



U.S. Department of Agriculture



Office of Inspector General  
Midwest Region

# Audit Report

## Controls Over Guaranteed Farm Loan Interest Rates and Interest Assistance

Report No. 03601-17-Ch  
September 2008

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UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250



09/29/2008

REPLY TO

ATTN OF: 03601-17-Ch

TO: Teresa C. Lasseter  
Administrator  
Farm Service Agency

THROUGH: T. Mike McCann  
Director  
Operations Review and Analysis Staff

FROM: Robert W. Young /s/  
Assistant Inspector General  
for Audit

SUBJECT: Controls Over Guaranteed Farm Loan Interest Rates and Interest Assistance

This report presents the results of our audit of Controls Over Guaranteed Farm Loan Interest Rates and Interest Assistance. Your written response to the official draft report, dated September 23, 2008, is included in its entirety as exhibit A in this report. Excerpts of your response and the Office of Inspector General's (OIG) position are incorporated into the Findings and Recommendations section of the report.

Based on your response, we have reached management decisions on Recommendations 1, 2, 3, 6, and 7. Please follow your agency's internal procedures in forwarding documentation for final actions to the Office of the Chief Financial Officer. Management decisions can be reached for Recommendations 4 and 5 once you have provided us with the additional information outlined in the report section, OIG Position.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation of those recommendations for which management decisions have not yet been reached. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance and final action to be taken within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

# Executive Summary

## Controls Over Guaranteed Farm Loan Interest Rates and Interest Assistance

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### Results in Brief

This report presents the results of our audit of the Farm Service Agency's (FSA) controls over guaranteed farm loan interest rates and interest assistance. We initiated this audit because of concerns raised by farmers and the U.S. Department of Justice over interest rates being charged on FSA-guaranteed loans.

Through its Farm Loan Programs, FSA provides financial assistance in the form of guaranteed loans to high-risk borrowers who are unable to obtain commercial credit. A loan guarantee substantially reduces the lender's risk of loss because FSA will reimburse the lender up to 95 percent of the outstanding loan principal and interest if a borrower were to default. To qualify for a guarantee, lenders must make sure each borrower has the ability to repay the loan and maintain appropriate collateral. Lenders can also apply to FSA for interest assistance (IA) on a guaranteed operating loan when the borrower cannot achieve a positive cash flow<sup>1</sup> without the IA, but can achieve a positive cash flow with IA. Through the IA program, FSA reimburses lenders up to 4 percentage points on the loan, in exchange for the lender reducing the interest rate charged to the borrower by that amount.

Each lender enters into a signed agreement with FSA that states the lender will follow Federal regulations. Interest rates are negotiated between the lender and the borrower. Federal regulations state that guaranteed loan interest rates may not exceed what the lender charges to its average agricultural loan customer. In addition, the lender must be able to provide evidence of the rate charged to its average agricultural loan customer<sup>2</sup> (hereinafter referred to as the "average agricultural loan customer rate"). An "average agricultural loan customer" is defined in regulations as a borrower who is neither high nor low-risk.<sup>3</sup>

Our audit found that FSA did not have effective controls in place to ensure that interest rates met program requirements for its 56,000 guaranteed loans, valued at \$12.1 billion.<sup>4</sup> Neither FSA personnel nor the lenders interviewed during the audit could articulate what criteria they used to demonstrate compliance with the interest rate limitation specified in program regulations. Therefore, we could not fully validate the reasonableness of the interest rates charged for FSA-guaranteed loans. FSA officials acknowledged that they did not have adequate controls or oversight of interest rates, but instead, relied upon lenders to follow regulations.

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<sup>1</sup> Positive cash flow is when a borrower's cash inflows exceed their cash outflows.

<sup>2</sup> Title 7 *Code of Federal Regulations* (CFR) § 762.124(a)(3), dated February 12, 1999, and amended April 9, 2007.

<sup>3</sup> 7 CFR § 762.102, dated February 12, 1999, and amended April 9, 2007.

<sup>4</sup> FSA's Guaranteed Loan System contained 55,906 loans as of October 24, 2007, that carried a value of \$12.1 billion at loan origination.

We visited four counties in two States and reviewed controls over interest rates for the guaranteed loans made in those counties. At the time of our audit, the selected counties had 839 guaranteed loans totaling \$167 million. We judgmentally selected 71 loans to review that totaled \$16.9 million and were approved from FY 2000 through FY 2007. We found that the FSA officials responsible for approving the guaranteed loans<sup>5</sup> did not evaluate whether the interest rates charged by the lenders met requirements or require lenders to provide evidence of the reasonableness of the rates charged to its borrowers. These FSA officials stated that they have not received guidance or training on how to determine compliance with interest rate program requirements.

We performed work at five lenders<sup>6</sup> in four counties and not a single lender could provide evidence of its average agricultural loan customer rate, as required by Federal regulations.<sup>7</sup> Our review was limited, however, because we had no access to private loan information through the terms of the loan guarantee agreements. We question how FSA can monitor and validate program compliance if guaranteed interest rates can not be validated based on readily available information provided by the lenders.

Therefore, we calculated average interest rates for each lender using the methodologies reported to us by the lenders. We found that 4 lenders charged interest rates for 28 of 71 loans we reviewed above their average agricultural loan customer rates. One lender charged as much as 2.25 percent above its average agricultural loan customer rate. For illustrative purposes, we calculated that the 28 borrowers could potentially save approximately \$277,000 over the life of the loans, had the lenders' interest rates been established and justified, as required by FSA regulations.

We also determined that FSA officials were not aware of the problems we identified because interest rates were not being reviewed as part of FSA's national, State and county reviews of operations and controls. Each year FSA officials conduct Farm Loan Program Risk Assessments, lender file reviews, and the County Operations Review Program reviews to evaluate program effectiveness and/or compliance with applicable statutes, regulations, directives or other goals. We found that FSA had not established procedures for its oversight reviews to evaluate the interest rates being charged by participating lenders.

FSA officials agreed that additional controls are needed over interest rates in the guaranteed loan program, and they informed us that they have already

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<sup>5</sup> *FSA Handbook 1 Farm Loan Program (FLP)*, par. 29, dated December 31, 2007, states that county officials have approval authority for guaranteed loan applications up to \$500,000. Guaranteed loan applications that exceed \$500,000 must be approved by officials at the FSA State office.

<sup>6</sup> The 5 selected lenders had 446 guaranteed loans listed in FSA's Guaranteed Loan System as of October 24, 2007, at an approved value of \$80.3 million.

<sup>7</sup> 7 CFR § 762.124(a)(3), dated February 12, 1999, and amended April 9, 2007, states that the lender must provide evidence of the rate charged to the average agricultural loan customer.

initiated actions and studies to provide a simple, clear regulation that specifies the rate-setting methodology that should be used. Our audit did not find any problems with the approval and application of interest assistance to borrower accounts.

**Recommendations  
In Brief**

We recommended that FSA:

- Review and clarify interest rate requirements for the guaranteed loan program;
- Issue instructions to lenders to clarify their responsibilities regarding interest rate requirements and revise the Lender’s Agreement to specify such requirements;
- Require lenders to provide evidence that interest rates meet program requirements at the time of FSA’s approval of the loan guarantee;
- Seek legal advice to determine what actions can be taken in those cases where the lenders potentially charged higher interest rates to borrowers than allowed by regulations; and
- Evaluate interest rates as part of its oversight reviews and, periodically on a nationwide basis, identify any trends or questionable information that may require management attention.

**Agency Response**

In their response, FSA officials agreed with the recommendations in the report. We have incorporated applicable portions of their response, along with our position, within the Findings and Recommendations sections of the report. The agency’s response is included in its entirety as exhibit A of this report.

**OIG Position**

Based on the response, we have reached management decisions on Recommendations 1, 2, 3, 6, and 7. Management decisions can be reached on Recommendations 4 and 5 once FSA has provided us with the additional information outlined in the report section, **OIG Position**.

## ***Abbreviations Used in This Report***

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CFR	<i>Code of Federal Regulations</i>
COR	County Operations Review
FLP	Farm Loan Program
FLPRA	Farm Loan Program Risk Assessment
FO	Farm Ownership Loan
FSA	Farm Service Agency
FY	Fiscal Year
IA	Interest Assistance
OCFO	Office of the Chief Financial Officer
OIG	Office of Inspector General
OL	Operating Loan

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# ***Background and Objective***

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## **Background**

The Farm Service Agency (FSA) was established under the Department of Agriculture Reorganization Act of 1994 (Public Law 103-354), as amended. FSA's mission is to contribute to the viability of American agriculture by providing commodity price and income support, disaster assistance, and direct and guaranteed farm loans. FSA provides these services through its 51 State offices<sup>8</sup> and approximately 2,350 county offices nationwide.

The Consolidated Farm and Rural Development Act (Public Law 109-771), as amended, gives the Secretary of Agriculture the authority to make and insure loans to farmers and ranchers who meet specific eligibility requirements. Through its Farm Loan Programs, FSA provides financial assistance in the form of direct and guaranteed farm ownership loans (FO) and operating loans (OL) to borrowers unable to obtain commercial credit. FSA makes and services direct loans using Government funds. Borrowers who meet specific eligibility requirements for guaranteed loans must apply to a commercial lender, which arranges with FSA for the guarantee. FSA can provide lenders with up to a 95 percent guarantee of the principal and interest for FOs and/or OLs, not to exceed \$949,000 combined. At the time of our audit, approximately 3,000 lenders had loan guarantees from FSA for 56,000 loans valued at \$12.1 billion.<sup>9</sup>

Borrowers that are approved for a guaranteed OL may also be eligible for the Interest Assistance (IA) Program. A borrower may be eligible for IA if they can demonstrate inability to achieve a positive cash flow<sup>10</sup> without IA, but can achieve a positive cash flow with IA. Under the IA Program, FSA agrees to reimburse the lender up to 4 percentage points in exchange for the lender reducing the interest rate charged to the borrower by that amount. In fiscal year (FY) 2007, FSA reimbursed lenders approximately \$26 million in IA.

The loan interest rate is negotiated between the lender and borrower. However, the interest rate on the guaranteed loan may not exceed the lender's average agricultural loan customer rate. Guaranteed FOs may be used to purchase farmland, construct or repair buildings, and refinance debt. Guaranteed OLs may be used to purchase items needed for a successful farm operation, such as livestock, farm equipment, and other operating expenses.

Lenders originate and service FSA-guaranteed loans. As part of the origination process, the lender reviews a borrower's loan application to determine whether the borrower meets the eligibility requirements, has a satisfactory credit history, demonstrates repayment ability, and can provide

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<sup>8</sup> FSA also has an office in Puerto Rico.

<sup>9</sup> Source: FSA's Guaranteed Loan System as of October 24, 2007.

<sup>10</sup> Positive cash flow is when a borrower's cash inflows exceed their cash outflows.



sufficient security for the loan. Guaranteed loan servicing includes ensuring that the loan funds are used for authorized purposes, that borrowers are in compliance with all applicable regulations, and that the collateral is adequate.

FSA national, State, and county officials monitor the Farm Loan Programs through formal reviews. These reviews include lender file reviews, the Farm Loan Program Risk Assessment (FLPRA), and the County Operations Review (COR). The lender file reviews are the primary tool that FSA uses to monitor whether lenders are meeting the underwriting, origination, and servicing requirements of their Lender's Agreement and the Guaranteed Loan Handbook.<sup>11</sup> Lender file reviews are performed annually by each level of FSA:

- FSA national officials lead file reviews of lenders with guaranteed loans made in 3 or more States, when requested by Farm Loan Program management. As part of these reviews, 20 percent of the borrower files will be checked.
- FSA State officials review 20 percent of the borrower files at lenders with guaranteed loans made in 1 or 2 States.
- FSA county officials review up to 40 percent of the borrower files at lenders with guaranteed loans made in 1 State.

On an annual basis, FSA national officials perform FLPRA reviews to evaluate the effectiveness of Farm Loan Program delivery systems and to ensure compliance with applicable statutes, regulations, and directives. Using a risk-based approach, FSA performs FLPRA reviews in approximately 10 to 12 States per year, with low-risk States being reviewed about every 5 years and high-risk States being reviewed more frequently.

FSA officials conduct the COR to assess county office programs and activities compliance with stated objectives and requirements. The COR results are accumulated in a nationwide report for use by FSA management.

We initiated this audit because of concerns raised by farmers and the U.S. Department of Justice over interest rates being charged on FSA guaranteed loans.

## **Objective**

To evaluate FSA's controls over the guaranteed farm loan interest rates charged and interest assistance provided to borrowers.

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<sup>11</sup> *FSA Handbook 2 FLP*, dated December 31, 2007.

# **Findings and Recommendations**

## **Section 1: FSA Needs to Improve Controls Over Guaranteed Farm Loan Interest Rates**

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Through its Farm Loan Programs, FSA provides financial assistance in the form of guaranteed loans to high-risk farmers who are unable to obtain commercial credit. A loan guarantee substantially reduces the lender's risk of loss because FSA will reimburse the lender up to 95 percent of the outstanding loan principal and interest if a borrower were to default. Federal regulations state that guaranteed loan interest rates may not exceed what the lender charges to its average agricultural loan customer. In addition, the lender must be able to provide evidence of the rates charged to its average agricultural loan customer.<sup>12</sup> An "average agricultural loan customer" is defined in regulations as a borrower who is neither high nor low-risk.<sup>13</sup>

Our review found that none of the five lenders we visited could provide evidence of their average agricultural loan customer rates, as required by Federal regulations. FSA officials responsible for approving loan guarantees did not request any evidence from the lenders to support the rates charged, or verify whether the rates exceeded program limits. Based on our calculations, four of the five lenders potentially charged guaranteed loan borrowers interest rates higher than their average agricultural loan customer rates. We calculated that the borrowers could potentially save approximately \$277,000 over the life of the loans had the lenders' interest rates been established and justified, as required by FSA regulations.

Even though FSA officials perform several types of oversight reviews to ensure the proper management of the guaranteed loan portfolio, we found that these reviews did not disclose any problems with the lenders' documentation of the interest rates charged or whether the rates charged exceeded prescribed limits. We found that FSA's oversight reviews did not assess lender compliance with the interest rate requirements at loan origination or during the life of the loan. FSA officials acknowledged they did not review interest rates. They relied on lenders to honor their agreement with FSA, which requires lenders to adhere to Federal regulations.<sup>14</sup>

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<sup>12</sup> 7 CFR § 762.124(a)(3), dated February 12, 1999, and amended April 9, 2007.

<sup>13</sup> 7 CFR § 762.102, dated February 12, 1999, and amended April 9, 2007.

<sup>14</sup> Form FSA 1980-38, "Lender's Agreement," dated July 31, 2007, states that the lender and its agents shall provide access to allow the Agency, or any party authorized by the Agency, to conduct reviews of the lender's operations for the purpose of verifying compliance with this agreement and Agency regulations and guidelines.

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## Finding 1

### **FSA Did Not Verify That Lenders Complied With Interest Rate Requirements for Guaranteed Loans**

None of the five lenders we reviewed were able to provide any evidence to support that the interest rates charged on their FSA guaranteed loans did not exceed their average agricultural loan customer rate. The lenders stated they were aware of the regulatory requirements for interest rates, however, they were not clear how to determine the rate for an average agricultural loan customer.

The FSA State and county officials responsible for approving loan guarantees<sup>15</sup> did not request any evidence from the lenders to support the rates charged or verify that the rates did not exceed program limits. Based on the methodologies the lenders stated they used to establish FSA-guaranteed loan rates, we calculated the average agricultural loan customer rates. We found that 28 (or 39 percent) of the 71 guaranteed loans that we reviewed exceeded the lender's average agricultural loan customer rate by as much as 2.25 percent. As a result, we concluded that FSA has no assurance that the lenders were charging interest rates in accordance with program requirements.

Federal regulations<sup>16</sup> state that the interest rate on FSA-guaranteed farm loans may not exceed the rate the lender charges its average agricultural loan customer. At the request of the agency, the lender must provide evidence of the average agricultural loan customer rate. Federal regulations define the average customer as a conventional farm borrower who is required to pledge crops, livestock, and/or real estate security for the loan. This does not include the high-risk farmer with limited security or the low-risk farm customer who obtains financing on a secured or unsecured basis, with collateral items such as savings accounts to pledge for the loan.<sup>17</sup>

#### Lenders Could Not Provide Any Evidence to Support Rates Charged

The five lenders we reviewed did not calculate or maintain evidence of their average agricultural loan customer rates. At each lender, officials stated that they were familiar with FSA's policies and interest rate requirements. However, because they were not clear on how to determine their rates charged an "average agricultural loan customer", they used factors such as borrower risk, their cost of funds, the Federal Reserve Prime Rate or competition from other lenders. Because the lending officials did not

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<sup>15</sup> *FSA Handbook 1 FLP*, par. 29, dated December 31, 2007, states that county officials have approval authority for guaranteed loan applications up to \$500,000. Guaranteed loan applications that exceed \$500,000 must be approved by officials at the FSA State office.

<sup>16</sup> 7 CFR § 762.124(a)(3), dated February 12, 1999, and amended April 9, 2007.

<sup>17</sup> 7 CFR § 762.102, dated February 12, 1999, and amended April 9, 2007.

calculate or maintain evidence of their average agricultural loan customer rates, we based our analysis on the lenders' stated methodology and any historical rate information they could provide.

The two lenders we visited in Nebraska were not able to provide their average agricultural loan customer rates, but they provided historical interest rate records for their agricultural loans and a verbal explanation of how they established interest rates. Officials from all three Wisconsin lenders stated that they did not maintain historical interest rate records nor did they have any written policies describing how they established agricultural loan rates. However, we were able to obtain verbal descriptions of the interest rate policies from the Wisconsin lenders and some supplemental information related to interest rates.

#### OIG Calculation of the Average Agricultural Loan Customer Rate

Using the information provided by the lenders, we established average agricultural loan customer rates at the times each of the 71 guaranteed loans in our sample was made, taking into account factors such as loan type, term, amount, and whether the rate was variable or fixed.<sup>18</sup> We then compared our calculated (average agricultural loan customer) rate to the interest rate on the loan note. However, we found that the methodology and historical information provided to us by the lenders did not always correlate to the loan note rates we wanted to compare.

For example, Lender A originally explained that it established interest rates based on its assessment of each borrower's risk.<sup>19</sup> According to the lender, after completing a risk assessment, the borrower was assigned an interest rate using a 4-tiered rate system. Borrowers representing the least amount of risk of loss to the lender received the best (lowest) interest rates. Lender A indicated that the middle of the risk-tiers would be its average agricultural loan customer rate. It also provided historical interest rate information for the periods covering the loans in our sample.

We attempted to apply the methodology explained to us by the officials at Lender A and compare interest rates against the average agricultural loan customer rate of the risk-tiered system. However, we determined that the interest rates on the loan note did not always follow the stated process or correlate to the historical rate information provided by the lender. The interest rates fluctuated such that no process could logically explain them, as interest rates were both above and below the average agricultural loan customer rates that we calculated. While the lender did provide us with some additional adjustments to its interest rate process that we used, officials were

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<sup>18</sup> A lender's average agricultural loan customer rate would include both its guaranteed and non-guaranteed agricultural customers, and we did not have access to the lender's non-guaranteed loan portfolio to confirm their true average agricultural loan customer rates, or verify the information they provided.

<sup>19</sup> The lender assessed risk based upon such items as evaluating the borrowers' financial position, lending history, collateral, and credit rating.

not able to explain why the rates fluctuated. We concluded that this lender charged up to 1.2 percent above the average agricultural loan customer rate for 7 of 16 loans, and as much as 2 percent below the average agricultural loan customer rate for 9 of 16 loans.

Overall, we found that guaranteed loan interest rates at 4 of the 5 lenders exceeded the interest rates charged to their average agricultural loan customers (as computed by OIG) for 28 of 71 (39 percent) of the loans reviewed. Table 1 shows the distribution of the 28 loans in relation to the average agricultural loan customer rates that we calculated.

**Table 1**

<b>Range Over the Average Agricultural Loan Customer Rate</b>	<b>Number of Loans</b>
1.51% to 2.25%	4
1.01% to 1.50%	6
0.51% to 1.00%	10
0.16% to 0.50%	8
<b>TOTALS</b>	<b>28</b>

For illustrative purposes, we calculated the amount of extra interest borrowers could potentially pay for the 28 loans we determined exceeded the average agricultural loan customer rate. For example, we computed the average for a 20-year Farm Ownership loan to be 9.35 percent; however, the borrower received an interest rate of 9.85 percent. We calculated that this borrower could pay more than \$16,000 in extra interest over the life of the loan. In total, we calculated that the 28 borrowers could have potentially saved about \$277,000 in interest payments had the interest rates been limited to a verified average agricultural loan customer rate.

Comparison of Guaranteed Loan Rates to the Federal Reserve Prime Rate

Each of the lenders had difficulty providing an interest rate methodology that we were able to verify with the loans in our sample. We found that interest rates widely fluctuated among the loans in our sample. We compared the distribution of interest rates for the 71 loans we reviewed against the Federal Reserve Prime Rate<sup>20</sup> (Prime) because 4 of the 5 lenders claimed to use Prime to either establish or adjust interest rates throughout the life of the loan (see table 2 on the following page). The interest rates of the 71 loans fluctuated from Prime by as much as 5.50 percent. Lender B, for example, set one loan rate equal to Prime, but set another loan at 5.50 percent above Prime.

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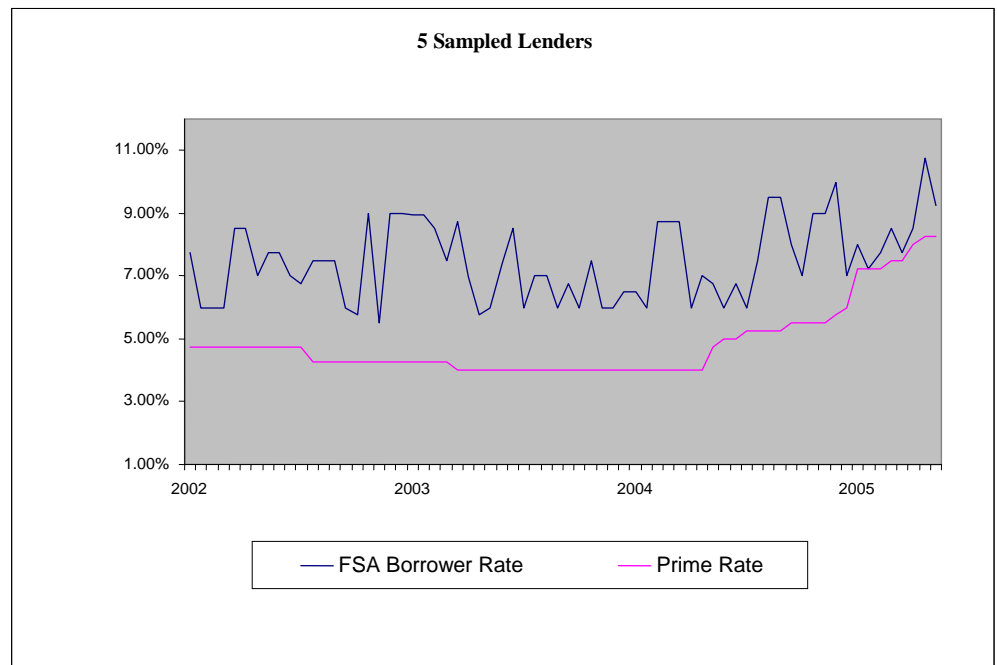
<sup>20</sup> The Federal Reserve Board defines its Prime Rate as the lowest interest rate being offered by banks to its preferred borrowers.

**Table 2**

<b>Range Over the Prime Rate</b>	<b>Number of Loans</b>
More than 4.00%	14
3.00% to 3.99%	15
2.00% to 2.99%	19
1.00% to 1.99%	16
Less than 1.00%	7
<b>TOTALS</b>	<b>71</b>

We also plotted the guaranteed loan interest rates for all 71 loans in our sample on the same time continuum and compared the interest rates with Prime. As chart 1 illustrates, the interest rates widely fluctuated among all the loans in our sample, and in comparison to Prime.

**Chart 1<sup>21</sup>**

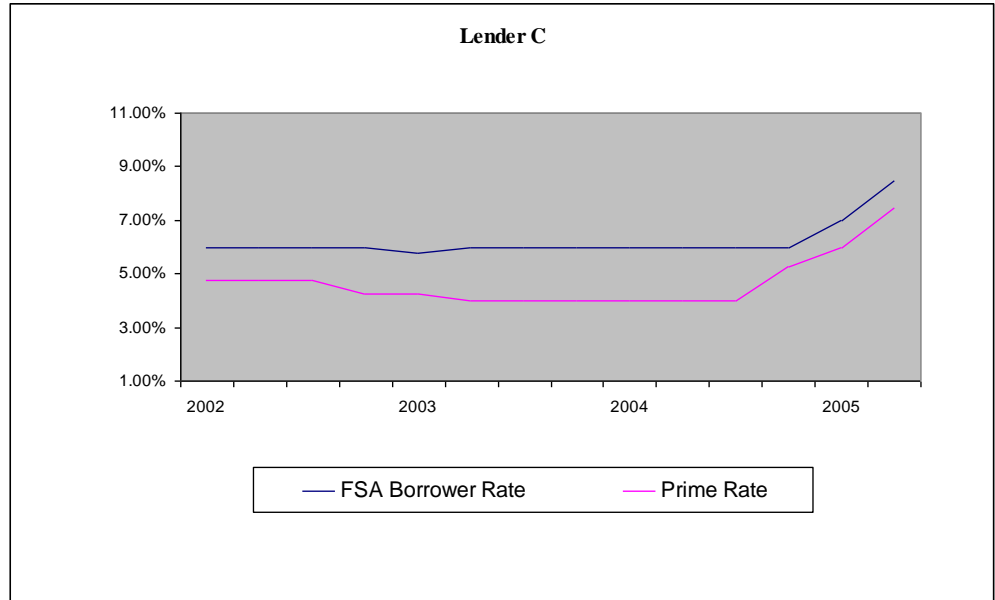


We found that only Lender C established interest rates that were generally consistent with Prime (see chart 2 on the following page), but we had difficulty getting a clear explanation of how it established rates. Officials at Lender C originally explained that rates were established using its cost of funds<sup>22</sup> plus 4 percent. We were subsequently told it was set by using Prime plus a percentage. The final explanation we received was that it used Prime plus a percentage that can be adjusted by their local lending officials “based on credit risk and other related factors.”

<sup>21</sup> Our sources for the guaranteed loan interest rates were the loan origination documents on file with both the lender and FSA’s county offices. The source of the Federal Reserve Prime Rate used in the report was Federal Reserve Board’s website at <http://www.federalreserve.gov>.

<sup>22</sup> Officials at Lender C stated that their cost of funds was a complicated calculation that could use as many as 20 different variables including items such as local deposits, brokered certificates of deposit, and variable rate brokered money market accounts.

**Chart 2**



We discussed our results with each of the lenders. Lending officials were familiar with FSA’s interest rate requirements and the need to apply an average agricultural loan customer rate and to keep evidence of the rate. However, lending officials told us that interest rates were not based on an agricultural average, but on items such as their assessment of borrower risk, the Prime rate, or their cost of funds. Lending officials were not able to explain why our results were inconsistent with their stated methodology or provide evidence of how they established interest rates. Lenders did state that factors such as competition from other lenders could result in deviation from their general interest rate policies. Officials at two lenders stated that they charged as high a rate as the borrower would accept, and one of these lenders said that FSA’s approval of the guarantee was its evidence that its interest rate was acceptable. Lenders generally stated that they were not clear what an “average agricultural loan customer” represented and FSA officials never requested this information.

We also discussed our results with FSA State and county officials who were responsible for approving loan guarantees.<sup>23</sup> They indicated that interest rates were not a priority, and they had no specific requirement to verify lender compliance. Furthermore, they did not request lenders to provide evidence of the average agricultural loan customer rate because they were not clear what documentation to request. They did not have instructions or receive training on how to administer the interest rate requirements.

<sup>23</sup> *FSA Handbook 1 FLP*, par. 29, dated December 31, 2007, states that county officials have approval authority for guaranteed loan applications up to \$500,000. Guaranteed loan applications that exceed \$500,000 must be approved by officials at the FSA State office.

As mentioned earlier, 7 CFR § 762.124(a) (3) states that the interest rate on the FSA-guaranteed loan cannot exceed the rate the lender charges its average agricultural loan customer. Furthermore, at the request of the agency, the lender must provide evidence of its average agricultural loan customer rate.

We noted that the “Lender’s Agreement” (Form FSA-2201) does not specifically cite the above regulatory requirement, except to state that the lender must maintain compliance with the criteria set forth in 7 C.F.R. part 762. In the “Conditional Commitment” (Form FSA-1980-15), which is submitted by the lender to FSA with each loan application, part B – “Conditions,” item 15, states that the interest rate cannot exceed the rate the lender charges its average farm customer. The lender must certify on form FSA-1980-22 that all requirements of the Conditional Commitment have been or will be met on the guaranteed loan by the loan closing date.

## **Recommendation 1**

Review and clarify interest rate requirements for the guaranteed loan program.

### **Agency Response**

In their response, FSA officials agreed with our recommendation and stated that the current regulations have been confusing to some lenders. FSA officials have prepared a proposed rule to simplify and clarify interest rate requirements. The final rule should be published by June 30, 2009.

### **OIG Position**

We accept FSA’s management decision on this recommendation.

## **Recommendation 2**

Issue instructions to lenders to clarify their responsibilities regarding interest rate requirements and revise the Lender’s Agreement to specify such requirements.

### **Agency Response**

In their response, FSA officials agreed with our recommendation and will amend the instructions in 2-FLP Handbook and revise the forms when the final rule on interest rate requirements is published by June 30, 2009.



### **OIG Position**

We accept FSA's management decision on this recommendation.

### **Recommendation 3**

Issue instructions to the FSA State and county loan approving officials to obtain documentary evidence from lenders to use in reviewing and approving interest rates charged to FSA-guaranteed loan borrowers.

### **Agency Response**

In their response, FSA officials agreed with our recommendation and will amend the instructions in 2-FLP Handbook and revise the forms when the final rule on interest rate requirements is published by June 30, 2009.

### **OIG Position**

We accept FSA's management decision on this recommendation.

### **Recommendation 4**

Require lenders to provide evidence that interest rates meet program requirements at the time of FSA's approval of the loan guarantee.

### **Agency Response**

In their response, FSA officials agreed with our recommendation and stated that they will develop an automated system that will interface through the Guaranteed Loan System and be linked to specific indices. Under this system, loans that are tied to published indices will be flagged if the rate does not meet program requirements. In addition, the system will generate a report that will notify staff to make corrections. The regulation and 2-FLP will require lenders that utilize risk based pricing models to provide evidence that interest rates meet program requirements. These enhancements will be implemented by December 31, 2009.

### **OIG Position**

We agree with the actions proposed by FSA; however, the implementation date for these actions is December 31, 2009, which differs by 6 months from the anticipated implementation dates for the regulatory and instructional changes detailed in FSA's response to Recommendations 1 through 3. In order to reach management decision, FSA needs to provide a response that includes interim corrective actions to be put in place at the time the new

regulation and other instructional changes go into effect, until the new interface and other program policy changes are implemented.

## **Recommendation 5**

Seek legal advice to determine what actions can be taken in those cases where the lenders potentially charged higher interest rates to borrowers than allowed by regulations.

### **Agency Response**

In their response, FSA officials agreed with our recommendation, and they requested legal advice from the Office of the General Counsel. In a subsequent message to OIG, FSA officials reported that the request was dated August 27, 2008.

### **OIG Position**

In order to reach management decision on this recommendation, FSA needs to provide OIG with the actions it intends to take, if any, based on the legal advice received from the Office of the General Counsel.

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## Finding 2

### FSA Needs to Enhance its Oversight to Include a Review of Interest Rates

FSA officials were not aware that lenders participating in the guaranteed loan program did not comply with interest rate requirements (see Finding 1). FSA's oversight processes and review guides did not require an assessment of lenders' interest rates. FSA officials stated that they did not monitor or evaluate compliance with interest rate requirements because they relied on lenders to honor their written agreement with FSA, in which the lenders agree to follow Federal regulations and FSA guidelines. As a result, FSA officials have reduced assurance that lenders complied with program interest rate requirements. FSA has guaranteed 56,000 loans nationwide.<sup>24</sup>

FSA conducts oversight reviews<sup>25</sup> of the guaranteed loan program to evaluate the effectiveness of the program and to ensure compliance with applicable regulations, directives and statutes. These reviews are conducted by national, State and/or county personnel.

We assessed FSA's oversight reviews<sup>26</sup> for its guaranteed loan program and found that the reviews did not identify any program weaknesses or non-compliance with interest rate requirements. We also reviewed FSA's Farm Loan Program review requirements in the Farm Loan Handbooks<sup>27</sup> and the oversight review guides used for its FLPPRA, lender file reviews and the COR. We found that these guides did not include an evaluation of compliance with interest rate requirements.

At one of the two States we visited, FSA officials amended their annual lender review checklist to include a question about interest rates. The question asked lending officials if the interest rates charged were equal to or less than its average agricultural loan customer rate. FSA State and county officials informed us that they always accept a lender's response to that question because they do not know what evidence to request to confirm compliance. Both of the lenders we visited in this State responded that their rates were less than their average agricultural loan customer rate. As reported in Finding 1, we determined that neither lender calculated or used an average agricultural loan customer rate, nor were all their interest rates at, or below, the rate charged to their average agricultural loan customer.

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<sup>24</sup> Based on the 55,906 guaranteed loans in the Guaranteed Loan System as of October 24, 2007.

<sup>25</sup> FSA oversight reviews include FLPPRA, lender reviews, and the COR review program.

<sup>26</sup> We reviewed all 22 FLPPRA reviews from FY 2005 to FY 2007, the COR reviews for FY 2005 and FY 2006, and 43 of 77 lender file reviews that were completed during FYs 2006 and 2007, for the 4 counties we visited.

<sup>27</sup> FSA's Farm Loan Program review requirements are listed in three handbooks: (1) County Operations Review Program, (2) Loan Making and Servicing, and (3) General Program Administration.

When we discussed oversight procedures with FSA national officials, they stated they did not perform any type of nationwide monitoring or analysis on interest rates. FSA officials stated that it was up to the lender and borrower to negotiate the interest rate, and they would not question a lender's interest rate unless it was dramatically higher (e.g., one percent or more) than other lenders in the area. However, because FSA officials are not performing an analysis of interest rates, they were not aware that a loan was entered into Guaranteed Loan System with a 70.5 percent interest rate. After OIG questioned this rate, FSA officials determined there was an input error and the correct rate should have been 10.5 percent.

FSA national officials also stated that they rely on lenders to adhere to program rules and Federal regulations in accordance with the agreement each participating lender signs, and the State and county office staffs' familiarity with lenders. FSA officials also stated that competition from other lenders would also keep a tight control on interest rates. However, as noted in Finding 1, we found that the five lenders we reviewed were not following interest rate requirements, and we determined that four lenders potentially charged some borrowers as much as 2.25 percent over the lenders' average agricultural loan customer rates (see Table 1 on page 6).

We concluded that FSA has not established procedures to effectively review or analyze whether the lenders' interest rates exceeded regulatory requirements. FSA should amend its Guaranteed Loan Handbook and review guidelines to include an assessment of the lenders' interest rates. The handbook should also include detailed instructions for State and county officials to follow on what documents should be reviewed and what corrective actions to take. Until FSA officials enhance their oversight process, they have reduced assurance that lenders are not charging FSA guaranteed loan borrowers interest rates higher than the lenders charge their average agricultural loan customers.

FSA officials agreed that additional controls are needed over interest rates in the guaranteed loan program. They informed us they have already initiated actions and studies to determine the best means to make adjustments to the program.

## **Recommendation 6**

Develop and implement in the Farm Loan Program review process, specific steps to review and verify whether lenders were in compliance with interest rate requirements. This process should detail what documentation to review, as well as corrective actions to take when problems are found.

## **Agency Response**

In their response, FSA officials stated that they will develop an automated system to verify if lenders that tie interest rates to published indices are in compliance with interest rate requirements. System development should be completed by December 31, 2009. Additionally 2-FLP will be amended to outline a specific review process for those lenders utilizing risk based pricing models by September 30, 2009.

## **OIG Position**

We accept FSA's management decision on this recommendation.

## **Recommendation 7**

Establish and implement procedures to periodically monitor interest rates on guaranteed loans on a nationwide basis to identify trends or questionable information. The procedures should include follow-up actions to be taken when questionable or incorrect items are identified to assure adequate and timely resolution.

## **Agency Response**

In their response, FSA officials stated that they will develop automated reports through the Guaranteed Loan System database and maintain them at National Headquarters. The reports will be developed by September 30, 2009, and will be modified when new regulations change the process. Headquarters staff will review reports, identify trends, and take appropriate actions to correct any identified deficiencies.

## **OIG Position**

We accept FSA's management decision on this recommendation.

# Scope and Methodology

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We performed our audit fieldwork from September 2007 through May 2008 at FSA's national office in Washington, D.C., State offices in Nebraska and Wisconsin, and two county offices in each State. The audit covered FSA's current guaranteed loan-making and servicing rules, policies, and procedures. As of October 24, 2007, FSA's Guaranteed Loan System included approximately 3,000 lenders with loan guarantees on 55,906 loans valued at \$12.1 billion.<sup>28</sup>

We judgmentally selected the Nebraska and Wisconsin State offices for review because both States were among the top five States in terms of overall participation in the guaranteed loan and IA programs. In addition, both States had over 150 loans with interest rates over 10 percent. In FY 2007, the 2 States had 6,074 guaranteed loans at a total value of \$1.3 billion, 1,254 guaranteed loans with IA totaling \$8.7 million, and a total of 356 lenders participating in the guaranteed loan program.

We judgmentally selected 71 loans totaling \$16.9 million to review from the 839 guaranteed loans valued at \$167 million that were approved by the 4 counties we visited in Nebraska and Wisconsin. The 71 loans we selected were approved by FSA between FYs 2000 and 2007, of which 68 were approved from FY 2002 to FY 2006. We based our sample selection on interest rates for OLs that exceeded 10 percent and FOs that exceeded 8 percent. Another criterion for our sample was to select OLs with interest assistance. Our sample of 71 loans included 47 with interest assistance.

We also visited five lenders, two in Nebraska, and three in Wisconsin, based on having a large number of loans that met the criteria as stated above. The 5 lenders had 446 FSA guaranteed loans at a value of \$80.3 million. The first two lenders we visited provided various explanations of their interest rate policies and historical rate sheets for farm loans. However, the next three lenders provided only brief descriptions of their interest rate policies and did not provide us with historical rate information. We did not have access to any of the five lenders' non-guaranteed agricultural loan portfolios. The lack of reliable information and access to interest rate information for all agricultural loans made by the lenders limited our ability to conclusively state whether interest rates charged guaranteed borrowers exceeded the lenders' average agricultural loan customer rates.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a

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<sup>28</sup> Source: The loan information listed above was derived from FSA's Guaranteed Loan System as of October 24, 2007. We present the value of the guaranteed loans at the time of their approval by FSA.

reasonable basis for our findings and conclusions based on our audit objectives. We believe that, except for the scope limitation described in the preceding paragraph, the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

To accomplish our audit objectives we:

- Interviewed FSA national, State, and county officials to determine interest rate requirements for guaranteed loans and the IA program.
- Reviewed the Consolidated Farm and Rural Development Act, Federal regulations, and the Farm Loan Program Handbooks that detailed FSA's policies and procedures for interest rates and IA program.
- Reviewed all 22 FLPRO reviews from FY 2005 to FY 2007 and the COR reviews for FYs 2005 and 2006.
- Reviewed State and county office records and 43 of 77 lender file reviews that were completed in the 4 selected counties during FYs 2006 and 2007.
- Analyzed the loan information maintained in Guaranteed Loan System to identify a sample of loans to review from the universe of active guaranteed loans. We used the results of our analysis to make State, county, and lender selections.
- Reviewed lender files at State offices to determine if State reviews of lenders disclosed any weaknesses or areas of concern.
- Reviewed borrower files at county offices to document data for comparison to lender records and to verify the accuracy of IA claims and compliance with interest rate requirements.
- Reviewed borrower eligibility determinations for guaranteed loans and participation in the IA program at county offices.
- Reviewed lender records to ensure the accuracy of IA payments made to lenders and the reduction of borrowers' interest payments.
- Interviewed lender officials to obtain an understanding of their interest rate policy and FSA guaranteed loan making and servicing activities.

- Established an average agricultural loan customer rate at each lender using historical interest rate records and/or a verbal explanation of how they established interest rates, and compared it to the actual rate received by the guaranteed borrowers. We also compared the loan note rate to the Federal Reserve Prime Rate.
- Calculated estimates of the total interest expense over the life of the loan using both the loan's original interest rate and the average agricultural loan customer rate that we established at each lending institution.



# Exhibit A—Agency Response

Exhibit A – Page 1 of 4



United States  
Department of  
Agriculture

Farm and Foreign  
Agricultural  
Services

Farm Service  
Agency

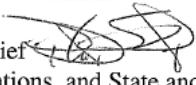
Operations Review  
and Analysis Staff

Audits,  
Investigations and  
State and county  
Review Branch

1400 Independence  
Ave, SW  
STOP 0540  
Washington, DC  
20250-0501

SEP 23 2008

**TO:** Director, Farm and Foreign Agriculture Division  
Office of Inspector General

**FROM:** Philip Sharp, Chief   
Audits, Investigations, and State and County Review Branch

**SUBJECT:** Response to Audit 03601-17-CH, Controls Over Guaranteed Farm Loan  
Interest Rates and Interest Assistance

Attached is a copy of a memorandum dated September 22 from the Farm Service Agency's Deputy Administrator for Farm Loan Programs, which responds to your official draft report on the subject audit.

Please address any questions to Lisa Goree at 720-3583.

Attachment

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# Exhibit A—Agency Response

Exhibit A – Page 2 of 4



SEP 22 2008

United States  
Department of  
Agriculture

Farm and Foreign  
Agricultural  
Services

Farm Service  
Agency

1400 Independence  
Ave, SW  
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Washington, DC  
20250-0522

**TO:** T. Mike McCann  
Director  
Operations Review and Analysis Staff

**FROM:** Carolyn B. Cooksie  
Deputy Administrator for Farm Loan Programs

**SUBJECT:** *Carolyn B. Cooksie*  
OIG Audit 03601-17-CH, Controls Over Guaranteed Farm Loan Interest Rates and Interest Assistance

This is in response to the recommendations contained in the above named audit.

Recommendation 1:

Review and clarify interest rate requirements for the guaranteed loan program.

Response:

FSA agrees with this recommendation. The current regulations state that “the rate lenders may charge on FSA guaranteed loans cannot exceed the rate the lender charges its average agricultural loan customer.” This requirement has been confusing to some lenders. The Agency has prepared a proposed rule that will simplify and clarify interest rate requirements. The final rule should be published by Third Quarter, FY-2009.

Recommendation 2:

Issue instructions to lenders to clarify their responsibilities regarding interest rate requirements and revise the Lender’s Agreement to specify such requirements.

Response:

The Agency agrees with this recommendation and will amend 2-FLP handbook instructions and revise forms when the final rule on interest rates requirements is published. Proposed completion date is Third Quarter, FY-2009.

Recommendation 3:

Issue instructions to the FSA state and county loan approving officials to obtain documentary evidence from lenders to use in reviewing and approving interest rates charged to FSA-guaranteed loan borrowers.

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Response:

The Agency agrees with this recommendation and will amend 2-FLP handbook instructions and revise forms when the final rule on interest rates is published. Completion date is expected Third Quarter, FY-2009.

Recommendation 4:

Require lenders to provide evidence that interest rates meet program requirements at the time of FSA's approval of the loan guarantee.

Response:

The Agency will develop an automated system that will interface through Guaranteed Loan System (GLS) and be linked to specific indices. Under this system, loans that are tied to published indices will be flagged if the rate does not meet program requirements. In addition, the system will generate a report that will notify staff to make corrections. The regulation and 2-FLP will require lenders that utilize risk based pricing models to provide evidence that interest rates meet program requirements. These enhancements will be implemented by First Quarter, FY-2010.

Recommendation 5:

Seek legal advice to determine what actions can be taken in those cases where the lenders potentially charged higher interest rates to borrowers than allowed by regulations.

Response:

FSA agrees with the recommendation. The Agency has requested legal advice from the Office of General Council.

Recommendation 6:

Develop and implement in the Farm Loan Program review process specific steps to review and verify whether lenders were in compliance with interest rate requirements. This process should detail what documentation to review, as well as corrective actions to take when problems are found.

Response:

The Agency will develop an automated system to verify if lenders that tie interest rates to published indices are in compliance with interest rate requirements. System development should be completed First Quarter, FY-2010. 2-FLP will be amended by Fourth Quarter FY-2009 to outline a specific review process for those lenders utilizing risk based pricing models.

Recommendation 7:

Establish and implement procedures to periodically monitor interest rates on guaranteed loans on a nationwide basis to identify trends or questionable information. The procedures should include follow-up actions to be taken when questionable or incorrect items are identified to assure adequate and timely resolution.

Response:

The Agency will develop automated reports through the GLS database and maintain them at National Headquarters. The reports will be developed by Fourth Quarter, FY-2009, and will be modified when new regulations change the process. Headquarters staff will review reports, identify trends and take appropriate actions to correct any identified deficiencies.

Informational copies of this report have been distributed to:

Administrator, FSA	(10)
Attn: Agency Liaison Officer	
Government Accountability Office	(1)
Office of Management and Budget	(1)
Office of the Chief Financial Officer	
Director, Planning and Accountability Division	(1)