For release on delivery
10:00 A.M.E.S.T.
September 30,1987

Statement by

Wayne D. Angell

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

September 30, 1987

I am pleased to appear before the House Committee on Banking, Finance, and Urban Affairs in response to your request that the Board of Governors of the Federal Reserve System provide comments on proposals to establish, for farm mortgage loans, a secondary market backed by a government guarantee.

Secondary markets for private debt instruments, broadly defined as mechanisms whereby loans are resold in the national financial market, perform a function of growing importance in our economy. Because of inherent factors such as their remote geographic location or the small size of their individual credit needs, borrowers in some sectors lack direct access to the national credit market. When their loans are securitized or repackaged for that market, borrowers in such a sector are more likely to obtain credit in amounts and at interest rates that truly reflect the relative creditworthiness of that sector, as determined in the national marketplace. Consequently, the nation's capital resources are more likely to be allocated to the more productive uses, promoting economic progress as well as equity.

In addition to improving the credit-market access of farm borrowers, substantial benefits could flow to farm lenders from the establishment of a secondary market for their mortgage loans. Rural commercial banks, for example, would be enabled to become truly "full service" farm lenders, making long-term farm real estate loans as well as the operating, machinery, and livestock loans that constitute the major part of their current farm loan business. It is relatively risky for a small bank to hold a large amount of fixed-rate, long-term loans in its own portfolio. Hence, many rural banks have had to restrict such lending, relying instead on greater amounts of adjustable rate mortgages. The ability to transfer fixed-rate loans to investors via a secondary market will allow banks to serve long-term credit needs without undue exposure to the associated risks posed by unexpected changes in either interest rates or the profitability of farming.

A private secondary market, therefore, would be a very positive development for both farm borrowers and lenders. Before discussing how current legislation could usefully facilitate the development of such a private market, however, I want to address the adverse effects of establishing the market via the easy route of providing a guarantee on its offerings.

The introduction of a government guarantee on the debt of a particular sector, whether placed directly on the individual loans or on secondary-market securities representing such loans, is a very serious step. In taking such action, the Congress in effect overrides the judgment of the market and moves the credit rating of that sector to the top rank, above that of all the other sectors to which government backing has not been granted. The sector awarded such government backing is virtually assured of ample funds at relatively favorable interest rates. The problems of the Farm Credit System in this decade provide a compelling demonstration of the grave consequences that can follow excessive lending and investment stimulated by artificially low interest rates.

To be certain, in the past the nation deemed the market's allocation of funds to be inappropriate. In these rare instances, legislation deliberately altering the decision of the market was justified by an overwhelming public interest to encourage additional borrowing for a specified purpose or by a particular group. Government backing increased borrowing for the construction and purchase of homes. Similarly, government guarantees helped college students to finance their higher education. For both of these purposes, the Congress found increased debt-financed investment to be so much in the national interest that it substituted the creditworthiness of the nation for the original creditworthiness of the targeted borrowers.

In the case of housing, the goal was to increase home ownership; for student loans, to increase the number of college-educated citizens. And now, in turn, farm mortgage loan subsidies would stimulate investment in farm productive capacity. Capital improvements, machinery, and operating expenses would tend to be funded from the lower-cost mortgage funds, increasing the amounts of these items. The resulting expansion in agricultural production would be contrary to the aim of existing farm programs, which attempt to curtail production. Should greater productive potential be stimulated at this time by a public already shouldering much of the financial burden of present farm productive capacity? And in what other sectors would credit usage and investment be curtailed? Only a limited volume of savings is available to be channeled into investment and to the extent that funds are diverted to agriculture, some other potential investment is denied--perhaps the sort of productivity-enhancing investment our business sector needs so badly to compete effectively in the international arena.

In addition, the investment stimulus of subsidized, lower-priced mortgage credit could well be manifested by driving up land prices; that is, the cost advantage secured by farm borrowers will tend to be capitalized in the price of land. Ironically, because about two-fifths of farmland is owned by nonfarmers, only three-fifths of this capital gain will accrue to farmers. Furthermore, to the extent that the interest-rate advantage is capitalized, only current landowners benefit. For the next generation of farmers, the higher price of the land will offset the lower interest rate.

For a land buyer to capture the benefit of the relatively lower, subsidized mortgage interest rate, he must be a borrower. Thus the availability of government-backed credit will tend to increase the degree of leverage employed by farmers as well as by nonfarm investors in farmland; indeed, as we have seen, the thought behind providing government-backed credit is to increase the use of debt for specified purposes. But in an industry such as agriculture, which is subject to sharp financial swings arising from both natural and economic causes, high debt leverage can be extremely dangerous--as has been painfully demonstrated during the past 10 years.

Despite these problems, within certain limits, agriculture already is among the sectors for which government-backed credit traditionally has been legislated. Programs of the Farmers Home Administration promote borrowing by farmers with limited means, and in the past have promoted borrowing by farmers that encountered natural disasters or economic emergencies. In addition, credit markets have long regarded the Farm Credit System, which represents one type of secondary-market mechanism, as having the implied stand-by backing of the government. Implicit guarantees are called on to be made explicit from time to time, as illustrated by the assistance being requested by the Farm Credit System. Over the long-term, it would be in the public interest to phase out these implicit and other guarantees provided for farm lending. Instead, it is now proposed that the government extend explicit backing, via a guarantee for mortgage-backed securities, to the farm mortgage loans of all lenders.

Indeed, concern for financially distressed farm borrowers and lenders other than those in the Farm Credit System appears to have been part of the motivation behind proposals for the government-backed secondary market. Initially, some lenders may have envisioned the government purchasing their weak loans at face value, just as they proposed that the government purchase and "warehouse" the farmland they had already acquired through foreclosure. Similarly, some troubled borrowers may have hoped the government would acquire their loans and then exercise forbearance in the fashion of the Farmers Home Administration. It is clear that the secondary market now being proposed accommodates neither of these ends. It will serve only borrowers who are financially strong at the time the loans are made, because the originating lender will retain exposure to the first portion of any eventual loss.

If, by introducing and maintaining high quality standards, credit markets can be assured that the loans are strong, a secondary market could exist without a government guarantee. Its development, however, is considerably more difficult, because a securitizing or pooling agency must be established, credit quality standards promulgated, implemented, and enforced, and so forth. Legislation could establish an agency that would develop such a market, probably as an entity of the Farm Credit System. Government assistance to this venture that stops short of a guarantee could be very helpful in the developmental phase of a secondary market, particularly in view of the technical challenge presented by the diversity of farming. But, we should be very careful that government sponsorship is not seen as an implicit government guarantee. Past experience suggests that a guarantee intended just to help get the market started would be almost impossible to withdraw, because borrowers would loathe to give up the considerable interest-rate advantage. It would seem best to face forthrightly the establishment of a private market at the very beginning.