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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-201890

JANUARY 30, 1981

The Honorable Roger W. Jepsen
United States Senate

Dear Senator Jepsen:

Subject: Summary of Major Deficiencies in the Farmers Home Administration's Business and Industrial Loan Program (CED-81-56)

Your letter of January 12, 1981, asked us to summarize major deficiencies found in the U.S. Department of Agriculture's (USDA's) Farmers Home Administration's (FmHA's) Business and Industrial Loan Program. Your letter asked that we base our summary on audits by our Office and USDA's Office of Inspector General (OIG) and internal FmHA studies. It also asked for our observations or recommendations for correcting any continuing problems.

In September 1977 we reported on loan evaluation and servicing deficiencies in FmHA's Business and Industrial Loan Program. Our review of OIG audits and FmHA internal assessments showed that many of the deficiencies identified in our report still exist.

In response to the reported deficiencies, FmHA has acted or promised action on many of our and OIG's recommendations. According to FmHA program officials, FmHA has acted quickly to correct deficiencies but considerable time was required to change regulations. They said that policy changes alone were difficult to enforce without regulatory changes. Further, they said that only time will tell if the changes made or in process would suffice to correct deficiencies.

We believe the continuing deficiencies in the FmHA Business and Industrial Loan Program are the result of an imbalance between FmHA staffing levels and program activities and the failure of FmHA staff to follow or enforce program requirements. We believe that to correct the deficiencies:

--A better balance will be needed between FmHA staffing and program activities.

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--Loan approving officials should be required to certify loan approval to some outside entity, such as OIG, for loans previously rejected at a lower review level.

--FmHA needs to continue strengthening its monitoring capabilities.

--Periodic audits and congressional oversight should be carried out as needed to surface problems and ensure their correction.

--Remedial training, and where appropriate, disciplinary action, must be provided when program requirements are not followed.

FmHA program officials agreed that an imbalance existed between staffing and program activities. They attributed this imbalance to the budget process. They also said that FmHA's reduced travel budget has affected its ability to provide training and that loan approval authority had been withdrawn from FmHA staff on occasion as a means of disciplinary action.

OIG officials believed certifying loan approval to the OIG for previously rejected loans was a good idea as it would give such loans greater visibility and provide the OIG with a basis for systematically reviewing such loans.

In our September 1977 report, we suggested that FmHA require national office approval for guaranteed loans used to refinance a borrower's existing debts, especially if the refinancing also reduced the lender's risk of loss. In response to our reaffirmation of the need for this action, FmHA program officials explained that many FmHA loans involved some degree of refinancing and that national office review of all such loans would be a burden. Further, they stated that FmHA was in the process of tightening program requirements for loans involving refinancing and that these new requirements should minimize differences in interpretations of FmHA requirements and thus result in approving sounder loans. FmHA officials also said that they would monitor implementation of the new requirements. We believe that if FmHA's new requirements do not achieve the desired results, FmHA should reconsider subjecting such loans to national office approval as we previously suggested.

A detailed summary of deficiencies previously identified and our observations are in enclosure I.

As arranged with your office, we did not take the time to obtain official agency comments.

Copies of this report are being sent to the House and Senate Committee on Appropriations; Senate Committees on Agriculture, Nutrition and Forestry and Governmental Affairs; House Committees on Agriculture and Government Operations; the Secretary of Agriculture; and the Director, Office of Management and Budget. We will also make copies available to other interested parties.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

Enclosure

## SUMMARY OF MAJOR DEFICIENCIES IN THE BUSINESS AND INDUSTRIAL LOAN PROGRAM

### BACKGROUND

The Business and Industrial Loan Program was authorized by the Rural Development Act of 1972 (7 U.S.C. 1932 (Supp. II, 1972)). Under this program, FmHA can guarantee, insure, or make direct loans to public, private, or cooperative organizations or individuals to acquire, construct, reorganize, or expand rural businesses to save existing jobs or create new ones. To date, the program has been basically a guaranteed loan program whereby FmHA guarantees up to 90 percent of a loan made by a commercial lender. From program inception through fiscal year 1980, business and industrial loans have totaled about $4.4 billion.

### OBJECTIVES, SCOPE, AND METHODOLOGY

Pursuant to your January 12, 1981, letter, this report's objective is to summarize major deficiencies in FmHA's Business and Industrial Loan Program and to provide our observations or recommendations for corrective actions. In preparing our summary we considered past reports issued by our Office and reviewed OIG's semiannual reports to the Congress for the periods October 1, 1979, to March 31, 1980, and April 1 to September 30, 1980, and selected OIG audit reports on the FmHA Business and Industrial Loan Program released during fiscal year 1980. Some of the selected OIG audits we reviewed were requested by FmHA and/or involved known problem loans or lenders. We interviewed OIG officials concerning their ongoing audits and investigations in this area. In addition, we reviewed selected internal FmHA assessment studies made of the program in fiscal year 1980.

Because of the time available, we did not independently verify the effectiveness of the corrective actions taken or promised by FmHA in response to the audit reports and internal FmHA studies we reviewed. Also, we did not obtain official agency comments, but we did discuss the content of this report with FmHA program and OIG officials and their comments were included where appropriate.

### GAO'S PRIOR REVIEW OF THE PROGRAM

In our report on this program entitled "Farmers Home Administration's Business and Industrial Loan Program Can Be Improved" (CED-77-126, Sept. 30, 1977), we reported on the need for FmHA to improve its loan evaluation policies and procedures and its loan servicing and management assistance efforts. Among other things, we found that in approving loans FmHA and the lender did not:

- --Obtain required financial data, including updated financial data.
- --Question sales and profit projections that appeared overly optimistic or inadequately supported.
- --Adequately determine why existing businesses were operating at a loss or experiencing problems.
- --Require applicants to contribute sufficient equity.
- --Adequately evaluate applicants' management capabilities or market analyses.
- --Obtain sufficient information to make a complete and adequate evaluation.
- --Effectively use consultants in evaluating loans.

We also found that FmHA had not adequately reviewed the qualifications and/or independence of appraisers used by lenders to evaluate property used as collateral for loans. In addition, we questioned using FmHA guaranteed loans to refinance borrowers' existing debts when they reduced the participating lender's exposure to loss.

We concluded that to achieve its goal of making quality loans and providing more lasting economic benefits to rural areas, FmHA needed to (1) further revise, clarify, and strengthen its regulations and instructions for approving loans and (2) ensure that its procedures were followed.

On loan servicing and management assistance, we reported that FmHA needed to (1) identify more quickly actual and potential problems of borrowers and establish a management assistance program and (2) assure that loan proceeds are used for approved and authorized purposes. We made several recommendations on these actions, which are summarized on page 9 of this enclosure.

OIG AUDITS SHOW MOST PROBLEMS STILL EXIST

In its semiannual report to the Congress for the period ending March 31, 1980, OIG reported that its previous audits had disclosed two general areas of concern in the Business and Industrial Loan Program: pre-loan analysis and loan servicing. Typical problems in these two areas included failure to

--obtain the required financial data from the applicant,

--obtain financial data before issuing conditional loan commitments,

--analyze sales and profit projections,

--require the applicant to contribute sufficient equity,

--adequately evaluate the applicant's management capability, and

--provide sufficient guidance to field personnel on the servicing requirements for the loans.

OIG audit reports issued during fiscal year 1980 showed that many of these problems were continuing. In a review of 10 loans 1/ made to six borrowers 2/ in the carpet industry in Georgia, OIG found that:

--Four borrowers who received seven loans totaling about $7.7 million did not meet FmHA's minimum equity and financial requirements when their loans were closed. These included two borrowers who received guaranteed loans in 1978.

--Financial statements for the four borrowers showed differences that raised questions about the statements' reliability, but no follow-up action was taken.

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1/OIG report, "Farmers Home Administration Business and Industry Loans--Carpet Industry," Audit Report 499-35-At, March 11, 1980.

2/Loans to four borrowers were guaranteed in 1974-76 and included the first FmHA-guaranteed loan. Loans to the other two borrowers were guaranteed in 1978.

--The loans did not result in lasting benefits to the rural area but significantly reduced the lenders' risk exposure. For two borrowers, the lenders' liability was reduced almost $2 million.

--Lender loan servicing and FmHA's follow-up action was adequate.

--FmHA's potential losses on these loans could be as much as $3 million. Five loans to two borrowers were being liquidated at the time of OIG's review.

A subsequent audit 1/ in Georgia was made to determine if deficiencies existed for other business and industrial loans. The case files of six borrowers with seven guaranteed loans 2/ totaling $3.4 million were reviewed for this audit. OIG reported that the conditions it found in this audit were similar to those in its carpet industry audit report. On one of the loans reviewed, OIG reported that the FmHA State office had rejected the loan twice (June 17 and Sept. 1, 1977) for numerous reasons. According to the audit report, a memorandum in the lender's files showed that the borrower was going to try, through political pressure, to get the application "forced" through. A loan was subsequently approved on November 3, 1977. The audit report stated that the auditors could find no evidence to indicate that any of the unfavorable conditions had changed at the time the loan was closed on November 22, 1977.

As a result of an audit 3/ of six guaranteed loans made to three borrowers by a bank in Mobile, Alabama, OIG reported that serious deficiencies were evident in how the program was managed at both the State and national level. These deficiencies included:

--Approving loans to ineligible borrowers, possibly because of political pressures. (Loans to two borrowers would have no significant benefit to rural areas.)

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1/OIG report, "Farmers Home Administration Business and Industry Loans, Georgia State Office," Audit Report 499-44-At, November 6, 1980.

2/These loans were closed between January 1977 and January 1980.

3/OIG report, "Farmers Home Administration Audit of Selected Business and Industry Loans, Alabama State Office," Audit Report 499-17-At, May 7, 1980.

--Apparent preferential treatment of loan applications due to political influence or personal friendship with borrowers.

--Improper loan processing.

--Approving "bail-out" loans in which the lender's risk exposure was significantly reduced and the primary purpose was to refinance debt of financially unsound businesses.

--Approving temporary financing through loans with long-term repayment.

--Accepting inadequate collateral for loans and questionable appraisals of the collateral.

--Approving a nonlocal lender that had no loan servicing department.

--Insufficiently supervising lender loan servicing.

--Inaction on known or reported violations of conditional commitments for guarantee requirements, lender agreements, and/or loan agreements.

--Inadequate follow-up on known or reported misrepresentation by the lender and borrowers.

OIG stated that FmHA's losses on five of the loans, which were closed between August 1977 and December 1978, could amount to more than $7 million because of the cited deficiencies.

In September 1980 OIG completed a review 1/ of 40 business and industrial loans, each in excess of $1 million. This review had been undertaken because of concerns voiced by various USDA officials, including OIG and FmHA officials, and persons outside USDA about the loan guarantee decision-making process More specifically, the review was concerned with

--whether external pressures were leading to the approval of loan guarantees for reasons unrelated to their financial and economic feasibility and impact and

1/OIG report, "Loan Decision-Making Process in the B&I Loan Program," Audit Report 04618-1-Hq, September 7, 1980

--the appearance that external political or other pressures were factors in approving such loans.

OIG did not conclude that all the loans with external pressure were unworthy of loan approval. But it did state that its audit highlighted the issue that there is an appearance that the loans reviewed could have been made for other than financial and economic reasons.

Of the 40 loans reviewed, 22 were selected because loan approval had initially been denied by the State office and/or the National Loan Review Committee or loan review officer. Eighteen were selected from fiscal year 1979 operations because of the large dollar amount of the loan. Four of the 18 had been previously rejected. In all, 26 of the 40 loans reviewed had been previously rejected.

For 21 of the 40 loans reviewed, OIG reported that there was evidence of support for the loan by outside parties such as the Office of the Secretary, Members of the Congress, congressional staff, White House staff, or State and local elected officials. This evidence of support included only those instances where strong letters of support for the loan were on file or there was evidence of meetings or personal contacts between FmHA officials and outside interested parties. Routine congressional or other inquiries on the status of loan applications were disregarded. Of the 26 loans that had been previously rejected, OIG reported that 14 appeared to have considerable support for final approval from Members of the Congress or the Office of the Secretary.

OIG also reported that in many of the cases where outside support existed for loan approval, the documentation of the processing and the factors on which approval of the applications was based appeared inadequate. We believe this finding is significant since most of the previous findings reported by our Office and OIG involved loans approved on the basis of inadequate pre-loan analysis.

OIG also has conducted a nationwide audit of 30 business and industrial loans in 21 States. These loans were statistically selected from the total loans obligated in fiscal year 1979 and closed during fiscal years 1979 and 1980 through December 31, 1979. An overall report on the results of this review has not been released.

Separate reports on the results of the nationwide audit in four States--Florida, Alabama, Mississippi, and Kentucky--have been issued According to these OIG reports, there were no serious problems with the loans reviewed in Florida and Mississippi but serious deficiencies existed in the loans reviewed in Alabama and Kentucky. Serious deficiencies in the management of the Alabama program 1/ included:

--Inadequate staffing of the FmHA State business and industry section.

--Improper loan processing and pre-loan analysis.

--Approving a loan guarantee for an unsound project.

--Approving a loan that significantly reduced the lender's exposure through the refinancing of a financially marginal business (bail-out).

--Accepting inadequate collateral for loans and inadequate appraisals of collateral.

--Insufficiently supervising loan closing and lender loan servicing.

--Inaction on known and reported violations of one lender's loan agreements.

For the one loan reviewed in Kentucky, OIG concluded that the loan did not meet the objectives and eligibility requirements of the program. The borrower was financially unsound and had been a problem account for the lender before the loan guarantee. Equity requirements were not met and collateral was insufficient to reasonably assure loan repayment. About 100 percent of the loan funds were to be used to refinance debts, most of which were held by the lender--a bail-out situation. Also, about $150,000 in loan proceeds was used for unauthorized purposes. The loan was for $950,000, of which 80 percent was guaranteed by FmHA.

In November 1980 OIG began an audit of FmHA business and industrial loan guarantees totaling about $342 million to construct 15 fuel alcohol projects in 14 States. Loan guarantees for the 15 projects were committed in September and October

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1/This review was based on a cursory review of 10 loans, totaling about $4.5 million, and an indepth audit of one loan for $136,000; the latter loan was part of the nationwide audit.

1980. According to an OIG official, this audit, among other things, will address allegations that the loan guarantees were approved for political purposes. The OIG expects to have a report to the agency by late January 1981.

## FmHA's ASSESSMENTS SHOWS SIMILAR PROBLEMS

FmHA has established assessment teams composed of FmHA and OIG personnel to improve its management controls. These teams periodically visit each State and selected district and county offices to identify program weaknesses and their causes and effects and to make recommendations to correct them. Assessment teams have been established for several FmHA programs, including the Business and Industrial Loan Program.

In fiscal year 1980 assessments of the Business and Industrial Loan Program were completed in nine States: Oregon, Minnesota, Wisconsin, Indiana, Colorado, West Virginia, Tennessee, Texas, and Mississippi. The nine assessments covered 144 loan guarantees totaling about $104 million. Separate assessment reports were prepared on each State. In March 1980 a summary report on the nine States was prepared for the FmHA Administrator.

According to the summary report, problems existed in the following areas:

--Obtaining and analyzing financial data, both before and after loan closing.

--Meeting minimum equity requirements.

--Evaluating projections and verifying the data used.

--Obtaining appraisals by qualified appraisers.

--Obtaining adequate and sufficient collateral.

--Checking on the past performances of management individuals and comparing their performance with the borrower's management needs.

--Obtaining security and financial updatings from personal guarantors.

--Servicing.

On loans involving refinancing, the summary report stated that:

--Current and cash flow positions were not improved in 16 percent of the cases.

--Collateral was insufficient to secure 19 percent of the loans.

--Lenders brought themselves under the umbrella of FmHA's guarantee in 58 percent of the cases reviewed.

--More than 50 percent of unreported problem loans involved refinancing.

The assessment summary also raised questions as to whether FmHA's staff was large enough to properly perform all work. It also recognized the need for FmHA staff and lenders to receive periodic refresher training on the program's purpose and requirements. According to FmHA officials, inadequate FmHA staffing of the program was the major reason for the problems disclosed by the assessment studies.

## CURRENT OBSERVATIONS

As noted on page 2, our September 1977 report contained several recommendations directed at (1) improving loan evaluations, (2) better establishing loan security, (3) eliminating the use of loans that transfer loan risks to FmHA, (4) improving loan servicing, (5) providing a sufficient staff of experienced and trained employees, and (6) emphasizing to FmHA staff and lenders the need to follow program requirements, fully analyze all information, and document the justification for loan approval. Similarly, OIG has made numerous recommendations to correct the deficiencies it found.

FmHA has acted or is acting on many of the recommendations made by our Office and OIG. According to FmHA program officials, FmHA has acted quickly to correct these deficiencies but recognition must be given to the time required to change regulations--generally up to 9 months and sometimes longer. Without regulatory changes, they said that policy changes alone were difficult to enforce. Further, they said that only time will tell if the changes made or in process would suffice to correct deficiencies.

We believe the continuing and recurring deficiencies in FmHA's Business and Industrial Loan Program, as identified by recent OIG reviews, are the result of an imbalance between

FmHA staffing levels and program activities and the failure of FmHA staff to follow or enforce program requirements.

FmHA staffing

In early 1979 OIG reviewed past audits of FmHA programs and found that many of them reported the same general problems--inadequate review of loan applications, inadequate servicing of loans and delinquent accounts, and inadequate review of borrowers to determine if they should be graduated to commercial credit sources. OIG attributed many of these continuing problems to the imbalance between the size and complexity of FmHA programs and the size and skills of its staff. The adequacy of FmHA staffing for the Business and Industrial Loan Program was discussed in our September 1977 report and in FmHA's internal assessment reports on the Business and Industrial Loan Program.

According to OIG's semiannual report to the Congress for the period ending September 30, 1980, FmHA has loaned or issued grants totalling $73.2 billion from 1935 through fiscal year 1979. Thirty-eight billion dollars, or 45 percent, of the total had been obligated between fiscal year 1976 and fiscal year 1979. OIG also stated that FmHA services the accounts of about 1.25 million borrowers with a principal indebtedness of more than $40 billion. In contrast, OIG stated that the number of full-time employees has increased from 8,057 at the end of fiscal year 1972 to 8,456 in April 1980. During the same period, part-time employment increased from 1,491 to 1,674. OIG reported that because staffing has not kept pace with the number of loans, the number of staff years available to make and service loans has decreased from 1 for every $1 million in program money in fiscal year 1969 to 0.2 in fiscal year 1979. Also, OIG stated that the average value of loans outstanding handled by each employee has increased from $960,000 in fiscal year 1969 to $4.7 million in fiscal year 1979.

OIG did not believe that the effective management of FmHA loan programs depended entirely on the adequacy of FmHA resources. OIG believed an equally large part of the problem rested with FmHA getting the loan made, often at the expense of careful review of the loan application, financial statements, availability of commercial credit, and loan servicing.

FmHA program officials agreed that FmHA staffing had not kept pace with program activity. They said that this imbalance was also true for the Business and Industrial Loan Program.

They attributed this problem to the budget process. For example, they told us that they had requested without success 41 additional staff members for FmHA's field offices to service business loans. Further, they said that they had limited authority at the national headquarters over staffing and hiring of FmHA's State office business and industrial loan staff.

In view of the above, we question whether FmHA staffing of the Business and Industrial Loan Program is adequate to do all required work, do it properly, and still get all program funds obligated. Obviously, a better balance is needed between FmHA staffing levels and program activities to eliminate deficiencies.

Compliance with program requirements

A better balance between FmHA staffing and program activities should make it easier for FmHA staff to follow or enforce program requirements. However, some additional actions are needed to further assure compliance with program requirements.

In connection with its audit on the loan decisionmaking process in the Business and Industrial Loan Program, OIG recommended several actions to improve the decisionmaking process. In one of the recommendations, OIG recommended that each review level within FmHA should fully document its recommendations for loan approval or disapproval and the specific factors on which such recommendations are based. OIG reported that FmHA was implementing this recommendation.

Although this documentation is a good start, we believe the final loan approving official should be required to certify loan approval to some outside entity, such as OIG, for any loan previously rejected or disapproved at a lower review level. Such certification should give the reasons the loan was previously rejected, any specific action taken to overcome these reasons, and/or the rationale that invalidates these reasons or now makes loan approval appropriate. Such certifications would give previously rejected loans greater visibility and provide a basis for systematically reviewing such loan approvals.

FmHA program officials said that they do justify their loan approval decisions and questioned the merits of certifying them to OIG. Since the information required for the certifications is already available, such certifications should not be an undue burden to FmHA Further, OIG officials agreed with us that certifying loan approval to OIG for previously rejected loans was a good idea as it would give such loans greater visibility and provide a basis for systematically reviewing such loans.

In addition, FmHA needs to further strengthen its monitoring capabilities. The FmHA assessment teams are a good start and should be continued. However, FmHA needs to establish a good management information system. In 1978 and again in 1980, we reported 1/ on FmHA problems in establishing such a system.

In addition to the assessment teams discussed above, OIG has recommended that FmHA establish an internal review capacity. According to OIG, FmHA has traditionally relied upon OIG to provide the resources necessary to test and monitor the internal controls in FmHA's programs and financial operations, and, to a lesser extent, on internal reviews performed on an ad hoc basis. Because FmHA programs have grown tremendously and become increasingly complex, OIG has focused its resources on those program areas that are most susceptible to fraud, abuse, and waste. With this shift in emphasis, OIG has not had the available resources to routinely check on internal controls in FmHA programs at FmHA State and county offices. For this reason, OIG has recommended that FmHA establish an internal review staff of between 50 and 75 persons. According to OIG's semiannual report for the period ending September 30, 1980, FmHA had developed a plan for creating an internal review staff but had not yet assigned staff to this function.

Besides FmHA monitoring activities, periodic audits and congressional oversight are needed to surface problems and ensure prompt and appropriate corrective action.

Finally, when noncompliance with program requirements is found, FmHA must provide remedial training when such noncompliance is unintentional. When noncompliance is intentional, we believe FmHA must take appropriate disciplinary action. The latter can be an important deterrence to others who may be tempted to disregard program requirements.

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1/"Farmers Home Administration Needs to Better Plan, Direct, Develop, and Control Its Computer-Based Unified Management Information System," (CED-78-68, Feb. 27, 1978) and "Farmers Home Administration's ADP Development Project-Current Status and Unresolved Problems," (CED-80-67, Feb. 19, 1980)

FmHA program officials said that FmHA's reduced travel budget has affected FmHA's ability to provide training. In addition, they said that loan approval authority had been withdrawn from FmHA staff on occasion as a means of disciplinary action.

Refinancing

One other matter warrants comment--refinancing or the so called bail-out situation. In our September 1977 report on the program, we recommended that FmHA reduce the guarantee to maintain the same level of exposure lenders had on debts that were being refinanced. FmHA did not believe this was always feasible to do because some areas only have one bank and if that bank was prohibited from reducing its exposure, many businesses would cease to exist due to a lack of financing. FmHA also said that such a procedure would force borrowers to change lenders to avoid such a requirement and could eliminate the bank's ability to provide credit for short-term financing. We pointed out, however, that as a minimum, FmHA should require such loans to be approved at the national office level. We believe this suggestion needed to be given renewed consideration, especially in view of the findings of FmHA's own assessment teams.

FmHA program officials, however, did not believe that loans involving refinancing should be approved by the national office. They explained that many FmHA business loans involve some degree of refinancing and that national office approval of all such loans would be a burden. Further, they said that FmHA was in the process of tightening program requirements for loans involving refinancing and that these new requirements should minimize differences in the interpretations of FmHA requirements and thus result in approving sounder loans. FmHA officials also said that they would monitor implementation of the new requirements through the FmHA assessment teams and their review of loans over $1 million, which are currently subject to national office review. We believe that if FmHA's new program requirements do not eliminate the bail-outs, FmHA should reconsider subjecting such loans to national office approval as suggested in our September 1977 report.