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THE STATUS OF FARMER MAC

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The Agricultural Credit Act of 1987, which amended the Farm Credit Act of 1971, marked the beginning of a new era in farm and rural lending in the United States. One of the major provisions of the act was the establishment of a loan resale market for farm and rural housing mortgages in which the lender sells the loan to an investor. This new "secondary" market has the potential to revolutionize lending in the farm and rural housing sectors by creating uniform credit underwriting and appraisal standards, diversifying and reducing credit risk, increasing competition among lenders, and attracting new investor capital to the agricultural mortgage market. Despite the potential benefits from the creation of a secondary market for agricultural mortgages, it is important to recognize that this is not a bail out program for the agricultural sector, but a potential source of funds for agricultural land and rural housing mortgages. Its long range objective is to add stability and predictability to agriculture financing which will benefit borrowers through a more efficient agricultural real estate market.

Although the foundation for the new secondary market is currently being put into place, there is information on what the program will be, how it will work, who will be eligible, and what the expected impacts of the program are. This paper summarizes the major aspects of the program and its likely availability to interested parties. Much of the information reported in the paper is taken from the Federal Agricultural Mortgage Corporation Offering Circular, the Farmer Mac 1989 First Quarter Report, various issues of National Farm Finance News, and the Federal Agricultural Mortgage Corporation Credit Underwriting, Loan Repayment and Security Standards.

WHAT IS FARMER MAC?

The 1987 Agricultural Credit Act established the Federal Agricultural Credit Corporation which is typically referred to as "Farmer Mac." The corporation is an instrument of the U.S. government and Member Institution of the Farm Credit System (FCS). However, Farmer Mac is not liable for any debt or obligation of the FCS nor is the FCS or any Member Institution liable for any debt or obligation of Farmer Mac. Although there is direct government oversight, Farmer Mac is not a government agency, but a strictly for-profit corporation. The primary intent is to provide the same assistance to borrowers and lenders in the agricultural sector as is available to borrowers and lenders in the residential real estate markets through the secondary markets that were created for residential mortgage loans (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae).

Farmer Mac's primary functions are: (1) to develop uniform underwriting, appraisal, and repayment guidelines for agricultural real estate and rural housing loans that qualify for trading on the secondary market; (2) certify agricultural mortgage marketing firms that are authorized to pool and issue securities representing an interest in or obligations backed by pools of qualified loans; and (3) provide guarantees for the timely payment of principal and interest on such securities or obligations.

The Act authorizes Farmer Mac to borrow up to $1.5 billion from the U.S. Treasury to accomplish its objectives. The debt will bear interest at a rate determined by the U.S. Secretary of the Treasury based on the then current cost of funds to the U.S. government. Any debt incurred by Farmer Mac must be repaid within a reasonable amount of time. It should be noted that Farmer Mac does not intend to borrow from this credit reserve.

Because Farmer Mac is a for-profit corporation, it must have investors who hold equity positions in the corporation. These investors can be Farm Credit Institutions, banks, insurance companies, business and industrial development companies, savings and loan associations, associations of agriculture producers, agricultural cooperatives, commercial finance companies, trust companies, credit unions, or any other entity who originates and services agricultural mortgage loans. Investors in Farmer Mac must own a minimum required number of shares of voting stock in the corporation. The minimum ownership requirements depend on the type and size of institution and on whether the investor wishes to originate mortgage loans at the local level (i.e., act as an "originator") or pool mortgage loans for resale (i.e., act as a "certified facility" or a "pooler").

Poolers must meet certification standards beyond the qualification of firms who wish to act solely as originators. A pooler must be a Member Institution of the FCS or a corporation, association, or trust organized under the laws of the U.S. or any state in the U.S. It must have as one of its purposes the sale or resale of pool securities and must demonstrate managerial ability in underwriting, servicing, and marketing agricultural mortgage loans that is acceptable to Farmer Mac. It must also agree to allow representatives of Farmer Mac access to its records and facilities for the purpose of examining its operations.

The pooler must meet or exceed capital standards established by Farmer Mac. It must adopt agricultural mortgage loan underwriting, appraisal, and service standards set by Farmer Mac. It must adopt minimum standards and procedures for agricultural mortgage loan administration and disclosure to borrowers in conformity with uniform standards established by Farmer Mac concerning terms and rights applicable to loans. The certification of a pooler will be effective for up to five years but can be revoked by Farmer Mac if the pooler does not meet Farmer Mac's standards. Any pooler may also act as an originator of loans at the local level.

The stock sold by Farmer Mac to the originators and poolers is divided into three classes. Stock purchased by financial institutions (e.g., banks, thrifts, insurance companies) is Class A stock and contains voting rights. Stock purchased by Member Institutions of the FCS is Class B stock and also contains voting rights. Each share of Class A and Class B stock purchased by investors in the initial stock offering is accompanied by a share of Class C stock which contains no voting rights.

The Farmer Mac board of directors may issue additional Class C shares to the public at which time the Class A and Class B investors may sell their Class C shares. The Class C shares will eventually be freely transferable and most likely traded publicly. Thus, the Class A and Class B stock are much like a franchise opportunity for agricultural mortgage loan originators and poolers and the Class C shares are essentially an investment instrument which will hopefully have resale value at a future date. The Farmer Mac board of directors consists of fifteen members: five elected by Class A shareholders; five elected by Class B shareholders; and five appointed by the president subject to congressional approval.

The initial stock offering took place in early 1989 and investor reaction was much stronger than anticipated, especially the demand for stock from the financial institutions. As a result, the initial costs per share of Class A stock was significantly reduced. The initial offering brought in Farmer Mac's goal of $20 million of capitalization funds which will be used to pay operating expenses and for the payment of any losses on guarantees of pool securities.

In all, approximately 1,700 institutions purchased the minimum stock required to be originators and nearly 50 purchased enough stock to meet the ownership requirement for poolers. There were over 1,600 financial institution that purchased Class A stock and 93 percent of these were commercial banks. Of the commercial banks that purchased stock, 74 percent had assets less than $50 million and 38 percent had assets of less than $25 million. There were 22 financial institutions that purchased enough Class A shares to qualify for pooler certification provided they meet Farmer Mac's criteria. These firms included 10 commercial banks, 3 investment banks, 6 insurance companies, 2 trust companies, and 1 commodity firm. The important point in examining the characteristics of the investors in Farmer Mac stock is that a good representation of both small and large institutions is present and these firms are operating in all states. Prudential Insurance Company and Norwest Banks (a $21.5 billion bank holding company) made the largest investments with each purchasing 40,000 shares at a total cost of $800,000.

HOW WILL IT WORK?

Farmer Mac will be the key element in a secondary market for agricultural real estate mortgages and rural housing. The market will function essentially as a three party process. Local lenders will originate mortgage loans at the farm level. The local lender (i.e., the originator) will then sell the loan to a pooler (e.g., Norwest Banks). The pooler will purchase mortgage loans from a variety of originators. The pooler then sends the "pool" of loans to Farmer Mac who will evaluate the loans in the pool and, if the loans meet predetermined quality guidelines, guarantee a subordinated 90 percent of the timely payment of interest and principal payments of the corresponding security issued by the pooler. The pooler can then keep the pool security in its portfolio or sell it on the open market. Investors who purchase the pool security are purchasing a financial instrument of the pooler, not the actual pool of loans. The pooler, or the originators, or both must establish a reserve for, or retain a subordinated interest in, each pool equal to at least 10 percent of the outstanding principal amount of the qualified loans in the pool. A pooler must take full recourse against the reserve or subordinated interest before making any demand on Farmer Mac for its guarantee. The pooler and/or originators will absorb any loss up to 10 percent of the timely interest and principal payments of the pool security and Farmer Mac will absorb any losses over the first 10 percent. Thus, an investor in a pool security backed by Farmer Mac will receive the timely payment of principal and interest even if the underlying mortgage loans are defaulted by the borrowers. It is important to recognize that Farmer Mac does not issue obligations backed by real estate mortgages nor will it guarantee repayment of qualified loans in the pool, but it will guarantee 90 percent of the principal and interest payment on the financial securities issued by the poolers. The pooler relies on the underlying pool of real estate loans as a revenue source to use in making the principal and interest payments.

WHO QUALIFIES FOR THE PROGRAM?

A qualified loan must be secured by agricultural real estate located within the U.S. The principal amount of the loan may not be less than $50,000 nor more than $2,500,000, as adjusted for inflation. The Act contains an exception to the $2,500,000 maximum in that agricultural real estate consisting of a total of 1,000 acres or less may qualify. The borrower must be a U.S. citizen or national or an alien lawfully admitted to the U.S. for permanent residence. A private corporation or partnership may qualify if the majority of its members, stockholders, or partners are citizens or nationals of the U.S. or aliens lawfully admitted for residency. The borrower must have training or farming experience that suggests a reasonable chance of repayment of the loan according to its terms.

Qualified agricultural real estate falls into two separate categories. The first category is land, or a structure affixed to land, that is used in the production of agricultural commodities and/or products. Farmer Mac will establish minimum acreage and/or use requirements for real estate that falls into this category. The second category is principal rural residences that have a purchase price of less than $100,000 after adjustment for inflation. The residence must be a single family dwelling and can not be located in a community with a population of over 2,500 people.

The permanent board of directors for Farmer Mac submitted its first quarterly report on April 12, 1989. The report contained a discussion of proposed underwriting and appraisal standards for Farmer Mac. The proposed standards were then modified and submitted for congressional review on June 30, 1989. The approved credit underwriting and repayment standards included the following points:

(1) A complete and current credit report including a current lien search, historical credit experience, report of all debts, and pertinent legal information must be obtained from each borrower.

(2) At least the current year's "fair market value" balance sheet and income statements for the current year and the two preceding years must be obtained from each borrower with specified adjustments made to the current financial statements to reflect the value of production.

(3) The borrower should have a pro forma debt-to-asset ratio of 50 percent or less after closing any new loan. Exceptions to this can be made for borrowers who exhibit a strong history of earnings or liquidity.

(4) The borrower must generate sufficient earnings and liquidity to satisfy all capital obligations as they come due over the term of the loan including capital replacements and contingencies. To accomplish this the borrower must have: (a) a total debt coverage ratio of no less than 1.25:1 including net income from farm and nonfarm sources; and (b) a current ratio of no less than 1:1. Both ratios will be computed on a pro forma basis including any new loan.

(5) The loan to appraisal value ratio shall not exceed 75 percent. Also a minimum 1:1 cash flow debt service coverage ratio for the financed real estate will be required. The debt service ratio will be computed using the Net Property Income as determined by the appraiser. The minimum cash flow debt service coverage ratio may be waived on the subject real estate if: (a) the borrower's principal residence is on the property securing the loan; <u>and</u> (b) the pro forma debt coverage ratio of the entity being financed has for the last three years been no less than 1.5:1.

(6) The financed property shall meet minimum acreage or minimum annual receipts requirements set by Farmer Mac.

(7) Loan conditions such as loan agreements, personal liability, additional collateral, title and casualty insurance will be required. The loan must be a level-payment or level-principal payment and either: (a) fully amortize principal over a 30-year period; <u>or</u> (b) amortize principal according to schedule not to exceed 30 years, and mature no earlier than the time at which the remaining principal balance of the loan equals 50 percent of original appraisal value of the property securing the loan.

(8) For housing loans, Farmer Mac will adopt credit underwriting standards similar to those of Fannie Mae with adjustments to reflect the usual and customary characteristics of rural housing. The 75 percent loan-to-market value may be met in part with insurance support such as private mortgage insurance (PMI).

(9) Farmer Mac may accept loans that do not meet one or more of the above standards when: (a) the loans demonstrate compensating strength on one or more of the standards to which they do conform; and (b) those loans are made to borrowers who produce agricultural commodities or products in a segment of agriculture in which non-conformance and compensating strength are typical of the financial condition of sound borrowers.

The appraisal standards impose policies designed to insure that:

(1) The appraisal function is conducted and administered by qualified individuals.

(2) Appraiser qualifications are verified.

(3) Estimates of market value, market rent, net property income, characteristics of the property, and relevant market forces are reported in a reliable, accurate, and uniform fashion.

(4) Originators of loans conduct appraisal reviews designed to indicate departures from Farmer Mac appraisal standard in a timely and reliable fashion.

(5) Poolers conduct reviews of selected appraisals to check if the appraisal function conducted by loan originators is in compliance with Farmer Mac standards.

The appraisal function must be independent of all other functions associated with the loan origination process. The standards go on to discuss specific policies regarding: appraiser selection and qualifications; options of poolers and originators to set additional standards; minimum appraisal standards; specific reporting standards; appraisal of rural housing; and requirements of current appraisals.

WHAT IMPACT WILL FARMER MAC HAVE?

The creation of Farmer Mac and the secondary market for agricultural mortgage loans takes place in an already rapidly changing financial market place. If the secondary market is successful, it will likely lead to a national integration of the financial markets serving the agricultural sector. Mortgage lending in the agriculture sector will become a more standardized and liquid market. For the first time, long term lenders in the agricultural sector will operate on equal ground. All participant lenders in Farmer Mac will have access to funds at a cost near to or at the level of the price of funds to the Farm Credit Banks Funding Corporation of the FCS. This new access to funds which were previously available only to Member Institutions of the FCS should lead to increased participation by banks, life insurance companies, and thrifts in the primary and secondary mortgage markets.

Regardless of the future success of the secondary market, Farmer Mac has made large strides toward the establishment of the first set of national credit and appraisal standards for the agricultural real estate loan market. Through its committees, staff, and board, Farmer Mac has incorporated useful input from a broad spectrum of interested parties in the establishment of these standards. In general, these standards are quite conservative when compared to recent historical practices. However, had they been applied during 1970s and early 1980s, many of the credit problems in the agricultural sector would have likely been avoided.

If the program becomes functional, banks in local communities will be able to directly serve a larger portion of their customers needs. Because of the short-term nature of their deposits, rural banks have tended to make short-term loans for seed, feed, and equipment while the Federal Land Banks have tended to make the majority of long term mortgage loans. The new access to long-term capital and the secondary market will allow rural banks to act as originators for mortgage loans and then sell the loans to a pooler. Thus rural banks can move toward becoming full service lenders. Mortgage lending in the agricultural sector will likely become more profitable for some lending institutions because of profits from the sale of mortgage loans and perhaps Farmer Mac stock appreciation at some point in the future. However, it seems unlikely that we will see a significant change in the participants in the agricultural mortgage market or the demand for agricultural credit as a result of Farmer Mac. Instead, the uniform access to investor funds and increased profitability will most likely lead to some increase in the level of competition for long-term agricultural loans to financially sound borrowers at the local level.

Agricultural borrowers may also benefit from a successful secondary market. It is important, however, to emphasize that the secondary market will not act as a bail out program for the agriculture sector, but instead will bring with it increased stability and liquidity, and alternative sources of funds for some borrowers. The standardization of mortgage loan underwriting in an established system should better define quality agricultural credit which will help avoid the pitfalls that asset based lending caused in the late 1970s and early 1980s. The uniform credit standards, risk diversification through loan pooling, 90 percent guarantee of Farmer Mac, and increased competition among lenders should combine to create a more liquid and efficient market for long-term funds. However, as discussed later, the current structure of Farmer Mac has several new cost components over and above existing sources of long-term funds which bring into question the ability of Farmer Mac to be a competitive source of funding on a cost efficiency basis.

An aspect of the program which needs to be stressed is that only financially strong borrowers will be able to qualify for the loans. Historical and pro forma financial statements must meet what are, from an historical perspective, fairly restrictive criteria. For example, the proposed debt-asset ratio must be less than 0.50. Table 1 shows the distribution of farm operator debt by debt-asset ratio and lender for January 1, 1988. Of all existing debt, 55 percent is held by farms with debt-asset ratios greater than 0.40 and 23.5 percent is held by farms with debt-asset ratios greater than 0.70. The situation in the Lake states is even worse with 64 percent of the debt held by firms with debt-asset ratios greater than 0.40 and 30 percent greater than 0.70. Clearly a large amount of the existing debt would not qualify for Farmer Mac on this first criteria alone. The Lake

States region also had the largest number of moderately solvent and vulnerable farms in the U.S. as 22 percent of the farms had debt-asset ratios greater than 0.41 and 7 percent had ratios above 0.70.[1] Nationally the largest number of moderately solvent and vulnerable farms by commodity group were dairy producers (25%), cotton producers (24%), poultry producers (22%) and cash grains producers (21%) while the national average for all farms was 15 percent. Thus certain commodity groups will have better access to the Farmer Mac program.

A strong debt-asset ratio does not assure qualification for the loans. The borrower must still meet the additional liquidity, coverage, and cash flow requirements in addition to providing the necessary 25 percent down payment. Table 2 shows the percent of farms in the Lakes States area that had negative net income during 1987. It is clear that a large number of "solvent" firms as defined by their debt-asset ratio would have had difficulty qualifying for a loan on a cash flow basis during 1987.

The situation in Michigan is similar. Table 3 shows the percent of Michigan farms with negative cash farm income and debt-asset ratios above 0.40 by sales level and type of farm in 1988. Out of all Michigan farms, 49 percent had negative cash farm income with the majority of these having sales of less than $40,000. Other livestock and poultry farms were most likely to have a negative cash farm income followed by cash grain farms and then other crops. Sixteen percent of all Michigan farms had debt-asset ratios of 0.40 or above. Larger farms (sales of $250,000 or above) had higher debt/asset ratios

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[1]Financial Health Categories:
Favorable--positive income and a debt/asset ratio of 0.40 or less.
Marginal Income--negative income and a debt/asset ratio of 0.40 or less.
Marginal Solvency--positive income and a debt/asset ratio above 0.40.
Vulnerable--negative income and a debt/asset ratio above 0.40.

than smaller farms. Dairy farms carried higher debt ratios than other farm types. Clearly, there will be many Michigan farmers, spread across economic class and type of farm, who will not meet Farmer Mac's standards.

Thus, while financially strong borrowers will see some direct benefits from the Farmer Mac program, a large number of farmers (and an even larger proportion of the total credit needs) will not qualify for Farmer Mac loans. It should be noted that the credit underwriting standards have provisions for beginning farmers and borrowers who do not meet a particular standard, but who do have sufficient offsetting strength in other financial areas. However, the fact remains that the program is structured to provide credit only to borrowers who are very strong financially.

One aspect of the program which appears to offer substantial opportunities to benefit rural areas is the availability of funds to finance rural housing. The existing secondary markets for residential mortgage loans are restricted from including rural housing mortgages in their loan portfolios. The ability of lenders to sell rural mortgage loans to Farmer Mac poolers for resale on the secondary market will lead to an increase in the amount of funds available for rural housing.

Finally a key group which may receive direct benefits from the secondary market are investors who purchase the Pool Securities and thus supply the majority of capital for the mortgage loans and provide liquidity to the secondary market. Although these investors will benefit from an additional investment vehicle in which to earn returns and diversify their portfolios, the amount of the potential benefits will be limited by the size of the secondary market which will probably be much smaller than its counterparts in the residential mortgage markets. For example, according to the Kansas City

Federal Reserve Bank, there is approximately $8 billion of new farm mortgage credit each year of which only a portion will qualify for backing by Farmer Mac (Barkema, et. al.). The outstanding principal balances of residential mortgages backing securities guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae totaled $670 billion in 1987. As shown in Table 1, the total farm debt to all lenders total only $88 billion. Thus, the secondary market for agricultural mortgage loans will, at least initially, be a relatively small investment market.

REMAINING ISSUES AND CONCERNS

While the secondary market has the potential to provide benefits to the agricultural sector, it must deal with several major issues and face some major tests. The ultimate viability of the program will depend on the volume of loans available and the ability of poolers to price the pool securities competitively. Key players in the program are the rural bankers and the FCS whose participation and involvement in the program are essential from the outset. There is considerable debate in the banking sector over various aspects of the program.

The American Bankers Association (ABA) wants more flexibility in the underwriting standards proposed by the Farmer Mac board of directors. The ABA feels that many of the ratio requirements to qualify for the program are too restrictive and the focus should be on long term profitability. They feel that the loan to value ratio should be set at 80 percent before requiring PMI as is the case with Fannie Mae Mortgage securities. In addition, the ABA believes all off- and on-farm income sources to a borrower should be considered in the loan making decision. The ABA also wants to increase the scope of rural mortgage lending by allowing hobby farmers and country estates to qualify for the program. The Independent Bankers Association of America (IBAA) is taking a more conservative approach. They feel that the real estate financed by qualified mortgage loans should produce enough income to service the debt. The mortgage loans should be limited to financing farm real estate and not personal property. The IBAA feels that nonfarm income should count only towards living expenses. In general, the banking community is split over many of the issues involved in implementing the Farmer Mac program. The ABA wants a more flexible "rural lending" program which will help farmers and encourage people to move to rural areas, resulting in a higher loan volume. The IBAA wants a more conservative "farm lending" program designed to help full-time farmers.

While there is clearly disagreement among various potential originators and poolers regarding different aspects of the program, there is less disagreement that the current structure of the Farmer Mac program may prohibit participating firms from providing a long-term fixed rate mortgage product that is competitive with alternative sources of funding. The current structure of the program adds several new cost components over and above competing sources of funds. The Farmer Mac program was structured in a way to protect itself from credit risk by restricting the absorption of a pooled security's losses to the subordinated 90 percent of the securities principal and interest payments. In reality, there is virtually no credit risk to Farmer Mac. Thus, the originators and poolers essentially carry the credit risk for the entire pool. Bank regulators have been concerned with the amount of risk exposure held by originators and poolers and there has been considerable debate as to whether to require the originators and/or poolers to maintain equity capital support for the entire value of the pool, as if it were never sold, instead of equity capital on only the 10 percent exposure they actually have in the security. While the bank regulators are probably correct in their assessment of the relative risk held by the originators and poolers, this capital requirement would remove many of the benefits that the originators and poolers would receive from the sale of the security and Farmer Mac's guarantee.

For example, suppose a pooler has a $10,000,000 pool of loans guaranteed by Farmer Mac. The poolers maintain a 10 percent senior interest in the security and Farmer Mac guarantees 90 percent of the pool. The pooler issues a security based on the senior portion of the pool guaranteed by Farmer Mac and, thus, has only a 10 percent or $1,000,000 credit risk exposure. For a standard loan, the pooler would be required to hold 8 percent of the $1,000,000 or $80,000 as equity capital. However, because the entire credit risk for the $10,000,000 pool is associated with the poolers $1,000,000 exposure, the pooler will be required to hold 8 percent of the $10,000,000 value of the pool or $800,000 for its $1,000,000 credit risk exposure. This increased capital requirement would eliminate much of the economically desirable aspects of the sale of the securities and Farmer Mac's guarantee.

Currently, it appears that the selling bank will be able to retain up to a 10 percent recourse in a pooled security and will only be required to hold capital against the 10 percent retain portion of the security. However, new risk based capital guidelines are scheduled to go into effect December 31, 1990 which would require all banks to hold capital against all assets sold without recourse. Fortunately, there are strong signals that these guidelines will be modified prior to December 31, 1990. The future status of bank's capital requirements for assets which are sold without recourse clearly has important implications on the success of Farmer Mac, as well as the residential secondary markets.

In addition to the increased capital equity requirements, the Farmer Mac program has several additional cost components which will increase the cost of funds to borrowers. These costs include: an investor risk premium for a new and untested security, the cost of Farmer Mac's guarantee, the cost of the originator and pooler compensation, the cost of investor reporting and review, the cost associated with registering and marketing the senior securities, and the cost associated with the handling of additional payments. Norwest Corporation estimates these cost elements to add between 0.6 percent and 0.9 percent to the annual cost of delivering Farmer Mac loan funds.[2] These are costs in addition to the costs involved in delivering shorter term and variable rate farm real estate loans. The Farm Credit Bank of the St. Paul District estimates that the cost of delivering Farmer Mac loan funds will be between 1.25 and 1.6 percent above comparable housing mortgage real estate rates by Fannie Mae.[3]

In summary, there is justifiable concern as to whether Farmer Mac loan securities can be delivered on a competitive basis given the additional cost elements associated with the securities and the capital equity requirements of the firms that will be delivering the loans. If rural bank originators,

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[2]Oral testimony by Jerry Thompson, Norwest Corporation, before the Subcommittee on Policy, Research, and Insurance of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, Wednesday, September 13, 1989.

[3]Estimates presented by Ken Reiners, Credit and Operation's Division, Farm Credit Services, St. Paul, MN, at a presentation to the NCR-113 and NCR-123 Regional Research Committee on October 11, 1989.

financial institution poolers, and the Farm Credit System are unable to deliver an economically competitive product, then the Farmer Mac program will almost certainly live a short life.

The "borrower rights" aspect of the Act could be another possible stumbling block for Farmer Mac. Borrower rights (including restructuring procedures, right to appeal, and right of first refusal to repurchase or lease property lost in liquidation) which apply to borrowers from Member Institutions of the FCS will not apply to loans guaranteed by Farmer Mac. Originators that are Member Institutions of the FCS will give each potential borrower a notice stating their rights if a loan is not placed in the pool. The borrower has the right to decide whether to place the loan in the pool or whether the loan will be subject to borrower rights. The Member Institutions will establish separate rates and terms for loans with borrower rights and loans placed in a pool.

CONCLUSIONS

The creation of the secondary market for agricultural and rural housing mortgage loans has the potential to have a significant impact on the agricultural financial sector. Increased competition among lenders, uniform access to investor funds, risk diversification through the pooling of mortgage loans, and increased standardization and liquidity of agricultural mortgage loans could help make long-term mortgage lending profitable to an increased number of lenders and make available new credit sources to some farmers. However, the program is likely to be an alternative source of credit only to farmers who are financially sound.

The program has a number of difficult issues to resolve prior to its implementation. The most discouraging aspect of the program is that the additional cost components implicit in its structure may make it difficult for participating originators and poolers to offer a competitive fixed rate long-term source of funds. The success of the program depends on structuring the program so that rural lending institutions and borrowers find it profitable to create a large enough volume of qualified mortgage loans to create a liquid secondary market and that investors accept the pool securities.

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Table 1: Distribution of Farm Operator Debt by Debt/Asset Ratio and Lender, January 1, 1988

Lender	Debt/Asset Ratio 0.01-0.10	0.11-0.40	0.41 0.70	0.71-1.0	Over 1.0	All Farms
	Million Dollars					
Commercial banks	2,797	13,129	9,724	3,169	3,053	31,871
Federal land banks	741	6,731	5,553	2,189	1,768	16,981
Farmers Home Administration	221	3,332	4,781	2,390	3,357	14,081
Production Credit Association	383	2,837	1,320	652	426	5,619
Commodity Credit Corporation (storage and drying loans)	46	227	106	171	19	569
Merchants and dealers	372	963	545	191	99	2,169
Life insurance companies	170	1,287	666	377	114	2,614
Other individuals	752	4,761	4,533	1,552	735	12,332
All other lenders	165	1,014	533	259	225	2,196
All lenders	5,647	34,281	27,760	10,949	9,796	88,433

Source: Financial Characteristics of U.S. Farms, January 1, 1988.

Table 2: Percent of Negative Income by
Debt/Asset Ratio, January 1, 1988

Lake States	No Debt	0.01- 0.10	0.11- 0.40	0.41 0.70	0.71- 1.0	Over 1.0	All Farms
	Debt/Asset Ratio						
Percent of Farms with negative net-farm income	21.43	26.95	25.42	27.00	45.41	34.66	25.84
Percent of Farms with negative cash income	41.22	40.61	44.33	54.85	56.44	62.86	45.29
Percent of Farms with negative family income	40.44	32.42	35.37	43.88	70.34	46.11	39.85

Source: Financial Characteristics of U.S. Farms, January 1, 1988.

Table 3: Percent of Michigan Farms With Negative Net Cash Farm Income and Debt/Asset Ratio by Economic Class and Type of Farm

	Negative Cash Farm Income	Debt/Asset Ratio Greater Than 0.40
All Farms	49	16
Economic Class:		
Sales above $250,000	14	37
Sales $40,000 - $250,000	21	28
Sales below $40,000	63	9
Type of Farm:		
Cash Grain	52	17
Other Crops	44	12
Dairy	18	27
Other Livestock & Poultry	65	12

Source: Farm Costs and Returns Survey 1988 Summary: Michigan.