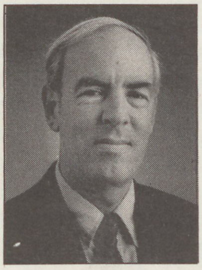
Farmer Mac's New Secondary Market Environment

by Peter J. Barry



Peter J. Barry is a professor of agricultural finance and Director, Center for Farm and Rural Business Finance, University of Illinois.

Major revisions in Farmer Mac's statutory provisions have given the organization renewed energy to establish an effective secondary market for farm real estate loans and rural housing loans.

Included among the changes in the Farm Credit System Reform Act of 1996 are: 1) The power to purchase eligible loans directly from originating lenders and to issue guaranteed securities backed by such loans; 2) The ability to conduct business without the 10% minimum cash reserve or subordinated participation interest previously required with each loan; 3) The elimination of commodity and geographic diversification requirements for loan pools; and 4) The phase-in of revised capital requirements, including an equity capital target of at least $25 million by February 1998 (equity capital on June 30, 1996 was $14.9 million) and full implementation of higher minimum regulatory capital requirements by February of 1999.

The general goal is to provide a viable secondary market for farm real estate...

These changes and several others in the Act have made Farmer Mac's operating structure essentially the same as that of other government-sponsored enterprises (Fannie Mae and Freddie Mac) providing secondary markets for residential mortgage loans. The general goal is to provide a viable secondary market through which commercial banks, life insurance companies, the Farm Credit System, and other eligible lenders can sell loans to fund the farm real estate and rural housing components of their loan portfolios.

The potential effects include a widening of financial options for rural financial institutions and borrowers, stabilization of rural credit availability, enhanced local competition, lowering of barriers to entry for non traditional lenders, added product and service offerings by commercial banks, and more uniform and perhaps lower interest rates across regions. A viable secondary market provides additional flexibility for rural borrowers as financial markets continue to evolve toward larger, more consolidated bank and non bank systems.

The Securitization Concept

The competitively priced and potentially profitable securitization of farm mortgage loans can occur through sales by originating banks and other lenders of new loans or through swaps of seasoned loan portfolios, financed in both cases by the issuance of agricultural mortgage-backed securities with lower capital requirements. This process allows the efficient reallocation of credit risks (with Farmer Mac guarantees) and interest rate risks to financial market investors with the risk-reducing benefits of securitization. Farmer Mac's alternatives in security design allow considerable flexibility in tailoring the characteristics of pools to different classes of investors. The specialized, information-intensive functions of loan origination, monitoring, and servicing can remain with the local lenders.

Characteristics of Farmer Mac Approved Banks

The characteristics of the commercial banks currently originating and selling loans to Farmer Mac are important to consider because these characteristics provide signals about the nature of Farmer Mac's customer base. Positioning a bank to utilize loan sales is a key element of an asset-liability management strategy intended to enhance overall bank performance.

On average, Farmer Mac's customer base likely includes higher performing banks that more rigorously exercise asset-liability management. Higher performance would be indicated by above average profitability, substantial commitment to lending activities, and greater ratios of loans-to-deposits and loans-to-total assets. Higher profitability generally implies greater financial leveraging and perhaps a greater risk position, consistent with the risk-return trade off in business enterprises. Effective asset-liability management ensures, however, that the appropriate mix of profitability, risk, and liquidity in bank operations is strategically established, carefully monitored, and adapted when necessary.

Bank call report data for year end 1995 are used to calculate selected measures of bank profitability, liquidity, and risk, as reported in Table 1. These measures are categorized by bank size (total assets) and allow comparisons between the measures for the 63 Farmer Mac approved banks and the same measures for all U.S. banks (10,536).

The ROA for Farmer Mac approved banks exceeds the ROA for all banks...

The data reported in Table 1 clearly indicate that Farmer Mac approved banks on average have higher profitability, greater utilization of lending capacity, lower capital positions, and larger size than the averages for all banks. The return on assets (ROA) of 1.21% for Farmer Mac approved banks consistently exceeds the ROAs for all banks (1.14). The return on equity (ROE) of 14.13% for Farmer Mac banks exceeds the average ROEs for all banks (11.79%) by an even wider margin. This ROE effect reflects the leveraging from the lower capital ratio for the Farmer Mac approved banks (8.88) relative to all banks (10.58).

The Farmer Mac approved banks also have a greater average of loan-to-deposit ratios (73.85) versus 67.71 for all banks, and a significantly greater ratio of total loans to total assets. Finally, Farmer Mac approved banks also have a lower average ratio of allowance for loan losses to total loans (1.52) than for all banks (1.66).

These relationships tend to hold with a

Table 1. Selected Financial Ratios for Farmer Mac Approved Sellers and Other Types of Banks

Bank Size (millions of dollars)	No. of Banks	Average Assets ('000s)	Return on Assets	Return on Equity	Equity Assets (%)	Loans Deposits (%)	Ag Loans to Total Loans (%)	Total Loans To Total Assets (%)	Allowance for Loan Losses to Total Loans (%)
Selected Financial Ratios for All U.S. Banks:									
<25	1,801	$16,387	0.94	8.90	13.18	62.56	32.15	51.91	1.84
25 to <50	2,437	$35,184	1.12	11.12	10.63	65.03	22.06	55.27	1.62
50 to <100	2,646	$68,513	1.19	12.21	10.17	67.51	13.47	57.30	1.54
100 to <300	2,403	$158,066	1.22	12.89	9.87	70.03	6.56	59.04	1.54
300 to <500	474	$366,398	1.21	13.61	9.30	74.06	2.97	60.70	1.91
>500	775	$4,578,240	1.23	14.63	8.78	80.52	1.53	62.54	1.93
Average		$417,443	1.14	11.79	10.58	67.71	15.72	56.84	1.66
Selected Financial Ratios for Farmer Mac Approved Sellers:									
<24	4	$18,527	1.13	15.17	7.74	64.93	35.18	59.13	2.59
25 to <50	5	$39,780	1.09	11.99	8.79	73.35	42.47	63.01	1.52
50 to <100	15	$70,735	1.21	13.03	10.16	62.75	31.49	57.10	1.42
100 to <300	28	$174,124	1.28	14.35	8.93	76.88	22.73	64.15	1.54
300 to <500	1	$366,199	1.19	15.26	8.03	81.73	10.10	71.91	1.26
>500	10	$4,801,027	1.17	15.96	7.53	84.97	5.37	65.09	1.45
Average		$865,681	1.21	14.13	8.88	73.85	24.26	62.18	1.52

Source: *1995 End of Year Bank Call Report data.*

Note: *Means for Farmer Mac Approved Sellers are significantly different (95% level) from the means of Other Types of Banks, except for Return on Assets.*

relatively high degree of consistency across the bank size categories, especially for ROE, the capital ratio, and the loan-to-deposit and total asset ratios. Similar relationships were found when banks were classified into "agricultural" and "other rural" categories.

In general, Farmer Mac appears to have attracted higher performing banks as members of its customer base. These banks apparently see strategic merit in the potential utilization of Farmer Mac's secondary services, and they may highlight the types of banks who will become Farmer Bank customers in the future.

Environmental Outlook

The future competitive environment for Farmer Mac also depends upon the financial outlook for the agricultural sector, structural changes in commercial banking, and new developments affecting other government-sponsored enterprises. The near term (3-5 years) outlook for agriculture is generally favorable. Income conditions overall are good, export prospects are favorable, land values are steadily increasing, and farm real estate debt, while a mature market, reflects modest growth potential. Continuation of these near term conditions, however, depends heavily on worldwide swings in the production of major farm commodities. Variations in weather, cropping patterns and trade conditions can strongly influence the expected level and variability of aggregate production. Longer term prospects are more uncertain, reflecting the withdrawal of government involvement in crop production and marketing, and anticipated termination of the seven year transition payments for crop producers.

In rural financial markets, the average loan-to-deposit ratio of agricultural banks has risen substantially in recent years (from an average of .551 in 1991 to .674 in the third quarter of 1996), although still falling below desired levels for many banks, as reported in several federal reserve bank surveys (Agricultural Finance Databook). Greater interest rate stability and today's flatter yield curve may also lead to a stronger demand for fixed rate loans by agricultural borrowers. In general, the near term provides a relatively favorable set of conditions in which Farmer Mac can contribute to greater liquidity in rural financial markets, stabilize credit availability for farm real estate, and allow rural banks to offer a wider range of financial products and services.

The ongoing transition of commercial banking in the U.S. toward larger, more consolidated and diverse branching and holding company systems is also important to consider. This transition could diminish and destabilize the availability of credit to agricultural and rural borrowers, especially family farmers and other small scale borrowers. This transition is especially challenging to community banks, although it is well recognized that agricultural and rural lending will remain important niche markets for well capitalized, highly competitive, and strongly managed banks that have strong customer relationships and that can effectively use various services from larger financial institutions, including the secondary market services of Farmer Mac. Both small banks and large banks may view loan origination and securitization through loan sales as a profitable element of their asset-liability management strategies.

The long term status of several government-sponsored enterprises (GSEs) is subject to considerable uncertainty. Pressures for privatization continue. Sallie Mae requested and recently received congressional authority to eventually privatize. Fannie Mae is being scrutinized closely for possible prioritization through recent reports by the General Accounting Office and the Congressional Budget Office that identify large subsidies, only part of which goes to homeowners.

The currently proposed Enterprise Resource Bank Act of 1996 intends to restructure the Federal Home Loan Bank System into a wholesale GSE lending system for depository institutions. The Farm Credit System is also addressing competitive changes in its marketplace, and has sought possible expansions in its lending authority. Within this dynamic, uncertain