United States General Accounting Office

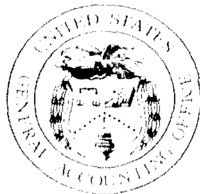
GAO

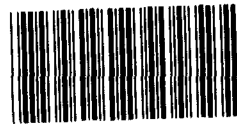
Report to Congressional Requesters

June 1991

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Issues Facing the Secondary Market for FmHA Guaranteed Loans





GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-220507

June 13, 1991

The Honorable Glenn English
Chairman, Subcommittee on Conservation,
Credit and Rural Development
Committee on Agriculture
House of Representatives

The Honorable Lindsay Thomas
House of Representatives

The Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624, Nov. 28, 1990) authorized the Federal Agricultural Mortgage Corporation (Farmer Mac)—a government-sponsored enterprise—to facilitate the creation of a secondary market for Farmers Home Administration (FmHA) guaranteed loans. These loans, made by private lenders, are backed by FmHA's promise to reimburse the lender for up to 90 percent of lost principal and interest and for loan liquidation costs if the borrower defaults. In this secondary market, to be known as Farmer Mac II, Farmer Mac would purchase—or have others purchase—the guaranteed portions of FmHA loans, assemble them into pools, and sell them as securities to investors. Overall, the Congress hoped that this market would make more funds available to small agricultural lenders.

This report responds to your requests that we identify the issues Farmer Mac faces in facilitating the creation of a secondary market for FmHA guaranteed loans. It also discusses certain aspects of the impact this secondary market may have on the government's exposure to risk.

Results in Brief

Farmer Mac has made significant strides by establishing, within 3 months of being authorized to do so, the infrastructure and policy that will guide the operations of a secondary market for FmHA guaranteed loans. However, Farmer Mac faces several difficulties in facilitating a viable secondary market. First, unlike most loans sold into secondary markets, current FmHA guaranteed loans do not share the same loan characteristics—such as maturity dates, interest rates, and payment dates. Second, while most specialized secondary markets were created in part to address a perceived credit shortage, many lenders currently have adequate funding to meet loan demand. And third, it is unclear whether the volume of FmHA guaranteed loans will be large enough to support a market backed by pools of these loans. These difficulties may affect Farmer Mac's ability to assemble pools of loans and sell securities

at prices attractive to investors, as well as lenders' incentive to participate.

In addition, Farmer Mac's strategy for establishing the price for purchasing guaranteed loans may place Farmer Mac II at a competitive disadvantage with the existing secondary market, in which FmHA guaranteed loans are traded on an ad hoc basis. Overall, the success of Farmer Mac II is likely to depend on advantages it will offer that do not already exist in the current ad hoc market, such as providing (1) a uniform infrastructure for selling loans and securities and (2) a guarantee of the timely payment of principal and interest to investors.

As GAO has previously reported, two principal problems in the guaranteed-loan program may increase the government's exposure to risk: (1) lenders using the program to refinance loans of existing customers who are financially stressed and (2) improper management by FmHA, contributing to guaranteed-loan losses absorbed by the federal government. Since the intention of Farmer Mac II is to increase the number of FmHA guaranteed loans, financial risk to the government may also be increased.

Background

Because of increased economic stress in agriculture and tightened federal spending in the mid-1980s, the previous administration became concerned that the budget would not be able to support a large increase in direct—i.e., government-funded—FmHA loans to farmers. To meet the increased demand for these loans, the administration and the Congress shifted FmHA's lending emphasis from its direct-loan program to its guaranteed-loan program. The purpose of this shift was to keep farm lending in the private sector, reduce budgetary outlays for direct loans, and devote more effort to servicing FmHA's highly delinquent direct loans.[1] To help this transition, the Congress mandated that the U.S. Department of Agriculture (USDA) facilitate a secondary market for pooling the guaranteed portion of farmer program loans. This market was to help ensure that rural lenders had a predictable source of funding to meet the increased demand for the guaranteed loans. (See Related GAO Products for a list of reports and testimony on secondary markets.)

[1]The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508, Nov. 5, 1990) further escalated this shift in FmHA's lending policy by reducing funding to the direct-loan program.

What Is a Secondary Market?

The investment market is usually defined in terms of primary and secondary markets. A primary market exists at the point at which an original debt or ownership interest is created—for example, when a lender makes a loan directly to a borrower or a company sells a new issue of stock. In its simplest form, a secondary market transaction occurs when a loan is sold by the original lender or a stock is resold by an investor. Thus, a secondary market for loans essentially involves the buying and selling of existing, rather than new, loans.

The Farmer Mac II program is intended to establish a continuing, predictable, and competitively priced secondary market in which lenders can sell to Farmer Mac the guaranteed portions of their FmHA guaranteed loans. FmHA guarantees up to 90 percent of a loan, and when it is sold, the originating lender retains at least 10 percent of the loan as well as the responsibility for servicing it. Under the program, Farmer Mac plans to assemble the guaranteed portions of these loans into pools. Securities backed by these pools of loans will then be sold to investors. With Farmer Mac pooling the loans, the Congress envisioned that Farmer Mac would be able to offer investors an easily marketable security, enabling lenders to sell smaller loans that would not be attractive to investors as individual purchases. The program will also provide a uniform infrastructure for buying and selling loans and a guarantee of the timely payment of principal and interest to investors, neither of which exists in the current ad hoc market for FmHA guaranteed loans.

Historically, secondary markets, especially the home mortgage market, have been credited with performing economic functions, such as shifting funds from areas with surplus capital to areas with insufficient capital to meet borrowers' needs. These functions promote efficiency and equity in lending markets. Farmer Mac II—as envisioned—would be no different: It is expected to provide greater liquidity and lending capacity for small, rural lenders. Buying and selling loans in a secondary market will enable these lenders to diversify their loans by location, borrower, and maturity. This could bring new participants into agricultural lending via the capital markets. Additionally, this secondary market could provide lenders with the opportunity to offer more favorable loan terms to borrowers.

The History of Farmer Mac II

As originally conceived in the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988), USDA was to administer a secondary market for the guaranteed portions of FmHA's farmer program loans. The act was similar to legislation authorizing a secondary market for Small Business

Administration (SBA) loans, and its authors expected that the FmHA program would be set up as the already existing SBA program is. The two programs are not similar, however, primarily because of the unpredictable nature of the farming industry. For example, guaranteed farmer program loans can vary by repayment pattern, geographic region, and commodity type; consequently, the characteristics of the individual loans are different and difficult to pool and sell as securities. SBA loans are more uniform and more closely resemble home mortgage loans.

USDA encountered several other roadblocks in its efforts to facilitate a secondary market. First, an official from the Office of Management and Budget (OMB) stated that the additional guarantee of timely payment of principal and interest, which USDA intended to offer to investors, represented a further government outlay and therefore had to be treated as an on-budget item. This position negated the administration's original intent to have guaranteed loans treated off-budget.

Second, according to FmHA, the costs involved in establishing such a market—including hiring expert staff to facilitate it—would have been too great. Consequently, USDA's Under Secretary for Small Community and Rural Development began to look elsewhere for this expertise. USDA officials noted that Farmer Mac, which was in the process of establishing a program for a secondary market for agricultural real estate and rural housing loans—now called Farmer Mac I—possessed the relevant expertise. Also, as a government-sponsored enterprise, Farmer Mac was an entity whose activities were not treated as on-budget.

On January 17, 1990, USDA and Farmer Mac entered into a memorandum of understanding (MOU) stating that both would "initiate efforts to amend the Farmer Mac Act to authorize Farmer Mac to issue and guarantee securities backed by FmHA." The stated purpose of the MOU was to implement the congressional intent and to advance the public interest by providing a stable supply of credit for farmers and ranchers at competitive rates of interest. On November 28, 1990, the Food, Agriculture, Conservation, and Trade Act of 1990 granted Farmer Mac the authority to pool the guaranteed portion of farmer program loans and issue securities backed by pools of those loans.

In conjunction with FmHA, Farmer Mac has (1) convened a task force of industry representatives to quickly establish guidelines for developing its program, (2) surveyed lenders who participate in FmHA's guaranteed-loan program regarding their interest in and potential for participating in Farmer Mac II, (3) established a toll-free telephone line for potential

sellers and investors to call with questions about the program, and (4) developed a comprehensive loan purchase program guide, which it distributed to all FmHA field offices and 8,000 lenders FmHA identified as participants in the FmHA program.

On February 14, 1991—78 days after the act was passed—Farmer Mac announced its schedule for forming and securitizing the first pools of guaranteed loans for Farmer Mac II. It set a deadline of March 15, 1991, for lenders to submit documentation for the sale of loans into Farmer Mac II. Farmer Mac also announced that, within a few weeks, it expected its first "swap transaction"—whereby lenders would exchange one or more guaranteed portions of loans for securities rather than cash—which would result in the issuance of the first Farmer Mac guaranteed security. (See app. I for details on Farmer Mac guidelines and progress in these efforts.)

Farmer Mac Faces Several Challenges in Facilitating the Secondary Market

Several factors may make it difficult for Farmer Mac to establish a secondary market for FmHA guaranteed loans that accomplishes the legislated objectives, including offering securities to investors at prices that are competitive with other loan-backed securities. These factors are discussed below.

Loans Lack Common Characteristics

Loans with common characteristics can be more easily pooled and sold in a secondary market. According to investment bankers and other financial experts, existing FmHA guaranteed farmer program loans will be difficult to combine into marketable pools because the characteristics of the individual loans are not alike. For example, loan interest rates, maturity dates, payment dates, and interest rate adjustment dates for variable-rate loans vary more widely among guaranteed farmer program loans than among home mortgages and SBA loans. Additionally, not all lenders use a common index—such as the prime rate published in the Wall Street Journal—to make interest rate adjustments on variable-rate loans. We could not determine the extent of this lack of commonality because FmHA does not maintain such detailed loan information.

According to investment bankers and participants in other secondary markets, there are two methods of addressing the lack of commonality among loans. One method pools existing loans with mixed, but not widely different, characteristics. For example, loans with different maturity dates can be grouped and sold using a weighted average

maturity. Similarly, loans with different interest rates can be grouped and sold on a weighted average basis. But the greater the differences among these characteristics, the less predictable the potential return for investors. Therefore, investors may require a relatively higher return when purchasing securities backed by such pools. Moreover, some loan characteristics may not be successfully grouped, such as different indices for interest rate adjustment and adjustment dates for variable-rate loans.

The other method uses standardized terms when loans are initially made, or originated. For example, by using a common interest rate index for variable-rate loans and adjusting the interest rates on those loans on the same date, lenders can achieve some standardization. Investment bankers and other participants in secondary markets maintain that standardization of terms at loan origination is the best way to overcome a lack of commonality and thereby increase the population of poolable loans. They attribute much of the success of the secondary market for SBA guaranteed loans to that agency's approach to promoting the use of standardized loan terms. GAO believes that FmHA could take a similar approach. FmHA field officials have direct, regular contact with lenders and therefore the opportunity to explain that the use of standardized loan terms will give lenders more flexibility should they choose to sell loans through the Farmer Mac II program.

Farmer Mac officials agreed that common loan characteristics are desirable to make the market successful on a large scale and said that they are working toward this goal. In the meantime, the officials explained, existing loan characteristics, such as interest rates, can be altered by the lender—with permission of the borrower—to make certain the loan will qualify under the published parameters of a pool before that loan is sold to Farmer Mac. The officials also noted that, in other secondary markets, common loan characteristics did not exist when the markets were created, but resulted after the market was established. They believe that such a scenario may occur for Farmer Mac II.

Lenders May Not Currently Need Additional Liquidity

Although one of the purposes for establishing a secondary market is to increase lending capacity, many agricultural banks are currently well positioned to extend credit, according to officials from national banking associations. A traditional measurement of a bank's liquidity, or funds available for credit, is the bank's loan-to-deposit ratio: the lower the ratio, the more funds should be available for lending. Currently, loan-to-

deposit ratios for most agricultural banks are below desired levels, indicating that banks have more than adequate funds available for loans. An official with the Independent Bankers Association of America supported this view in testimony before the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture, in February 1991. He stated that most agricultural banks "have money to lend"; most banks have a loan-to-deposit ratio ranging from 30 to 45 percent, down significantly from the average of 60 to 70 percent in the early 1980s.

Similarly, studies by the Economic Research Service (ERS) indicate that agricultural banks are substantially more liquid than small, rural nonagricultural banks. For example, a 1991 ERS report states that loan-to-deposit ratios were 48.8 percent for agricultural banks in 1990, compared with 59.8 percent for small nonagricultural banks.[2] ERS officials told us that these ratios for agricultural banks have not changed significantly within the past several years.

Farmer Mac officials stated that decreased liquidity needs nationwide do not necessarily inhibit the establishment of this market. According to unofficial surveys conducted by Farmer Mac, institutions in certain "pockets" of the country do need liquidity. The officials stated that their marketing strategy is to seek out those institutions individually. In addition, they said that liquidity is dynamic and can change dramatically.

Officials from Farmer Mac also pointed out that liquidity may not be the only incentive for lenders to participate in the market. For example, lenders may participate to manage interest rates. "Swaps" can also attract sellers to the market. However, it is unclear whether these incentives will entice lenders to participate if they have no corresponding need for liquidity.

An Insufficient Number of Loans May Make a Secondary Market Impracticable

Because of both the perceived problems in pooling FmHA guaranteed loans and the current liquidity in the agricultural sector, the number of these loans that can be assembled into pools may be too low to support a market in securities backed by these loans. According to secondary market experts we spoke to, a viable secondary market is one that supports securities sales of at least $1 billion annually. Although FmHA's annual guaranteed-loan volume may currently be at or above $1 billion,

[2] Agricultural Income and Finance, Situation and Outlook Report, ERS (Washington, D.C.: Feb. 1991).

most of these loans would probably not be sold through Farmer Mac II. Over half of the guaranteed loans obligated by FmHA are 3-year line-of-credit loans that are not eligible for pooling. Given this—and the lack of common loan characteristics among the existing loans—FmHA officials estimated that Farmer Mac II would be a small market, with only $300 million to $400 million traded each year.

Farmer Mac officials maintain that this program can be viable with activity of less than $1 billion. They cited two small SBA markets—one that operates at $100 million a year and another at $300 million a year. However, this comparison may be misleading. According to an SBA official, loans that make up these two markets are much more uniform than the FmHA guaranteed loans; consequently, it is more economical to participate in a smaller market.

Furthermore, the 1991 ERS report indicates that borrower demand for guaranteed farmer program loans—despite increasing 3.5 percent from previous years—remains sluggish. For instance, of the $3 billion available for guaranteed farmer program loans in 1990, only $1.3 billion (41 percent) was actually loaned. A stronger farm economy, in which the financial position of farmers continues to improve, provides some explanation for this weak demand, according to the ERS report. In addition, investment bankers and other participants in the ad hoc secondary market told us that the supply of guaranteed portions of individual loans currently meets, or is less than, investors' demand for these loans. One participant in the ad hoc secondary market stated that unless the supply of loans increases dramatically, there may be too few loans—beyond those being sold in the ad hoc market—to make pooling the loans for sale as securities worthwhile.

According to Farmer Mac officials, low guaranteed-loan activity is not necessarily due to low borrower demand, but to lenders' reluctance to "make" the guaranteed loans. Lenders these officials informally surveyed said that the application process for FmHA guaranteed loans is complicated and cumbersome and may discourage some lenders from making this type of loan. Farmer Mac has also worked closely with FmHA to develop AGPAK II, a computer software package designed to assist lenders in preparing FmHA loan application forms.

FmHA officials expect to see an increase in the demand for guaranteed farmer program loans as a result of current initiatives to shift from direct to guaranteed lending. In addition, FmHA has accelerated its efforts to promote the guaranteed-loan program in its state and local

offices. Whether these efforts will result in enough new guaranteed loans to make the secondary market viable cannot be determined at this time.

Pricing Strategy May Not Be Competitive

Farmer Mac may experience difficulties in offering competitive prices to sellers of guaranteed loans. Farmer Mac initially plans to purchase loans at par—100 percent of the guaranteed portion of the loan—and offer lenders who sell loans to Farmer Mac a "management premium."[3] That is, over the life of the loan, sellers would earn a return, recapture loan origination costs, and retain the prepayment risk—the risk of losing interest on loans that are paid off before maturity. This approach differs from that followed by the ad hoc secondary market, in which buyers purchase loans at a premium—more than par value. By selling loans at a premium, sellers in the ad hoc market earn a return at the time the loan is sold—rather than over the life of the loan—and immediately recapture loan origination costs, avoiding prepayment risk. Investment bankers told us that sellers may find Farmer Mac's pricing strategy unattractive.

On the other hand, Farmer Mac officials state that, in fact, Farmer Mac II prices will be competitive with those being offered elsewhere. Once lenders and other sellers understand the management premium, these officials maintain, they will realize that Farmer Mac II's prices are actually comparable to—and more reliable than—those being quoted in the ad hoc market. They added that should this pricing strategy not be successful, Farmer Mac can still change its strategy and buy loans at a premium. On May 6, 1991, subsequent to providing written comments to a draft of this report, Farmer Mac introduced a new loan pricing option. Although we did not evaluate the potential impact of this new pricing alternative, Farmer Mac maintains that it will attract more participants to this market.

In establishing a loan purchase price, Farmer Mac must also consider the return that investors require to buy securities backed by these loans. In short, the higher the return investors require, the lower the purchase price Farmer Mac can offer to sellers. Farmer Mac maintains that its securities will be priced competitively with securities trading in existing secondary markets for home mortgages and SBA loans. However, investment bankers we interviewed said that investors may require a higher

[3] The management premium represents the amount the lender collects over and above Farmer Mac's minimum servicing fee.

return on Farmer Mac II securities because of two factors secondary markets do not normally face: (1) It will be difficult to evaluate the prepayment risk of loans within a pool, and (2) the securities will be difficult to resell until enough are issued to make investors comfortable with Farmer Mac II.

Farmer Mac II May Continue Risks to the Government Caused by the Underlying FmHA Loan Program

A viable Farmer Mac II program could support the Congress' intention to shift FmHA's emphasis from direct to guaranteed lending. It could offer a continuing and predictable secondary market for the sale of guaranteed farmer program loans and may assure lenders that they can sell the guaranteed portions quickly and efficiently, thereby increasing the attractiveness of making FmHA guaranteed loans. However, as we have previously reported, potential abuses in FmHA's guaranteed-loan program pose increased financial risks to the government. (See Related GAO Products.) Larger numbers of guaranteed loans thus could increase the potential for lenders to abuse the system, thereby exposing the government to further risks.

In previous reports, we noted two principal problems with the guaranteed-loan program, both of which increased the federal government's exposure to financial risks. First, in a February 8, 1990 report, we noted that lenders were using the program to refinance loans of existing customers who were financially stressed. This practice, in effect, allowed lenders to shift the risks of certain high-risk borrowers to the federal government. Second, in a September 11, 1989, report, we pointed out a number of FmHA management problems that contributed to the increasing numbers of guaranteed-loan losses absorbed by the federal government. These problems included (1) inadequate assessment of borrowers' finances and collateral for guaranteed loans, (2) unclear guidance for determining the percentage of the loan that is guaranteed before loan approval, (3) failure to obtain timely default notices and/or liquidation plans, and (4) failure to require action to recover from borrowers' losses paid to lenders.

Others have also expressed concern about the risks associated with the guaranteed-loan program and the ways such risks could be continued through Farmer Mac II. For example, according to ERS officials, lenders participating in the guaranteed-loan program are more likely to have problems with their loan portfolios, for example, higher delinquency rates and larger loan losses. These lenders are also more likely to have other financial difficulties. Additionally, both OMB and ERS officials stated that failures to foreclose are likely to increase when these loans

are sold into the secondary market. That is, lenders will be less inclined to foreclose on loans that default. As a result, FmHA would be forced to foreclose on the loans, incurring additional cost to the government. FmHA officials state that such a scenario is unlikely, citing the agency's lender's agreement, which requires the lender to foreclose on the loan unless FmHA relieves it of that obligation. According to FmHA officials, it is always the policy to have the lender foreclose on the loans because private entities are much more efficient at this process.

Existing secondary markets currently have methods to detect lenders who may abuse the market. For example, SBA monitors its secondary market not only to compile prepayment statistics but also to collect information on the overall credibility of lenders, including the incidence of abuses. SBA includes in the loan's sale document a provision stating that if a loan is prepaid or a borrower defaults within 90 days of the sale—or after three scheduled loan payments—the seller must repay any premium received for the sale of the loan. Additionally, broker/dealers who trade in the ad hoc FmHA secondary market stated that they monitor the lenders they consistently trade with in order to detect abuse of the market. Finally, OMB is strengthening its oversight requirements for guaranteed-loan programs, including the monitoring of loans sold into the secondary market. The new regulations call for increased monitoring—with annual or biannual on-site reviews—of lenders participating in government guaranteed-loan programs by the federal agency administering the program.

Currently, Farmer Mac is developing plans for monitoring the new secondary market. The Agricultural Credit Act of 1987 requires that the Secretary of Agriculture monitor the market and compile data on the uses of the market, which will then be reported to the Congress. Farmer Mac officials said they will compile the required data and report them to FmHA. In addition, Farmer Mac officials believe that oversight of the market to detect any possible abuse by lenders is in the market's best interest. The officials believe that it is not within their authority to "clean up" FmHA's guaranteed-loan program, but the ability to detect and weed out those sellers who abuse the market should better enable Farmer Mac to assure participants that the securities are viable. The officials anticipate sharing information about any abuses with FmHA. FmHA, however, does not plan to monitor the market other than by continuing with its current review of loans at origination.

Conclusions

Farmer Mac has made significant strides in quickly implementing a program to facilitate the creation of a secondary market for securities backed by the pooled portions of guaranteed farmer program loans. However, Farmer Mac may experience difficulty in establishing a viable secondary market. Challenges inherent in the market—lack of commonality among the loans, lack of lenders' need for liquidity, and low loan volume—may be difficult to address. Additionally, Farmer Mac may have to compete with the ad hoc market, in which sellers are offered purchase terms that appear to be more attractive. Farmer Mac's ability to distinguish itself from the ad hoc market is likely to depend on the value participants place on (1) a uniform infrastructure for selling loans and securities and (2) the guarantee of timely payment of principal and interest to investors.

FmHA and Farmer Mac both stated that one result of a viable secondary market will be an increase in the number of guaranteed loans made. However, this increased lending activity may further expose the government to financial risks resulting from abuses in the guaranteed-loan program. Currently, for example, some lenders use the guaranteed-loan program to refinance problem debt that exists in their loan portfolios, thereby transferring the risk from the lender to the government. If not properly monitored, funds generated by selling loans into the secondary market may enable lenders to continue or expand this practice.

Agency Comments and Our Evaluation

In general, Farmer Mac and FmHA officials agreed that the factors identified in this report were potential difficulties in facilitating the market. FmHA noted, as we do in our report, that these factors are inherent in the market and are issues that would face any facilitator. Farmer Mac stated, however, that the report tends to underestimate the abilities of Farmer Mac and agricultural lenders to respond to the obstacles in the program. Farmer Mac officials maintain that many of these difficulties have been addressed or are being addressed as the market is being established. We have recognized these efforts throughout the report.

Farmer Mac and FmHA both believe that the risks to the government will not be increased as a result of Farmer Mac II. Both maintain that the expansion of the guaranteed-loan program is a public policy issue that is unrelated to the establishment of the new secondary market. Both also noted that there are some incentives for lenders not to sell questionable loans into the secondary market. FmHA, for example, stated that lenders could lose their management premium if loans become delinquent. Finally, FmHA stated that, historically, losses from its guaranteed loans

have been much lower than losses from its direct loans. As a result, the agency believes that expanding the guaranteed-loan programs, coupled with reducing the direct-loan programs, will reduce, not increase, risks to the government.

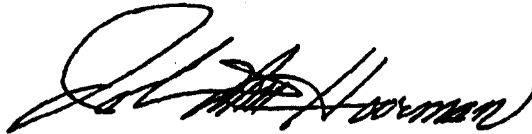
We agree with FmHA and Farmer Mac that expansion of the guaranteed-loan program is a public policy issue. We also agree that there may be incentives for lenders not to sell questionable loans into the market, although we are uncertain about the strength of these incentives. In regard to FmHA's comments on the potential risks surrounding the program, we agree that, in general, direct loans present more risks to the government than guaranteed loans. However, we did not analyze the potential effects that a shift from direct to guaranteed loans would have on the overall exposure of the government to financial risks. Our point is merely to recognize that there are financial risks associated with the guaranteed-loan program and that expanding the program may increase such risks. We continue to believe that this is an important issue associated with the development of a secondary market for the guaranteed portion of FmHA farmer program loans.

Comments from both Farmer Mac and FmHA have been incorporated into the body of this report where appropriate and are included in full in appendixes II and III, respectively.

The objectives, scope, and methodology of our review are discussed in appendix IV.

Copies of this report will be sent to the appropriate Senate and House committees; interested Members of Congress; the Secretary of the Treasury; the Secretary of Agriculture; the Administrator, FmHA; the Director, OMB; the Chairman of the Board, Farmer Mac; the Chairman of the Board, Farm Credit Administration; and other interested parties. We will make copies available to others upon request.

Major contributors to this report are listed in appendix V. If we can be of further assistance, please contact me at (202) 275-5138.



John W. Harman
Director, Food and
Agriculture Issues

Contents

Section	Subsection	Page
Letter		1
Appendix I Pooling and Swap Activities to Date		18
Appendix II Comments From the Federal Agricultural Mortgage Corporation		19
	GAO Comments	25
Appendix III Comments From the Farmers Home Administration, U.S Department of Agriculture		27
	GAO Comments	30
Appendix IV Objectives, Scope, and Methodology		31
Appendix V Major Contributors to This Report		32
Related GAO Products	Reports and Testimony on Farmer Mac and Secondary Markets	36
	Reports on FmHA	36

Abbreviations

ERS	Economic Research Service
FmHA	Farmers Home Administration
GAO	General Accounting Office
GSE	government-sponsored enterprise
MOU	memorandum of understanding
OMB	Office of Management and Budget
SBA	Small Business Administration
USDA	U.S. Department of Agriculture

Pooling and Swap Activities to Date

Farmer Mac issued its first securities on April 5, 1991. The Farmer Mac II securities were backed by five loans totaling approximately $700,000. Five securities were issued, each backed by an individual loan.

In addition, Farmer Mac announced that its first "swap transaction" also occurred on April 5, 1991. The Zions First National Bank, Salt Lake City, Utah, traded approximately $250,000 in Farmers Home Administration (FmHA) loan guarantees for Farmer Mac securities. Swap transactions will typically involve only one lender, can occur at any time, and will require at least $250,000 in guaranteed portions.

According to Farmer Mac officials, on May 29, 1991, a second group of Farmer Mac II securities—those backed by approximately $1.5 million worth of FmHA guaranteed farmer program loans—were issued. As with the first issuance, each security was backed by an individual loan.

Farmer Mac continues to announce indicated net yield quotes for pools composed of fixed-rate and other variable-rate loans. These quotes, which will provide lenders with information necessary to determine the profitability of participating in Farmer Mac II at a given point in time, will be announced weekly. Officials at Farmer Mac stated that they will continue to publish indicated net yield quotes; however, the closing date for the pools will be left open in order for Farmer Mac to acquire enough loans to meet the specific needs of investors wanting to buy the securities.

Comments From the Federal Agricultural Mortgage Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Farmer Mac
Federal Agricultural Mortgage Corporation
Suite 200
1667 K Street, N.W.
Washington, D.C. 20006
(202) 872-7700

April 30, 1991

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Re: GAO Draft Report: "Federal Agricultural Mortgage Corporation -- Issues Facing the Secondary Market for FmHA Guaranteed Loans"

Dear Mr. Bowsher:

See comment 1.

We appreciate this opportunity to comment on a draft of the above-referenced Government Accounting Office Report (the "Report"). The Report reflects a great deal of thought and work on the part of the GAO staff who prepared it. While we agree with many of the facts set forth in the Report, we believe the conclusions tend to underestimate the dynamic abilities of Farmer Mac and the agricultural lenders it serves to respond to static obstacles.

See comment 2.

When the Report was originally requested, the Farmer Mac secondary market for guaranteed portions of Farmers Home Administration of the U.S. Department of Agriculture (FmHA) guaranteed loans was only a legislative proposal. As the Report notes, Farmer Mac received legislative authority to proceed and did so on a timely basis. While the Report was being drafted, the Farmer Mac II program went from a legislative initiative to a reality in the marketplace.

Farmer Mac II has progressed from the enactment of the law on November 28, 1990 to where we are now, with millions of dollars in transactions completed and underway and hundreds of interested agricultural lenders. The program was designed with sufficient flexibility and economic efficiency to be attractive to lenders and borrowers alike. Many of its aspects reflect input we solicited from the FmHA, commercial lenders, Farm Credit System institutions, potential investors, investment banking firms and agricultural groups. The terms of the program, as set forth in our "Loan Purchase Plan," were carefully formulated to be straight-forward and efficient for participants. The Plan itself is easy to read and contains diagrams and illustrations to facilitate understanding. We developed a computer software program, AGPAK II, that effectively "automates" the process of completing FmHA guaranteed loan applications.

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
April 30, 1991
Page 2

Farmer Mac II can accommodate virtually all of the various fixed and floating interest rate loans now outstanding in the FmHA guaranteed loan program. These accomplishments, all within less than five months, buttress our firm conviction that a dynamic approach to the delivery of financial services to agriculture can result in benefits to farmers and ranchers throughout this country. The responsiveness of agricultural lenders demonstrates the viability of the program, and compliance with the terms of the FmHA programs ensures that there will be no new material risk to the government beyond that contemplated when Congress established and allocated funds for the FmHA guaranteed loan program.

Moreover, based on our experience to date, we have developed a new loan purchase structure that may trim as much as one full percentage point off the rate Farmer Mac requires on Guaranteed Portions purchased from lenders at par. This approach, which uses Farmer Mac's cost of funds as an index for adjustable-rate guaranteed loans, creates no new risks for Farmer Mac (or the government), while substantially enhancing the value of the FmHA programs to agricultural lenders and their borrowers. At the same time, continuing compliance with FmHA standards, enforced independently by the FmHA and not Farmer Mac, should maintain the government's historically low risk level on these loans.

See comment 3.

There are a few points I would like to make with particular reference to the Report. It identifies several items we agree are important issues affecting implementation of the new program. We also agree, in part, with the statement that these issues "may make it difficult for Farmer Mac to establish a secondary market for FmHA guaranteed loans that accomplishes the objectives set forth in the legislation. . ." (Report, p. 8). We question, however, the premise of the Report that a valid inference of the potential for the success of the Farmer Mac II secondary market can be drawn from the fact that certain challenges exist and must be overcome. The establishment of any new secondary market is clearly a complex and difficult undertaking. While the issues identified in the Report certainly do not make the process any easier, they are unsurprising relative to Farmer Mac's undertaking.

See comment 4.

Concerns are expressed in the Report (p. 8) over the lack of common characteristics among FmHA guaranteed loans. Farmer Mac has already addressed many of those concerns in the structuring of its program. We have identified investors and investment bankers who can accommodate inconsistent loan characteristics in the Farmer Mac guaranteed securities they purchase. We have developed structures for securities that minimize the impact on investors of those characteristics. We have been able to guide lenders in the origination of new loans to promote conformity in the future. In addition to the economic incentive for lenders to standardize loans for secondary market sales, Farmer Mac has taken other steps to overcome the difficulty of pooling

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
April 30, 1991
Page 3

loans with non-uniform characteristics. While FmHA guaranteed loan characteristics do tend to vary widely, this is not generally true within a single lending institution. Farmer Mac is working to identify lenders who already have a significant volume of similar loans in their portfolio that can be pooled or who originate a significant volume of new loans that they will sell. We have had considerable success in this effort so far. As the program expands, the number of lenders who participate efficiently will grow and volume will increase.

See comment 5.

During the early stages of development of the Ginnie Mae program a former Secretary of the Treasury asserted that "Ginnie Mae will never work" because of the non-uniform characteristics of the Veterans Administration and Federal Housing Administration loans in that program. Within a short time after Ginnie Mae began operations, this issue was eliminated by widespread standardization of loan terms by lenders seeking to maximize the opportunity through Ginnie Mae provided to them. That agency now has over $350 billion of securities outstanding, backed by government guaranteed housing loans. It is universally viewed as extremely successful. In Farmer Mac II, we have already experienced a similar response by lenders who have modified loan terms to conform to the requirements of the first Farmer Mac II pool. In the process, lenders have already begun to reduce rates to borrowers on existing loans, simultaneously reducing the cost to the borrower and the risk to the government. The indications are that this is a trend.

See comment 6.

See comment 7.

See comment 8.

The Report (p. 10) identifies a second issue: that lenders may not currently need additional liquidity. The Report correctly points out that, for much of the agricultural lending industry, loan-to-deposit ratios are below desired levels and funds for lending are readily available. This is probably the most significant hurdle confronting the near-term implementation of the new secondary market. Two factors suggest that it will not be insurmountable. Historically, we know this condition changes for many lenders over the course of a lending year, and may change across the agricultural credit industry as conditions in agriculture change. (As an aside, we disclaim the statement on page 11 of the Report, that Farmer Mac officials "maintained that farm program changes mandated in the 1990 Farm Bill could cause such a swing. . .") The second factor is competition among banks. For a variety of reasons, some banks have more loans on their books relative to their deposits. In some instances, shrinking loan demand is the determinant. In others, it may be disintermediation of banks resulting from depositor shifts to money market mutual funds. Farmer Mac II will be attractive to banks that do not perceive themselves as "under-loaned," for whatever reason.

See comment 9.

Unquestionably, the start-up of Farmer Mac II would be facilitated if strong lender demand for new funding sources existed at this time. Farmer Mac II will still be able to target the many lenders who have high loan to deposit ratios and those who seek

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
April 30, 1991
Page 4

the advantages of swap transactions. The Report does not adequately address these important aspects of our program potential.

See comment 10.

Beginning on page 12, the Report discusses a third issue: the assertion that an insufficient number of FmHA guaranteed loans exists for the secondary market to be practicable. The discussion asserts that a secondary market requires a $1 billion minimum annual volume of business to be viable. The Report cites to the Small Business Administration (SBA) loan secondary market as one of the smallest in existence and states that it "currently trades $1.5 billion annually." This statement appears to have lumped together all of the SBA programs in disregard of the fact that there are several independent issuance programs, two of which operate *outside* the SBA. For instance, the SBIC Funding Corporation program, a distinct secondary market, operates at an annual level of only about $100 million, and the Development Company Funding Corporation, another distinct secondary market, operates at something under $300 million annually. Without conceding that the market would be that small, if Farmer Mac II were to operate within the $300-400 million range that the Report refers to, that level of activity would be sufficient to maintain a viable program. This is even more probable within the broader context of other, unrelated business at Farmer Mac.

See comment 11.

The Report goes on to suggest that expansion of the FmHA guaranteed loan programs is unlikely due to "sluggish" borrower demand. This is likely to be one factor, at least in parts of the nation, but certainly is not the only explanation for the low level of obligations in the guaranteed loan programs during recent years. In fact, during recent hearings held by Chairman Glenn English on the FmHA programs, several members of the Subcommittee stated that borrowers in their districts wanted FmHA guaranteed loans but could not find lenders willing to make them. Lender groups have asserted for years that usage of the guaranteed loans programs would be higher if the process of completing the applications and seeking approval of the guarantee was not so burdensome. In this respect, the Report significantly omits mention of "AGPAK II," our computer software package to assist lenders in the preparation of FmHA loan application forms. AGPAK II is finished and many copies have already been mailed to lenders for use in the guaranteed loan program.

See comment 12.

See comment 13.

The fourth issue identified in the Report relates to the pricing strategy established under the Farmer Mac II program. The Report suggests (p. 13) that Farmer Mac's decision to buy loans at par and return value to the lenders over the life of the loans through a management premium may not be as attractive to lenders as the existing practice in the ad hoc secondary market of paying a premium for loans sold. Although the Farmer Mac II pricing approach is new in this market, it brings unprecedented efficiency to loan sales in this market. Historically, a severe prepayment assumption has prevented lenders from realizing the potential premium value of their Guaranteed

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
April 30, 1991
Page 5

Portions, which bear yields well in excess of federal Agency levels. The Farmer Mac II program permits lenders to retain the *full* dollar value of the premium, while cashing out of their Guaranteed Portions at par.

See comment 14.

In addition, the current ad hoc secondary market varies widely in its availability and pricing depending on the parties involved and the region of the country. Farmer Mac II is a national secondary market with uniform pricing to all sellers of comparable loans. The Farmer Mac II secondary market will be continuously available, thus eliminating any problem lenders may have had in the past of finding a buyer at the time they choose to sell a loan. Thus, the Report only half-addresses the issue, in that it omits a comparison of the different pricing methods, citing instead a few conclusory (and possibly uninformed) comments by anonymous investment bankers. It is certainly well within the capability of the GAO to calculate the relative value the Farmer Mac II alternative presents to lenders. The numbers are quite impressive. Our experience to date, with hundreds of lenders, is that they almost invariably agree the Farmer Mac II offer is more attractive.

See comment 15.

The final section of the Report (beginning on page 15) raises the suggestion that a viable Farmer Mac II program could increase risk exposure to the federal government by contributing to the expansion of the FmHA guaranteed loan programs. The Report cites previous evaluations of the guaranteed loan programs by GAO and lists certain problems with the administration of them as contributing to government losses. This entire discussion raises a public policy issue -- whether the guaranteed loan program should be expanded -- that is totally unrelated to Farmer Mac. In addition, the discussion walks past the fact that the existence of a viable Farmer Mac II secondary market is likely to contribute to improved performance of guaranteed loans. The Farmer Mac II program structure which creates strong incentives (previously discussed) for lenders who sell loans to service the loans conscientiously and keep them in accruing status to maturity.

Several key points in response to this discussion are appropriate. There is absolutely no evidence to support the contention that a viable Farmer Mac II program will increase government risk under the FmHA guaranteed loan programs. Farmer Mac II may well contribute to increased volume in these programs (although it should be noted that the remainder of the Report curiously focussed on exactly the opposite premise -- that Farmer Mac II will not succeed). No causal relationship is shown in the Report to link the existence of a viable secondary market to an increased level of losses in the guaranteed loan programs.

Farmer Mac already has in place the necessary procedures to monitor lender performance and to respond to lenders who abuse the program, similar to the practices

The Honorable Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
April 30, 1991
Page 6

of other secondary market agencies discussed in the Report. For example, the Loan Purchase Plan requires a seller to provide representations to the effect that a sold loan is not expected to prepay for any reason within the first 12 months after sale (section 2.02), and establishes conditions for continued lender participation in the secondary market (section 2.7). In addition, Farmer Mac will monitor loan performance through information gathered by the program Trustee.

See comment 15.

Finally, the issue of expanding the FmHA guaranteed loan programs is a matter with significant public policy implications that is totally unrelated to the existence of Farmer Mac II. Both Congress and the Administration have determined that the guaranteed loan programs should be expanded. Congress has repeatedly allocated funding to these programs during recent years in excess of twice the amount of program obligations. Expansion of the guaranteed loan programs is an integral part of the shift of government agricultural credit support away from direct lending programs. Thus, the issue of risk to the government is a matter of broad public policy that must be evaluated in the context of the positive contribution of Farmer Mac II, as a national secondary market, to these policy objectives and to the benefits of reduced government direct lending programs.

We appreciate GAO's continuing effort to evaluate and monitor the progress of Farmer Mac's implementation. We are hopeful that as this implementation proceeds, GAO will better appreciate the dynamic nature of Farmer Mac's evolution. The development of Farmer Mac II has moved forward rapidly and the program will continue to grow. This progress is the direct result of our continuing efforts to recognize the type of challenges discussed in the Report and to respond effectively to them. I believe we have been very successful in this endeavor. Once again, thank you for this opportunity to review and comment on the Report.

Very truly yours,

Henry D. Edelman
President and
Chief Executive Officer

The following are GAO's comments on Farmer Mac's letter dated April 30, 1991.

GAO Comments

1. Farmer Mac's overall position is summarized on page 12 of the report. Farmer Mac's specific comments have been incorporated throughout the report.

2. See pages 2-5 for a discussion of this point.

3. See page 12 for a discussion of this point. It is not our intention to imply that Farmer Mac cannot overcome the challenges presented in the report, but merely to point out these issues as challenges that are inherent in the market.

4. See pages 5-6 for a discussion of this point.

5. See page 6 for a discussion of this point.

6. See pages 6-7 for a discussion of this point.

7. The statement referred to was removed from the final version of the report.

8. See pages 6-7 for a discussion of this issue. According to bankers we spoke with, few agricultural lenders perceive themselves as "under-loaned."

9. See pages 5 and 7 for a discussion of swap transactions and Farmer Mac's marketing strategy.

10. See page 8 for a discussion of this point. The statement referred to was removed from later drafts of the report because of Farmer Mac's comments that smaller secondary markets exist. These markets may not be comparable to the Farmer Mac II market, however.

11. See page 8 for a discussion of this point.

12. A discussion of AGPAK II has been included in the final report.

13. See page 9 for a discussion of this point.

14. Because the Farmer Mac II market is in its very early stages, the discussion of the market's pricing structure was limited to Farmer Mac's overall policy to purchase loans at par as compared with the ad hoc market's practice of purchasing loans at a premium. Until more loans are purchased by Farmer Mac, we do not plan to evaluate whether the management premium is a more attractive offer to lenders than what exists in the ad hoc market.

15. See page 12 for a discussion of this issue.

Comments From the Farmers Home Administration, U.S Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of Agriculture | Farmers Home Administration | Washington D.C. 20250

APR 3 0 1991

Mr. John W. Harman
Director, Food and Agriculture Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Harman:

See comment 1.

This responds to your letter of April 23, 1991, requesting comments on the draft report, Federal Agricultural Mortgage Corporation: Issues Facing the Secondary Market for FmHA Guaranteed Loans. The Farmers Home Administration (FmHA) is pleased to have the opportunity to provide comments.

General Comments

The theme of the report is clearly stated on page 8 as, "Several factors may make it difficult for Farmer Mac to establish a secondary market for FmHA guaranteed loans that accomplishes the objectives set forth in legislation..." We agree that the factors identified (lack of uniformity, small volume, small investor interest) are correct; however, these are issues that would face any facilitator, including FmHA, if they were to establish the market. These are factors that are inherent in the types of loans involved and the current, highly liquid, state of rural agricultural banking. But they are presented as limitations uniquely associated with the secondary market structure as established by Farmer Mac.

See comment 2.

The report also concentrates on the misplaced concern that promoting any secondary market will increase financial risks of the Government since success of the secondary market will promote expansion of FmHA's guaranteed programs. Historically, FmHA's losses on its guaranteed programs are much lower than its direct loan losses. The Administration's goal is to move from direct lending to guaranteed lending, and to increase the Agency's use of its guaranteed lending authority. Expansion of the guaranteed programs is coupled with a reduction in the direct programs, thereby reducing, not increasing risks to the Government. Under direct programs the Government faces 100 percent of any loss while with guarantees the Government shares losses with the private sector. Initial funding for guaranteed loans is the responsibility of private lenders, not the Government. The Government does not need to borrow until any losses are realized and loss settlements paid. In addition, the size of, and rules for, the FmHA guaranteed program are defined by the Congress. Unlike a secondary market for private-sector loans, success by Farmer Mac II will not increase the guaranteed loan program beyond the parameters established by Congress.

See comment 3.

The report does not acknowledge that the primary reason for establishing Farmer Mac II was to have one government-sponsored secondary market structure for agriculture that included both private and public-sector loans. Since both markets were likely to be small in the short term, both markets could contribute to covering the expense of establishing, promoting and administering an agricultural secondary market. In addition, utilizing Farmer Mac rather than FmHA as the facilitator for a secondary market eliminates the

Farmers Home Administration is an Equal Opportunity Lender.
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, D.C. 20250

need for the taxpayers to pay start-up costs and operational costs of a secondary market.

Specific Comments

1. PAGE 6 - The report asserts that the second reason FmHA did not establish the secondary market "in house" was "...the costs involved in establishing such a market -- including hiring expert staff to facilitate it -- would have been too great." It is correct that utilizing Farmer Mac as a facilitator is more efficient than had FmHA proceeded independently in market development. But, the roadblock which significantly increased the expense was the "public funds" concerns of the Office of the General Counsel (OGC). Under the original proposed structure, where FmHA would rely on a Fiscal and Transfer Agent (FTA) in a manner similar to the Small Business Administration structure, the flow of funds became "public funds." As "public funds" FmHA would be faced with extensive control and disbursement requirements, making that structure unduly cumbersome to operate (requiring extensive systems development) and unduly expensive. The cost of the FTA would have been borne by the taxpayer and could not be offset by interest earnings that would have accrued to the FTA.

2. PAGE 8 - "FmHA Loans Lack Common Characteristics"
PAGE 10 - "Lenders May Not Currently Need Additional Liquidity"
PAGE 12 - "An Insufficient Number of Loans May Make a Secondary Market Impracticable"

See comment 4.

These issues are presented as factors limiting the potential for the secondary market, with the suggestion that they are uniquely related to utilizing Farmer Mac as the facilitator. However, these factors are not relevant to the structure of the market. They are characteristics of the underlying loans, or current characteristics of agricultural banks. They are not a function of market structure, that is, whether FmHA or Farmer Mac facilitates the market. In their presentation, they appear as criticisms of the program.

See comment 5.

The availability of a nationwide secondary market will add uniformity to loan origination, as lenders will package loans that can fit into a pool. Section 2.12 of the Farmer Mac Loan Purchase Plan cites Wall Street Journal Prime and U.S. Treasury indexes as common and acceptable indexes. It further states less commonly used indexes will adversely affect pricing of the loan. Farmer Mac has also developed "Ag Pac," a software package of forms required for a guaranteed loan.

See comment 6.

The issues of adequate bank liquidity and small volume of guaranteed loans available for sale are, currently, valid. However, these are volatile factors. Credit shortages in rural areas will again appear, and an efficient secondary market will mitigate future problems.

3. PAGE 13 - "Pricing Strategy May Be a Competitive Disadvantage"

See comment 7.

The report is critical of Farmer Mac's pricing strategy, in that Farmer Mac will buy at par (without premiums) and pay out a "management premium" over the

life of a loan. However, this practice will discourage lenders from dumping questionable loans into the secondary market to take advantage of buyers' premiums. Payments of "management premiums" to the lender provides the lender with a financial incentive for the borrower's long-term success. If the borrower becomes delinquent and FmHA repurchases the guaranteed portion, the lenders will no longer receive a management or servicing fee. Farmer Mac should be congratulated for devising this strategy, as it tends to minimize a potential abuse and encourages responsible loan servicing by the lender.

See comment 8.

4. PAGE 14 - "FmHA, however, does not plan to monitor the market other than the Agency's existing review of loans at origination."

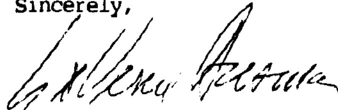
The report is critical of a perceived lack of FmHA monitoring of the secondary market to identify lender abuses. Under current Agency regulations FmHA routinely monitors guaranteed loans whether or not they are sold in the secondary market. This monitoring of loans and lenders continues over the life of each loan. If a lender seeks to sell a loan, the lender must obtain FmHA concurrence. Such concurrence is only forthcoming after field staff reviews the current status of the loan. Both Farmer Mac and FmHA will be interested in identifying loans which become delinquent soon after they are sold in the secondary market.

See comment 9.

It is not the purpose of a secondary market organization to police program issues. Lenders found to be abusing the program should be debarred under existing loan program regulations.

Thank you for this opportunity to provide comments on this draft report.

Sincerely,



LA VERNE AUSMAN
Administrator

The following are GAO's comments on the Farmers Home Administration's letter dated April 30, 1991.

GAO Comments

1. FmHA's overall position is summarized on pages 12-13 of the report. FmHA's specific comments have been incorporated throughout the report.

2. See pages 12-13 for a discussion of this point.

3. See pages 2-5 for a discussion of this point.

4. On page 12 of the report, we state that these challenges are inherent in the market. The issues are presented as challenges to the Farmer Mac II program, not as criticisms of FmHA or Farmer Mac.

5. A discussion of AGPAK II has been included in the final report.

6. We recognize that the nature of the agricultural economy is cyclical; however, the objective of this report is to present the issues facing Farmer Mac as it facilitates this secondary market.

7. See pages 9-10 for a discussion of this point. Until the market is operational, we cannot assess whether lenders will choose to use the management premium; therefore, its potential use as an incentive for the borrower's long-term success could not be determined.

8. See page 11 for a discussion of this issue.

9. See page 11 for a discussion of this issue.

Objectives, Scope, and Methodology

On June 18, 1990, Representative Lindsay Thomas asked us to examine whether Farmer Mac or FmHA should be the principal facilitator of a secondary market for FmHA guaranteed loans. On September 10, 1990, the Chairman, Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture, joined as a co-requester. During the initial stages of our review, the Congress enacted the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624), which granted Farmer Mac the authority to facilitate the market. As a result, we redirected our work toward identifying the issues facing Farmer Mac in its program to facilitate the new secondary market, which is Farmer Mac II.

To address the objective, we interviewed regional broker/dealers who handle 42 percent of the Small Business Administration (SBA) market and a regional broker of individual FmHA guaranteed loans. We also interviewed representatives from four major Wall Street investment firms that are involved in SBA's secondary market and/or the trading of FmHA's individual loans. Additionally, we interviewed SBA officials to obtain information about SBA's secondary market. Their perspectives were particularly important because the SBA market was to serve as a model for Farmer Mac II. Other organizations from which we obtained data and views were FmHA, Farmer Mac, the Office of Management and Budget, the Farm Credit Administration, the American Bankers Association, and the Independent Bankers Association of America.

We discussed the issues presented in our draft report with the same investment firms and regional broker/dealers we had interviewed. We obtained informal comments on our draft from Farmer Mac, FmHA, and SBA and incorporated them where appropriate.

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington, D.C.

Robert E. Robertson, Assistant Director
J. Kenzel Goodmiller, Assignment Manager
Tracy Kelly Solheim, Evaluator-in-Charge
Carolyn Kirkpatrick, Evaluator
Carol Herrnstadt Shulman, Reports Analyst

Related GAO Products

Reports and Testimony on Farmer Mac and Secondary Markets

Federal Agricultural Mortgage Corporation: Secondary Market Development and Risk Implications (GAO/RCED-90-118, May 4, 1990).

Federal Agricultural Mortgage Corporation: Issues Surrounding Underwriting Standards Developed by the Federal Agricultural Mortgage Corporation (GAO/T-RCED-89-62, Sept. 27, 1989).

Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-62, Sept. 12, 1989, and GAO/T-RCED-89-71, Sept. 27, 1989).

Farm Finance: Provisions for Secondary Markets for Farm Real Estate Loans in H.R. 3030 (GAO/RCED-88-55FS, Nov. 5, 1987).

Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 17, 1987).

Farm Finance: Legislative Proposals for Secondary Markets for Farm Real Estate Loans (GAO/RCED-87-172FS, July 2, 1987).

Issues Surrounding a Secondary Market for Agricultural Real Estate Loans (GAO/T-RCED-87-29, June 3, 1987).

Reports on FmHA

Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95, Feb. 8, 1990).

Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86, Sept. 11, 1989).

Ordering Information

The first five copies of each GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.

United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100