Ag + Agency = Bond Alternative

Farmer Mac brings diversification opportunity to community banks

By Jim Reber

All good community bank portfolio managers have, as part of their risk-abatement strategy, the policy of diversification. This can be applied in multiple layers. One is to buy a range of investment sectors (i.e., mortgage-backed securities, munis, government agencies). Another is to purchase a variety of different maturities (which is partly dictated by the community bank’s interest rate risk posture), and another is to spread the investments around a range of issuers.

In the government agency sector, the most visible names are Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. Even though those three government-sponsored enterprises (GSEs) have seen shrinkage in their borrowings in the last five years, they still in aggregate have about $1.8 trillion in bonded debt. Most community banks own at least some of each of these GSEs.

As an alternative, another agency that issues bonds is the Federal Agricultural Mortgage Corp., or Farmer Mac. Farmer Mac is unique among GSEs for several reasons, starting with that it is a Preferred Service Provider of ICBA. Congress created it in 1988 during an agricultural credit crisis to provide a secondary market for qualifying agricultural and rural housing loans. Its common stock is traded on the New York Stock Exchange (stock symbol AGM), and its operations are financed primarily by issuing debt.

Same, but different
A key differential a potential investor should know is that the volume of outstanding debt is less than that of the other GSEs. As of Dec. 31, 2014, Farmer Mac had about $12.8 billion in notes payable and has seen a slow, steady growth in its entire balance sheet. That tally, however, still leaves it far smaller than its government agency brethren.

Another unique characteristic is that Farmer Mac bonds are not rated by any of the major rating services. Their debt is senior and unsecured, and supported by the equity capital. The regulators have assigned a 20 percent risk weighting to the debt, which mirrors that of the other GSEs, and it is eligible collateral for FHLBank advances.

Risk/return in practice
Some community banks have invested in Farmer Mac debt as a means of spreading risk. By owning positions in a different obligor, they assume some other, different, risks. One is the perceived risk of owning a nonrated security. However, for many community banks that own Farmer Mac bonds, the 20 percent risk weighting allows the investment to comply with their investment policies.

Another risk is the slightly less liquidity that these bonds have compared to other GSE securities, due to their smaller scale.
Because of these two differences, Farmer Mac bonds tend to have somewhat higher yields than Fannie Mae, Freddie Mac or FHLBank issues of similar structure. For example, in February 2015, a five-year non-callable Farmer Mac bond was available at a spread over the five-year Treasury of 18 basis points (0.18 percent). At the same time, similar FHLBank bonds were trading at a spread of about 14 basis points (0.14 percent). Shorter maturities have less yield pickup, and longer maturities have more.

Be duly diligent
The Farmer Mac website, at www.farmermac.com, contains a lot of the information a community banker will want from an investigative point of view. For practical purposes, an investment manager should ensure that nonrated debt is permissible according to that community bank's investment policy, or that a maximum dollar exposure is quantified.

Finally, as you discuss Farmer Mac bonds with your favorite brokers, their supply is such that you may want to be notified when new issues come to market. Farmer Mac, depending on its financing needs, often issues a one-, three-, five- and 10-year bond each month, in block sizes generally from $5 million to $25 million. Your broker can advise you of the expected yields, spreads and maturities in the next issuance cycle.

Open Enrollment
ICBA Securities’ investment school, the ICBA Bond Academy, will be held Nov. 9—10 at the Peabody Hotel in Memphis, Tenn. The school teaches new and upcoming managers to design, build and maintain a profitable investment portfolio. Up to 16 hours of Continuing Professional Education credits are available. To register visit www.icba-securities.com, or call (800) 422-6442 with questions.