of 1971, as amended by the Agricultural Credit Act of 1987 (the Act) in January 1988. In accordance with the Act, President Reagan appointed the nine-member Interim Board of Directors of Farmer Mac in May 1988. The Interim Board arranged for the sale of Farmer Mac's common stock in November 1988, in which I acted as financial advisor. (A copy of the Offering Circular for the stock issue is included as Exhibit A hereto.) The stock sale, in turn, created stockholders who were able to elect the Permanent Board of Directors (the "Permanent Board") of Farmer Mac in March 1989. (A copy of the Proxy Statement is included as Exhibit B hereto.) As required by the Act, Farmer Mac established Eligibility Standards were submitted to Congress on July 18, 1989. (Copies of all these standards are attached as Exhibits C, D and E hereto.) The following other relevant Farmer Mac documents are included as Exhibits F through I, respectively: 1988 Annual Report; 1988 Financial Statements; 1989 First Quarter Report and 1989 Second Quarter Report.

Farmer Mac, as constituted by the Act, represents an important innovation from the pattern of existing Government-Sponsored Enterprises (GSEs). Although it will function much like the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA), it is engaged in a line of business familiar to the private sector capital markets. Functionally, Farmer Mac will be closely analogous to a number of specialized participants in the capital markets, known as "mono-line bond insurers" (bond insurers). We are accordingly structuring Farmer Mac's operations to resemble those of the bond insurers in many respects. This means that, before Farmer Mac places its guarantee on <u>any</u> pool of loans, it will not only ascertain that the loans conform to its various standards, but will also run an industry-standard computerized risk analysis of the pool.

Farmer Mac has worked in conjunction with consultants from an independent public accounting firm that has in-depth experience with computerized risk analysis techniques routinely used by bond insurers. Those techniques, known as a "stress test," simulate a series of adverse economic scenarios and their impact on a pool of loans. Utilizing historical data from agricultural loans made during the period 1965-1988, we have tested the validity and reliability of our standards by using them as the primary screening device in a series of special runs of our stress test. The detailed analyses made on that basis have demonstrated to us that <u>loans conforming to our standards, used as collateral for the issuance of Farmer Mac-guaranteed senior securities in accordance with the statute, should result in and guarantee payments by Farmer Mac in excess of guarantee fees received</u>.

QUALIFIED LOANS

Farmer Mac has been established to benefit borrowers and lenders in the agricultural and rural sectors of the United States by facilitating the financing of real estate through improved access to the capital markets. The loans that will qualify under this program are described as follows.

1. AGRICULTURAL REAL ESTATE LOANS

Throughout the legislative deliberation on the Act, the primary focus of the House and Senate Agriculture Committees was to facilitate the financing of agricultural real estate to meet the continuing needs of farmers and ranchers for an adequate source of credit on flexible terms and at competitive rates of interest. Real estate is the largest single area of capital commitment for most producers. Farmers and ranchers have not had the benefits of an active secondary market similar to the secondary markets in existence for residential mortgages. Under the Act, a loan is qualified for inclusion in a Farmer Mac pool if it is an obligation secured by a first mortgage on land, or a building affixed to land, that is used for the production of one or more agricultural commodities or products.

Additional conditions specified in the Act essentially limit eligible Farmer Mac borrowers to United States citizens and legal aliens, as well as certain domestic businesses and to other entities. Further, agricultural mortgage loans will be required to meet credit underwriting, loan repayment, security appraisal and loan diversity standards to qualify for inclusion in a Farmer Mac pool.

2. RURAL HOUSING LOANS

In addition to the primary objective of facilitating the efficient financing of farm land, Congress recognized the need to provide rural residents greater access to residential mortgage financing, and provided for access to the Farmer Mac secondary market for rural housing loans. This could have significant benefits for home financing in small communities across the nation. Currently, most rural housing is excluded from the secondary market programs operated by FNMA or FHLMC because of typical characteristics which do not conform to the standards applicable to those programs. We have specifically designed the Farmer Mac program to accommodate pools of rural housing loans. This approach is in accordance with Congressional intent and is consistent with current rural development initiatives under consideration by the Administration and in Congress.

Under the Act, a rural housing loan is qualified if it is a first mortgage obligation on a single-family dwelling used as the principal residence of the borrower, with a value not exceeding $100,000 (adjusted for inflation since the enactment of the Act) and located in a rural area or community of 2,500 or fewer inhabitants.

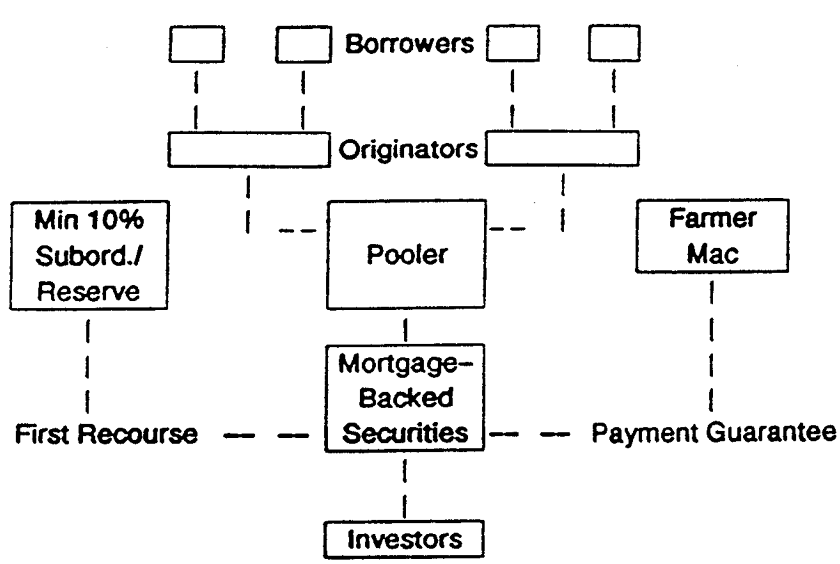
In developing standards for qualified rural housing loans for inclusion in a Farmer Mac pool, we have taken advantage of the experience of FNMA by adopting most of its underwriting standards. However, the FNMA standards, which are common industry norms for residential mortgages eligible for sale in the secondary markets, have been modified to eliminate the limitations normally imposed upon rural housing loans. The FNMA property exceptions for rural housing mortgages that will be considered for inclusion by Farmer Mac in rural housing loan pools are set forth in Schedule I attached to this statement. Certain limitations will be applicable to rural housing loans under the Farmer Mac program, such as the required 75 percent loan to value ratio and the property value limitation as specified in the Act. Our preliminary analyses give us clear indications of the stability of housing ownership in rural communities, the elements of real estate valuation in those communities and the critical void in available financing for rural housing. We believe that permitting the property excluded from the FNMA program into the Farmer Mac program will ensure those homeowners access to the secondary market without undue risk of losses to the pools or to Farmer Mac.

The benefits of this increased financing will extend to the rural communities served as well as to the lending institutions which provide rural housing loans. Of course, rural housing pools will be subject to the same evaluation process as agricultural loan pools to assure that these pools demonstrate the same integrity and soundness.

HOW THE FARMER MAC MARKET WILL OPERATE

Turning to how the Farmer Mac market will operate, it is useful to view the process diagrammatically. The figure below shows the steps involved in originating "qualified loans" through the issuance of Farmer Mac-guaranteed mortgage-backed securities.

HOW FARMER MAC WORKS



Farmer Mac-guaranteed securities begin with the extension of loans to farmers and ranchers and other eligible borrowers. A borrower will most likely shop among Farmer Mac originators in his local area to find a loan with the terms that best suit his particular needs and credit position. He will apply to a participating lender ("originator") for a loan secured by collateral that is defined as "permissible" under the Act. This includes: (a) land of certain minimum acreage and maximum value or acreage, used for the production of agricultural commodities or products and (b) single-family residences in rural areas.

An originator may be any Farm Credit System institution or a "bank, insurance company, business and industrial development company, savings and loan association, of agricultural producers, agricultural cooperative, commercial finance company, trust company, credit union, or other entity that originates and services agricultural mortgage loans." Minimum voting common stock ownership requirements for originators has been established by Farmer Mac's Board of Directors. (See Schedule II.)

Originators will be responsible for the extension of approved loans to qualified borrowers. In reviewing a loan for approval, the originator must underwrite the borrower's credit and appraise the property pursuant to standards established by Farmer Mac. Upon approval of the loan by the originator, the borrower will place a mortgage on the collateral. The loan will be further documented by the originator using documentation that conforms to Farmer Mac standard representations and warranties. The result will be "qualified loan" that the originator may sell to a pooler for the use as collateral against which Farmer Mac-guaranteed securities may be issued. Farmer Mac itself will not originate or pool any loans under the program, thus, it will not be in competition with originators. This structure will facilitate additional lending by Farm Credit System institutions as well as community banks and other traditional agricultural lenders.

Much as borrowers may shop among competing originators for the best loan terms, so also originators may shop among competing poolers for the best terms of sale for their qualified loans. Originators may retain the servicing of the loans and an interest in the cash reserves or subordinated securities created in connection with the securitization of the loans. These will be points of negotiation between originators and poolers, though the Act provides that originators "shall be permitted to retain" the right to service their loans.

A Farmer Mac pooler, formally designated a "Certified Facility," must meet the same criteria as originators, as well as certain other criteria currently or hereafter established by Farmer Mac. Under the Act, a pooler must be "an institution of the Farm Credit System or a corporation, association, or trust" organized under federal or state law. One of its purposes must be the sale or resale of securities representing interests in, or obligations backed by, pools of loans qualified under the Farmer Mac program. Poolers will be required to comply with criteria set by Farmer Mac, including: (1) maintaining minimum capital of $2 million; (2) adopting appropriate loan underwriting, security appraisal and loss servicing and marketing; (4) establishing acceptable procedures for loan administration and disclosure to borrowers concerning the terms and rights applicable to the Farmer Mac program; and (5) permitting periodic audits by Farmer Mac of its books and records relating to its pooling and securitization activities. In addition to these statutory criteria, there is a 5,000-share minimum Farmer Mac voting common stock ownership requirement for poolers. To ensure the safety and soundness of poolers and the integrity of the pooling process, Farmer Mac will continuously monitor the poolers and require pooler recertification at least every five years.

POOL SECURITIZATION

It is anticipated that origination, pooling and securitization of Farmer Mac-qualified loans will follow existing practices in the mortgage-backed securities market, subject to the special procedures previously outlined. Poolers will pool qualified loans and issue senior securities backed by those pools, supported by some combination of cash reserves and subordinated securities. The senior securities will carry Farmer Mac's guarantee of timely payment of principal and interest.

Under the Act, Farmer Mac-guaranteed securities will to be "registered" under the Securities Act of 1933. This will require filing with the Securities and Exchange Commission (the "SEC") a "prospectus" containing specific disclosures about the issuer (the pooler or its subsidiary) and the underlying loans, as well as a description of the nature of Farmer Mac's guarantee. Although the SEC has agreed to review these filings on an expediated basis, it is too early to say whether this will satisfy poolers who must assume market risk during the review period.

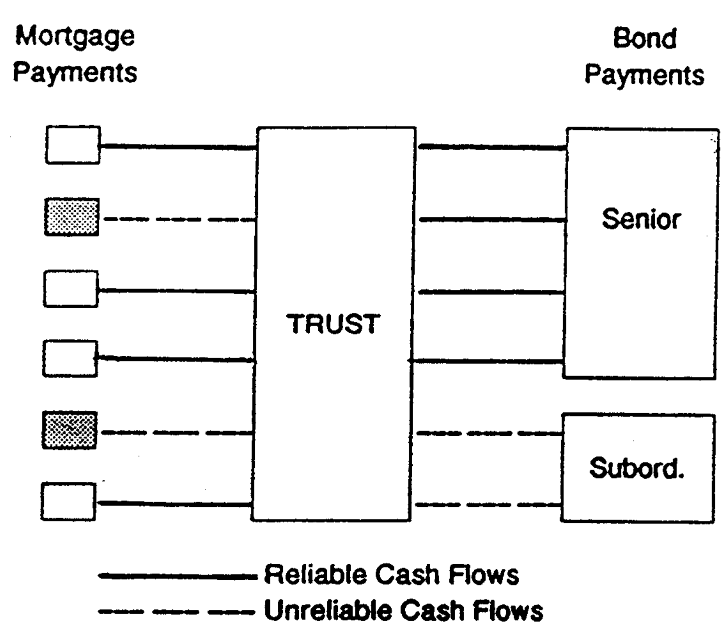
SECURITY STRUCTURES

It was recognized by the Congress that the qualified loans for pools of securities guaranteed by Farmer Mac would be eligible for favorable tax treatment as REal Estate Mortgage Investment Conduits (REMICs). The REMIC security has brought enormous benefits to the residential mortgage market through such securities issued by FNMA and the Federal Home Loan Mortgage Corporation (FHLMC) in the billions of dollars. A unique characteristic of the REMIC security is the diversity of the form of security which may be issued to meet the changing needs of markets and investors.

The Act creating Farmer Mac contains broad authority for the guarantee of securities by Farmer Mac. To satisfy investor demands for the most efficient security, Farmer Mac will not attempt to limit the form of security structure eligible for its guarantee. It is critical to the success of Farmer Mac-guaranteed securities in the capital markets that the structure of these securities should utilize the broad statutory authority and have the flexibility to meet ever-changing market requirements.

The essence of a senior/subordinated structure is internal credit enhancement by allocation of interests in loan payments instead of individual loans. Within any pool of loans, many individual loans will be reliable, but some will be unreliable. The following diagram illustrates this concept.

SENIOR/SUBORDINATED STRUCTURE



In fact, this structure also corresponds to the roles assumed by the participants in the transaction. Originators generate mortgage loans, most of which will generate reliable loan payments, indicated by white boxes and solid lines, but under stress some may generate less reliable loan payments, indicated by shaded boxes and broken lines. The pooler will typically form a trust that acts as a collector and filter for those loan payments in the senior/subordinated structure. The reliable loan payments will be allocated to the investors who are senior security holders, and the less reliable loan payments will be allocated to those who are subordinated security holders.

Structures relying exclusively on cash reserves are possible. To the extent cash reserves are used, securities that would otherwise have been subordinated may be issued with a Farmer Mac guarantee. The drawback inherent in this structure, however, is the certain loss ("negative spread") implied by the difference between the yield on the securities and the almost invariably lower yield derived from reinvestment of the cash reserves.

Many security structures still require some level of liquidity reserves. Loan servicers will make short-term advances to cover any delinquencies (30 to 60 days) that occur; however they will expect these to be repaid from a liquidity reserve. To achieve this, some senior/subordinated structures start with small cash reserves that are initially funded by loan payments that otherwise would have been paid to subordinated security holders. Once the cash reserves are adequately funded, they are held at that level for several years, than allowed to diminish as a constant percent of the steadily declining outstanding principal amount of the loans. On the other hand, a "shifting interest" structure often pays senior security holders in full in advance of principal payments to subordinated security holders.

The following diagram illustrates the payment priorities in a typical senior/subordinated structure. The flow of payments illustrated is from left to right and the priority of payments is from top to bottom.

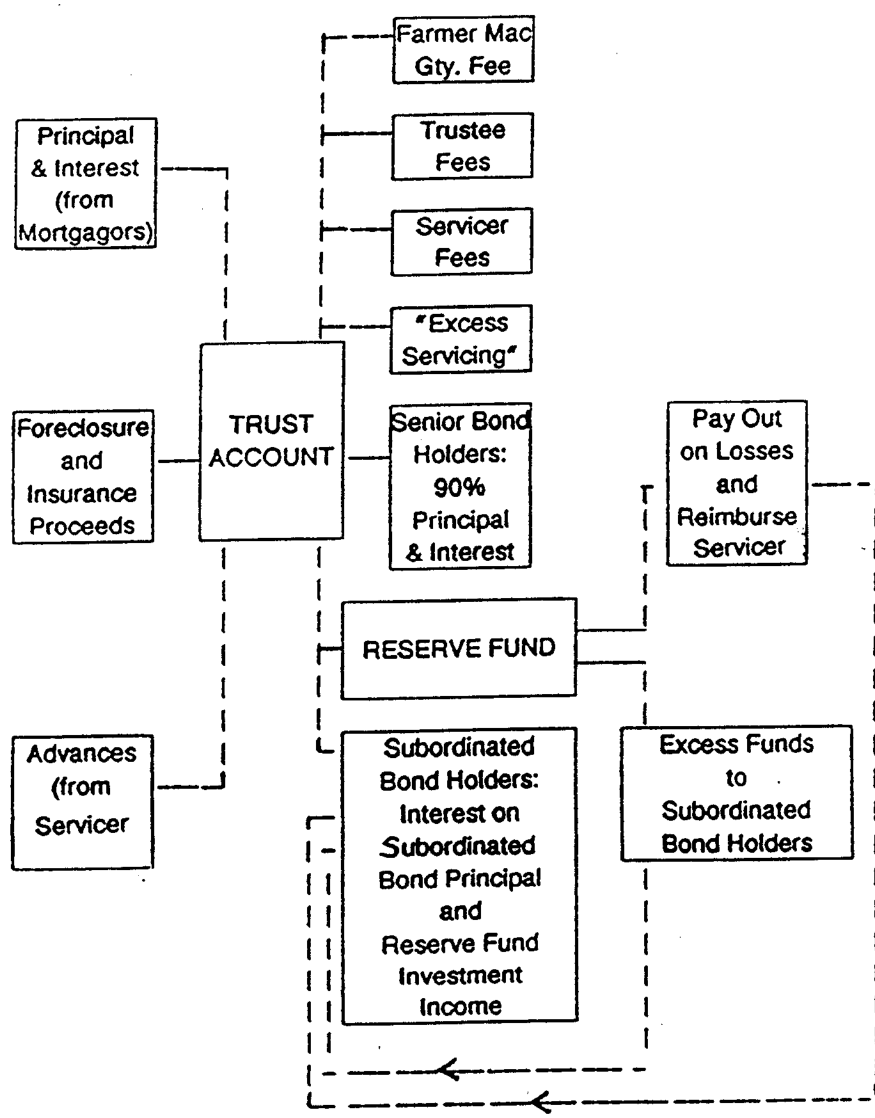
The relative merits of subordinated securities and cash reserves will have to be determined on a pool-by-pool basis. While reserves do permit the issuance of larger Farmer Mac-guaranteed security classes, as mentioned previously, reserves create a "negative spread" problem. And, while subordinated securities may eventually be salable, it will be more difficult to sell interests in cash reserves.

The form of the security structure will be determined by the make-up of each pool and the segment of the investment population that has been targeted for the sale of the securities. This process does not lend itself to the constraints of a hypothetical generic subordination agreement. However, each structure can be verified as achieving the desired goal for pool losses to be adequately covered by the subordinated securities. We believe that the most efficient and effective approach for Farmer Mac to is to let the market place and poolers define the securities structures and for Farmer Mac then to test each structure and verify that it works.

THE FARMER MAC GUARANTEE

Farmer Mac will guarantee timely payment of principal and interest on securities that represent no more than the most reliable 90% of the loan payments generated by pools of qualified loans formed by poolers. To be eligible for the guarantee, the pool must be composed of loans that meet Farmer Mac's credit underwriting, loan repayment, security appraisal and diversification standards. Farmer Mac is authorized by the Act to charge poolers an annual fee of up to 1/2% of the outstanding principal balance of each guaranteed pool. Farmer Mac's financial integrity -- and, hence, the strength of its guarantee -- will be supported by four key elements: (1) the reserve and subordination requirements, which will be verified from pool to pool, depending upon pool and security characteristics: (2) initial and annual guarantee fees; (3) its loss reserves and equity, derived from its initial offering of voting common stock, as well as any subsequent issuance of equity or debt securities and retained earnings; and (4) after the reserves and subordinated interest in a pool -- and its own loss reserves and equity -- have been exhausted, Farmer Mac ultimately may

SENIOR/SUBORDINATED PAYMENT PRIORITIES



issue up to $1.5 billion of debt to the U.S. Treasury to fulfill its guarantee obligations. Of course, it is the intention of Farmer Mac never to draw upon the line to Treasury.

Farmer Mac's principal protection from guarantee losses will come from the enforcement of its standards and its determination, on a pool-by-pool basis, of the level of cash reserves or subordinated securities necessary in a transaction to obtain its guarantee on the senior securities. It would be difficult, perhaps impossible, to achieve this result through guarantee fee variation, within existing statutory limitations.

HOW FARMER MAC DEVELOPED ITS STANDARDS

The Act requires Farmer Mac to establish credit underwriting, security appraisal and loan repayment standards for loans to be pooled in Farmer Mac-related pools; diversification standards governing the composition of each pool to reduce the risks incurred by Farmer Mac in providing guarantees; and standards for the certification of poolers. Congress provided certain requirements relating to each set of standards and required that Farmer Mac submit its proposed credit underwriting, security appraisal and loan repayment standards to Congress within 120 days after the election of the Permanent Board and that Farmer Mac submit its proposed pool diversification standards to Congress. congress also provided that Farmer Mac issue its standards for the certification of poolers within 120 days after the election of the Permanent Board. Farmer Mac has compiled with all these statutory mandates.

Late in the summer of 1988, the Interim Board appointed several task forces, chaired by its own members, to begin developing recommended requirements for loan underwriting, appraisal and eligibility of certified facilities. These steps were taken to enable the Permanent Board to begin considering those standards as soon as possible after its election. Experts from a variety of Farmer Mach constituent groups, including community banks, large commercial banks, insurance companies and the Farm Credit System, were included on each of the task forces. The Permanent Board, seated in March 1989, did in fact continue to use these task forces.

The Credit Underwriting and Security Appraisal task forces each produced a discussion draft of their standards. Recognizing the importance of practical comments from Farmer Mac's constituents, those discussion drafts were made a part of the Farmer Mac 1989 First Quarter Report and distributed to stockholders and other interested parties for review and comment in April 1989. We held a public forum to receive oral comments from interested parties in May 1989. The Board members who chaired the task forces and the members of the task forces and the members of the task forces attended and participated in the public forum. Interested stockholders, lenders, farmers, ranchers, consumer groups and government agencies submitted written statements on the standards and participated in panel discussions at the forum. The written submissions and the transcript of the public forum were reviewed with the Board at its May 1989 meeting. Revised standards were approved by the Board at its June 1989 meeting. Farmer Mac submitted the revised credit Underwriting, Loan Repayment and Security Appraisal Standards" to Congress on June 30, 1989, within the statutory time frame of 120 days after the Permanent Board's first meeting.

The Certified Facilities task force formulated a discussion draft of Eligibility Standards for certified facilities, commonly known as "poolers." That draft was circulated to shareholders and other interested parties in early June 1989. These proposed standards were discussed in a public forum held later the same month, at which Farmer Mac again received useful practical comments. Many of these were incorporated in the final version of the "Eligibility Standards for Certified Facilities (Poolers)," established by the Permanent Board on June 30, 1989, consistent with the same statutory time frame mentioned earlier.

The Loan Diversification Standards task force worked with an outside consulting firm with expertise in agricultural statistics and economics to assist it in formulating an approach to diversification of agricultural economic risk. With that expert assistance, this task force formulated the "Loan Diversification Standards" that were approved by the Board and submitted to Congress on July 18, 1989.

During the months of July and August, after the standards had been submitted to Congress for review, a number of questions were raised by the Independent Bankers Association of America regarding the interpretation and intent of certain provisions. The Farmer Mac Board and management considered the resolution of these concerns, as well as other questions raised by various interested groups and individuals, as meriting high priority attention. Every effort was made to fully discuss these issues and identify solutions acceptable to all parties involved in the program. I am very pleased to report that these efforts were successful. Each issue has been resolved without the need of making any change in the language of the standards themselves. Attached to this statement as Exhibits J and K, are two important letters documenting the understanding between Farmer Mac and the IBAA on the issues raised by that association.

CREDIT UNDERWRITING AND LOAN REPAYMENT STANDARDS

Farmer Mac has adopted nine Credit Underwriting and Loan Repayment Standards in all. The first eight reflect the general profile of a sound agricultural borrower. These include credit application and financial statement requirements; a debt-to-asset ratio; loan repayment parameters; and incorporate underwriting standards of FNMA, adjusted to reflect the usual and customary characteristics of rural housing.

Farmer Mac's ninth Credit Underwriting Standard was added in response to concerns that sound borrowers in certain segments of agriculture conform to credit profiles other than our general profile. Therefore, this standard provides that Farmer Mac may, <u>on a pool-by-pool basis</u>, accept loans that do not conform to all eight of the other standards if two conditions are met. The non-conforming loans must consistently exceed one or more of the standards with which they do conform, <u>and</u> they must be made to producers of <u>particular agricultural commodities or products for whom such a credit profile typifies a sound borrower</u>. Farmer Mac will require that this be convincingly demonstrated, most likely by reference to a historical record of high-quality loans to borrowers who meet the proposed commodity-specific profile.

Considered collectively, these standards make provisions for a broad range of agricultural borrowers, regardless of the commodity they produce, to qualify for financing under the Farmer Mac program. Consistent with Congressional intent, these standards will allow loans into programs of such quality as to meet substantially and generally the purchase standards imposed by private mortgage securities investors without undue risk exposure to government. However, the standards will accommodate both large and small agricultural borrowers so long as they are financially sound credits.

APPRAISAL STANDARDS

The Appraisal Standards task force sought to accomplish two purposes. Aware of the wide variance of backgrounds of appraisers currently used by community banks and Farm Credit System banks throughout the country, this task force sought not to exclude a significant portion of the qualified mortgages from the Farmer Mac program by setting specific qualifications for appraisers used by originators. At the same time, in an effort to achieve uniform quality, specific qualifications <u>were</u> set for appraisers used by certified facilities (poolers), with the intent that poolers should review the appraisals submitted to them for uniform quality. The standards provide for reliable appraisals of collateral for Farmer Mac loans which recognized actual circumstances confronting potential originators in connection with the availability of qualified agricultural real estate appraisers in different regions of the country. The second objective was to rely upon an existing set of standards for agricultural real estate appraisals. The Uniform Standards of Professional Appraisal Practice (USPAP) were used for this purpose, with the permission of the Appraisal Foundation.

The Appraisal Standards relate to appraiser selection, qualifications and proficiency (with the distinction mentioned earlier for appraisers for originators and appraisers for certified facilities); definition of appraisal terms; contents of the appraisal report; and currency (age) of the appraisal. In addition to the Appraisal Foundation's explanatory comments to its standards, there are specific Farmer Mac interpretive comments. With respect to rural housing, the FNMA "Property and Appraisal Guidelines" were adopted, with certain exceptions appropriate to rural housing as mentioned earlier.

POOL DIVERSIFICATION STANDARDS

Particular emphasis was placed on the Pool Diversification Standards, because of the benefits that should be achievable by managing geographic and commodity risks. These standards focus on minimizing risks confronting individual originators within a diversified subset of the agricultural sector, rather than on those posed by individual borrowers. The Poll Diversification Standards task force approached the formulation of these standards with several objectives. First, strong emphasis was placed on the importance of complying with the statutory requirements. Second, recognition was given to the importance of keeping regional poolers viable in the program and optimizing pooler competition. Third, the standards were designed to be able to evolve predictably over time, to ensure that they continue to reflect a well-balanced risk among agricultural commodities.

All specific statutory requirements were adopted as written; this is reflected in standards nos. 4, 5 and 6. In the case of standard no. 5, the Farmers Home Administration definition of related borrowers was adopted by way of clarification.

In order to achieve wide variation in the initial principal amount of loans, a requirement was included that 5% by principal amount of each pool be composed of loans under $100,000. The language of the Act's general requirement as to size was also included to ensure that loans not be concentrated at the two ends of the size distribution spectrum.

It was found that the U.S. Department of Agriculture's ten geographic regions which are used in connection with much of the Departments economic and financial data collection and analysis, made the most sense in terms of grouping states by commodities, weather and natural risks. Several alternative formulations of acceptable minimum groupings of regions were considered, such as the use of non-contiguous regions. However, it became apparent that either the requirement would have to be so complex and difficult to achieve that it would discourage pooler participation, or that almost any reasonable requirement could be defeated through deliberate concentration. This led to the conclusion that the requirement should be for loans in a pool to originated from at least three of the USDA regions, with the caveat that Farmer Mac "reserves the right to reject any pool that does not comply with the spirit of this standard." While this is aimed particularly at loan concentration around the several three-way convergences of those regions, it is also directed to pools that do not show a reasonable level of dispersion of loans within each of their included regions, regardless of number.

Several approaches to commodity diversification were considered. The final method of measurement choices was gross revenue attributabel to a commodity, based on the combination of cash receipts and government payments. Because farm revenue data is readily available is determined in the market place, it does not need to be imputed. This was determined to be the best surrogate for the ability of producers of each commodity to service their loans, although it was acknowledged that the production of some commodities is more acpital intensive than others.

Related commodities were grouped into sixteen categories (listed in Exhibit E). A statistical analysis was made and confirmed that the economics of these categories were highly independent of one another, based on USDA data since 1965. The "concentration" of each of these groups in the national totals was calculated, and the groups were refined so that each represented neither too small nor too large a percentage of the total national revenues from all groups. It was determined that a concentration of up to three times the national level would permit pools to be formed on a regional basis without creating excessive exposure to any one commodity. This was further refined by imposing a 40% cap on the acceptable level of any commodity in a pool. Also, a provision was made for periodic revisions to the acceptable concentration levels for all commodities, based on shifts in national produciton patterns over time.

SYNERGY AMONG FARMER MAC STANDARDS

Farmer Mac has formulated credit underwriting, loan repayment, security appraisal, and loan diversification standards that work interactively to produce pools that should result in ultimate losses of less than 10% in "worst-case" economic scenarios. While no single standard would be sufficient to screen out all losses, they were designed to work interactively to achieve this result. This approach is made viable as a risk management technique when it is recognized as the screening phase in pool formation. A pool that passes this initial screen must then pass our stress test by demonstrating that Farmer Mac should not be required to make guarantee payments beyond its guarantee fee income in the "worst case" economic scenario. Although we have written our standards to achieve such a result with 10% subordination, it has always been Farmer Mac's position that it will also evaluate pools individually.

Several further observations should be made about Credit Underwriting standard no. 9. The interaction between this standard and Loan Diversification standard no. 3, which requires commodity diversification, will result in a limitation on the number of loans in a pool that may qualify for any commodity-specific credit profile. The commodity-specific profile must be able to withstand the "worst case" scenario in the Farmer Mac stress test which, in turn, focuses on economic downturns related to commodities as well as geograhical areas. Finally, originators and poolers who formulate the proposed exceptions will have to live with the long-term economic consequences of holding or selling the securities. We believe these very significant constrainst on the use of Credit Underwriting standard no. 9 will limit Farmer Mac's exposure to loss while facilitating the desired flexibility.

DYNAMIC EVALUATION OF FARMER MAC POOLS

The legislative history of the Act is clear that the Congress intended that Farmer Mac undertake its secondary market responsibilities in the most efficient manner. There are repeated references to the secondary markets created by the other privately-operated agencies, Fannie Mae and Freddie Mac. In determining the most effective method of providing its guarantee to pools of qualified loans, Farmer Mac is following the practices of these other secondary market agencies which have a proven track record. Rather than rely solely upon the credit underwriting, appraisal and pool diversification standards, Farmer Mac will examine each pool in its totality to determine that the senior securities guaranteed by Farmer Mac are adequately protected.

It has been the stated intent of Farmer Mac to go beyond its standards in evaluating each loan pool. While we have heard concerns expressed to the effect that our standards might not be sufficient to protect Farmer Mac in every instance, these comments appear to be based ont he assumption that Farmer Mac would perform only "static evaluations" of the pools. That evaluation method would permit the formation of pools of loans that merely pass a set of standards, as would be typical of many "entitlement" programs now administered by Government agencies. If Farmer Mac were to attempt to operate on that basis, it could never adequately protect itself from abuse, short of adopting standards that exclude loans from the majority of the borrowers and financial institutions it was intended to benefit. Rather, we have followed the intent of the Act and organized Farmer mac to perform what I shall refer to as "dynamic evaluations" of the pools.

In the beginning of my testimony, I noted the significance of the statutory requirement that Farmer Mac issue its guarantee only upon securities credit enhanced by either an unguaranteed subordinated class of securities issued against the same collateral, or cash reserves. This led Farmer Mac early on to the conclusion that, regardless of the standards it would set for credit underwriting, loan repayment, security appraisal, or loan diversification, further analysis of each pool would be necessary to ensure that potential losses in an economic stress situation would not exceed the level of subordination or reserves supporting each pool. In this regard, the Offering Circular for the inital public offering of Farmer Mac Class A and Class B Units, dated November 23, 1988 (p. 23), expressly stated:

Reserves and Subordinated Interests... The Interim Board will recommend to the Permanent Board that each Certified Facility be required to establish Reserves for, or retain Subordinated Iterests in, each pool equal to at least 10% of the Pool, the amount thereof to be determined by Farmer Mac on a Pool-by-Pool basis in accordance with guidelines to be established by the Permanent Board. The Interim Board will also recommend to the Permanent Board that it develop <u>guidelines for establishing minimum amounts that incorporate factors similar to those used by nationally recognized rating agencies and bond insurers for rating mortgage-backed securities</u>. (Emphasis added.)

Using this dynamic evaluation approach, Farmer Mac always has the right to reject a pool, to require restructuring of a pool, or to require greater than 10% reserves or subordination for a pool that is economically weak, even though its loans comply with all of our standards. Participants in the capital markets who work with the rating agencies and bond insured have long accepted dynamic evaluation of pools. It is in the interest of Farmer Mac, its stockholders, the Government and the sound borrowers and lenders who seek to benefit from securization of agricultural real estate and rural housing mortgages that we also take this approach, and we intend to do so.

REGULATORY ISSUES OF CONCERN TO FARMER MAC

As an important part of the start-up of Farmer Mac, we are working with a number of federal agencies that have authority over Farmer Mac and the institutions that will participate in its program. Several regulatory issues have arisen and are being actively monitored and addressed. In addition, Farmer Mac is working with the two federal agencies that have regulatory and review responsibilities for its operations to facilitate their procedures.

<u>Office of the Comptroller of the Currency (OCC)</u> - There are three issues of particular concern to Farmer Mac currently under consideration by the OCC. It should be noted that the first issue will be a parallel concern at the other members of the Federal Financial Institutions Examination Council (FFIEC), particularly the Federal Deposit Insurance Corporation and the Federal Reserve Board.

<u>Risk Retention by National Banks</u>. The treatment of the retention of a Farmer Mac subordinated interest in connection with the sale of loans into a pool as a sale of assets with recourse under OCC risk-based capital guidelines is an issue of tremendous importance to Farmer Mac. The OCC staff's current position on the issue would result in the selling bank being required to hold capital against the entire loan, as opposed to only against the retained interest. The OCC is treating the lending limits restriciton and risk retention by national banks. The position taken by OCC so far would place Farmer Mac in an enequitable position relative to the treatment already accorded to FNMA by OCC for housing programs FNMA operates that are functionally equivalent to Farmer Mac's. The failure of OCC to apply its current regulations in a manner consistent with its treatment of FNMA will significantly limit the participation of national banks in the Farmer Mac program.

We recognize that the rules of a regulatory agency such as OCC are under constant review. Thus, if and when the rules applicable to FNMA are modified it is contemplated that the Farmer Mac program would necessarily have to conform to then existing requirements for FNMA. For current purposes, however, the ability of Farmer Mac to compete efficeintly in the capital markets is contingent on receiving a favorable response from OCC to its request.

Lending Limits - The Independent Bankers Association of America has requested an interpretive ruling to the effect that the non-participation portion of a loan sold to a certified facility for pooling should not weigh against the originating bank's lending limits.

Glass-Steagall Act. Farmer Mac's counsel has prepared a request to the OCC to confirm that Farmer Mac-guaranteed securities are eligible for unlimited purchase, dealing in, underwriting and holding by national banks under 12 U.S.C. 24.

Department of Treasury - By letter dated February 17, 1989, John Dahl, as Chairman of the Interim Board of Directors of Farmer Mac, requested that the Secretary of the Treasury exercise the discretion granted to the Secretary by Congress and authorize Farmer Mac-guaranteed securities to be traded without the need of producing a physical security. A favorable determination by Treasury is extremely important to Farmer Mac for the following reasons. First, it would place Farmer Mac-guaranteed securities on a par with those of other GSEs that are allowed book-entry trading. This should support the quasi-Federal status of Farmer Mac-guaranteed securities that is critical for them to be favorably priced. Second, it would eliminate the unnecessary expense and inefficiency involved with trading of physical securities. Finally, it is consistent with Congressional intent and with agreements between members of Congress and the Secretary of the Treasury during the conference on the Farmer Mac legislation in late 1987. Farmer Mac has communicated regularly with representatives of the Secretary of the Treasury but is still awaiting a decision on this issue. I want to express my appreciation to the Chairmen and Ranking Members of the House and Senate Agricultural Committees for their support of our efforts to get favorable treatment from Treasury on this matter (copies of letters to Secretary Brady attached as Exhibits N and O), and my concern that even with this support Treasury Secretary Brady's staff has still failed to reach a decision on the matter.

Securities and Exchange Commission - In February and September 1989, representatives of Farmer Mac met with the staff of the Division of Corporate finance to discuss expedited registration procedures for Farmer Mac-guaranteed securities. The staff has expressed its willingness to work with Farmer Mac to streamline registration procedures. It is the position of the SEC staff, however, that Rule 415 "shelf registration" will not currently be available to Farmer Mac, though it may become so at a later date after the SEC completes a general review of the rule with a view to expanding its availability. Thus, at present, we will only be able to offer poolers expedited SEC registration procedures. Poolers have already indicated to Farmer Mac their misgivings about this arrangment, for they must bear market risk on the securitized mortgages during the review period.

Farm Credit Administration (FCA) - Of serious concern to Farmer Mac at this time is the posture that has been adopted by the Farm Credit Administration (FCA) staff with regard to the adequacy of the standard. In reaching its position, we are concerned that the FCA staff apparently focussed in on the varius ratios and other provisions without considering the cumulative effect of the standards and the interaction among them. Moreover, there does not seem to be a good comprehension of the fact that pools of qualified loans will be subjected to considerable further evaluation before the guarantee is provided. Our principal responses to the FCA staff's concerns are:

- The standards were developed to serve as guiding principles for the program within the relatively short period of 120 days that Congress provided for the task. This was done with the input of a great many experts from the agricultural credit sector. However, the standards are not intended to provide specific details for program operation.

- In order to avoid excluding from the program the majority of agricultural producers in the country, it was necessary to design the standards as a first screen for the process. That is, the standards create a reasonable credit risk profile for agricultural borrowers, with sufficient flexibility provided for to include all segments of agriculture.

- We recognize that experience may dictate refinements to the Securities Guide, which allows for maximum flexibility in making such changes.

- The agency does not give due credit to the fact that the standards will actually be applied on a pool by pool basis rather than on a loan by loan basis. Finally, it is not necessary for the standards to establish a zero loss tolerance for loans accepted into the pools because the statute specifically requires a 10 percent cushion for losses before the guarantee provisions can be invoked.

The standards submitted to the Subcommittee have been specifically designed to achieve the intent of Congress to provide farmers and ranchers access to new sources of funds through national capital markets. We agree that any one of the standards could probably be made more strict; however, this is not necessary to achieve a reasonable level of confidence that the program can be operated in a safe and sound manner, and would substantially defeat the objective of the program.

CONCLUSION

Farmer Mac has accomplished much in the year since the Interim Board first met. There are a number of significant issues which I have mentioned today that will need to be resolved to make the secondary market for agricultural real estate and rural housing loans as effective and efficient as possible.

Farmer Mac's Board of Directors and its management are pledged to make the secondary market for agricultural real estate loans and rural housing loans successful. We appreciate your interest and thank you for the opportunity you have provided us to make this statement.