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The Status of the Farmers Home Administration's Farm Loan Portfolio and Farm Loan-Making Criteria and Policies

Statement of
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Before the
Committee on Agriculture, Nutrition,
and Forestry
United States Senate

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Mr. Chairman and Members of the Committee:

We are here today at your invitation to discuss the financial condition of the U.S. Department of Agriculture's (USDA) Farmers Home Administration (FmHA) farm loan portfolio and changes in loan-making policies FmHA has proposed to improve that portfolio. You specifically asked us to provide any information we may have on the proposal's potential impact on FmHA borrowers' ability to qualify financially for future farm loans.

Over the past 2 years, we have examined the financial condition of FmHA's farm loan portfolio and its borrowers. In January 1986 we testified before this Committee and released two reports--one providing an overview of FmHA's farmer program debt, delinquencies, and loan losses, and the other analyzing the financial condition of individual FmHA borrowers. These reports portrayed the seriously stressed financial condition of FmHA's farm loan portfolio and its borrowers.

A year later, the story is much the same, despite FmHA's recent efforts to implement new policies to improve the portfolio's condition. About half of FmHA's $28 billion farm loan portfolio remained delinquent as of June 30, 1986. Loan losses continue to escalate, as evidenced by a 275-percent increase between 1984 and 1986. FmHA could potentially lose about $7 billion in outstanding principal on its severely delinquent borrowers, or about one-fourth of its farm loan portfolio. Individual borrower debt load is high. Shrinking equity, annual operating-cash shortfalls, and high debt-to-asset ratios mean that many FmHA borrowers may be headed toward financial failure.

My testimony today will discuss the condition of FmHA's farm loan portfolio and what FmHA has proposed to improve that portfolio. I will also provide the preliminary results of our ongoing review of FmHA loan-making policies and some overall observations.

THE FINANCIAL CONDITION OF FmHA's FARM LOAN PORTFOLIO

The financial condition of farmers and their lenders has deteriorated rapidly since 1980. As a result, increasing numbers of farmers have been turned down for financing by their private lenders and have come to FmHA for credit assistance.

FmHA has responded to these credit requests by substantially increasing its loan portfolio. Over the 10-year period from 1977 to 1986, FmHA's farm debt in its five major farmer programs--farm ownership, operating, emergency disaster, economic emergency, and soil and water--increased about 370 percent, from about $6 billion to about $28 billion.

In January 1986 we testified before this Committee on the poor financial condition of FmHA's farm loan portfolio as of June 30, 1985. The updated statistics we provide today for the end of June 1986 show some changes, but continue the same bleak picture.
Mr. Chairman, I am going to be mentioning quite a few numbers here, and I have a schedule attached to my statement that may be of help in following them. Also attached to my statement are a series of graphs that further illustrate the portfolio's condition.

As you can see from the schedule, the numbers of borrowers and loans are down somewhat, while the amount of outstanding principal increased about $100 million. The number of delinquent borrowers decreased moderately--from about 97,000 to about 93,000. The amount of delinquent payments rose about $400 million, from $6.4 billion to $6.8 billion, while outstanding principal on delinquent loans still remained about half the total farm loan portfolio. Delinquent amounts and outstanding principal on these delinquent loans would be much higher if FmHA had not made about 18,500 of its delinquent borrowers current in fiscal year 1986 without requiring full loan payments. FmHA accomplished this through servicing actions, such as rescheduling loan terms and deferring loan payments.

The number of severely delinquent borrowers, those who were over 3 years delinquent on one or more loans, decreased slightly between June 1985 and June 1986 but continued to represent a high percentage of total delinquencies at over 36,000 borrowers. Over this same period, the delinquent amount owed by borrowers over 3 years delinquent increased from $4.8 billion to $5.4 billion, while their outstanding principal decreased slightly from $7.0 billion to $6.9 billion. According to FmHA, borrowers over 3 years delinquent probably will not be able to catch up on their payments and most likely will fail.

For the past 10 fiscal years, annual FmHA direct farm loan losses (net of proceeds from sales of loan collateral) grew from $26 million in 1977 to $490 million in 1986. These losses increased about 275 percent between 1984 and 1986, growing from $178 million to $490 million. FmHA estimates that it will write off as losses another $2 billion in the near future.

One of the reasons for the poor condition of FmHA's farm loan portfolio is that, in recent years, FmHA has made some policy decisions that were intended to help farmers stay in business with the hope that the farm economy would improve. One such decision occurred in February 1982 when FmHA instituted a farm loan "continuation policy" that allowed existing borrowers to obtain additional FmHA operating financing without showing the ability to repay existing debt. Although this policy was terminated in November 1985, the effects are still being seen in terms of delinquencies, increasing losses, and many FmHA borrowers overburdened with debt.

FmHA's PROPOSED REVISION OF ITS FARMER PROGRAM REGULATIONS

Given the deteriorated financial condition of its portfolio, FmHA has proposed revising its farmer program regulations to become a more prudent lender while at the same time trying to fulfill its mission as a lender of last resort.

In January 1987 FmHA proposed regulations that, among other things, are intended to help target its resources to only those farmers who have a realistic chance of surviving. To accomplish this, FmHA introduced a credit scoring system to be used in determining a farmer's financial eligibility to participate in its farm loan programs. Prior to this proposal, FmHA based its loan-making decisions on a farmer's cashflow ability. That is, FmHA would have loan applicants estimate their total income and expenses on a farm and home plan. If the estimate showed that the applicant had sufficient revenue to repay expenses, including debt repayment, during the current year, FmHA would approve the loan.

FmHA's proposed credit scoring system would use various financial ratios in addition to cashflow in a two-stage review process to determine a borrower's creditworthiness. In the first, or preapplication, stage the farmer completes a loan application, and the financial information provided on the form is used to compute three financial ratios. These ratios reflect the borrower's debt relative to assets, short-term liquidity, and profitability. An applicant whose financial condition meets the standard set forth in the proposed regulations can continue to the second stage of the process. In the second stage, FmHA uses financial information provided by the applicant on a farm and home plan. The county supervisor must agree with these estimates of the applicant's financial position. This stage involves the recalculation of some of the borrower's financial ratios and also the borrower's repayment ability or cashflow. The county supervisor would be expected to reject any applicant whose preapplication or farm and home plan shows no reasonable prospect for success and a high degree of potential loan failure or risk.

GAO REQUESTED TO REVIEW FmHA LOAN-MAKING POLICIES

On October 24, 1986, the former Chairman of this Committee requested that GAO review FmHA's loan-making policies to evaluate whether FmHA's financial assistance actually helps family farmers survive rather than increasing their unprofitable debt load and decreasing their equity. After we began our review, FmHA proposed the aforementioned changes in its regulations, including the credit scoring system. We then expanded the scope of our work to assess the impact of the proposed credit scoring system on borrower eligibility.

Before I provide you with the preliminary results of our work, I need to caution you that it is still ongoing and is based on FmHA's January 1987 proposal, which is currently being revised. We have not evaluated the appropriateness of FmHA's proposed credit scoring system but rather documented its impact on borrower eligibility.

We began our initial work in two FmHA county offices, one in Wisconsin and one in Iowa. We selected these offices because they had relatively high levels of borrowers who received new loans during the first 6 months of 1986. In each office we randomly selected 14 borrowers with 1986 loans for review.

For each borrower we gathered information on the nature and purpose of the 1986 loans, servicing actions on these loans, the borrower's financial condition, and the FmHA county supervisor's opinion about the future financial viability of the borrower's operation. We also asked the county supervisor whether the proposed credit scoring system accurately reflected the borrower's financial position. For each borrower we used the proposed system to determine whether the applicant would have been eligible for an FmHA farm loan on the basis of the financial information estimated in his/her 1986 farm and home plan.

To date our preliminary work indicates that of the 28 borrowers who received new farm loans in 1986, half would not have qualified under FmHA's proposed credit scoring system. These 14 borrowers would be ineligible because the scoring system identifies them as having an unacceptably high level of financial risk. The factors that led to these 14 borrowers being designated as unacceptable risks varied. No single financial ratio eliminates a borrower from eligibility.

Our observations on the financial condition of the 14 borrowers who would not have qualified under FmHA's proposed credit scoring system are as follows:

- Two borrowers had farm and home plans that did not show a positive cashflow and, as such, would not have been eligible for loans under FmHA's current loan-making criteria.
- Seven of the borrowers were technically insolvent, that is, their total debts exceeded their total assets. In 1986 these borrowers received about $210,000 in additional loan funds and had loans in the amount of

about $453,000 serviced for more favorable loan rates and terms.

-- Twelve of the borrowers with positive cashflows would have negative cashflows without nonfarm income, indicating that these farm operations, by themselves, were not financially viable with the borrowers' current debt loads.

-- These 14 borrowers, who on average have been with FmHA for just under 6 years, have received about $2.18 million in loans but have not repaid about $1.92 million. This amount of unpaid principal outstanding (88 percent) indicates that the borrowers have made little progress toward freeing themselves from subsidized credit.

-- Eleven of the 14 borrowers had their equity decline while receiving financial assistance from FmHA.

In addition to analyzing the financial situation of these borrowers, we examined FmHA servicing actions on them and found that 12 of the 14 borrowers had their loans serviced at some point in time. Seven of these borrowers had loans serviced in 1986, six of which were for loans made in 1985, reflecting the rapid deterioration of the borrowers' ability to repay the loans.

Concerning the future financial viability of these farm operations, the FmHA county supervisors responsible for loan-making decisions told us that 7 of the 14 high-risk borrowers would liquidate their farm operations by the end of 1988. In 1986 these seven borrowers received loan funds totaling about $280,000 and had loans serviced in the amount of about $453,000. The borrowers received new 1986 loans because their farm and home plans estimated that they could cashflow for at least one more year.

Finally, for 26 of the 28 borrowers reviewed, county supervisors told us that the proposed credit scoring system generally reflected the borrowers' financial condition. In the other two cases, the county supervisor stated that the proposed system understated the borrowers' financial condition because both borrowers had extensive off-farm income that would not be considered in the preapplication stage and one was also restructuring his debt. Since we completed this preliminary work, FmHA has made plans to revise its credit scoring system to include nonfarm income in the preapplication stage, as well as the second stage. Concerning the restructuring of debt, FmHA has stated that it no longer plans to make loans to borrowers until after debt restructuring actually occurs and the borrower is shown to be an acceptable financial risk.

Mr. Chairman, our review of FmHA's loan making is currently being expanded to four states, and our audit team will be examining FmHA lending actions on a random sample of 160 additional farm borrowers. Our objective is to further document the potential impact of FmHA's revised credit scoring system and determine whether FmHA loan-servicing actions actually help borrowers return to profitability or forestall financial failure while increasing the borrowers' debt loads, reducing their equity, and increasing potential future losses to the government.

GAO OBSERVATIONS

Our work to date indicates that FmHA's use of a cashflow criterion, by itself, does not assure sound loan-making decisions. Considering only a borrower's estimated ability to cashflow allows loans to be made to borrowers who are already technically insolvent. Generally, these borrowers are so financially stressed that, as the condition of FmHA's portfolio indicates, they end up delinquent and cannot cashflow without FmHA loan-servicing actions. FmHA county supervisors can use extensive loan servicing to make many existing borrowers cashflow "for one more year" and keep the farmers in business. However, the overall financial condition of many of these borrowers is so poor that new loans only increase the farmers' unprofitable debt loads and decrease their equity without long-term prospects for financial viability. Eventually, when all the equity is gone, the farmers can no longer obtain financing and are forced out of business. At this point, the farmers have no remaining assets, and the federal government is often left with loan losses.

Under the law FmHA is to make loans to family farmers who cannot obtain sufficient credit elsewhere to finance their actual needs at reasonable rates and terms. As such, FmHA provides financial assistance to high-risk borrowers. On the other hand, FmHA is also tasked with using generally accepted sound loan-making practices to ensure that its loans have a reasonable chance of being repaid or that sufficient collateral exists to secure loans if borrowers default.

The proposed credit scoring system, rather than relying solely on cashflow, attempts to ensure that FmHA makes loans only to borrowers who have a reasonable chance of repaying their debt and ultimately having a viable farm operation. As long as FmHA's mission is to be a viable lender and not a grant agency, we agree with the basic thrust of FmHA's efforts to improve its loan-making criteria. We have not fully evaluated the reasonableness or fairness of FmHA's proposed credit scoring system, but the system does attempt to draw the line between those financially troubled farmers who can be helped and those who cannot.

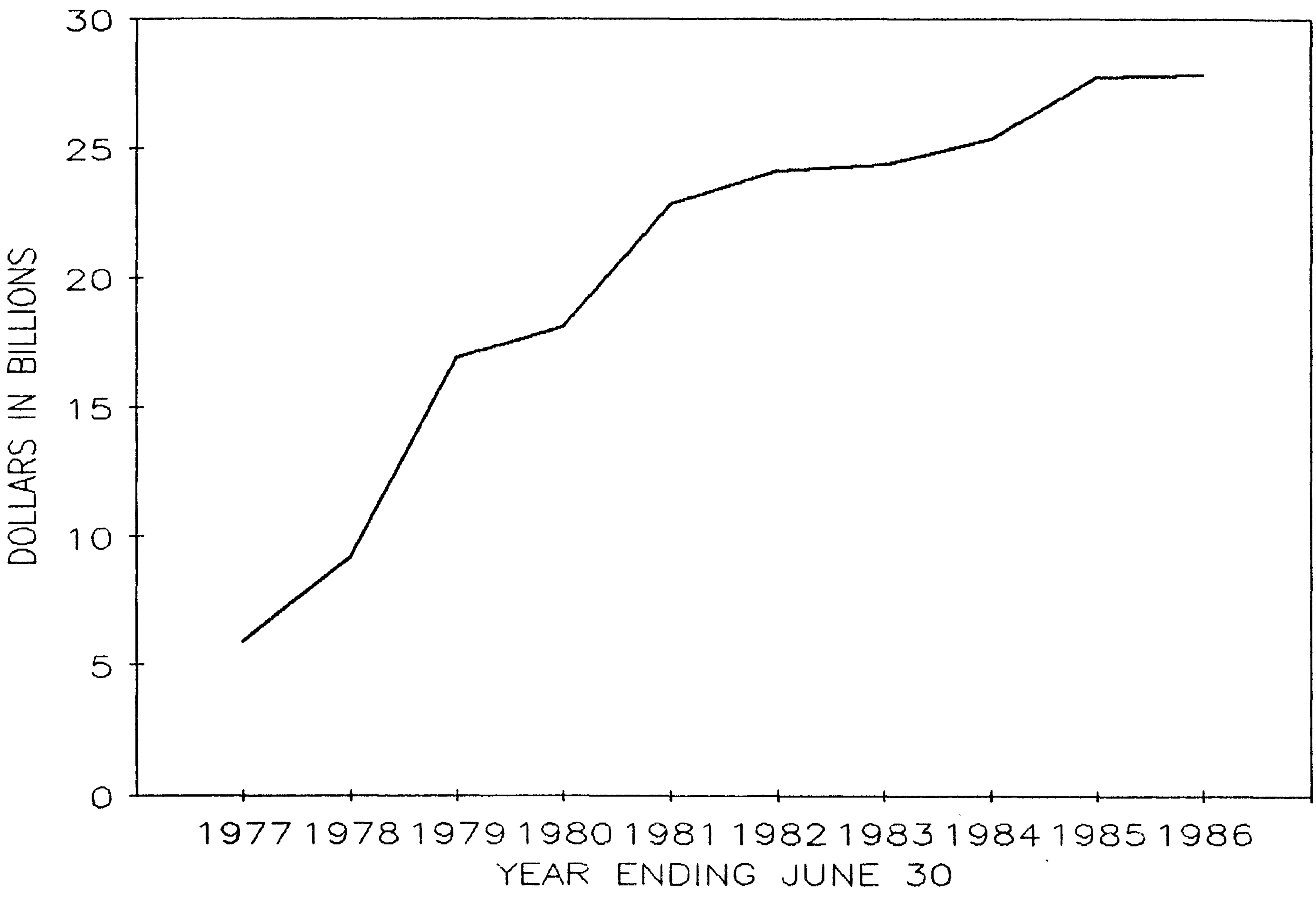
During this difficult economic time for U.S. agriculture, financially weak farm operations are going to fail. We believe FmHA must target its limited resources to those farmers who have the best chance of survival and work toward developing other ways to help those who will not make it.

That concludes my statement. We will be glad to respond to any questions.

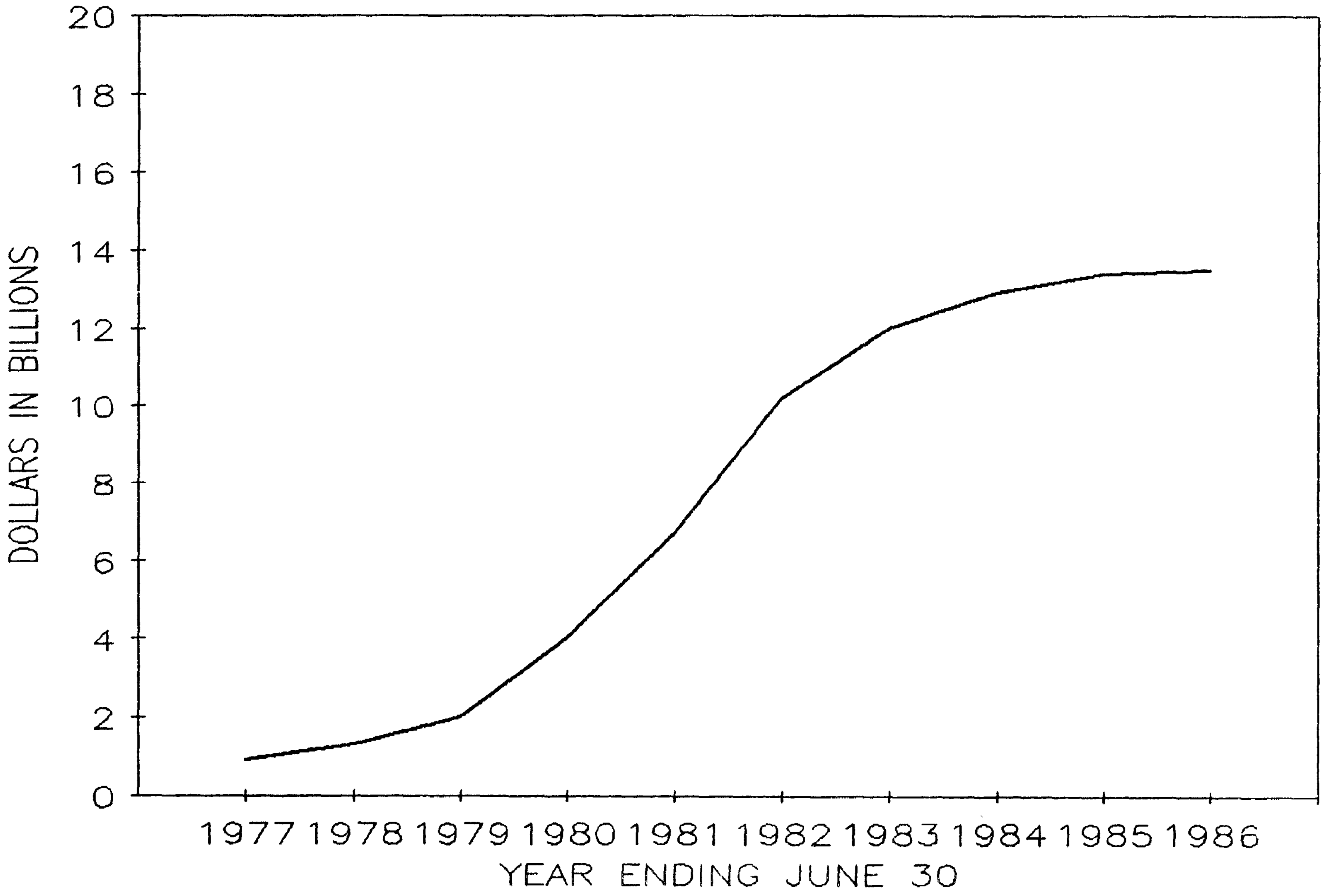
FINANCIAL CONDITION OF FmHA'S FARM LOAN PORTFOLIO
JUNE 30, 1985-JUNE 30, 1986

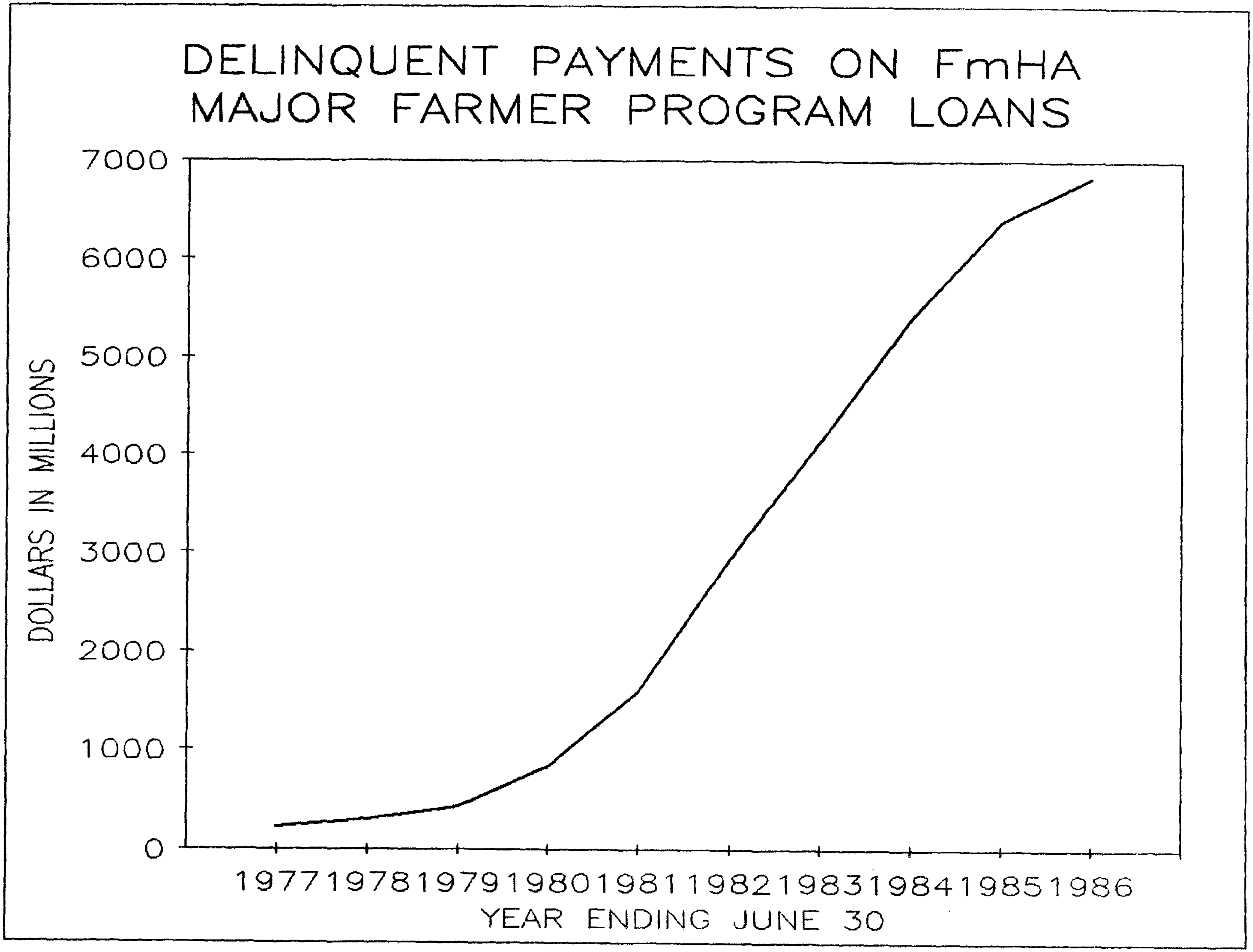
	1985	1986
NO. BORROWERS	270,058	260,969
NO. LOANS	757,219	738,737
OUTSTANDING PRINCIPAL	$27.7 billion	$27.8 billion
NO. BORROWERS DELINQUENT	97,427	92,914
DELINQUENT LOANS	344,732	331,369
DELINQUENT AMOUNT	$6.4 billion	$6.8 billion
OUTSTANDING PRINCIPAL ON DELINQUENT LOANS	$13.4 billion	$13.5 billion
NO. BORROWERS OVER 3 YEARS DELINQUENT	36,953	36,358
NO. LOANS OWED BY BORROWERS OVER 3 YEARS DELINQUENT	185,145	177,431
AMOUNT OWED BY BORROWERS OVER 3 YEARS DELINQUENT	$4.8 billion	$5.4 billion
OUTSTANDING PRINCIPAL OWED BY BORROWERS OVER 3 YEARS DELINQUENT	$7.0 billion	$6.9 billion

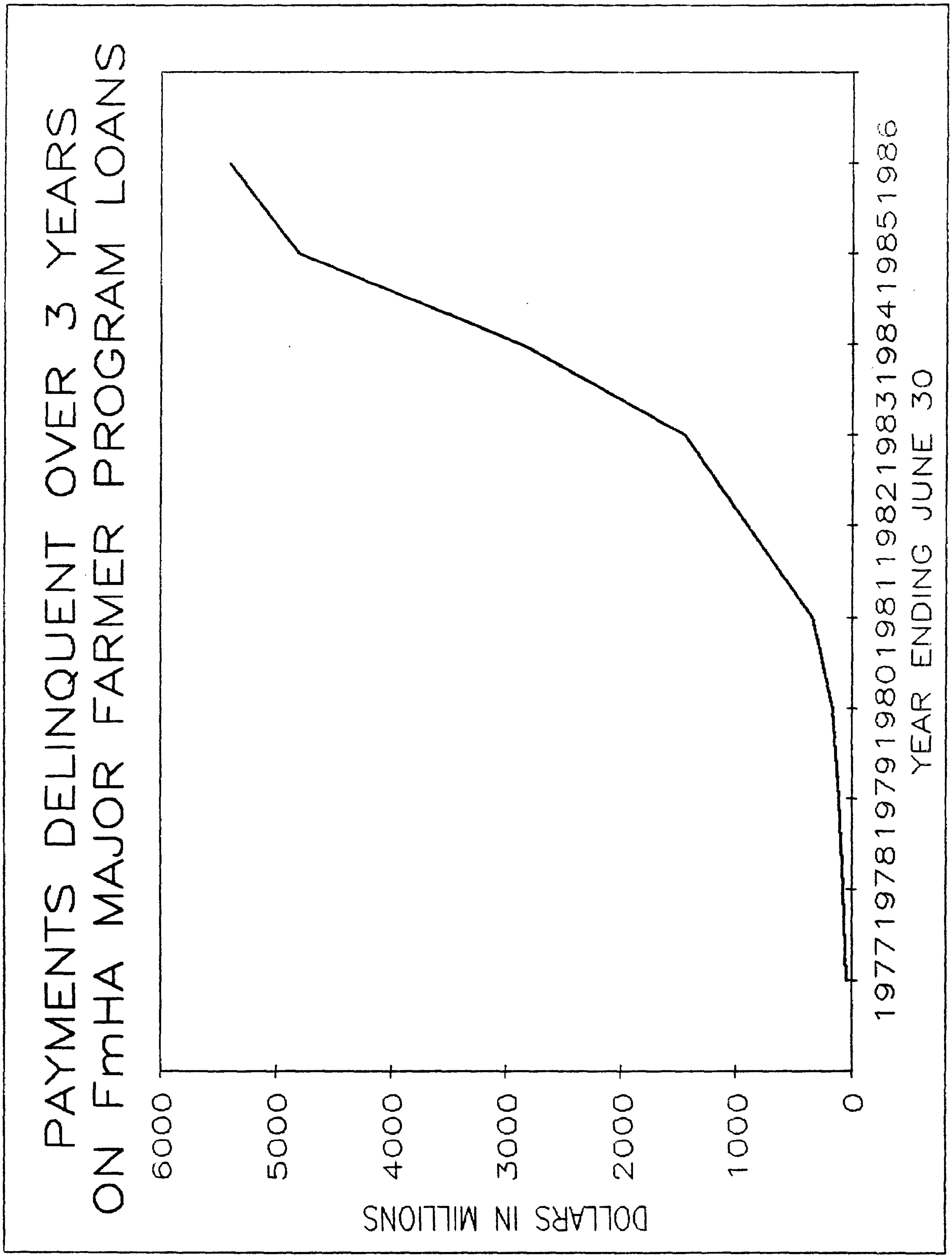
OUTSTANDING PRINCIPAL ON FmHA MAJOR FARMER PROGRAM LOANS

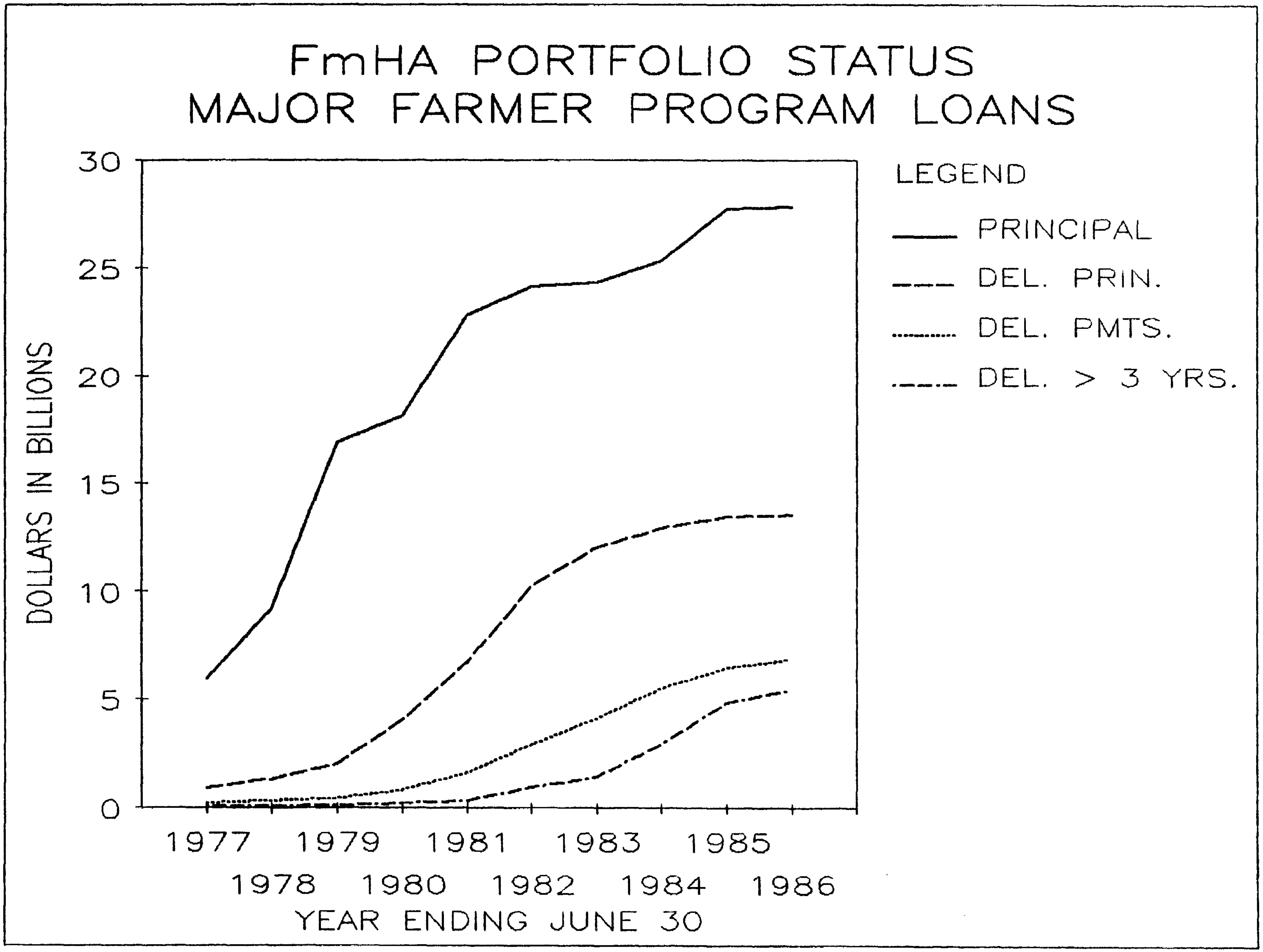


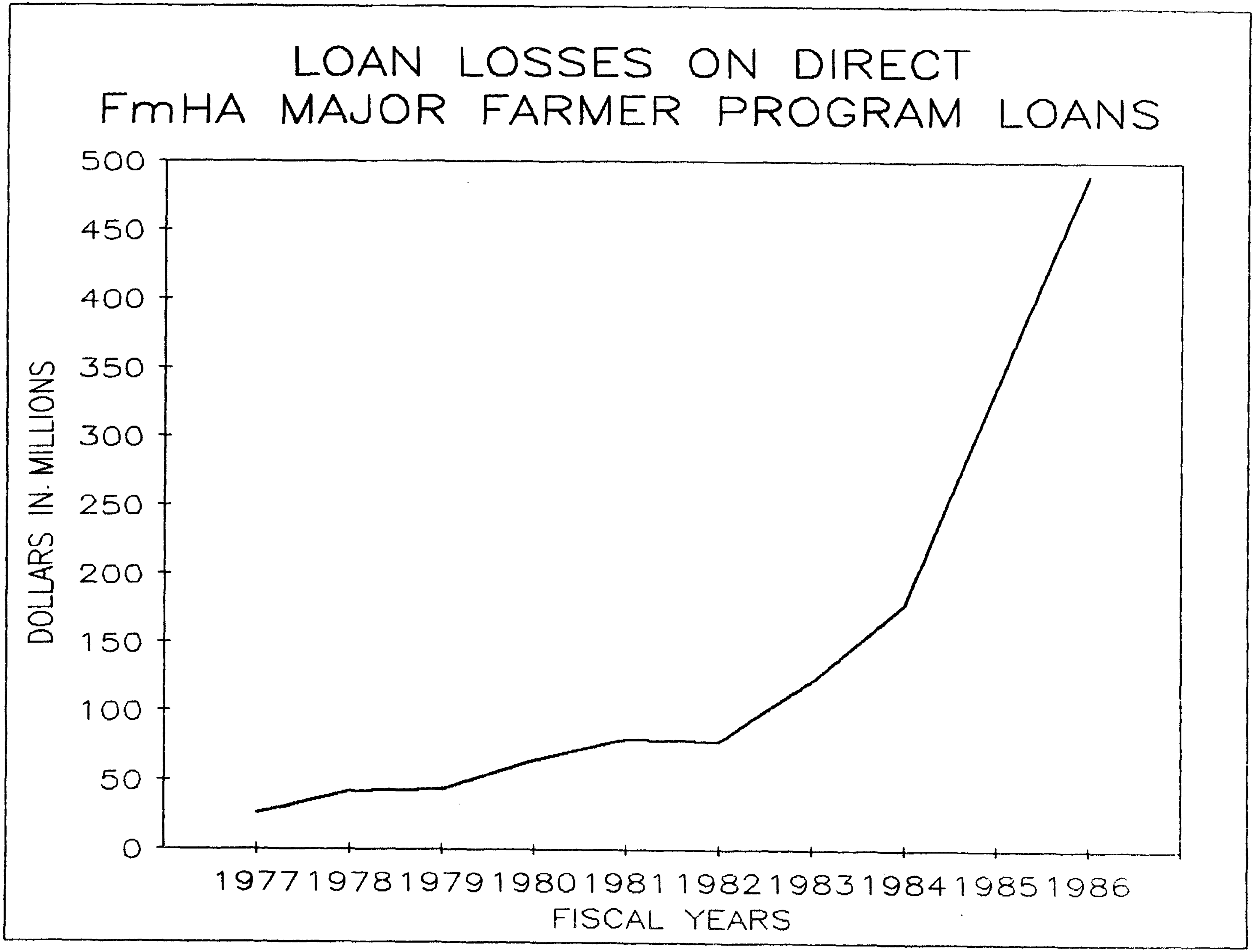
OUTSTANDING PRINCIPAL ON DELINQUENT FmHA MAJOR FARMER PROGRAM LOANS




DELINQUENT PAYMENTS ON FmHA
MAJOR FARMER PROGRAM LOANS
7000
6000
5000
4000
3000
2000
1000
0
DOLLARS IN MILLIONS
1977 1978 1979 1980 1981 1982 1983 1984 1985 1986
YEAR ENDING JUNE 30


PAYMENTS DELINQUENT OVER 3 YEARS
ON FmHA MAJOR FARMER PROGRAM LOANS
DOLLARS IN MILLIONS
6000
5000
4000
3000
2000
1000
0
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
YEAR ENDING JUNE 30


FmHA PORTFOLIO STATUS
MAJOR FARMER PROGRAM LOANS
DOLLARS IN BILLIONS
0
5
10
15
20
25
30
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
YEAR ENDING JUNE 30
LEGEND
PRINCIPAL
DEL. PRIN.
DEL. PMTS.
DEL. > 3 YRS.


LOAN LOSSES ON DIRECT
FmHA MAJOR FARMER PROGRAM LOANS
DOLLARS IN MILLIONS
0
50
100
150
200
250
300
350
400
450
500
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
FISCAL YEARS