Growing Your Agricultural Loan Portfolio: The Case for the Secondary Market

By Jackson Takach

Can you have your cake and eat it too? Many ag lenders seem to believe that is impossible as it pertains to their agricultural loan portfolios. To some bankers, a loan sold into the secondary market is an asset gone, a lost opportunity for balance sheet growth. However, the evidence offered in support of this sentiment is largely anecdotal rather than statistical. FDIC Call Reports and Farmer Mac internal customer data shed some light on secondary market transactions and their impact on farmland-secured loan portfolio growth. An analysis of this data upends the traditional view of loan portfolios: over the last 10 years, participants in this secondary market have farmland loan portfolios that grew at a faster rate than non-participants.

Simply put, a secondary market for loans is one in which previously originated loans are bought and sold; a robust secondary market increases the liquidity and ultimately the value of the underlying assets being traded. For loans secured by agricultural real estate, the primary agent of the secondary market is the Federal Agricultural Mortgage Corporation, better known as Farmer Mac. Farmer Mac is a congressionally chartered corporation born in the 1980s out of the agricultural banking crisis. At more than $14 billion in loans and guarantees, the company has many programs to achieve its mission of improving the liquidity of farmland-secured loans and providing long-term fixed rates to farmers and ranchers. Such programs include whole loan purchases of and participations in farmland loans, USDA guaranteed farm loans and rural utility cooperative loans, in addition to credit enhancements such as guarantees and commitments to purchase. While there are certainly loans bought, sold and participated outside of Farmer Mac's market share, Farmer Mac's customer sales data offers a very good proxy of secondary market participation.

According to the FDIC data, commercial banks accounted for $81 billion in farmland-secured loans outstanding as of Sept. 30, 2014. Since 2004, the amount of farmland-secured loans at commercial banks has increased by almost 100 percent, and the average agricultural bank has grown its farmland portfolio at a clip of 3.3 percent per quarter. For the purpose of this analysis, agricultural banks are defined as having either: (1) a ratio of agricultural loans to all loans and leases that is greater than the average commercial bank (typically 16 percent), or (2) more than $20 million in farmland-secured loans. While the aggregate outstanding balance of farm real estate loans has steadily increased, the number of agricultural banks has steadily decreased from 2,611 in 2004 to 2,116 in 2014.

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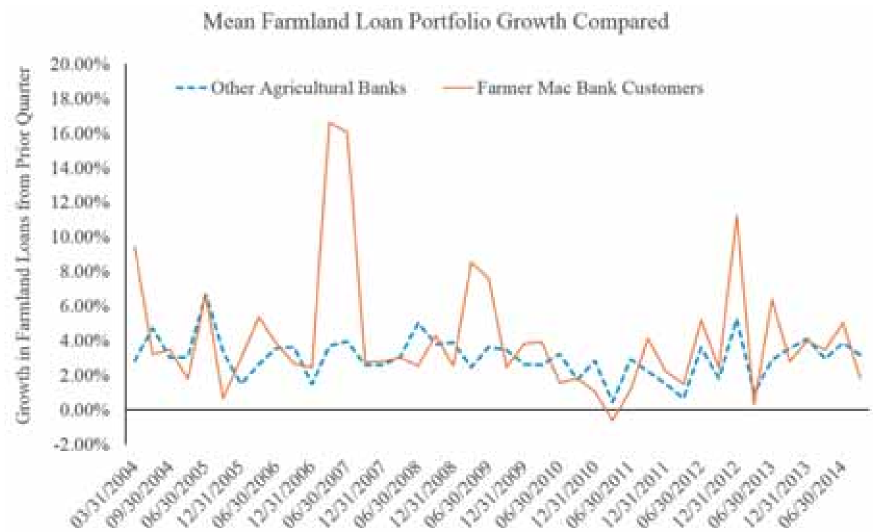

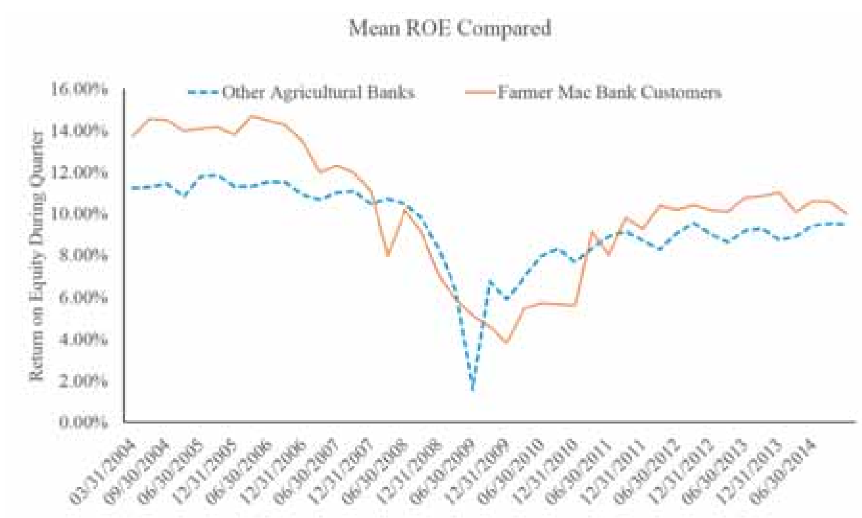

When combined, the FDIC and Farmer Mac datasets mentioned above provide the foundation necessary to test our hypothesis. If a bank has outstanding business in a Farmer Mac program it is considered an active customer during that quarter; all other agricultural banks without outstanding business are considered non-customers. The two metrics looked at here are the change in the bank's farmland loan portfolio from the previous quarter and the reported return on equity for the bank during the quarter (theoretically, participants in the secondary market should earn a higher ROE as they retain income or spreads on a lower level of required capital).

Between third quarter 2004 and 2014, active Farmer Mac customers grew their retained farmland loan portfolios at average rate of 4.0 percent per quarter compared to an average of 3.2 percent per quarter for non-customers. The held portfolios of customers grew at this rate despite placing over $5.7 billion in loans and guarantees into the secondary market. The difference between the two averages is statistically significant at the 99 percent level, indicating a very high likelihood that the difference did not happen by chance. There is also a measurable significant difference between Farmer Mac customers and non-customers for quarterly ROE: 9.9 percent per quarter compared to 7.5 per quarter for customers and non-customers respectively.

There's another saying that this analysis brings to mind: correlation does not imply causation. There are certainly many possible explanations for portfolio growth rates and earnings efficiency; this analysis is not sufficient to indicate a causal relationship between participation in the secondary market or a specific program and bank success. However, it calls into question the argument that the secondary market detracts from growth in the farmland loan portfolio. It also supports other often-cited motivations for participation such as complimentary offerings for customers, portfolio diversification benefits (including exceeding hold limits), and alternative fee income. The secondary market for farmland loans may just offer a sweeter deal than ag lenders originally thought. ●

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