A Secondary Market for North Dakota Farm Mortgages

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Investment markets are usually defined in terms of primary and secondary markets. A primary market exists at the point where an original debt or ownership interest is created. For example, a primary market is one in which an agricultural lender makes a real estate loan to a farmer. Another primary market occurs when the corporations issue new stock. Secondary market transactions occur when the company's stock is resold on a stock exchange by the original investors or when the farm mortgage is sold by the original lender.

Well developed secondary markets exist for many diverse financial instruments--stocks, corporate bonds, treasury securities, home mortgages, and student loans. Perhaps the most popular secondary market is the New York Stock Exchange where several hundred million shares of stock are traded daily. Less developed markets exist for car loans, credit cards debt, and notes receivable.

The Agricultural Credit Act of 1987 creates a secondary market for agricultural loans. The following sections present the background leading to the development of a secondary market, describe the operation of a secondary market, and discuss likely economic impacts on agricultural capital markets in North Dakota.

BACKGROUND DEVELOPMENTS

The Farm Credit System (FCS) is the dominant real estate lender serving North Dakota farmers. In 1986, FCS held 51 percent of all farm real estate debt in the state (fig.1.). The other major source of financing comes from individual sellers willing to hold contracts for deed. Subsidized Farmers Home Administration (FmHA) loans are limited because a majority of farmers do not qualify for them. In short, most North Dakota farmers have had only one or two financing options when purchasing real estate.

Commercial banks and other financial institutions such as savings and loan associations, credit unions and insurance companies have offered few farm real estate loans by comparison. These institutions rely heavily on local markets for sources of funds. Because of limited geographical diversification, they are especially vulnerable to changes in local agricultural conditions.

Most appraisals of farm credit suggest that farmers', and thus agricultural lenders', needs for non-local sources of funds will continue to increase, even with the deregulation of financial markets brought about by the Depository Institutions Acts of 1980 and 1982. These acts initiated the removal of interest rate controls (Regulation Q) on depository accounts, and have equated competition among financial institutions for funds in local markets.

Principal sources of nonlocal funds for North Dakota agricultural lenders in the past were correspondent loan participations; discounting of loans with FCS, the Bank of North Dakota and Mid-America Bank Service Company (MABSCO); seasonal borrowing from the Federal Reserve (by member banks); and purchases of federal funds. However, none of these sources have been highly dependable or cost effective. Correspondent relationships entail compensating balance requirements, variable interest in participation over time, and a lack of expertise in agricultural lending. Most lenders are reluctant to participate with peer institutions because of their competitive relationship.

Agricultural lenders, most notably commercial banks, have long argued for the creation of a secondary market. Indeed, the original development of Federal Intermediate Credit Banks (FICB) as part of FCS was to provide rural

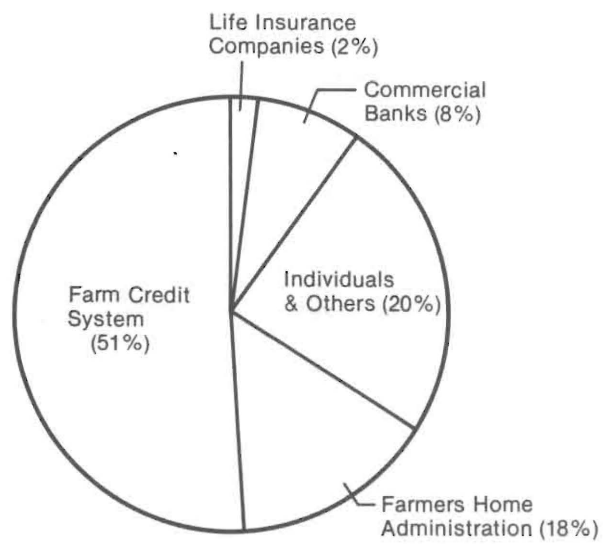

Fig.1. North Dakota farm real estate debt, market share by lender, 1986.

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banks with a source of new funds by discounting their agricultural loans. In the 1970s, the Federal Reserve Board of Governor's committee on rural banking problems and the Agricultural Credit Task Force of the American Bankers Association designed a mechanism whereby a subsidiary of a large commercial bank or a joint venture by a group of small banks could obtain funds from non-local sources and transfer them to rural areas of the nation. The effort failed because agreement could not be reached on uniform credit standards, documentation, minimum operational sizes, capitalization procedures, funding sources and other details.

Williford estimated a successful regional secondary market in the 1980s requires a minimum total annual loan volume of at least $50 to $100 million, participating banks to retain a portion of each farm loan, and system equity equal to one-sixth of total loan volume. His analysis found money market and FICB sources of loan funds to be equally profitable.

Lender interest in a secondary market subsided in the early 1980s. At that time profit spreads narrowed as a result of costs of funds from non-local sources in the general economy rising more rapidly than lending rates in the farm sector, tight liquidity and competition from non-bank institutions evolving from market deregulation. Interest again heightened when Congress began drafting legislation to help the ailing FCS. Other agricultural lenders besides the FCS had also experienced hardship as a result of the farm financial crisis and sought similar relief as FCS to maintain an equilibrium competititve environment in agricultural credit.

OPERATION OF A SECONDARY MORTGAGE MARKET

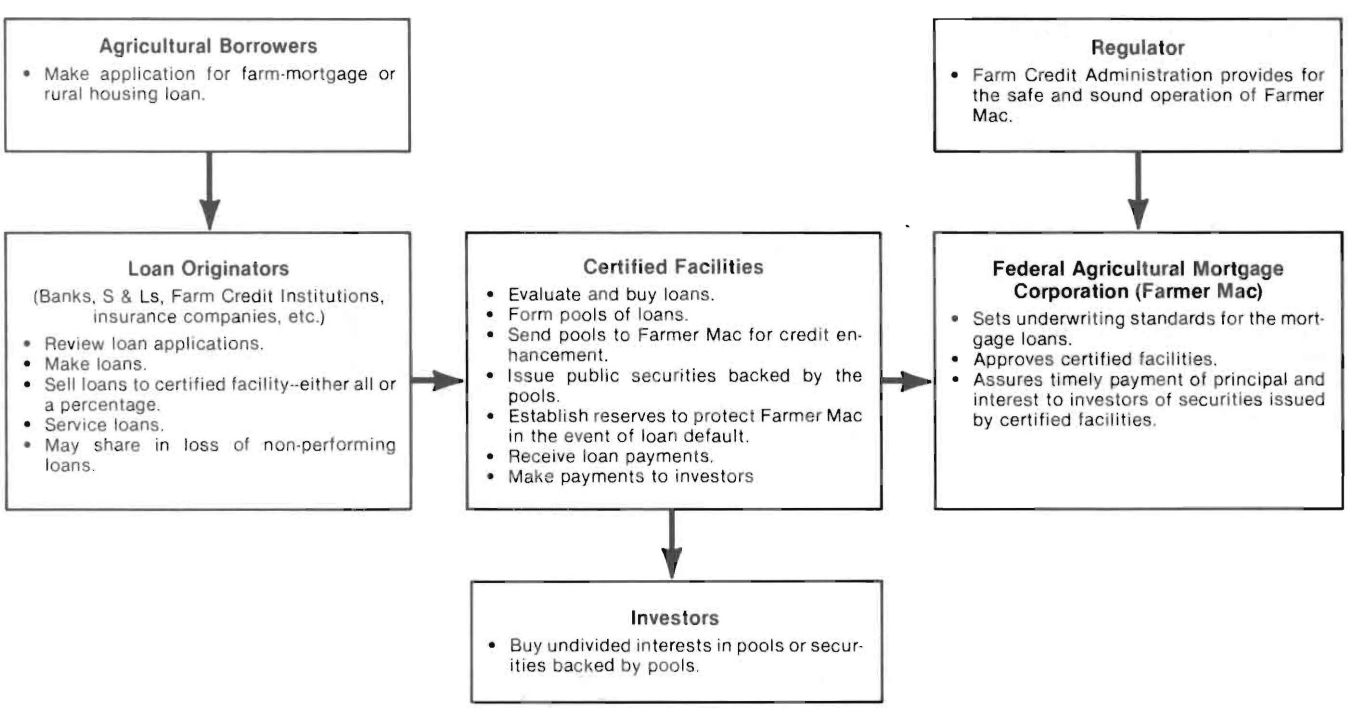
The Agricultural Credit Act of 1987 enhances the supply of credit to agriculture by developing a secondary market for agricultural mortgages. A secondary market for agricultural real estate mortgages is diagrammed in fig.2. In essence, lenders pool a number of farm mortgages and sell shares in the pool to investors in open financial markets.

A farmer would contact either a commercial bank, savings and loan association, insurance company, credit union, or any other participating financial institution and apply for a real estate loan in the usual fashion. The participating lender, referred to as the **originator,** writes the mortgage and retains responsibility for 10 percent of the loan so it is still at risk and does not have the incentive to make poor loans.

The remaining 90 percent of the loan is sold to a **certified facility** whose responsibilities are to bundle groups of loans into pools. These certified facilities or poolers may be any FCS institution, corporation, association, or trust organized under U.S. or state law. The loans are purchased by the certified facility on a nonrecourse basis. There must be at least 50 loans in a pool.

Once the certified facility bundles a package of loans, it applies to the Federal Agricultural Mortgage Corporation, "Farmer Mac," for credit enhancement, which is the assurance that interest and principal will be paid to the final mortgage holders. Farmer Mac is a part of FCS, but FCS is

Elements of the secondary market for agricultural loans



not liable for Farmer Mac. Ultimately, Farmer Mac will consist of a 15-member panel of five FCS representatives, five non-FCS members who intend to originate secondary loans and five members appointed by the president.

Farmer Mac has the responsibility for developing uniform underwriting standards, creating and overseeing the operation of the certified facilities and guaranteeing payments of principal and interest to investors. In addition, Farmer Mac sets the underwriting, security appraisal, and repayment standards. The act specifies that these standards shall not discriminate against small originators or small agricutural mortgage loans providing that they are at least \$50,000. Other standards set by Congress include:

- Each pool containing at least 50 loans must be diversified among various commodities and over a wide geographic area.
- Loans must have a loan-to-asset ratio of 80 percent or less.
- No one loan can be in excess of 3.5 percent of its pool.
- The maximum size for pooled loans is the greater of \$2.5 million or 1,000 acres.
- Loans to two or more related borrowers cannot be in the same pool.
- Rural housing loans are limited to single-family residences of less than \$100,000, in communities with populations of 2,500 or less.

Loan originators are responsible for the first 10 percent of any loan losses. All remaining losses are guaranteed by Farmer Mac. In order to capitalize Farmer Mac and create a reserve to fund its guarantee, each certified facility will be required to purchase capital stock in Farmer Mac. This assessment will be based on the perceived riskiness of each pooler. The General Accounting Office will annually review Farmer Mac's fees to determine actuarial soundness. In the unlikely event that Farmer Mac's reserves are insufficient to cover loan losses, it can draw on \$1.5 billion federal line of credit from the Secretary of Treasury for the sole purpose of fulfilling obligations under its guarantee.

Having obtained credit enhancement, the certified facility sells the pool of loans to investors in the nation's capital markets. These debt securities can be either "mortgage-backed bonds" or "pay-through bonds." Mortgage-backed bonds are a debt obligation of the certified facility and collateralized by mortgage loans. The bonds' payment characteristics are like other bonds with stated maturities and regular payments of interest. The pay-through bond is similar to the mortgage backed bond. However, rather than regular payments of interest, holders of pay-through bonds receive payments (less servicing fees) as the originators and certified facilities receive payments, hence the term "pass through."

The certified facility reduces transaction costs associated with the sale of bonds backing the pool of mortgages. Fees charged for this service are the spread between interest rates charged by the originator and those on the secondary market. The originator retains responsibility for servicing the loan and collecting principal and interest payments from the farmer.

The advantage of a secondary market to lenders is that they get back funds extended to farmers sooner. Lenders can then proceed to reinvest the funds in other loans or short-term investments. In addition, the lender is no longer exposed to the interest rate risk associated with holding loans with long maturities.

In an economic sense, FCS functions as a secondary market--raising funds in the nation's capital market and distributing them to farmers through regional associations. However, FCS differs from a secondary market entity in that it does not buy (sell) mortgage loans from (to) other lenders.

ADVANTAGES OF SECONDARY MORTGAGE MARKET

There are numerous concerns surrounding a secondary market. On the positive side, a successful secondary market for agricultural mortgages may have a dramatic effect on credit availability. North Dakota farmers will have additional sources of financing beyond FCS and FmHA. Other lenders, particularly commercial banks, could not consistently offer real estate loans because they had to rely on local deposits for investment capital. Now they can compete directly with FCS because the availability of a secondary market permits them to margin scarce loanable funds and thereby originate a greater number of farm real estate loans. Even though originators are required to retain a 10 percent interest in all secondary market loans, the amount of credit available will likely increase by more than a factor of 10 because of new diversification opportunities.

The additional credit will be available to farmers with greater certainty. In the past, some farmers were unable to obtain real estate mortgages even though they were willing to pay market rates of interest because available funds were rationed by creditors. With uniform credit standards nationwide, farmers will know precisely what characteristics are necessary to qualify for a mortgage or lower interest rates.

A third benefit of a secondary market to North Dakota farmers is lower interest rates. Once again, farmers will be able to obtain fixed rate long-term financing. FCS interest rates are expected to remain relatively high over the long term because of greater risk premiums being attached to their cost of funds, increased costs associated with repayment of the federal government's capital infusion, and reduced profitability due to additional borrower rights (Gustafson, Saxowsky and Braaten). Also, regional variation in interest rates will be reduced as distant financial institutions obtain equal access to loan funds.

A successful secondary market should lessen the need for subsidized state and federal agricultural credit programs. These programs transfer significant amounts of capital to the agricultural sector at a fairly high cost. Hughes and Osborne state subsidies on federal FCS loans total 50 basis points (.5 percentage points of interest) while subsidies on FmHA loans approach 900 basis points (9 percentage points of interest). Reduction of these subsidies would be welcome in the current era of large fiscal budget deficits.

DISADVANTAGES OF SECONDARY MORTGAGE MARKET

As in most economic problems, a number of tradeoffs exist in the creation of a secondary market. In order to qualify for greater credit and lower interest rates via a secondary market, farmers will have to maintain comprehensive financial statements, provide regular updates to lenders, and complete more complicated application sheets. Because all borrowers participating in the secondary market will be subjected to similar credit standards, lenders will have greater difficulty tailoring loan terms to the needs of individual borrowers.

A second concern relates to the viability of a secondary market. Large, frequent, and regular bond offerings are required for successful operation of a secondary market. An agricultural secondary market may not possess all of these fundamental characteristics. Farmers' interest in a secondary market is uncertain. If they elect to have their loans sent to the secondary market (which presumably would result in lower borrowing costs), they must agree to waive most of their borower rights, including the eligibility of debt restructuring at some future date and the right of first refusal.

Further, it is not clear how investors will react to a secondary mortgage market for agricultural loans. Bonds backed by these mortgages can be redeemed prior to maturity. Hence, certified facilities are subject to prepayment risk if interest rates rise and must operate with a greater spread between their cost of funds and lending interest rate. FCS bonds are "noncallable;" once issued, they cannot be redeemed. Thus, capital raised in a secondary market would have a higher cost than FCS funding.

The relative volatility and riskiness of agriculture implies that a secondary market will only function with fairly high levels of government support. This guarantee affects the flow of capital among sectors of the economy. More capital could flow into agriculture than is merited on strictly economic grounds. The resulting expansion in the production would be contrary to other farm programs which seek to curtail production. In addition, excess capital is one of the factors that contributed to the agricultural sector's financial crisis of the 1980s. Excess capital leads to rising farmland and asset values, which benefits current landowners but makes the purchase of those assets more expensive for future generations. Opponents of a secondary market are concerned that initial government guarantees will be difficult to remove in the future as borrowers become accustomed to considerable interest rate savings.

Finally, a successful secondary market competes directly with FCS for profitable loans and hampers recovery of the system. The main purpose of the Agricultural Credit Act was to restore FCS to profitability. To minimize these effects, the maximum volume of real estate mortgages sold on the secondary market will be limited to 2, 4, and 8 percent of total farm real estate debt in the first three years of operation, respectively.

CONCLUSION

Development of a secondary market for North Dakota real estate mortgages provides small rural financial institutions in the state with an additional source of loanable funds and profit opportunities while supplying farmers with a greater quantity of credit at competitive market interest rates. Previously, farmers had few alternatives for financing real estate purchases. Obtaining credit in amounts and at interest rates that truly reflect the relative creditworthiness of farm borrowers increases economic expansion, efficiency, and equity as scarce capital resources are allocated to their highest productive use.

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