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Changes in Farmer Mac's Charter

Who's Affected?

by Ron Feldman

In 1987, the Congress charted a new government-sponsored enterprise (GSE) called the Federal Agricultural Mortgage Corporation (Farmer Mac) to create a secondary market in which banks could sell agricultural real estate and rural housing loans to investors. A GSE is a privately owned, federally chartered corporation that operates nationally with specialized lending powers. The Congress charters GSEs to correct perceived failures in private credit markets. To assist GSEs in achieving their goals, the Congress structures them so that they benefit from an implicit federal taxpayer guarantee on their obligations. Despite this advantage, Farmer Mac could have faced regulatory takeover in 1996 had it not been for legislative changes to its charter. How could these changes affect Farmer Mac's future success, the profitability of commercial banks, and taxpayers?

Farmer Mac's dual—often conflicting—policy goals

Farmer Mac's initial powers and restrictions on its activities reflected two potentially conflicting policy goals. Some policy makers and bankers believed that farmers would have benefited during the farm crisis of the 1980s if they had assumed long-term, fixed-rate mortgages for their farm land during the 1970s. However, smaller agricultural/rural banks that rely on deposits rarely have the long-term liabilities or capital necessary to fund such loans safely. Farmer Mac was supposed to create an additional source of longer-term, fixed-rate funds for lenders by guaranteeing the timely payment of principal and interest on securities backed by pools of qualified farm land and rural home loans. The Farmer Mac guarantee, which is implicitly backed by federal taxpayers, should make investors more willing to buy the securities and lend funds to those firms that pooled the loans and sold the securities. This investor demand would support a group of firms that would want to buy loans from banks and thus provide the banks with an alternative source of funds to deposits.

At the same time, policy makers limited Farmer Mac's activities so that the chance that taxpayers would bear any costs from Farmer Mac's activities was very remote. For example, Farmer Mac could not issue its own asset-backed securities or engage in portfolio lending (i.e., issuing debt and using the funds to purchase loans to hold in its portfolio). Instead, it had to rely on third parties to pool qualified loans and issue securities backed by the pools. Farmer Mac also was not allowed to make good on its guarantee unless losses equal to 10 percent of the pool's principal were first absorbed by the poolers, originators, or investors. To reduce the risk that a regional economic downturn would lead to significant defaults in a pool of loans, each pool was required to be diversified geographically and with respect to the commodities produced on the farm land collateral. In addition, Farmer Mac had to raise capital from the public, and in 1988, it issued $21.6 million of common stock. In 1991, the Congress created a separate division within the Farm Credit Administration (FCA) to monitor Farmer Mac and established capital requirements to go into full effect in December 1996.

Farmer Mac's near failure and legislative rescue

Farmer Mac has lost $10.3 million dollars from its first days of operation in October 1989 until March 31, 1996. Farmer Mac's stockholders' equity was $11.4 million as of the first quarter of 1996, a

figure equal to 53 percent of its initial capital. Farmer Mac's poor financial performance reflects its inability to generate income from secondary market activity. As of March 1996, Farmer Mac has guaranteed seven pools with a total principal of $827 million. Farmer Mac also was given the power in 1991 to purchase certain U.S. Department of Agriculture (USDA) guaranteed loans. While the volume of such loan purchases has increased, the total is still very small, at $192 million as of March 1996. During 1995, Farmer Mac lobbied intensively for revisions to its charter. In particular, Farmer Mac wanted to delay the transition to higher capital requirements past the legislated December 31, 1996, implementation date. Farmer Mac would have fallen $5 million below its minimum capital requirement if the capital requirements that would have gone into effect in December 1996 were in place in March 1996. (The references in the "For more information" section are the sources for the statistics used in this article.)

Farmer Mac argued that its regulatory constraints were primarily responsible for its limited secondary market activity. The Farmer Mac guarantee adds very little value for investors who are already well protected by the 10 percent loss reserve that exceeds historical worst-case scenarios by a very wide margin. Farmer Mac also asserted that it would achieve cost savings and volume increases by bringing all facets of the secondary market process in-house. In response, the Farm Credit System Reform Act of 1996, passed into law in February 1996, made the following major changes:

- Permanent minimum capital standards were raised to higher levels (from 2.5 percent of on-balance sheet assets to 2.75 percent and from 0.45 percent for off-balance sheet assets to 0.75 percent) but implementation of these standards was delayed for three years. In addition, Farmer Mac must raise capital to approximately twice current levels ($25 million) within two years. Farmer Mac's on- and off-balance sheet items were capped at $3 billion until it reaches its capital requirement. Failure to raise the $25 million in two years will result in the cessation of new transactions.
- Farmer Mac was given the authority to purchase qualified loans directly from originators and hold them in its portfolio or package them as securities.
- The 10 percent reserve and the pool diversification requirements were eliminated.
- Farmer Mac was made more similar to other GSEs by requiring the Federal Reserve Banks to act as its depositories and fiscal agents.

Elimination of the various regulatory restrictions should make Farmer Mac's GSE status valuable again. Other firms have been able to take advantage of their unhindered GSE cost advantages to quickly expand their level of activity and profitability.

In addition to its regulatory constraints, Farmer Mac faced unfavorable market conditions. During most of its existence, the difference between long-term interest rates and short-term interest rates gave borrowers an incentive to use adjustable rate mortgages instead of the fixed-rate loans Farmer Mac specializes in. Moreover, the demand for farm debt was weak. Banks were also not in short supply of cash to make loans, as reflected in low loan-to-deposit ratios, and thus did not need to sell loans to fund additional lending. Some market conditions, such as lower long-term interest rates, have

become more favorable to Farmer Mac over the last year or two. In addition, Farmer Mac hopes to greatly increase its volume through the relatively new National AgriMortgage Funding program. This program involves the pooling of loans purchased by Western Farm Credit Bank from a network of participant originators. Finally, Farmer Mac can point to an early market validation of its new charter and market potential. In April 1996, Zions First National Bank located in Utah purchased $2.5 million of Farmer Mac's common stock. This is, however, only 10 percent of the capital Farmer Mac needs to raise.

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Will legislative changes save Farmer Mac?

Farmer Mac asserts that its new regulatory and market conditions should allow it to flourish. However, the limited demand for Farmer Mac's services may reflect more fundamental attributes of the farmland and rural home loan markets that will not be altered by these changes. As such, there is still reason to be skeptical about Farmer Mac's future viability. The USDA estimates about $80 billion of farm debt is outstanding, with Farmer Mac able to finance roughly 20 percent of the total under its current underwriting standards. If about 15 percent of total outstanding debt is rolled over in a given year, Farmer Mac would have access to about $2.5 billion in annual new originations. Farmer Mac believes it will have access to roughly twice as much annual volume.

Farmer Mac must have between $1 to $2 billion in annual business to cover expenses. Thus, even under its own assumptions, Farmer Mac would have to achieve high penetration of this market fairly quickly in order to raise more capital and to generate enough revenue to remain viable over the agricultural business cycle. Yet the market for financing high-quality farm loans is already extremely competitive. Indeed, Farmer Mac must compete with another GSE, the Farm Credit System, for these loans. Farmer Mac's limited success to date could also reflect farmers' preferences for adjustable rate debt rather than unmet demand for fixed-rate loans. Finally, even with historically high loan-to-deposit ratios in 1995, commercial banks have enough liquidity to be reluctant to sell off their best agricultural loans given limited profitable alternative uses of their funds.

Effect of changes to Farmer Mac's charter on bank profitability

Clearly, if Farmer Mac never becomes viable, it will have little effect on rural and agricultural banks. But, how would a successful Farmer Mac affect bank profitability? Despite support of Farmer Mac reform by banking organizations, the effect of a successful Farmer Mac on the profitability of rural and agricultural banks is ambiguous. Farmer Mac could allow some banks to offer larger loans and loans with longer maturities that they cannot offer now because of capital and funding constraints. This ability would allow banks to offer new products to some of their customers. For example, a bank which previously could only make a short-term operating loan to a borrower could now offer long-term, large-farm mortgages. Loan sales to Farmer Mac could also generate consistent fee income.

However, the tremendous growth in farm real estate lending by banks from 1983 to 1995 suggests to some analysts that commercial banks are already providing the loans that their customers require. During that period, banks' share of farm real estate debt increased from 9 percent to 28 percent while their holdings of farm real estate debt increased from about $8 billion to $22 billion. Furthermore, by using its GSE cost-of-funds advantage, Farmer Mac hopes to be able to offer borrowers loans on better terms than are available on bank-financed loans. By doing so, Farmer Mac's

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activities could cut into the net interest margin on farm and rural home loans. Farmer Mac could rely on banks or even captive finance companies (e.g., John Deere Credit) already in place to originate loans. If Farmer Mac proves that selling securities backed by rural home and farmland loans is profitable, new competitors may enter the market. Mortgage broker-like firms that would originate loans for sale without the regulatory and fixed costs that banks face could exert competitive pricing pressure on banks. Indeed, several mortgage brokers are already able to originate mortgages for Farmer Mac. The same combination of GSE funding and origination specialists proved quite effective in reducing spreads on mortgages held in the portfolio of thrifts, although the conforming, one-to-four family mortgage market and the rural home and farm mortgage markets are quite different.

Effect of legislative changes on taxpayers' contingent liabilities

As opposed to the effects on banks, the legislative reforms unambiguously increase the contingent liabilities of taxpayers (the costs taxpayers face if an event such as Farmer Mac's failure occurs). Taxpayers face higher explicit and implicit contingent liabilities if Farmer Mac takes on additional credit and interest rate risk without adequately pricing for that risk and/or holding enough capital or other forms of loss protection. Farmer Mac must now bear the risk of the subordinated piece of the loan pool that the FCA described at congressional hearings as "hard to price...because there is no track record for such pools." Thus, by definition, Farmer Mac will assume new risks that are hard to evaluate. At the same hearing, the FCA testified that under its new interim capital guidelines, Farmer Mac could not withstand losses on loans in its guaranteed pools or portfolio "similar to those that have occurred in the past." Furthermore, while Farmer Mac needs to build volume, its incentive to control risk-taking is eroded by its lack of capital and implied federal guarantee on its debt. The removal of the 10 percent reserve requirement also gives originators an incentive to sell their most risky loans to Farmer Mac.

Taxpayers' contingent liability for Farmer Mac arises from two sources. First, the Treasury Department can be forced to purchase up to $1.5 billion of Farmer Mac obligations if Farmer Mac cannot make good on its guarantee. Second, because of its GSE status, taxpayers could be called to make good on an implicit guarantee on Farmer Mac's obligations to the degree to which the Treasury loan is insufficient to cover Farmer Mac's losses. Because Farmer Mac is taking on additional risks during a period of relaxed capital and loss protection, the probability that taxpayers will have to make good on the Treasury loan and on Farmer Mac's obligations increases, although the exact magnitude of this increase is not easily quantified. While Farmer Mac's current incentives parallel many of those faced by the "zombie thrifts" of savings and loan crisis fame, there also are differences. For example, Farmer Mac appears to be devoting resources to increasing its risk-management capabilities. ■

■ For more information

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The views expressed in this article are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.

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