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Report to the Congress

January 1990

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

GAO Actions to Meet Requirements in the Agricultural Credit Act of 1987

GAO/RCED-90-90

GAO

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Comptroller General
of the United States

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To the President of the Senate and the
Speaker of the House of Representatives

This report responds to provisions of the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) that required us to conduct certain studies by January 6, 1990, concerning a new secondary market for agricultural real estate and rural housing loans created by the act. These studies are to cover the implementation of the act; the effect of the new market on producers, lenders, and capital markets; the feasibility and appropriateness of such a market without the guarantee provided in the act; and the feasibility of expanding the market to loans for farm-related and rural small businesses. In addition, the act required us to conduct periodic actuarial and financial reviews.

Results in Brief

The Agricultural Credit Act of 1987, among other things, indicated that the Congress expected that the new secondary market would begin operations quickly and that its secondary market program would have been in place and operating as a basis for the GAO work required by the act. Because the new market—to be administered by the Federal Agricultural Mortgage Corporation (known as Farmer Mac)—is not fully operational, we have not been able to complete the studies and other periodic reviews required by the act. However, we have worked closely with various congressional committees and testified before them concerning Farmer Mac's proposed underwriting and other standards designed to guide the new market's operation. We are staying abreast of Farmer Mac activities, are continuing planning efforts, and will initiate the major bodies of mandated work as pertinent data become available. Farmer Mac officials have told us that the secondary market should be fully operational in early 1990.

The following sections of this report provide information on (1) Farmer Mac's development and current status, (2) our past work relating to agricultural real estate secondary market issues and Farmer Mac, (3) the studies and reviews that the act requires us to do concerning Farmer Mac, and (4) our planned work relating to the statutory requirements.

Development and Status of Farmer Mac

Farmer Mac was established as a federally-chartered instrumentality of the United States generally to provide more lending capacity for farm real estate and rural housing and more long-term credit for farmers and

and Urban Affairs, and the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture, during the committees' oversight hearings. In late October 1989, Farmer Mac also mailed to potential poolers the application to become a certified loan-pooling facility.

According to Farmer Mac officials, Farmer Mac is developing a comprehensive Securities Guide that will cover in detail the program operating procedures and the responsibilities of all secondary market participants. Farmer Mac indicated that, subject to approval by its Board of Directors, the Securities Guide will be printed and distributed to all Farmer Mac stockholders around the end of 1989. Although the act does not require Farmer Mac to submit the Securities Guide for congressional review, Farmer Mac officials said they plan to provide it to jurisdictional congressional committees at the same time that it becomes an official operating manual for the new market.

Past GAO Work Concerning Agricultural Real Estate Secondary Market Issues and Farmer Mac

We have issued several reports and testified on several occasions on agricultural real estate secondary market issues overall and Farmer Mac in particular.[1] One of our first products in this area, a July 1987 report,[2] provides information on secondary markets, in general, and key issues concerning the development of a secondary market for agricultural real estate loans that we believed merited further attention during the congressional debate on developing a secondary market for agricultural real estate loans. Issues raised in that report focus on whether federal government involvement would be needed to establish the market, the role the Farm Credit System (FCS) would play, the effects of such a market on existing farm lenders, and what loans should be eligible to be sold in the new market. Most of those issues are still the subject of debate today, and some were incorporated in the Agricultural Credit Act of 1987 as studies mandated for us to perform. Appendix I provides further information on those issues.

In a May 5, 1989, report[3] we provide information on underwriting standards for secondary markets, in general, and key issues that we believed

[1]Our previous related reports and testimonies are listed in "Related GAO Products" at the end of this report.

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

[3]Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 1989).

potential financial exposure of the federal government, and (3) minimizing any potential impact on the borrowing of the federal government. GSEs are generally privately owned and operated corporations chartered by the U.S. government generally to serve public policy purposes, such as to facilitate credit flow to agriculture.

GAO Studies Required by the Agricultural Credit Act of 1987

The Agricultural Credit Act of 1987 requires us to perform five separate studies/reviews concerning Farmer Mac. Three are one-time studies that the enabling legislation required to be completed within 2 years—January 6, 1990—after enactment. The other two are recurring actuarial and financial reviews. The one-time studies are to address the

- implementation of the act's provisions by Farmer Mac and the effect of Farmer Mac's operations on producers, the FCS, other lenders, and the capital markets,
- feasibility and appropriateness of establishing a secondary market for securities backed by agricultural real estate loans that do not have a Farmer Mac guarantee, and
- feasibility of expanding the authority granted by the act to authorize the sale of securities based on or backed by loans made to farm-related and rural small businesses—farm-related businesses are those that make 90 percent or more of their annual dollar volume of sales to agricultural producers.

The recurring reviews are to be

- annual reviews of the actuarial soundness and reasonableness of fees established by Farmer Mac[5] and
- financial audits of Farmer Mac "on whatever basis the Comptroller General determines to be necessary."[6]

[5]These fees are to be established by Farmer Mac and can be no more than one-half of 1 percent of the initial principal amount of each pool of qualifying loans; and beginning at the end of the second year after a guarantee is issued, Farmer Mac may assess an annual fee of not more than one-half of 1 percent of the principal amount of the loans then constituting the pool.

[6]The conference report that accompanies the act states that such financial audits shall be performed at least once every 3 years.

affected by removing the Farmer Mac guarantee will be a less theoretical question than it is today. Furthermore, once sufficient experience is gained through Farmer Mac's full implementation of the secondary market provisions mandated by the enabling legislation, we will be in a better position to comment on the feasibility of expanding the market's program provisions to include loans to farm-related and rural small businesses.

In addition to providing a necessary basis for us to conduct the studies originally required by January 1990, the normal operations of Farmer Mac will, as a matter of course, provide the basis to conduct the recurring actuarial and financial reviews also required by the act. We will be able to begin our annual reviews of the actuarial soundness of the guarantee fees—which Farmer Mac can charge loan poolers to cover the risk incurred by Farmer Mac in providing guarantees on the loan pools—when Farmer Mac establishes those fees and when information is available on the characteristics of loans in the pools.

Finally, a financial audit of Farmer Mac is feasible at any time after it has conducted a financial transaction, such as the sale of stock to capitalize Farmer Mac, which was completed in December 1988. However, a more comprehensive view can be gained of Farmer Mac once it becomes fully operational. Under the authority vested in us in the Agricultural Credit Act of 1987, we currently plan to audit Farmer Mac's financial statements in accordance with the requirements of the act.

We are sending copies of this report to the various congressional committees with jurisdiction over Farmer Mac; the Secretaries of Agriculture and the Treasury; the Chairman of the Board, Federal Agricultural Mortgage Corporation; the President and Chief Executive Officer, Federal Agricultural Mortgage Corporation; the Director, Office of Management and Budget; the Chairman, Securities and Exchange Commission; and the Chairman of the Board, Farm Credit Administration. Copies will also be made available to other interested parties who request them.

Abbreviations

CEO	Chief Executive Officer
Fannie Mae	Federal National Mortgage Association
Farmer Mac	Federal Agricultural Mortgage Corporation
FCS	Farm Credit System
GAAP	generally accepted accounting principles
GAO	U.S. General Accounting Office
GSE	government-sponsored enterprise
RCED	Resources, Community, and Economic Development Division

Key Issues Concerning the Development of Underwriting Standards for Farmer Mac

On the basis of our review of underwriting standards provisions for Farmer Mac in the Agricultural Credit Act of 1987, underwriting standards and practices used in various existing secondary markets, and our discussions with individuals and officials from both the private sector and the federal government, we reported in May 1989 that the following issues relating to overall risk management merited consideration during the legislative review process for Farmer Mac underwriting standards.[1]

- What are the implications of the geographical diversity requirements in the act?
- What are the implications of the agricultural commodity diversity requirements of the act?
- Can state-of-the-art real estate appraisals provide enough assurance in verifying cash-flow potential and agricultural real estate values to enable prudent loan-making decisions?
- How would the use of lender or pooler subordinated participation interests[2] versus cash reserves affect the federal government's financial risk on securities guaranteed by Farmer Mac?
- Will the prescribed risk-based fees be adequate for Farmer Mac?
- What implications do Securities and Exchange Commission registration and disclosure requirements have for Farmer Mac-guaranteed securities?
- What effect will the loan-to-value ratio in the act have on government risk?
- What effect will rural housing provisions have on Farmer Mac-guaranteed securities and how will such loans be packaged?

[1]This appendix was developed from information contained in section 4 of our report entitled Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 1989). A detailed discussion of the issues listed in this appendix is included in that report.

[2]Subordinated participation interests are created when a pooler and/or lender retains a portion of a mortgage pool and the holders of the retained portion do not receive principal and interest payments (subordinated payments), on terms agreed to by the involved parties, until after all other investors have received their payments (senior payments).

terms could potentially result in loans in the pool that do not meet Congress' expectations. This standard requires that the property financed meet the minimum acreage or minimum annual receipts requirements to be established by Farmer Mac, but does not elaborate on the key terms "minimum acreage" or "minimum annual receipts." For purposes of oversight, such a standard provides little assurance of what borrowers Farmer Mac will ultimately include in the market.

Exceptions to the Standards

While it is necessary to allow for flexibility in loan underwriting standards to provide the capability to react to nonconforming but acceptable situations, it is also important that the exception does not become the rule because that could create a situation where the market is potentially guided by a case-by-case subjective judgment that ultimately may not provide the risk protection intended under broader pooling criteria. The credit underwriting, loan diversification, and certified facility standards include broad language to allow for exceptions to and/or broader interpretations of the standards. For example, credit underwriting standard 9 provides that

> "Farmer Mac may, on a pool-by-pool basis, accept loans that do not conform to one or more of the preceding standards when: (a) those loans demonstrate compensating strength on one or more of the standards to which they do conform; and (b) those loans are made to producers of particular agricultural commodities or products in a segment of agriculture in which such non-conformance and compensating strength are typical of the financial condition of sound borrowers."

Several financial sector officials and potential market participants indicated that Farmer Mac could better ensure that the exception would not become the rule by establishing some limitations on the absolute amount of exceptions allowed in any given pool.

Consistency of Financial Information

As is the case with terms and concepts, it is important that the financial information in each loan application be reported in a consistent and comparable manner to better ensure comparable and known risks in the loan pool. Many potential market participants we talked to acknowledged that the underwriting standards do not require financial information in a manner that ensures such consistency. As a result, loans could be included in pools that may not have comparable or even known risk characteristics. For example:

- Credit underwriting standard 5 requires that the real estate being financed have a minimum 1 to 1 cash flow to debt service coverage ratio, except for loans in which (a) the borrower's principal residence is on the property securing the loan and (b) the proforma debt coverage ratio of the entity being financed has for the last 3 years been no less than 1.5 to 1. We have been told that a large portion of agricultural real estate loans being made to farmers today are for add-on purchases. Some potential market participants have expressed concerns that it is unreasonable to require such add-ons to meet the cash flow to debt service coverage ratio of 1 to 1. They pointed out that in agriculture, as well as in the rental housing markets, new purchases generally do not economically cash-flow in the first few years. One way to accommodate this phenomenon may be to require more stringent ratios and criteria for the overall farm operation.
- Some lenders told us that the standards may allow loans to be based on the value of an unusually high-priced residence on the property, and not necessarily the ability of the property to carry debt based on its production capability. To illustrate this point, one banker told us that a farmer had off-farm income that supported the construction of a residence on his farm at a cost that exceeded the value of an average house in the area by about $100,000. The banker also told us that, when the farmer defaulted and the farm was offered for sale, the buyers were willing to pay only the average value of a home in the area; therefore the bank lost about $100,000. Some lenders said that to avoid liquidity problems that could result in losses upon default, Farmer Mac may want to consider limiting the allowable dollar value of the house in determining the ultimate loan amount for the entire property or allowing only a certain percentage of off-farm income to be used to qualify as income supporting the loan application.

Standardized Market Operating Agreement

The marketing agreement between the lender and pooler can determine exactly who bears the ultimate risk in the market. This agreement basically spells out the rights, responsibilities, and liabilities—including recourse provisions—for lenders and poolers. If such agreements are not done properly and consistently, even small changes in language can result in huge liability shifts. Most potential market participants that we talked to acknowledged these risk implications. The Farmer Mac certified facility standards are very general in defining the framework for a standard market operating agreement between lenders and loan poolers. In addition, used to produce a wide range of agricultural commodities. These standards are important because they can determine the overall risk that will exist in any given pool and may also affect the market's structure. The current diversification standards may allow poolers to potentially bypass the geographic diversification requirement of the act by drawing loans from the intersection of three contiguous regions, which could reduce the diversity of individual pools due to similar agricultural commodities and climatic conditions in these areas. Farmer Mac could prevent this by disallowing the formation of pools of loans that come from such a limited geographic area. In the September 1989 oversight hearings mentioned previously, Farmer Mac officials indicated in response to questions from the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance and Urban Affairs, that they would not allow the diversification requirements of the act to be bypassed.

Appraisal Standards

Appraisal standards are a key part of the loan-making decision because they govern the valuation of property and cash flows that will be used as a basis for the collateral and earning capacity to repay the loan in case of default. Farmer Mac's appraisal standards rely, in large part, on Uniform Standards of Professional Appraisal Practice for such items as appraisal definitions, education requirements, and appraisal reporting developed by the Appraisal Foundation.[5] Farmer Mac standards also have broad provisions for monitoring the implementation of the standards.

While we did not specifically evaluate Farmer Mac appraisal standards, we noted that they do not come under the appraisal provisions of the recently passed Financial Institutions Reform, Recovery and Enforcement Act of 1989. The act requires appraisal standards at the federal level to ensure that loans or transactions requiring appraisals have appraisals performed in accordance with standards to be developed under the purview of the Federal Financial Institutions Examination Council—an organization that coordinates the activities of agencies that regulate depository institutions, such as commercial banks, credit unions, and savings and loan institutions. It appears that loans made by insurance companies and FCS institutions—potential major participants

[5]The Appraisal Foundation is a nonprofit entity established by U.S. and Canadian appraisal associations to help ensure that appraisers are qualified to offer their services to financial institutions and to the real estate industry.

Farmer Mac Standards' Development and Implementation

In its September 1989 testimonies,[6] Farmer Mac described the development and operation of its secondary market. We are including in this report the following information Farmer Mac provided us from the testimony describing the standards' development and planned implementation.

Farmer Mac officials stated that, before guaranteeing any pool of loans, Farmer Mac will ascertain that the loans conform to its various standards and will evaluate the pool using a computerized "stress-test" model to ascertain that the loss performance of the pool will be within acceptable levels. According to Farmer Mac, the standards are intended to (1) work interactively to eliminate loans that would be bad credit risks, (2) function primarily as a first screen in determining the soundness of pools under the program, and (3) produce loan pools with ultimate losses, in "worst-case" economic scenarios, of 10 percent or less. Each pool of loans that passes the standards will be further analyzed using an industry-standard computerized risk analysis model to ensure that potential losses in an economic stress situation will not exceed the level of subordination or reserves supporting the pool. Further, in the case of any pool that cannot pass this dynamic evaluation process, Farmer Mac reserves the right to require that the pool (1) be restructured, (2) have more than 10 percent reserve or subordination, or (3) be rejected for guarantee entirely.

Farmer Mac also indicated that the validity and reliability of the standards were tested with the stress-test model by using the standards as the primary screening device in a series of special runs utilizing historical data from agricultural loans made during the 1965-1988 period. Farmer Mac reported that the analysis made on that basis demonstrated that loans conforming to its proposed standards, used as collateral for the issuance of Farmer Mac-guaranteed senior securities in accordance with the statute, should result in no guarantee payments by Farmer Mac in excess of guarantee fees received on the pools.

[6]Statement of Henry D. Edelman, President and CEO, Federal Agricultural Mortgage Corporation, before the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance and Urban Affairs (Sept. 12, 1989), and the Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture (Sept. 27, 1989).

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ranchers at stable interest rates, including fixed rates. To achieve this, Farmer Mac is authorized to guarantee the timely payment of principal and interest on securities backed by agricultural real estate and rural housing mortgage loans—pooled by loan poolers that are to be certified by Farmer Mac—and sold to investors.

In May 1988, the President appointed an interim Board of Directors of Farmer Mac that arranged for the sale of Farmer Mac's common stock. The stock sale that was completed in December 1988 created stockholders who elected 10 members to a 15-member permanent Board of Directors that included 5 presidential appointees. The Board first met with a quorum present on March 2, 1989, and on June 1, 1989, appointed a President and Chief Executive Officer.

The act required Farmer Mac to develop the following standards and set forth certain requirements for submitting those standards for congressional review and determining when the standards would become effective.

- Underwriting, security appraisal, and repayment standards were to be submitted to the Congress for review not later than 120 days after the appointment and election of the permanent Board of Directors. The standards were to take effect no later than 30 legislative or 90 calendar days after submission to the Congress.
- Loan pool composition standards were to be submitted to the Congress for review, but the act contains no provision for when the standards were due. The standards were to take effect no later than 30 legislative or 90 calendar days after submission to the Congress.
- Certification standards for agricultural mortgage marketing facilities were not required to be submitted for congressional review. They were to be issued within 120 days after the permanent Board first met with a quorum present.

Farmer Mac submitted the required standards within the legislated time frames; and the last congressional review period officially ended on October 16, 1989, 90 days after Farmer Mac submitted the last standards—loan composition standards—to the Congress for review. Although Farmer Mac was not required to submit the certification standards for agricultural mortgage marketing facilities for review, it submitted them along with the underwriting, security appraisal, and repayment standards to the Congress on June 30, 1989. Farmer Mac testified in September 1989 on these standards before the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance merited further attention during congressional oversight as Farmer Mac developed its underwriting standards. Issues raised in that report primarily relate to the potential government risk and the ability of Farmer Mac to include various sizes and types of farms, ranches, financial intermediaries, and loans in this market. Appendix II provides further information on those issues.

Our most recent work focuses on issues and concerns related to Farmer Mac's specific underwriting and other standards that it submitted to the Congress for review. We reviewed these standards at the request of the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance and Urban Affairs, and the Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition, and Forestry. We testified before the Subcommittee on Policy Research and Insurance, House Committee on Banking, Finance and Urban Affairs; Subcommittee on Conservation, Credit and Rural Development, House Committee on Agriculture; and the Subcommittee on Oversight, House Committee on Ways and Means on our issues and concerns related to the specific Farmer Mac standards.[4] These focused on whether the loan criteria, market structure, and risk parameters in the Farmer Mac standards would satisfy the broad expectations that the Congress had when it passed the enabling legislation. Appendix III provides further information on issues and concerns we raised relating to Farmer Mac's proposed standards. It also provides information, based on discussions with Farmer Mac officials, on the standards' development and planned implementation.

According to Farmer Mac officials, the Securities Guide will address many of these issues and concerns when it is finalized. We plan to review the Farmer Mac Securities Guide when it is completed to be in a position to continue to assist the various congressional committees in their oversight activities.

In addition to the above work, we started work in September 1989 under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Sec. 1004, P.L. 101-73, Aug. 9, 1989). That act requires us to conduct studies of risks undertaken by certain organizations referred to as government-sponsored enterprises (GSEs)—which include Farmer Mac—and the appropriate level of capital for such enterprises consistent with (1) the financial soundness and stability of the GSE, (2) minimizing any

[4] 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).

Planned GAO Work on Farmer Mac Studies Required by the Agricultural Credit Act of 1987

As mentioned previously, the Agricultural Credit Act of 1987, indicated that the Congress expected that Farmer Mac would begin operations quickly and that its secondary market program would have been in place and operating as a basis for the GAO work required by the act. However, according to Farmer Mac officials, its secondary market operations will not be fully operational until at least early 1990. We have testified at congressional oversight hearings concerning the implementation of Farmer Mac's proposed underwriting and other standards. We have also coordinated with key jurisdictional committees concerning our general plans to initiate further work on the mandated studies as soon as Farmer Mac's secondary market operations become fully operational, and the committees have concurred with our plans. We will continue to coordinate with them in developing a plan of action for sequencing and initiating the mandated Farmer Mac studies.

Because agricultural real estate loans are a new frontier for a national secondary market, we believe that once Farmer Mac becomes fully operational, its program will yield new and invaluable insights into agricultural financing that will facilitate our efforts to respond to the three legislatively-mandated studies that the Congress envisioned could be done by January 6, 1990. For example, we will be better able to report on the effects of Farmer Mac operations on the market participants and others once information is available on pools of loans, including borrower characteristics, such as type, size, and location of farm operations; loan terms, such as interest rates, repayment periods, and loan amounts; and lenders and poolers, such as type, size, location, and market activity.

Further, the new secondary market's operation will provide more credible insights into whether such a market could be feasible without a Farmer Mac guarantee. In a report entitled Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 17, 1987), we raised a related issue of whether federal government involvement was needed to develop a large national-scope secondary market for farm real estate loans. On the basis of our review of the development of the housing secondary market—which is the most developed secondary mortgage loan market today and relies in large part on guarantees by agencies similar to Farmer Mac—we indicated that government involvement, such as that seen in the housing market, was probably necessary to get an agricultural secondary market up and running. Once Farmer Mac is operational and the financial markets gain experience with Farmer Mac-generated securities, the issue of how the market would be

This work was done under the direction of John W. Harman, Director, Food and Agriculture Issues, (202) 275-5138. Other major contributors to this report are listed in appendix IV.

for

Charles A. Bowsher
Comptroller General
of the United States

Contents

Key Issues Concerning the Development of a Secondary Market for Agricultural Real Estate Loans

On the basis of our examination of nine legislative proposals introduced in the 100th Congress and our discussions with individuals and officials from both the private sector and the government, we reported in July 1987 that the following issues merited additional consideration in the debate concerning the development of a new national-scope secondary market for agricultural real estate loans.[1]

- Is federal government involvement needed to develop a large national-scope secondary market for farm real estate loans?
- What impact would a large national-scope secondary market for farm real estate loans have on FCS and other lenders?
- Should FCS be given powers to operate as the secondary market for all lenders?
- Could a new secondary market entity coexist with the FCS?
- What loans should be eligible to be sold in the secondary market?

[1] This appendix was developed from information contained in section 3 of our report entitled Farm Finance: Secondary Markets for Agricultural Real Estate Loans (GAO/RCED-87-149BR, July 17, 1987). A detailed discussion of the issues listed in this appendix is included in that report.

Key Issues Concerning Farmer Mac-Developed Underwriting Standards

On the basis of our examination of the Farmer Mac provisions of the Agricultural Credit Act of 1987 and the Farmer Mac-developed standards[1] and discussions with individuals and officials from both the private sector and the federal government, we testified in September 1989 that several issues merited further consideration by the Congress during the legislative review period to ensure that the loan criteria, market structure, and risk parameters satisfy Congress' broad expectations. Our observations below should help highlight the issues involved.[2]

During congressional oversight hearings in September 1989 and in subsequent meetings with us, Farmer Mac officials commented on some of these issues and said they plan to issue a Securities Guide in December 1989 that will address many of the issues we and others had raised. At these later meetings, Farmer Mac officials also provided us with information describing the standards' development and planned implementation. This information is presented at the end of this appendix.

As part of our responsibilities under the Agricultural Credit Act of 1987—to study the implementation of Farmer Mac—and to be in a position to continue to assist the various congressional committees in their continuing oversight activities, we plan to review the Securities Guide when it is completed.

Key Terms and Concepts

It is important that key terms and concepts governing the eligibility of loans be adequately defined to ensure that the loans in a pool have met certain basic criteria that (1) allow only loans of known and comparable risk into the pool and (2) ensure that Congress' broad expectations are met. Some terms and concepts included in Farmer Mac's standards are undefined.

Throughout the standards Farmer Mac does not specify accounting practices to be used in calculating financial ratios and preparing financial statements. Different accounting interpretations could result in loans with noncomparable risk. We will discuss broader implications of this later. Credit underwriting standard 6 illustrates how undefined

[1]These standards are "Credit Underwriting, Loan Repayment and Security Appraisal Standards," June 30, 1989; "Eligibility Standards for Certified Facilities," June 30, 1989; and "Loan Diversification Standards," July 18, 1989.

[2]This appendix was developed from information contained in our testimony entitled 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) and from conversations with Farmer Mac officials.

- Standardized accounting terms and methods are not required. These terms and methods are necessary to ensure consistency of financial information used to make loan decisions that ultimately determine the risks in the loan pools. Farmer Mac does not require borrowers' financial statements supporting loan applications to follow specific accounting principles such as generally accepted accounting principles (GAAP). The lack of reliance on GAAP or some set financial disclosure practice makes it very difficult to compare financial information on all loans in a loan pool. The Farm Financial Standards Task Force[3] is currently completing a national study of the use of accounting conventions in agricultural finance. The task force found a lack of consistency in the use and understanding of accounting practices and terms used in agriculture and plans to issue its report in early 1990, which it hopes will lead to more consistency in the presentation of financial information.
- Projected financial statements are not specifically required. Projected financial statements are important because they represent how the farmer plans to carry out the farming operation during the projected period. These statements are particularly important if the farmer plans to change cropping or production systems on land he currently farms, or buys new land and is farming it for the first time. As part of projected financial statements, a cash-flow analysis is a valuable tool because it provides lenders with a detailed repayment plan of how the farmer plans to meet currently maturing debt obligations. Most lenders we talked with told us that they currently prepare cash-flow analyses as an integral part of their credit approval processes. They also told us that it is imperative to have 3 years of tax returns together with the other financial statements required by the standards to prepare reliable cash-flow analyses. Farmer Mac does not require borrower tax returns to be submitted with loan documentation. The "forward looking" approach, which predicts future financial performance, is missing in the standards.

Financial Ratios

It is important that Farmer Mac fully evaluate the potential effects of its standards and accompanying financial ratios to determine if they will have intended effects. Financial ratios are used together with other criteria as determinants of the ability of a loan to qualify to be sold into the Farmer Mac secondary market. Some examples of potential unintended effects follow.

[3]The task force is sponsored by the American Bankers Association and composed of members from many groups, including the academic community, commercial banks, insurance industry, FCS, accounting profession, and regulatory agencies.

- Recourse provisions of the subordinated participation interests[4] have not been addressed in the standards. This one element will be a pivotal point that will determine if and when the government has to provide funds to keep the market afloat in a recession scenario such as agriculture experienced in the mid-1980s. Our report entitled Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR), dated May 5, 1989, provides further information on the subordinated participation interest issue.
- Several lenders and others we talked to raised concerns that, without a market agreement specifically geared to making sure smaller lenders with lower volume loans could participate in the market, small lenders either may be excluded through competitive pressures or receive less than desirable market agreements from individual poolers.

Regulatory Approaches

According to many sources we talked to, the potential market participants could be regulated by several different regulators and this could result in some participants' being regulated more strictly than others. This could result in inhibiting competition and actually excluding some participants from the market. For example, there is some concern that commercial bank regulators may require significantly more capital to be held against Farmer Mac loans than insurance company regulators may require. Both banks and insurance companies have acknowledged this issue and agree that banks, under certain scenarios, could essentially be excluded from the market or have to act as mortgage bankers by simply originating mortgages and not retaining any part of the loan. While Farmer Mac standards require that poolers have at least $2 million in capital, they do not specify capital requirements in the sense of commercial banking's safety and soundness regulations. It is also probable that appraisals will be regulated by several different regulators, posing a similar concern. Farmer Mac needs to examine the potential implications of differing regulatory approaches on all market participants and how such approaches may affect Farmer Mac's activities.

Pool Diversification Standards

The Agricultural Credit Act of 1987 specified that each pool of loans meet diversification requirements including that each pool be secured by agricultural real estate that is widely distributed geographically and is

[4]Subordinated participation interests are created when a pooler and/or lender retains a portion of a mortgage pool and the holders of the retained portion do not receive principal and interest payments (subordinated payments), on terms agreed to by the involved parties, until after all other investors have received their payments (senior payments).

in the new market—will not come under the appraisal provisions of the 1989 act.

Because the Congress studied the appraisal issue and decided on federal involvement in aspects of the appraisal industry that potentially cover at least some loans sold into the Farmer Mac secondary market, we believe additional consideration needs to be given to how the Congress wants to assure itself that the collateral for all loans in the Farmer Mac market is appraised adequately.

Standards for Rural Housing

Credit underwriting standard 8 provides that Farmer Mac will adopt credit underwriting standards similar to those of the Federal National Mortgage Association (Fannie Mae), adjusted to reflect the usual and customary characteristics of rural housing. The standard establishes a 75-percent loan-to-value ratio that can be met in part with private mortgage insurance.

Farmer Mac has not identified specific Fannie Mae standards that will be used, nor what adjustments will be made to reflect the usual and customary characteristics of rural housing. We believe that Farmer Mac standards should include more criteria on what the rural housing loans will look like, so that the Congress has a better idea of the risk parameters for that market and the adequacy of the 75-percent loan-to-value ratio set in the standards.

In the September 1989 oversight hearings mentioned earlier, Farmer Mac officials testified that in developing the standards for qualified rural housing loans, Farmer Mac was taking advantage of Fannie Mae's experience by adopting most of Fannie Mae's underwriting standards. Farmer Mac's testimony also listed nine Fannie Mae property exceptions for rural housing mortgages that will be considered for inclusion by Farmer Mac in rural housing pools.

Major Contributors to This Report

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

John P. Hunt, Jr., Assistant Director
Michael E. Gilbert, Assignment Manager
J. Ken Goodmiller, Evaluator-in-Charge
Carolyn R. Kirkpatrick, Evaluator
M. Jane Hunt, Reports Analyst

Related GAO Products

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

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