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Report to the Honorable Richard H. Lehman, House of Representatives

August 1991

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Potential Role in the Delivery of Credit for Rural Housing

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Resources, Community, and
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The Honorable Richard H. Lehman
House of Representatives

Dear Mr. Lehman:

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) created the Federal Agricultural Mortgage Corporation, known as Farmer Mac, to facilitate a secondary market for buying and selling agricultural real estate and rural housing loans. Among other things, the Congress hoped that a secondary market would make more long-term, fixed-rate loans available to rural borrowers.

Under Farmer Mac I,[1] poolers—such as investment banks and insurance companies—will buy agricultural real estate and rural housing loans originated at the local level, assemble them into pools, and issue securities backed by these pools to investors. Farmer Mac will then guarantee timely payment of principal and interest to these investors. The program will deal with two types of loans—agricultural real estate and rural housing—that will probably not be commingled in the same pools because these two types of loans are significantly different. Consequently, Farmer Mac may have separate programs for each loan type.

This report responds to your request for information on the rural housing aspects of Farmer Mac by examining (1) Farmer Mac's actions to establish a secondary market for rural housing loans, including the development of standards to govern the quality of those loans; (2) Farmer Mac's potential role in facilitating the delivery of credit for rural housing, given the government-sponsored mechanisms already in place to serve rural areas; and (3) barriers Farmer Mac may face in facilitating the delivery of credit for rural housing.

Results in Brief

Farmer Mac has taken the necessary steps to allow it to sponsor a secondary market for rural housing loans, including developing underwriting and other standards to qualify loans for the rural housing portion of Farmer Mac I. However, it has not yet guaranteed any securities backed by pools of loans. Farmer Mac has interpreted its enabling legislation to allow it to accept loans for properties valued at up to

[1]Farmer Mac calls its program to facilitate a secondary market for agricultural real estate and rural housing loans Farmer Mac I, to distinguish it from its program for a secondary market for guaranteed portions of Farmers Home Administration (FmHA) loans, which is known as Farmer Mac II.

$200,000 (adjusted for inflation). In our view, this limit is not consistent with Farmer Mac's enabling legislation, which places a maximum of $100,000 (adjusted for inflation) on the purchase price of homes that qualify for Farmer Mac loans.

It is uncertain what role Farmer Mac I may have in rural housing. It will have to function along with several other entities that are already active in rural housing, including the Farm Credit System (FCS), Farmers Home Administration (FmHA), Federal Housing Administration (FHA), Department of Veterans Affairs (VA), and other sponsors of the home mortgage secondary market. Loan originators we spoke with have mixed opinions on Farmer Mac I's future role. On the one hand, they question the need for additional credit programs like Farmer Mac for rural housing. On the other, they note that Farmer Mac I could allow rural lenders and FCS institutions better access to the home mortgage secondary market than they now have. In part this is because Farmer Mac is legislatively restricted to rural areas. These areas have often been overlooked by current sponsors of the home mortgage secondary market who focus primarily on urban and suburban borrowers.

Any role for Farmer Mac in the company of existing avenues of credit will depend on how it addresses a number of problematic issues that could affect its ability to sponsor a secondary market for rural housing. These issues include (1) an unknown loan volume, which could make it difficult for poolers to justify a continued commitment to the program; (2) uncertainty about the pricing of both the original mortgage and the securities sold in the secondary market, which may limit Farmer Mac I's competitiveness with other markets; (3) the administrative burden for originators participating in a secondary market; (4) the potential inability of poolers to form networks of lenders in order to meet a legislative requirement for geographically diverse loan pools; and (5) regulatory requirements lenders will have to meet if they choose to retain a subordinated participation interest[2] in the loan or in the related pool of loans. Further, some rural lenders think that Farmer Mac's definition of "rural" is unclear and may make it difficult for them to know which loans will qualify for sale through Farmer Mac I.

[2]Subordinated participation interests represent the originator's right to receive a portion of the principal and interest payments on a loan or the related pool of loans, but only after investors in the Farmer Mac-guaranteed securities backed by these pools have received all payments due to them. Originators may retain subordinated participation interests in the loans they sell through the Farmer Mac program, or they may sell these interests to a pooler.

Background

The Congress included provisions for rural housing in the 1987 act to increase the availability of long-term credit in rural areas where credit needs were not being adequately served. One way of providing more credit to these areas is through a secondary market. A secondary market is a market in which existing products—such as agricultural real estate and rural housing loans—rather than new products—such as a new issue of stock—are bought and sold. These loans, or securities backed by these loans, are sold to investors, and the sales return funds to the lenders (loan originators). This creates liquidity for lenders and allows them to make additional loans or otherwise reuse the funds. In addition, a secondary market can help to facilitate the origination of more long-term, fixed-rate loans because it allows banks to remove the interest rate risk[3] associated with such loans.

The act defines a rural home as a principal residence that is a single-family, moderately priced residential dwelling located in a rural area; it excludes any community having a population in excess of 2,500 inhabitants and any dwelling with a purchase price exceeding $100,000 (adjusted for inflation).

The act requires that each security Farmer Mac guarantees be backed by pools of loans secured by properties that are widely distributed geographically. To be geographically diverse, pools must be composed of qualified loans drawn from at least 3 of the 10 U.S. Department of Agriculture regions. Pools of loans concentrated in one region of the country are more likely to fluctuate with that area's economic conditions, thereby making the pool riskier. By requiring geographically diverse pools, the act is designed to reduce the overall risk of the program to the government.

Farmer Mac's Actions to Establish a Secondary Market for Rural Housing Loans

Farmer Mac has established credit underwriting, repayment, and security appraisal standards for agricultural real estate and rural housing loans. These standards, which were set forth in the Securities Guide in December 1989, will govern the quality of loans for Farmer Mac I pools and will provide structure for the program. Farmer Mac has interpreted its authorizing legislation to allow it to accept loans for properties priced up to $200,000. While this ceiling may be consistent

[3]Interest rate risk is the possibility of lender losses resulting from an increase in the interest rate on its obligations. These obligations are supported by loan payments the lender receives from borrowers. If the interest rate a bank must pay on its short-term deposits increases beyond the rate it is receiving from the loans it holds in portfolio, the bank will suffer a loss.

with limits for FCS banks and other sponsors of the home mortgage secondary market, we believe it is not consistent with Farmer Mac's authorizing legislation. Farmer Mac has not accepted any loans for properties that exceed the $100,000 limit because, as of early July 1991, it had yet to guarantee any securities backed by pools of loans.

Standards Established for Rural Housing

Farmer Mac is to guarantee securities backed by pools of rural housing loans that meet its established standards. This guarantee is a promise that Farmer Mac will make the timely payment of principal and interest to investors if a pooler is unable to make such payment. In addition to standards for rural housing, Farmer Mac's Securities Guide also contains the requirements and responsibilities of poolers and originators for participation in Farmer Mac I.

The Congress expected Farmer Mac to institute rural housing loan standards that are comparable with standards established by the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). For example, Farmer Mac's underwriting standards, although primarily based on those of Fannie Mae and Freddie Mac, make important allowances for the unique characteristics of rural housing. These include, among other things, allowing loans secured by properties that are subject to unusual easements, have larger sites than those for normal residential properties in the area, and are located in areas that are less than 25 percent developed. (See app. II.)

Property Value Limit Misinterpreted

Farmer Mac's authorizing legislation provides that the purchase price of the residential dwelling securing a rural housing loan cannot exceed $100,000 (adjusted for inflation). Farmer Mac has interpreted this to allow it to accept loans secured by a dwelling with a value of up to $100,000 with associated land valued at up to 50 percent of the appraised value of the combined land and dwelling. Essentially, by separating the value of the land from the value of the house, this interpretation allows rural housing loans for properties valued at up to $200,000 into Farmer Mac I pools. This means that loans from high-cost regions and for high-cost properties from other regions would qualify for Farmer Mac pools. To illustrate, a house with a purchase price of $100,000 sits on land valued at $100,000, making the total value of the property $200,000. Since the value of the land does not exceed 50 percent of the value of the combined land and house, Farmer Mac—using its interpretation—could accept a loan for this property.

However, in our view, Farmer Mac's authorizing legislation cannot be construed to authorize a rural housing loan secured by a property in excess of $100,000 (adjusted for inflation) for two principal reasons. First, the plain meaning of the legislation does not support Farmer Mac's interpretation. The "purchase price" of a home ordinarily refers to the combined value of the dwelling and the property on which it is located. Farmer Mac interprets "purchase price" as if it means "appraised value" of the house itself. We could find no statutory support for Farmer Mac's position. Second, Farmer Mac's interpretation is inconsistent with the legislation's definition of a loan that qualifies for its rural housing program. The statute's definition of qualified loan[4] describes the security for the loan in terms customarily used to refer to an interest in real property or real estate. Real property or real estate usually concerns the land and the building on it. Thus, in our view, a "dwelling" cannot be considered independently from the land on which it sits.

The act's $100,000 limit on the purchase price of the dwelling is lower than loan limits in other programs that deliver credit for housing. For example, Fannie Mae and Freddie Mac accept loans for up to $191,250 and accept loans from certain high-cost areas that exceed that limit. Furthermore, the Farm Credit Administration (FCA) recognizes that property values differ across the country and allows FCS district banks—which make loans exclusively in rural areas—to set region-specific limits that will accommodate these differences and reflect prudent lending practices.

Potential Role in Rural Housing

The extent of Farmer Mac I's role in the delivery of credit for rural housing is uncertain and depends upon the willingness of poolers and originators to participate in the program. Their interest, in turn, hinges on how effectively Farmer Mac can compete with other existing credit alternatives. Loan originators we spoke with have mixed views on the need for and viability of the rural housing portion of Farmer Mac I.

Other Credit Delivery Entities Exist in Rural Areas

Entities that deliver or facilitate the delivery of credit for rural housing may affect the volume of loans Farmer Mac can attract. To the extent that these institutions retain loans in portfolio, or sell them through other sponsors of the home mortgage secondary market, they can limit Farmer Mac's role. On the other hand, to the extent that they sell loans

[4] A "qualified loan" is defined as an obligation "secured by a fee-simple . . . mortgage . . . on agricultural real estate." 12 U.S.C. 2279aa(9)(A).

through Farmer Mac I, they can increase Farmer Mac's role. These entities include lending institutions, such as FCS, FmHA, savings and loan associations, and commercial banks that sell loans into the home mortgage secondary market; loan insurers and guarantors such as FHA and VA; and other secondary market sponsors such as Fannie Mae and Freddie Mac. Two of these—FCS and FmHA—operate solely in rural areas, financing agricultural real estate and rural housing. The others are not limited to rural areas but are nonetheless active in financing rural housing. Each credit delivery mechanism has different borrower qualifications and loan requirements. More details are contained in appendix III.

Mixed Views on Farmer Mac's Potential Role

Loan originators who are potential participants in Farmer Mac I had mixed views about the role Farmer Mac I may have in facilitating the delivery of credit for rural housing. They told us that creditworthy borrowers—for whom Farmer Mac I is designed—already have adequate credit avenues for financing rural home purchases. Some originators told us that the real credit shortage is for borrowers with poor credit histories or limited resources who have few or no credit alternatives available to them. Farmer Mac, however, was designed to hold the government's risk at a minimum and therefore cannot accommodate the credit needs of borrowers who are poor credit risks.

These rural bankers believed, however, that Farmer Mac I could provide better access to the home mortgage secondary market than current sponsors do and thus offer opportunities for lending institutions to expand their product lines and their loan volumes. These lenders told us that they do not participate with current sponsors of the home mortgage secondary market because they (1) are not familiar with the basics of these programs; (2) are not convinced that the volume of loans they could generate would be attractive to one of these sponsors of the home mortgage secondary market; (3) believe that many loans in rural areas would have to be pooled on an exception basis since the loans do not fit these sponsors' underwriting standards; and (4) may choose to hold some loans in portfolio, rather than sell them through the secondary market.

Rural bankers we spoke with noted that the current sponsors of the home mortgage secondary market do not often focus on rural areas since it is frequently not cost-effective for them to work with lenders in rural areas because of the relatively small number of loans originated there compared with urban areas. Because Farmer Mac is legislatively limited to guaranteeing only pools of agricultural real estate and rural housing loans from areas with populations of 2,500 or less, it will necessarily have to deal with situations unique to rural lenders. These include the relatively small volume of loans rural banks can generate and the perceived administrative burden lenders associate with participation in a secondary market. Rural bankers we talked to were encouraged by the prospect of more attention from Farmer Mac, noting that they are often overlooked by other secondary market sponsors because of their size and remote location.

Potential Barriers to Farmer Mac's Activity

In addition to having to compete with other credit delivery entities, Farmer Mac I faces a number of factors that may limit the extent to which it can facilitate a secondary market for rural housing loans. These factors, which are largely beyond Farmer Mac's control, include (1) an unknown loan volume, (2) uncertain loan and securities pricing, (3) the administrative burden of participating in a secondary market, (4) the potential inability of poolers to develop a network of originating institutions to meet geographic diversification requirements, and (5) the regulatory requirements lenders will have to meet if they choose to retain a subordinated participation interest in the loan or in a related pool of loans. Furthermore, some rural lenders are unsure about what loans will qualify as "rural" under Farmer Mac's definition. Farmer Mac has recently introduced an initiative that it believes will address at least some of these barriers. This initiative would establish a separate corporation to buy and hold securities backed by qualifying pools of loans issued by poolers and guaranteed by Farmer Mac. Since this initiative has just been introduced, we have not evaluated it and thus cannot comment on its potential effectiveness.

Unknown Loan Volume

The potential volume of rural housing loans that can be sold through Farmer Mac I is a major indicator of how viable it will be. Currently, it is not possible to determine this volume, nor to quantify the level of demand for long-term, fixed-rate loans for rural housing. Most rural bankers we spoke with welcome the opportunity to participate in Farmer Mac I but note that the volume of loans they could individually generate would be small.

Uncertain Loan and Securities Pricing

It is also unclear whether the interest rates on loans originated for sale through Farmer Mac I will be competitive, especially initially when the price at which the Farmer Mac-guaranteed securities backed by rural housing loans will trade is unknown. Since no securities backing rural housing loans have been guaranteed, it is difficult to say what the pricing of either will be. Market analysts told us that initially the securities will be priced higher than those already trading in the home mortgage secondary market, simply because this is a new financial product. Their estimates vary, however, on how large this difference will be.

The pricing of loans and securities is interrelated and is crucial to the viability of Farmer Mac I. To attract borrowers, originators must offer favorable interest rates. To attract originators, poolers must offer favorable prices for their loans. For poolers to continue in this market, they must offer investors favorable rates of return on their securities. If either the interest rate on the loans or the pricing of securities is too high, the market may not be successful. Because the probabilities of such risks as loan defaults and prepayments cannot be easily established, the securities may be less saleable. In turn, this would increase the loan rate, making Farmer Mac I loans less competitive. As Farmer Mac I loans build a history of performance so that prepayments, rates of default, and payment speeds become more predictable, the pricing of loans and securities will become more predictable as well.

Administrative Burden

Rural bankers we spoke with recognized that Farmer Mac I could potentially provide typical secondary market opportunities for them in rural housing, but they also had serious reservations about participating in the program. They are concerned about the length of time it may take to prepare a loan for sale through Farmer Mac I, as well as the other administrative burdens that may accompany a government-sponsored program. In addition, rural lenders may not be able to justify dedicating more resources to process Farmer Mac I loans, yet they believe the program's administrative burdens would require it.

However, the administrative burden of additional paperwork and staff time might be better justified if banks were also participating in the agricultural real estate portion of Farmer Mac I. Banks that do so would then have to deal with only one secondary market, rather than one market for agricultural real estate and one for rural housing. Also, such banks would already have a degree of familiarity with Farmer Mac and could better justify dedicating staff to it full-time.

Achieving Geographic Diversification

Legislatively required geographic diversification may be difficult to achieve. Since poolers will necessarily rely on commercial lenders to originate the loans for pooling, they will need to develop a network of originators to participate in Farmer Mac I. These originators—most of whom will be small rural banks with limited lending territories—will have to be dispersed so that poolers can form geographically diverse pools. Poolers that are regional institutions may find it difficult to establish relationships with originators in various parts of the country and may be unable to service loans in remote areas.

When Farmer Mac issued its Securities Guide, 73 percent of the commercial lending institutions that had purchased enough stock in Farmer Mac to become originators were located in three contiguous regions in the Midwest. This fact may prevent poolers from achieving geographic diversification if they cannot form networks of originators in the Midwest.

Meeting Regulatory Requirements

New regulatory requirements may make participation in Farmer Mac I unattractive to originators. These regulatory constraints—which were not anticipated at the time Farmer Mac I was designed—arose following the adoption of risk-based capital adequacy standards. These new risk-based standards require, among other things, banks and FCS institutions that sell loans through Farmer Mac I and choose to retain a subordinated participation interest in the loans or in the related pool of loans to hold more capital against this interest than they did under the old standards. Now, lenders who choose to retain a subordinated participation interest must hold capital against the face amount of the entire loan as if it had not been sold.

From a lender's perspective, this reduces the benefits of participating in a secondary market because the capital that the lender holds cannot be used to support additional lending or other activities. As a result, banks and FCS institutions may not want to sell loans through Farmer Mac I if they have to retain a subordinated participation interest in them. Many originators we spoke to indicated that—in the case of rural housing—they would probably not retain a subordinated participation interest in the loans or the related pool of loans they sell; in those cases no capital would be required to support such an interest.

Definition of Rural

Potential lenders in this market indicated that it may be difficult to determine which loans will qualify for Farmer Mac I, since they are unsure how Farmer Mac will interpret its definition of "rural." For example, many lenders do not know whether an area can qualify as "rural" if it is adjacent to a metropolitan area. Farmer Mac's current definition, set forth in its Securities Guide, does not specifically address this question. It indicates that a "rural area" is any small city, village, subdivision, or other community area with a population not exceeding 2,500. However, Farmer Mac officials told us that Farmer Mac will, in fact, accept loans for properties that are adjacent to metropolitan areas.

Conclusions

Farmer Mac has taken the necessary steps to allow it to sponsor a secondary market for rural housing loans, but the eventual role it will play in delivering credit for rural housing is uncertain at best. Its success depends, at least in part, on whether and to what extent it can provide rural lenders with better access to the home mortgage secondary market than they already have through existing sponsors. This in turn will depend on the success of Farmer Mac in overcoming a number of barriers, some of which are beyond its direct control. These barriers include, among other things, unknown loan volume, unknown loan and securities pricing, and the administrative burden for originators that participate in a secondary market.

Farmer Mac has interpreted its authorizing legislation to allow it to accept loans for properties valued at up to $200,000. This interpretation allows Farmer Mac to accept loans from high-cost regions and for high-cost properties from other regions. However, we believe this interpretation is inconsistent with Farmer Mac's authorizing legislation, which established a limit of $100,000 on the purchase price of homes eligible for Farmer Mac loans. It should also be noted that Farmer Mac's limit is lower than the limits of other sponsors of the home mortgage secondary market, such as Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac accept loans for up to $191,250 and from certain high-cost areas that exceed that limit. Additionally, FCA recognizes that property values differ across the country and allows FCS district banks to set region-specific limits that will accommodate these differences and reflect prudent lending practices.

Recommendation to the Federal Agricultural Mortgage Corporation

We recommend that the President and Chief Executive Officer of Farmer Mac accept only eligible loans for properties that have a purchase price of no more than $100,000 (adjusted for inflation) to be consistent with its authorizing legislation. If Farmer Mac believes that the $100,000 limit on the purchase price of rural housing prevents eligible borrowers in certain high-cost areas from participating in Farmer Mac I, it should prepare a justification for increasing the limit and seek authorization from the Congress to do so.

Matter for Congressional Consideration

In view of Farmer Mac's continuing position that it will accept loans for properties that exceed the $100,000 limit, the Congress, through its oversight process, may wish to take measures to ensure that Farmer Mac will adhere to the limit.

Alternatively, the Congress may wish to consider authorizing a higher limit and direct Farmer Mac to establish region-specific loan caps within this higher limit to accommodate varying housing costs nationwide and to ensure that only moderately priced properties are included in Farmer Mac I pools.

Agency Comments

Farmer Mac officials generally agreed with the information presented on the background of Farmer Mac I, the development of the program, and the identification of certain barriers to its widespread use by potential poolers and originators.

Farmer Mac officials do not agree with the report's conclusion that Farmer Mac's interpretation of the $100,000-purchase-price limit is incorrect. In reaching our conclusion, we carefully considered all the arguments presented to us in Farmer Mac's General Counsel memorandum of November 1990. As stated in the report, we believe that Farmer Mac's legislation cannot be construed to authorize the inclusion in loan pools of rural housing loans secured by property in excess of $100,000 (adjusted for inflation). The "purchase price" of a dwelling ordinarily refers to the combined value of the dwelling and the property on which it is located. If Farmer Mac is correct in its claim that the $100,000 ceiling applies only to the purchase price of the dwelling, excluding lands, then there is no statutory limit on the "purchase price" or value of the land. The present 50-percent limit has been established by Farmer Mac only as a matter of policy. In our view, Farmer Mac's position is inconsistent with the Congress' obvious concern with limiting the purchase price on housing eligible for Farmer Mac loans.

Where appropriate, we have incorporated Farmer Mac's comments into the body of this report. They appear in their entirety in appendix IV, along with our detailed responses to them.

Copies of this report are being sent to the appropriate Senate and House Committees; interested Members of Congress; the Secretary of the Treasury; the Secretary of Agriculture; the Director, Office of Management and Budget; the Chairman of the Board, Farmer Mac; the Chairman of the Board, FCA; and other interested parties. We will also make copies available to others upon request.

This work was performed under the direction of John W. Harman, Director, Food and Agriculture Issues, who may be reached on (202) 275-5138. Other major contributors to this report are listed in appendix V.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

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Abbreviations

FCA	Farm Credit Administration
FCS	Farm Credit System
FHA	Federal Housing Administration
FmHA	Farmers Home Administration
GSE	government-sponsored enterprise
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
MSA	metropolitan statistical area
VA	Department of Veterans Affairs

Objectives, Scope, and Methodology

On January 29, 1990, Representative Richard H. Lehman requested that we determine what role Farmer Mac may have in establishing a secondary market for rural housing loans. As subsequently agreed, we examined

- Farmer Mac's actions to establish a secondary market for rural housing loans, including the development of standards to govern the quality of the loans;
- Farmer Mac's role in providing credit for rural housing, given the government-sponsored mechanisms already in place to serve rural areas; and
- barriers Farmer Mac may face in facilitating the delivery of credit for rural housing.

We interviewed Farmer Mac officials, 9 potential poolers, and 55 potential originators in the Farmer Mac I program. We also interviewed officials of each of the credit delivery mechanisms already active in financing rural housing, insuring rural housing loans, or guaranteeing pools of loans that include rural housing loans. These include five Farm Credit District Banks (Baltimore, Columbia, Omaha, Springfield, and St. Paul), the Farmers Home Administration (FmHA), the Department of Housing and Urban Development (HUD), the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac).

We also reviewed each program's written guidance and operational manuals for rural housing. We reviewed loan data from each of the five Farm Credit District Banks we visited and FmHA. We also reviewed FHA and VA data on loans they insure and guarantee to determine how active these agencies are in rural counties. Since neither of these agencies collects information on which loans are rural and which urban, we used the Census Bureau classification of rural counties to determine if the loans were rural or urban. We also used the most recent statistics available (1989) from the Department of Commerce's and HUD's American Housing Survey for the United States to present further information on the number of loans FHA, VA, and FmHA make, insure, or guarantee in rural areas and to provide specific information about mortgage activity in these areas. Fannie Mae, Freddie Mac, and Ginnie Mae do not store data on whether a loan is for a rural or an urban home. We addressed this data limitation through interviews with these organizations, as well as with originating institutions in rural areas.

We interviewed officials from three housing associations with particular knowledge about rural housing and rural development: the National Council of State Housing Agencies, the Housing Assistance Council, and the National Association of Homebuilders. We also interviewed associations representing financial institutions, including the American Bankers Association, the Independent Bankers Association of America, the United States League of Savings Institutions, and the Mortgage Bankers Association of America.

We reviewed Farmer Mac's General Counsel memorandum of November 1990 regarding its interpretation of the $100,000-purchase-price limit on housing for loans eligible for inclusion in Farmer Mac-guaranteed pools.

planning, water and sanitation regulations. The property should not be subject to any known hazards, including toxic and hazardous materials, and detriments that are of such magnitude that the current market value is expected to decline significantly.

Securities Guide Developed

In its Securities Guide, Farmer Mac sets out the following standards for rural housing loans to qualify for inclusion in Farmer Mac I. A rural housing loan must be secured by a single-family, owner-occupied principal residence that (1) is located in a rural area; (2) has a purchase price of no more than $100,000, as adjusted for inflation since January 1988; and (3) is located on land with reasonable access to a public road. If the loan is for refinancing rather than purchase, the current appraised value of the dwelling must be no more than $100,000, as adjusted for inflation since January 1988. In addition to the dwelling itself, a rural housing loan can be secured by land associated with the dwelling of up to 10 acres with an appraised value of no more than 50 percent of the total appraised value of the combined property. Farmer Mac has interpreted its enabling legislation to allow it to accept loans secured by property that includes a dwelling with a purchase price of no more than $100,000 (adjusted for inflation) with associated land of up to 10 acres with an appraised value of no more than 50 percent of the appraised value of the combined land and dwelling. This interpretation would allow rural housing loans for properties valued at up to $200,000 into Farmer Mac I pools. To illustrate, a dwelling with a purchase price of $100,000 sits on land valued at $100,000, making the total value of the property $200,000. Since the value of the land does not exceed 50 percent of the value of the combined land and dwelling, Farmer Mac would accept a loan for this property. In our view, this is not consistent with Farmer Mac's enabling legislation, which places a maximum of $100,000 (adjusted for inflation) on the purchase price of homes that qualify for inclusion in Farmer Mac pools.

Other Actions Taken by Farmer Mac

Farmer Mac has also developed and made available a software package called AGPAK to assist originators in meeting its loan underwriting standards. In addition, it has made available standard appraisal forms for agricultural real estate. These forms were designed by an industry task force sponsored by the American Society of Farm Managers and Rural Appraisers, specifically in anticipation of the market's development. Farmer Mac has also supported the work of the Farm Financial Standards Task Force, which recently published a reference manual on

Existing Credit Delivery Mechanisms for Rural Housing

According to the latest available statistics from the Department of Commerce (1989), a total of 59.9 million homes were owner-occupied in the United States, and 10.0 million—or 16.7 percent—of these were located in rural areas.[1] Of the total, 34.5 million were mortgaged, and 4.3 million—or 12.5 percent—of these were in rural areas.

FCS, FmHA, FHA, VA, savings and loan institutions, and commercial banks that sell loans into other home mortgage secondary markets provide or facilitate the provision of credit for homes in rural areas. Two of these programs—FCS and FmHA—operate solely in rural areas, financing agricultural real estate and rural housing. The others are not specific to rural areas but are nonetheless active in financing rural housing.

Each program has different purposes, borrower qualifications, and loan requirements, and is active to varying degrees in rural areas. Additionally, some programs may compete with Farmer Mac, while others may coexist with Farmer Mac.

Because there is no universally accepted definition of rural, it is difficult to compare programs that deliver credit to rural areas. Furthermore, the definitions of rural that do exist seem unclear—their parameters are vague, and they do not use the same terminology. As a result, there seems to be a degree of flexibility in how the term rural is interpreted and how its use is applied across programs.

Farm Credit System

Farm Credit System (FCS) banks are allowed to dedicate up to 15 percent of their portfolios for loans to rural home buyers who meet FCS standards of creditworthiness. These standards are similar to those for sponsors of the home mortgage secondary market but make certain allowances for the rural nature of these loans. According to officials from the five FCS district banks we visited, most rural housing loans these banks originate have variable rates because of the interest rate risk exposure that is associated with long-term, fixed-rate loans. Farmer Mac I could provide a means for FCS banks to sell long-term, fixed-rate rural housing loans, thus avoiding interest rate risk and allowing FCS banks to increase their rural housing lending capacity beyond the 15-percent limitation. The extent to which FCS will use Farmer Mac I

[1] Non-farm locations outside of a metropolitan statistical area (MSA). An MSA, as defined by the Office of Management and Budget, is an area where there is a city of at least 50,000 population, or a Census Bureau-defined area of at least 50,000 population with a total metropolitan population of at least 100,000 (75,000 in New England). Except in New England states, an MSA is defined in terms of entire counties. In New England, MSAs are composed of cities and towns.

residence is a single-family, moderately priced dwelling with appropriate appurtenances, is or will be a permanent year-round home used by the applicant, and is located on an appropriate site in a rural area. Rural residences may include conventional housing, modular housing, or mobile homes that are on a specific real estate site. A moderately priced dwelling is one that provides adequate housing, does not exceed the living standards of persons in the middle range of income, and is not inconsistent with the general quality and standards of housing existing in, or planned for, that area of the Farm Credit district.

Because of the differences in housing costs and income levels, what qualifies as moderately priced housing may vary from district to district. Therefore, FCA allows each of the 11 FCS district banks to establish region-specific loan limits.

Activity in Rural Areas

FCS currently delivers credit for rural housing through its 11 district banks and each bank's network of associations and local offices. According to FCA, the 11 FCS district banks had 57,500 rural home mortgages in portfolio at the end of fiscal year 1990. This would represent 1.3 percent of the 4.3 million home mortgages in rural areas, as defined by the Department of Commerce.

Potential Relationship With Farmer Mac

According to FCS officials we interviewed, while the majority of loans that FCS originates have a variable interest rate, most borrowers prefer to finance their rural home purchases with long-term, fixed-rate loans. By selling loans into a secondary market, FCS institutions could make more long-term, fixed-rate loans because they would avoid the interest rate risk of holding the loans in portfolio. Several FCS district banks have been certified as Fannie Mae sellers and servicers, i.e., they now have the option to sell loans into Fannie Mae and have the benefits of participating in a secondary market.

If Farmer Mac can offer attractive rates, it might compete with Fannie Mae for some of the FCS banks' rural housing loans. Farmer Mac may be able to accept more rural housing loans than other sponsors of the home mortgage secondary market because its standards make important allowances for the unique characteristics of rural housing. Officials from four of the five FCS district banks that we talked to said that they would be interested in selling rural housing loans into Farmer Mac, but only if Farmer Mac can offer competitive prices and make it advantageous for district banks to participate in the market.

and are unable otherwise to obtain mortgage credit at terms they can reasonably be expected to pay. Section 502 loans may be made to eligible applicants to buy, build, repair, renovate, or relocate homes and provide related facilities; or to refinance home debts, under certain conditions, when necessary to help a family retain ownership of its home. Funds may also be used to improve water and waste disposal systems.

The loan program is generally limited to rural areas, which include communities with populations of less than 10,000 in MSAs and communities with populations between 10,000 and 20,000 in non-MSAS. FmHA notes that establishing such population limits is in keeping with its mission of providing credit exclusively for individuals in rural areas. Loans may also be made in areas with a population in excess of 10,000 but less than 20,000 if (1) the area is not included in an MSA and (2) the Secretaries of Agriculture and Housing and Urban Development determine that the location has a serious lack of mortgage credit for low- and moderate-income borrowers. In 1984, these Secretaries determined that there was a shortage of credit in all rural areas, effectively eliminating the use of the latter criterion.

Although there is no statutory limit on either the mortgage amount or the property value, housing prices have been set by FmHA to range from a low of $31,000 in a low-cost area to a high of $100,000 in a high-cost area. Loans may be made for up to 100 percent of the FmHA-appraised value of the house.

Activity in Rural Areas

Since 1988, FmHA has made about 37,000 section 502 loans annually. FmHA officials told us that, without reviewing each loan portfolio, it is not possible to determine the overall number or amount of loans that were made for purchasing or building houses—rather than for other purposes such as repair and restoration—but that almost 95 percent of the section 502 loans are for purchasing. In 1990, 2,939 of the section 502 loans were originated in rural counties, as defined by the Census Bureau. (The Census Bureau definition of rural most closely resembles Farmer Mac's definition.) These loans amounted to $87.9 million and represented 8.1 percent of the 36,244 loans originated during 1990.

According to the Department of Commerce, as of 1989, 182,000 of the 4.3 million home mortgages in rural areas[2] had been made by FmHA. This represents 4.2 percent of all home mortgages in rural areas.

[2]Non-farm locations outside of an MSA.

Almost any borrower who has a satisfactory credit record, the necessary down payment at closing, and enough steady income to make the monthly payments can qualify for FHA insurance.

As of 1991, the maximum mortgage that FHA will insure for a one-family residence ranged from $67,500 to $124,875. Limits are adjusted for the cost of housing in different areas.

Activity in Rural Areas

FHA defines rural as non-farm areas and small towns under 5,500 in population, usually remote from urban centers. According to the Department of Commerce, as of 1989, 363,000 of the 4.3 million home mortgages in rural areas were insured by FHA. This represents 8.4 percent of all rural home mortgages.

FHA may have such a small presence in rural areas because mortgage bankers, who often use FHA insurance, are not located in rural areas. According to representatives of the Mortgage Bankers Association, their members tend to concentrate their efforts in large population centers rather than rural areas because loan volume is low in rural areas and many rural housing loans do not meet comparable sale requirements set by secondary markets. Volume is extremely important to mortgage bankers because they rely on servicing fees for their livelihood, rather than on interest from loan payments.

Some small commercial bankers knowledgeable about FHA insurance told us that the maximum mortgage limits preclude some borrowers from participating. Certain bankers in the Southeast noted that the FHA-established loan limit in their area can often be restrictive for rural housing, especially if the house sits on 5 to 10 acres.

Potential Relationship With Farmer Mac

FHA-insured loans may be sold through Farmer Mac, but most of these loans are currently sold through Ginnie Mae.

Department of Veterans Affairs

VA provides guarantees for fixed-rate loans to borrowers who meet specific requirements. This guarantee protects the lender against default losses. VA guarantees are not necessarily directed at rural housing; rather, they are targeted to borrowers with specific income levels who meet certain qualifications. Of course, some of these borrowers may live in rural areas.

rural areas as it could be; therefore, it is seeking ways to increase its involvement. For example, three FCS district banks are now Fannie Mae-approved lenders.

Purpose

The investment market is usually defined in terms of primary and secondary markets. A primary market exists at the point that an original debt or ownership interest is created, when, for example, a lender 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 essentially involves the buying and selling of existing mortgage loans or securities backed by mortgage loans, rather than new products.

The sale of such loans and securities returns funds to the lender, creating liquidity and allowing the lender to make additional loans or otherwise reuse the funds. In this way a secondary mortgage market supplies a ready source of funds for housing at market interest rates. It also provides a means of spreading financial risk and making credit available to qualified borrowers.

Ginnie Mae, Fannie Mae, and Freddie Mac were chartered by the federal government, and the financial community perceives that their securities are backed by the government.[3] In reality, Ginnie Mae is a federal agency, and its debt is backed by the full faith and credit of the federal government. Fannie Mae and Freddie Mac are private organizations without explicit federal government guarantees.

All these organizations encourage investors to buy securities representing a pool of mortgages by assuming risks that would otherwise be borne by the original lender. This is done by providing a guarantee to investors that the principal and interest on the securities, which is to be derived from the underlying mortgage payments, will be paid to the investor in the case of borrower default.

Borrower Qualifications and Loan Requirements

Ginnie Mae guarantees pools consisting only of FHA, VA, and FmHA loans; therefore, these loans are subject to the requirements of each of these agencies, as discussed above.

[3]This perceived government backing has not been tested for Fannie Mae and Freddie Mac.

Potential Relationship With Farmer Mac

Farmer Mac could compete with existing sponsors of the home mortgage secondary market for certain loans. Some of these small commercial bankers said that they may be more inclined to sell mortgages into Farmer Mac I pools since Farmer Mac will have to target rural areas. Because Farmer Mac is legislatively limited to guaranteeing only pools of rural housing loans from areas with populations of 2,500 or less, it will necessarily have to focus its activities on rural areas. Some bankers we talked to were encouraged by this fact, noting that they are often overlooked because of their size and remote locations. They added that if they sell agricultural real estate loans into Farmer Mac I, they would also probably sell rural housing loans since (1) they would have a level of familiarity with the program and (2) they could better justify the dedication of resources to a secondary market that accepts both kinds of loans.

Fannie Mae has recognized that it is not as strong in rural areas as it could be and is making attempts to increase its presence there. Most notably, it has recently approved at least three FCS district banks as sellers/servicers. FCS bank officials we interviewed said that they are interested in selling some of their rural housing loans into Fannie Mae. Currently, these institutions are originating mostly variable-rate loans but recognize that the larger demand is for long-term, fixed-rate loans. FCS institutions have avoided making such loans because of the interest rate risk that these loans pose when kept in portfolio. By selling loans into a secondary market, FCS institutions shift that interest rate risk to the pooler. FCS district banks consider participation with Fannie Mae as a viable option with several benefits, and Fannie Mae views its relationship with FCS as a means of better serving rural areas.

A Fannie Mae representative noted that existing rural housing loans would probably not fit into Fannie Mae pools; however, he indicated that future fixed-rate loans originated according to Fannie Mae standards can be easily assembled into Fannie Mae pools. He also explained that rural housing loans, often considered ineligible for Fannie Mae pools because of property characteristics that do not meet conventional standards, will actually qualify. This representative said that Fannie Mae has always had the policy of accepting loans for homes that deviate from certain standards if the home is typical for the "local custom." For instance, Fannie Mae will not generally purchase a mortgage that is secured by a property in a rural area or any other area that is less than 25 percent developed if the site exceeds 30 percent of the total appraised value of the security property. However, according to a

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

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June 20, 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

Dear Mr. Bowsher:

Thank you for providing us with the opportunity to review and comment on the draft GAO report entitled: "Federal Agricultural Mortgage Corporation: Potential Role in the Delivery of Credit for Rural Housing" (hereafter referred to as the "Report"). This Report is being prepared in response to the request by Congressman Richard H. Lehman, Chairman of the Subcommittee on Consumer Affairs and Coinage, Committee on Banking, Finance and Urban Affairs of the United States House of Representatives, at the time of the request.

See comment 1.

We would first like to express our appreciation to the GAO staff working on this project for meeting with Farmer Mac representatives during the development of the Report and allowing us the opportunity to provide information and to comment informally on an early version of the draft. The discussion of the background of Farmer Mac and development of the program and the identification of certain barriers to widespread use of the program by potential originators and poolers are generally correct, although we have comments on a few specific points. Of greater significance, however, the Report challenges Farmer Mac's interpretation of its statutory authority regarding the imposition of value limitations on eligible rural housing under the program. We strongly disagree with the discussion of this issue and with the conclusion and recommendation set forth in the Report.

See comment 2.

The Report expresses GAO's disagreement with Farmer Mac's interpretation of Section 8.0(1)(B)(ii) of the Agricultural Credit Act of 1971, as amended (12 USC 2279aa et seq., hereinafter called the "Act"), which provides that rural housing eligible for inclusion in pools of Qualified Loans (as defined in the Act) shall exclude "any dwelling with a purchase price exceeding $100,000 (as adjusted for inflation)." In its Securities Guide released on December 28, 1989 ("Guide") Farmer Mac stated that the $100,000 limitation applied to the structure and that land of up to ten acres with a value not exceeding that of the structure could also be included as security for the rural housing loan. Guide, Section 3.23.

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June 20, 1991
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See comment 8.

for OCC's decision that lending limits would not apply to loans sold into Farmer Mac pools. In addition, this structure significantly reduces each lender's exposure to losses incurred by a pool and converts the lender's local loss exposure on loans sold to a broadly diversified risk. This distinction is a significant aspect of the program and is very important to the resolution of the remaining regulatory barriers concerning the application of risk based capital guidelines and to the attractiveness of the program to individual lenders.

Now on page 5.
See comment 9.

On page 8 of the Report, GAO discusses other credit delivery entities that serve rural areas and suggests that they may "compete with Farmer Mac I and limit the volume of loans it can attract." The discussion then lists "FCS, FmHA, savings and loan associations, and commercial banks that sell loans into the home mortgage secondary market; loan guarantors such as FHA and VA; and other secondary market sponsors such as Fannie Mae and Freddie Mac." We believe the Report incorrectly suggests that Farmer Mac is in competition with the primary lenders listed above and implies a greater level of access by rural residents to mortgage financing than Congress found to exist in 1987 when the Agricultural Credit Act was enacted. The Farmer Mac secondary market is available for use by all of the primary lenders listed in the Report and is specifically designed to provide access to capital markets funding for rural properties not otherwise eligible for such funding. Farmer Mac does not compete with any primary lender in providing rural housing financing.

See comment 10.

With regard to existing secondary market entities, we recognize the potential for overlap between Farmer Mac and the other residential secondary markets, however, Congress determined in 1987 that Farmer Mac was needed "in order to provide rural residents greater access to residential mortgages....in those areas not adequately served by other residential secondary markets." (Conference Report 100-490, H.R. 3030, December 18, 1987, page 207.) The discussion set forth in the Report does not provide any information to suggest that the conditions addressed by Congress in creating Farmer Mac were incorrect or have materially changed since 1987, thus reducing the need for implementation of the Farmer Mac rural housing secondary market at this time.

Now on pages 7 and 9-10.
See comment 11.

On page 11, the Report states that "some rural lenders are unsure about what loans will qualify as 'rural' under Farmer Mac's definition" of rural housing. This point is discussed further on page 14. "Rural Housing" is a term specifically defined in the Farmer Mac Securities Guide and discussed at some length in different parts of the Guide. The definition is based directly on the definition of the term set forth in the Act. We agree that some lenders may have questions about the applicability of the Farmer Mac provisions to certain areas or to certain loans, however, it was not realistic to address every situation possible in the Guide. We have stated repeatedly that as loan pooling volume increases the experience gained will provide the basis for refinements in program requirements and clarifications will be made as needed. In addition, Farmer Mac maintains a toll free telephone line which is available to lenders who have questions about the program.

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See comment 16.

clarified to distinguish between the Farmer Mac I and II programs, and that it should point out that under Farmer Mac II loans in the approximate value of $2.5 million have been securitized to date.

We appreciate the continuing effort by GAO to evaluate and monitor the progress of Farmer Mac's implementation. We are hopeful that as program implementation proceeds and loan volume increases, GAO will have the further opportunity to evaluate the effectiveness of the many steps taken by Farmer Mac to address the "difficulties" GAO has focussed on up to this point. We believe that solid foundations have now been laid for a sound and efficient secondary market to serve the current and future credit needs of the farmers, ranchers and rural residents of this nation. The success of the residential mortgage secondary markets is a blueprint for the opportunity presented to Farmer Mac, and we are confident that Farmer Mac will achieve its Congressionally mandated purposes. Once again, we thank you for this opportunity to review and comment on the Report.

Sincerely,

Thomas R. Clark

Thomas R. Clark
Vice President - Corporate Relations

Enclosure

6. If the Congress wished to achieve comparability with the statutory mortgage loan limits of Fannie Mae and Freddie Mac, it could have provided for this specifically in Farmer Mac's legislation. Since it did not, we recommend in the report that if Farmer Mac can show that certain eligible borrowers are being excluded because of the purchase price limit, then Farmer Mac should provide justification to the Congress for raising that limit.

7. The purpose of the purchase price limit is to ensure that only moderately priced homes are included in Farmer Mac I, not to make geographic diversification easier to ensure a certain volume of rural housing loans. However, we do identify poolers' potential inabilities to meet geographic diversification requirements as a barrier to Farmer Mac's role in the delivery of credit for rural housing.

8. We have clarified information in the report to reflect that a subordinated participation interest may be retained in a loan or the related pool of loans.

9. Appendix III addresses Farmer Mac's concerns. We clarified language on pages 5-6 to reflect the information presented in appendix III.

10. We did not attempt to evaluate the correctness of including rural housing provisions in the legislation creating Farmer Mac. Rather, we discuss Farmer Mac's potential role and the barriers it will face in facilitating the creation of a secondary market for rural housing.

11. Although Farmer Mac discusses the term "rural" in its Securities Guide, this does not mean that lenders will understand what kinds of loans will qualify for inclusion in Farmer Mac-guaranteed pools. We merely describe the problems that rural lenders have with the term that, in turn, may affect their desire to participate in the program.

12. We point out these barriers as possible impediments to Farmer Mac's role in delivering credit to rural areas. We have added language on page 7 to note that many of these factors are largely beyond Farmer Mac's control.

13. At the time the draft that Farmer Mac commented on was written, Farmer Mac had not introduced its Linked Portfolio Strategy. We have added language to address this initiative on page 7, although we are not in a position to comment on the effectiveness of this strategy because it was not a subject of the work on this review.

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Farmer Mac's Actions to Facilitate the Creation of a Rural Housing Secondary Market

A presidentially appointed interim board of directors established Farmer Mac at its first meeting in May 1988. In December 1988 the board offered Farmer Mac's public stock for sale and subsequently raised $22.8 million. In June 1989 it appointed a president and chief executive officer, and submitted for congressional review loan underwriting and other standards designed to limit risk. These standards were submitted within the legislated time frames, and the congressional review period for the standards ended in October 1989. In late December 1989, Farmer Mac published a manual of its operating guidelines, known as the Securities Guide, which specifies standards governing the quality of rural housing loans. By January 1990 Farmer Mac had announced that it was ready to certify poolers and guarantee securities. To date, Farmer Mac has certified two poolers for the Farmer Mac I program but has not issued securities backed by pools of loans—either for agricultural real estate or rural housing. Farmer Mac has securitized individual loans under Farmer Mac II—its secondary market for guaranteed portions of FmHA loans. See our recent report, Federal Agricultural Mortgage Corporation: Issues Facing the Secondary Market for FmHA Guaranteed Loans (GAO/RCED-91-139, June 13, 1991), for detailed information.

Underwriting Standards Developed

Farmer Mac has adopted credit underwriting standards for rural housing loans that are similar to those of Fannie Mae, adjusted to reflect the usual and customary characteristics of rural housing. The Securities Guide notes that the underwriting standards permit some characteristics of rural housing that are not usually present in urban and suburban homes. Rural housing loans may be secured by properties that (1) are subject to unusual easements, (2) have larger sites than those for normal residential properties in the area, (3) are located in areas that are less than 25 percent developed, (4) possess significant out buildings, (5) mix rural residence and business use, and (6) are located on roads that do not have specific maintenance agreements, as long as public roads are legally and physically accessible.

Required Property Characteristics Established

To qualify for a Farmer Mac rural housing loan, the dwelling securing the loan must be of conventional design or design common enough in the area for comparable sales to be available. The site should have access to public utilities and be commensurate with the type and quality of dwelling in the community. If access to public utilities is unavailable, the residence must have adequate water and waste disposal systems, including wells and cisterns, and shared or private disposal systems. The property must meet all applicable zoning, subdivision, land use appraising and financial reporting for agricultural producers for use by farmers and ranchers, lenders, academics, and accountants.

depends on a number of factors, including whether FCS banks are approaching their rural home loan limits, and how profitable such sales would be to FCS banks.

Purpose

FCS is a cooperatively owned system of financial institutions that provides loans for farms and a limited range of agriculture-related businesses to ensure an adequate, reasonably priced supply of credit for agriculture. FCS was created to provide a more stable source of funds to farmers by relying on securities rather than on deposits as commercial lending institutions do.

Each FCS district and association maintains its own loan records, and no central repository exists for data on these loans. Therefore we gathered the information presented in this appendix from the five district banks we visited during this review.

Borrower Qualifications and Loan Requirements

FCS standards for rural housing loans are similar in certain respects to Farmer Mac's standards. The Farm Credit Administration (FCA), the regulating body for FCS, has set standards governing rural housing loans originated by FCS institutions. Its standards say that a "rural area" is open country that may include any city or village with a population not exceeding 2,500 persons or any rural subdivision whose design is determined to encourage orderly development pursuant to policies adopted by the bank board for such divisions. A rural area does not include cities, subdivisions, or villages associated with a larger population center. FCA's intent in establishing these parameters is to avoid FCS' lending in concentrated, high-density, residential areas or villages that are a part of an urbanizing area surrounding or immediately adjoining an urban area of a larger population center. When so designated by the district board and approved by FCA, rural areas may also include open areas that are undeveloped for housing and still devoted to agricultural use within other political boundaries, including towns exceeding 2,500 persons.

For purposes of non-farm lending, a rural residence is a property that does not have the capacity to produce farm products for sale on a sustained basis or, if it has that capacity, is not intended to be used in that manner. For these loans (1) a rural resident is an individual who resides in a rural area and is a citizen of the United States or has been lawfully admitted into the United States for permanent residence and (2) a rural

Two factors can limit the amount of rural housing loans that FCS banks can originate: (1) FCA places a 15-percent cap on the portion of an FCS bank's portfolio that may consist of rural housing loans and (2) there is an inherent interest rate risk that long-term, fixed-rate loans present when they are kept in portfolio. If FCS banks sell rural housing loans into the home mortgage secondary market—whether it is Farmer Mac, Fannie Mae, or another sponsor of the secondary market—the loans will no longer be in FCS portfolios and will thus not count toward the 15-percent cap nor create an interest rate risk. The FCS district banks we interviewed noted that they are not now approaching the 15-percent cap but that cap could eventually be limiting (e.g., if the number of farm loans decreases and/or the number of rural housing loans increases). FCA established this limit to ensure that FCS banks are primarily involved in lending for farms and agricultural production.

Farmers Home Administration

FmHA provides long-term, fixed-rate loans for rural housing through its loan guarantee program and through its direct lending program. In the former program, FmHA guarantees the loans; in the latter, FmHA holds the loans in portfolio.

Purpose

FmHA is the credit agency for agriculture and rural development in the U.S. Department of Agriculture. For agriculture and rural housing, FmHA is the "lender of last resort." As such, it lends money to borrowers who could not qualify for loans that would qualify for pooling in Farmer Mac I. Therefore, the number of FmHA loans originated does not indicate the demand for Farmer Mac I loans, nor does it indicate how many loans would qualify for sale through Farmer Mac I.

FmHA's mission statement directs it to serve as a temporary source of supervised credit and technical support for rural Americans to improve their farming enterprises, housing conditions, community facilities, and other business endeavors until they are able to qualify for private sector resources.

Borrower Qualifications and Loan Requirements

FmHA's primary program for rural housing support is its section 502 single-family housing program as defined in the 1983 amendment to the Housing Act of 1949. The program was established to provide housing credit for farm households because private credit sources were either nonexistent or inadequate in rural areas. Today the program provides loans to rural households that meet certain income and asset limitations

Potential Relationship With Farmer Mac

As the "lender of last resort," FmHA lends money for rural housing to borrowers who could not qualify for loans under Farmer Mac I. Consequently, the amount of FmHA loans originated does not indicate the demand for Farmer Mac I loans, nor does it indicate how many loans would qualify for sale through Farmer Mac I. Farmer Mac has been authorized to facilitate the creation of a secondary market for guaranteed portions of FmHA-guaranteed loans. This program is known as Farmer Mac II and is discussed in our recent report, Federal Agricultural Mortgage Corporation: Issues Facing the Secondary Market for FmHA Guaranteed Loans (GAO/RCED-91-138, June 13, 1991).

Some small commercial bankers we interviewed stated that there is enough credit for the low-risk borrower (for whom Farmer Mac I is designed) but not enough credit for the high-risk borrower (for whom FmHA is designed). Others argue that there is a segment of borrowers who are over-qualified for FmHA loans but whose credit needs are not being met. They contend that small commercial banks could fill this gap by participating in Farmer Mac I.

Federal Housing Administration

FHA provides insurance for variable- and fixed-rate loans to borrowers who meet specific requirements. This insurance protects the lender against default losses. FHA insurance is not necessarily directed at rural housing; rather, it is targeted to borrowers with specific income levels who meet certain qualifications. Of course, some of these borrowers may live in rural areas.

Purpose

FHA was created in 1934 to stabilize the housing industry. It also has a long-standing objective of making affordable housing available to lower- and middle-income families. This has been accomplished by allowing such families to purchase homes with lower down payments than would be required under conventional lending standards. FHA operates as an insurance program, collecting premiums and maintaining reserves for payment of lender claims. Most of these loans are assembled into pools and guaranteed by Ginnie Mae.

Borrower Qualifications and Loan Requirements

FHA offers a number of programs under which insurance can be extended to borrowers. The most commonly used program is its section 203b, which insures loans on one- to four-family detached residences. Of all the FHA programs, this one would insure loans comparable to those that would be sold through the Farmer Mac I secondary market.

Purpose

VA guarantees default losses rather than insuring the lender against losses. This means that VA does not operate an insurance fund and does not collect insurance premiums. Other than a small qualifying fee charged to eligible borrowers, any default losses paid by VA are subsidy benefits made available by the federal government. VA offers guaranteed mortgages to qualifying veterans to help them finance the purchase of homes with favorable loan terms. For example, an attractive feature of a VA loan is that as long as the purchase price of the home is not more than the reasonable value of the property, the lender does not require a down payment.

Borrower Qualifications and Loan Requirements

VA will guarantee up to 50 percent of a home loan for up to $45,000. For loans ranging from $45,000 to $144,000, VA will guarantee up to 40 percent of the loan, or a maximum of $36,000. Loans above $144,000 can receive a 25-percent guarantee. There are no legislatively mandated ceilings on the maximum loan amount that VA can guarantee; however, a VA representative told us that loans in excess of $184,000 are rare, since they cannot qualify for inclusion in a secondary market.

Activity in Rural Areas

In 1990, VA guaranteed 192,621 home loans totaling $15.8 billion. Although VA does not keep a data base on its loans by rural or urban area, we used data supplied by VA to determine that 2,123—or 1.1 percent—of the VA-guaranteed loans are located in counties that the Census Bureau considers rural. The dollar value of these loans totals $202.9 million, or 1.3 percent of the total amount VA guaranteed in 1990. According to the Department of Commerce, as of 1989, 169,000 of the 4.3 million home mortgages in rural areas were guaranteed by VA. This represents 3.9 percent of all home mortgages in rural areas.

Potential Relationship With Farmer Mac

VA-guaranteed loans may be sold through Farmer Mac, but nearly all of these loans are currently sold through Ginnie Mae.

Home Mortgage Secondary Markets

The home mortgage secondary market is sponsored by three national organizations: Ginnie Mae, Fannie Mae, and Freddie Mac. Ginnie Mae guarantees securities backed primarily by FHA-insured and VA-guaranteed loans. Fannie Mae and Freddie Mac pool and guarantee securities backed by loans that meet their specified criteria. A Fannie Mae official told us, though, that Fannie Mae recognizes that it is not as active in

Fannie Mae and Freddie Mac will purchase single-family mortgages with a maximum original loan amount of $191,250 that are secured by residential properties in urban, suburban, or rural areas. A rural location is one that is in the country or anywhere beyond a suburban area. Fannie Mae and Freddie Mac do not designate certain areas as acceptable or unacceptable, but they will not purchase mortgages on agriculture-like properties (such as farms, orchards, or ranches), on undeveloped land, or on land development properties. In certain high-cost areas, they will accept mortgages with a maximum original loan amount of $286,875.

Fannie Mae and Freddie Mac require that lenders who sell loans through the home mortgage secondary market establish that the borrower has the ability and willingness to repay the debt, and that the property is sufficient security for the mortgage. Their underwriting guidelines provide the guidance for determining these three requirements. Generally, the borrower must make a minimum cash down payment of 5 percent.

Activity in Rural Areas

None of these entities could provide us with information on the number and dollar value of rural housing loans in their pools, since their data bases do not make such kinds of distinctions. However, many small commercial bankers that we interviewed said that they do not sell any loans into secondary markets. Both Fannie Mae and Freddie Mac officials told us that they are not as active in rural areas as they could be. A Fannie Mae official told us that Fannie Mae is assessing ways that it can better serve rural housing needs in the future. Ginnie Mae, which guarantees pools of FHA, VA, and FmHA loans, is active in rural areas only to the extent that these three agencies are. As noted earlier in this appendix, FHA and VA insure and guarantee a limited number of loans in rural areas, and FmHA serves as the lender of last resort for risky borrowers who would not qualify for Farmer Mac I.

Certain rural housing loans have been sold into existing home mortgage secondary markets. However, many small commercial bankers we interviewed in rural areas said they have never or do not frequently sell loans into existing home mortgage secondary markets. They cited two major reasons for this: (1) the low volume of loans they originate is not attractive to home mortgage secondary markets and does not warrant the amount of resources the bank must dedicate to participating in one and (2) the lack of understanding of secondary markets and the administrative burden they create is a disincentive for banks to participate.

Fannie Mae official, this mortgage would be acceptable if it is a typical residential property for that particular area.

The Honorable Charles A. Bowsher
June 20, 1991
Page 2

Now on pages 2, 3-5, and 19.

See comment 3.

See comment 4.

The Report asserts that the word "dwelling" should be interpreted to mean the house and the land on which it is situated (pages 2, 5-8 and 21 of the Report) and recommends that Farmer Mac not accept loans on properties with higher values (pages 15-16 of the Report). The Report fails to mention that Farmer Mac, in November, 1990, furnished GAO with a memorandum from its General Counsel concluding that Farmer Mac's interpretation of the Act was proper and consistent with the intent of Congress. A copy of the relevant portion of that memorandum is attached to this letter. Nowhere in the Report does GAO even attempt to dispute the fact that the word "dwelling" is almost always used to mean a structure and does not include the underlying land, as shown by the cases, statutes and regulations cited in the memorandum.

Now on pages 10 and 30.

See comment 5.

See comment 6.

See comment 7.

Now on pages 7 and 9.

It should be noted that, under Farmer Mac's standards, the maximum amount of a rural housing loan at the prescribed loan-to-value ratio of 75% would be $150,000. Adjusted for inflation to January, 1991, this figure would be $173,790, less than the comparable figure for Fannie Mae and Freddie Mac loans which, as the Report notes (pages 15, 35-36) ranges from $191,250 up to $286,875 in high-cost areas. If Farmer Mac were to adopt the interpretation recommended by GAO, the loan limit would be cut in half to $86,895, 45% of the lowest Fannie Mae and Freddie Mac limits, and only 30% of these limits in high cost areas. This would drastically restrict Farmer Mac's ability to serve the market which Congress intended it to serve and would have a very serious negative impact on the volume and the geographic diversity of loans eligible for Farmer Mac pools. As the Report recognizes, uncertainty of volume and geographic diversification are significant obstacles for Farmer Mac and potential participants in the rural housing program (Report, pages 11, 13). GAO's strained interpretation of the term "dwelling" would make it far more difficult to assemble a geographically diverse pool of rural housing loans and, accordingly, would frustrate the Congressional purpose and compromise the financial viability of the rural housing program.

Now on pages 2, 7, and 9.

As noted previously, there are a few other points raised in the Report which merit specific comment. In several places, the Report makes reference to the subordinated participation requirement under the Farmer Mac program and the impact it may have on originators and/or poolers of rural housing loans (pages 3, 10, 13 and 14). We believe that the wording used in the Report does not properly describe the requirement and may confuse the readers as to the nature of the subordinated securities involved in the program. On page 3, for example, the Report refers to the "regulatory requirements lenders will have to meet if they choose to retain a subordinated participation interest in the loan..." We agree with the substantive point being made, that the subordination requirement is an element of participation that complicates implementation of the program, however, the subordinated securities ("participation interests") contemplated under the program are not loan specific as stated in the Report. As the program is currently structured, cash reserves or subordinated securities, equal to at least 10 percent of the principal value of each pool, are required and will represent an undivided interest in the entire pool of loans. The subordinated securities constitute a diversified interest in the pool rather than an interest in any single loan as suggested in the Report. The diversified nature of the subordinated securities provided the basis

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Now on pages 7-10.
See comment 12.

On pages 10-14, the Report lists five factors that GAO believes "may limit the extent to which...[Farmer Mac] can facilitate a secondary market for rural housing loans" (Report, page 10). The factors include unknown loan volume, uncertain loan and security pricing, administrative burdens on lenders who sell loans, potential problems poolers may face developing adequate lender networks to meet the pool diversification requirements, and regulatory obstacles. We note that similar observations have been made in previous GAO reports concerning Farmer Mac. We have previously pointed out that the establishment of a new secondary market is clearly a complex and difficult undertaking and agreed that the factors identified certainly do not make the process any easier. The issue, however, is not whether Farmer Mac must deal with factors that make the process "difficult," but, rather, whether Farmer Mac has recognized these challenges, is capable of dealing with them responsibly and is, in fact, responding to them in ways that will assure a reasonable chance of success despite the "difficulties."

See comment 13.

We believe that the Report does not adequately discuss the measures Farmer Mac has taken to respond to these and many other potential barriers, nor does it evaluate the degree of importance that should be accorded to any of them. For instance, uncertainty of loan and security pricing is a very important element of implementing the secondary market and has been the focus of considerable attention by Farmer Mac. The Report fails to note the development of the Linked Portfolio Strategy to specifically address this matter for both agricultural and rural housing loans under the Farmer Mac I program.

See comment 14.

Another example is the issue of administrative burdens. The Report indicates that some rural bankers GAO interviewed had reservations about participating in the program due to the administrative burdens that will be encountered. However, other than one reference to additional paperwork, the report is not specific as to the nature of the alleged administrative burdens and omits mention of efforts taken by Farmer Mac to minimize administrative requirements on participating lenders. More specifically, Farmer Mac not only developed uniform application forms for use by lenders in the program, but the forms were carefully designed to be readable and easy to use. In addition, Farmer Mac has developed a computer program -- AGPAK I -- for use by lenders in completing the forms and evaluating applications. Considerable efforts have been made by Farmer Mac to streamline requirements for participants in the secondary market and to minimize the administrative burdens associated with program participation, none of which are mentioned in the Report.

See comment 15.

Other examples could be cited. Our concern, however, is that the Report has focussed on certain negative factors, which are present in the development of the Farmer Mac secondary market and very likely have complicated the implementation of the program, but has not evaluated the significance of the factors identified or Farmer Mac's response to them.

Now on page 18.

On page 19, the Report states that Farmer Mac has not issued securities backed by pools of loans as of the date of the Report. We believe that this statement should be

The following are GAO's comments on the Federal Agricultural Mortgage Corporation's letter dated June 20, 1991.

GAO Comments

1. Farmer Mac's overall comments are summarized on page 11.

2. Pages 3-5 and 11 address this point in detail. See also comment 4 below.

3. In our discussion of this issue, we say "Farmer Mac has interpreted its enabling legislation . . .," which is a reference to the November 1990 memorandum.

4. Pages 5 and 11 address this point in detail. As previously noted, we carefully considered all the arguments set out in the November 1990 memorandum. We believe that Farmer Mac's legislation cannot be construed to authorize the inclusion in loan pools of rural housing loans secured by property in excess of $100,000 (adjusted for inflation). First, the "purchase price" of a dwelling ordinarily refers to the combined value of the dwelling and the property on which it is located. In our view, neither the dictionary definition of "dwelling" nor the cases, statutes, and regulations cited in Farmer Mac's memorandum make a persuasive case for changing the plain meaning of the statutory term "purchase price." While, we understand, a dwelling is usually appraised separate from the land on which it sits, we found no evidence that the Congress meant to define "purchase price" as "appraised value."

Second, Farmer Mac's interpretation of "purchase price" is inconsistent with the statute's definition of "qualified loan." This term is defined in terms customarily used to refer to an interest in real property. A "qualified loan" is an obligation "secured by a fee simple" or "leasehold" mortgage, which customarily includes both land and any buildings affixed to it. In light of the definition of "qualified loan" in terms normally associated with an interest in land and the structures attached to it, we do not believe that the "dwelling" can be considered in this statute apart from the land to which it is affixed.

5. The report uses the term "purchase price" to remain consistent with the language in the legislation. Farmer Mac uses the term "loan limit," which is not consistent with the terminology in the legislation.

14. On page 8 we mention paperwork, additional staff time, and length of time it may take to prepare a loan for sale through Farmer Mac as possible administrative burdens facing lenders who originate Farmer Mac loans. In appendix II, we discuss Farmer Mac's actions to date, including the development of AGPAK.

15. Our objective was to identify the potential barriers that could limit Farmer Mac's role in rural housing. As such, the report identifies those factors that could impede Farmer Mac's progress.

16. We make a clear distinction between Farmer Mac I and Farmer Mac II on page 1 of the report. We later refer the reader to Federal Agricultural Mortgage Corporation: Issues Facing the Development of a Secondary Market for FmHA Guaranteed Loans. GAO/RCED-91-139, June 13, 1991) for a further discussion of Farmer Mac II. We have included language on page 18 of the report to address the Farmer Mac II program.

Related GAO Products

Federal Agricultural Mortgage Corporation: Issues Facing the Secondary Market for FmHA Guaranteed Loans (GAO/RCED-91-138, June 13, 1991).

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

Issues Surrounding Underwriting Standards Developed by the Federal Agricultural Mortgage Corporation (GAO/T-RCED-89-62, Sept. 12, 1989, and GAO/T-RCED-89-71, Sept. 27, 1989).

Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 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).

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