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AGRICULTURAL LETTER

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A secondary market for farm mortgages

The legislation enacted in January to provide financial assistance to the FCS contained provisions for developing a secondary marketing arrangement, with guarantees, in farm real estate and rural home mortgages. The widely-endorsed development of a secondary market holds promise of adding a significant, new dimension to agricultural credit markets. Among other things, such a market could add liquidity to the portfolio of qualified farm mortgages held by lenders, give lenders new funding sources for farm mortgages, and give borrowers access to new lenders. The new secondary market could become operational by late this year.

The Act provides for three functioning entities in the operation of the secondary market; a loan originator, a certified loan marketing facility (or loan pooler) and the soon-to-be created Federal Agricultural Mortgage Corporation (FAMC). Any entity that originates and services farm mortgages can serve as a loan originator. Any legal corporation, association, or trust (including a loan originator), upon certification by the FAMC, can serve as a loan pooler. In general, loans that qualify for the FAMC secondary market are to be made by the originator and sold, without recourse, to a loan pooler. The originator, however, must be permitted to retain the loan servicing rights and a subordinated participation interest in the loan. The pooler will combine several such loans into a loan pool and, in turn, sell securities to the investing public. The securities will represent an interest in, or an obligation backed by, the pooled loans held by the pooler and will carry a guarantee from the FAMC that assures timely interest and principal payments to the investor. The Act provides for various reserves to protect the interests of the security holders in the event of a default on a pooled loan. However, the last-resort backing for the FAMC guarantee is to be provided by a $1.5 billion federal line of credit that permits the U.S. Treasury to cover the guarantee.

The FAMC is to be chartered as a separate federal entity within the Farm Credit System. Although chartered as an entity within the FCS, the Act stipulates that the FAMC is not to be liable for obligations of other FCS institutions and that other FCS institutions are not to be liable for FAMC obligations. The FAMC will be headed initially by a 9-member interim board of directors that must be appointed by the President by early April. The composition of the interim board is to be made up of 3 members that represent FCS institutions, 3 members that represent banks, insurance companies, and other financial institutions, and 3 members (2 of which must be farmers) that represent the general public.

The primary responsibility of the interim board is to arrange for the initial capitalization of the FAMC through an offering of voting common stock. The initial stock offering must be fairly distributed between those eligible to hold Class A stock (banks, insurance companies, and other non-FCS financial institutions) and Class B stock (FCS institutions). Once paid subscriptions to the initial stock offering reach $20 million, the interim board must arrange for the election and appointment of a permanent board of directors. Following the first meeting of the permanent board, the issuance of additional shares of voting common stock will be restricted to institutions that either originate or pool mortgages that are qualified for the secondary market.

The permanent board of directors for the FAMC is to have 15 members. Of those, 5 are to be elected by holders of Class A stock, 5 are to be elected by holders of Class B stock, and 5 are to be appointed by the President as representatives of the general public. Among the appointed members, at least 2 must be experienced in farming, 1 must be designated (by the President) as chairperson, and none may hold, or ever have held, a position as an officer or director of any financial institution. The five presidentially-appointed members must be appointed no later than early October.

Within 120 days after the establishment of the permanent board, the FAMC is to issue eligibility standards for the certification of loan poolers and establish (in consultation with loan originators) uniform underwriting, security appraisal, and repayment standards for loans and loan pools that will qualify as collateral for securities guaranteed by the FAMC. Qualified loans must be secured by a first lien on agricultural real estate located in the United States. Agricultural real estate is defined to include the principal residence of a single family home, priced at no more than $100,000 (adjusted for inflation) and located in a rural community of 2,500 or less. Qualified loans must have a loan-to-value ratio of less than 80 percent, with value to be established in consideration of the purpose for which the real estate is taxed. Also, the loan must be to a borrowing entity that has a demonstrated cash flow sufficient to service the mortgage, that is (or will be) actively engaged in farming, and who is a citizen of the United States or has majority ownership by U.S. citizens. The maximum size for a qualified loan must be limited to the larger of $2.5 million (adjusted for inflation) or that secured by no more than 1,000 acres.

Regarding the composition of an eligible loan pool, the Act stipulates that each pool must contain at least 50 qualified loans that vary widely as to amount of principal and, in the aggregate, are secured by a wide geographic distribution of agricultural real estate producing a broad range of agricultural commodities. In addition, 2 or more loans to related borrowers are not to be included in the same pool and no single loan in the pool can account for more than 3.5 percent of the principal of all loans in the pool.

In the event of a default on loans that collateralize the securities to be sold by poolers, the FAMC guarantee of timely payment of principal and interest on those securities is not to become an obligation of the U.S. Treasury until other reserves required by the Act have been exhausted. The Act stipulates that a reserve, equal to at least 10 percent of the outstanding principal of all loans included in the pool, must be established for each loan pool. The pooler is responsible for establishing the reserve, but contributions to the reserve can be made by either the loan originators or the loan pooler, or shared by both. The contributions to the reserve can be either in the form of cash (which must be invested by the pooler in a segregated account of U.S. Treasury or agency securities) or in the form of retained, subordinated participation interests in the loans included in the pool, or in some combination of the two. The Act also requires the FAMC to charge poolers a guarantee fee and, if necessary, hold the monies so collected in a segregated account as an additional reserve against U.S. Treasury losses that might otherwise arise from the guarantee. An initial guarantee fee of up to 1/2 of 1 percent of the loan principal of each pool must be assessed at the time the guarantee is extended. Two years later, the FAMC may begin to assess an annual fee of up to 1/2 of 1 percent of the remaining loan principal in the pool. The fees must be established on an actuarially sound basis in relation to the risk incurred in providing the guarantee.

The Act permits some interesting exemptions regarding certain aspects of loans that are eligible for pooling in the FAMC secondary market. For instance, state usury laws that limit interest charges on loans are not to be applicable on farm mortgages included in such a pool. In addition, the expanded loan restructuring and borrower rights provisions extended to FCS borrowers in the same legislation (see *Agricultural Letter* #1729) are not to apply on any FCS loan included in a qualified pool. However, a FCS borrower can retain their borrower rights by refusing permission for the FCS lender to pool their loan. Also, certified poolers may impose extra discounts or charges on qualified loans that were originated in states that have borrower rights laws, such as for loan mediation purposes.

The Act also limits the maximum amount of guarantee obligations the FAMC can make during each of the first three years of operation. The limits are expressed in terms of a percentage of all farm real estate debt outstanding, excluding that held by the Farmers Home Administration. The applicable percentages are 2 percent during the first year following enactment, 4 percent the second year, and 8 percent the third year. However, the limits are cumulative and applicable only with respect to guarantees associated with loans originated by banks, insurance companies, and other non-FCS institutions.

Gary L. Benjamin

Milk production continues to rise

Milk production in 1987 dropped almost 1 percent from the year earlier record. However, the decline was attributable to a 3 percent year-to-year drop in output that occurred during the first half of the year. Second half milk production outpaced year-earlier levels, almost completely offsetting the drop that was registered through July. USDA reports indicate that the year-to-year gains have continued into the early months of 1988 and will likely lead to another record level of milk production this year.

Dairy cow numbers registered year-to-year declines throughout 1987. The whole-herd Milk Termination Program (MTP) first implemented in April 1986, continued through September of last year and accounts for the trend in dairy cow numbers. After registering declines from year-earlier levels of 6.3 percent and 5.4 percent during the first two quarters of 1987, dairy cow numbers fell about 3.6 percent during the final months of the MTP. Fourth quarter dairy cow numbers were down about 2.4 percent from the comparable period of a year earlier.

Offsetting these declines, milk production per cow registered substantial gains. After recording a 3 percent year-to-year rise during the first quarter, output per cow rose continuously, jumping to a 5.5 percent year-to-year increase during the final three months of 1987. The sharp gains in productivity are attributable to record milk-feed price ratios and increased concentrate feeding. The milk-feed price ratio, a benchmark of the profitability in milk production, rose almost 6 percent from the year-earlier level in 1987. The increase was due to a slight rise in average milk prices (after adjustments for support-program deductions) combined with a year-to-year drop in feed costs. Average prices for feed concentrate were down as well, dropping about 3 percent from 1986 levels. The decline boosted returns over concentrate costs about 3 percent from a year earlier.

Along with the decline in output last year, commercial disappearance of milk continued to trend higher. Up about 3 percent for the year, commercial disappearance of milk recorded a fourth consecutive year of substantial annual gains. However, the strongest gains occurred during the first half of 1987, with commercial use registering more moderate increases during the final months of the year. Moreover, USDA analysts indicate that much of the increase in commercial use was concentrated in butter and cheese, with fluid milk sales growing at a much slower pace than the one maintained over the previous several years.

The continued gains in commercial use of milk along with lower production last year contributed to a sharp reduction in Commodity Credit Corporation (CCC) purchases of manufactured dairy products. Purchases of excess supplies of dairy products by the CCC is the mechanism through which the federal government supports milk prices. Throughout last year, CCC net purchases totaled about 6.7 billion pounds on a milk equivalent basis, more than a third lower than the 1986 level. The sharp reduction held CCC net removals to about 4.7 percent of 1987 milk production, down from 7.4 percent of output the previous year and 9.2 percent in 1985.

Milk production through the first two months of 1988 has exceeded year-earlier levels and initial projections of annual production point to an overall increase for the year. Milk production in the 21 major producing states registered a year-to-year gain of 3 percent in January, as an almost 5 percent increase in output per cow more than offset a 1.5 percent drop in the number of milk cows. Production among this group of states, which typically accounts for 85 percent of total U.S. milk production, continued to show substantial gains during February. Without adjusting for the extra day in February, milk production was up 5.6 percent from a year earlier. Assuming a constant daily rate of production, adjusting for the extra day this year would suggest a 2 percent year-to-year increase in output. Once again, a 1.3 percent decline in the number of milk cows was more than offset by increased output per cow.

The increased output in the early months of 1988 has occurred despite a January 1 cut in the milk support price. A price support cut of 50 cents per hundredweight was mandated by legislation if USDA estimated that net purchases by the CCC to support milk prices would exceed 5 billion pounds on a milk equivalent basis in 1988. USDA projections pointed to 7.3 billion pounds of net removals during 1988 without a 50 cent reduction, necessitating the cut in the milk support price to $10.60 per hundredweight on January 1. In addition to the support price cut, a deduction of 2.5 cents per hundredweight of milk marketed by dairy farmers will be assessed throughout 1988. This deduction through the year takes the place of larger discounts in payments that would be required under the Gramm-Rudman-Hollings legislation for fiscal 1988 that ends in September.

Despite the reduction in the support price, and expected increases in feed prices, milk output in 1988 is expected to exceed last year's level. However, the resulting lower milk-feed price ratio is likely to dampen gains in output per cow and may elicit some additional small reductions in the number of milk cows this year. Nevertheless, USDA analysts expect milk output for the year to rise between 1 and 3 percent, approaching a new production record.

Although commercial use of milk is projected to be up this year, it will not be sufficient to substantially reduce net CCC purchases of manufactured dairy products. With little upward pressure on retail dairy prices expected, current USDA projections point to an annual increase in commercial disappearance of milk between 1 and 3 percent in 1988. With a similar gain expected in milk output, USDA estimates of net CCC purchases, accounting for the 50 cent support price cut and the 2.5 cent deduction, point to 6 billion pounds of net removals for the year.

Peter J. Heffernan

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Chicago,IL 60690
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Selected Agricultural Economic Indicators

	Latest period	Value	Percent change from: Prior period	Year ago	Two years ago
Prices received by farmers *(1977=100)*	February	130	-0.8	7	7
Crops *(1977=100)*	February	110	-4.3	11	0
Corn *($ per bu.)*	February	1.83	3.4	29	-21
Oats *($ per bu.)*	February	1.81	1.7	23	-10
Soybeans *($ per bu.)*	February	5.90	3.0	26	14
Wheat *($ per bu.)*	February	2.83	2.9	10	-10
Livestock and products *(1977=100)*	February	150	2.0	4	13
Barrows and gilts *($ per cwt.)*	February	47.50	8.2	-3	10
Steers and heifers *($ per cwt.)*	February	72.00	4.2	15	28
Milk *($ per cwt.)*	February	12.30	-1.6	-5	-1
Eggs *(¢ per doz.)*	February	46.9	-4.9	-20	-24
Prices paid by farmers *(1977=100)*	January	165	0.0[†]	4	4
Production items	January	152	1.3[†]	7	2
Feed	January	112	6.7[†]	13	-2
Feeder livestock	January	193	1.6[†]	18	31
Fuels and energy	January	161	-4.2[†]	5	-19
Producer Prices *(1982=100)*	February	106	-0.3	2	2
Agricultural machinery and equipment	February	110	0.5	1	1
Fertilizer materials	February	96	1.2	13	7
Agricultural chemicals	February	106	0.2	4	5
Consumer prices *(1982-84=100)*	January	116	0.3	4	6
Food	January	116	0.9	3	8
Production or stocks					
Corn stocks *(mil. bu.)*	December 1	9,767	N.A.	-5	13
Soybean stocks *(mil. bu.)*	December 1	1,755	N.A.	-10	-10
Beef production *(bil. lbs.)*	January	1.94	0.9	-8	-9
Pork production *(bil. lbs.)*	January	1.24	-10.5	0	-2
Milk production *(bil. lbs.)*[††]	February	9.74	-4.6	6	2

N.A. Not applicable
[†] Prior period is three months earlier.
[††] 21 selected states.

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Public Information Center
P.O. Box 834
Chicago, Illinois 60690

(312) 322-5111

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