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Report to the Chairman, Subcommittee on Conservation, Credit, and Rural Development, House of Representatives

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FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Secondary Market Development Slow and Future Uncertain

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GAO

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Resources, Community, and
Economic Development Division

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

Dear Mr. Chairman:

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) created the Federal Agricultural Mortgage Corporation (Farmer Mac) to promote the development of a secondary market for agricultural real estate and rural housing loans through a program now called Farmer Mac I. The Congress hoped that a secondary market for buying and selling these loans—in the form of securities guaranteed by Farmer Mac—would help make additional long-term credit available to farmers, ranchers, and rural homeowners. As you requested, this report discusses three aspects of the market's development: (1) the actions that Farmer Mac has taken to establish the basis for the market, (2) the current status of the market, including the factors that have constrained its development, and (3) the market's effects on agricultural credit to date. We have previously reported on the rural housing provisions of the Farmer Mac I program and on a new program for Farmers Home Administration (FmHA) guaranteed loans, known as Farmer Mac II.[1]

Results in Brief

Since its creation in early 1988, Farmer Mac has taken the steps required by the act to establish the basis for a secondary market for agricultural real estate and rural housing loans. In late 1989, it published an operating manual that, among other things, contains requirements for those wishing to be certified to participate in the Farmer Mac I program as "poolers"—financial institutions that will buy qualified loans from other lenders or "originators," assemble or "pool" the loans, and issue and sell securities that are backed by these pools. Farmer Mac is to guarantee timely payment of principal and interest to investors who purchase these securities. By January 1990, Farmer Mac had announced that it was ready to certify poolers and guarantee securities.

[1]See Federal Agricultural Mortgage Corporation: Potential Role in the Delivery of Credit for Rural Housing (GAO/RCED-91-180, Aug. 7, 1991) and Federal Agricultural Mortgage Corporation: Issues Facing the Secondary Market for FmHA Guaranteed Loans (GAO/RCED-91-138, June 13, 1991). Farmer Mac issued its first guaranteed securities—under the Farmer Mac II program—in April 1991.

Although Farmer Mac has had its operating guidelines in place for over a year, no securities had been issued under the Farmer Mac I program as of June 28, 1991. Furthermore, of the 46 financial institutions that were eligible to apply for certification as Farmer Mac poolers in December 1988, only 3 had done so. Two of them had been certified. In discussions with these organizations, we found that only one other planned to apply for certification within the next 2 years, and most of the remainder had no plans to ever be certified.

Potential poolers are reluctant to participate in the Farmer Mac I program because they are concerned that there may be an insufficient volume of loans to justify their commitment to the program or to support a viable Farmer Mac-sponsored secondary market. Low volume, they point out, may occur because the interest rates and terms available to borrowers on loans originated for sale through the Farmer Mac I program may not be competitive. Moreover, risk-based capital requirements for banks and Farm Credit System (FCS) institutions adopted since Farmer Mac was authorized make it less advantageous for these lenders to participate in the Farmer Mac I program than originally anticipated. Finally, agricultural lenders note that because there is no pressing need for funds to meet additional demand for credit, there is little incentive to sell loans in a secondary market at this time.

Farmer Mac is in the process of developing a new approach to the Farmer Mac I program that is designed to increase participation and stimulate more secondary market activity. Under this new approach, Farmer Mac would, in effect, operate as a portfolio manager as well as a guarantor, much as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) do. It is too early to predict whether this new approach will in fact significantly increase participation in the Farmer Mac I program.

Although Farmer Mac has guaranteed no securities under its original program, some agricultural lenders maintain that it has nevertheless had a limited effect on increasing competition in agricultural credit. Additionally, they said that Farmer Mac's and others' efforts to promote the development of a secondary market could help standardize agricultural lending practices.

Background

A secondary market is a financial market for buying and selling loans, either individually or in the form of securities backed by groups or "pools" of loans. The Congress envisioned the Farmer Mac-sponsored secondary market as a means of providing additional long-term credit—including long-term, fixed-rate loans, which have not been widely available in the recent past—to creditworthy farmers, ranchers, and rural homeowners. Ideally, such a market would provide lenders with access to the capital markets, which, by returning cash to lenders in exchange for securities backed by the loans, would generate additional funds for them to lend and help them to manage financial risk. Farmer Mac's authorizing legislation indicated that the Congress expected that Farmer Mac's operating guidelines would be in place and that a large, nationwide Farmer Mac-sponsored secondary market would develop quickly, thus providing the basis for the GAO work required by the act in early 1990.[2]

To promote the development of a secondary market, Farmer Mac is authorized to guarantee timely payment of principal and interest on securities backed by qualifying pools of agricultural real estate and rural housing loans and to establish the ground rules under which lenders and others may participate in the market.[3] Under the Farmer Mac I program, Farmer Mac is to certify certain agricultural lenders and other financial institutions to act as poolers. These poolers will buy qualified loans from originators, form pools, and issue and sell Farmer Mac-guaranteed securities backed by these pools. Farmer Mac poolers may include banks, insurance companies, and institutions of the FCS—a government-sponsored enterprise that is a cooperatively owned network of lenders to agricultural producers and to a limited range of agriculture-related businesses. The authorizing legislation for Farmer Mac did not permit it to pool loans itself: Farmer Mac may not buy and hold agricultural real estate or rural housing loans as part of its normal business operations under the Farmer Mac I program, although it may buy portions of FmHA-guaranteed loans under the Farmer Mac II program.

The act requires that poolers and/or originators maintain either a cash reserve to cover at least the first 10 percent of losses arising from defaults on the pools of loans backing Farmer Mac-guaranteed securities

[2]We reported in January 1990 that we had been unable to complete the required study—on the effects of the market on agricultural producers, the FCS, other lenders, and the capital markets—because the market was not yet functioning. See Federal Agricultural Mortgage Corporation: GAO Actions to Meet Requirements in the Agricultural Credit Act of 1987 (GAO/RCED-90-90, Jan. 5, 1990).

[3]Agricultural real estate and rural housing loans will probably not be commingled in the same pools because of the significant differences between the loan types. Consequently, within the Farmer Mac I program, there may be in effect two separate programs, one for each type of loan.

or that holders of "subordinated participation interests"[4] absorb these losses. The act also requires that each pool be composed of loans secured by properties from different geographic locations that are used to produce different agricultural commodities. This requirement provides added protection against financial risk to investors in Farmer Mac-guaranteed securities and to Farmer Mac and the government.

Steps Taken to Establish the Basis for the Market

Farmer Mac has completed the steps it was required to take to establish the basis for the secondary market envisioned by the act. Farmer Mac was established in May 1988 when an interim board of directors was appointed by the President. After raising $22.8 million in its initial public offering of stock in December 1988 and appointing a president and chief executive officer in June 1989, Farmer Mac submitted loan underwriting and other standards for congressional review within the legislated time frames. Agricultural real estate and rural housing loans must meet these standards in order to be part of the pools of loans bought and sold as Farmer Mac-guaranteed securities. In late December 1989, Farmer Mac published the Securities Guide, a manual of its operating guidelines for the Farmer Mac I program. By January 1990, Farmer Mac had announced that it was ready to certify poolers and guarantee securities.

In order to apply for certification as a Farmer Mac pooler, an organization must, among other things, own at least 5,000 shares of Farmer Mac stock, representing an investment of $100,000. Minimum stock ownership and other requirements also apply to financial institutions that wish to become Farmer Mac originators. The minimum stock ownership requirements were established by the interim board of directors when Farmer Mac made its initial public offering. At that time, 46 stockholders purchased a sufficient number of shares to apply for certification as poolers—35 commercial banks, investment banks, insurance companies, and other financial institutions, and all 11 FCS Farm Credit Banks. About 1,700 stockholders bought enough shares to become originators, including about 1,100 small banks with less than $50 million in assets. Farmer Mac stockholders are located predominantly in the Midwest.

[4]Subordinated participation interests represent the right to receive a portion of the principal and interest payments on a loan or 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 I program or they may sell them to a pooler.

Few Are Participating in the Farmer Mac I Program

Only a few potential poolers have applied for certification to participate in the Farmer Mac I program. By June 28, 1991, Farmer Mac had received applications from three potential poolers and had certified two of them: Manufacturers Hanover Securities Corporation (MHSC) and Goldman Sachs Mortgage Company (GSMC). Farmer Mac certified MHSC, the first pooler, in September 1990 and GSMC in January 1991. As of June 28, 1991, neither pooler had issued any securities guaranteed by Farmer Mac.

Not many other organizations plan to apply for pooler certification. In discussions with actual and potential Farmer Mac poolers, we found that the majority—35 of the 41 organizations currently representing the original 46 eligible stockholders—had no definite plans to apply for certification. Three of the six remaining organizations had already been certified or had applied, and only one more had specific plans to apply within the next 2 years. Appendix I provides more information on our interviews with actual and potential poolers.

Factors That Have Constrained Market Development

Potential poolers, as well as originators who would be selling loans to the poolers, mentioned several factors that have constrained the development of the Farmer Mac-sponsored secondary market. In general, potential poolers are reluctant to participate because they are concerned that a sufficient number of loans may not be originated for sale through the Farmer Mac I program to justify their commitment to the program or to support a viable secondary market. In particular, poolers expressed concern that enough loan volume may not be generated because (1) overall demand for agricultural credit has declined, (2) borrowers may find the interest rates and terms on loans originated for sale through the Farmer Mac I program unattractive, and (3) new regulatory constraints make participation in the Farmer Mac I program less advantageous than anticipated. Originators noted that agricultural lenders lack incentive to participate in a secondary market at this time because they have sufficient funds to lend.

Demand for Agricultural Credit Has Declined

The number and dollar amount of loans packaged for sale through the Farmer Mac I program determines whether poolers can cover expenses and make a profit they consider reasonable, as well as whether there will be a viable market for Farmer Mac-guaranteed securities. Overall demand for agricultural credit has declined significantly since the early 1980s. According to the U.S. Department of Agriculture's Economic Research Service (ERS), total outstanding agricultural real estate debt was $72.3 billion at the end of 1990, representing a 31-percent decline from its 1983 peak. Banks, insurance companies, and FCS institutions held $51.3 billion, or about 70 percent of this total; the remainder was owed to FmHA or to individuals and other institutions. ERS reports that farmers remain cautious about taking on new debt. No large increases in farm borrowing are forecast for next year, although ERS expects the amount of total farm debt, including agricultural real estate debt, to increase slightly in 1991, ending a 7-year trend of debt retirement.

Agricultural lenders are hesitant to make commitments to the Farmer Mac I program because of the uncertainty of future conditions in agricultural credit. They disagree about the extent of demand for long-term, fixed-rate loans for agricultural real estate. Such loans normally require borrowers to make higher payments than the variable-rate loans currently offered by most agricultural lenders. As a result, borrowers may find these loans unattractive. Some lenders are concerned that significant demand for long-term, fixed-rate agricultural real estate loans will not develop unless interest rates below 10 percent can be offered.

Loans May Not Be Competitive

Potential poolers and originators are also concerned that the interest rates on long-term, fixed-rate agricultural real estate loans originated for sale through the Farmer Mac I program may not be competitive. Estimates of the interest rates borrowers would pay on these loans vary widely. These estimates are based on (1) the return required by investors in Farmer Mac-guaranteed securities, (2) the fees and expenses associated with selling and servicing the loans, and (3) the return required by holders of the subordinated participation interests in the loans or pools of loans. Recently, Farmer Mac officials estimated that borrowers' interest rates would be 10.25 to 10.65 percent. However, financial experts from three Farmer Mac stockholders who have been active in promoting the development of the market and who are potential Farmer Mac poolers disagreed with this view. Borrowers' interest rates may have to be significantly higher—in the range of 10.75 to 12.90 percent—to provide adequate returns to investors and to cover costs.

Most of the difference in these estimates is due to varying assessments of the return required by holders of the subordinated participation interests. The estimates also differ in their assessment of some of the costs poolers will bear, such as the cost of educating originators about the Farmer Mac I program and meeting geographic and commodity diversification requirements for each pool of loans. At the upper end of the range of estimates, the interest rates on loans originated for sale through the Farmer Mac I program would not be competitive. However, since long-term, fixed-rate loans are not widely available on agricultural real estate, it is difficult to directly compare these estimates with the interest rates and terms on loans currently offered to farmers and ranchers. Table II.1 in appendix II compares estimates of the interest rates available to borrowers through the Farmer Mac I program.

Regulatory Constraints Make Participation Less Attractive

Most potential poolers and originators we spoke with said that new regulatory constraints, which apply not only to sales of loans in the Farmer Mac-sponsored secondary market but to all transactions involving subordinated participation interests, make participation in the Farmer Mac I program less attractive. These regulatory constraints were not anticipated when the Farmer Mac I program was designed. They arose following the adoption of risk-based capital adequacy standards, agreed to in July 1988 and effective on December 31, 1990, for banks. Bank regulators first provided guidance specific to the Farmer Mac I program in June 1990. The Farm Credit Administration (FCA) proposed similar guidance for FCS institutions—which are also subject to risk-based capital requirements—in January 1991.

The new risk-based capital standards, among other things, require banks and FCS institutions to hold more capital against subordinated participation interests than they did under the old standards. Now, in effect, if banks and FCS institutions retain the subordinated participation interest in a loan or in the related pool of loans sold through the Farmer Mac I program, they will have to hold capital against the face amount of the entire loan, as if it had not been sold. This is required because the subordinated participation interest, in the regulators' view, represents substantially all the credit risk associated with the loan. Under the old standards, banks and FCS institutions expected to hold capital only against the face amount of the subordinated participation interest, which for the Farmer Mac I program, was anticipated to be only 10 percent of the face amount of the loan. As a result, these lenders may not want to sell loans through the Farmer Mac I program or become poolers if they have to retain subordinated participation interests in the loans, since no capital will be freed up to support additional lending or other activities.

Furthermore, the new regulations generally will not permit banks or FCS institutions to hold subordinated participation interests in the loans or pools of loans backing Farmer Mac-guaranteed securities except in connection with sales of their own loans; they will not be permitted to buy them from others without restriction as had been generally expected. This makes it more difficult to find buyers for the subordinated participation interests, and, therefore, according to poolers and originators, less profitable to participate in the Farmer Mac I program. We discuss the regulatory treatment of sales of loans through the Farmer Mac I program by banks and FCS institutions in appendix III.

Current Lack of Incentives to Use a Secondary Market

Other incentives to participate in a secondary market for agriculture-related loans also appear to be absent at this time. Many agricultural lenders told us that they currently have no need for the additional lending capacity that participation in a secondary market could provide. Similarly, according to ERS, all categories of agricultural lenders surveyed in 1990—banks, insurance companies, and FCS institutions—reported that the capacity to lend is high relative to demand.

Another incentive to participate in a secondary market—the ability to sell long-term, fixed-rate loans in order to avoid interest rate risk—may not currently apply in agricultural credit.[5] While banks and other agricultural lenders said they would like to be able to sell any long-term, fixed-rate loans they might make, this incentive to participate in the Farmer Mac-sponsored secondary market is important only if there is significant demand for this type of loan for agricultural real estate, which has not been demonstrated.

New Approach Changes Operating Style

Farmer Mac is developing a new approach to the Farmer Mac I program that is designed to increase participation and stimulate more secondary market activity.[6] In effect, under the new approach, Farmer Mac would operate as a portfolio manager as well as a guarantor, much as Fannie Mae and Freddie Mac do. This would involve establishing a separate corporation to buy and hold securities backed by qualifying pools of loans

[5]To avoid interest rate risk, banks, for example, generally do not offer long-term, fixed-rate loans unless they can be sold in a secondary market because the short-term funds that banks obtain from customer deposits cannot prudently be committed to making such loans. If interest rates rise before a long-term, fixed-rate loan is paid off, and a bank has to pay more to retain its short-term customer deposits than it receives in interest on the loan, the bank will experience a loss from the interest rate risk it assumed.

[6]Farmer Mac has developed a similar new approach to the Farmer Mac II program. To fund its Farmer Mac II operations, on May 2, 1991, Farmer Mac made its first public offering of unsecured debt—for $50 million in short-term notes. See Federal Agricultural Mortgage Corporation: Conditions May Slow Development of Secondary Markets (GAO/T-RCED-91-66, June 13, 1991).

that are issued by certified Farmer Mac poolers and guaranteed by Farmer Mac. Farmer Mac would issue unsecured debt to fund the purchase of these securities by its new subsidiary. In order to minimize the exposure to interest rate risk that the purchase of these securities will create, Farmer Mac has stated that they will be backed by pools of loans that have interest rates linked to the interest rates on Farmer Mac's unsecured debt issues.

This new approach has raised questions about the types of risks Farmer Mac will face if it operates as both a portfolio manager and a guarantor. For example, as a guarantor, Farmer Mac would not directly undertake interest rate risk, and would not necessarily have to issue large amounts of debt. Farm Credit Administration (FCA) officials told us that they are currently reviewing Farmer Mac's new approach, including the question of whether Farmer Mac has the statutory authority to make public offerings of unsecured debt.

Effects of the Market

Some agricultural lenders told us that efforts to develop the Farmer Mac-sponsored secondary market have had a limited effect on agricultural credit. For example, while few of those we spoke with said that Farmer Mac had increased competition in agricultural credit, some cited products and services that are now available that might not have been if not for the creation of Farmer Mac. According to FCS officials, long-term, fixed-rate loans are now available to FCS customers in some areas of the country. Also, some insurance companies are working with rural banks to buy or make agricultural real estate loans to a greater extent than in the past. In one such effort in 1990, a major insurance company purchased or originated approximately $100 million in agricultural real estate loans that, according to a representative we interviewed, could qualify for sale through the Farmer Mac I program.

Additionally, several developments associated with Farmer Mac could help standardize agricultural lending practices. In addition to its Securities Guide, Farmer Mac has developed and made available a software package called AGPAK to assist originators in meeting its loan underwriting standards. It has also made available standard appraisal forms for agricultural real estate. These were designed by the American Society of Farm Managers and Rural Appraisers. Farmer Mac has also supported the work of the Farm Financial Standards Task Force, which is publishing a reference manual on financial reporting for agricultural producers.

Conclusions

When the Congress passed the Agricultural Credit Act of 1987, many expected that the Farmer Mac-sponsored secondary market for agricultural real estate and rural housing loans would develop quickly and be widely used. This has not happened, nor does it appear that it will happen in the near future. There are many factors—largely beyond the control of Farmer Mac officials—that contribute to the lack of activity in the market.

Poolers and originators are hesitant to participate in the Farmer Mac-sponsored secondary market because they are not certain whether loans originated for sale in it will have competitive interest rates and terms and because new regulatory constraints make participation in the Farmer Mac I program less advantageous than had been expected. In addition, many originators currently have little incentive to participate because they do not need the advantages that such a market is designed to deliver. Questions also still exist about the viability of the market because of the decline in overall demand for agricultural credit, and because the extent of demand for long-term, fixed-rate agricultural real estate loans is unknown.

It is too early to predict whether the new approach Farmer Mac is developing will in fact increase participation in the Farmer Mac I program to a significant degree. The new approach addresses only one of the factors we identified as constraints on the Farmer Mac-sponsored secondary market's development—the uncertainty of the competitiveness of the interest rates lenders will be able to offer on loans originated for sale through the Farmer Mac I program. Furthermore, it is not certain that this new approach will have the effect of inducing lenders to sell loans or that it will result in more competitive interest rates for borrowers.

Nevertheless, the creation of Farmer Mac may have already had some indirect positive effects on agricultural credit. How widespread and long-lasting these effects will be remains to be seen.

Farmer Mac's Comments and Our Response

Farmer Mac agreed that the factors identified in this report have affected the development of the Farmer Mac-sponsored secondary market and have discouraged participation in the Farmer Mac programs. However, Farmer Mac was concerned that the report was overly negative concerning the market's long-term potential for success. More specifically, Farmer Mac stated that the GAO review was, in its opinion, premature and did not adequately consider the impact of the new approach to the Farmer Mac programs, which officials believe will increase participation in the market.

Our report takes no position on the potential for the long-term success of the Farmer Mac-sponsored secondary market. Rather, our conclusions address its development in the near future. The market's long-term success would be difficult to forecast, given the large number of economic and other factors that could influence the agricultural credit market in general. With regard to Farmer Mac's concern about the timing of our review, we note that most of our work was conducted 1 year after Farmer Mac had announced that it was ready to certify poolers and guarantee securities and 2 years after its authorizing legislation was enacted. We believe that this is an appropriate time to report on the status of the market. Concerning the impact of Farmer Mac's new approach, we continue to believe that it is too early to predict whether this approach will increase participation in the Farmer Mac programs or to what degree it will benefit agricultural lenders or borrowers.

Farmer Mac's response to a draft of this report and our comments on the response are included in full in appendix IV.

We performed our work for this report between January 1990 and May 1991 in accordance with generally accepted government auditing standards. Our objectives, scope and methodology are discussed in appendix V.

We are also sending copies of this report to appropriate congressional committees; the Chairman of the Board, Federal Agriculture Mortgage Corporation; the Chairman, Board of Directors, Farm Credit Administration; the Secretary of Agriculture; the Secretary of the Treasury; and the Director, Office of Management and Budget. Copies will also be made available to others upon request.

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

Sincerely yours,

Flora H. Milans for

John W. Harman
Director, Food and Agriculture
Issues

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Abbreviations

ERS	Economic Research Service
FCA	Farm Credit Administration
FCS	Farm Credit System
FmHA	Farmer's Home Administration
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency

Results of Survey of Actual and Potential Farmer Mac Poolers

In December 1990 and January 1991, GAO conducted a telephone survey of all 46 original stockholders—35 non-Farm Credit System (FCS) institutions and 11 FCS institutions—that had purchased a sufficient number of shares at the time of Farmer Mac's initial public offering, which was completed in December 1988, to be eligible to apply for certification as Farmer Mac poolers. The survey was to determine what steps eligible stockholders had taken to become certified poolers, how many of them planned to apply, and what factors were important in their decisions on whether to participate in the Farmer Mac I program.

Status of Eligible Stockholders

The December 1988 initial public offering of Farmer Mac stock was made only to financial institutions interested in participating in the Farmer Mac-sponsored secondary market. Farmer Mac set minimum stock ownership requirements for both poolers and originators, depending on the size and type of institution. Farmer Mac may waive these requirements in certain instances. Those interested in applying for certification as Farmer Mac poolers had to purchase at least 5,000 shares of stock, representing an investment of $100,000. This requirement applied equally to non-FCS and FCS stockholders. We did not investigate whether any organizations—other than the 46 that were eligible as of December 1988—now meet Farmer Mac's minimum stock ownership requirements for poolers.

We used responses from 30 organizations—6 FCS and 24 non-FCS—for our analysis because these organizations had originally planned to become poolers when they bought stock and were still eligible to become poolers. More specifically:

- Six of the 11 FCS stockholders are currently involved in a joint effort to form a separate corporation to act as a pooler, leaving a total of 6 FCS organizations in our survey.
- Eleven of the 35 non-FCS stockholders either (1) were no longer eligible to apply for certification, having sold all or part of their holdings of Farmer Mac stock, or (2) purchased the stock strictly for investment purposes, not to become a Farmer Mac pooler. This left a total of 24 non-FCS organizations in our survey.

Of the 24 non-FCS stockholders surveyed, 12 are commercial banks or investment banking affiliates of commercial banks, 6 are investment banks, 4 are insurance companies, 1 is a savings bank, and 1 is an investment banking affiliate of a nonfinancial, agriculture-related business. Most of the non-FCS stockholders are large institutions whose parent organizations' trade or service areas were described as international or national, although 8 of the 12 commercial banks in this group serve a particular region or state. Most of the non-FCS organizations package loans for sale in other secondary markets, including those associated with the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae), the Student Loan Marketing Association (Sallie Mae), and the Small Business Administration. The FCS respondents reported little or no secondary market involvement, although 3 of the 11 Farm Credit Banks have recently become Fannie Mae seller/servicers of rural housing loans.

Few Eligible Stockholders Plan to Become Certified Farmer Mac Poolers

As table I.1 shows, only 6 of the 30 organizations had definite plans to apply for certification as a Farmer Mac pooler at the time of our survey; two of these had already been certified or had applied. Since then, one organization that reported it had plans to apply within 6 months has submitted its application.

Table I.1: Eligible Stockholders' Plans to Apply for Certification as Farmer Mac Poolers

	Number of organizations		
Certification anticipated	**Non-FCS**	**FCS**	**Total**
Had already been certified or had applied	2	0	2
Within 6 months	1	0	1
Within 1 year	0	0	0
Within 2 years	1	0	1
Thereafter	2	0	2
Subtotal	**6**	**0**	**6**
Plans depend on future developments	2	2	4
Do not anticipate becoming a pooler	16	4	20
Subtotal	**18**	**6**	**24**
Total	**24**	**6**	**30**

Steps Eligible Stockholders Had Taken Toward Certification

We asked survey respondents about the steps their organizations might have taken to become a certified Farmer Mac pooler. As shown in table I.2, only eight respondents—in addition to the two who had been certified by June 28, 1991—reported that their organizations had discussed the certification process in detail with Farmer Mac officials at any time since Farmer Mac mailed out pooler applications in October 1989, while nine had not taken any steps toward applying. We asked the 21 that had taken one or more such steps to rate how Farmer Mac officials had addressed their questions and concerns. Seventeen of them said "adequately" or "more than adequately."

Table I.2: Steps Eligible Stockholders Had Taken Toward Certification

Certification status[a]	Number of organizations Non-FCS	FCS	Total
Certified by Farmer Mac	1[b]	0	1
Applied for certification	1[b]	0	1
Prepared an application	0	0	0
Discussed the certification process in detail with Farmer Mac	7[b]	1	8
Reviewed Farmer Mac's operating manual in detail	8	3	11
None of the above	7	2	9
Total	**24**	**6**	**30**

[a]Highest progression made in the certification process.

[b]Since the survey one other organization has been certified and one has applied for certification.

We also found that only 3 non-FCS stockholders reported having contacted more than 10 originators to determine their interest in selling loans to them as a Farmer Mac pooler. Two FCS organizations reported having contacted originators, primarily the FCS institutions in their service areas.

Furthermore, few organizations had dedicated any staff full-time to the Farmer Mac I program during the past 2 years. However, several respondents said that they had invested considerable time and effort in the program. Not all provided an estimate of the expenses they had incurred. Estimates ranged from less than $10,000 to $1 million for non-FCS stockholders, and $10,000 to approximately $500,000 for FCS organizations. We also asked respondents to estimate, on the basis of their experience to date, the start-up cost of a certified Farmer Mac pooler. Again, not all responded, but some estimates were in the range of $500,000 to $1 million.

Factors Influencing Eligible Stockholders' Decisions on Participation

We presented survey respondents with a list of eight possible reasons for not participating in the Farmer Mac I program. This list was based on interviews with selected organizations conducted prior to the survey and on other research. Respondents were asked to rate each of these eight factors as "very important," "somewhat important," or "not at all important." Table I.3 presents these results for the 24 organizations that did not have definite plans to apply for certification.

Table I.3: Relative Importance of Factors Influencing Eligible Stockholders' Decisions Not to Apply for Certification

	Number of organizations		
Factors	Very important	Somewhat important	Not at all important
1. Rates and terms available to borrowers through Farmer Mac may not be competitive.	19	3	2
2. Unless interest rates fall below 10 percent, farmers' demand for long-term, fixed-rate loans may continue to be low.	7	13	4
3. Since overall demand for agricultural credit continues to decline, there may not be enough new loan volume to sustain a viable secondary market.	11	12	1
4. Since loans to agricultural producers are not standardized, a secondary market may not be efficient.	5	14	5
5. Originators think that the Farmer Mac program is too complicated.	6	12	6
6. The new risk-based capital requirements for commercial banks and other regulatory restrictions have made participation in Farmer Mac unattractive.[a]	15	5	3
7. Pooling for Farmer Mac may be less profitable or more risky than our established line of business.	11	10	3
8. We are taking a generally conservative approach to new business ventures at this time.	6	8	10

[a]Responses do not total 24 because 1 respondent did not answer this question.

Eligible Stockholders' Views on the Market's Effects to Date

Finally, we asked respondents what effects, if any, the Farmer Mac-sponsored secondary market has had on agricultural lending to date. We asked whether, for example, the creation of Farmer Mac had led to more uniformity in areas such as accounting procedures for farmers, credit analysis standards, or appraisal methods. Of the 30 respondents, 10 answered that one or more such effects could be attributed to Farmer Mac; 11 said that there had been no such development as a result of Farmer Mac; and 9 expressed no opinion. When asked specifically whether Farmer Mac had increased competition in agricultural lending, only 3 of the 30 respondents said "yes;" 20 said "no;" and the remaining 7 expressed no opinion.

Estimated Interest Rates Available to Borrowers Through Farmer Mac

Estimates of the interest rates borrowers would pay on long-term, fixed-rate loans originated for sale through the Farmer Mac I program vary widely—by more than 2 percent. At the upper end of the range of estimates, these interest rates would not be competitive. Table II.1 presents a comparison of an estimate made by Farmer Mac officials[1] —the lowest estimate we found—with our analysis of the range of figures we obtained from experts from three financial institutions we contacted. These institutions are Farmer Mac stockholders that have been active in promoting the development of the Farmer Mac-sponsored secondary market. To discuss methodology, we also contacted other financial institutions, as well as a team of agricultural economists who are knowledgeable in agricultural finance. The estimates are based on a model that presents (1) the return required by investors in Farmer Mac-guaranteed securities; (2) the fees and expenses associated with packaging the loans for sale, issuing the securities, and servicing the loans; and (3) the return required by holders of the subordinated participation interests in the underlying loans or pools of loans.

Table II.1: Estimated Interest Rates Available to Borrowers Through Farmer Mac

Figures in percent

	Factors in determining borrower interest rate	Farmer Mac's estimate	GAO analysis of experts' estimates	Difference
1.	Return on Farmer Mac-guaranteed securities	9.30–9.40	9.45–9.90	.15–.50
	Yield on U.S. Treasury securities	8.00	8.00	0
	Mortgage-backed securities spread	1.30–1.40	1.45–1.90	.15–.50
2.	Fees and expenses	.85–.95	.90–1.25	.05–.30
	Farmer Mac guarantee fee	.25	.25	0
	Trustee fee	.10	.10	0
	Other securities issuance fees and expenses	.10	.10–.15	.00–.05
	Pooler administrative expense	[a]	.05–.25	.05–.25
	Loan servicing expense	.40–.50	.40–.50	0
3.	Impact of return on subordinated participation interests	.10–.30	.40–1.75	.30–1.45
	Total	10.25–10.65	10.75–12.90	.50–2.25

[a]Farmer Mac's estimate does not include this category.

[1]See Tom Olson and Tom Clark, "Farmer Mac: Full Steam Ahead," Northwestern Financial Review, Vol. 175, No. 49 (Dec. 8, 1990), pp. 22-26.

As the first section of table II.1 shows, the return required by investors in Farmer Mac-guaranteed securities backed by long-term, fixed-rate loans depends primarily on the return or yield investors can obtain on long-term U.S. Treasury securities. That is, as the interest rates on U.S. Treasury securities rise and fall, the interest rates available to borrowers through the Farmer Mac I program will do the same. Investors also require a differential or "spread" over the yield on U.S. Treasury securities—which may vary over time—to compensate for the greater risk of investing in home mortgage-backed securities. While Farmer Mac officials maintain that this spread will be the same for Farmer Mac-guaranteed securities as it is for home mortgage-backed securities, the experts say it could be as much as .50 percent higher, at least for the initial phases of the new market's development, for two primary reasons. First, according to investment bankers, an active market for Farmer Mac-guaranteed securities will probably not develop until investors are comfortable with the securities. Second, it may take several years to develop the kind of statistical information on agricultural real estate and rural housing loans that investors in home mortgage-backed securities use to evaluate the risk that borrowers will default or pay off the loans prior to their scheduled maturity dates.

In the second section of table II.1, there is a smaller variation—.05 to .30 percent—between Farmer Mac's estimate and the experts' estimates of the impact of fees and expenses associated with issuing Farmer Mac-guaranteed securities and packaging the loans for sale through the Farmer Mac I program. This is largely explained by Farmer Mac officials' omission of the category labeled "pooler administrative expense." This category covers such expenses as the cost of marketing the pooler's services to originators, monitoring originators' performance, and assuming financial risk while pools of loans that meet the geographical and commodity diversity requirements are being formed. Farmer Mac officials take the position that these expenses are included in the category labeled "loan servicing expense," while some of the experts said that the amount in this category will cover only routine accounting, reporting, and borrower contact.

The last section of table II.1 shows that holders of subordinated participation interests in the pools of loans backing Farmer Mac-guaranteed securities could demand a significantly higher rate of return than Farmer Mac officials have estimated. This translates to a difference of .30 to 1.45 percent in the estimates of borrowers' interest rates. This required rate of return may vary, depending on whether the subordinated participation interests are held by the originator, the pooler, a third party, or some combination of holders. Farmer Mac officials estimate the required rate of return on the subordinated participation interest at 11 percent to 13 percent, while the estimates that we obtained ranged from 12 percent to 25 percent.

Regulatory Treatment of Loans Sold Through Farmer Mac by Banks and FCS Institutions

This appendix describes the regulatory treatment of sales of loans through the Farmer Mac I program by banks and FCS institutions under the new risk-based capital requirements.

Risk-Based Capital Requirements

The Office of the Comptroller of the Currency (OCC), which regulates national banks, published guidelines on its risk-based capital requirements in January 1989. Similar guidelines have been adopted by the other U.S. bank regulators. The Agricultural Credit Act of 1987 mandated risk-based capital requirements for FCS institutions, which are described in Farm Credit Administration (FCA) regulations published in October 1988.

The new risk-based capital requirements for banks are consistent with the international framework for capital adequacy standards established in July 1988 by the Basle Committee on Banking Supervision, which meets under the auspices of the Bank for International Settlements. These requirements represent the culmination of efforts over several years to develop internationally consistent capital standards. Concern about capital adequacy—whether a bank's capital is sufficient to support its activities—centers on capital's role as a buffer to absorb unexpected losses that an institution's current earnings cannot cover. The new capital adequacy standard is a ratio of total capital to total risk-weighted assets. Banks were required to meet an interim standard of 7.25 percent by December 31, 1990. The December 31, 1992, final standard is 8 percent. FCS institutions must meet a 7-percent standard by January 1, 1993.

The changes that have been made in banks' capital requirements have primarily involved definitions of capital, risk weights on assets, and inclusion of off-balance-sheet activities. Risk weights refer to percentage figures assigned to asset categories, such as loans, on the basis of broad categories of credit risk. Assets with a high-risk profile are assigned a high weight while lower-risk assets are assigned a lower or zero weight. Off-balance-sheet activities refer to transactions involving assets or liabilities of a bank that are not necessarily reported on its balance sheet under current accounting rules. Under the risk-based capital guidelines, the face amount of an off-balance-sheet item is converted to an amount that permits it to be related to an on-balance-sheet asset in terms of credit risk. This amount is then risk-weighted to determine the amount of capital required.

Off-balance-sheet items include asset sales with recourse, such as sales of loans through the Farmer Mac I program in which a bank retains a subordinated participation interest in the loan or in the related pool of loans.[1] Recourse refers to a financial institution's acceptance, assumption, or retention of some or all of the risk of loss generally associated with ownership of an asset, whether or not the institution owns or has ever owned the asset. In the past, banks and savings and loan associations, in calculating regulatory capital requirements, did not include loans sold with recourse through certain Fannie Mae and Freddie Mac programs, even though these banks and savings and loan associations retained up to 100 percent of the risk of loss associated with those loans. Recent amendments to regulatory guidelines have clarified that risk-based capital is required for such sales.

Regulatory Treatment of Sales of Loans Through Farmer Mac

The OCC provided guidance on the regulatory treatment of sales of loans through the Farmer Mac I program by national banks in October 1990 in its Banking Circular 248, including the treatment of such sales under the new risk-based capital guidelines. Other bank regulators will probably propose similar guidelines. FCA proposed similar guidelines for FCS institutions on January 23, 1991.

If a loan is sold through the Farmer Mac I program without recourse—that is, if no subordinated participation interest is retained—no risk-based capital requirements apply to the sale. If a loan is sold with recourse, the regulatory treatment varies according to how the risk involved in holding a subordinated participation interest in the loan is shared. For example, the holder of a subordinated participation interest may (1) assume responsibility for the specified amount—usually the first 10 percent—of losses in case of nonpayment or default for a single loan or (2) share this responsibility for a pool of loans backing a Farmer Mac-guaranteed security with other holders on a pro-rata basis. The instrument representing the second arrangement has become known as a "diversified subordinated interest" and is expected to take the form of a separate security.

Under either arrangement, the risk-based capital requirement is the same. In effect, the bank or FCS institution must allocate capital as if the

[1] Although poolers or originators may also establish a cash reserve in order to qualify for a Farmer Mac guarantee on the loans they sell through the Farmer Mac I program, few are likely to choose to do so because of the relatively higher cost of this alternative.

loan itself were still on its balance sheet and had not been sold. However, under the second arrangement, banks and FCS institutions may exclude the entire amount of a loan sold through the Farmer Mac I program—including the investment in the security representing a diversified subordinated interest—in calculating the amount of credit extended to any one borrower for purposes of complying with statutory lending limits.

Banks and FCS institutions generally may be the holders of subordinated participation interests only in connection with sales of their own loans through the Farmer Mac I program and only in an amount corresponding to the amount of loans they sell. The total amount of subordinated participation interests that a bank may hold may not exceed 25 percent of the bank's capital. An FCS institution may purchase subordinated participation interests from non-FCS institutions only if the FCS institution is acting as a pooler of the related loans. These restrictions reflect safety and soundness concerns over holdings of subordinated instruments generally.

Comments From the Federal Agricultural Mortgage Corporation

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

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June 28, 1991

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

Dear Mr. Bowsher:

See comment 1.

Thank you for providing us with the opportunity to review and comment on the draft GAO report entitled: "Federal Agricultural Mortgage Corporation: Secondary Market Development Slow and Future Uncertain" (hereafter referred to as the "Report"). The Report states that it is being prepared in response to a request by Congressman Glenn English, Chairman of the Subcommittee on Conservation, Credit and Rural Development, Committee on Agriculture of the United States House of Representatives.

See comment 2.

Let me begin by first expressing our appreciation to the GAO staff who worked on this report for their cooperation with Farmer Mac and for the opportunities they accorded us to provide information to be integrated into the review process. The resulting Report, by-and-large, has identified issues that we, too, recognize as having affected the progress of development of the Farmer Mac secondary market. Further, we are pleased to note that the problems identified in the Report stem from factors associated with the <u>current economic conditions</u> in the agricultural credit industry and the <u>statutory structure</u> of the secondary market authorized for agriculture, rather than from any errors or flaws identified by GAO in the implementation effort undertaken by the Farmer Mac Board and management. The uncertainty expressed in the Report with respect to the future viability of Farmer Mac is not surprising, we believe, given the premature timing of the review it reflects and the fact that *the Report gives only passing consideration to the significant program refinements adopted by Farmer Mac in response to many of the same factors credited in the Report for the failure of lenders and poolers to become active participants in the program.*

See comment 3.

More specifically, although the Report appears fair and balanced in its discussion of the specific issues identified, we are concerned that the overall impression conveyed by the Report is not an accurate assessment of the value, merit and potential for success of the Farmer Mac agricultural secondary market in the long term. The title, for example -- "Secondary Market Slow and Future Uncertain" -- conveys a level of negativity regarding Farmer Mac not supported by the text of the Report. In addition, the Report focusses on current economic conditions in the agricultural credit sector

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(falling debt levels, excessive lender liquidity, interest rate competitiveness and poor demand for long-term fixed rate loans), in assessing the need for Farmer Mac, but fails to look at historic conditions and cyclical trends in the agricultural credit sector or to evaluate the need for Farmer Mac as a long-term proposition. We believe the Report would be more productive if GAO had looked at the reasons Congress authorized Farmer Mac in 1987, and evaluated whether the need for Farmer Mac as a long-term proposition has changed since its creation, rather than focussing on the short-term conditions that impact more on the pace of development than on the need for the program.

Having said this, we agree with GAO that the factors identified in the Report have discouraged early participation in the Farmer Mac programs. Our view of the future, however, is much more positive than GAO's, resulting in part from the fact that the Report is based on information that is in many cases several months old (the pooler survey for example). Since the end of 1990, several important developments have taken place at Farmer Mac that support a much more optimistic outlook of the prospects for more active participation on the part of lenders and potential poolers than is reflected in the Report. Interest in Farmer Mac II is clearly growing with each transaction. We are in daily contact with many lenders and currently have new commitments for the sale of more loans in that program. Also, in the wake of the announcement of the Linked Portfolio Strategy, some of the potential poolers that GAO surveyed and found to be disinterested in Farmer Mac have now expressed serious interest in becoming actively involved in Farmer Mac. With these developments currently unfolding, we believe that the negative assessment of the future viability of Farmer Mac, expressed in the Report, is inaccurate and seriously outdated.

See comment 4.

As you know, Farmer Mac presented a complete review of the development of the secondary market to date and the challenges we have faced at a June 13, 1991 hearing before the Subcommittee chaired by Congressman English, at which GAO also testified. We believe that our testimony at that hearing provides a fair and objective response to the points raised in this Report and that those points should have been addressed in the draft Report published two weeks after the testimony. Accordingly, the balance of this letter restates the substance of Farmer Mac President Henry Edelman's statement at that hearing.

See comment 5.

Farmer Mac now has two secondary market programs in place and operating, serving a broad spectrum of agricultural and rural borrowers. In Farmer Mac I, the original authority under the Agricultural Credit Act of 1987 (the Act), there are currently two certified poolers. An application from a third potential pooler has been received by Farmer Mac and is currently being evaluated. Although as of this date no mortgage-backed securities have been issued by these poolers under the Farmer Mac I program, we know that the poolers are currently analyzing loan data on nearly $2 billion of potentially qualified loans. Significantly, that data was obtained from several major lenders representing commercial banks, insurance companies and Farm Credit System institutions, all interested in selling the loans into Farmer Mac pools. Subject to the

See comment 6.

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loans qualifying under the Farmer Mac standards, and compliance with the other requirements for Farmer Mac pools, we are optimistic that the first Farmer Mac I securities could be issued in the next few months.

In Farmer Mac II, the new secondary market for Farmers Home Administration (FmHA) guaranteed loans authorized in the 1990 Farm Bill, we have developed a highly efficient program that has already produced $2.5 million in guaranteed securities. New fixed rate and floating rate pools are currently being formed, and we anticipate pool closings on a regular basis.

Turning for a moment to the pricing breakthrough mentioned earlier, Farmer Mac has developed an alternative mechanism for Poolers to price Farmer Mac guaranteed senior securities. That mechanism may be used when the interest rate on pooled loans is based on Farmer Mac's Cost of Funds Index (COFI). As the table below illustrates, the currently indicated rates represent a dramatic improvement in the economics of the Farmer Mac I secondary market.

See comment 7.

	Rate Reset to Farmer Mac COFI	Required Yield to Farmer Mac
Short-Term Interest Rate Reset, Open Prepayment Loans:	3 Month	6.95%
	1 Year	7.80%
Medium-Term Interest Rate Reset, Yield Maintenance Loans:	3 Year	7.85-7.90%
	5 Year	8.70-8.80%
	10 Year	8.95-9.25%

As a direct result of this improvement in the economics of the program, Farmer Mac I transactions are now more clearly in sight. In addition, a resurgence of pooler interest in being seen. Several of the institutions who purchased enough Farmer Mac stock to become poolers, but watched from the sidelines for the past two years, have now expressed interest in becoming poolers. One major agricultural lender is completing a pooler application and several others are reviewing the documents they would need to complete. At last, it appears that farmers and ranchers who qualify under the Farmer Mac I underwriting standards will have the benefit of loans with interest rates based on these highly competitive senior security yields.

We would like to review how we arrived at these pricing breakthroughs. We had initially organized and implemented Farmer Mac I to operate as a mature mortgage-backed securities market participant, similar to the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac") as they currently exist. We, and many market participants, did not believe it

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would be necessary for Farmer Mac to duplicate the evolutionary processes that got Fannie Mae and Freddie Mac to where they are today.

That strategy probably would have worked well, but for a number of factors (some of which were also discussed in the Report) that developed in the agricultural and financial markets during 1989 and 1990. A growing surplus of lending capital was chasing a shrinking number of agricultural loans. Moreover, the interest rates on those loans were being driven by non-financial factors that went beyond the capital market efficiency a mature secondary market can support -- such as the need of competing sectors of the industry to maintain or increase their market shares. Many lenders had responded to borrower demand for lower rates by offering long term credit at competitive, but short term, rates or at intermediate term rates, often including some form of protection of the lender against prepayment risk. Under those circumstances, the normal "mortgage-backed security spread," the component of mortgage interest rates that compensates investors for the uncertain prepayment characteristics of mortgages as compared to bonds, was not fully reflected in rates. This sharply diminished the competitiveness of rates available in conventional transactions in the mortgage-backed securities market, which generally requires those spreads.

Our activities in starting the Farmer Mac II market during the early months of 1991 gave us new insights into the loan pricing problem. As we geared up to fund our purchases of FmHA guaranteed loans through a discount note program, we saw that Farmer Mac could access debt at rates comparable to Fannie Mae and Freddie Mac, despite its newness and relative small size in that market. On May 2, 1991, a $50 million offering of Farmer Mac 90-day discount notes was priced at a bond-equivalent yield of 5.76%, a rate equal to that achieved by Fannie Mae on the same terms that day. This was in sharp contrast to the relatively wider mortgage-backed securities spreads that would have been available for Farmer Mac guaranteed mortgage-backed securities. It immediately became evident to us that Farmer Mac could most readily accomplish its statutory objectives by retracing the development of the other agencies.

The first step came in Farmer Mac II. On Monday, May 6, 1991, Farmer Mac announced a new pricing structure for certain variable rate guaranteed loans under the Farmer Mac II program. For lenders who index their variable rate loans to a new Farmer Mac Three-Month Cost of Funds Index (COFI), the "Net Yield" required to be paid by the lender to Farmer Mac on guaranteed portions of FmHA guaranteed loans sold into Farmer Mac II was 6.95%, and continues at that level on this date. The Farmer Mac II Net Yield for loans tied to our One-Year Cost of Funds Index was initially 7.75%, and is now 7.80%. These rates, which represent the total yield required by Farmer Mac from the guaranteed portions of FmHA guaranteed loans sold into our secondary market, are a dramatic reduction in the funding cost to lenders who make these loans to FmHA borrowers and sell the loans into the secondary market. Lenders who view these numbers as a cost of funding can make floating rate loans to farmers and ranchers who qualify for the FmHA guaranteed loan programs at dramatically lower

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rates than have previously been available based on Prime. We see this as a major step in the realization of the benefits for farmers and ranchers intended by Congress when the Farmer Mac II legislation was passed and amended in the 1990 Farm Bill.

The second step came in Farmer Mac I. On Thursday, May 9, 1991, the Farmer Mac Board of Directors authorized the implementation of a modified approach to the establishment of the secondary market. This new strategy is a major development in the implementation of the Farmer Mac I secondary market. It was strongly supported by the Farmer Mac Board, including representatives of a wide cross-section of our stockholders. It promises to be a key to the initiation of loan pooling activity under the Farmer Mac I program. We have already received strong indications of interest in this new opportunity from the Farmer Mac poolers. Equally important, there has been a resurgence of interest in the program by institutions own enough Farmer Mac stock to apply for pooler certification but have so far chosen not to do so.

See comment 8.

Under this modified approach, a Farmer Mac subsidiary will purchase certain senior securities issued by poolers in accordance with the standards of the Farmer Mac I program, as reviewed by Congress in September 1989. Farmer Mac will require that each pool pass its stress test, based on the same high standards under which the program was implemented. *It is important to emphasize that Farmer Mac will* ***not*** *take on any greater credit risk under this strategy than under the existing strategy.* Farmer Mac will fund the purchases of the senior securities with its own straight debt issued directly into the public capital markets. The mortgages backing the senior securities can have any final maturity, but the interest rate must be tied directly to the Farmer Mac Cost of Funds Index corresponding to the maturity or interest rate reset period of the loan. The initial level of the Index for the loan will be determined by the actual yield on associated Farmer Mac debt issuances. This will eliminate any Farmer Mac exposure to interest rate risk. Open prepayment is acceptable for loans with reset periods or final maturities that do not exceed one year. Protection against the risk of prepayment ("yield maintenance" or its equivalent) must be provided to Farmer Mac if the reset periods exceed one year. The rates are recalculated and published weekly, to enable lenders to monitor pricing.

It has been two years since the management team took office and began to shape the Congressionally designed statutory outline for Farmer Mac into a functioning, developing business with detailed operating policies and procedures and effective business strategies and tactics. We would like to review the development of Farmer Mac over the last two years, our significant accomplishments and the numerous obstacles we have faced and addressed. Finally, we will review the outlook for Farmer Mac as we see it at this time.

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Development of Farmer Mac

- Background

Farmer Mac's accomplishments during the past two years are best understood in the context of the circumstances that gave rise to the creation of the Corporation. In 1987, the agricultural lending community had just gone through the most serious credit crisis it had confronted since the Great Depression of the 1930's. This prompted concern in the United States Congress that farmers, ranchers and rural homeowners might someday be without stable sources of long-term credit. In response to those concerns, Congress passed legislation at the end of 1987 to facilitate the creation of a secondary market for agricultural real estate and rural housing mortgages. The purpose of the new secondary market, which gave Farmer Mac its corporate mission, was to:

- increase the availability of long-term credit at competitive rates of interest;
- enhance lender liquidity and loan capacity; and
- provide agriculture with new sources of funding through the capital markets.

To carry out that purpose, it was determined that the new Government-sponsored enterprise needed to focus on agricultural and rural housing mortgages the same way the Fannie Mae, Freddie Mac and the Government National Mortgage Corporation (Ginnie Mae) focus on residential mortgages in metropolitan areas. Through the efforts of many farm, agricultural commodity and lending associations, Farmer Mac was authorized in January 1988.

Thus, Farmer Mac was created by Congress as a federally chartered corporation under the Agricultural Credit Act of 1987. Farmer Mac was established as an institution of the Farm Credit System (FCS), but unlike the banks and associations of the FCS, Farmer Mac was to facilitate the creation of a secondary market equally available to all agricultural lenders and would not perform direct lending to borrowers. Farmer Mac is governed by a Board of Directors representing all the major sectors of the agricultural credit industry and of the public. As a result, Board members representing the banks and associations of the FCS, commercial banks, insurance company lenders, agricultural producers and capital market participants, provided input in the development of Farmer Mac's programs. Despite their diverse backgrounds, the members of the Farmer Mac Board have joined together to develop and foster the secondary market under very difficult circumstances.

The function of Farmer Mac, as a secondary market, is to provide access to the capital markets for all lenders of qualified agricultural and rural housing loans to enable

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them to *sell* loans they have made to borrowers from funds otherwise available to them from deposits or their own borrowings. The secondary market does not lend money to the lenders, it facilitates the sale of loans and allows the lenders to focus on the process of loan origination and servicing, rather than on the task of managing credit and interest rate risks associated with the lending industry. Managing those types of risks can be accomplished much more effectively when it is done on a large scale -- in terms of billions -- by the investors in the capital markets of this nation. The benefits that can flow to borrowers from the availability of Farmer Mac are: increased competition among lenders; greater availability of credit over the long haul; increased uniformity of loan application forms and lending standards; wider access to a broader choice of loan products, such as long-term loans and fixed-rate loans; and ultimately, more competitive interest rates. In the case of the agricultural lenders who will be using Farmer Mac the benefits involve: increased uniformity of loan origination forms, procedures and standards; ready access to attractively priced funds from capital market investors who buy the guaranteed securities; fairer competition among lenders in the different segments of the industry; the opportunity to offer a broader range of loan products to borrowers and to serve both the long-term and the short-term credit needs of those borrowers at the same time; the opportunity to focus earnings on risk free fee income from loan origination and servicing while eliminating most of the interest rate and credit risks that they otherwise face on loans held in portfolio; and the opportunity to diversify their credit exposure through participation in national or regional loan pools.

While Farmer Mac resembles Fannie Mae, Freddie Mac and Ginnie Mae as to the structure of its programs, it is not directly analogous to any of them. The comparisons seem plausible, but cannot be sustained when it comes down to practical details. In many ways, Farmer Mac is an original. It is the first secondary market entity required to make use of a cash reserve or subordinated interest in every loan pool formed and securitized; it is the first to have its underwriting, appraisal and diversification standards reviewed by Congress; it is the first to guarantee securities that must be registered with the Securities and Exchange Commission. Of particular significance, it was the first to deal with non-residential, commercial loans. Moreover, the loans have diverse collateral characteristics unfamiliar to capital market investors. The operations backing the loans lack uniform financial and accounting data due to the absence of any industry-wide accounting standards or even terminology. Agriculture was an industry with no standard lending practices and no meaningful industry-wide historical loan performance data. The list of firsts goes on and on, but the point is that Farmer Mac was not able to follow the paths of the other secondary markets. Rather, it has had to blaze a new trail, encountering and solving many novel problems along the way.

In November of 1988, Farmer Mac was capitalized in accordance with the statutory requirements through the sale of approximately $20 million worth of common stock to the institutions of the Farm Credit System, commercial banks, insurance companies, investment banks, mortgage companies and other types of financial institutions that make agricultural or rural housing mortgage loans. None of the stock was sold to the federal government, and no appropriations of taxpayer money are made

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to fund the operating expenses of this corporation.

The Offering Circular under which Farmer Mac's stock was originally offered for sale in October 1988, under the heading "Risk Factors", stated that "the level of involvement of Originators and Certified Facilities [poolers] in the Farmer Mac program. . . will affect the profitability of Farmer Mac." The success of the business as a whole therefore is tied to use of the many individual franchises acquired by potential participants when they purchased their Farmer Mac stock.

Ongoing recognition of the franchise aspect of the Farmer Mac program by stockholders is critical to the level of success Farmer Mac will be able to achieve. It was understood at the outset that Farmer Mac stock was not simply a conventional stock investment that could be expected to increase in value and begin paying dividends in the short-term. It was understood that, conversely, the stock purchase represented an investment in a start-up corporation with "no operating history," similar to a venture capital investment in a start-up corporation, and that the corporation first had to be set up and then develop its secondary market business. Moreover, it was understood that such development would take time and would require expenditures to be made <u>before</u> income or dividends could be generated, just as is the case for any start-up business. In fact, the "Risk Factors" section of the Offering Circular stated further that "There has been no significant secondary market for agricultural mortgage loans. It is uncertain <u>if</u> or <u>when</u> an active secondary market for agricultural mortgage loans will be developed." and that "Farmer Mac may require each Originator and Certified Facility to make <u>non-refundable</u> capital contributions to meet the administrative expenses of Farmer Mac." (Emphasis added.)

Once the Farmer Mac stock was sold, the stockholders had to elect the permanent Board of Directors, and did so in accordance with the <u>minimum</u> timing requirements of the governing securities laws in early March 1989. The Board then immediately began its search for management qualified to carry out the Farmer Mac mission. The first members of the management team identified took office on June 1, 1989.

Now, about two years after management was hired by the Farmer Mac Board of Directors, we have completed the full development of <u>two</u> secondary market programs. We have also provided the agricultural credit industry with a number of important tools for its use in improving the soundness and efficiency of the credit system available to farmers, ranchers and rural residents. For instance, the first nationally accepted credit underwriting standards have been developed by Farmer Mac along with a model note and mortgage form. Standardization of the appraisal process and report forms for agriculture has been accelerated by Farmer Mac and uniform loan application forms have been developed for use by these lenders. In addition, Farmer Mac has not only provided an efficient computer program for its own standard application forms package, but has now completed development of such a program for the loan forms used by the Farmers Home Administration (FmHA) for guaranteed farmer program loans. This is

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just to mention only a few major accomplishments as a prelude to our most recent accomplishment -- the pricing breakthrough mentioned earlier.

With the approval of the modified Farmer Mac I strategy by the Farmer Mac Board on May 9, 1991, we are now able to offer favorable mortgage-backed securities pricing to the banks and associations of the FCS, to the commercial banks and to the insurance company lenders for loans and loan pools under certain conditions. The significance of this program is that it will provide a major new incentive for all lenders to offer competitively priced loans to agricultural and rural borrowers.

The modification of the program mechanism is a detail of "how" Farmer Mac will initially apply the provisions of the Act and carry out the intent of Congress, in a manner consistent with the provisions of the Act. We have always taken those provisions seriously, and have carried them forward faithfully into the Farmer Mac I Securities Guide and the Farmer Mac II Loan Purchase Plan. By one means or another, we can always adapt "how" Farmer Mac will do business, but "why" Farmer Mac will do business is a covenant among ourselves, our stockholders and Congress, based on the statement of our corporate mission in the Act. The Board of Directors and management of Farmer Mac are committed, above all, to the accomplishment of that mission. We recognize that there are and will continue to be hurdles to overcome on the way to its full realization, but we intend to persevere and innovate to ensure the success of Farmer Mac for our stockholders and for farmers, ranchers and rural homeowners throughout this nation.

It is impossible to talk about the our progress during the last two years or the outlook for the future without discussing several key factors in the regulatory and business operating environments that affected Farmer Mac and its Originators and Poolers in major ways.

- Regulatory Issues

During 1989 and 1990, federal regulatory issues -- matters not addressed in the statute that created Farmer Mac -- created significant uncertainty and arose as obstacles to lender access to the program. In early June 1989 Farmer Mac President Henry Edelman first met with the Comptroller of the Currency to discuss the regulatory treatment of national banks that would sell loans into the new program. During the late summer and early fall of 1989, as Farmer Mac was preparing for Congressional hearings to review its credit underwriting, appraisal, diversification and other standards, the Office of the Comptroller of the Currency (OCC) focussed upon a number of questions about the application of bank lending limits and regulatory capital requirements to loans originated and sold into a Farmer Mac pool. The OCC took the position that, with regard to the banks it regulates, loans sold into a Farmer Mac pool would not be considered "sold" for purposes of lending limits and risk-based capital guidelines if the bank retained the minimum 10% subordinated interest in the pool required by the Farmer Mac statute.

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The OCC position on lending limits immediately raised a serious obstacle to participation in the Farmer Mac program by community bankers who were frequently lent to their limits with their best customers and were counting on being able to sell any new loans made to these same borrowers. For more leveraged community banks, and for many larger banks with a potential interest in becoming Farmer Mac poolers, the OCC position on risk based capital would require them to hold high-cost capital against loans and loan pools as if they had not been sold.

These regulatory concerns, which had not been addressed in the Farmer Mac statute, placed a serious chill on the enthusiasm of the many bank participants that had been expected to be early participants in the Farmer Mac program. For many banks, the OCC position was a serious obstacle if not an outright block to program participation. In September 1989, Farmer Mac representatives initiated the first in a long series of meetings with OCC staff to find a solution that would not hinder program implementation. The process that ensued involved an enormous effort by Farmer Mac and industry representatives and consumed a period of about ten months, during which the bankers waited on the sidelines -- legitimately -- for the outcome. In the meantime, despite completion and distribution of the Securities Guide and announcement of the initiation of the Farmer Mac secondary market, would-be bank originators and poolers began to lose interest.

The solution, such as it was, came at the end of June 1990, in the form of a letter from the OCC indicating that the lending limit requirement would not apply to loans sold into Farmer Mac pools by banks that receive a corresponding diversified subordinated interest in the pool. In that same letter, OCC also addressed the eligibility of banks to own the subordinated securities in the first instance, coming to the conclusion that, subject to certain limitations favorable to banks as originators but not as poolers, such ownership would be permitted. In October 1990, the OCC decision was formalized with the issuance of a Banking Circular. The Farm Credit Administration (FCA) reached similar conclusions with respect to the Farm Credit institutions under its regulatory authority, and resolved the capital issue for its regulated entities in a way that did not encourage participation in the new secondary market.

OCC did not, however, resolve the capital issue, which continues to be a disincentive to bank participation to the present time. OCC deferred resolution of that issue to the Federal Financial Institutions Examination Council (FFIEC), which had a related rulemaking proceeding underway. This process was slated for final decision by the end of December 1990 when the risk based capital guidelines would become effective. Last December, FFIEC announced a one-year delay in the anticipated rulemaking decision, leaving the capital obstacles firmly in place for Farmer Mac program participants.

Considerable efforts to resolve those issues were made by Farmer Mac and lender organizations during the first half of 1990. Despite the previously mentioned limitations, the OCC action in late June was sufficient to rekindle the interest of many

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agricultural lenders. This cleared the way for Manufacturers Hanover Securities Corporation to submit the first pooler application in August, which we approved in September, and opened a direct link between agricultural lenders and a participant who could officially purchase their loans for sale into the new secondary market. Management worked extensively with the new pooler to help initiate its operations.

At the same time, we continued to encourage other potential poolers to step forward. Those efforts resulted in Farmer Mac's receipt in December of a second pooler application, from Goldman Sachs Mortgage Company. Subsequently, in January 1991, that firm was certified as the our second pooler. Farmer Mac has developed an extensive network of contacts among prospective Originators and has worked closely with both Poolers to help establish working relationships among them.

It is significant that, while the capital issue has not been resolved favorably, Farmer Mac's new pricing strategy provides economics that significantly ameliorate the problem. The lower senior security yields achievable in the Farmer Mac I program should enhance the value of the subordinated interest or reserve and so facilitate sale of that interest. Meanwhile, the enhanced economics could make holding the subordinated interest a neutral or even slightly favorable financial opportunity for originators and poolers.

- Business Conditions

In addition to the regulatory issues Farmer Mac faced in 1989 and 1990, adverse economics also impeded pooling activities.

High interest rates and declining farm debt were the primary adverse economic factors. Following the initial capitalization of Farmer Mac in late 1988, long-term interest rates rose and remained at levels that discouraged long-term fixed rate borrowing during 1989 and much of 1990. Short-term rates were low, and there were predictions of declines in long-term rates (which finally materialized in late 1990). This predisposed borrowers toward short-term variable rate financing. Consequently, potential poolers became uncertain that they could generate adequate long-term fixed rate loan volume to support pooling operations.

Although agricultural interest rates declined during the fourth quarter of 1990, the higher rates of the preceding seven quarters tainted the environment for initiation of the secondary market and contributed to frustrating delays in program implementation.

There was a dramatic 31% decline in total farm debt from the 1983 peak of $192.7 billion to $133.9 billion in 1990, the lowest level since 1978. This has dampened loan demand and resulted in excess liquidity and lending capacity for many agricultural lenders. Average loan-to-deposit levels at agricultural banks declined during 1989 and the first half of 1990 to an undesirably low 55.3% according to statistics published by USDA's Economic Research Service. Loan activity had improved slightly by year end

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1990, but no significant change in demand for funds occurred. The decline in total farm debt has recently slowed, but excess lending capacity remains a major short-term disincentive to the sale of loans by agricultural lenders.

- Other Factors

The organizations that represent our stockholders as agricultural lenders worked hard to obtain the legislation that created Farmer Mac. What they succeeded in getting was a state of the art secondary market for agricultural credit. "State of the art" here means that the senior/subordinated security structure was built into the statute that created Farmer Mac. It is critical to recognize that, while that structure may seem complicated, it draws upon principles that have existed for years in the banking and loan factoring industries, long before secondary markets were created. By polarizing interest rate risk in the senior securities and credit risk in the subordinated securities and providing Farmer Mac as the underwriter of catastrophic credit risk, Congress made it possible for agriculture to have access to a market which has resisted the securitization of commercial credit for many years due to its lack of standardization.

Farmer Mac and the poolers have undertaken extensive educational efforts to raise the comfort level of lenders and poolers with the senior/subordinated security structure. Nevertheless, the required use of that structure has slowed the progress of efforts to form the first loan pools. In addition, the lack of any meaningful industry-wide historical data on the performance of agricultural loans, combined with investors' lack of familiarity with agricultural operations, created uncertainty among investors. This uncertainty caused a yield premium to be required on the senior Farmer Mac guaranteed securities and made it difficult to market the subordinated interest, even at a significant yield premium above the senior security rate.

Another major challenge we faced in the process of implementing the secondary market was a preconception by many potential participants that somehow the secondary market would just *materialize* and immediately provide lenders with a new source of competitively priced credit. Recognition of the franchise aspect of the Farmer Mac program and the need for the participation of stockholders will continue to have a strong impact on the level of service Farmer Mac will be able to provide to farmers and ranchers.

- Business Developments

Farmer Mac began 1990 with the distribution of the Farmer Mac I Securities Guide in January 1990. *Ever since that time, Farmer Mac has been open for business and ready to guarantee securities.*

Throughout the first half of 1990, the Board and management focussed their attention on the process of educating originators and poolers about the operating details

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and business opportunities of the Farmer Mac program. Presentations were made to all of our major stockholder organizations, and meetings were held with many other interested financial, commodity and trade groups. AGPAK I, our computer software package that simplifies the completion of application forms, was made available to lenders at a nominal charge. Model note and mortgage forms -- a first for agricultural lending -- were drafted for use in the Farmer Mac program.

In the fall of 1989, the U.S. Department of Agriculture first contacted Farmer Mac regarding the possibility of expanding our program to include the guaranteed portions of FmHA guaranteed loans. This initial contact resulted in the development of a Memorandum of Understanding between USDA and Farmer Mac and ultimately the submission of proposed legislation to authorize the expanded program. After considering compelling arguments by the Department of Agriculture, Farmer Mac, and many groups that have continuously supported Farmer Mac, Congress concurred. The authority for this new program, now known as "Farmer Mac II," was included in the 1990 Farm Bill which President Bush signed into law on November 28, 1990. That action expanded Farmer Mac's charter and provided near-term prospects for the securitization of loans and business revenue from guarantee fee activity on the securities issued.

From November 28th until the end of the year, we worked to develop the new program. A concise operating manual for Farmer Mac II -- the "Loan Purchase Plan" -- was drafted in December 1990 with the help of an industry task force and distributed to over 7,000 lenders during January 1991. Farmer Mac II was designed as an easy-to-use program available to all lenders who originate FmHA guaranteed farmer loans. Farmer Mac II accepts loans that conform with the FmHA program, and the FmHA Guaranteed Portions of those loans are purchased directly by Farmer Mac.

Vigorous marketing efforts have identified considerable interest in the Farmer Mac II program among agricultural lenders, transactions have been completed and the potential for significant business during 1991 is very good. In addition, our continuing support and assistance to the Farmer Mac I certified poolers is beginning to generate promising opportunities for substantial business under the original Farmer Mac I authority.

Coming into 1991, the solid institutional cornerstone of Farmer Mac was in place. The foundation for future growth of business operations is real. Economic and regulatory influences, however, will continue to have a considerable impact on the inclination of lenders and borrowers to step forward and use the new tools we have provided in the course of creating the secondary market.

Favorable Outlook

Farmer Mac is well positioned for business growth during 1991. The Corporation's credibility and acceptance have been enhanced by the addition of the

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Farmer Mac II authority and the programs's rapid development, start-up and growing business. Economic conditions for secondary market participation have improved in several respects and appear to be following favorable trends. Changes in agricultural program policies and reduced levels of monetary price support for agriculture may result in increased demand for agricultural credit. As a result of the work of the Farm Financial Standards Task Force, the industry is becoming more uniform in its approach to the collection, analysis and reporting of agricultural financial information. This will facilitate the acceptance of Farmer Mac's application procedures in the market. Finally, although the regulatory obstacles to Farmer Mac's development have not been totally eliminated, regulatory changes made during 1990 will facilitate secondary market participation in 1991 by many important lenders.

The nature of our business is such that corporate earnings will build in annuity "layers" as guarantee volume builds. The guarantees Farmer Mac provides in one year will generate continuing fee income in subsequent years. Income will build in "layers" from year to year. While this will delay realization of the benefits of current activity and so defer bottom-line profitability, it should stabilize our business for the future. This should provide the financial momentum necessary to carry Farmer Mac through the business cycles of agricultural finance with increasing safety and soundness.

Our objectives for 1990 were achieved in large measure and Farmer Mac has been well established as an institution with significant opportunities for profitable business in 1991. The success of the residential mortgage secondary markets is a blueprint for the opportunity presented to Farmer Mac. Farmer Mac was conceived as and continues to be a long-term initiative to assure a stable and adequate supply of competitively priced funding for the farmers, ranchers and rural homeowners of this nation.

We appreciate having this opportunity to respond to the draft Report. We believe that the material we have provided here is essential to any evaluation of the pace of development or the potential future viability of Farmer Mac. We also believe that we have succeeded in establishing a solid foundation for an efficient and sound 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

The following are GAO's comments on Farmer Mac's letter dated June 28, 1991.

GAO Comments

1. Farmer Mac's overall position is summarized on pages 10 and 11 of the report.

2. A discussion of Farmer Mac's concerns about the timing of our review and the impact of the new approach appears on pages 10 and 11 of the report. We also discuss the new approach on pages 2, 8, and 9.

3. See pages 1, 42, and 43 for a discussion of the objectives, scope, and methodology of the review conducted for this report. We focused on current conditions in agricultural credit because our primary objective was to report on the current status of the Farmer Mac-sponsored secondary market. An analysis of the need for such a market in the long run was not within the scope of this review.

4. Farmer Mac declined our request to identify the potential poolers who expressed increased interest, citing, among other things, poolers' concerns about confidentiality. Consequently, we were unable to verify the increased level of interest in the Farmer Mac I program mentioned in Farmer Mac's letter to us.

5. The remainder of Farmer Mac's letter does not directly address the report. Rather, it gives additional information on the history and background of Farmer Mac, reiterates and elaborates on the obstacles to implementation of the Farmer Mac programs already covered in this and other recent GAO reports, and discusses at some length the new approach Farmer Mac is taking, which it believes will increase secondary market activity.

6. Farmer Mac said that it could not provide further information on the sources or characteristics of these loans, noting that only the poolers, not Farmer Mac, had complete information. Consequently, we were unable to verify the level or scope of potential activity mentioned in Farmer Mac's letter to us.

7. It is uncertain whether these rates will increase participation or benefit borrowers. These rates are not directly comparable to the figures shown in appendix II (see the first section of table II.1 labeled "return on Farmer Mac-guaranteed securities" on page 20) because the characteristics of the loans involved are significantly different, nor does

Farmer Mac compare them to other sources of funds available to agricultural lenders, such as bank certificates of deposit or FCS unsecured debt issues. We would also point out that these rates do not take into account the additional costs that are included in the rates borrowers ultimately pay on loans packaged for sale through the Farmer Mac I program, such as those listed in the other sections of table II.1, and therefore are not directly comparable to the estimates of borrowers' rates discussed in the report on pages 6 and 7 and in appendix II.

8. We agree that the new approach, as presented, would maintain Farmer Mac's expected level of exposure to credit risk and minimize its new exposure to interest rate risk. Since no transactions have occurred, the actual level of Farmer Mac's exposure to either credit or interest rate risk cannot be determined. Our objective in discussing the risks associated with the new approach was merely to point out that, by operating as both a portfolio manager and a guarantor, rather than exclusively as a guarantor, Farmer Mac will face different types of risks. We modified the report on pages 8-9 slightly to clarify this point.

Objectives, Scope and Methodology

On September 10, 1990, the Chairman, Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture, requested that we prepare this report as part of an on-going review of the Farmer Mac-sponsored secondary market. Specifically, we were asked to provide information on (1) Farmer Mac's actions to date, (2) the factors that have constrained the development of the market, and (3) the market's effect on agricultural credit.

In order to determine what actions Farmer Mac had taken to establish the basis for the secondary market, including the steps it was required to take by the Agricultural Credit Act of 1987, we met several times with Farmer Mac officials between January 1990 and March 1991. We also reviewed Farmer Mac's operating manual and other materials provided by Farmer Mac officials to understand issues raised in the interpretation of its operating guidelines.

To gain a perspective on the factors that have constrained the market's development, and on the effects of the market on agricultural credit to date, we discussed the Farmer Mac I program with Farmer Mac officials, representatives of all major categories of commercial lenders to agriculture—23 banks, 3 insurance companies, and 4 FCS institutions—as well as others who have expressed interest in the market, including 6 investment banks and 2 regulatory authorities. On the basis of recommendations from the American Bankers Association and the Independent Bankers Association of America, we met with groups of executives from 20 small banks located in the Midwest and West. We also met with three selected large banks and three insurance companies that have a significant involvement in agricultural lending. We visited three FCS Farm Credit Banks, and met with a representative of the Farm Credit Mortgage Corporation—an FCS institution being formed to act as a Farmer Mac pooler. We also met with the FCA, which has regulatory authority over Farmer Mac as well as the FCS as a whole, and with the OCC.

We conducted a telephone survey of all stockholders who were eligible, at the time of Farmer Mac's initial public offering in December 1988, to apply for certification as Farmer Mac poolers. The survey was conducted in December 1990 and January 1991. We obtained information on what steps eligible stockholders had taken toward participating in the Farmer Mac-sponsored secondary market, how many of them planned to become Farmer Mac poolers, and what factors influenced their decisions on whether to apply for pooler certification.

This report, in general, relates to the Agricultural Credit Act of 1987's requirement that GAO conduct a study by January 6, 1990, on the effects of Farmer Mac's operations on agricultural producers, the FCS, other lenders, and the capital markets. We reported in January 1990 that we had not been able to complete the required study because the market was not yet functioning.[1] The act also required us to conduct two other studies—on the feasibility of such a market without the guarantee authority provided in the act, and on the feasibility of expanding that authority to loans for farm-related and rural small businesses. Additionally, the act required us to conduct annual reviews of the actuarial soundness and reasonableness of fees established by Farmer Mac and to perform financial audits of Farmer Mac "on whatever basis the Comptroller General determines to be necessary." We have not undertaken these studies and reviews at this time because of the lack of activity in the Farmer Mac-sponsored secondary market.

[1]See Federal Agricultural Mortgage Corporation: GAO Actions to Meet Requirements in the Agricultural Credit Act of 1987 (GAO/RCED-90-90, Jan. 5, 1990).

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Related GAO Products

Federal Agricultural Mortgage Corporation: Potential Role in the Delivery of Credit for Rural Housing (GAO/RCED-91-180, Aug. 7, 1991)

Federal Agricultural Mortgage Corporation: Development of Secondary Markets (GAO/T-RCED-91-66, June 13, 1991)

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

Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991)

Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990)

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)