United States General Accounting Office

GAO

Report to Congressional Committees

April 1992

FARMERS HOME ADMINISTRATION

Billions of Dollars in Farm Loans Are at Risk

GAO/RCED-92-86

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-246532

April 3, 1992

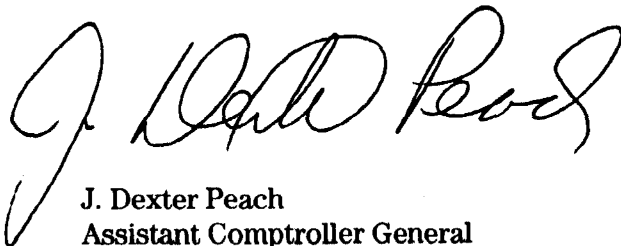
Congressional Committees

GAO has implemented a special audit effort to help ensure that areas vulnerable to fraud, waste, abuse, and mismanagement are identified and that appropriate corrective actions are taken. This effort focuses on 16 areas, one of which is the U.S. Department of Agriculture's (USDA) Farmers Home Administration (FmHA) farm loan programs.

This report presents the results of our review of FmHA's direct and guaranteed farm loan programs as well as of the agency's management of farm properties obtained as a result of defaults on federal loans. We are recommending a variety of actions to the Congress and USDA to reduce the substantial risks associated with these programs.

We are sending copies of this report to the appropriate Senate and House committees; all Members of Congress; the Secretary of Agriculture; the Administrator, FmHA; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

This work was performed 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 VII.



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Executive Summary

Purpose

In 1989, a borrower received a $132,000 direct farm operating loan from the Farmers Home Administration (FmHA) even though, just 2 months earlier, he had received about $428,000 in debt relief. By March 1991, he was $28,000 past due on payments. Similarly, in 1990, FmHA guaranteed a $189,000 loan to a borrower whose direct loans had been reduced 8 months earlier by about $216,000. By April 1991, this farmer was $94,500 past due on the guaranteed loan's payments.

Such examples are not unique in FmHA's farm lending programs. Of about $24 billion in outstanding direct and guaranteed loans to the nation's farmers, as much as $15 billion, or about 60 percent, is held by problem borrowers who may not meet some or all of their loan obligations. This risk, together with the prospect of FmHA's making or guaranteeing additional loans worth billions of dollars over the next several years, prompted GAO to review FmHA's direct and guaranteed farm loan programs and the agency's management of farm properties obtained as a result of defaults on federal loans. In each of these three areas, our objectives were to (1) assess compliance with existing loan-making, loan-servicing, and property management standards and (2) identify program policies that contribute to financial risk.

GAO's review of FmHA's farm loan programs was part of a special audit program implemented in 1990 to respond to congressional and GAO concerns about the continued existence of serious breakdowns in internal control and financial management systems throughout the government. This program focuses on areas that GAO believes are highly vulnerable to waste, abuse, and mismanagement. It is a long-term effort that will evolve over time as agencies correct their problems and as GAO identifies new areas of concern. Continued efforts to identify and correct deficiencies in these high-risk areas and other federal programs should significantly reduce losses of federal funds due to waste, abuse, and mismanagement and increase the economy and efficiency of federal programs.

Background

FmHA, an agency of the U.S. Department of Agriculture (USDA), provides credit to farmers who are unable to obtain funds elsewhere at reasonable rates and terms. The agency provides credit assistance through direct loans, which are funded by the government, and through guaranteed loans, which are made by commercial lenders to farmers and guaranteed up to 90 percent by the government. FmHA's assistance is intended to be temporary; once farmers have become financially viable, they are to "graduate" to commercial sources of credit. When borrowers do not repay their loans,

FmHA can acquire the properties that were pledged as security for the loans and subsequently sell the properties.

Results in Brief

The multibillion-dollar federal investment in farmer loan programs is not being adequately protected. In the direct loan program, field lending officials have not complied with agency loan-making and loan-servicing standards established to safeguard federal financial interests. In addition, FmHA's loan-making and loan-servicing policies —designed, in large part, to help farmers stay in farming—have increased the government's losses. By allowing delinquent borrowers to obtain additional credit, FmHA has reinforced its lending to poor credit risks, and by providing debt relief to borrowers who have defaulted on their loans, it has created incentives for farmers to avoid repaying their debts.

In the guaranteed loan program, ineffective implementation of agency standards and imprudent policies have also jeopardized the federal investment. FmHA lending officials have approved guarantees without obtaining proof of borrowers' creditworthiness and have not adequately monitored commercial lenders' servicing of guaranteed loans. Additionally, policies permitting commercial lenders to refinance existing farm debt and obtain maximum-rate guarantees for most loans, regardless of risk, have encouraged lenders to shift their high-risk farm debt to the government.

Finally, FmHA's management of its farm properties has not protected the government's financial interests. Agency officials have not ensured proper maintenance of the properties, and some properties have been used without FmHA's approval. Moreover, legislative mandates regulating property sales have limited FmHA's return on the properties and increased the agency's holding costs.

Weaknesses in FmHA's management have contributed to these longstanding problems. Over the past several years, GAO and others have reported on a variety of such problems, including poor management information systems and weak financial controls. However, it is important to note that the agency's congressionally defined mission—to help keep high-risk farmers on their farms—often conflicts with normal fiscal controls and policies designed primarily to minimize risk and financial losses. No clear guidelines enable FmHA to balance its responsibilities as the lender of last resort for the nation's farmers with its responsibilities as a fiscally prudent

lender. Until FmHA's role and mission are clarified, the agency's problems will continue.

Principal Findings

Problems With Direct Loans

GAO estimates that almost $14 billion, or as much as 70 percent of FmHA's direct loan portfolio ($19.5 billion outstanding as of September 30, 1990), is at risk because it is held by delinquent borrowers or by borrowers whose debts have been rescheduled in response to past repayment difficulties. This level of risk exists even though FmHA forgave about $4.5 billion in direct loan debt in fiscal years 1989 and 1990.

Ineffective implementation of FmHA's loan-making and loan-servicing standards has contributed to FmHA's direct loan problems. For example, agency officials have approved loans that were not based on realistic estimates of production, income, and expenses, and they have not verified borrowers' debts as required. FmHA reviews of direct loans made from fiscal years 1988 through 1991 disclosed that 13.5 percent of the sampled loans did not demonstrate the borrowers' repayment ability. In fiscal year 1991, 18 percent of the sampled loans in 15 states did not show that borrowers' debts had been verified. In addition, FmHA lending officials have not, as required, annually inspected property offered as loan collateral and have not annually analyzed the operations of borrowers experiencing financial difficulty.

Lenient loan-making policies, some congressionally directed, have further increased the government's exposure to direct loan losses. For example, from fiscal year 1988 through the first 8 months of fiscal year 1991, FmHA lent $67 million to delinquent borrowers. Furthermore, during fiscal years 1989 and 1990, FmHA lent $38 million to over 700 borrowers who had not repaid previous loans that had resulted in losses totaling $108 million. Almost half of these borrowers became delinquent again on their FmHA loans.

Loan-servicing policies have resulted in losses for the government without making farmers financially viable and able to graduate to commercial credit. Debt rescheduling and debt reamortization—options that extend the repayment period for farm operating and ownership loans —typically capitalize unpaid interest and add it to the outstanding loan principal

without increasing the loan security. Such actions can result in excessive debt and loss of equity for borrowers and in undersecured loans for the government. Furthermore, congressionally directed debt write-downs and debt write-offs—options that reduce or forgive debts that are 180 days or more overdue—provide incentives for farmers to default on their loans and result in substantial losses for the government. Overall, FmHA's efforts to strengthen the financial positions of borrowers by restructuring their loans have not succeeded. As a 1990 GAO report disclosed, over 90 percent of the borrowers reviewed were financially weak, with high debt-to-asset ratios and/or low cash flow margins, after their debts were restructured. According to FmHA, about 43 percent of all borrowers whose debts were restructured from November 1988 to March 1990 became delinquent again.

Problems With Guaranteed Loans

In recent years, FmHA has shifted its loan-making emphasis from direct to guaranteed loans. Like the direct loan portfolio, the guaranteed loan portfolio suffers from problem debt. FmHA estimates potential losses of $1.2 billion, or about 28 percent of its guaranteed loan portfolio ($4.1 billion outstanding as of September 30, 1990). This level of risk exists even though FmHA has paid commercial lenders about $300 million to cover loan losses during the past few years. In February 1992, FmHA told GAO that its guaranteed loan loss projections are unrealistically high and that it plans to change its loss projection formula. GAO agrees with FmHA's assessment that its guaranteed loan loss projections appear high. However, GAO remains concerned that the federal government's investment in this program is at risk because the program has experienced many of the same problems as the direct loan program and has the budget authority to grow significantly in the near future.

In the guaranteed, as in the direct, loan program, FmHA officials often do not meet loan-making and loan-servicing standards. For example, FmHA reviews from fiscal years 1988 through 1991 showed that 13.4 percent of the sampled guaranteed loans did not meet a key FmHA standard covering repayment ability. Furthermore, USDA Office of Inspector General and GAO reviews in recent years have shown that county officials are not adequately overseeing commercial lenders to ensure that they are carrying out their loan-servicing responsibilities.

FmHA's guaranteed loan policies also contribute to the government's exposure to financial loss. For example, because FmHA allows commercial lenders to refinance existing debt and routinely guarantees most loans at the maximum 90 percent, private lenders have shifted their high-risk debt

to the government. In fiscal year 1988, about $550 million, or about 44 percent of the guaranteed loan funds, was used to refinance existing debt. In addition, because FmHA allows borrowers who have defaulted on past direct loans that resulted in losses to receive new guaranteed loans, 137 borrowers received about $15 million in guaranteed loans in fiscal years 1989 and 1990 after having previously received about $26 million in debt relief.

Problems With Farm Inventory Properties

FmHA estimates that, as of September 30, 1991, it had about 3,100 farms in inventory that were acquired from borrowers who did not repay their loans. Legislation requiring FmHA to sell acquired properties at fixed prices to targeted purchasers—often the previous owners—has limited FmHA's return on these properties and increased its holding costs. Also, targeting may not achieve legislative objectives and may, in fact, result in abuse by purchasers. Finally, weaknesses in FmHA's oversight of inventoried properties have at times resulted in the unauthorized use of the properties.

Conflicting Roles Cloud FmHA's Mission

By almost any measure, FmHA's loan programs have become good examples of how programs should not be implemented and managed. Because legislation has not established clear priorities for FmHA's mission, the agency has tried simultaneously to meet conflicting objectives—to be fiscally prudent and to provide high-risk borrowers with temporary credit to keep them in farming until they secure commercial credit. Arguably, FmHA has not achieved either objective. Its shaky loan portfolio does not reflect the operations of a prudent lender. Furthermore, as an assistance agency, FmHA has had little success in graduating borrowers to commercial sources of credit, as was originally anticipated. Ironically, some of FmHA's clients are financially weaker after FmHA's help than they were before.

Recommendations

GAO makes numerous recommendations to the Congress and to the Secretary of Agriculture that are aimed at (1) improving compliance with loan and property management standards and (2) strengthening policies and program design in the direct loan, guaranteed loan, and farm inventory property areas. For example, GAO is recommending that FmHA establish a system to ensure that lending officials adhere to the agency's loan standards, that delinquent borrowers be prohibited from receiving direct loans, that FmHA establish a range of guarantees that places the highest percentage guarantee on the least risky loan and a lower percentage guarantee on the most risky loan, and that FmHA use competitive methods

in selling farm inventory properties. Chapters 2, 3, and 4 contain additional recommendations.

Matters for Consideration by the Congress

GAO's recommendations are directed toward improving FmHA's program management. Ultimately, however, the Congress needs to clarify FmHA's role and mission. Until it does, continued deterioration in FmHA's farm loan portfolio and further losses are likely. GAO believes that, in clarifying FmHA's role, the Congress should consider, among other things, establishing guidance concerning (1) the level of loan losses that it is willing to accept; (2) the length of time that an FmHA borrower can expect to receive assistance before being graduated from the program; and (3) the types of assistance, if any, that should be made available to unsuccessful borrowers who want to leave farming.

Agency Comments

FmHA agreed with each of GAO's recommendations to the Secretary of Agriculture and cited ongoing or planned actions and decisions to reduce the identified risks. FmHA also agreed that its role and mission require better definition and that congressional action is needed to correct many of the problems that GAO identified. Specific FmHA comments and GAO's evaluation are discussed in chapters 2 (direct loans), 3 (guaranteed loans), and 4 (farm inventory property).

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Abbreviations

ACIF	Agricultural Credit Insurance Fund
AHP	average holding period
APTS	Acquired Property Tracking System
CAR	Coordinated Assessment Review
Con Act	Consolidated Farm and Rural Development Act
FMFIA	Federal Managers' Financial Integrity Act
FmHA	Farmers Home Administration
GAO	General Accounting Office
OIG	Office of Inspector General
USDA	U.S. Department of Agriculture

Introduction

As the "lender of last resort" for the nation's financially troubled farmers, the Farmers Home Administration (FmHA) is the third leading institutional lender to the agricultural sector, after commercial banks and the Farm Credit System. It has a multibillion-dollar portfolio of outstanding farm loans and makes or guarantees between $2 billion and $3 billion in new loans each year. However, FmHA has lost billions of dollars on its farm loans in recent years and continues to have a very high level of problem debt that may result in additional losses totaling billions of dollars. As of September 30, 1990, delinquent borrowers held about $8.3 billion, or 35 percent of total outstanding principal, on direct and guaranteed loans. More significant, however, are FmHA's estimated potential losses of $12.1 billion, or about 51 percent of outstanding principal, on its total direct and guaranteed loans.

Overview of FmHA's Farmer Loan Programs

FmHA, a lending agency within the U.S. Department of Agriculture (USDA), provides financial assistance to farmers through direct loans and guarantees on loans made by other agricultural lenders, such as commercial banks and the Farm Credit System. To be eligible for a direct FmHA loan, a borrower must be unable to obtain commercial credit at reasonable rates and terms. To obtain a loan guarantee, a lender must certify that it is unwilling to make the loan without a guarantee. FmHA is supposed to serve only as a temporary source of credit for family farmers. FmHA regulations state that FmHA borrowers should eventually overcome their financial difficulties and "graduate" to non-FmHA sources of credit for their financial needs. Since FmHA lends money and guarantees loans to borrowers who are not considered creditworthy by others, its portfolio can be characterized as being at "high risk." As of September 30, 1990, its farm loan portfolio totaled $23.6 billion, of which $19.5 billion was in direct loans and $4.1 billion in guaranteed loans.

FmHA's primary legislative authority for lending federal moneys and for guaranteeing farm loans made by other agricultural lenders comes from the Consolidated Farm and Rural Development Act (referred to as the Con Act), as amended (P.L. 87-128, Aug. 8, 1961). Funding for FmHA's farmer program loans is provided through the Agricultural Credit Insurance Fund (ACIF), a revolving fund established in the 1940s. The ACIF is financed by the incoming flow of loan and interest payments, borrowings from the U.S. Treasury, and congressional appropriations to cover losses from direct and guaranteed loans and interest subsidies.

FmHA provides loan services through a highly decentralized organization consisting of a national program office in Washington, D.C., a finance office in St. Louis, Missouri, and a field office structure comprising 46 state offices, about 260 district offices, and about 1,900 county offices throughout the nation. FmHA county supervisors who manage the county offices have extensive responsibility and authority for administering the agency's farm programs, including approving and servicing loans and managing inventory property. FmHA district directors are to provide guidance and supervision to county supervisors within designated geographic areas in making and servicing farmer program loans, and state directors are to administer and oversee operations within one or more states. Also, district and state directors have approval authority for certain loans.

Purposes of FmHA Loans

About $2.1 billion, or 95 percent of total farmer program obligations incurred in fiscal year 1990, were for farm operating loans and farm ownership loans. The remaining 5 percent were for other types of loans, such as emergency disaster and soil and water loans. Table 1.1 summarizes how loan funds were obligated for 1990.

Table 1.1: FmHA's Direct and Guaranteed Farm Loan Obligations, Fiscal Year 1990

Dollars in millions

Loan type	Obligated amount	Percent of total
Direct		
Farm operating	$733.3	33.7
Farm ownership	80.0	3.7
Other[a]	107.0	4.9
Subtotal	**$920.3**	**42.3**
Guaranteed[b]		
Farm operating	908.7	41.7
Farm ownership	348.7	16.0
Subtotal	**$1,257.4**	**57.7**
Total	**$2,177.7**	**100.0**

[a]Includes emergency disaster and soil and water loans.

[b]Excludes guaranteed soil and water loans totaling about $600,000.

Source: FmHA.

Farm operating loans—direct and guaranteed—are authorized for various purposes, including buying feed, seed, fertilizer, livestock, and farm

equipment; paying family living expenses; and refinancing existing debt. Direct operating loans may not exceed $200,000, including any outstanding principal on other direct farm operating loans. Guaranteed operating loans may not exceed $400,000 in total outstanding loan principal. When a farm operating loan is made, collateral must be provided as security.

Farm ownership loans—direct and guaranteed—are authorized for various purposes, including buying and improving farmland; constructing, repairing, and improving farm buildings; and refinancing existing debt. Direct and guaranteed farm ownership loans may not exceed $200,000 and $300,000, respectively, including any outstanding principal on other farm ownership loans, soil and water loans, and recreation loans. When a farm ownership loan is made, real estate or a combination of real estate and chattel property must be provided as security.[1]

In addition to the farm operating and ownership loans, FmHA makes several other types of direct farm loans, such as emergency disaster loans and soil and water loans. Emergency disaster loans are for farmers whose operations have been substantially damaged by adverse weather or by other natural disasters. These loans are intended to assist farmers in covering actual losses incurred so that they can return to normal farming operations. Soil and water loans are made to help farmers and ranchers develop, conserve, and properly use land and water resources. From 1978 through 1984, FmHA also made economic emergency loans, which were intended to allow farmers to continue operations during a time when there was a serious lack of agricultural credit or when the costs of production exceeded the prices farmers received for their products. As of September 30, 1990, economic emergency loans totaling $2.4 billion remained in FmHA's portfolio.

Lending Emphasis Shifts to Guaranteed Loans

In fiscal year 1984, FmHA began placing more emphasis on guaranteed loans and less on direct loans in order to encourage farm lending from private lenders, reduce budget outlays on direct loans, and devote more effort to servicing its growing numbers of direct loans and increasingly delinquent direct accounts. The Food Security Act of 1985 (P.L. 99-198, Dec. 23, 1985)—referred to as the 1985 Farm Bill—supported the shift in emphasis by decreasing authorizations for direct loans and increasing authorizations for guaranteed loans. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508, Nov. 5, 1990) continued this shift, decreasing

[1]Chattel property, as opposed to real estate, is personal property used in farming operations for the production of income, including such property as trucks, tractors, and other major equipment.

FmHA's fiscal year 1991 direct loan lending authority by $482 million and increasing its guaranteed loan lending authority by the same amount. Appendix I shows FmHA's direct and guaranteed farm loan lending authority, as changed by the 1990 reconciliation act, over the fiscal year 1991-95 period.

FmHA Has Lost Billions of Dollars on Prior Loans

FmHA incurs a loss on a direct or a guaranteed farm program loan when a borrower defaults and the proceeds from selling the loan collateral do not equal the outstanding loan amount plus the costs of acquiring and disposing of the collateral. FmHA also incurs interest subsidy losses (expenses) because it (1) lends money at rates below its cost of borrowing and (2) provides payments to commercial lenders so that they will lend money at rates below their cost of borrowing. FmHA recognizes its loan losses and interest subsidy expenses after they are incurred and subsequently receives congressional appropriations to reimburse the ACIF. However, the Federal Credit Reform Act of 1990 (title XIII, subtitle B of the Omnibus Budget Reconciliation Act of 1990) requires, starting with loans made in fiscal year 1992, that FmHA recognize and project its expected losses and subsidies in its budget before incurring these costs and that funding be appropriated to cover these costs in the year in which the loans are made.

The ACIF has accumulated a multibillion-dollar deficit as a result of loan losses and interest subsidies since the fund was established in 1946. Our May 1991 audit report of FmHA's financial statements disclosed that the ACIF had incurred cumulative net losses of about $43 billion from its inception through the end of fiscal year 1989, while receiving cumulative reimbursements for losses (appropriations from the Congress) of about $14.5 billion.[2] As a result, the ACIF had a $28.5-billion cumulative deficit as of September 30, 1989.

FmHA Continues to Hold High Levels of Problem Debt

In addition to past losses that FmHA has incurred, significant portions of its current loan portfolio are at risk. As of September 30, 1990, the outstanding principal on FmHA's direct farm loans was about $19.5 billion, of which slightly over $8 billion, or about 41 percent, was held by delinquent borrowers. Furthermore, FmHA's allowance for loan losses—the amount of loan principal that FmHA estimated in its financial statements as potential losses—on its direct farm loan portfolio was $10.9 billion, or 56

[2]Financial Audit: Farmers Home Administration's Financial Statements for 1989 and 1988 (GAO/AFMD-91-36, May 6, 1991).

percent of the total outstanding principal. FmHA categorized about 41 percent of the farm operating, 32 percent of the farm ownership, 81 percent of the emergency disaster, and 88 percent of the economic emergency outstanding debt in the allowance for loan loss account.

As of September 30, 1990, the outstanding principal on guaranteed farm loans was about $4.1 billion. Borrowers who were delinquent on guaranteed loans owed about $200 million, or about 5 percent of the total outstanding principal. The allowance for loan losses, which is an FmHA estimate based on past loss experience plus a contingency allowance, totaled about $1.2 billion. FmHA categorized about 29 percent of the guaranteed farm operating and about 25 percent of the guaranteed farm ownership outstanding debt in the allowance for loan loss account. In February 1992, FmHA told us that its guaranteed loan loss projections are unrealistically high and that it plans to change its loss projection formula.

Appendix II provides detailed information about the number of borrowers and the amount of debt for each type of loan, as of September 30, 1990.

FmHA Acquires and Sells Farm Properties

When borrowers are unable to repay their loans, FmHA may acquire the farm property that was pledged as security for the loans and subsequently try to sell that property to recover some or all of the unpaid debt. FmHA acquires farm properties through voluntary conveyance, foreclosure, or forced liquidation by other lenders. Once a property enters its inventory, FmHA generally tries to sell it to minimize its loan losses. Before a property is sold, it can be leased. Additionally, the Con Act, as amended by the 1985 Farm Bill and the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988), provides several options for former owners to recover farm property after it enters FmHA's inventory. Specifically, former owners have the option of leasing or purchasing either the entire farm property or the farm homestead, including farm buildings and up to 10 acres of land.

FmHA is one of the largest farm landlords in the United States. Its records indicated that on September 30, 1991, the agency had 3,109 farms in inventory that were valued at about $405 million. During fiscal year 1991, FmHA acquired 742 farms while selling 1,203 farms from inventory.

Objectives, Scope, and Methodology

Our work was part of a special GAO governmentwide audit effort to help ensure that areas potentially vulnerable to fraud, waste, mismanagement, and abuse are identified and that appropriate corrective actions are taken.

This review examined FmHA's direct farmer loan program, guaranteed loan program, and management of farm inventory property. In each of these three areas, our objectives were to (1) assess compliance with existing loan-making, loan-servicing, and property management standards and (2) identify program policies that contribute to financial risk.

In addressing these objectives, we conducted work at 26 FmHA county offices in 11 states, FmHA's Finance Office, and FmHA headquarters. At some of the county offices we conducted work in the direct loan, guaranteed loan, or farm inventory property area; at other county offices we conducted work in both the direct loan and guaranteed loan areas. Additionally, we reviewed and analyzed GAO reports issued since the passage of the 1985 Farm Bill (see app. III for a list of prior GAO reports); USDA and FmHA reports on actions taken in response to GAO's recommendations; USDA Office of Inspector General (OIG) reports issued since fiscal year 1986; the annual reports from the Secretary of Agriculture to the President required by the Federal Managers' Financial Integrity Act (P.L. 97-255, Sept. 8, 1982), referred to as FMFIA; the results of FmHA's own internal control reviews; and relevant congressional reports and hearing records. Appendix IV provides more detail on our scope and methodology.

We started our work in April 1990 and used September 30, 1990, as a cut-off date for much of the financial information about FmHA's farm loan portfolio. This date allowed us to have relatively recent and comparable data on the financial status of FmHA's direct and guaranteed farm loan portfolios. It also allowed us to estimate the extent of the direct loan portfolio held by borrowers who had kept current and who had not kept current on their loan payments. In addition, we conducted detailed field work through May 1991, updating selected information throughout 1991. We performed our work in accordance with generally accepted government auditing standards.

In May 1991, we testified before the Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture, on the preliminary results of the guaranteed portion of this review.[3] In April 1991, we issued a report on the sales of inventory properties that contains information relevant to that appearing in chapter 4 of this report.[4]

FmHA's written comments on the results of our work appear in appendix V.

[3]Guaranteed Farm Loans by the Farmers Home Administration (GAO/T-RCED-91-55, May 14, 1991).

[4]Farmers Home Administration: Sales of Farm Inventory Properties (GAO/RCED-91-98, Apr. 9, 1991).

Lending Practices and Policies Contribute to FmHA's Direct Loan Losses

Over the past few years, FmHA has experienced substantial losses in its direct loan program. For example, during fiscal years 1989 and 1990 alone, FmHA forgave about $4.5 billion in debt to borrowers who were unable to repay loans. The future does not look much brighter. We estimate that, as of September 1990, as much as 70 percent of FmHA's almost $20 billion in outstanding direct farm loans is held by borrowers who will have difficulties repaying the loans—borrowers who are delinquent or who previously had their loans restructured either to avoid becoming delinquent or as a result of being delinquent.

Part of FmHA's direct loan problem occurs because agency lending officials do not always adhere to loan-making and loan-servicing standards, some of which are lenient compared to commercial standards. For example, before approving loans, FmHA county offices do not always adequately review and verify key financial information submitted by loan applicants. As a result, FmHA often uses inaccurate information in assessing an applicant's ability to repay a loan. Also, FmHA county offices do not always inspect farm property to ensure that assets backing loans have not been sold. Nor do FmHA county officials always annually analyze borrowers' farming operations to help improve their farming and management practices. Both procedures are required under FmHA regulations to protect the government's investment.

Lenient loan-making criteria are another source of FmHA's problems. For example, FmHA's policies do not preclude lending money to borrowers who have defaulted in the past or who are delinquent on existing debts. Furthermore, rather than evaluating a variety of factors to determine whether a loan should be made, including an applicant's ability to pay for unplanned expenses and replace equipment, FmHA bases its decision primarily on an applicant's ability to project a positive cash flow—to have projected annual income that equals or exceeds projected expenses.

Finally, certain loan-servicing policies have contributed to the risk in FmHA's loan portfolio. Most importantly, current policies may actually encourage farmers to become delinquent because, by doing so, they may qualify to have significant portions of their debt forgiven. Furthermore, under current servicing policies, farmers can have their loans rescheduled or reamortized[1] in a manner that increases their total debt without correspondingly increasing the collateral backing the debt. As a result, if a

[1]The terms rescheduled and reamortized mean rewriting loan terms for operating or emergency loans and for farm ownership loans, respectively, and may include reducing interest rates.

borrower does default, the assets that FmHA can recover may be worth far less than the outstanding loan.

Billions of Dollars in FmHA Loans Have Been Lost and Billions More Are Vulnerable

During fiscal years 1989 and 1990, FmHA "forgave" about $4.5 billion in loans to delinquent borrowers. FmHA provided most of this debt relief—$2.5 billion—under the debt-servicing provisions of the Agricultural Credit Act of 1987. This act, intended to help borrowers stay in farming, required that FmHA notify borrowers whose loan payments were 180 days or more overdue of various debt relief options, including two new servicing options: (1) "writing down" (reducing) portions of restructured debt, and (2) satisfying the debt in its entirety by paying FmHA an amount based on an adjusted value of the collateral securing the debt (referred to as net recovery value buy-out) and "writing off" (forgiving) the remaining debt.[2] In restructuring loans under this law, FmHA "wrote down" outstanding debt by over $1 billion and "wrote off" about $1.5 billion. In addition to these losses, FmHA wrote off (forgave) an additional $1.9 billion through its debt settlement process. Under this process, borrowers who are generally no longer in farming agree to pay a specified amount to settle the outstanding debt, and FmHA writes off the difference.

Despite the significant debt relief that FmHA has recently provided, its direct loan portfolio is still very risky. As of September 30, 1990, FmHA had outstanding direct farm loans to almost 190,000 borrowers totaling almost $20 billion.[3] We estimate that, of this amount, $8 billion, or about 40 percent, was held by borrowers who were not current on their loan payments. However, payment status does not provide a complete measure of the potential risk associated with the portfolio because it does not include (1) previously delinquent borrowers who were current only because their debts were restructured and (2) borrowers whose debts were rescheduled or reamortized (i.e., whose payment terms were changed) to keep them from becoming delinquent. We estimate that these types of borrowers hold another $5.9 billion, or about 30 percent, of the outstanding debt. These borrowers, combined with those who are delinquent, hold an estimated 70 percent of the total debt in FmHA's direct

[2]Debt write-downs and net recovery value buy-outs added to the servicing options that existed before the enactment of the 1987 Agricultural Credit Act. These options included rescheduling and reamortizing loans and were not dependent upon a borrower's payments being at least 180 days overdue.

[3]The data on the outstanding debt presented in this part of the chapter are based on GAO estimates from a dollar-unit statistical sample of loans to 400 borrowers. Appendix IV discusses our sampling procedures in detail and provides the sampling errors for our estimates.

loan portfolio. Table 2.1 summarizes both the number of borrowers and the amounts of debt in each of these high-risk categories.

Table 2.1: Estimated Number of Borrowers and Amount of Debt That Was and Was Not Current on Loan Payments, September 30, 1990

Dollars in billions

	Estimated borrowers		Estimated outstanding debt	
Loan category	**Number**	**Percent**	**Amount**	**Percent**
Original loan				
Paid current	87,241	46.2	$ 5.1	25.8
First payment not due	4,517	2.4	0.7	3.7
Subtotal	**91,758**	**48.6**	**5.8**	**29.5**
Rescheduled loan				
Paid current	30,852	16.3	3.8	19.4
First payment not due	14,725	7.8	2.1	10.6
Subtotal	**45,577**	**24.1**	**5.9**	**30.1[a]**
Original or rescheduled loan not paid current	51,626	27.3	8.0	40.4
Total	**188,961**	**100.0**	**$19.7**	**100.0**

Note: We obtained the figures for the total number of borrowers (188,961) and the total outstanding debt ($19.7 billion) from FmHA's Finance Office records and used these figures as a basis for sampling and calculating a resulting projection.

[a]This estimated subtotal does not add because of rounding.

Source: GAO projection based on a sample of FmHA outstanding loans.

FmHA Uses Inaccurate and Unverified Information in Making Loans

Before approving a loan,[4] lending officials must, among other things, according to FmHA loan-making standards, verify an applicant's existing debt, ensure that income and expense projections are realistic, and ensure that projected income for the next year equals or exceeds projected expenses. However, FmHA lending officials often fail to follow these standards and rely on inaccurate and unverified information concerning an applicant's ability to repay the loan. As a result, loans are made that should not be made.

The applicant's Farm and Home Plan is FmHA's primary source of information in making loan decisions. This plan discloses how borrowers intend to pay all expenses and debts, including payments on the new loan. In submitting Farm and Home plans, potential borrowers must show what

[4]County supervisors have authority to approve direct loans up to $175,000. Loans for more than that amount are formally approved by district or state directors, depending on the amount of the loan.

they are going to farm and produce; how many acres of land they will farm; what income they expect to earn; and what farm and personal expenses, such as family living expenses, they expect to incur. The lending official is responsible for ensuring that the financial information submitted by the borrower is complete, reasonable, and documented in sufficient detail to reflect adequately the overall condition of the farming operation. In particular, the lending official must ensure that the borrower will meet FmHA's cash flow requirement—i.e., that estimated income will equal or exceed total estimated expenses, including all debt payments.

However, as FmHA, in its internal reviews; the OIG; and we have reported, FmHA lending officials frequently base their loan decisions on inaccurate information, often relying on borrowers' estimates of their financial circumstances, with little or no verification. For example, in evaluating loans to more than 4,000 borrowers in July 1986, FmHA found that (1) borrowers frequently provided incomplete or inaccurate information in applying for loans and (2) many estimates of production, income, and expenses were unrealistic. Similarly, the OIG, in 1987 and in 1988, reported numerous examples of unrealistic, inaccurate, or incomplete information in Farm and Home plans. Furthermore, in our February 1989 report covering a sample of 100 borrowers,[5] we found that their (1) estimated repayment ability was overstated by an average of 24 percent, (2) estimated total cash farm income was overstated on the average by more than 18 percent, and (3) estimated family living expenses were understated on the average by about 10 percent.

Our current review shows continuing problems in this area. For example, although FmHA policies require that loan approval be based on realistic production estimates as well as reasonable projections of income and expenses, the following illustrates a case in which FmHA approved a loan whose application did not provide realistic estimates of production and projected income and, as a result, did not demonstrate repayment ability.

Case Example 1 — A borrower who had received FmHA financing since 1985 applied for a farm operating loan in 1988. The borrower's application was denied by the county office because his actual production yields, as contained in his Farm and Home Plan, did not result in a positive cash flow. However, in 1989 the county supervisor approved the borrower's application for a $49,000 operating loan by basing the borrower's estimated farm income on county averages rather than on the borrower's

[5]Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria (GAO/RCED-89-9, Feb. 14, 1989).

actual yields. The county supervisor told us that if actual yields had been used, the Farm and Home Plan would not have shown a positive cash flow and the borrower would not have obtained the 1989 loan. The borrower became delinquent in 1990 on his total FmHA debt of $134,000 and subsequently received a $122,000 write-off.

Furthermore, while FmHA policies require that the financial information submitted in a loan application be verified, the following illustrates a case in which FmHA approved a loan that was not based on complete information—that is, the applicant's existing debt was not verified.

Case Example 2 — A borrower was $545,000 delinquent on loans from one county office. He moved to another county, applied at a second FmHA county office for new FmHA financing without disclosing the delinquent debt, and received two additional farm loans totaling about $33,000. The county supervisor in the second office told us that he had failed to check FmHA loan reports to determine whether the borrower had other outstanding FmHA debt. If he had checked, he should have denied the loans on the grounds that the applications did not disclose all liabilities and expenses. Our review disclosed that this borrower has since defaulted on the two new loans.

In addition to not verifying farm-related debt, supervisors in four county offices that we reviewed stated that they do not verify an applicant's nonfarm expenses, such as living expenses, but rely entirely on the information that the applicant provides.

The illustrations above are not isolated cases; problems in this area occur frequently. A primary FmHA internal control review, referred to as the Coordinated Assessment Review (CAR),[6] has continually reported on lending offices' failures to ensure that loans are made on the basis of accurate and verified information. Table 2.2 shows that although compliance has increased in some areas, loan-making standards are still not always implemented. For example, in the CARs for fiscal years 1988 through 1991, 554 sampled loans, or 13.5 percent of the 4,101 loans reviewed, did not meet FmHA's cash flow standard.

[6]In FmHA's CAR, a random sample of loans is examined each year to measure and estimate compliance with loan standards. Loans made in about 15 states are sampled and reviewed each year so that each state is reviewed every 3 years. For example, the fiscal year 1991 CAR for direct loan making covered a sample of 1,052 loans from a universe of 5,735 loans in 15 states.

Table 2.2: Percentage of Direct Loans Not Meeting Specific FmHA Loan-Making Requirements, Fiscal Years 1988-91

	Percent of loans		
Fiscal year	Not cash flowing	Not based on realistic prices, yields, and expenses	With debts not verified
1988	16.0	24.1	34.1
1989	13.9	17.9	44.3
1990	12.6	11.6	26.5
1991	11.4	7.1 to 10.7[a]	17.9

[a]In CARs before fiscal year 1991, FmHA disclosed a composite score for noncompliance with its standard that loans be based on realistic prices, yields, and expenses. In the 1991 CAR, FmHA reported on these tests separately. For example, the 1991 CAR disclosed noncompliance as follows: realistic prices (7.1 percent), realistic operating expenses (8.9 percent), and realistic production yields (10.7 percent).

Source: FmHA's CAR summaries for each year.

The direct loan segment of our current review included five of the states covered by the fiscal year 1990 CAR. FmHA state office officials in three of these five states told us that although applicants' Farm and Home plans met the agency's cash flow requirement on paper, many would not have met the requirement if county supervisors had (1) used realistic prices, yields, or expenses in estimating farm income and (2) verified and included all debts.

FmHA Has Not Followed Its Loan-Servicing Standards

FmHA has established certain standards to protect the government's investment once a loan has been made. In particular, FmHA county officials are required annually to inspect the collateral backing the loans to ensure that borrowers have not disposed of the property without first obtaining FmHA's approval. County officials must also analyze borrowers' farm operations each year to help borrowers adopt sound farming and management practices. However, some county offices are not following these standards, and, as a result, FmHA is further exposed to potential losses.

Infrequent Inspections of Property Securing FmHA Loans

FmHA requires that county office staff inspect a borrower's operation at least once a year to (1) verify that the borrower possesses all the loan security, including chattel property; (2) determine if the security is being properly maintained; and (3) update the loan security agreement. However, in reporting on property securing farm loans in 1988, the OIG stated that FmHA did not properly account for such property because FmHA

county officials were not making the required farm visits. As a result, crops and livestock were not properly accounted for, and equipment was not properly accounted for or maintained by borrowers. The OIG estimated that property valued at about $92.3 million that had been used to secure FmHA loans was missing. Moreover, the OIG reported that borrowers disposed of livestock valued at $35.6 million without FmHA county office authorization.

FmHA's annual CARs have also shown that loan files do not have records of required chattel inspections or supervisory contacts with borrowers. For example, the summary report for 1991 disclosed that about 12.5 percent of the sampled loans did not have records of annual chattel inspections and about 11 percent did not have records of supervisory contacts with borrowers. The summary report for 1990 disclosed that about 25 percent and about 20 percent of the sampled loans did not comply with these two standards, respectively. The following case example from our review illustrates the kinds of problems that can arise when county officials do not adequately inspect and supervise borrowers' operations.

Case Example 3 — FmHA restructured a delinquent borrower's loans in 1989, including writing down slightly more than $2 million of his outstanding debt. In December 1990, the borrower was again delinquent on his remaining debt. We found no evidence that the county supervisor had made the required farm visits from 1988 through 1990. However, for each of these years, the county office loan file for this borrower contained an updated security agreement between FmHA and him that listed the property securing the FmHA loans. We visited the borrower's farm and found that the security agreement was inaccurate—e.g., some of the security property had been disposed of and replaced with equipment that was not listed on the current agreement. In explaining these discrepancies, the county supervisor told us that he had probably copied each preceding year's agreement and given it the current year's date. He also told us that the county office staff concentrated their efforts on borrowers viewed as more likely to repay their farm loans than on those, such as this borrower, deemed less likely to repay.

Infrequent Analyses of Borrowers' Farming Operations

FmHA's loan-servicing instructions require that county supervisors annually analyze the farm operations of borrowers whose loans have been restructured and of borrowers who are experiencing financial or production problems. This analysis, which primarily compares planned versus actual performance, is designed to help a borrower develop and use

sound farming and management practices and to plan for future farming operations.

As the OIG and we have reported, however, FmHA is not consistently conducting the required annual analysis. For example, in 1988 the OIG reported in its nationwide audit of loan security that FmHA county office personnel did not always estimate borrowers' planned, or record borrowers' actual, farm production. Our February 1989 report disclosed that actual production data had not been compiled for 66 of 160 sampled borrowers in 1985 and for 60 of 160 sampled borrowers in 1986.

County offices are still not completing the required analyses. For example, the supervisor at one county office told us that he had never done an analysis for any of the 122 borrowers with outstanding loans under his jurisdiction. He also told us that the annual analysis had not been conducted because his office's main priority was processing loan applications rather than supervising borrowers.

The failure to review farm operations occurs frequently. FmHA's CAR has reported annually since 1988 that the required analyses are not being done. According to the fiscal year 1991 CAR summary report, about 20 percent of the sampled loan files in 15 states contained no evidence of annual analyses and subsequent planning. The 1990 summary report disclosed 43 percent noncompliance with this FmHA standard.

Reasons for Noncompliance With Loan-Making and Loan-Servicing Standards Vary

FmHA has not systematically analyzed why loan-making and loan-servicing standards are not implemented. The CAR, one of FmHA's key oversight mechanisms, does not provide such information. FmHA officials with whom we spoke have differing opinions about the principal causes of noncompliance. The most frequent reason cited by county officials was lack of resources—particularly for servicing loans. Other reasons they noted included (1) negligence or oversight on the part of field office lending officials and (2) changing regulations.

The FmHA Deputy Assistant Administrator for Farmer Programs acknowledged that limited resources may be a problem in some cases. However, he indicated that inadequate training was a more significant cause of noncompliance; some county officials simply lacked the requisite financial knowledge to make good decisions. Accordingly, FmHA initiated a credit quality training program for all county, district, state, and national loan officers during fiscal year 1991. In addition, he cited other factors that

he thought might contribute to compliance problems: (1) county officials were not accountable for the quality of their loan-making and loan-servicing decisions and (2) county officials had incentives to make as many loans as possible because the volume of loans affects their grade level.

To improve compliance with loan-making standards, the FmHA Assistant to the Assistant Administrator for Farmer Programs told us that some FmHA state directors, including those in Alabama, Iowa, Texas, and Wisconsin, are requiring a state office review of loan applications before county offices approve the loans.

Loan-Making Policies Increase FmHA's Vulnerability to Loss

The lending criteria that FmHA follows in making direct loans, which are partially the result of congressional direction, expose the agency to potential losses. In particular, borrowers who defaulted on past loans are not barred from obtaining new loans. Furthermore, in some cases, farmers can obtain new operating loans while they are delinquent on existing FmHA debts. Finally, the method that FmHA uses to calculate a loan applicant's ability to repay a debt, which is based on cash flow, draws too optimistic a profile of the farmer's financial circumstances. Stricter lending criteria would better protect the government's interests. However, a recent FmHA attempt to tighten loan standards failed because of congressional concern about the adverse impact that stricter requirements might have on FmHA's borrowers.

Borrowers Who Defaulted Are Not Barred From Obtaining New Loans

Borrowers who received debt relief (i.e., debt write-down or write-off) under the provisions of the Agricultural Credit Act are not barred from obtaining additional direct farm program loans. As table 2.3 shows, we identified 731 such borrowers who have obtained additional direct loans.

Table 2.3: Borrowers Who Obtained FmHA Loan Obligations During Fiscal Years 1989 and 1990 After Receiving FmHA Debt Relief

Dollars in millions

Borrower category	Number of borrowers	Amount of debt relief	Amount of new loan obligations
Restructured with debt write-down	724	$106.0	$37.1
Net recovery value buy-out with debt write-off	7	1.7	0.6
Total	**731**	**$107.7**	**$37.7**

Source: GAO analysis of FmHA Finance Office records.

Our review shows that many of the borrowers who obtained additional direct loans after having received debt relief became delinquent again. More specifically, 349 of the borrowers whose loans were restructured and 5 of the borrowers who bought out their previous loans were delinquent as of March 1991 on the new loans. Additionally, as discussed in chapter 3, borrowers who received debt relief through restructuring or buy-out have also obtained FmHA guaranteed loans, and some of these are delinquent on this debt.

The following examples illustrate this cycle of delinquency. A borrower who received about $424,000 in debt relief when his loans were restructured in March 1989 received a $149,000 loan in June 1989. He was $126,000 past due on payments in March 1991. Another borrower who received about $428,000 in debt relief when buying out in March 1989 received a $132,000 operating loan in May 1989. He was $28,000 past due on payments in March 1991.

Delinquent Borrowers Can Obtain New Loans

Under a congressionally directed policy, borrowers can obtain new FmHA direct loans while they are delinquent on their existing FmHA debt. Specifically, a policy referred to as the continuation policy allows borrowers to obtain new operating loans without having to demonstrate that they are able to repay their existing FmHA debt. The purposes of the policy, which FmHA first promulgated in February 1982 in response to a deteriorating agricultural economy, were to continue lending money to financially stressed borrowers until economic conditions improved and to slow the number of liquidation cases. FmHA rescinded the policy in November 1985 following GAO's disclosure that many unsound loans were being made. However, the Congress, in making supplemental appropriations for fiscal year 1987 (P.L. 100-71, July 11, 1987), directed FmHA to reinstate the continuation policy.

From fiscal years 1988 to 1990, FmHA made continuation loans totaling about $37 million. During the first 8 months of fiscal year 1991, it made about $30 million in additional continuation loans. At one county office we visited that had made five such loans in 1990, the county supervisor told us that he had made these loans to borrowers who were less than 180 days past due on their existing loan payments. These loans allowed the borrowers to continue operations in anticipation of their becoming 180 days delinquent so as to be eligible for debt relief under the Agricultural Credit Act. This FmHA county supervisor acknowledged that continuation loans are highly risky because the borrowers have already been delinquent on previous loans.

With the Congress's reinstatement of the continuation policy, FmHA officials told us that it is difficult for FmHA to act in a fiscally prudent manner. Six of the 10 county supervisors whom we interviewed told us that the policy of making continuation loans increases the government's vulnerability to loss because borrowers are not required to demonstrate their ability to pay the outstanding principal and unpaid interest on their debts.

Cash Flow Criteria May Misrepresent Applicants' Abilities to Repay Loans

Under FmHA's current cash flow criteria, an applicant's estimated income need only equal estimated expenses for the applicant to qualify for a loan. However, as we reported in February 1989, FmHA's cash flow analysis (1) tends to be optimistic in its projection of farm income and expenses, (2) does not uniformly use past operating data to evaluate performance, and (3) does not provide for contingencies or replacement of equipment. Prior to our report, in 1987, FmHA attempted to improve its loan-making criteria by proposing regulations requiring financial analysis as part of revised loan-approval criteria. This analysis would have included calculation of an applicant's debt-to-asset ratio, return on assets, and current ratio to measure solvency, profitability, and liquidity, respectively. However, in a March 1987 hearing before the Senate Committee on Agriculture, Nutrition, and Forestry, we and others testified that because the proposed loan-making criteria were stringent, they would exclude many existing and potential borrowers from FmHA farm loan programs. Congressional concern over this adverse impact, the lack of a published study of the proposal's impact, and the relatively short period that FmHA provided for public comment eventually led to FmHA's withdrawing the proposal.

In our February 1989 report, we recommended that FmHA develop more comprehensive loan-making criteria to assess an applicant's financial

solvency, profitability, liquidity, and repayment ability before making new loans. In September 1989, FmHA awarded a contract for a study of loan-approval and borrower-selection criteria. The study was completed in June 1991. FmHA has indicated that it plans to (1) evaluate the results and revise its regulations as appropriate and (2) consult with the Congress to obtain congressional support for the necessary changes in the criteria for approving loans and selecting borrowers.

Policies Governing Loan Servicing Invite Losses

The Agricultural Credit Act of 1987 provided for substantial revisions in FmHA's servicing of delinquent debt. If a borrower is unable to meet payment due dates, FmHA can restructure loans and reduce debts. However, in many cases these servicing actions have not been effective; borrowers have frequently returned for additional servicing actions, continuing the delinquency-servicing-delinquency cycle. FmHA can also terminate loans and forgive a borrower's entire debt if it believes the borrower's financial condition is so tenuous that restructuring, even with debt reduction, is not financially viable. However, in reaching these types of servicing decisions, FmHA calculates certain costs in a questionable manner that increases the debt relief provided to certain borrowers.

Furthermore, FmHA's practice of rescheduling and reamortizing loans has created excessive debts for borrowers and resulted in undersecured loans. Finally, and perhaps most significantly, the ease by which FmHA borrowers can obtain servicing actions involving debt reduction under provisions of the Agricultural Credit Act of 1987 may actually encourage borrowers to become delinquent intentionally.

Borrowers Delinquent Again After Receiving Debt Relief

Our August 1990 report noted that 91 percent of the 160 borrowers whom we reviewed were financially weak, with high debt-to-asset ratios and/or low projected cash flows, after their delinquent debt was restructured under the terms of the Agricultural Credit Act.[7] Our current review shows that borrowers have often become delinquent again after FmHA has restructured their previously delinquent outstanding debt. Borrowers may farm a year or longer after their loans have been restructured, become delinquent on the restructured loans, and then request and receive additional loan servicing. According to FmHA, about 9,500 borrowers, or about 43 percent of those whose loans were restructured from November 1988 to March 1990, became delinquent again. Nationwide, we identified

[7]Farmers Home Administration: Changes Needed in Loan Servicing Under the Agricultural Credit Act (GAO/RCED-90-169, Aug. 2, 1990).

2,432 borrowers who received multiple debt servicing from January 1989 to September 1990. The following case illustrates how FmHA has restructured borrowers' debts, only to have the borrowers again become delinquent and receive additional servicing.

Case Example 4 — FmHA restructured a borrower's three outstanding loans in 1989, including writing down one loan's $97,623 outstanding balance by $65,760. After the borrower became delinquent again in 1990, FmHA again restructured two of his loans and also made him a $27,500 operating loan. As of July 1991, the borrower was again delinquent and FmHA had again made him another operating loan.

Before the enactment of the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624, Nov. 28, 1990), referred to as the 1990 Farm Bill, delinquent borrowers could more than once obtain loan restructuring with debt write-down or receive net recovery value buy-out with debt write-off. The 1990 Farm Bill allows only one write-down or write-off and limits total debt forgiveness to $300,000. However, borrowers can still obtain restructuring without debt write-down more than once.

FmHA Calculation of Property Holding Period Increases Borrower Debt Relief

In calculating the amount of debt reduction to offer delinquent borrowers, FmHA considers, among other things, its estimated costs to hold farm properties in inventory. These estimated costs are significantly influenced by the average holding period (AHP) for property that FmHA has in its inventory—the longer the AHP, the greater FmHA's estimated holding costs and, in turn, the debt relief provided. We found that delinquent borrowers are receiving excessive debt relief because FmHA includes in its estimates periods when properties are not available for sale.

FmHA guidance provides that properties in inventory be used to compute the AHP. However, using inventory properties has produced an unrealistically long AHP, since some properties were not available for sale during FmHA sales moratoriums that resulted from administrative decisions or legislative requirements. From August 1984 to December 1990, FmHA imposed four moratoriums on farm inventory property sales, including one that began in December 1990 pending issuance of final regulations implementing the 1990 Farm Bill. As a result of the four moratoriums, FmHA properties were not available for sale for about 45 months, from August 1984 to June 1991.

As would be expected, when the moratorium periods are excluded from calculations of the time that properties are held in inventory, the AHP is substantially reduced. The following case example shows how excluding the moratoriums can significantly reduce the amount of debt relief that delinquent borrowers may receive.

Case Example 5 — The AHP for Wisconsin properties between July 1989 and June 1990 was 47 months, but it was reduced to 21 months when the moratorium periods were excluded. In April 1990, a Wisconsin delinquent borrower buying out his FmHA debt at the net recovery value received a $271,161 write-off. His equity in the security property at that time was $125,000. However, as table 2.4 shows, a difference of about $60,000 in the net recovery value amount for this borrower can be attributed to FmHA's use of a 47-month instead of a 21-month AHP.

Table 2.4: Impact of Holding Cost Estimates on Debt Relief

	Average holding period	
Factor	**47 months**	**21 months**
Appraised property value	$136,000	$136,000
Less prior lien	11,000	11,000
Equals borrower's equity	125,000	125,000
Plus estimated change in value	15,980	7,140
Equals total estimated value	140,980	132,140
Less estimated expenses		
Interest	43,945	19,635
Depreciation	39,688	17,733
Taxes	23,500	10,500
Management expense	15,915	7,111
Advertising	1,003	448
Administrative expenses	5,135	5,135
Total estimated expenses	129,186	60,562
Equals net recovery value amount attributable to holding period	$11,794	$71,578

Source: FmHA county office records and GAO analysis.

Furthermore, the AHP that FmHA uses does not represent the time that it takes for comparable farms that are not subject to sales moratoriums to sell in the commercial market. For example, the comparable farms used to determine the appraised value in the above Wisconsin example were on

the market for an average of 16 months before they were sold, as compared with FmHA's 47-month AHP.

Routine Rescheduling and Reamortizing of Loans Creates Excessive Debts

FmHA's loan-servicing operating instructions require county supervisors to keep nondelinquent borrowers from becoming past due on their loan payments, if possible, by using such techniques as rescheduling and reamortizing loan terms. When these techniques fail and borrowers miss loan payments, other techniques, such as loan payment deferrals, may be used in conjunction with rescheduling and reamortization to avoid long-term delinquency.

While such servicing may keep borrowers' loans technically current —that is, loan payments are not past due—extensive and repetitive loan servicing can burden farmers with excessive debt because it often includes the capitalization and addition of unpaid interest to outstanding principal. For example, we identified one borrower who had received a $170,000 farm ownership loan in 1983. In 1989 FmHA reamortized the loan and capitalized about $103,600 of unpaid interest, thereby increasing the total farm ownership debt to about $273,600. As we noted in our February 1989 report, such servicing is not a viable long-term solution to borrowers' repayment problems and it has negative consequences that affect both borrowers and the government, including (1) increasing a borrower's total debt, (2) turning short-term debt into long-term debt, (3) eroding a borrower's equity, (4) increasing the government's costs by providing loans at interest rates below borrowing costs, and (5) jeopardizing the government's security position.

While the Con Act limits new direct farm ownership or operating loans to $200,000, no ceiling is stipulated on the amount of outstanding ownership or operating indebtedness that can be accumulated through actions such as rescheduling or reamortizing existing loans. As a result, some borrowers' accumulated debt is high. Nationwide, as table 2.5 shows, we identified 2,345 borrowers who each had more than $200,000 in outstanding farm ownership or operating debt. In total, these borrowers had accumulated debts totaling about $75 million more than they could have accumulated through new loans. FmHA officials told us that borrowers primarily accumulate such high debt because their unpaid interest is capitalized to keep them technically current.

Table 2.5: Borrowers With Outstanding Debts Greater Than $200,000, as of March 1990

Dollars in millions

Farm loan type	Number of borrowers	Actual debt	Maximum loan debt[a]	Difference
Ownership	2,059	$480.3	$411.8	$68.5
Operations	286	63.3	57.2	6.1
Total	**2,345**	**$543.6**	**$469.0**	**$74.6**

[a]Amounts based on the number of borrowers times the $200,000 maximum amount for a farm ownership or operating loan.

Source: GAO analysis of FmHA Finance Office records.

Rescheduling and Reamortizing Leads to Loans That Are Not Adequately Secured

FmHA regulations for a farm ownership or operating loan state that before a new loan can be approved, security must be adequate to ensure repayment if the borrower defaults on the loan. However, similar security requirements do not apply when FmHA services an existing loan. Specifically, for loans that are rescheduled or reamortized, FmHA does not require security in addition to the security that was pledged when the original loans were made. Thus, the outstanding principal for such loans may exceed the value of the loan security. If borrowers default on such loans, the collateral that secured the original loans may no longer suffice to cover the debt, and FmHA will incur a loss.

Our February 1989 report disclosed that loan security was inadequate for the loans to 111 of 160 sampled borrowers when we compared the total outstanding loan principal with the total value of the loan security. Our analysis showed that the government would incur significant losses if the loans for these 111 borrowers were liquidated.

Policy on Debt Reduction Encourages Delinquency

As part of its servicing activities, FmHA may reduce delinquent borrowers' debts by substantial amounts. For example, under the Agricultural Credit Act, debt reduction—write-down and write-off—is specifically allowed for borrowers whose loan payments are 180 days or more overdue. This policy invites potential abuse because borrowers may intentionally default on loan payments to qualify for debt reduction.

Numerous farmers who responded to FmHA's request for comments on its proposed regulations to implement the debt-servicing provisions of the act, as announced in May 1988 in the Federal Register, expressed concern that borrowers who struggled to make loan payments would not be

eligible for debt reduction, whereas borrowers who did not would be eligible. For example, one borrower responded that

> "I feel this is most unfair and feel that I also, because I am a good farmer and did not live beyond my means, should be given the same rights and privileges. So at this time, I am suspending payments to FmHA until it is explained to my satisfaction why I should not be given these same privileges."

As our August 1990 report noted, 18 of 30 nondelinquent borrowers whom we interviewed told us that they felt penalized for paying their debts. Some told us that they were looking for ways to become delinquent so that they could qualify for debt reduction. Also, several FmHA county and state office officials speculated that some borrowers who had made their loan payments on time in the past might attempt to become delinquent so that they could apply for servicing. Since the act precludes servicing benefits for borrowers who cause their delinquencies, county supervisors may deny servicing to such borrowers. However, borrowers could misrepresent their incomes and expenses and thus qualify for debt relief because county office personnel base their decisions primarily on information that borrowers submit.

During our current review, almost all of the county supervisors with whom we spoke agreed that the act created an environment conducive to waste and abuse. The following case shows how the act encouraged delinquencies.

Case Example 6 — A borrower who owed FmHA $382,312 told us that although he was current on his non-FmHA debt, he would be unable to make his FmHA loan payment. He also told us he would be seeking debt relief because he had seen how other FmHA borrowers who were delinquent had benefited. This borrower's Farm and Home Plan disclosed that about $18,600 of his non-FmHA debt repayments went to purchase a lake property with a cabin.

Conclusions

FmHA's direct loan program has lost billions of dollars in recent years and stands to lose billions more because (1) lending officials do not always adhere to loan-making and loan-servicing standards and (2) certain policies and legislative directives run counter to sound loan-making and loan-servicing decisions.

The reasons why FmHA's field offices have not followed existing loan-making and loan-servicing standards are perplexing, especially since noncompliance has been reported repeatedly for over 5 years and has contributed to the high level of problem debt in FmHA's direct loan portfolio. Many factors have contributed to these problems, including inadequate resources, insufficient training, and lack of accountability on the part of lending officials. Another possible cause may stem from a belief that FmHA's highest priority is to assist farmers at any cost, rather than make prudent lending decisions. We saw this attitude reflected in the actions of the county supervisor who used optimistic production estimates instead of an applicant's actual production history to help the applicant qualify for a loan. To better ensure that loans are meeting credit quality standards, some FmHA state directors have, in effect, elevated authority for approving loans from the county office level to the state office level.

Certain basic FmHA loan-making policies, some of which are the result of congressional direction, also contribute to the extensive federal risk. Specifically, FmHA has little assurance that loans will be repaid because its loan-approval standards are based simply on an applicant's ability to project an income that equals estimated expenses. Furthermore, congressionally directed policies allow loans to be made to borrowers who (1) defaulted on past loans and subsequently received debt relief and (2) are delinquent on existing loans.

Similarly, certain servicing policies, such as those offering substantial debt relief through loan restructuring with write-down, are not only ineffective—many borrowers whose loans have been serviced became delinquent again—but also costly to the government. In fact, servicing policies have created incentives for borrowers to become delinquent deliberately in order take advantage of lucrative debt relief terms.

The Congress addressed some loan-servicing problems in the 1990 Farm Bill—it, for example, limited the total amount of debt relief that a borrower could receive to $300,000 and made debt relief available only one time per borrower. However, the following problems still remain: (1) delinquent borrowers may receive excessive debt relief because FmHA includes in its calculations of average holding periods times that inventory property cannot be sold; (2) delinquent borrowers can obtain multiple instances of debt servicing without repaying their loans because there are no limits on the number of times a borrower whose loan payments are 180 days or more overdue can receive restructuring without a write-down; (3) borrowers whose loan payments are not 180 days overdue can avoid

repaying their loans because there are no limits on capitalizing and adding unpaid interest to their outstanding principal; and (4) borrowers whose loans are serviced may increase their outstanding loan principal without increasing the security supporting their debt.

Recommendations to the Secretary of Agriculture

To increase compliance with existing standards for making and servicing direct loans, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop and implement a system that will ensure that lending officials adhere to FmHA's loan-making and loan-servicing standards.

While it is important for FmHA to spend the necessary time to develop and implement a system to ensure better adherence to lending and servicing standards, we believe that more immediate actions are warranted to avoid making new loans that will add to the current high level of problem debt. Therefore, as an interim step towards improved compliance, we recommend that the Secretary of Agriculture direct the FmHA Administrator to require that all direct loan applications—or, if resources do not permit, a randomly selected sample of such applications—be reviewed by state offices before they are finally approved.

To strengthen FmHA's lending policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop more comprehensive loan-making criteria for direct loans that go beyond the current emphasis on cash flow and that assess an applicant's financial solvency, profitability, liquidity, and repayment ability before a new loan is made.

To strengthen FmHA's direct loan-servicing policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to (1) develop a method for calculating the average holding period that reflects normal property market conditions in servicing delinquent borrowers' debts and (2) require security for serviced loans that at least equals the loan's outstanding principal or that provides the best security interest available on all of the borrower's assets.

Recommendations to the Congress

To strengthen FmHA's direct loan-making policies, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to (1) prohibit direct loans to previously delinquent borrowers whose direct loans were bought out with debt write-off or restructured with debt

write-down and (2) eliminate direct loans under the continuation policy to currently delinquent borrowers.

To strengthen FmHA's direct loan-servicing policies and to limit the amount of debt that can be accumulated through rescheduling and reamortizing loans, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to (1) limit a borrower whose debt is 180 days or more overdue to one restructuring action and (2) require that a borrower repay the interest portion of the loan payment as a condition of rescheduling or reamortizing loans that are less than 180 days delinquent.

Appendix VI contains suggested language that the Congress may wish to use in amending the Con Act.

Agency Comments and Our Evaluation

In commenting on a draft of this report (see app. V), FmHA stated that it agreed with each of the direct loan recommendations to the Secretary of Agriculture and noted its actions and decisions aimed at reducing the identified risks.

In response to the first recommendation—that FmHA develop and implement a system that will ensure that lending officials adhere to direct loan standards—FmHA discussed various internal agency reviews for monitoring compliance with loan standards, an ongoing task force review of internal control and program management systems, and the use of internal review results to evaluate lending officials' performance. Each of these actions should help ensure better compliance with existing standards. Although FmHA provided little information on the specific objectives and time frames established for the task force's work, we hope that the task force critically examines the underlying reasons for noncompliance with loan standards and ensures that the internal control system addresses these problems. Furthermore, in commenting later on one of our guaranteed loan recommendations, FmHA discussed another task force study that is researching guaranteed loan-making and loan-servicing issues. In our opinion, the results of that study may also help FmHA in developing a formal system to ensure compliance with both direct and guaranteed loan-making standards before loan funds are obligated and compliance with loan-servicing standards as specified in the agency's operating instructions and regulations.

In commenting on our second recommendation, which calls for FmHA state offices to review direct loan applications as an interim measure until a

formal system to ensure compliance is established, FmHA observed that its state offices have either implemented, or are in the process of implementing, a loan review underwriting process to ensure compliance. FmHA's actions in this regard appear to go a long way toward meeting the intent of this recommendation and may eventually result in the agency's meeting the above direct loan recommendation. However, we remain concerned that these actions may not fully resolve the problems that led to our recommendations because we do not know whether this process requires state offices to approve loan applications before loan funds are obligated and whether this process is to be followed by each state office or is an ad hoc system that may be followed by some but not all offices.

Our third recommendation—that FmHA develop more comprehensive loan-making criteria—prompted FmHA to discuss its recent training of loan officers and its resulting evaluation of loan applications that takes into consideration an applicant's capital position, liquidity, profitability, historical earnings capability, operational efficiency, and asset management. We believe that such a thorough analysis of loan applications is essential to the development of sound loan-making criteria. However, in our opinion, FmHA needs to obtain congressional support for these necessary changes in its loan-approval criteria so that the reaction that led to the withdrawal of its 1987 proposed loan-making criteria does not recur. Also, we believe that FmHA needs to revise its regulations formally so that this significant change in its loan-approval criteria is presented to the public.

FmHA generally agreed with our fourth recommendation, which calls for the agency to develop a method for calculating an average holding period that reflects normal property market conditions in servicing delinquent borrowers' debts. Although FmHA did not address our principal concern that moratorium periods were included in calculations of the average holding period, it did assert that its ability to reduce the average holding period was limited by statutory requirements that properties be offered to certain categories of lessees or purchasers in a fixed order of priority.

In response to our fifth recommendation—that FmHA require security for a serviced loan that at least equals the loan's outstanding principal or provides the best security interest available on all of the borrower's assets—FmHA commented that its regulations are being revised to require that the best possible lien position be obtained on all of a borrower's assets whenever a loan is made or serviced. FmHA added that the principal balance of a restructured loan should not exceed the value of the loan

security. FmHA expressed its belief that the Con Act needs to be amended to allow it to comply fully with this recommendation.

Lending Practices and Policies Make FmHA Vulnerable to Guaranteed Loan Losses

In recent years, the Congress and FmHA have shifted lending emphasis from direct loans to guaranteed loans. Although the amount of outstanding principal in guaranteed loans is still relatively small compared with that in direct loans, it has the potential to grow significantly, given that FmHA has about $21 billion in guaranteed loan authority from fiscal years 1991 to 1995. However, the guaranteed loan program has experienced many of the same loan-making and loan-servicing problems as the direct loan program.

For guaranteed loans, as for direct loans, FmHA field lending offices have not consistently followed standards for ensuring the loans' soundness. Agency officials have not adequately reviewed loan applications and, consequently, have approved guaranteed loans that were not creditworthy. In addition, they have not adequately reviewed lenders' loan-servicing activities and have not enforced FmHA's servicing requirements. In the absence of adequate oversight, some lenders have not serviced guaranteed loans according to FmHA's standards, and borrowers, among other things, have used loan funds for purposes that FmHA did not approve.

Certain loan-making policies also make FmHA's guaranteed loans risky. In the guaranteed, as in the direct, loan program, borrowers who have defaulted on other debts are eligible for and receive loans. Lenders can also use guaranteed loans to refinance their existing customers' debts. Lenders have taken advantage of this policy by using guaranteed loans to provide financing for their problem borrowers, thereby decreasing their own risk. Finally, by routinely guaranteeing the riskiest loans at the highest allowable percentage instead of at lower levels, FmHA increases its exposure to significant losses.

Shift to Guaranteed Loans

In fiscal year 1984, FmHA began to shift its emphasis from direct to guaranteed loans to encourage farm lending by private lenders, reduce budget outlays on direct loans, and devote more effort to servicing its own growing and increasing delinquent direct accounts. Recent legislation, including the 1985 Farm Bill and the 1990 Omnibus Budget Reconciliation Act, supported this shift by authorizing funding levels that decreased direct loan authority and increased guaranteed loan authority.

As a result of this shift in lending emphasis, FmHA's direct loan obligations have decreased and its guaranteed loan obligations have increased considerably from 1984 to 1990. For example, while direct loans decreased from $2.6 billion in fiscal year 1984 to slightly over $900 million in fiscal year 1990, guaranteed loan obligations increased from $153 million to

about $1.3 billion in the same period. The emphasis on guaranteed loans will continue from 1991 to 1995, during which period FmHA has about $2 billion in direct loan authority and about $21 billion in guaranteed loan authority.

In guaranteeing a farm loan, FmHA agrees, in the event of default, to reimburse a commercial lender for up to 90 percent of the lost principal, plus accrued interest and liquidation costs. From fiscal years 1987 through 1990, FmHA paid commercial lenders about $300 million to cover guaranteed loan losses.[1] According to FmHA's financial statements, as of September 30, 1990, the outstanding principal on FmHA-guaranteed farm loans totaled about $4.1 billion, of which about $200 million was owed by delinquent borrowers. Also, FmHA estimated potential guaranteed loan losses totaling about $1.2 billion. (This estimate is further discussed in the agency comment section of this chapter.)

FmHA Does Not Ensure That Guaranteed Loan Standards Are Followed

FmHA has established internal controls to ensure that a borrower funded by a guaranteed loan is qualified to receive and capable of repaying the loan. Controls also exist to ensure that loans are properly serviced so that risks are minimized. However, FmHA field lending offices often do not comply with these controls, concentrating instead on expanding the guaranteed loan program. As a consequence, many guaranteed loans do not meet credit quality standards.

FmHA Does Not Adequately Review Loan Applications

To ensure that only qualified borrowers receive the commercial lenders' loans that FmHA guarantees and to minimize the risk that borrowers will be unable to repay these loans, FmHA regulations require that county supervisors examine the data in loan applications. Lenders are required to ensure that the applications contain the applicants' financial history and, where possible, actual production yields for the past 5 years (not county averages). Lenders are also required to verify all the data, including all debts and any income from sources other than farming, using commercial credit reports and other documentation. Then, before approving a loan,[2] county supervisors must determine whether the repayment plan outlined in the loan application is realistic and whether the proposed plan of operation is likely to meet FmHA's cash flow requirement—i.e., that

[1]In fiscal year 1991, FmHA paid about $51.7 million to cover guaranteed loan losses, about a 9-percent decrease compared with the $57.1 million it paid in fiscal year 1990.

[2]County supervisors have authority to approve guaranteed farm ownership loans up to $260,000 and farm operating loans up to $350,000. Loans for more than these amounts are formally approved by district or state directors, depending on the amount of the loan.

anticipated income exceed cash outflow, including all debt repayments by at least 10 percent.

Loan files at FmHA's county offices indicate that county supervisors are not adequately reviewing loan applications. A 1988 OIG review of 234 randomly selected loan files found at least one deficiency related to loan approval (e.g., an inadequately supported projection of income and expenses) in each file. Our September 1989 report identified many of the same problems.[3] For example, we found that statements of income and expenses were inaccurate in 13 of 74 loan applications. Supervisors had verified little, if any, of the information in the loan applications and financial statements.

In our present review, we found similar problems. For example, none of the 25 guaranteed loan files that we judgmentally selected to review at four county offices in Iowa and Kansas contained the required production history, and only 13 contained the required financial history. At a county office in Texas, we found that even though the required information appeared in the loan applications, it was not used to verify projected production yields or operating expenses. Thus, FmHA's reviews were not always adequate, and field lending officials guaranteed loans that did not meet the agency's credit quality standards. Two examples follow.

Case Example 1 — A borrower received four guaranteed farm operating loans between 1988 and 1990—three for production purposes and one for refinancing existing debt. All four loans, guaranteed at 90 percent, had problems. The lender's records did not show that the borrower's existing debts had been verified for any of the loans. The lender did not submit to FmHA a report of the borrower's financial history with the 1988 and 1989 loan applications. The borrower's plans of operation did not include all debts, and projected income for several years was inflated. Had the projected income in the 1989 loan application been realistic, the borrower would have had only a 98-percent cash flow and therefore would not have qualified for the loan. He did not repay about $22,200 of the 1989 operating loan. The 1990 loan application, while including the FmHA unpaid principal as debt, excluded $44,000 owed to another lender. The exclusion of this debt from the borrower's application resulted in the calculation of a 113-percent cash flow, and FmHA approved the guarantee for a loan that, in fact, did not meet cash flow requirements.

[3]Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86, Sept. 11, 1989).

Case Example 2 — A borrower received four guaranteed loans in 1987 and 1988—two for refinancing existing debts and two for production purposes. All four loans, totaling almost $533,000 ($367,400 for refinancing and $165,400 for farm operations) and guaranteed at 90 percent, had problems indicating that these loans should not have been approved. Specifically, projected yields were not based on production records, and both debt payments and operating expenses were understated. Had realistic yields been used in the 1987 application, the borrower would have had a 98-percent cash flow and would not have qualified for the loan. Had all debt payments and operating expenses been included in the 1988 application, he would have had a 95-percent cash flow and would not have qualified. The borrower did not repay the two refinancing loans and in November 1989 declared bankruptcy. FmHA then paid the lender its $251,000 loss claim. Even though these two loans were supposed to be secured—the first refinancing loan by a lien on 676 acres of real estate and the second by a lien on equipment—the security was overvalued. For example, the real estate that secured one loan ($300,000) had a $57,000 value after a first lien was satisfied. Even with this past record, FmHA guaranteed a $103,000 operating loan for this borrower in 1990, again at the 90-percent level.

According to FmHA's annual CAR summaries, problems such as the ones described above occur frequently. For example, in 1988, 48 percent of the randomly selected loans in the 15-state CAR sample did not comply with the FmHA standard that financial and production history be documented; in 1990, 42 percent failed to comply. Also, a total of 349 sampled loans, or 13.4 percent of the 2,613 loans reviewed in the CARs for fiscal years 1988 through 1991, did not meet FmHA's cash flow standards. As table 3.1 shows, the annual CARs have also shown that borrowers' farm budgets were not based on their proven records, proposed plans of operation did not demonstrate the borrowers' ability to repay all debts, and property securing loans was not realistically appraised.

Table 3.1: Percentage of Guaranteed Loans Not Meeting Specific FmHA Loan-Making Requirements, Fiscal Years 1988-90

	Percent noncompliance		
Standard	1988	1989	1990
Financial and production history	47.9	43.1	42.0
Farm budget based on proven records	37.0	30.8	43.5
Cash flow all debts	10.6	13.1	18.9
Security property based on realistic appraisals	22.9	24.7	27.3

Source: FmHA's CAR summary reports for each year.

FmHA made substantial revisions in its reporting of 1991 CAR test results for compliance with most guaranteed loan standards. As a result, comparison with prior years' results for most standards is not possible. However, one comparison that is possible indicates improved compliance with the agency's cash flow standard. Specifically, the 1991 CAR disclosed that about 11 percent of the sampled loans did not show a positive cash flow at loan approval. The 1990 CAR had disclosed that about 19 percent of the sampled loans did not meet cash flow requirements.

FmHA Does Not Routinely Review Lenders' Servicing of Guaranteed Loans

FmHA field offices' reviews of lenders' servicing of guaranteed loans and some lenders' servicing of such loans often do not comply with FmHA's standards. FmHA requires county supervisors to monitor the servicing of all loans within 90 days of loan closing and of at least 20 percent of a lender's outstanding loans annually. Monitoring determines the extent to which the lender is meeting FmHA's servicing requirements, such as inspecting collateral to ensure that the borrower possesses and is maintaining security property, providing the same servicing for FmHA-guaranteed loans as for other loans, and ensuring that loan funds are used properly. If the servicing does not meet the agency's standards, FmHA can cancel the loan guarantee or decline fully to pay a lender's subsequent claim for losses.

The 1988 OIG report found loan-servicing deficiencies in over half of the 234 loans reviewed. For example, lenders had allowed borrowers to use guaranteed loans for purposes other than those identified in the approved plan of operation and had not inspected collateral. FmHA's reviews had either not detected these deficiencies or not corrected the inadequate servicing.

In our present review, we also found loan-servicing problems. Three of the four county supervisors whom we interviewed in Louisiana and Texas, for example, said that they do not monitor the servicing of guaranteed loans in their areas because they do not have the time. The fourth supervisor, however, said that he visits lenders at least three times a year to review all guaranteed loans and documents the results of these reviews. According to this official, reviews may be time-consuming but are critical to ensure the integrity of the guaranteed loan program.

Overall, according to FmHA's 1991 CAR, county supervisors did not review the servicing of 24.6 percent of 988 sampled loans in 15 states. The 1990 CAR disclosed 45.3 percent noncompliance with this FmHA standard.

The following case shows the kinds of problems that can arise when FmHA fails to monitor the servicing of a loan.

Case Example 3 — A borrower received a guaranteed loan in 1990 to refinance $195,000 in existing debts and cover $107,000 in production expenses. The borrower is the brother of the president of the commercial bank that made the loan. The refinancing part of the loan covered existing debt that the borrower owed to the commercial bank. The operating part covered his proposal to grow cotton, milo, and wheat and to raise cattle.

In addition to problems with the loan application, the loan was not being serviced according to FmHA regulations. The county supervisor had not visited the bank to determine whether the lender was servicing the loan, and the lender had not monitored the borrower's operation to determine whether funds were being used in accordance with the approved plan of operation. Consequently, both the supervisor and the lender told us, they were unaware that the borrower was not raising cattle as proposed. Although we informed the county supervisor that the lender had not serviced the loan properly, the guarantee was not canceled.

Emphasis Is on Making Loans

For the guaranteed as well as the direct loan program, FmHA officials are not certain why county offices are not always complying with loan-making and loan-servicing standards. They offer many of the same possible explanations, including lack of training and lack of resources. To improve compliance with loan-making standards, as noted in chapter 2, some state directors have required state office review of loan applications before county office approval.

One factor unique to guaranteed loans that may contribute to noncompliance is the emphasis that FmHA has placed on promoting the program. Some county, district, and state officials told us that this emphasis has placed pressure on them to make guaranteed loans. Furthermore, supervisors have not been held accountable for the quality of the guaranteed loans they approve or for reviewing the servicing of these loans. Rather, county supervisors have been evaluated on how well they promote the guaranteed loan program, including whether they achieve percentage goals for providing farm loans through guarantees.

Policies Governing Guaranteed Loans Do Not Protect the Government's Financial Interests

In the guaranteed, as in the direct, loan program, certain policies—some legislatively imposed—increase FmHA's risk of loss. First, borrowers who have defaulted on previous FmHA loans—even borrowers whose debts were reduced—can obtain a guaranteed loan. Second, lenders can refinance their financially stressed borrowers' existing debts using guaranteed loans. Thus, lenders can—and do—shift their highest risks to FmHA. Finally, FmHA guarantees the riskiest loans at the 90-percent level rather than at lower levels that might present less of a danger to the agency's financial standing.

Borrowers Who Previously Defaulted Are Eligible for Guaranteed Loans

Borrowers who have defaulted on FmHA's guaranteed or direct loans are allowed to receive new guaranteed loans. We found that 27 borrowers received $2.5 million in new guaranteed loans from fiscal years 1988 to 1990 after FmHA had paid $2 million in loss claims on their previous guaranteed loans. For example, FmHA made a $176,400 guaranteed farm operating loan in September 1990 for a borrower who had defaulted on two earlier guaranteed operating loans, thereby causing FmHA to pay loss claims of $173,200 in March 1990. Also, we found that 36 borrowers received $4.8 million in guaranteed loan obligations in fiscal years 1989 and 1990 after having bought out their direct loans at the net recovery value and receiving $6.3 million in debt relief. Additionally, 101 borrowers received $10.6 million in guaranteed loan obligations in fiscal years 1989 and 1990 after their direct loans had been restructured with $19.8 million in debt relief.

Some of these high-risk borrowers became delinquent on their new guaranteed loans. As of April 1991, 3 of the 36 borrowers who bought out their direct loans and 9 of the 101 borrowers whose loans were restructured with debt relief were delinquent on these new loans. For example, one borrower whose debt was forgiven by about $216,000 when he bought out his loans in August 1989 received a $189,000 guaranteed operating loan in April 1990. By April 1991, he was $94,500 past due on payments. Another borrower whose debt was reduced by about $996,000 when his loans were restructured on May 4, 1989, received a $100,000 guaranteed operating loan on May 19, 1989. By April 1991, he was $41,400 past due on payments.

In our September 1989 report, we recommended that FmHA develop, in consultation with the Congress, and implement more comprehensive guaranteed loan-approval criteria. FmHA contracted for a study of

loan-approval and borrower-selection criteria and anticipates issuing revised regulations after evaluating the study's results.

Guaranteed Loans Are Used to Refinance Risky Debt

Under the provisions of the Con Act and FmHA's implementing regulations, private lenders can use guaranteed loans to refinance existing debts and thereby shift to the government most risks of loans to financially stressed borrowers. Indeed, our September 1989 report noted that, according to officials from FmHA state and county offices as well as private lending institutions, lenders were primarily interested in obtaining loan guarantees to cover loans made to their financially stressed customers who had marginal loan security, marginal cash flow, poor debt-to-asset ratios, and/or insufficient net worth. Furthermore, our report noted that lenders viewed guaranteed loans primarily as a vehicle for increasing the security of their agricultural loan portfolios. Lenders thereby ensure that most of the money they loan is repaid and their losses are minimized.

A November 1991 OIG report also noted that using guaranteed loans to refinance existing debts is risky. Specifically, the OIG reported on a judgmental sample of 45 borrowers who received guaranteed loans on which FmHA subsequently paid lenders' loan loss claims. Thirty-five of these 45 borrowers received guaranteed farm ownership or farm operating loans for refinancing existing debt. The OIG concluded that a primary cause of FmHA's losses on loans to these 35 borrowers was the lenders' use of guarantees to secure existing loans that were in financial jeopardy. Furthermore, the OIG reported that in many cases the borrowers defaulted on the guaranteed loans shortly after receiving them, often without ever having made an installment payment. For example, 6 of the 35 borrowers defaulted on the loans within 12 months, and another 15 borrowers defaulted within 18 months. FmHA paid lenders' loan loss claims totaling $4.8 million for the guaranteed loans that were used to refinance these 35 borrowers' existing debts.

As our February 1990 report showed,[4] commercial lenders often used guaranteed loan funds not to expand farming operations or provide credit to new customers but to assist existing customers in refinancing their debts. In a probability sample of 900 guaranteed loans made in fiscal year 1988, we found that lenders' existing customers received about 80 percent of the guaranteed farm ownership loan funds and about 79 percent of the

[4]Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR, Feb. 8, 1990).

guaranteed farm operating loan funds. In total, lenders' existing customers received $980 million of the $1.2 billion in guaranteed loan obligations.

Guaranteed loans provided to commercial lenders' existing customers were used primarily to refinance these customers' existing debts. Specifically, we estimated that about 69 percent of the guaranteed farm ownership loan funds were used to refinance existing debts and 20 percent were used to purchase farm property. We also estimated that 34 percent of the guaranteed farm operating loan funds were used to refinance existing debt while 55 percent were used to cover farm operating expenses. In total, almost $550 million, or 44 percent, of the $1.2 billion in guaranteed loan obligations was used to refinance the borrowers' existing debts with the lenders.

Our February 1990 report included loan-use projections based on a probability sample of 900 guaranteed loans. We subsequently compared these sampled loans with FmHA's Finance Office records and identified 827 loans in the April 1991 guaranteed loan file. We sorted these loans into three loan-use categories—entirely for refinancing existing debt, partly for refinancing and partly for other uses, and entirely for uses other than refinancing; determined for each loan whether the borrower had defaulted; and projected the results to the universe of 12,283 loans obligated in fiscal year 1988.[5] On the basis of our analysis, we estimate, as table 3.2 shows, that guaranteed farm ownership loans used for refinancing debt had a higher delinquency rate than loans used for other purposes.

[5]This part of the report chapter presents data based on our estimates from a random sample of guaranteed loans. Appendix IV discusses our detailed sampling procedures and provides the sampling errors for our estimates.

Table 3.2: Projection of Delinquency Rates on Guaranteed Farm Ownership and Operating Loans Used for Refinancing and for Other Purposes

Loan type	Loan use: Refinance debts only	Refinance debts and other purposes	Other purposes
Farm ownership			
Number of loans	1,335	213	671
Number with late payments[a]	101	16	12
Percent behind	7.6	7.4	1.8
Farm operating			
Number of loans	1,948	822	6,372
Number with late payment[a]	208	79	597
Percent behind	10.7	9.6	9.4

Note: The information in the table is based on a sample of loans and on an estimate of how the sample results project to the universe of fiscal year 1988 loans. Table IV.3 in appendix IV provides details on the sampling errors and confidence levels of our estimates. For example, when sampling errors are considered, farm operating loans used for refinancing did not have a higher delinquency rate than loans used for other purposes. Also, the precision of the delinquency estimates for farm ownership loans used for other purposes must be qualified because none of the loans we reviewed in one stratification was past due.

[a]The number of loans with late payments represents the number of loans for which payments were past due or on which loan loss payments had been made as of April 1991.

Source: GAO projection based on a sample of FmHA guaranteed loans.

Guaranteed Loans Are Made at the Highest Risk Level

FmHA's policy is to guarantee most loans, regardless of their risk, at the maximum 90 percent, even though the agency can guarantee loans at lower rates. Consequently, loans to borrowers who have a bad credit history (e.g., those who have defaulted on prior loans) are guaranteed at the same level as loans to those with more solid credit histories. Furthermore, loans for refinancing the existing debt of financially stressed borrowers are guaranteed at the same level as loans for new credit purchases. This policy provides commercial lenders with incentive to use the program as a means of shifting to the federal government the risk of loans to their financially troubled borrowers. About 81 percent of all guaranteed loans to date have been guaranteed at 90 percent.

In our September 1989 report we recommended that FmHA establish a range of loan guarantee percentages based on loan risk, with the higher percentages for lower-risk loans. However, FmHA has not implemented our recommendation out of concern that it might diminish commercial lenders' participation in the program.

Conclusions

The guaranteed loan program suffers from problems similar to those found in the direct loan program. In short, the federal government's risk of significant financial losses is high because (1) FmHA field offices do not always follow loan-making and loan-servicing standards and (2) certain loan-making policies allow FmHA lending officials to guarantee loans whose potential for loss is high. These problems are particularly significant in view of FmHA's sizeable and increasing guaranteed loan authority through fiscal year 1995. Unless FmHA and the Congress take action to correct these problems, the guaranteed loan program may experience the same level of losses as the direct loan program.

In the guaranteed, as in the direct, loan program, the reasons for FmHA field offices' inadequate compliance with existing loan-making and loan-servicing standards are perplexing. Factors contributing to compliance problems include limited resources, inadequate training, and lack of accountability on the part of lending officials. FmHA's emphasis on promoting the use of guaranteed loans may also have contributed to compliance problems by creating the unintended impression that the number of guaranteed loans is more important than the quality of these loans. In efforts to improve compliance with loan-making standards, some state directors have, in effect, elevated authority for approving loans from the county office level to the state office level.

In addition to compliance problems, certain loan-making policies, some of which are the result of congressional direction, increase FmHA's risk and encourage commercial lenders to use the program to protect themselves against losses on loans to their high-risk borrowers. More specifically, FmHA (1) has not developed comprehensive loan-making criteria and (2) guarantees most loans, regardless of risk, at 90 percent, which encourages commercial lenders to shift their risk to the government. Furthermore, congressionally directed policies (1) allow borrowers who have defaulted on previous loans to obtain new guaranteed loans and (2) do not limit the extent to which commercial lenders can use the program to refinance their existing high-risk borrowers' debts, further encouraging lenders to transfer their risks to the federal government.

Recommendations to the Secretary of Agriculture

To increase compliance with existing standards for making and servicing guaranteed loans, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop and implement a system that will ensure that lending officials adhere to FmHA's loan-making and loan-servicing standards.

While it is important for FmHA to spend the necessary time to develop and implement a system to ensure compliance with guaranteed lending standards, we believe that more immediate actions are needed to better ensure that any new loans that FmHA guarantees do not add to the current high level of risk exposure. Therefore, as an interim step towards improved compliance, we recommend that the Secretary of Agriculture direct the FmHA Administrator to require that all guaranteed loan applications—or, if resources do not permit, a randomly selected sample of such applications—be reviewed by state offices before loan guarantees are finally approved.

To strengthen FmHA's lending policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop more comprehensive loan-making criteria for guaranteed loans that assess an applicant's financial solvency, profitability, liquidity, repayment ability, and repayment history before a loan guarantee is approved.

Recommendations to the Congress

To protect the government from excessive losses on FmHA's guaranteed loans, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to require FmHA to establish and implement a range of guarantees that places the highest percentage guarantee on the least risky loan and a lower percentage guarantee on the most risky loan. At a minimum, this could include limiting the guarantee percentage on certain loans (1) used for refinancing existing debt or (2) made to a commercial lender's existing borrowers.

To strengthen FmHA's loan-making standards, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to prohibit loan guarantees for borrowers (1) whose defaulting on previous guaranteed loans resulted in FmHA's paying commercial lenders' loan loss claims or (2) whose direct loans were bought out with debt write-off or restructured with debt write-down.

Appendix VI contains suggested language that the Congress may wish to use in amending the Con Act.

Agency Comments and Our Evaluation

In commenting on a draft of this report (see app. V), FmHA provided general comments on three key topics discussed in this chapter: estimated potential losses, refinancing, and the percentage of the loan guarantee. Regarding estimated potential losses, FmHA stated that its projections of

guaranteed loan losses do not reflect the current performance of the guaranteed loan portfolio and that actual losses indicate that its projections are unrealistically high. As a result, the agency plans to change its loss projection formula to reflect actual guaranteed lending conditions and loss experience. We agree with FmHA's assessment that its guaranteed loan loss projections appear high: whereas a loss of $1.2 billion is projected, about $200 million in outstanding debt is owed by delinquent borrowers. However, we remain concerned that the federal government's investment in this program is at risk because this program has experienced many of the same problems as the direct loan program and has the budget authority to grow significantly over the next few years. Also, since FmHA has not revised its loss projections, we report the projections contained in the agency's financial statements.

FmHA acknowledged the potential for abuse in refinancing debt—a use of loan funds that is authorized by the Con Act. However, the agency stated that refinancing is a complex issue that our report oversimplifies. More specifically, FmHA noted that guaranteed loans provide benefits to rural communities, rural businesses, agricultural lenders, and borrowers. We agree with FmHA's assessment that using guaranteed loans for refinancing is complex and that guaranteed loans provide benefits to rural America. However, we are concerned that the unrestricted use of guaranteed loans for refinancing the existing debt of commercial lenders' financially stressed customers exposes the federal government to unnecessarily high levels of risk. Hence, we are recommending that the Congress amend the Con Act to reduce the percentage of the guarantee on risky loans, including loans used for refinancing.

In regard to the guarantee percentage, FmHA stated its belief that its current policy of placing the highest percentage guarantee on the riskiest loan is, with some modification, appropriate. Although FmHA did not specify what these modifications might be, it noted that placing a lower percentage guarantee on high-risk loans would force more borrowers to seek direct loans, implying that commercial lenders would not refinance their financially stressed existing customers' debts without the highest percentage guarantee available. In our opinion, a commercial lender benefits from obtaining a federal guarantee, even at less than the maximum 90 percent, because a guarantee minimizes potential losses on high-risk debt. Also, a guarantee on a loan improves a lender's security position and overall portfolio quality. Specifically, since the quality of a loan portfolio is supervised by bank regulatory agencies, adverse loan

evaluations can negatively affect a lender. Thus, obtaining a guarantee can upgrade a lender's loan portfolio with regulators.

In commenting on the guaranteed loan recommendations, FmHA stated that it agreed with each recommendation to the Secretary of Agriculture and noted its actions and decisions aimed at reducing the identified risks.

Regarding our first recommendation—that FmHA develop and implement a system that will ensure that lending officials adhere to guaranteed loan standards—FmHA discussed various internal agency reviews for monitoring compliance with loan standards and the use of review results to evaluate lending officials' performance. As we indicated in the direct loan chapter, these are important actions toward improving compliance. FmHA also noted that a task force, whose report is scheduled to be issued in July 1992, is examining guaranteed loan-making and loan-servicing issues that include lender oversight and that a guaranteed loan loss claim review process has been implemented. FmHA discussed another task force's ongoing review of internal control and program management systems, but it provided little information on the specific objectives and time frames associated with this effort. We hope that this second task force critically examines the underlying reasons for noncompliance with loan standards and ensures that the internal control system addresses these problems. In our opinion, these studies and the loss review process may prove very useful in developing a formal system to ensure compliance with loan-making standards before loan funds are obligated and compliance with loan-servicing standards as specified in the agency's operating instructions and regulations.

In commenting on our second recommendation, which calls for FmHA state offices to review guaranteed loan applications as an interim measure until the formal system to ensure compliance is established, FmHA noted, as it did for direct loans, that its state offices have either implemented, or are in the process of implementing, a loan review underwriting process to ensure compliance. As with direct loans, FmHA's actions in this regard appear to go a long way toward meeting the intent of this recommendation and may eventually result in meeting the above guaranteed loan recommendation. However, we remain concerned that these actions may not fully resolve the problems that led to our recommendations because we do not know whether this process requires state offices to approve loan applications before loan funds are obligated and whether this process is to be followed by each state office or is an ad hoc system that may be followed by some but not all offices.

In responding to our third recommendation—that FmHA develop more comprehensive loan-making criteria—FmHA discussed an ongoing task force review of internal control and program management systems for guaranteed loan-making and loan-servicing, its training of loan officers, and its evaluation of loan applications that takes into consideration an applicant's capital position, liquidity, profitability, historical earnings capability, operational efficiency, and asset management. We believe that FmHA's cited actions go a long way toward meeting this recommendation. Specifically, analyzing loan applications on the basis of more than cash flow is essential to developing sound loan-making criteria. However, as with direct loans, FmHA needs to obtain congressional support for these necessary changes in its loan-approval criteria so that a negative reaction does not reinstate loan-approval criteria based primarily on projected cash flow. Also, as with direct loans, we believe that FmHA needs to revise its regulations formally so that this significant change in its loan-approval criteria is presented to the public.

Policies and Practices Do Not Protect the Government's Interest in FmHA's Farm Inventory Properties

FmHA owns over 3,000 farm properties obtained from farmers unable to repay their FmHA loans. Although the sale of these properties presents an opportunity to recoup loan losses, FmHA's management and sale of these properties does not ensure the highest possible return. Certain legislative requirements concerning inventory properties are conducive to management problems and lower returns. Specifically, instead of being able to sell inventory property to the "highest bidder," FmHA must first offer most inventory properties to selected buyers, such as former owners, at a fixed price. Therefore, FmHA's farm properties may not be sold at the highest attainable prices. Furthermore, targeting properties increases the time properties remain in inventory and, in turn, increases FmHA's management costs. Finally, while most FmHA farm properties are targeted to selected buyers to accomplish certain legislative objectives, targeting may not accomplish these objectives and may result in program abuses.

The government is also vulnerable to abuse and losses stemming from FmHA's failure to follow management controls for acquired property. Specifically, because FmHA has not adequately overseen the use or maintenance of inventory properties, some properties have been used without FmHA's approval, and FmHA has not been compensated for their use. Also, FmHA's overall efforts to manage the properties have been hampered because the agency's system for recording and tracking farm inventory properties contains errors. As a result, the agency's reports cannot be relied upon to provide accurate information on the number of properties in inventory or their appraised value.

Legislative Mandates Increase Costs and Reduce Returns on Property Sales

Certain legislative requirements for classifying and selling farm inventory properties may reduce returns when the properties are sold and increase FmHA's management costs. Specifically, legislation requires FmHA to determine whether a property has potential for agricultural use, and if it does, to offer it to selected buyers, such as former owners or their family members, at a fixed price in order to accomplish certain legislative objectives. Properties not classified as having agricultural uses can be offered for sale to the general public for either agricultural or nonagricultural uses. The classifying and targeting of properties may not result in the highest possible selling price and may increase the time that properties remain in inventory, thereby increasing management costs. Furthermore, the targeting efforts may not accomplish the intended objectives and are subject to abuse by some of the targeted buyers.

Legislation Restricts Inventory Property Sales

Several laws that have amended the Con Act, including the 1985 Farm Bill, the 1987 Agricultural Credit Act, and the 1990 Farm Bill, provide FmHA with specific guidance for selling farm inventory properties. This guidance specifies the type of buyer, sales price, market period, and method of sale. Obtaining the highest return to the government is not the primary objective in selling such properties. Rather, other farm program objectives take precedence, such as selling properties to former owners to enable them to continue farming or to beginning farmers to assist them in starting operations.

In selling farm property, FmHA classifies property as either suitable or surplus. Suitable property is farmland that can be used for general farming purposes; surplus property is land that is not recognized as farmland or that was classified as suitable property but did not sell within a specified time frame. Because FmHA considers properties with even 1 acre of cropland or pasture suitable for farming purposes, most properties—86 percent—are classified as suitable.

Suitable property is offered for sale to certain persons at a fixed price for a specific time. FmHA gives the former owner and others with an interest in the property an opportunity to buy or lease it before offering it for sale to other parties. The 1990 Farm Bill stipulates that if these targeted buyers do not purchase or lease the property, FmHA is to give priority to beginning farmers and then to other family-size farm operators. The 1990 Farm Bill also requires that a buyer be selected at random if more than one family-size farm operator offers to purchase a farm inventory property. Surplus property, however, is sold to the general public through auction, negotiated sales, or sealed bids, or through real estate brokers.

The selling price for suitable property is based on the property's agricultural market value. This is determined by an appraisal that considers the value of other farm properties, the productivity of the property, and the value of the land and buildings. The 1990 Farm Bill stipulates that property generally remain classified as suitable for 1 year from the date that FmHA publicly advertises it for sale at the fixed price. After this period, it is classified as surplus. Before passage of the 1990 Farm Bill, property generally remained classified as suitable for 3 years after the date of FmHA's acquisition.

Targeting Properties to Selected Buyers Is Costly to the Government

As we previously reported,[1] selling FmHA farm properties to selected buyers at a fixed price limits the potential market for such properties and the potential sales price that FmHA can obtain. For example, officials in FmHA's Wisconsin State Office told us that, in their opinion, farm inventory properties could be sold at higher prices if the properties were not targeted or sold at a fixed price. In Wisconsin the potential for obtaining higher prices through competitive sales seems to exist because during 1990 FmHA advertised 115 farm properties for sale and received 624 purchase offers. FmHA state office officials in three of the remaining five states we reviewed shared the views of Wisconsin officials concerning the benefits of competitive bidding.

Targeting properties to selected buyers at fixed prices can also add to FmHA's expenses by lengthening the time that properties are held in inventory and thereby increasing FmHA's property management costs. On average, FmHA holds inventoried properties over 40 months and spends an estimated $65 million annually to manage them. Targeting the sale of FmHA properties to selected purchasers increases average property holding times because it restricts the potential market. More specifically, until the 1990 Farm Bill, the sale of suitable properties was limited to targeted purchasers for 3 years after FmHA acquired and classified the properties as suitable. The 1990 Farm Bill attempted to reduce the time that properties are targeted for selected purchasers by stipulating that suitable property retain its classification for 1 year after FmHA publicly advertises it for sale at a fixed price. However, the act does not establish a time by which the properties must be advertised for sale and thus may not necessarily reduce the time that suitable properties are held in inventory.

Incorrectly priced properties can also lengthen FmHA's property holding times. For example, FmHA may price a suitable property above what buyers are willing to pay. Consequently, the properties remain in inventory until they are reappraised or reclassified and sold competitively as surplus property. While the property remains in inventory, FmHA incurs additional management expenses. For example, a 303-acre Kansas suitable property that was advertised at a fixed $64,000 price did not receive a purchase offer. Subsequently, FmHA reclassified the property as surplus and listed the property with a real estate firm. FmHA then sold it for $50,000 in November 1990. Had FmHA been able to offer and sell the property on a competitive basis sooner, its management costs would have been reduced.

[1] Farmers Home Administration: Federally Acquired Farm Property Presents a Management Challenge (GAO/RCED-86-88, June 13, 1986).

Targeting Properties May Not Achieve Legislative Objectives

Targeting FmHA's farm properties may not effectively assist the targeted groups of purchasers. Even though FmHA classifies most of its properties as suitable, many may not be appropriate for farming operations because they have physical limitations—e.g., the properties may not be viable independent farm units or they may be too costly to purchase or operate as farms. For example, in our April 1991 report covering 72 farm properties in seven states, we found that local FmHA officials considered only 11 properties appropriate for beginning farmers. Most were not appropriate for a variety of reasons, including poor soil conditions, deteriorated farm buildings, or high costs to purchase or operate as farms. The following case example illustrates a suitable inventory property whose physical condition and cost limit its value for beginning farmers.

Case Example 1 — A 300-acre Wisconsin property was appraised in February 1990 at about $118,000. The property contained buildings with no economic value, including a deteriorated farm house and a barn that needed a new ceiling, and it lacked the necessary equipment to run a dairy operation. The county supervisor estimated that $20,000 to $30,000 was needed to restore the house to a liveable condition, repair the barn, and purchase equipment. In addition, farming the property would require applying chemicals to the soil—adding approximately $3,000 to a buyer's expenses. The appraisal indicated that the dwelling's poor condition limited the property's attractiveness to buyers.

Other inventory properties classified as suitable may not be appropriate for farming by beginning farmers or anyone else. For example, an Arizona inventory farm that was classified as suitable had facilities for, and had previously been operated as, a 200-cow dairy operation. However, according to the appraiser, the University of Arizona has estimated that an Arizona dairy farm needs about 350 cows to operate successfully. The most recent appraisal stated that the highest and best use of the property was as a rural residence. Furthermore, three different FmHA borrowers in succession had failed to operate the farm successfully because they could not generate a positive cash flow.

Targeting Properties May Result in Abuse

The resale of inventory properties by targeted buyers may result in program abuse and undermine the Congress's intent to provide former owners and others with the opportunity to operate family-size farms. Targeted buyers, such as former owners, may not intend to farm the properties; instead, they may resell the properties for a profit in which FmHA does not share. The Con Act does not require targeted buyers to

operate the inventory farms they purchase, nor does it provide FmHA with the authority to offset earlier loan losses by sharing in profits that former owners may realize in selling the properties. Targeted buyers who sell or lease inventory property circumvent the legislative intent that the properties be used by targeted buyers for agricultural purposes. The following case examples illustrate instances in which former owners exercised their rights to purchase property from FmHA and did not apparently intend to farm the property or sold some or all of the property.

Case Example 2 — A husband and wife had farmed a 205-acre South Dakota property until the husband died in 1983. After his death, the wife moved to a nearby town, purchased a house with an FmHA rural housing loan, and began working as a clerk at a local bank. In January 1985, she conveyed the property to FmHA in settling her outstanding debt. Because she was the prior owner, FmHA gave her the opportunity to purchase the property at the fixed price of $68,200. She exercised her purchase option, using a loan from the bank where she worked. The property is located near a lake resort area, and the county supervisor stated that its value should increase because of its location. The supervisor also told us that the woman has not farmed the property and does not apparently intend to farm it because she still lives in the town and works at the local bank.

Case Example 3 — In December 1985, FmHA obtained 46 acres in settling an Iowa borrower's $176,000 outstanding debt. The property is adjacent to an interstate highway exchange. In March 1988, the former owner repurchased the property from FmHA for $50,600. In August 1989, he sold part of the property—about 18 acres—for $95,000 to a local municipality, which, in turn, sold the property to a corporation that subsequently constructed a retail outlet store on the property. In May 1991, the owner was developing part of the remaining 28 acres of the property for commercial use. These acres are adjacent to other commercial properties, including two fast food restaurants.

Case Example 4 — In December 1984, FmHA acquired a borrower's 360-acre South Dakota farm. FmHA subsequently leased 160 acres to one individual and the other 200 acres to another individual. In March 1989, the former owner repurchased the property from FmHA for $107,100. On the same day, he resold the property as two parcels to two other parties. The county supervisor told us that he believed the individual made a profit of about $18,000 by purchasing and immediately reselling the property.

Property Management Control and Information Are Inadequate

Management control over farm properties in FmHA's inventory rests primarily with the agency's county offices, and oversight of the properties depends largely on actions by local agency officials. However, FmHA county office officials do not always follow existing standards for the use and maintenance of inventory properties. Additionally, FmHA's property information system does not adequately track and account for acquired property. As a result, the government's interest in FmHA's inventory properties is not adequately protected.

FmHA's Implementation of Controls Does Not Protect the Government's Interests

Since 1986, our reports and USDA internal reviews have cited numerous cases in which FmHA county office officials have not followed established management procedures for leasing, inspecting, appraising, and maintaining property. For example, our June 1986 report discussed how FmHA had made only minimal efforts to manage its farm properties. The OIG issued 12 reports between October 1986 and January 1990 covering farm inventory property matters in 11 states and 45 counties. Of these 12 reports, 10 cited leasing problems, 5 mentioned maintenance and inspection problems, and 3 discussed appraisal problems. FmHA's 1990 CAR also disclosed inventory property management deficiencies in 33 of 57 county offices. According to an FmHA headquarters official who monitors property management activities, these problems are continually recurring and are due, in part, to the decentralized management of properties by local county offices and to the demands of other high-priority duties, such as making and servicing loans.

Leasing Problems

FmHA regulations require that leases be written for the use of FmHA properties and that lease amounts be comparable to those for similar properties in the area. However, the OIG has reported numerous instances in which properties have been (1) used without FmHA's permission, (2) rented without written leases, (3) leased for amounts below the prevailing rental rates, (4) leased without lease payments being collected, and (5) used with FmHA's permission by individuals whom FmHA did not require to make lease payments.

A 1987 OIG report disclosed that 18 of 20 county offices reviewed had no formal documented system to monitor whether properties had been leased or whether lease payments had been collected. OIG visits to 57 inventory properties revealed that individuals were allowed to live on and/or use 14 properties without signing a lease or paying rent; the OIG identified an additional 5 such cases through reviews of county case files. The following

case example from a 1986 OIG report illustrates the use of a farm property without a lease agreement.

Case Example 5 — An inventory farm property valued at approximately $120,000 was farmed during the 1986 crop year without a written lease agreement. In addition, when OIG officials visited the property, they found that the former owner continued to occupy the farm residence rent-free after FmHA had acquired the property. The county supervisor was unaware of the illegal usage. When this information was brought to the county supervisor's attention, a written agreement to lease the farmland for $4,600 annually and the farm residence for $150 per month was obtained.

In addition to problems with implementing leasing controls, FmHA must also contend with individuals who abuse the leasing of inventory properties. The following example illustrates the unauthorized use of an FmHA farm inventory property for which FmHA was not compensated.

Case Example 6 — In May 1987, FmHA leased a 747-acre Illinois farm to the former owner of the property. The agreement was a 1-year cropshare lease covering corn, soybeans, and hay, and rental of the residence and farm buildings. Before leasing the property, the county supervisor questioned the former owner's ability to make the required lease payments. In response, according to the county supervisor, the former owner showed her $10,000 in cash to demonstrate his financial viability. However, at the end of lease period, FmHA was paid only $3,578 of the $17,230 that was due. In April 1988, the county supervisor informed the former owner that he did not have a current lease and that he was not authorized to farm the property. The former owner then rented the cropland to another farmer for an unknown amount. FmHA estimated that it lost about $19,000 in potential rental income by not having leased the property to another farmer in 1988.

In March 1989, FmHA again informed the former owner that he was not authorized to farm the property or to rent it to others, and he was also ordered by a U.S. attorney to vacate the property. However, he remained on the property and grew crops on it during 1989. We inspected the property in August 1990 and noted that the former owner was still there and that crops were growing on the property. The former owner received an eviction notice from the U.S. attorney's office, and a court hearing was scheduled for March 1991. In May 1991, the county supervisor told us that she was unaware of the hearing's outcome but that the former owner was still occupying the property and she believed that he had again rented it to

another farmer. FmHA estimated that it had lost about $55,500 on this property from 1987 to 1989.

Inspection, Appraisal, and Maintenance Problems

FmHA field office officials have also not consistently followed standards pertaining to property inspection, appraisal, and maintenance. For example, while county supervisors are supposed to inspect farm inventory property periodically to detect and prevent unauthorized use and intentional damage, our review showed that county office files often do not contain documentation showing whether inspections have been made. As a result, FmHA may not know the condition of many of its properties. For example, only 2 of 10 FmHA inventory property files that we reviewed in two county offices, one in Kansas and one in Iowa, contained documentation of inspections performed annually.

Additionally, our work and a 1989 OIG report have disclosed that property appraisals were not reviewed as required. In the review that led to our April 1991 report on sales of farm inventory properties, we found no record of property appraisal reviews for 69 of 72 properties that we analyzed. Such reviews are important because they help ensure that FmHA prices its properties correctly: Properties that are appraised too low will command inadequate returns, while properties that are appraised too high could delay sales, thereby increasing the government's holding costs. Furthermore, the OIG reported 70 errors or omissions on appraisals for 46 of 95 farm properties it reviewed. Only 12 appraisals for these 95 properties had been reviewed by FmHA field office officials.

Finally, OIG reports have identified numerous problems concerning property maintenance. For example, on the basis of a review of FmHA's property management activities in 10 states, the OIG reported in June 1987 that 74 percent of 57 properties visited were not adequately maintained to protect the government's interest. According to this report, one 225-acre farm was so badly overgrown with grass, weeds, and brush that some pasture land would require bulldozing and reseeding to be productive.

Additionally, in 1986 and in 1987, the OIG reported deficiencies in FmHA's payment for property management services. For example, repair contracts were awarded without competition, repairs exceeded authorized dollar limits, payments were made for repair work not performed, and payments were made twice for the same repair work.

Factors Contributing to Property Management Problems

According to an FmHA official responsible for monitoring property management activities, the types of problems that we and the OIG have identified continue to exist. He stated that several factors lead to property management problems. One factor is that the responsibility for property management rests with the local county office, and some county officials are not familiar with the regulations, guidance, and requirements for managing inventory property. County officials have a wide variety of responsibilities, making it difficult for them to be familiar with all aspects of county operations, and they give higher priority to FmHA loan activities than to inventory property management. Also, during annual performance evaluations, county officials have not been held accountable for managing farm properties or for complying with property management standards.

Furthermore, the location of inventory properties may contribute to problems in managing them. Frequently these properties are scattered throughout a state. For example, as of June 30, 1990, 132 properties were listed in inventory in Wisconsin, and responsibility for their management was divided among 43 separate county offices. The greatest number of properties in any one county was 10. According to a property management official at FmHA headquarters, centralizing property management at the state office level could improve the situation by making only one person—rather than many county supervisors—responsible and accountable. He also indicated that a recent study on property management in the federal government had recommended centralizing the function.[2]

Tracking of Inventory Properties Remains Inadequate

FmHA lacks other controls to ensure that its properties are properly managed. For example, its Acquired Property Tracking System (APTS) contains errors and cannot be relied upon for accurate information. APTS is further limited because it does not track management actions and decisions concerning specific inventory properties. Therefore, control over these properties depends primarily on internal reviews or audits to detect wasteful or wrongful practices.

FmHA developed APTS in response to concerns over internal accounting controls. APTS is an automated subsidiary accounting system for farm and housing properties acquired through foreclosure and voluntary conveyance. The system provides information such as the date of acquisition, market value, number of acres, months held in inventory, and

[2]Recommendations for Managing and Disposing of the Federal Government's Real Property Acquired Through Loan Defaults, Department of the Treasury, Financial Management Service (Feb. 1991).

type of farming activity (i.e. dairy, field crops, pasture) for every inventory farm.

However, APTS cannot be relied upon to provide an accurate accounting of the number and value of properties in inventory. According to a recent annual FMFIA report by the Secretary of Agriculture to the President, FmHA's APTS is the system most in need of improvement within USDA. We have found extensive errors in APTS and have therefore had to qualify our financial audit reports of FmHA. For example, in our May 1991 report on FmHA's 1988 and 1989 financial statements, we reported that our statistical sample of properties at 119 county offices had disclosed that values were incorrectly reported in 43 percent of the cases reviewed. In one case, the February 1990 APTS report showed a Mississippi farm valued at $7.3 million that had been appraised in May 1989 for $971,000. Furthermore, the reports produced by APTS have not been reconciled with detailed acquired property records, as required by title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies.

According to FmHA, efforts are under way to correct the problems associated with APTS. However, despite a USDA February 1991 target date for completing corrective actions reported in the Secretary's December 1990 FMFIA report, these actions had not been completed as of September 1991. As a result, the reliability of APTS report data remains questionable. Our review of APTS data for 10 inventory farms in Iowa and Kansas, for example, found that 14 errors existed—APTS listed one property's acquisition value as $27,000 when it was actually $127,000.

Even with accurate information, APTS does not provide an overall system for FmHA to manage inventory property because APTS is primarily an accounting system rather than a management information system. For example, the system does not contain information on the management of specific properties, such as when the last inspection was performed, what type of maintenance was needed, and whether the maintenance was completed. Therefore, FmHA officials have only limited information to use in managing inventory property.

In September 1989, the OIG reported that APTS was not designed to monitor FmHA's property management efforts and that property management reviews were used to manage the inventory. However, once problems have been identified, no follow-up exists to ensure that corrections have been made. Also, no mechanism exists to disseminate the information throughout FmHA so that similar problems can be identified and corrected.

As a result, property control is dependent on internal management reviews or audits to detect wasteful or abusive practices.

FmHA recognizes that APTS is not a true management information system and provides only limited data. At the time of our review, FmHA was analyzing APTS to correct data and identify common property management problems, such as not receiving payments on existing leases. FmHA was also considering whether to centralize property management at headquarters.

Conclusions

Restrictive legislative mandates governing farm inventory property sales and FmHA management problems leave the government vulnerable to financial losses, waste, and program abuse. Mandates on selling property, particularly targeting sales to specific buyers and selling at a fixed price, limit the potential market and price FmHA can obtain. As a result, FmHA does not maximize returns from property sales and receives less revenue than it would under normal market conditions. Likewise, property management costs are greater than they would be under normal market conditions because properties are held in inventory for longer periods of time. The classifying of most FmHA inventory properties as suitable, even though they may not be appropriate for farming operations, has further increased management costs because the properties remain in inventory until they can be reclassified and sold as surplus. Also, the physical limitations of many properties classified and sold as suitable for farming may predispose certain buyers' farming operations to failure.

By targeting the sales of inventory properties to designated purchasers, FmHA gives lower priority to obtaining revenue than to achieving program objectives, such as (1) giving former owners a chance to reclaim their land and continue farming and (2) helping beginning farmers get started. However, the effectiveness of using inventory properties for such purposes is questionable, since, for example, the physical condition of many FmHA suitable properties precludes their use as viable, independent farms.

FmHA's management of its properties is inadequate, in part, because the agency lacks an adequate accounting and management information system to track its properties and because its reports cannot be relied upon to provide accurate information. In addition, FmHA county offices have not followed existing management controls that, among other things, are designed to maintain the value of the agency's inventory properties.

County offices, for example, do not always inspect their properties or perform necessary maintenance. Furthermore, some FmHA properties are used without FmHA's permission and without compensation.

In part, noncompliance with property management controls by FmHA's field offices stems from the agency's decentralized operations. County supervisors, who have a wide range of responsibilities, are often not familiar with FmHA's property management requirements and concentrate more on making and servicing loans than on managing inventory property. FmHA officials have noted that, in view of the few inventory properties at any given county office, it may make sense to centralize property management functions. Among other advantages, this action would decrease the need to ensure that thousands of county officials are familiar with complex property management standards and regulations.

Recommendations to the Secretary of Agriculture

To improve management control over FmHA's farm inventory properties, we recommend that the Secretary of Agriculture direct the FmHA Administrator to centralize property management functions at the FmHA state office level.

To provide accurate information for property management, we recommend that the Secretary of Agriculture direct the FmHA Administrator to place high priority on completing the APTS corrections and conducting full testing to ensure that these efforts have been successful.

Recommendations to the Congress

To improve the quality of FmHA's properties that are used for program purposes, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to change the definition of suitable property to reflect only properties that FmHA considers to be viable, independent farming units for the locale.

To increase FmHA's returns from sales of suitable farm inventory properties and reduce the amount of time that properties remain in inventory, we recommend that the Congress amend the Consolidated Farm and Rural Development Act to require that FmHA use competitive methods in selling such properties to targeted purchasers.

Appendix VI contains suggested language that the Congress may wish to use in amending the Con Act.

Agency Comments and Our Evaluation

In commenting on a draft of this report (see app. V), FmHA provided a general comment on sales of its farm inventory property. Specifically, FmHA stated that its farm inventory properties are now sold at fair market value, on the basis of guidance in the 1990 Farm Bill, and that it ensures receipt of the highest possible price by requiring that properties be properly appraised. In our opinion, questions arise about whether FmHA is receiving the highest possible price, since USDA's OIG and we have shown that property appraisals are not always reviewed according to FmHA's existing property standards. Furthermore, our work has shown that selling properties at a fixed price may not yield the highest return to the government. As a result, we are recommending an amendment to the Con Act that will direct FmHA to sell properties competitively to the targeted buyers.

In its comment on the draft report, FmHA stated that it agreed with the two farm inventory property recommendations to the Secretary of Agriculture. Regarding the first recommendation—that property management be centralized at the FmHA state office level—FmHA cited the experience of certain state offices that have centralized property management and disposal as evidence that this action is effective in reducing both the number of properties in inventory and the cost of managing such properties. In commenting on the second recommendation, which calls for FmHA to give high priority to correcting the problems in its property tracking system and to conduct full testing to ensure that its efforts have been successful, FmHA said that revisions to the system are under way and should be completed during fiscal year 1992.

FmHA's Role Needs to Be Clarified

The extensive work that we, USDA's OIG, and FmHA have conducted in recent years, substantiated by work supporting this report, shows that by almost any measure FmHA's programs have become good examples of how programs should not be implemented and managed. The agency has been given two broad, but often conflicting, responsibilities—to operate as a fiscally prudent lender and to provide high-risk borrowers with temporary credit to keep them in farming until they secure commercial credit. Available evidence suggests that FmHA has not successfully fulfilled either responsibility and that it will continue to experience problems until the Congress better defines FmHA's fundamental role and mission.

FmHA Has Not Been Prudent in Lending Federal Money

As the federal lender to the nation's financially stressed farmers, FmHA would be expected to incur some loan losses because the creditworthiness of its borrowers is marginal at best. Logically, these losses would be greater than those of commercial lending institutions that can use more stringent credit standards to select borrowers. However, in our opinion, FmHA's past losses far exceed those that might be anticipated even for a "lender of last resort." As noted in chapter 2, billions of dollars in direct loans were not repaid—FmHA forgave about $4.5 billion during fiscal years 1989 and 1990 alone. Furthermore, FmHA may lose billions more, since as much as 70 percent of its existing loan portfolio is held by borrowers who pose high risks, even by FmHA standards. FmHA's guaranteed loan portfolio, which is still relatively small, may follow the same road as the direct loan portfolio because the guaranteed program is experiencing many of the same problems as the direct program. As noted in chapter 3, FmHA's field lending offices do not always follow credit standards, and certain loan-making policies allow FmHA lending officials to guarantee loans with a high potential for loss.

Several factors have contributed to this alarming condition, including some beyond the control of either FmHA or the Congress. For example, the general economic decline of agriculture in the 1980s weakened not only FmHA's loan portfolio but also the portfolios of commercial lenders. Additionally, judicial decisions in 1984 and 1987 prevented FmHA from foreclosing on delinquent borrowers.

However, other factors contributing to FmHA's problems were within FmHA's and/or the Congress's ability to influence. More specifically, FmHA has not adequately managed its farm loan programs. The agency has not ensured that field lending offices are implementing loan-making and loan-servicing standards and has allowed program policies that increase

the government's exposure to risk (e.g., making loans and approving loan guarantees on the basis of projected cash flow, and guaranteeing most loans—regardless of their risk—at the maximum level). Also, as we reported in July 1991,[1] FmHA managers lack the information needed to manage the programs effectively. Accurate information is particularly critical in view of the agency's highly decentralized operations. Although FmHA initiated a $500-million effort to modernize the systems that support its loan programs, our October 1991 report[2] noted that this effort is jeopardized by the lack of an adequate strategic business plan and a supporting information systems plan. A strategic business plan would outline procedures for FmHA's operations in the future, and an information systems plan would link specific modernization projects to the business plan. Without these plans, FmHA does not know what information technology it will need to support its mission and operations in the future. FmHA also lacks adequate oversight of the modernization effort—the agency's executive board responsible for overseeing the effort has been inactive for over 3 years. FmHA has responded to the October 1991 report by suspending modernization spending until it has addressed these problems.

Congressional actions emphasizing FmHA's role as an assistance agency over its role as a prudent lender were perhaps a greater cause of farmer loan program problems than was program management. For example, FmHA's 1987 attempt to make loan standards more stringent was not implemented because of, among other things, congressional concern about the adverse impact that the proposed changes might have on farmers. FmHA was also directed in 1987 to reinstate the continuation policy, which permits delinquent borrowers to obtain additional loans. Furthermore, the Agricultural Credit Act of 1987 allowed delinquent farmers to obtain billions of dollars in debt relief and created incentives for nondelinquent borrowers deliberately to become delinquent. Besides directly weakening loan-making and loan-servicing standards, these actions, in our opinion, sent an indirect message to FmHA field lending officials that the agency's primary mission was to help farmers, even at the expense of financial prudence.

Neither FmHA nor the Congress intended to create lending programs that would lose massive amounts of money. However, that is exactly what has happened. Moreover, the program's primary source of financial

[1]U.S. Department of Agriculture: Strengthening Management Systems to Support Secretarial Goals (GAO/RCED-91-49, July 31, 1991).

[2]ADP Modernization: Half-Billion Dollar FmHA Effort Lacks Adequate Planning and Oversight (GAO/IMTEC-92-9, Oct. 29, 1991).

vulnerability may have little to do with fraud or other attempts to circumvent established financial controls intended to protect government funds. Rather, a more serious source of vulnerability may stem from the program's own lending and servicing policies. In short, the financially stressed condition of FmHA's loan portfolio is not surprising in view of lending policies that, for example, do not prohibit loans to borrowers who have defaulted on previous loans or servicing policies that create incentives for delinquency by offering substantial debt relief to delinquent borrowers.

FmHA Has Become a Source of Permanent, Not Temporary, Credit

FmHA's troubled lending record has, in part, been justified on the basis of the agency's responsibility to help farmers remain on the farm until they secure commercial credit. However, FmHA has not been an effective assistance agency. More specifically, FmHA was originally intended to provide federally subsidized credit temporarily to farmers who would eventually graduate to commercial credit. A high number of borrowers graduating from the program would therefore serve as a measure of the effectiveness of such assistance. However, many farmers have come to rely on FmHA as a continuous source of credit and are not strong enough financially to obtain commercial credit. Furthermore, FmHA lends a large proportion of its funds to existing customers rather than to new borrowers. In some cases, continued FmHA assistance has actually worsened the financial condition of farmers who have entered the program. Such problems raise questions as to whether FmHA is helping farmers or merely prolonging the ultimate failure of many.

Our past work indicates that FmHA has evolved into a continuous source of subsidized credit for nearly half of its borrowers. In fact, current policies foster dependence on federal credit, for they provide borrowers with little incentive to seek commercial credit. For example, if borrowers repaid their loans on schedule, they might be required to pay higher interest rates or to graduate to commercial credit—both more costly alternatives.

The ineffectiveness of FmHA's farm loan programs is indicated not only by borrowers' apparently low graduation rate but also by the deterioration over time of the financial condition of some borrowers who have received FmHA assistance. As discussed in chapter 2, this deterioration can result from frequent debt servicing that, over the long run, increases a borrower's total debt. This possibility is not merely hypothetical. For example, after 15 years in FmHA's farm loan programs, one borrower had received 17 loan-servicing actions on 38 loans, including rescheduling and

reamortizing loan terms. The farmer had received about $50,000 in government interest rate subsidies and almost $100,000 in financial advantages over non-FmHA farm borrowers. However, despite this assistance, the borrower's net worth declined from $20,000 in 1971 to a negative $6,635 in 1986.

Conclusions

FmHA's attempts to operate simultaneously as a fiscally prudent lender and as an assistance agency have not worked. In the preceding chapters, we have made a number of recommendations that are aimed at making FmHA's lending and servicing standards more stringent and at having county offices better comply with agency standards. These recommendations are premised on the belief that FmHA should move toward being a more prudent lender in order to better protect taxpayers' moneys. However, in the final analysis, the extent to which FmHA moves in this direction will depend upon the Congress's better defining the agency's role—just how fiscally prudent should FmHA be as the nation's lender of last resort? Better definition of FmHA's role may include congressional guidance on the levels of loan losses that policymakers are willing to accept in order to accomplish other program objectives, as well as more specific delineation of these other objectives.

Matters for Consideration by the Congress

In clarifying FmHA's role, the Congress should establish some broad parameters for FmHA's operations that earlier recommendations have not addressed. In establishing these parameters, the Congress should specify

- acceptable ranges of losses for FmHA's direct and guaranteed loan programs;
- limits for the length of time that borrowers may receive FmHA financial assistance;
- the type and extent of assistance, if any, that should be made available to help unsuccessful borrowers obtain other employment;
- the extent that loan funds can be used by customers already holding loans made or guaranteed by FmHA and by new customers, such as beginning farmers; and
- the extent that loan funds can be used to refinance existing debts and for new credit purchases.

FmHA's Direct and Guaranteed Farm Lending Authority as Changed by the Omnibus Budget Reconciliation Act of 1990, Fiscal Years 1991-95

Dollars in millions

	Direct loan authority			Guaranteed loan authority			
Fiscal year	**Initial**	**Change**	**Revised**	**Initial**	**Change**	**Revised**	**Total**
1991	$1,019	$ (482)	$ 537	$ 3,156	$ 482	$ 3,638	**$ 4,175**
1992	1,060	(614)	446	3,283	614	3,897	**4,343**
1993	1,102	(760)	342	3,414	760	4,174	**4,516**
1994	1,147	(859)	288	3,550	859	4,409	**4,697**
1995	1,192	(907)	285	3,693	907	4,600	**4,885**
Total	**$5,520**	**$(3,622)**	**$1,898**	**$17,096**	**$3,622**	**$20,718**	**$22,616**

Source: Omnibus Budget Reconciliation Act of 1990.

FmHA's Direct and Guaranteed Farm Loans

Table II.1: FmHA's Direct Farm Loans and Delinquency Status, September 30, 1990

Dollars in millions

	Farm ownership	Farm operating	Emergency disaster	Economic emergency	Other[a]	Total
Borrowers[b]						
Total	100,366	83,154	74,156	29,915	11,478	**299,069**
Number delinquent	17,410	24,855	24,068	11,498	2,510	**80,341**
Percentage delinquent	17.3	29.9	32.5	38.4	21.9	**26.9**
Outstanding principal						
Total	$6,466	$4,394	$6,057	$2,406	$221	**$19,544**
Amount owed by delinquent borrowers	$1,504	$1,432	$3,802	$1,267	$72	**$8,077**
Percentage owed by delinquent borrowers	23.3	32.6	62.8	52.7	32.6	**41.3**
Allowance for loan losses	$2,079	$1,780	$4,907	$2,119	$38	**$10,923**
Allowance as a percentage of total	32.2	40.5	81.0	88.1	17.2	**55.9**

[a]This category includes all other individual direct farm loans, such as soil and water loans.

[b]Because this table presents data by loan type rather than by individual borrower, borrowers are counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA report, code 616, and information obtained from USDA's OIG on the basis of its audit of FmHA's fiscal year 1990 financial statements.

Table II.2: FmHA's Guaranteed Farm Loans and Delinquency Status, September 30, 1990

Dollars in millions

	Farm ownership	Farm operating	Other[a]	Total
Borrowers[b]				
Total	9,356	38,570	679	**48,605**
Number delinquent	369	1,351	160	**1,880**
Percentage delinquent	3.9	3.5	23.6	**3.9**
Outstanding principal				
Total	$1,287	$2,775	$78	**$4,140**
Amount owed by delinquent borrowers	$58	$120	$23	**$201**
Percentage owed by delinquent borrowers	4.5	4.3	29.5	**4.9**
Allowance for loan losses	$327	$798	$26	**$1,151**
Allowance as a percentage of total	25.4	28.8	33.3	**27.8**

[a]This category includes all other guaranteed farm loans, such as emergency livestock loans.

[b]Because this table presents data by loan type rather than by individual borrower, borrowers are counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA report, code 4067, and information obtained from FmHA Finance Office officials.

General Accounting Office Reports on FmHA Programs and Activities Since Passage of the 1985 Farm Bill

Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR, Jan. 2, 1986)

Farmers Home Administration: Financial and General Characteristics of Farmer Loan Program Borrowers (GAO/RCED-86-62BR, Jan. 2, 1986)

Farmers Home Administration: Debt Restructuring Activities During the 1984-85 Farm Credit Crisis (GAO/RCED-86-148BR, May 16, 1986)

Farmers Home Administration: Federally Acquired Farm Property Presents a Management Challenge (GAO/RCED-86-88, June 13, 1986)

Farmers Home Administration: Loan-Servicing Efforts Focus on Continually Delinquent Borrowers (GAO/RCED-87-13BR, Nov. 12, 1986)

Farmers Home Administration: Information on Agricultural Credit Provided to Indians on 14 Reservations (GAO/RCED-87-79BR, Mar. 11, 1987)

Farmers Home Administration: Problems and Issues Facing the Emergency Loan Program (GAO/RCED-88-4, Nov. 30, 1987)

Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses as of June 30, 1987 (GAO/RCED-88-134BR, May 20, 1988)

Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3, Nov. 22, 1988)

Financial Audit: Farmers Home Administration's Losses Have Increased Significantly (GAO/AFMD-89-20, Dec. 20, 1988)

Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria (GAO/RCED-89-9, Feb. 14, 1989)

Farmers Home Administration: Status of Participation in the Interest Rate Reduction Program (GAO/RCED-89-126BR, June 15, 1989)

Farmers Home Administration: Implementation Issues Concerning Four Sections of the Food Security Act (GAO/RCED-89-71, June 19, 1989)

Information Management: Issues Important to Farmers Home Administration Systems Modernization (GAO/IMTEC-89-64, Aug. 21, 1989)

Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86, Sept. 11, 1989)

Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS, Nov. 29, 1989)

Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987 (GAO/AFMD-90-37, Jan. 25, 1990)

Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR, Feb. 8, 1990)

Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses as of June 30, 1989 (GAO/RCED-90-158BR, June 26, 1990)

Farmers Home Administration: Changes Needed in Loan Servicing Under the Agricultural Credit Act (GAO/RCED-90-169, Aug. 2, 1990)

Farmers Home Administration: Sales of Farm Inventory Properties (GAO/RCED-91-98, Apr. 9, 1991)

Farmers Home Administration: Information on Appeals of Farm and Housing Loan Decisions (GAO/RCED-91-106, Apr. 9, 1991)

Financial Audit: Farmers Home Administration's Financial Statements for 1989 and 1988 (GAO/AFMD-91-36, May 6, 1991)

ADP Modernization: Half-Billion Dollar FmHA Effort Lacks Adequate Planning and Oversight (GAO/IMTEC-92-9, Oct. 29, 1991)

Farmers Home Administration: Debt Relief Actions for Business Entity Borrowers Are Questionable (GAO/RCED-92-29, Dec. 10, 1991)

Objectives, Scope, and Methodology

This appendix contains detailed information on how we conducted our direct loan, guaranteed loan, and farm inventory property work. Chapter 1 contains information on our overall objectives, scope, and methodology.

To gain a complete understanding of FmHA's credit standards in the three areas under review, to determine whether FmHA's field offices are complying with the agency's standards, and to assess the effectiveness of actions taken to correct previously identified compliance weaknesses, we reviewed FmHA's regulations, operating instructions, and other guidance to its field offices; relevant congressional reports and hearing records; GAO reports issued since the passage of the 1985 Farm Bill; USDA and FmHA reports of actions taken on GAO recommendations; USDA's OIG reports issued since fiscal year 1986; the Secretary of Agriculture's annual FMFIA reports to the President; and the results of FmHA's internal control reviews and other internal documentation. We also visited numerous FmHA county, district, and state offices around the country to review case files and discuss compliance issues with FmHA field officials.

To determine program policy problems that exist in the three areas under review and to assess the effectiveness of actions taken to correct previously identified weaknesses, we reviewed relevant congressional reports and hearing records; GAO and OIG issued reports; USDA and FmHA reports of actions taken on GAO recommendations; the Secretary of Agriculture's annual FMFIA reports; and FmHA's regulations, congressional testimonies and responses to congressional inquiries, internal and contractor studies, reports, and other internal documents. To determine legislative requirements for FmHA's farm programs, we reviewed laws and legislative histories, including the Con Act, the Rural Development Act of 1972 (P.L. 92-419, Aug. 30, 1972), the 1985 Farm Bill, the supplemental appropriations bill for fiscal year 1987, the Agricultural Credit Act of 1987, and the 1990 Farm Bill.

Additional information on various aspects of our direct loan, guaranteed loan, and farm inventory property work follow.

Direct Loans

To assess agency compliance with established direct loan standards, we performed work at 10 FmHA county offices and at 3 FmHA state offices. Specifically, we judgmentally selected six states to review for geographic spread—Florida, Georgia, Illinois, Louisiana, Minnesota, and Texas. We conducted detailed audit work at one county office each in Illinois and Minnesota and at two county offices in each of the other four states. Using

FmHA's St. Louis Finance Office computerized data bases, we selected county offices on the basis of their meeting at least one of the following conditions: they provided new loans to borrowers who had received debt relief under the Agricultural Credit Act and had then become delinquent on the new loans; they restructured borrowers' delinquent debts and the borrowers then became delinquent on the restructured debt and subsequently obtained additional debt servicing; or they allowed borrowers to accumulate over $200,000 in outstanding farm ownership or farm operating indebtedness.

At each of the selected county offices, we reviewed borrowers' loan files, concentrating on loans that FmHA had made since fiscal year 1989, to determine compliance with loan-making standards. In each county office we focused on identifying examples of continued weaknesses in implementing credit standards. Specifically, in these loan files, we reviewed documentation to determine whether, for example, Farm and Home plans met FmHA's cash flow requirements and whether county supervisors were basing production projections on borrowers' proven records of production. Also, we reviewed county offices' loan files for evidence of supervisors' having serviced the accounts according to FmHA's loan servicing standards, and we visited the farms of eight borrowers to assess compliance with FmHA regulations for maintaining collateral.

Additionally, to determine whether FmHA's lending policies contribute to risky direct loans, we interviewed county supervisors in each of the selected county offices as well as FmHA district and state office officials, and we made various matches of computerized information at the St. Louis Finance Office. We used these matches to identify the extent to which new loans were made to borrowers who were delinquent on their existing FmHA debts or had defaulted on past debts and received debt forgiveness.

To gain additional insight into FmHA's vulnerability to loss attributable to its loan servicing policies, we used computer matches to identify (1) borrowers who had accumulated more than $200,000 in farm ownership or operating debt as a result of loan servicing and (2) borrowers whose delinquent debt had received multiple instances of servicing under the Agricultural Credit Act. At the county offices we visited, we reviewed the loan files of borrowers whose loans had been rescheduled and who had thus incurred high outstanding indebtedness and undersecured loans.

Furthermore, since the length of time that farm properties are held in FmHA's inventory can affect the amount of debt relief that delinquent

borrowers can receive, we reviewed how FmHA calculates its average holding period for such properties and how different time periods influence debt relief. Specifically, we reviewed selected delinquent borrower loan files in the county offices where we conducted the farm inventory property segment of our study, and we interviewed state officials and county supervisors to determine what factors affect the length of time that properties remain in inventory and how the average holding period reflects non-FmHA property market conditions.

To estimate the proportion of FmHA's direct loan portfolio that is held by borrowers who have kept the payments on their original loans current and by other borrowers who have not kept current, we reviewed, through the St. Louis Finance Office, a dollar-unit sample of loans to 400 borrowers from the 188,961 borrowers in the computerized records who had loans outstanding as of September 30, 1990. The probability of borrowers' being selected was proportional to the dollar value of their unpaid loan principal. Thus, borrowers with higher unpaid principal balances were more likely to be sampled. We analyzed these borrowers according to whether their loans were original loans or rescheduled loans and whether the loans were paid current, the first loan payments were not due at the time of our analysis, or the loans were not paid current. We classified borrowers whose loans fell into more than one of these categories into the category that had the largest unpaid loan balance.

The computerized records provided to us by FmHA's Finance Office showed that these 188,961 borrowers had about $19.7 billion in outstanding debt. This amount differs slightly from the $19.5-billion figure that we extracted from FmHA's September 30, 1990, Insured Borrowers Delinquent report (Report code 616) and report as FmHA's outstanding direct loan debt in appendix II. We did not determine why these two FmHA information sources differed, since the difference was proportionally slight.

Since we used a sample (called a probability sample) of 400 borrowers to develop our estimates, each estimate has a measurable precision, or sampling error, which may be expressed as a plus/minus figure. A sampling error indicates how closely we can reproduce from a sample the results that we would obtain if we were to take a complete count of the universe using the same measurement methods. By adding the sampling error to and subtracting it from the estimate, we can develop upper and lower bounds for each estimate. This range is called a confidence interval. Sampling errors and confidence intervals are stated at a certain confidence level—in this case, 95 percent. For example, a confidence

interval, at the 95-percent confidence level, means that in 95 out of 100 instances, the sampling procedure we used would produce a confidence interval containing the universe value we are estimating.

Table IV.1 shows the sampling errors and the upper and lower confidence interval limits for our estimates of borrowers who kept current and did not keep current on their loan payments. Table IV.2 shows the sampling errors and the upper and lower confidence interval limits of our estimates for the FmHA debt that was kept current and not kept current by borrowers. In the tables, the figures for the total number of borrowers (188,961) and the total outstanding debt ($19.7 billion) are the actual figures we obtained from FmHA's Finance Office and used as a basis for sampling and making the resulting projections.

Table IV.1: Sampling Errors and Confidence Intervals for Estimated Number of Borrowers Who Did and Did Not Keep Current on Loan Payments

	Estimate	Sampling error	95-percent confidence interval	
			Lower limit	Upper limit
Estimated number of borrowers				
Original loan				
Paid current	87,241	21,013	66,228	108,254
First payment not due	4,517	3,077	1,440	7,594
Subtotal	**91,758**	21,237	70,521	112,995
Rescheduled loan				
Paid current	30,852	8,786	22,066	39,638
First payment not due	14,725	5,687	9,038	20,412
Subtotal	**45,577**	10,466	35,111	56,043
Original or rescheduled loan not paid current	51,626	12,267	39,359	63,893
Total	**188,961**			
Percentage of estimated borrowers				
Original loan				
Paid current	46.2	11.1	35.1	57.3
First payment not due	2.4	1.6	0.8	4.0
Subtotal	**48.6**	11.2	37.4	59.8
Rescheduled loan				
Paid current	16.3	4.6	11.7	20.9
First payment not due	7.8	3.0	4.8	10.8
Subtotal	**24.1**	5.5	18.6	29.6
Original or rescheduled loan not paid current	27.3	6.5	20.8	33.8
Total	**100.0**			

Table IV.2: Sampling Errors and Confidence Intervals for Estimated Debt That Was and Was Not Kept Current

Dollars in billions

	Estimate	Sampling error	95-percent confidence interval	
			Lower limit	Upper limit
Estimated outstanding debt				
Original loan				
Paid current	$ 5.1	$0.8	$4.3	$5.9
First payment not due	0.7	0.3	0.4	1.0
Subtotal	**5.8**	0.8	5.0	6.6
Rescheduled loan				
Paid current	3.8	0.7	3.1	4.5
First payment not due	2.1	0.5	1.6	2.6
Subtotal	**5.9**	0.8	5.1	6.7
Original or rescheduled loan not paid current	8.0	1.1	6.9	9.1
Total	**$19.7**			
Percentage of estimated debt				
Original loan				
Paid current	25.8	4.0	21.8	29.8
First payment not due	3.7	1.5	2.2	5.2
Subtotal	**29.5**	4.1	25.4	33.6
Rescheduled loan				
Paid current	19.4	3.4	16.0	22.8
First payment not due	10.6	2.7	7.9	13.3
Subtotal	**30.1**[a]	4.0	26.1	34.1
Original or rescheduled loan not paid current	40.4	5.4	35.0	45.8
Total	**100.0**			

[a]This estimated subtotal does not add because of rounding.

Guaranteed Loans

To assess agency compliance with established guaranteed loan standards, we performed work at 10 FmHA county offices and at 4 FmHA state offices. Specifically, we judgmentally selected six states to review for geographic spread—Florida, Georgia, Iowa, Kansas, Louisiana, and Texas. Detailed audit work was performed at one county office each in Florida and Georgia and at two county offices in each of the other four states. The county offices were selected on the basis of the number of their active

guaranteed loans and of their having made loans that had resulted in FmHA's paying guaranteed loan loss claims within the past 3 years.

At each of the county offices, we reviewed the loan files of borrowers who had received guaranteed loans to determine agency compliance with loan-making standards. Specifically, in these loan files, we reviewed documentation covering a borrower's production and financial history, projected yields and operating expenses, debt and projected debt payments, and plan of operation and cash flow margin. This information was used to determine whether FmHA had adhered to loan-making standards before loan closing and whether, therefore, the loan should have been approved. We discussed the results of our loan file reviews with FmHA county supervisors to ensure that our analyses of loan files were accurate and that our conclusions on compliance with agency standards were correct.

To determine whether county offices were complying with servicing requirements, we also reviewed FmHA loan files to document evidence that county supervisors had or had not monitored lenders through such means as visits to the lending institutions. We also interviewed county supervisors in each of the selected county offices to determine how they monitored lenders, including how frequently they contacted them. Furthermore, we interviewed eight lenders within the 10 county areas we visited to determine whether county supervisors had kept them informed of FmHA's loan requirements and whether county office personnel had visited them to review their guaranteed loan files.

To determine whether lenders were complying with the guaranteed loan-servicing requirements, we reviewed loan files at the county offices to document FmHA's evidence that the lender was or was not complying with loan-servicing requirements. We also reviewed 72 guaranteed loan files at 24 commercial lenders in the 10 county areas reviewed to document evidence that the lenders were servicing the guaranteed loans according to FmHA's requirements. We selected these lenders on the basis of the number of guaranteed loans they had. At the selected lenders, we reviewed the guaranteed loan files to determine whether the lenders were tracking the use of loan funds and accounting for crop proceeds, ensuring that loan funds were used for intended purposes, monitoring borrower activities that could affect loan repayment ability, and accounting for security in the event of a default. We also interviewed loan officials at the 24 lenders to obtain their views on FmHA's guaranteed loan program, determine their knowledge of FmHA's loan-servicing requirements, and identify the actions

they took to ensure that guaranteed loan funds were used for authorized purposes.

Additionally, to determine the extent of FmHA's vulnerability to losses attributable to certain of its guaranteed loan-making policies, we interviewed county supervisors and FmHA district and state office officials, and we matched computerized information at the St. Louis Finance Office. We used these matches to identify the extent that borrowers received new guaranteed loans after FmHA had paid loss claims on previous guaranteed loans or had forgiven delinquent direct loan debt.

Furthermore, our February 1990 report included loan-use projections based on a probability sample of 900 guaranteed loans. Specifically, our guaranteed loan estimates were based on a probability sample of 450 guaranteed farm ownership loans and 450 guaranteed farm operating loans. Each sample was stratified on the basis of loan amount, and 200 lower-valued and 250 higher-valued loans were selected. In that report, we estimated that lenders' existing customers received about 80 percent of the guaranteed farm ownership loan funds (3.5-percent sampling error), and about 79 percent of the guaranteed farm operating loan funds (4.1-percent sampling error). About 69 percent of the guaranteed farm ownership loan funds were used to refinance existing debts (3.9-percent sampling error), and 20 percent were used to purchase farm property (3.3-percent sampling error). Also, 34 percent of the guaranteed farm operating loan funds were used for refinancing existing debt (5.1-percent sampling error), while about 55 percent were used for farm operating expenses (4.9-percent sampling error).

We compared these 900 sampled loans with FmHA's Finance Office records and identified 827 loans in the April 1991 guaranteed loan file. We sorted these loans into three loan-use categories—(1) entirely for refinancing existing debt, (2) partly for refinancing existing debt and partly for other uses, and (3) entirely for uses other than refinancing—and then analyzed Finance Office records to determine which loans in each category had payments that were past due. To estimate the extent of delinquencies on the basis of loan use, we then projected the results of this analysis to the 2,432 guaranteed farm ownership loans and the 9,851 guaranteed farm operating loans that were made in fiscal year 1988.

As with the direct loan estimates discussed earlier in this appendix, since we used a probability sample of loans to develop our estimates, each estimate has a sampling error and a confidence interval at the 95-percent

confidence level. Table IV.3 shows the sampling errors and the upper and lower confidence intervals of our estimates of delinquency rates for the FmHA guaranteed farm ownership and operating debt that was used for refinancing and for other loan purposes.

Table IV.3: Sampling Errors and Confidence Intervals for Estimated Delinquencies on Guaranteed Farm Ownership and Operating Loans Used for Refinancing and for Other Purposes

Guaranteed loan type and planned use of funds	Estimate	Sampling error	95-percent confidence interval	
			Lower limit	Upper limit
Farm ownership loans				
Fund uses				
Refinance debts only	1,335	102	1,233	1,437
Number with late payments	101	40	61	141
Percent with late payments	7.6	3.0	4.6	10.6
Refinance debts and other purposes	213	57	156	270
Number with late payments	16	16	3[a]	32
Percent with late payments	7.4	7.4	0[a]	14.8
Other purposes	671	91	580	762
Number with late payments[b]	12	15	2[a]	27
Percent with late payments[b]	1.8	2.3	0[a]	4.1
Farm operating loans				
Fund uses				
Refinance debts only	1,948	357	1,591	2,305
Number with late payments	208	122	86	330
Percent with late payments	10.7	6.0	4.7	16.7
Refinance debts and other purposes	822	247	575	1,069
Number with late payments	79	77	4[a]	156
Percent with late payments	9.6	9.0	0.6[a]	18.6
Other purposes	6,372	433	5,939	6,805
Number with late payments	597	224	373	821
Percent with late payments	9.4	3.5	5.9	12.9

Note: The number of loans with late payments represents the number of loans for which payments were past due or on which loan loss payments had been made as of April 1991.

[a]The lower limit of the number and percent are based on the number of loans with late payments in our sample. Also, the lower limit percent for the two farm ownership loan-use categories is less than one-tenth of 1 percent.

[b]The precision of these estimates must be qualified because none of the 49 loans used for other purposes that we reviewed in one of the two stratifications ($140,000 or more) was past due.

Farm Inventory Property

To assess compliance with FmHA's standards for managing farm inventory property, we performed work at eight FmHA county offices. Specifically, we judgmentally selected 6 of the 10 states with the highest number of properties that were in inventory or that had been sold from inventory during fiscal years 1989 and 1990. The states selected were Arkansas, Illinois, Iowa, Kansas, Missouri, and Wisconsin. We then selected FmHA county offices in each state that had five or more properties that were in inventory or that had been sold during fiscal years 1989 and 1990. We conducted detailed audit work at two county offices each in Illinois and Wisconsin and at one county office in each of the other four states.

At each of the selected county offices, we reviewed farm property case files to determine whether farm inventory properties were being managed according to FmHA's established standards. Specifically, in these case files, we reviewed documentation to determine whether, for example, required property inspections were being conducted, properties were being maintained to protect their values, and appraisals were being reviewed for correctness and accuracy. Also, at each of the county offices, we reviewed the property case files of at least five inventory properties that had been sold to compile such information as the length of time properties remained in inventory, the properties' condition when appraised for sale, and the properties' appraised value and sales price. Furthermore, we interviewed FmHA officials to learn what types of buyers actually purchased the properties, how the buyers were selected, and whether other individuals had expressed an interest in purchasing the properties.

Comments From the Farmers Home Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of Agriculture | Farmers Home Administration | Washington D.C. 20250

FEB 06 1992

SUBJECT: Proposed GAO Report - Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk (GAO/RCED-92-86)

TO: John W. Harman
Director
Food and Agricultural Issues
Resources, Community, and
Economic Development Division

In response to GAO's report, "FmHA: Billions of Dollars in Farm Loans Are at Risk," Farmers Home Administration is responding to these recommendations as well as pointing out the ongoing management decisions already implemented that are making significant reductions in the identified risks.

GENERAL COMMENTS

See comment 1.

COMMENTS ON GUARANTEED LOANS: PROJECTED LOSSES: GAO has stated that FmHA's guaranteed loan portfolio suffers from problem debt. The report cites an agency projection of 28 percent of the existing loan portfolio as being highly susceptible to loss. This loss allowance does not reflect the current performance of the portfolio. As of September 30, 1990, actual FmHA loan loss percentages (principal and interest) for the various guaranteed programs since their inception are as follows: Operating Loans (OL), 3.6 percent; Farm Ownership (FO), 4.9 percent; Emergency Livestock (EL), 4.3 percent; Emergency (EM), 1.2 percent; Economic Emergency (EE), 20 percent. This trend has continued through September 30, 1991. These actual losses are indications that the percentage of loss used in the loss projection model was unrealistically high. (See Appendices A and B.)

See comment 3.

See comment 1.

When this model was developed, FmHA had no historical data on guaranteed loans and, therefore, used a method which included information from the Agency's direct lending experience. Since guaranteed lending data is now available, the Agency will change the loss projection formula to reflect actual guaranteed lending conditions and loss experience.

See comment 1.

COMMENTS ON REFINANCING:: The potential for abuse with the unrestricted refinancing of debt is understood by Agency management. Debt refinancing is an authorized loan purpose under the Consolidated Farm and Rural Development Act (CONACT). FmHA has operated with the understanding that limits on refinancing cannot be established under current statutory authorities.

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See comment 1.

However, the Agency is requesting guidance from the Office of the General Counsel on this issue.

FmHA believes the report's conclusion -- that refinancing and restructuring of debt under the guaranteed loan program has become a bailout for lenders -- oversimplifies a complex issue.

Consideration needs to be given to what the ultimate costs would be if the nonpayment of debts had been allowed to significantly and negatively impact rural businesses and agri-lenders. Refinancing has allowed many individuals to remain with their lenders and repay their debts. It has also enabled many rural lenders to maintain the customer base necessary for them to stay in business, thereby helping many hard-pressed agricultural-dependent businesses and communities to have a local source of credit.

Also, as noted in a December 1991 report by the Department of Agriculture's Economic Research Service (ERS), FmHA objectives may be met if marginal borrowers can refinance before their position deteriorates to a point where recovery is extremely difficult. If commercial lenders will stay with marginally credit worthy farmers with the benefit of guarantees, then the objective of helping these farmers obtain credit has been met. The ERS report concludes, "This line of reasoning suggests that heavy past use of the guaranteed loan programs to refinance bank loans may be an indication of the programs' success, rather than of misuse by lenders."

Another aspect of this issue is that many borrowers unable to refinance and restructure under the guarantee program might otherwise be eligible under FmHA's direct loan program. Providing credit through the guaranteed program is much more cost effective than the direct loan program, and the prospects for borrower success appear greater under the guaranteed program.

See comment 1.

COMMENTS ON PERCENTAGE OF GUARANTEE: FmHA contends that reducing the percentage of guarantee on high risk loans would force increased numbers of borrowers to seek the Agency's more costly direct loans. FmHA believes that, with some modification, the current policy is appropriate. It allows the borrower to retain financing through the commercial market. The relatively low loss experience of the guaranteed loan portfolio is indicative of that success.

See comment 1.

COMMENTS ON INVENTORY PROPERTY: GAO states that selling FmHA farm properties to selected buyers at a fixed price limits the potential market for such properties and the potential sales price that the Agency can obtain. Though GAO's observation may be correct, FmHA is, nevertheless, Congressionally mandated by Section 335(c) of the CONACT (7 USC 1985(c)) to offer the properties in this manner. Working within these constraints, the Agency ensures that the highest price possible is received when selling these properties by requiring that they are properly appraised at the fair market value.

GAO states that "The resale of inventory properties by targeted buyers may result in program abuse and undermine the Congress' intent to provide former owners and others with the opportunity to operate family-sized farms." As a result of the enactment of the FACT Act of 1990 (Section 1813(g)), FmHA is no longer required to sell inventory properties at their capitalization value, which had resulted in some profit-taking from the purchase and resale of these properties. FmHA now requires inventory properties to be sold at their fair market value.

GAO Recommendation for making and servicing direct loans:

1. To increase compliance with existing standards for making and servicing direct loans, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop and implement a system that will ensure that lending officials adhere to FmHA's loan-making and loan-servicing standards.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. In response to recommendations made by GAO in prior reports, the Agency has taken the following actions:

FmHA has put in place three types of reviews at State and National levels to monitor loan making and servicing standards. Reviews are made by 1), Program Review Assistants (PRAs), 2) State Evaluation Review (SER) and 3), National Office Coordinated Assessment Team Review (CAR). States are required to immediately take corrective action and report to the Administrator when they are in compliance with loan making and servicing standards. The findings of these reviews are also used to evaluate performance of FmHA field managers.

See comment 2.

A task force composed of Agency employees at the County, District, State and National levels is currently conducting an extensive review of all internal control and program management systems. Continued emphasis is being placed upon all of these reviews to identify improvements needed in the internal control process.

GAO Recommendation for making and servicing direct loans:

2. While it is important for FmHA to spend the necessary time to develop and implement a system to ensure better adherence to lending and servicing standards, we believe that more immediate actions are warranted to avoid making new loans that add to the current high level of problem debt. Therefore, as an interim step towards improved compliance, we recommend that the Secretary of Agriculture direct the FmHA Administrator to require that all direct loan applications or, if resources do not permit, a randomly selected sample of such applications be reviewed by state offices before they are finally approved.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. FmHA has taken action to improve the Agency's ability to maintain loan making and servicing standards. As of December 10, 1991, 37 of FmHA's 46 State Offices have implemented a loan review underwriting process to ensure that County Supervisors comply with loan making and servicing standards. The remaining States are evaluating their management options to determine the most feasible way to implement the underwriting process.

Additionally, reducing the number of loans that become delinquent within the first year has been made a performance criterion for the evaluation of FmHA field managers.

GAO Recommendation for making and servicing direct loans:

3. To strengthen FmHA's lending policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop more comprehensive loan-making criteria for direct loans that go beyond the current emphasis on cash flow and that assess an applicant's financial solvency, profitability, liquidity, and repayment ability before a new loan is made.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. As of September 1991, 4,189 loan officers had completed an intensive one-week course in a credit and financial analysis process that provides a comprehensive review of an applicant/borrower's farming business.

See comment 2.

Credit and Financial Analysis Worksheets developed for that course are now required documentation for all loan making and servicing actions These worksheets set forth the process to evaluate a farming operation's capital position, liquidity, profitability, historical earnings capability, operational efficiency, and asset management before a new loan is made or a servicing action taken. These tools will provide a consistent, methodical basis (and documentation) to ensure that FmHA assistance is provided to those applicants who can demonstrate reasonable prospects for success. This is an equally valuable tool for borrowers to evaluate their operations.

GAO Recommendation for making and servicing direct loans:

4. To strengthen FmHA's lending policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to (1) develop a method for calculating the average holding period that reflects normal property market conditions in servicing delinquent borrowers' debts and (2) require security for serviced loans that at least equals the loan's outstanding principal or that provides the best security interest available on all of the borrower's assets.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. (1) FmHA recognizes that its average holding period for farm inventory property is longer than that usually found in the private sector. However, the Agency is subject to Congressionally mandated requirements that give all former borrowers priority rights to lease and/or purchase the property, along with specific priorities which must be considered before properties are offered for sale to other farmers. In addition, all costs associated with acquiring, managing and selling inventory property when determining net recovery value for debt restructuring purposes must be considered.

Using average holding periods similar to those of the private sector might reduce the amount of debt written down, but such a change would force more delinquent borrowers into a net recovery buyout situation, with the property having a higher net recovery buyout value. This would force more borrowers into foreclosure and thereby increase agency costs. While we have no empirical evidence as to what the additional costs to the Agency might be, we seriously doubt that reducing the holding time to that of the private sector would result in any cost savings.

In the 1990 FACT Act, Congress authorized the Agency to reduce its holding period for suitable property from 3 years to 1 year, which will reduce the average holding time by several months.

See comment 2.

In view of agreement with the recommendation, it must be pointed out that FmHA has limited latitude under Section 335 of the CONACT to reduce inventory property holding time granted by statute to borrowers with leaseback/buyback and homestead protection rights. However, the Agency recognizes the impact of the issue and is seeking further clarification and guidance from the Office of the General Counsel.

(2) FmHA has taken steps to improve its collateral position. Regulations are being revised to require the best possible lien position on all of a borrowers' assets in both loan making and loan servicing actions.

A 10 percent down payment requirement (or 10 percent equity in other assets) for both direct and guaranteed farm ownership loans will be required. The agency anticipates that this change will go into effect in FY 1992.

FmHA agrees that the principal balance of restructured loans should not exceed the value of the security for the loan. However, without legislative relief from the requirements of Section 353(c) and (d) of the Consolidated Farm and Rural Development Act (CONACT), the Agency is limited in its ability to comply with this recommendation.

GAO Recommendation for making and servicing guaranteed loans:

1. To increase compliance with existing standards for making and servicing guaranteed loans, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop and implement a system that will ensure that lending officials adhere to FmHA's loan-making and loan-servicing standards.

Agency Response:

See comment 2.

The Agency agrees with this recommendation. In response to recommendations made in prior reports, FmHA has taken the following actions:

As in the direct loan program, the Agency has put in place three types of reviews at State and National levels to monitor loan making and servicing standards. Reviews are made by 1) Program Review Assistants (PRAs), 2) State Evaluation Review (SER) and 3) National Office Coordinated Assessment Review (CAR). These reviews monitor and evaluate compliance with loan making and servicing standards and determine whether FmHA personnel are reviewing the lender's loan file on new borrowers within 90 days of loan closing. Also, regulations require 20 percent of each lender's total guaranteed loan portfolio be reviewed annually.

See comment 2.

States are required to take corrective action and report to the Administrator when they are in compliance with loan making and servicing standards. In the case of CARs, follow-up by the National Office is continued and the review is not closed until the State provides adequate documentation that the identified weaknesses have been corrected. The findings of these reviews are also used to evaluate performance of FmHA field managers. Continued emphasis is being placed upon all of these reviews to identify improvements needed, so corrective measures can be taken.

The FmHA Administrator has issued a directive requiring all States to establish operational files on each Farmer Program lender and to document and analyze the performance of guaranteed lenders.

GAO Recommendation for making and servicing guaranteed loans:

2. As an interim step towards improved compliance, we recommend that the Secretary of Agriculture direct the FmHA Administrator to require that all guaranteed loan applications or, if resources do not permit, a randomly selected sample of such applications be reviewed by state offices before loan guarantees are finally approved.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. They have taken action to improve the Agency's guaranteed loan quality. As of December 10, 1991, 37 of FmHA's 46 State Offices have implemented a loan review underwriting process to ensure that loan making and servicing standards are complied with. The remaining States are evaluating their management options to determine the most feasible way to implement the underwriting process.

Reducing the number of loans that become delinquent within the first year has been made a performance criterion for the evaluation of FmHA field managers.

A major FmHA task force is researching guaranteed loan making and servicing issues and will make recommendations to the Administrator on establishing a comprehensive lender monitoring system, along with other suggestions for improvement of the guaranteed loan program. The report and recommendations are due to the Administrator by July 1992.

A guaranteed loan loss claim review process has been implemented. Samples of loss claims from each State are reviewed on a continuing basis by the National Office staff for compliance with FmHA regulations. The review will identify problems in the payment of loss claims and will trigger immediate corrective action.

GAO Recommendation for making and servicing guaranteed loans.

3. To strengthen FmHA's lending policies, we recommend that the Secretary of Agriculture direct the FmHA Administrator to develop more comprehensive loan-making criteria for guaranteed loans that assess an applicant's financial solvency, profitability, liquidity, repayment ability, and repayment history before a loan guarantee is approved.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. A task force composed of Agency employees from the County, District, State and National levels is currently conducting an extensive review of all internal control and program management systems related to guaranteed loan making and servicing.

As of September 1991, 4,189 loan officers had completed an intensive one-week course in a credit and financial analysis process that provides a comprehensive analysis of an applicant/borrower's farming business.

Credit and Financial Analysis Worksheets developed for that course are now required documentation for all loan making and servicing actions These worksheets set forth the process to evaluate a farming operation's capital position, liquidity, profitability, historical earnings capability, operational efficiency, and asset management. These tools will provide a consistent, methodical basis (and documentation) to ensure that FmHA assistance is provided to those applicants who can demonstrate reasonable prospects for success.

See comment 4.

As a result of the emphasis placed on credit quality beginning in 1990, credit quality compliance has dramatically improved in reviews conducted in FY 1991 and 1992. Currently, credit quality compliance for guaranteed lending nationwide is 93.79 percent.

GAO Recommendation on inventory properties:

1. To improve management control over FmHA's farm inventory properties, we recommend that the Secretary of Agriculture direct the FmHA Administrator to centralize property management functions at the FmHA state office level.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. In response to previous GAO reports, the Agency has taken the following actions:

See comment 2.

States with relatively high numbers of farm inventory properties have developed centralized staffs dedicated to the management and disposal of inventory properties. FmHA experience with this management decision shows that such efforts are effective in reducing the number and cost of managing farms in inventory.

GAO Recommendation on inventory properties:

2. To provide accurate information for property management, we recommend that the Secretary of Agriculture direct the FmHA Administrator to place high priority on completing the APTS corrections and conducting full testing to ensure that these efforts have been successful.

Agency Response:

See comment 2.

FmHA agrees with the recommendation. Revisions to the Acquired Property Tracking System (APTS) are currently underway. The revisions are expected to be completed and new software, with reporting capability, in place in FY-1992.

Summary: GAO indicates that FmHA's role and mission are not clear and states that "Until FmHA's role and mission are clarified, the agency's problems will continue." We agree with this assessment.

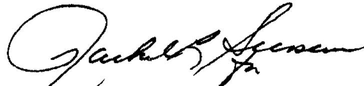
Most problems stemming from this lack of clarity are rooted in past and present Congressional mandates. Until those mandates are changed, many problems identified by GAO simply cannot be corrected. For example, FmHA is required by law to make new loans to delinquent borrowers and then restructure those same loans when the borrower defaults. However, within existing statutory authority, FmHA is in the process of establishing new loan making requirements. Specifically, the Agency has proposed that borrowers requesting direct loans must demonstrate a 5 percent debt service margin. We are considering adopting, in a final rule, provisions to require existing direct loan borrowers to meet the same standards by FY 1995.

See comment 5.

Additionally, the Agency is continuing its existing 10 percent debt service margin requirement for new guaranteed loans. (The audit's interpretation of this rule as cited on page 51 is misleading. FmHA requires a 10 percent debt service margin, not a 10 percent margin on cash flow.)

In the area of writedowns and writeoffs, GAO states, "Loan-servicing policies have resulted in losses for the Government without making farmers financially viable." Some Congressionally mandated loan making and servicing policies may adversely affect loan viability and FmHA losses. However, the Agency is obliged to follow Federal law.

We appreciate the opportunity to comment on the report.



LA VERNE AUSMAN
Administrator

The following are GAO's comments on the February 6, 1992, letter from the Farmers Home Administration.

GAO Comments

1. FmHA commented generally on the following key topics discussed in this report: estimated potential losses on guaranteed loans, the use of guaranteed loans for refinancing, the percentage of the loan guarantee, and the selling of farm inventory properties. Except as noted below, we addressed these comments in the discussion of agency comments and our evaluation in chapters 3 (guaranteed loans) and 4 (farm inventory property).

2. FmHA stated that it agreed with each of the direct loan, guaranteed loan, and farm inventory property recommendations addressed to the Secretary of Agriculture and noted its actions and decisions aimed at reducing the identified risks. Except as noted below, we addressed FmHA's comments in the discussion of agency comments and our evaluation in chapters 2 (direct loans), 3 (guaranteed loans), and 4 (farm inventory property).

3. FmHA provided us with appendixes containing recent guaranteed loan loss statistics. We did not reproduce and include the appendixes in this report. We added a note in chapter 3 to include the amount of the fiscal year 1991 guaranteed loan loss.

4. FmHA stated that its recent CAR results have shown dramatic improvement in compliance with guaranteed loan credit standards. We updated the report to include the results of FmHA's fiscal year 1991 CAR in chapters 3 (guaranteed loans) and 2 (direct loans). We also noted in chapter 3 that because FmHA has revised its format for reporting compliance with many of the guaranteed loan-making standards in fiscal year 1991, comparison with prior fiscal years is not appropriate.

5. FmHA stated that the draft report contained a misleading interpretation of its existing margin requirement for new guaranteed loans. We clarified chapter 3 to show that FmHA's 10-percent margin requirement applies to debt service and not to total cash flow.

Suggested Language for Amending the Consolidated Farm and Rural Development Act

This appendix contains suggested statutory language that the Congress may wish to use in amending the Consolidated Farm and Rural Development Act, as amended (P.L. 87-128, Aug. 8, 1961), to carry out the legislative recommendations contained in chapters 2, 3, and 4 of this report.

Direct Loan Recommendation: Prohibit direct loans to previously delinquent borrowers whose direct loans were bought out with debt write-off or restructured with debt write-down.

Suggested statutory change: Section 353 of the Consolidated Farm and Rural Development Act (7 U.S.C. 2001) is amended—by amending subsection (k) to read as follows:

"Effect of loan restructuring or termination on future creditworthiness of borrowers

A person who has had a delinquent farmer program loan restructured through debt write-down or terminated through net recovery buy-out shall be ineligible to receive subsequent insured farmer program loans. The creditworthiness of, or the adequacy of collateral offered by, any borrower whose loan obligations are restructured other than through debt write-down under this section shall be determined without regard to such restructuring."

The following suggestion further implements the above recommendation as well as the next recommendation.

Direct Loan Recommendation: Eliminate the continuation policy that permits direct loans to be made to currently delinquent borrowers.

Suggested statutory change: Real Estate Loans—Section 302 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1922) is amended—

(1) by striking "and" at the end of clause (3) of subsection (a);

(2) by striking the period at the end of clause (4) of subsection (a) and inserting a comma; and

(3) by adding at the end of clause (4) of subsection (a) the following new clauses (5) and (6):

"(5) not be a delinquent borrower under an existing farmer program loan; and

"(6) not have had a delinquent farmer program loan restructured through debt write-down or terminated through net recovery buy-out."

Suggested statutory change: Operating Loans—Section 311 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1941) is amended—

(1) by striking "and" at the end of clause (3) of subsection (a);

(2) by striking the period at the end of clause (4) of subsection (a) and inserting a comma; and

(3) by adding at the end of clause (4) of subsection (a) the following new clauses (5) and (6):

"(5) not be a delinquent borrower under an existing farmer program loan; and

"(6) not have had a delinquent farmer program loan restructured through debt write-down or terminated through net recovery buy-out."

Suggested statutory change: Emergency Loans—Section 321 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1961) is amended—by amending the proviso in subsection (a) to read as follows:

"Provided, (1) That they have experience and resources necessary to assure a reasonable prospect for successful operation with the assistance of such loan and are not able to obtain sufficient credit elsewhere; (2) that they are not a delinquent borrower under an existing farmer program loan; and (3) that they shall not have had a delinquent farmer program loan restructured through debt write-down or terminated through net recovery buy-out."

Direct Loan Recommendations: Limit a borrower whose debt is 180 days or more overdue to one restructuring action, and require that a borrower repay the interest portion of the loan payment as a condition of rescheduling or reamortizing loans that are less than 180 days delinquent.

Suggested statutory change: The Consolidated Farm and Rural Development Act is amended by adding the following new section (7 U.S.C. 1981g), which reads as follows:

"Limitations on certain primary loan service programs

(a) The Secretary may provide only one restructuring action for any borrower who is at least 180 days delinquent in the payment of principal or interest on a loan made or insured under this chapter.

(b) The Secretary shall require that a borrower pay the accumulated interest on a loan that is less than 180 days delinquent as a condition of rescheduling or reamortizing that loan."

Guaranteed Loan Recommendations: Require FmHA to establish and implement a range of guarantees that places the highest percentage guarantee on the least risky loan and a lower percentage guarantee on the most risky loan; prohibit loan guarantees for borrowers whose default on previous guaranteed loans resulted in FmHA's paying commercial lenders' loan loss claims; and prohibit loan guarantees for borrowers whose direct loans were bought out with debt write-off or restructured with debt write-down.

Suggested statutory change: Section 309 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1929) is amended—

(1) by redesignating the existing provision under subsection (h) as subsection (h)(1); and

(2) by adding subsections (h)(2), (3), and (4) as follows:

"(2) The Secretary shall establish and implement a system by which the percentage of a loan that the Secretary guarantees under this chapter may be fixed within a range that reflects the financial risk to the government represented by the loan, and under which the highest available percentage guarantee is assigned to loans with the least degree of risk and a lower percentage guarantee is assigned to loans with the highest degree of risk. The factors that could result in a determination that a loan represents a high degree of risk may include, at a minimum, that the loan is made (i) for the purpose of refinancing existing debt or (ii) to a commercial lender's existing borrower.

"(3) Any person whose default in the payment of a guaranteed loan results in the payment to a lender by the Secretary shall be ineligible to receive subsequent loan guarantees.

"(4) Any person who has had a delinquent farmer program loan restructured through debt write-down or terminated through net recovery buy-out shall be ineligible to receive subsequent loan guarantees."

Farm Inventory Property Recommendation: Change the definition of suitable property to reflect only properties that are considered by FmHA to be viable, independent farming units for the locale.

Suggested statutory change: Section 335 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1985) is amended—by amending the second sentence of subsection (c)(1) to read as follows:

"The County Committee shall classify or reclassify real property (including real property administered by the Secretary on January 6, 1988) that is farmland as being suitable for farming operation for such disposition only if the characteristics of the property are such that the property constitutes a viable, independent farming unit for the locale."

Farm Inventory Property Recommendation: Require that FmHA use competitive methods in selling suitable properties to targeted purchasers.

Suggested statutory change: Section 335 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1985) is amended—by amending subsection (c)(2)(B)(ii) to read as follows:

"(ii) offer such land for sale to prospective purchasers, including those persons identified in subsection (e)(1)(C) of this section, at a price that reflects the fair market value of such land as determined by bids after advertising or by negotiated sale;".

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