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AEI Presents Nothing Borrowed, Nothing Gained: How Farm Financing Works, and When it Doesn't or The Countercycle and the Future of Ag Lending

Episode 5: It's Always Bargain Time at Farmer Mac's

Sarah Mock: This is *Nothing Borrowed, Nothing Gained*: *The story of ag lending; past, present, and future.* I'm Sarah Mock. I have to admit -- When we first started talking about having a Farmer Mac discussion as part of this season, I was hopeful that I was about to learn about an incredible acronym. In my heart, I thought Congress, who first chartered the organization, might have really flexed their creative muscles, and come up with a title that nine full words long. I was hoping for something like -- Finance for Agricultural Risk Mitigation, Economic Rigor, and Managing Adverse Circumstances. I mean honestly, what are our tax dollars paying for if not really excellent wordplay? In fact, Farmer Mac is short for The Federal Agriculture Mortgage Corporation -- And I think we can all agree that pronouncing F-A-M-C "Farmer Mac" is, at best, a bit of a stretch. Though the name might not be what you'd call innovative, Farmer Mac was, in vision and purpose, meant to be quite innovative – and today I think it's fair to say, the organization is in active pursuit of innovation. An important thing to note, however, about doing things differently Is that innovation is not without risk. As one of the newest players in the ag lending space, Farmer Mac is an organization, has been dancing with risk since it first arrived on the scene. That's what we'll be talking about today - why Farmer Mac was created, how it works, and how the idea of innovation has by turns, transformed, and threatened it.
But we have to start at the beginning, and given that Farmer Mac was chartered pretty recently, in 1987, to be exact, we were excited to track down someone who was there.

Jeff Conrad: Jeff Conrad, president and founder of Agis capital.

Sarah Mock: The long and short on Jeff is, like most of our other sources, he's had a long and serious history in ag finance, and in the late 1980s, he was working at John Hancock, which was then the largest lender to farmers in the country. And with their large portfolio of ag debt going into the 1980s, the

organization was highly motivated to get Farmer Mac off the ground. I'm going to have Jeff explain why:

Jeff Conrad: When you look at the three lenders at that point in time, you have three kinds of lenders. You had the farm credit system, you had the banking system, and you had the insurance companies, and they were the three largest. And they were all behind this legislative effort in some capacity. The insurance company's being like John Hancock and Prudential, they want it to be pullers.

Sarah Mock: This gets a little jargony, but essentially, pullers would buy loans from originators – banks, in other words.

Jeff Conrad: The banking system, wanted the Farmer Mac, because they could be originators and then they could sell the loan to the pullers and the pullers could issue securities. And the pullers would also get the Farmer Mac guarantee as well. So, they could securitize.

Sarah Mock: Securitizing, or creating securities, is a pretty common practice in the finance world. Basically, it's when an institution purchases a whole bunch of loans as an investment, and pools them together. That way it can sell securities – a type of financial product - in a whole portfolio and the risk of default is minimized, as compared to alternative where say, an institution sold individual loans to individual investors. In that case, if the loan you bought can't be repaid, your investment is in trouble, but when instead own a small piece of 100 loans, your individual share of a loan that is not repaid is minimal.

Jeff Conrad: At the time that banks had to compete against farm credit and the banks had capital limitations because as the land values start to grow up in the '70s, they were in a position where their farm borrower would come in and say, "Hey, I want to continue to grow my operation. I want to buy my neighbor's farm. I'm going to need a million dollars loan." Because of the capital constraints of a bank, and the regulators, they might say, "No, you can't do a million-dollar loan for that borrow because your capital ratios, we won't allow you to do something that large." So, in that situation, they might say to their banking client, that they had a checking account with, they had maybe operating loans, and all of a sudden, they can't provide the mortgage - that borrower might walk over to farm credit and say, "Oh, can you do the million-dollar loan?" and farm credit would say, "You better bet I can. And by the way, I'd love to have your operating line." The banks had a need for a tool to be able to keep that borrow. And if they could write that mortgage loan and get it off their books, the regulators would be happy.

Sarah Mock: The benefits for bankers were pretty clear from Jeff's perspective, and it showed. The banking sector was a major driving force behind this congressional endeavor.

Jeff Conrad: And really what this is beyond just the bank being able to keep their borrower. Farmer Mac would allow everyone to get access to cheaper capital because they would have that implied government guarantee once it was securitized. So, the government would be at risk if the loans defaulted.

Sarah Mock: To put a fine point on this, the Farmer Mac idea promised to lower the cost of borrowing because it was opening up that government guarantee, that previously only farm credit enjoyed, to many more lenders. In short, the federal government was taking even more risk from the ag lending sector and putting it squarely on the federal balance sheet. And the thing is, just as was true for farm credit, there was real, tangible risk associated with Farmer Mac.

Jeff Conrad: I think it was the controller of the currency really did not want to approve another agency. When you think about Fannie Mae and Freddie Mac and these implied government guarantees what happens, a lot of people think happens, and it does to some degree is the government takes all the risk and the private sector makes the money. And then if things go bad, the government has all the downside, all the costs. Right?

Sarah Mock: That is right. In a lot of ways, the 1980s and its aftermath represented the start of a new era for lending in the U.S, one as far removed from the credit poor days of the 1890s as possible. The public sentiment had, largely, shifted to match what many saw as an outrageous new era of the government taking risk out of private lending, but leaving all the benefits in private hands. That's what Jeff is highlighting here - the days of the tight money supply, the ultra-conservative lender and their expensive and hard to come by credit were now safely in the past.
The federal government was ready to step in more and more to encourage lending, first by creating farm credit, and then by expanding farm credit-like

benefits to most of the rest of the banking sector. In response, the public had grown more and more skeptical about the newer challenge of too much debt, and more suspicious of the lenders who are eager to grant it. The public wanted to know who's left holding the bag when lenders get caught up in the euphoria. The answer has been the federal government, or in reality, taxpayers.
What few taxpayers at the time likely realized though, however unpalatable the farm credit bailout in the late 1980s might have been, part of that bailout actually led pretty directly to the creation of Farmer Mac. This is in part because of the argument we touched on last episode, that farm credit made mistakes very similar to other ag lenders but were rescued by taxpayers when other private lenders weren't. Arguments to right this perceived injustice were beginning to sound quite convincing on Capitol Hill.
But the original envisioners of Farmer Mac, were not immune to constituent complaints about not wanting any more bailouts, so lawmakers set out to deter the kind of behavior that might lead to one with a policy innovation of their own.

Jeff Conrad: So, when the legislation was gone through, they said that someone had to hold a 10% subordinated risk position. So, what that meant, let's say that $300 million portfolio we did at Hancock, you would say 10% of that or $30 million had to be subordinated risk - that would be the high-risk position. And we had to hold that and basically it was a mechanism, so the government wasn't taking on as much risk. And the fact that they put that in place really made Farmer Mac difficult to work in how it was envisioned.

Sarah Mock: I had to ask a lot of follow up questions to understand this hang-up, but the brass tacks here is, as Farmer Mac was originally created, the government would have your back in the event of a catastrophe – if say 50% of your loans went bad and turned into losses. But institutions would be on the hook for the first 10%, no matter what.

Jeff Conrad: So, what the government was saying, like you're going to have every interest to make sure that you're putting very good loans in there. And it doesn't matter when you have this more subordinated risk, you're in the first risk position. So even though I might only be having a holding value of 10% of that portfolio, any of the loans that were default, I would feel the pain in my subordinated risk position.

Sarah Mock: Though this structure made Farmer Mac a less appealing option for lenders, the deal still got done. And this specific hang-up was eventually changed, such that today, portfolios of loans sold to Farmer Mac require no subordinated risk position.
I want to come back to Jeff in a few minutes, for a last take on what Farmer Mac could have been, but first, I think we've got to figure what exactly Farmer Mac was and is today. To tell some of that story, I'll introduce you to perhaps the most inside of insiders.

Brad Nordholm: Brad Nordholm I'm CEO of Farmer Mac.

Sarah Mock: Brad has spent his career in and around ag, financial, and energy commodities, that is, after growing up in rural Minnesota and ranching in Montana for a while. He got his first bank job in Minneapolis just in time to get a front row seat for the 1980s farm crisis. One of his biggest professional takeaways from the experience was recognizing the need for more innovative tools – especially for tools that institutions could use to manage credit risk.
The parallels between Brad's lived experience and what actually happened are pretty clear, and when he claimed the helm at Farmer Mac 4 years ago, he began stewarding perhaps the most visible new tool that was created in the aftermath of the 1980s.

Brad Nordholm: At that time, Congress really recognized that it would be advantageous to have more sources of liquidity and even more important liquidity providers that can provide long-term fixed rate product as service to farmers and ranchers in American agriculture. And that was really the genesis behind the creation of Farmer Mac. ~~O~~ur enabling legislation was passed by Congress in 1987 so we're about 35 years old as measured by charter today. And the idea was let's create a government sponsored density that would have favorable access to the debt capital markets that could take down large blocks of money for periods ranging from a month to 30 years on a fixed rate basis and use that to fund very competitively priced products that would be originated by other institutions including commercial banks, credit unions, independent finance companies, farm credit banks, and others, and purchased by Farmer Mac. And by having that kind of structure we could provide more liquidity to those providing credit to American farmers and ranchers

Sarah Mock: There was a lot in there. In the simplest terms, Farmer Mac is a government sponsored entity that buys mortgages. So, when you go to your local bank and ask for a loan for new ground, and the bank offers it to you, your local lender is not likely to have a few million dollars in 30-year, fixed-rate deposits backing that loan. Instead, they plan to sell the loan to Farmer Mac, to ensure your loan stays fixed for decades. If you currently have a long term, fixed rate ag loan -- there's a decent chance it's actually been sold to Farmer Mac, though that doesn't change the fact that your local institution is still servicing it. And though the idea of a GSE like Farmer Mac may have been kind of new in agriculture, it had a direct inspiration that was already well seasoned from the broader economy. Here's Brent:

Brent Gloy: I think most people have heard of a Freddie Mac, Fannie Mae. Those are, government sponsored entities that buy home loans. And so, if you make a home loan today, very few banks are making a 30-year, fixed-rate home loan. They wouldn't do that because they have tremendous risk. If their cost of funds goes up over time, they could, be really underwater on those loans. So instead, what they do is they package all those loans together and sell them to investors. Agriculture is harder because you have all these small banks around the country making these agricultural loans so they needed a way to pool those, so that they could make those longer-term loans. That's why Farmer Mac came into play is they were developed to allow banks to make long-term, fixed-rate agricultural loans, Banks, didn't have that until Farmer Mac came along.

Sarah Mock: Notably too, Farmer Mac, unlike farm credit, was not another competitor in the marketplace -- as Farmer Mac is prevented by its charter from going directly to farmers to grant loans. All of this seems a pretty direct response to the unique circumstances of the 1980s, where much of the worst impacts were driven by floating interest rates, which are necessary for a local lender who doesn't have access to funds other than deposits. But what exactly is the "favorable access to debt markets" that Brad mentioned?

Brad Nordholm: We have a network of institutions that like to buy our debt out to 30 years. The types of institutions that are most tightly related to Farmer Mac in our debt issuance program, are city, county, state, pension plans, and retirement boards, some large institutional investors, such as insurance companies or some money market funds. Our funding sources are quite unique to Farmer Mac. We, for example, don't overlap much at all with the farm credit system or the federal home loan bank for that matter. So, it's these institutions that want to put money together so that, that 30-old-employee, when they're ready to retire at age 60, 65, the money has grown and is there for them. And so, they're interested in buying 30-year, 20-year, 10-year fixed-rate obligations, the Farmer Mac may issue, and they have become very comfortable with us as a government sponsored entity and so are very interested or willing to accept low-cost returns on those.

Sarah Mock: Though Farmer Mac and the farm credit system might not have a lot of overlap in who invests, their sales pitch is undoubtedly similar -- if you've got long-term capital, you can invest it in American agriculture -- the returns might not be super impressive, but the implicit backing of the U.S. government makes these investments pretty close to a sure thing. But Brad also spoke to some of the new -- to use his word, "innovative" products that Farmer Mac has been cooking up:

Brad Nordholm: In addition to issuing long-term ventures, another way that just recently Farmer Mac has begun accessing outside investors – we have done two of what are billed as the first agriculture mortgage back security. Now some people say, oh, I've heard of securitizations before those have been situations where a bank or credit union or a farm credit institution has originated loans, we've securitized them and sold them back to them. What is different about this is that we are taking first mortgage loans to farmers and ranchers. We're putting them in a special trust that we sponsor and then we are taking strips of the cash flows from those loans and selling pools of those strips of cash flows to investors.

Now, why is that important? It does a couple things. First of all, it attracts a completely new type of investor. Not just to Farmer Mac, but to America's farmers and ranchers. These are investors that include overseas pension plans, U.S. pension plans, some insurance companies but it's a new investor and that's good because it further diversifies our funding. Another reason is that the risks associated with those loans - credit risk, interest rate reset risk, refunding risk - those are all risks that are now born by those investors. So, it's a very good division of labor. The third reason that this is so important is that it provides a very cost-effective way for Farmer Mac to do this business. The regulatory capital charges that we have for this are considerably less than if we borrow big blocks of money in the debt capital markets and turn around and parse it out and purchase loans, ultimately passing it through to farmers and ranchers across the country. Well, you say that sounds abstract, “So what?” If we need to allocate less capital to that transaction because more risks are born by the outside investor, we, in the long run, can reduce our pricing. We can buy these loans at lower interest rates and pass that through to the farmer and rancher and by doing so we better fulfill our mission of increasing availability of credit, reducing cost of credit to rural America.

Sarah Mock: Brad calls this work "taking some of the friction" out of the various transactions -- in other words, it's all about making money flow more cheaply from investors to Farmer Mac to institutions and to, eventually, farmers' bank accounts, and that could be in terms of costs in dollars, hours, or expertise. Farmer Mac, of course, is still a relatively new institution, and their charter has expanded in the last 20 years. They do much of their business with loans to farmers and ranchers, but they also work with agribusiness, rural infrastructure, and expanding out into renewable energy. Brad says Farmer Mac has always been focused on supporting rural America, but that doesn't mean the organization hasn't advanced over the last 35 years.

Brad Nordholm: What has continued to develop is our expertise in underwriting, structuring, designing programs to deliver the credit that these different segments need. We have developed a huge reservoir of expertise and that enables us to make better decisions faster, cheaper, more confidently to be more responsive to our seller-servicers to farmers and ranchers.

Sarah Mock: I think Brad's done a good job, to this point, capturing a snapshot of where Farmer Mac is now. But I wanted to bring back Jeff Conrad, for a final insight into on what the envisioners of Farmer Mac thought it would be, and what it actually is today.

Jeff Conrad: By the time Farmer Mac finally got put in place the world has changed. Think about if you're a bank and your balance sheet, you let's say I can have a $100 million in loans and all of a sudden, land values fall 30%, 40%, and people are borrowing less. All of a sudden that $100 million of capacity by might be fine for me. And that's what happened. It's the banks who really wanted this system and did have a January need for it maybe in the '70s, early '80s, but by the time it got put in place, the banking system had solved its own problems just by land values falling and demand of their borrowers falling.

The way that we originally envisioned the sector unfolding, and Farmer Mac, working with the banks and insurance companies and to the extent that we expected it, that never happened.

Sarah Mock: If we take Jeff's perspective here, maybe Farmer Mac was never quite the solution it was meant to be. That's not terribly uncommon when it comes to innovations – bubble wrap, as a fun example, was originally invented as a textured wallpaper, but found a better use as a packing material. Play-doh, as an even more fun example, was originally invented to clean wallpaper, but obviously, is much more fun to play with. I asked John Blanchfield about Farmer Mac as well and he largely echoed Jeff's take, but also suggested that though Farmer Mac might have come too late to deal with the last crisis, it's day of reckoning might well be around the corner.

John Blanchfield: There's this old saying that your army is always prepared to fight the last war. So, when Farmer Mac was created in 1988, it was created to help mitigate interest rate shock. Well, basically from the time Farmer Mac was created to today, interest rates have moderated downward. So as a result, we really have not had the opportunity to see how effective a Farmer Mac will be during a period of rapidly increasing interest rates

Sarah Mock: Taken together, I think Jeff and John's perspectives beg the question - how has Farmer Mac been preparing for the better part of the last 40 years for the challenges ahead? That's after the break.

COMMERCIAL

Sarah Mock: To understand what tools and innovations Farmer Mac has been working on to prepare for the rising interest rate environment that John just outlined, I want to share an excerpt from my conversation with Brad.
He asked, at the end of our interview, if he could talk a little bit more about innovation at Farmer Mac, in addition to our earlier discussion about those new farm mortgage security offerings. I'm including a longer piece of the interview than I usually would here, for maximum transparency.
Here's how it went:

Sarah Mock: One of the themes we are exploring is a kind of deep economic theory about the fact that there is no such thing as innovation in debt because all debt is just debt and a lot of bad things have happened in history when people have tried to make innovations in debt, because it turns out it's just debt by a different name. So, I'd be really curious to learn about some innovations that are not scams.

Brad Nordholm: Yeah. Oh Sarah, you are so correct. And there have been times when people thought, "Oh, we've figured out how to do things so much smarter." We can do no-document loans, for example, or low document loans, we don't have to think about all the issues. That came to light in 2008 and 2009 with the global financial crisis that ultimately started as issues with not just sloppy, but intentionally streamline incomplete, I would say, underwriting of loans. So, when I talk about innovation at Farmer Mac, we're really not talking about less complete underwriting or consideration of loans. But let me talk about what we are talking about because it's very exciting. Let me give you a vision at our board planning retreat this last year, we said, "What if a farmer could go to a contract for purchase of a farm on a Friday and we could close their financing on a Monday?"

Why is there innovation there? There's innovation for how we use technology in our seller servicers' offices and on their phones to capture data from farmers and ranchers and other of our end borrowers there then the use of technology, how do we package and evaluate and massage and stress tests, that financial information to get to good credit decisions very quickly? We have a product called Ag Express and it used to be a few weeks or at least a few days now it's a couple hours for us to get credit decisions through that system. How can we keep pushing that into more and more products and not just make faster, but even better credit decisions?

The decisions that we make that way are proven to be better than the old manual way. How can we issue loan commitments and lock in funding in a very seamless way? Then the two big lead items - and anyone who's gone through a mortgage loan, I don't care who it's with, they've experienced that it takes just way too long to close the loan. And why is that? It's title work and title insurance and it's appraisals. And so, we have begun a pilot, for example, where we are using big data that we're collecting on land values to come up with a strong estimate of value, that's what an appraisal is, without taking the 45 to 60 days that manual process takes right now. And we can do that with data sitting on our desktop. I think it'll be only a matter of a few years before we're able to do that for the majority of our business in majority areas across the country. And then how can we ring time out of that title process as well, so that the documentation is produced

instantaneously and the title, insurance commitment - every state but Iowa requires it - is written almost instantaneously?
So again, let's take that vision. Farmer rancher wants to buy a property on Friday contracts to do so and we close it on a Monday. How can we be working towards that and think about innovation in that context? It's very exciting. And frankly, something that we're approaching with a sense of urgency, our view is if we don't do it, someone else will.

Sarah Mock: You mentioned that decisions made in some of these systems are better than they were previously could you say more about that? How are they different? What kind of data maybe is different?

Brad Nordholm: Sure. We have developed this very deep expertise in American culture and rural infrastructure. They're fantastic. They're the best in the business. But what we're able to do when we move towards more automated systems like our Ag Express system is identify just a few sources of data that are the most predictive in terms of that loan performance. And frankly, the other underwriting factors that may been utilized in the past we can now see as less necessary. I wouldn't go so far as to call them distractions, but less necessary. And so, by focusing on the things that matter the most, we can make decisions that are every bit as good, and in many cases, better.

Sarah Mock: I included this whole segment, so that you could draw your own conclusions from it. My takeaway was a cautious one. I think there's room to wonder and worry as lenders zero in on fewer and fewer data points in an effort to make the lending process ever more frictionless that something might at any moment, be missed. Obviously, we're looking at a direct tradeoff here, faster, cheaper loans on the one hand, and a more complete understanding of all the possible risks on the other. I think a lot of people, in ag and beyond, would be more than willing to make that tradeoff, but I think it's worth acknowledging that perhaps one of the reasons why getting a loan a few days or weeks faster, or saving a few tenths or hundreds of a percentage point of interest seems worthwhile, is because we've failed to recognize how significant some of the risks out there might be.
In an effort to balance out my skepticism, I put the question to David and Brent, who offered some solid nuance.

David Widmar: There are innovations, right? If we go back to even in the ‘80s or even farther back, there is innovation.

Brent Gloy: You can have innovation in how you originate debt or how you get debt to the customer or all the things that surround the fundamental product of debt. There's I guess, room for innovation. Innovation around that like data gathering, data processing, you name it could be valuable. How valuable, I think would be an open question.

Sarah Mock: This is definitely what Brad is talking about, right? Innovation in how debt is evaluated and originated. There's certainly space for some innovation here. The takeaway from all of this, for now, is to keep in mind that tradeoffs come with innovation especially in lending.
There’s one other aspect of this innovation in ag lending question that we haven’t touched on yet and it has to do with the same sector that brought us the “move fast and break things” mantra – what role, in short, might technology play in creating more opportunity ag lending?

Brent Gloy: In terms of like technology, technology can be useful. It used to be if you wanted to make a loan you had to go visit your banker in person and build a relationship with them and all that kind of stuff. Technology can make that a lot easier. You don’t have to have as much of a relationship and of course, those relationship lending practices are a little bit more expensive, it involves people. So, if you can intermediate, hook borrowers and lenders up through a technology platform, that can be an innovation.

Sarah Mock: Leading the way with tech, and leaving regulations behind, enter the non-bank. Next time, on *Nothing Borrowed, Nothing Gained*.

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Until next time, remember:

Curt Covington: The good times never last.