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Issues Surrounding a Secondary Market for Agricultural Real Estate Loans

Statement of
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Subcommittee on Conservation, Credit, and
Rural Development
Committee on Agriculture
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our ongoing work involving a secondary market for agricultural real estate loans. This work is being done at the request of Representative Richard H. Lehman, who has also requested that we present our preliminary results at today's hearing. We expect to issue our final report in the near future.

My testimony today will include information on

- -- secondary markets in general, including the purposes such markets have served in the past,
- -- legislative proposals for a national secondary market for agricultural real estate loans, and
- -- major issues meriting further attention in considering proposals for a secondary market for agricultural real estate loans and their potential effects on farmers, lenders, and the federal government.

I will present preliminary results of our work to date and discuss the major points to be included in our final report.

SECONDARY MARKETS AND THEIR FUNCTIONS

By way of background, 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, 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, essentially, a secondary mortgage market involves the buying and selling of existing rather than new products and provides the holders of those financial instruments the ability to sell them quickly, thereby creating liquidity.

The home mortgage secondary market, the most widely recognized and developed secondary mortgage market, is comprised of government and private organizations. In 1986, $383.8 billion in home mortgages were sold. In appendix I, we provide further information on the home mortgage secondary market's development, the different secondary market entities, market operations, and financial instruments used in the secondary mortgage market.

Economic functions performed by a secondary market

Historically, secondary markets have been credited with performing certain economic functions that promote efficiency and equity in lending markets. Those functions include

-- increasing liquidity, or improving the ability to convert financial instruments into cash, thereby enhancing the value of the item being sold and attracting a broader range of potential buyers,

-- moderating cyclical flows of capital caused by economic forces, which may result in fund shortages at certain points in the business cycle, by enabling a lender to sell loans during such a period and reloan that money,[1]

-- assisting regional flows of capital by stimulating the flow of funds from areas with excess capital to areas where capital is more in demand, and

[1]Home mortgage secondary markets performed this function in the early years of their development; however, general deregulation of interest rates has reduced the sensitivity of mortgage flows to cyclical changes in the economy.

-- <u>reducing regional differences in interest rates and allowing for portfolio diversification</u> since capital will flow to areas of higher interest rates thereby placing downward pressure on those rates and spreading risks of a single region, such as the Midwest, across a broad geographical base of investors.

CURRENT FARM REAL ESTATE SECONDARY MARKETS

Although an organized national-scope secondary market for farm real estate loans does not exist, we identified state-sponsored and private markets that are both formal and informal in nature.

The formal, or organized, markets are regional in scope and operate primarily in midwestern states. The annual loan volume in each of these markets is relatively small--under $50 million. The informal market is characterized by lenders selling small quantities of loans directly to individual investors and is referred to as a private placement market. Because of the limited geographical coverage and volume of current farm real estate secondary markets, their potential to perform the range and magnitude of functions performed by a much more highly developed secondary market, such as the home mortgage secondary market, is also limited.

SECONDARY MARKET FUNCTIONS PERFORMED BY THE FARM CREDIT SYSTEM (FCS)

FCS is a private national network of lenders that has been chartered by the Congress to make loans to the farm sector. It is the largest institutional farm real estate lender holding about $40 billion, or about 55 percent of outstanding farm real estate debt held by institutional lenders as of December 31, 1986. It obtains funds to make those loans through sales of general obligation bonds and holds those loans in its portfolio.

FCS differs from a secondary mortgage market entity in that it is a primary lender that does not buy or sell mortgage loans. However, its economic effect is similar to that of a secondary mortgage market entity in that it has created liquidity and attracted a wide range of investors, insulated its borrowers from cyclical fund flows, enhanced the regional flow of funds, and reduced regional differences in interest rates.

Created liquidity

Because of its "agency status," FCS' favored access to the capital market has enhanced its ability to raise cash. This has broadened its range of investors and added liquidity to the farm real estate market.

Insulated borrowers against effects of cyclical flow of funds

FCS has also had the effect of insulating its borrowers against adverse effects caused by outflow of funds during periods of general capital shortages. Because FCS is not a depository institution and relies primarily on sales of securities for its funds, aside from customer demand, proceeds from securities sales are the main determinant of how many loans it can make. Because of its "agency status," FCS bonds have been traditionally treated as favored investments by the investment community and, as a result, have provided FCS with a stable source of funds.

Enhanced regional flow of funds

FCS' ability to return to the national capital markets to borrow large amounts of funds from a broad range of investors and funnel those funds through a national network of mortgage lenders has enhanced the regional flows of funds and FCS' ability to make long-term loans.

Reduced regional differences in interest rates

FCS has also provided the basis to reduce regional differences in interest rates. Because FCS issues consolidated securities, proceeds of which are distributed to its banks, the cost of money

for all banks for any one issue is the same. A review of interest rates charged on FCS farm real estate loans, across FCS districts, indicates that this benefit has been passed through to borrowers. Historically, interest rates have been roughly equal in all FCS districts. It is not expected that the rates would be exactly equal, because individual banks obtain varying amounts of funds at different times and the rates on FCS securities, like other securities, vary for different issues, depending on economic conditions. In addition, each district has different operating costs.

FARM REAL ESTATE SECONDARY MARKET PROPOSALS

We have identified nine legislative proposals, introduced in the 100th Congress, to establish some form of a secondary market for farm real estate loans. Some of the bills are, essentially, reintroductions of bills from the 99th Congress, while others have resulted from the current debate on the issue of creating a national secondary market for agricultural real estate loans. Appendix II contains a list of the legislative proposals in the order of introduction. Several proposals have the same titles but all have some differences.

We identified the major provisions of each proposal and met with officials of two home mortgage secondary market entities--the Government National Mortgage Association, or Ginnie Mae, and the

Federal National Mortgage Association, or Fannie Mae. We discussed with them what elements should be considered in order to allow for a better understanding of a secondary market's potential impact on farmers, lenders, and the federal government. The elements we selected include purpose of the market, market organization and operation, sources of funding for the market, costs to establish and operate the market, eligibility criteria for lenders, loan and underwriting criteria, market volume, regulatory oversight requirements and cost, targeted investors, risk bearers, and market duration.

Not all of this information is available in each proposal. Some of the elements are not typically present in legislation, such as cost to operate or volume of activity. Others, such as eligibility criteria, may be left to be determined by the administering agency within broad legislative guidelines. Even when elements are present in the proposals they may not lend themselves to a complete understanding of the potential impact each proposal may have on farmers, lenders, and the government. To allow for such an understanding, most elements would have to be fleshed out and refined as the proposals go through the legislative process.

Because several new proposals have been recently introduced, we are not prepared today to discuss the specifics of each proposal. Our final report to Representative Lehman, however, will

include profiles of the proposals by each element. We also plan to provide in our report some insights into the proposals' similarities and differences.

SECONDARY MARKET ISSUES

On the basis of our preliminary results in examining the legislative proposals and our discussions with individuals and officials from the private sector and the government concerned with secondary markets, in general, and a national-scope secondary market for agricultural real estate loans, in particular, we believe that there are several issues that merit additional consideration in the secondary market debate. A further examination of the following questions and our observations will help highlight the issues involved.

Is federal government involvement needed to develop a large national-scope secondary market for farm real estate loans?

Given the historical experience with farm real estate lending, it is unlikely that a large national-scope secondary market for farm real estate loans can be established without federal government involvement. Historically, the federal government has encouraged FCS' role in providing farm real estate loans on reasonable terms because it had determined that such credit was not

being adequately provided through other lenders. FCS' "agency status" has historically enabled it to obtain a stable source of funds from the capital markets to make long-term farm real estate loans. Wall Street investment house representatives told us that a large secondary market for farm real estate loans could not exist without some degree of government involvement. Given the current financial stress in the farm sector--combined with the economic, weather, geographic, and political environments normally facing the sector--potential risks faced by investors are great.

The private sector has not, of its own accord, developed a large national-scope farm real estate secondary market. The legislative proposals all provide some degree of government involvement to, at a minimum, get such a market off the ground. The major consideration in this area is to what extent federal backing is needed to stimulate or sustain secondary market development. Will the federal government have to be involved in the short term or the long term to ensure the long-term existence of such a secondary market? Will the federal government have to provide some level of credit enhancement, such as a guarantee or insurance, or would a federal charter be adequate?

Direct federal involvement in the secondary market for home mortgages was critical to the development of that market and still plays a major role today. In the early years federal insurance and guarantees of mortgages and mortgage-backed securities helped

accelerate secondary market development. Today, a significant amount of the home secondary market activity is supported by a federally-owned organization--Ginnie Mae--and two other federally-chartered organizations--Fannie Mae and the Federal Home Loan Mortgage Corporation, or Freddie Mac. The federal government does not guarantee or insure Fannie Mae's or Freddie Mac's securities, but the organizations have "agency status" and investors assume the government stands behind their securities. The three agencies accounted for about 80 percent of all mortgage-related securities issued in 1986. Fannie Mae and Freddie Mac accounted for about 52 percent.

Like the home mortgage market, a federally-chartered agency (the FCS) supports the lion's share of farm real estate lending today. If the home mortgage secondary market offers any answers as to the need for government involvement to establish a large secondary market for agricultural real estate loans, the answer is probably yes.

<u>What impact would a large national-scope secondary market for farm real estate loans have on FCS and other lenders?</u>

The Congress is currently concerned about the health of FCS because it has lost billions of dollars in the last few years and is expected to need federal assistance in the future. The Congress

is also concerned about the health of commercial banks that serve agriculture because they have been failing at unusually high rates during the same period. We believe that a secondary market is not a short-term solution to the current financial stress in the agricultural sector, but it does have major long-term implications.

Development of a national secondary market for agricultural real estate loans could strengthen, weaken, or leave unchanged the fates of FCS and other lenders to agriculture. As noted earlier in my testimony, the current legislative proposals do not provide enough information to allow for a complete understanding of how farmers, lenders, or the government would be potentially affected.

Because of its access to a stable source of credit through the capital markets that other lenders could not match, FCS has dominated farm mortgage lending. Commercial banks generally, have obtained competitively priced short-term funds from customer deposits, which has allowed them to maintain a substantial market share for short-term agricultural loans. However, because these funds are short-term deposits, large percentages of them cannot prudently be committed to long-term loans. Commercial banks and other lenders see the ability to convert long-term mortgage loans to short-term assets (through mortgage loan sales) as positive.

If commercial banks could, without restriction, access the same source of funds at the same cost as FCS, they potentially

could increase their market share of total farm lending. Conversely, FCS could potentially lose market share and, all other things being equal, lose a proportionate amount of interest income.

However, the potential impact of a secondary market on FCS and other lenders could be better understood if we knew what organization would operate the market, what fees would be charged, what loan volume might be expected, and what restrictions would be placed on participation. If total farm lending increased substantially and FCS operated a secondary market that all lenders could access without restriction and for which it charged fees to lenders, including the FCS, to provide credit enhancement, it might improve its financial position, even if it lost market share as a primary lender.

On the other hand, if a secondary market for farm real estate loans were to be controlled by any particular lender group that group could use its control to improve its fee income or market share at the expense of other lenders. Also, entry to the market could be restricted by qualifying lender and loan criteria. For example, if only lenders with an asset size of $40 million or more would be able to participate, most "agricultural banks," as defined by the Federal Reserve Board, would be precluded from participating. As of December 31, 1986, the average asset size of agricultural banks was about $33 million.

Some commercial agricultural lenders are already concerned about FCS' market share because of the recent changes FCS made in response to the need to be more efficient and minimize operating losses, coupled with its favored access to the capital markets. Prior to the early 1980's, FCS' organizational structure was decentralized down to the local level, with separate locations and management for production credit and real estate credit activities. The commercial banking sector's concern about losing market share flows from reorganizations of FCS at the local level that have taken place since the early 1980's. For example, FCS production lending and real estate lending facilities have consolidated in some areas and colocated in others. The commercial banking sector sees the convenience of "one-stop banking" at FCS, for both production and real estate loans, as a catalyst that could eventually shift market share of short-term loans from commercial banks to FCS.

Should FCS be given powers to operate as the secondary market for all lenders?

Arguments for making FCS the secondary market for farm real estate loans are that FCS already performs some secondary market functions, operates in all states, and needs an infusion of capital. It provides liquidity and attracts a wide range of investors; insulates its borrowers against the effects of cyclical flows of funds; enhances regional flows of funds to farmers; and

reduces regional differences in interest rates by allowing money to flow to areas of higher interest rates thereby exerting downward pressure on those rates. FCS has been able to perform these functions largely because of its "agency status" that has traditionally enabled it to access the capital markets routinely for funds. In addition, its charter has permitted it to operate as a national lending agency enabling it to perform the cross-region functions normally attributed to secondary markets.

On the other hand, arguments can be made against FCS being the secondary market. With the changing face of agricultural lending, if the market is not structured in such a way as to allow agricultural lenders, other than FCS, equal access to the capital markets for farm real estate lending, the agricultural credit delivery network as a whole may become too vulnerable to financial stress. Commercial "agricultural banks" may become less able to compete with FCS.

Furthermore, the implications for managing the government's risk exposure to the national agricultural credit portfolio may be unacceptable if one lender--FCS--increases its market share of farm lending. A GAO report entitled Financial Condition of American Agriculture (GAO/RCED-86-09; Oct. 10, 1985) pointed out that farm lenders with loan portfolios more concentrated in agricultural lending were more vulnerable to financial stress in the sector. One solution to this problem may be to develop short-range and

long-range plans for agricultural lending that would encourage as many lenders as possible to compete for farm lending, spreading as much as possible the risk of lending to one sector throughout the lender and investor community. This strategy could possibly incorporate a plan for FCS to operate the secondary market, thereby deriving more of its future income from secondary market activities rather than from primary lending.

Could a new secondary market entity coexist with the FCS?

FCS' favored status in the capital markets raises questions as to whether a new secondary market entity could also compete as well for funds. The issue most related to this question is whether the new entity could attract funds at an interest rate that would allow lenders to make loans at competitive rates.

A related question is how well the investment community would accept another agricultural lending entity, especially when the agricultural sector is still experiencing financial stress and FCS is losing billions of dollars. Wall Street brokerage house representatives told us that if a new secondary market were to be established, it would require at least the same level of government backing perceived by investors for FCS and possibly more to initially establish the market.

What loans should be eligible to be sold in the secondary market?

Probably the most important issue to determining the potential impacts of a secondary market on farmers, lenders, and the government is underwriting criteria that embody specific loan criteria. This single element can determine such factors as market volume; expected loss experience; likely costs to risk bearers, such as, investors and credit enhancers; and social benefits to the farm community. For example, underwriting criteria that allowed virtually all farm loans to be sold in the secondary market would result in a high expected loss experience and high risk to investors and others who have provided credit enhancements.

Another component of this eligibility question is whether land based agricultural loans can be adequately standardized to be included in a national-scope secondary market. While it is possible to develop a standardized loan application that will go a long way to understanding risks associated with the farm sector and individual farm operations, it will likely be more difficult to develop large pools of loans with substantially homogeneous characteristics. For example, Midwest grain farms have much different cash-flow characteristics than West-coast ranches with tree crops, and vineyards.

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In summary, Mr. Chairman, we believe that there are several important issues surrounding the debate on a secondary market for agricultural real estate loans. These issues, among others, include the extent of federal government involvement, the impact on FCS and other lenders, and what entity should control such a market. Mr. Chairman, we hope that the questions raised in today's testimony, along with our observations, will aid the Subcommittee's efforts in examining the secondary market concept and its potential applicability for agricultural real estate loans.

This concludes my prepared statement. My colleagues and I will be happy to respond to questions at this time.

INFORMATION ON THE SECONDARY MARKET FOR HOME REAL ESTATE LOANS

A more detailed discussion of the secondary market for home real estate loans will provide a broader understanding of secondary market activities, in general. In this appendix we provide information on the home real estate market's development, the different secondary market entities, market operations, and financial instruments used in the secondary mortgage market.

HOW DID THE MARKET DEVELOP?

Several factors played key roles in facilitating the development of the secondary market for home real estate loans. Probably most important were the development of securities backed by mortgages, homogeneity of the mortgages underlying the securities, and improvement of the securities' marketability by risk reduction mechanisms known as credit enhancements. One such mechanism is a guarantee that investors will receive certain returns on their investments. The government played an important role in all of these secondary market developments. It is unlikely that the home mortgage secondary market would have become so well

developed if these factors had not been adequately considered and appropriately incorporated.

Mortgage-backed securities

As the housing finance industry developed, it increasingly obtained funds for home mortgage loans through sales of securities. Traditionally, lenders made home mortgages by relying on customer deposits. As the secondary market developed, lenders increasingly obtained funds to support their home mortgage lending through government-sponsored entities, charged with ensuring access to capital for the housing market. These organizations, discussed later, sold general obligation bonds, bought loans from lenders, and held those loans in their portfolios. As the market developed further, the organizations issued securities backed by pools of mortgage loans. These mortgage-backed securities are the leading source of funds for home mortgages today.

The increasing use of securities has enabled lenders to make more loans and has provided investors with an attractive investment. The ability to sell loans directly or indirectly to investors has provided lenders with an additional source of funding for long-term mortgages, not provided through relatively short-term customer deposits. The investors' ability to place large

investments with relative ease and quickly convert them to cash has greatly increased the attractiveness of home mortgages as investments. Those factors reduce both the lenders' and investors' transaction costs.

Homogeneity of mortgages

Standardization of home mortgages greatly facilitated pooling of home mortgages for securities and, therefore, development of the home mortgage secondary market. Development of the fixed-rate 30-year mortgage, home construction standards, and standard loan criteria sowed the seeds of secondary market growth. Traditionally, the ability to create loan pools with similar risks and terms has been desirable. Such standardization provides for ease of marketing and reduces administrative costs.

Improved securities marketability

Investor confidence in the integrity of the financial instrument is crucial to its marketability. Several types of credit enhancement mechanisms can be used to improve the marketability of an instrument including (1) insuring or guaranteeing certain returns to investors in the event of default by the borrowers, (2) requiring high levels of collateral, and (3)

providing recourse to the original lender in the event of borrower default. These enhancement tools can be used singularly or in concert to obtain the desired level of product marketability.

Federal government backing of mortgages was a major element in the growth of the home mortgage secondary market by improving the marketability of securities. In the early stages of the market, Federal Housing Authority (FHA)-insured and Veterans Administration (VA)-guaranteed loans were the backbone of the market. Federal government guarantees of timely payment of principal and interest on certain securities, backed by FHA and VA loans, dramatically enhanced the acceptance of home mortgages by the investment community. With the increasing use of securities, the percentage of home loans sold has grown dramatically from about 30 percent of all home loans originated in 1978 to about 78 percent in 1986. Later, use of conventional-mortgage-backed securities gained acceptance as quasi-governmental organizations issued securities with guarantees on principal and interest payments, coupled with private mortgage insurance requirements. Secondary market entities, also, require certain levels of collateralization, or loan-to-value ratios, for loans they purchase.

WHAT ENTITIES EXIST?

Organizations most often associated with the secondary home mortgage market are the Government National Mortgage Association, or Ginnie Mae, Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac. Other organizations, such as large banks, mortgage bankers, and state and local governments are also active participants in the secondary home mortgage market. All of these organizations differ somewhat in the role they play in the secondary market for home loans, but all make it possible for the existence of a large active investment market for home loans.

Ginnie Mae, Fannie Mae, and Freddie Mac were chartered by the federal government, and as a result their debt offerings have federal "agency status," with investors assuming that securities issued by them are backed by the government.[1] In reality, Ginnie Mae is a federal agency and its debt is backed by the full faith and credit of the federal government. However, Fannie Mae and Freddie Mac are private organizations without explicit federal government guarantees.

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

These organizations share a common characteristic of encouraging investors to buy mortgages or securities representing a pool of mortgages, by assuming risks that would otherwise be borne by the original lender or the investor. This is done by providing a guarantee to investors that the principal and interest derived from the underlying mortgage payments will be paid in case of borrower default.

In 1986, mortgage-related securities issued by these organizations totaled about $281 billion, or about 80 percent of all mortgage-related securities publicly issued. During the same year, private firms and state and local governments accounted for about $53 billion, or about 15 percent, and about $14 billion, or about 4 percent, respectively, of all publicly issued mortgage-related securities.

HOW DOES THE MARKET OPERATE?

Many different players can become involved in a secondary mortgage market transaction, but key activities occur in the process: a loan is made; the loan is sold or securities representing a pool of the loans are sold, often to securities dealers; and the securities are then sold to investors. It is not unusual for one entity to perform several of these activities. For

example, a mortgage banker may make the loan, pool it with other loans, and sell the security representing the loans to investors. Many other variations on this theme have developed.

Ginnie Mae, Fannie Mae, and Freddie Mac have established financial criteria and standardized mortgage applications that are used by most participants in the home secondary market. Freddie Mac purchases loans that meet its prescribed criteria, providing cash to the lender to make new loans or for other purposes. The lender receives income by (1) charging the borrower a loan origination fee and (2) receiving servicing fees for collecting the payments and forwarding them to the purchaser or designated agent. Fannie Mae also buys loans, but most of its activity is conducted through its "swap" program through which it issues securities to holders of loans and takes the loans in exchange. The holders can then hold the securities or sell them. Ginnie Mae does not buy loans; rather, it charges a fee to guarantee loan pools, which are packaged by financial institutions to sell to investors.

Once loans are purchased or guaranteed by a "secondary market" organization, they can be held in portfolio or packaged with other loans to form a pool that becomes the collateral for a securities issue. This issue is then sold to securities dealers, who, in turn, earn fees by selling the securities to investors. The

investors in such securities include commercial banks; savings and loan associations; mutual savings banks; state and local government agencies; pension funds; and private citizens, either individually or through mutual funds.

WHAT TYPES OF FINANCIAL INSTRUMENTS ARE USED?

The innovative use of securities to better match the investor cash-flow and risk needs has been a major factor in the development of the secondary market for home mortgages. The securities that promoted this development are generically referred to as mortgage-backed securities. These are issued as both ownership and debt securities, and are named for their cash-flow characteristics. They are issued with and without government or implied-government backing.

The most commonly known ownership issues are called "pass-through" certificates, which represent a pool of mortgages assembled by a mortgage lender. Once the pool has been sold to investors, the ownership of the pool lies with the investors. Although the investors own the mortgages, the loan originator collects all payments, both principal and interest; and all payments, less a servicing fee, are "passed-through" to the investors--hence the name "pass-through."

The most commonly known debt securities are called mortgage-backed bonds and pay-through bonds. A mortgage-backed bond is a debt obligation of a mortgage lending institution and is collateralized by mortgage loans. The bonds' payment characteristics are much like other bonds, having stated maturities and interest paid at regular intervals. The pay-through bond is also a debt of the mortgage lender and is collateralized by the underlying mortgages. However, its cash-flow stream is like that of a pass-through security, in that investors receive payments each month as monthly payments are passed through to them. Several variations on those types of mortgage securities have developed in recent years to respond to specific investor requirements.

LEGISLATIVE PROPOSALS FOR A SECONDARY MARKET FOR AGRICULTURAL REAL ESTATE LOANS

Legislative Proposal	Title
S. 234	Farm Mortgage Marketing Corporation Act of 1987
H.R. 497	Farm Mortgage Marketing Corporation Act of 1987
H.R. 575	Farm Credit Enhancement Act of 1987
S. 427	Farm Mortgage Guarantee Act of 1987
S. 848	Agricultural Mortgage Marketing Act of 1987
H.R. 2179	Farmers Home Administration Guaranteed Loan Improvement Act of 1987
S. 1172	Agricultural Mortgage Marketing Act of 1987

H.R. 2435	Agricultural Mortgage Marketing Act of 1987
S. 1219	Federal Farm Credit Mortgage Corporation Act of 1987 (Title IV, Farm Credit Borrower and System Restoration Act of 1987)