United States General Accounting Office

GAO

Report to the Honorable
Jesse Helms, U.S. Senate

February 1989

FARMERS HOME ADMINISTRATION

Sounder Loans Would Require Revised Loan-Making Criteria

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

Resources, Community, and
Economic Development Division

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February 14, 1989

The Honorable Jesse Helms
United States Senate

Dear Senator Helms:

As you requested, we examined the Farmers Home Administration's (FmHA) loan-making policies and practices to determine whether they result in financially sound loans that actually help family farmers survive difficult economic conditions. This report provides several recommendations to the Secretary of Agriculture for improving FmHA's loan-making process.

As arranged with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 3 days from the date of this letter. At that time we will send copies of the report to appropriate House and Senate Committees; interested members of Congress; the Secretary of Agriculture; and the Director, Office of Management and Budget. Copies will also be made available to other interested parties who request them.

This work was performed under the direction of John Harman, Director, Food & Agriculture Issues. Other major contributors are listed in appendix V.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

The Farmers Home Administration's (FmHA) outstanding farm loan portfolio increased from $5.1 billion in 1976 to $26.2 billion in 1987. Faced with difficult economic conditions, more and more family farmers have defaulted on their FmHA loans.

Senator Helms, then Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry, asked GAO to determine (1) whether the criteria FmHA uses to make and service loans are adequate, (2) how borrower equity positions (net worth) are affected by FmHA loan-making policies, (3) whether security for FmHA loans is adequate, and (4) what impact more stringent loan-making criteria proposed by FmHA in January 1987 would have on existing borrowers.

Background

FmHA, an agency of the U.S. Department of Agriculture (USDA), is the lender of last resort to financially troubled farmers who cannot get credit elsewhere. The increase in FmHA's portfolio and subsequent defaults are due to some extent to factors and conditions—such as an increase in the value of the dollar and export boycotts which decreased exports—beyond both the borrowers' and FmHA's control. As a result, FmHA was placed in the position of being a loan agency responsible for protecting the government's and, ultimately, the taxpayers' interests and an agency responsible for helping farmers, who cannot get help elsewhere, stay in business.

Results in Brief

GAO recognizes that balancing the role of FmHA as both an assistance and a loan-making agency requires basic policy decisions that can be made only by the Congress. These decisions should consider such factors as budgetary impacts, the extent to which farmers who are facing extreme financial stress can be helped by credit assistance, the length of time that such credit should continue, the impact of continued credit on farmers' financial viability, and the implications of these decisions on rural communities.

In making loan decisions, FmHA uses a cash flow criterion that requires borrowers' expected incomes to cover projected expenses, including loan repayment. However, because optimistic financial data are used, FmHA's cash flow analysis has frequently been unreliable for determining loan repayment ability and, by itself, is not a good indicator of creditworthiness.

As a result, borrowers often cannot make scheduled payments and require extensive FmHA loan-servicing actions, such as extended repayment periods. These actions help temporarily but frequently result in heavier debts and reduced borrower equity, which in the long run weaken the borrower's financial condition. This, in turn, exposes the government to significant potential losses—estimated to be about $8.7 billion by fiscal year 1990. Under poor agricultural market conditions, this situation will likely persist with FmHA's current policies.

In January 1987, FmHA proposed revised criteria to improve its loan-making decisions. However, because of congressional concern that many borrowers would be ineligible for further financial assistance, FmHA withdrew the proposal.

GAO's Analysis

FmHA's Cash Flow Analysis Overstates Repayment Ability

FmHA's analysis of cash flow tends to be overly optimistic in that it does not allow for unexpected expenses or equipment replacement, thus often overstating borrowers' repayment ability. Although not projectable, a review of 100 of 160 randomly selected borrowers' files (for which sufficient financial data were available) showed that repayment ability had been overstated, on average, by about 24 percent and cash farm income, on average, by over 18 percent.

Frequent Loan Servicing Often Decreased Borrowers' Net Worth

When borrowers cannot make their payments, FmHA can reduce interest rates, increase the repayment period, or take other loan-servicing actions. Over half of the 414 loans made in 1986 to GAO's sample of 160 borrowers were servicing actions on existing loans rather than the outlay of new funds. Many of the 1986 loans had been serviced before; 25 percent required servicing again by June 30, 1987.

However, loan servicing usually increases outstanding loan principal by adding (capitalizing) unpaid interest to the principal and creates long-term debt by lengthening (rescheduling) the payment period of a short-term loan. In GAO's sample of 160 borrowers, the unpaid interest capitalized on serviced loans added over $1.5 million to an unpaid principal of $13.2 million. In addition, about $3.2 million of the $5.5 million rescheduled amount represented 1-year loans for operating or family living expenses. Payment extensions on these averaged 8 years.

Increased debt and the declining value of assets used as loan collateral reduce borrowers' net worth, or equity. Financial data available on 106 borrowers in GAO's sample showed their average net worth dropping over 62 percent from 1984 through 1986. This decline resulted from events that decreased assets an average of almost $25,000 per borrower (from $275,600 to $250,900) and increased debts an average of about $26,800 (from $193,300 to $220,100).

Declining Net Worth and Asset Values Jeopardize Loan Security

Increased debt and declining asset values also caused inadequate collateral on some FmHA loans. In GAO's sample, outstanding loan principal exceeded collateral value by an average of about $67,000 for 95 borrowers with loans secured by non-real estate property. For loans secured by real estate, outstanding loan principal exceeded collateral values by an average of about $28,000 for 16 other borrowers. FmHA requires security adequate to ensure repayment of new loans but does not have similar security requirements for serviced loans. When inadequately secured loans are liquidated, the government incurs a loss.

Proposed Criteria Would Have Reduced Number of Eligible Borrowers

FmHA proposed stricter eligibility and loan-making criteria in January 1987 to speed up loan processing and improve the financial management of its loan portfolio. The proposed two-stage process, used in addition to the current cash flow analysis, would have computed eligibility and loan-risk indexes for borrowers. GAO applied the proposed criteria to 160 sampled borrowers and found that over half would have been ineligible for further FmHA assistance.

Congressional and public concern over inadequate information on the proposed criteria's impact, the potential denial of further assistance to many borrowers, and the short period to assess the criteria led FmHA to withdraw the proposal. However, in the Agricultural Credit Act, the Congress allows for future revision of certain FmHA loan-making criteria if the agency adequately determines the impact on borrowers and provides the Congress with sufficient time for review.

Past Congressional Direction

To assist financially stressed borrowers, in July 1987 the Congress directed FmHA to reinstate the "continuation policy" rescinded in November 1985. This policy allows existing borrowers to obtain additional FmHA operating loans without showing the ability to repay prior loans. In January 1988 the Congress also enacted the Agricultural Credit

Act of 1987 that directed FmHA to consider reducing delinquent borrowers' debt if, because of inadequate collateral, it was better financially for the government than asset liquidation.

Matters for Congressional Consideration

Congress has encouraged FmHA's use of credit as a way to keep financially troubled farmers in business and assist rural communities. This has presented FmHA with the difficult task of achieving its assistance goals while also employing sound loan-making policies. With the continued decline of the agricultural economy, the use of existing credit policies has decreased borrower equity, deteriorated FmHA's farm loan portfolio, and increased government loan losses. Given these long-term negative effects and costs, the Congress may want to reconsider whether the continuation and debt restructuring policies are the best means to assist already heavily indebted farmers and their communities.

Recommendations

GAO recommends that the Secretary of Agriculture direct the Administrator, FmHA, to develop, in consultation with the Congress, more comprehensive loan-making criteria that assist borrowers who can benefit from such credit and would also provide greater assurance of repayment.

GAO is also recommending specific changes related to (1) allowances for unexpected expenses and equipment replacement, (2) collateral, and (3) credit analysis training for county supervisors. (See ch. 2.)

Agency Comments

USDA generally agreed with GAO's findings but expressed concern with the thrust of the recommendations. USDA stated that the Congress mandated that FmHA place the highest priority on preserving the borrower's farming operation. USDA also stated that implementing GAO's recommendations, while improving the soundness of FmHA's farm loan portfolio, would preclude many farmers from obtaining further FmHA assistance.

GAO recognizes that the Congress wants FmHA to continue to assist financially stressed farmers and keep them in business if at all possible. GAO believes, however, that the further extension of credit may not always be the best way to accomplish Congress' objective. In the long run, such practices often do not improve the farmer's financial condition or protect the government's financial position. Specific USDA comments and our evaluation are discussed in chapters 2 and 3.

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Abbreviations

DCI	data collection instrument
FmHA	Farmers Home Administration
GAO	General Accounting Office
OIG	Office of Inspector General
OMB	Office of Management and Budget
RCED	Resources, Community, and Economic Development Division
USDA	U.S. Department of Agriculture

Introduction

The Farmers Home Administration (FmHA) is a lending agency within the U.S. Department of Agriculture (USDA) that makes direct loans (government-funded) or guarantees other lenders' loans. FmHA provides loans primarily to family farmers[1] who are unable to obtain credit at reasonable rates and terms. FmHA loans often supplement other credit obtained by farmers and are intended to be a temporary credit source for borrowers who are starting a farming operation or continuing their operation after a financial setback. Farmers receiving loans must sign a note promising loan repayment and provide collateral, such as farm property, for security. Because FmHA may be the farmers' last opportunity to obtain credit, it is often referred to as the "lender of last resort."

Besides providing loans when other credit is unavailable, FmHA direct loans have terms that are generally more favorable than those for commercial loans. In addition, if borrowers are unable to make scheduled loan payments, FmHA will usually rewrite, or "service," the loans to more favorable repayment terms. Through loan servicing FmHA tries to "stay with" borrowers rather than force liquidation when loan terms are not met. Generally, FmHA liquidates a borrower's loan account(s) only as a last resort. Liquidation occurs when FmHA demands immediate full payment of outstanding debt and, if that is not made, the borrower's loan collateral is acquired through foreclosure or voluntary conveyance and sold to recover the loan amount.

FmHA makes loans through several farm loan programs as authorized by the Consolidated Farm and Rural Development Act (P.L. 87-128, Aug. 8, 1961, as amended). These programs provide or guarantee loans for farm ownership, operating expenses, and soil and water resource improvements. FmHA also provides emergency loans to permit applicants who suffer losses as a result of natural disasters to recover and return to commercial sources of credit. In fiscal year 1987, operating loans accounted for approximately $1.3 billion of the $1.5 billion in total direct farm loans.

In administering its loan programs, FmHA has the difficult job of providing loans to many financially high-risk borrowers while protecting the government's and, ultimately, the taxpayers' financial interests. This job became more difficult during the early 1980s, when the agricultural economy began deteriorating and farmers experienced a reversal of the

[1] FmHA defines a family farm as one that can be operated and managed by the borrower's family or by the members of borrowers' families if the farm is operated by a partnership, corporation, or cooperative. A reasonable amount of hired labor may be employed on family farms during peak load periods.

1970s' favorable economic conditions. During the 1970s, agriculture experienced increasing sales and rising asset values. The boom was fueled by the opening of the Russian grain market, rapid economic growth in other countries, which generated more income to buy American products, and a weak dollar, which made U.S. products relatively inexpensive. These factors resulted in exports rising from about $7 billion in 1970 to a peak of $43.8 billion in 1981. When low real (inflation-adjusted) interest rates made credit cheap, inflation boosted the value of farm assets, and commodity prices remained relatively high, farmers became optimistic and borrowed to expand and produce for an apparently insatiable market. Consequently, total farm debt increased from $53 billion in 1970 to $202 billion in 1981.

The 1980s brought a reversal of these favorable conditions. On the international level, the U.S. embargoed grain sales to Russia, foreign economic growth waned, and debt problems restricted other nations' abilities to buy U.S. food products. At the same time, the dollar strengthened, making U.S. agricultural products relatively more costly and encouraging foreign countries to expand production.

Foreign competitors could price their export commodities just below the U.S. support price "umbrella" and expand their share as a supplier in world agriculture markets. As a result, U.S. exports declined from the 1981 peak of $43.8 billion to $26.1 billion in 1986. Domestically, real interest rates rose to unprecedented highs, inflation slowed, real commodity prices moved lower, and farm real estate values declined 38 percent nationally from their 1981 peak of $844 billion to $523 billion in December 1987. In some midwestern states, average land values declined over 50 percent between 1982 and 1987.

Declining real estate values decreased the amount of collateral available to pledge as security for additional borrowings, and more farmers turned to the lender of last resort—FmHA. The agency's mission of providing and servicing financially sound loans to high-risk borrowers became more difficult as demand for assistance increased and repayment ability decreased. FmHA's outstanding farm loan portfolio increased from $5.1 billion in 1976 to $26.2 billion in 1987.

Loan Approval Process

Obtaining an FmHA loan involves a two-step process. The first is an eligibility determination; and the second, a loan approval decision based on repayment ability, or "cash flow," and adequate security. In determining eligibility, farmers must first file an application with a local FmHA county office where it is reviewed for completeness. Eligibility for FmHA farm loan programs is contingent on several basic qualifying factors, such as having sufficient farming experience or training, and being unable to obtain sufficient credit elsewhere at reasonable rates and terms. County committees, which consist of three local residents, at least two of whom are farmers of whom only one can be an FmHA borrower, review the application and determine eligibility.

Once determined eligible, farmers must submit a Farm and Home Plan that is used in making loan approval decisions. The Farm and Home Plan contains financial information on the farmers' assets and liabilities and details how borrowers plan to pay expenses including scheduled loan payments. Local FmHA county supervisors review the plans. If a plan shows that income equals or exceeds expenses, including all debt payments, it meets the "cash flow" requirement for loan approval. Borrowers should also have adequate loan security and pledge this security in case of loan default. Loans are approved contingent on the availability of loan funds.

In response to a deteriorating agricultural economy in the early 1980s, FmHA modified its cash flow requirement in February 1982 by instituting a "continuation policy" that liberalized the cash flow requirement for existing borrowers. The continuation policy allowed existing borrowers to obtain additional (new) operating financing without showing the ability to repay all existing debts. Borrowers had only to show repayment ability for new loans. The purposes of this policy were to continue lending money to financially stressed borrowers until economic conditions improved and to slow the number of cases requiring liquidation. FmHA made many unsound loans under the policy and rescinded it in November 1985 because of the deteriorating financial condition of its loan portfolio.

In January 1987 FmHA proposed regulations[2] that would further improve the portfolio's condition by substantially changing its criteria for eligibility and loan approval. These proposed regulations would require calculating financial ratios from farmers' loan applications to determine an eligibility-risk index in addition to revising loan approval criteria. This eligibility-risk index would be used to identify and screen out those applicants who had little chance of financial success before requiring them to submit a detailed Farm and Home Plan. Under the proposed regulations, borrowers who met the eligibility criteria would then submit a

[2]52 Fed. Reg. 1706.

Farm and Home Plan, and additional financial ratios would be calculated to assign a loan-risk index that would determine the financial viability of the planned operation. The loan-risk index and the cash flow requirement would be used in making loan approval decisions.

The proposed regulations generated much concern in the Congress. Specifically, the 30-day period provided to comment before the proposed regulations were finalized was considered insufficient by members of the Congress and the public. They felt the proposed regulations constituted a major change in FmHA operations and were particularly concerned that FmHA had not published a study of the impact of the proposal on borrowers. As a result, FmHA extended the comment period another 30 days. Subsequently, in a March 1987 hearing before the Senate Committee on Agriculture, Nutrition, and Forestry, GAO and others testified that the proposed additional loan-making criteria were more stringent and would exclude many existing and potential borrowers from participation in FmHA farm loan programs. At that hearing, FmHA estimated that of its existing borrowers who could demonstrate a positive cash flow, 18 percent would not be eligible for further financial assistance under the proposed regulations. These borrowers would have been approved for FmHA financing under the existing eligibility and cash flow criteria. (When estimating the percentage of borrowers not eligible for further assistance under the proposed regulations, FmHA did not include an additional 28 percent of its borrowers who could not demonstrate a positive cash flow. These borrowers were excluded because they were not eligible for further assistance even under FmHA's existing cash flow requirement.)

After the March hearing, FmHA proposed to modify some of the ratios and values assigned to the ratios. These modifications would have loosened the criteria and allowed more borrowers to qualify. FmHA also agreed not to use the applicant screening eligibility-risk index for existing borrowers. However, congressional concern about the potential adverse impact of the proposed regulations remained. As a result, FmHA abandoned further work on measuring an applicant's financial viability and withdrew the proposal in the fall of 1987. In addition, the Congress, in making supplemental appropriations for fiscal year 1987 (P.L. 100-71, July 11, 1987), directed FmHA to reinstate the continuation policy (discussed in the next section of this report), which again liberalized the cash flow requirement for existing borrowers.

Extensive Credit Assistance Provided by FmHA

FmHA provides extensive credit assistance to farmers when they initially obtain loans and afterwards as FmHA borrowers. Initially, farmers receive loans from FmHA because they are unable to obtain credit elsewhere. These loans generally have lower than commercial interest rates and generous repayment periods. Once borrowers obtain loans, further assistance may be provided through loan servicing, which is intended to facilitate loan repayment. Additional credit may also be provided from FmHA or other credit sources with FmHA assistance. The servicing and favorable loan terms give FmHA borrowers a financial advantage over borrowers who must use commercial credit.

Interest rates on FmHA loans are generally less than commercial rates, which results in reduced interest expense for borrowers. The Secretary of Agriculture sets FmHA loan rates but at a level not to exceed the cost-of-money to the government plus 1 percent. Farmers who cannot make scheduled payments under these rates can receive lower, limited resource rates on FmHA loans, which bear interest at a rate of 3 percent below the cost-of-money to the government. During fiscal year 1986, FmHA made approximately 73 percent of all operating loans at the limited resource rate, and it estimated that this rate was 5 to 7 percent lower than commercial rates during the fiscal year.

The repayment periods for FmHA loans are also quite generous. Ordinarily, loans for annual operating and family living expenses are scheduled for repayment within 1 year with an initial maximum term of 7 years. However, if borrowers cannot make this payment, the repayment period is usually extended through servicing. The terms of operating loans can be extended indefinitely through servicing actions. The repayment terms for farm ownership loans are fixed at 40 years while those for emergency loans vary from 7 to 40 years depending on several factors, such as use of loan funds and available collateral.

After making loans FmHA uses extensive loan-servicing techniques to keep borrowers current on their loans. These loan-servicing techniques may involve changing interest rates and repayment periods or several other actions to give borrowers additional opportunities to repay their loans. After the agricultural economy began declining in 1981, FmHA emphasized to its program officials the importance of assisting and "staying with" borrowers. It stressed the use of loan-servicing techniques. In 1982 the Secretary of Agriculture instructed FmHA loan officials ". . . to make every effort to assist farmers in dealing with current farm credit conditions. . . ." The FmHA Administrator also stated in 1982, "We emphasize that FmHA at all levels will make every effort feasible to assist financially pressed borrowers to overcome their difficulties."

In carrying out these directives from October 1, 1981, through September 30, 1987, FmHA facilitated repayment by rescheduling, reamortizing, or consolidating loans for approximately 268,600 borrowers. These techniques typically involve lengthening the repayment period or reducing interest rates in order to lower borrowers' scheduled payments. During this period FmHA also deferred principal and interest on loans for about 18,000 borrowers. In fiscal year 1987 alone, FmHA rescheduled, consolidated, or reamortized loans for approximately 32,000 borrowers and deferred principal or interest for 1,250 borrowers. In a March 1987 hearing before the Senate Committee on Agriculture, Nutrition, and Forestry, FmHA testified that in fiscal year 1986 it had been able to keep 98 percent of its farm borrowers in business because of loan-servicing actions.

In addition to the above servicing techniques, the President ordered FmHA in September 1984 to initiate a debt set-aside program to further assist borrowers. This program was available to borrowers through September 30, 1985, and assisted borrowers whose income would not cover expenses and debt repayment. Under this program, repayment of a portion of existing FmHA loans could be postponed for 5 years without interest. FmHA could set aside up to 25 percent of the borrowers' total unpaid principal and interest not exceeding $200,000. In total, about 15,700 borrowers participated in this program with total principal and interest of over $676 million being set aside.

FmHA also assists borrowers in obtaining additional credit from commercial sources by subordinating its loan security or lien position to commercial lenders. Subordination is encouraged by FmHA because of limited direct loan funds, and in fiscal year 1987 FmHA subordinated its lien position on about 29,500 borrowers' loans. While subordination assists borrowers in obtaining additional credit, it may leave FmHA in a position of having a minor security interest and/or valueless lien. As indicated in a previous GAO report,[3] the subordination of liens may lead to losses when borrowers liquidate their farming operations and security values are inadequate to cover FmHA's subordinated lien position.

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

To further assist FmHA borrowers, the Food Security Act of 1985 (P.L. 99-198, Dec. 23, 1985) contained two special servicing options for FmHA direct loan borrowers. The first option allows the Secretary of Agriculture to purchase conservation easements from FmHA borrowers. These easements would restrict use of the borrowers' land to conservation, recreation, or wildlife purposes, and the Secretary would compensate borrowers by canceling part of their outstanding FmHA debt. The second servicing option provides for deferring and reamortizing distressed farm loans with the use of future revenue produced from softwood timber planted on marginal land. Payments on loans reamortized under this program may be deferred for up to 45 years. However, to qualify, borrowers must be able to show repayment ability after the deferral period during which interest on the loan continues to accrue.

The Food Security Act of 1985 also contained two provisions designed to assist qualified FmHA borrowers whose loan accounts have been liquidated through foreclosure, voluntary conveyance, or bankruptcy. The first provision was for homestead protection, which allows borrowers who are liquidating their operation to retain and occupy their homestead. The second provision allows the previous owners of FmHA-acquired farm property special consideration for leasing with or without an option to purchase the property. As of December 31, 1987, participation in these programs has been limited, assisting a total of about 430 borrowers. On February 23, 1988, the Chairman, Subcommittee on Conservation, Credit, and Rural Development, House Committee on Agriculture, requested that GAO determine the reasons for the low utilization of these provisions.

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) further modified FmHA loan-servicing options by directing FmHA to give priority consideration to reducing loan principal and interest of delinquent borrowers' debt when all other servicing options are not sufficient to allow the borrower to show a positive cash flow and meet loan payments. The act directs FmHA to reduce, or write down, borrower debt to a level at which a feasible Farm and Home Plan can be developed but only if the restructured loan(s) would be worth more to the government than the value recovered through liquidation of the borrower's collateral. (Recovery value is the current appraised value of the loan collateral minus administrative, legal, and other expenses associated with liquidating the loan and disposing of the collateral). FmHA has estimated that approximately 81,000 of its farm borrowers will be eligible for the loan write-down, with about $8.7 billion of debt eventually being written off as a loss. On September 14, 1988, FmHA published in the Federal Register an interim rule, with a 60-day comment period, to implement the act's provisions.

When a borrower's debts cannot be restructured and liquidation becomes imminent, the borrower still has a number of opportunities to continue farming. For example, the 1987 act provides such a borrower with the right to purchase the collateral securing the FmHA debt at net recovery value. In addition, with the reinstatement of the continuation policy, FmHA must try to keep the farmer in business by extending the borrower an annual production loan provided the borrower can demonstrate repayment ability on only the new loan, plus interest. No repayment ability needs to be shown on all other debt. When a borrower is unable to make payments on a continuation loan, then and only then, can FmHA require immediate full payment of the outstanding loan (acceleration) and, if not made, acquire the borrower's loan collateral by foreclosure. However, as stated earlier, if FmHA obtains the farm, the borrower has the opportunity to reacquire the property and continue farming under the leaseback/buyback program or through the homestead retention program for the home and 10 acres.

FmHA loan-servicing actions have generated numerous legal challenges and controversy. For example, in November 1985, FmHA issued new servicing regulations to provide consistency in servicing borrowers' loans in response to borrowers' legal challenges of existing FmHA loan-servicing actions. Implementation of the new servicing regulations began in February 1986, with delinquent borrowers being sent notices requesting them to select loan-servicing options or face adverse actions, including foreclosure. The revised regulations were again challenged in federal district court in May 1987. As a result, in June 1987, FmHA was ordered by the court to suspend sending servicing notices and stop adverse actions against its borrowers. On November 15, 1987, FmHA appealed the court order after the court ruled FmHA's revision of the intent-to-take-adverse-action letter was inadequate. However, the Agricultural Credit Act of 1987 addresses several of the issues contained in the appeal. The act prohibits FmHA from initiating any acceleration, foreclosure, or liquidation action on any farm program loan before the date the Secretary issues final regulations to carry out the debt restructuring and loan-servicing options of the new law. This provision will likely result in the court-ordered moratorium remaining in effect until new notification forms are published, commented upon, and finalized in the Federal Register. With the publication of an interim rule to implement the act's provisions in September 1988, the court permitted FmHA to send revised loan-servicing notices to delinquent borrowers in November 1988. However, the court-ordered moratorium on adverse actions against borrowers was still in effect as of December 1, 1988.

Objectives, Scope, and Methodology

In an October 24, 1986, letter, Senator Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at that time, requested that we review FmHA's loan-making policies and practices to determine if they result in financially sound loans. He also requested recommendations that would improve FmHA's ability to provide assistance that will protect both the farmers' and taxpayers' interests. In responding to the Chairman's request, we focused our work on answering the following questions:

- How adequate is the criteria FmHA uses to make and service loans?
- How are borrowers' equity positions affected by FmHA loan- making policies?
- Is security for FmHA loans adequate?
- What impact would the loan-making criteria proposed by FmHA in January 1987 have on borrowers?

Sample Selection, Data Gathering, and Analysis

To answer these questions, we developed a standard data collection instrument (DCI) to record selected information from borrowers' loan files. To gather information for the first question on loan making and servicing, we recorded data on borrowers' 1986 loans, financial planning information submitted to justify loans, actual financial information, and servicing actions that changed loan terms. To answer the question on loan security positions, we recorded data on the borrowers' secured debt for 1986 and compared it with asset values pledged as loan security. For the third question we identified changes in borrowers' equity positions by recording historical data on total debts and assets.

In determining the impact of FmHA's proposed loan-making criteria, we calculated for a sample of borrowers the eligibility and loan-risk values as defined in the January 1987 proposed regulations. We also separately calculated the revised loan-risk indexes as set forth by FmHA after a congressional hearing in March 1987. We did not assess the quality of the indexes but rather computed the values using borrowers' available financial information. After computing the eligibility and loan-risk indexes, we asked the cognizant FmHA county supervisors to comment on the appropriateness of the values based on their knowledge of the borrowers' financial position. We also asked them if they expected any borrowers to liquidate their operation by the end of 1988 for the purpose of determining whether FmHA's current loan-making criteria resulted in new loans being made to farmers whom the county supervisors expected to go out of business in the near future.

After developing and testing the DCI, we devised a methodology to select a sample of FmHA borrowers on which to apply it. Our strategy was to gather information in high loan volume geographical areas, which involved selecting counties in four states—Iowa, Louisiana, Texas, and Wisconsin. We selected these states because they had the greatest number of borrowers receiving 1986 farm loans as identified on the January 1987 FmHA Status Report of Farmer Program Accounts (FmHA report code 540). For each state we then identified the four counties with the greatest number of borrowers receiving 1986 loans. We randomly selected 10 borrowers for review in each county for a total of 160 borrowers who received 414 new loans in 1986 amounting to $16.9 million. Nationwide, 63,935 borrowers received 134,824 new loans in 1986 totaling $6.3 billion. These new loans included loan-servicing actions that changed the terms of existing loans but that did not provide borrowers with additional loan money. FmHA does not have information on the number of new loans that are strictly servicing actions.

After recording the information on the DCIs, the data were transcribed into an automated data base, summarized, and analyzed. Because our sample was limited, the results are not projectable beyond the 160 selected borrowers. To obtain more recent loan information for the selected borrowers, we updated the 1986 loan information using the June 30, 1987, FmHA Status Report of Farmer Program Accounts.

We made two other analyses to respond to the former Chairman's request. The first analysis was done to further document FmHA loan security positions by comparing updated USDA county average property values with loan file security property values for the selected borrowers. We performed this analysis to determine the appropriateness of property values contained in borrowers' files.

We made a second analysis to illustrate the cost advantage FmHA borrowers receive from reduced loan interest rates and to determine the interest rate subsidy cost borne by the government when providing these rates. To illustrate the cost advantage, we calculated—on a present value basis—the difference between interest to be paid by borrowers in our sample who got new additional money in their 1986 loans (150 of the 414 total sampled loans) and the interest that would be paid on the loans when using an interest rate of 10.4 percent. The 10.4-percent interest rate approximated the average 1986 rate for commercially graded BAA bonds, which FmHA officials agreed was a reasonable commercial rate for high risk agricultural loans. The loans used in this second analysis had additional loan funds disbursed and did not include loans that were servicing actions to refinance existing FmHA debt. To illustrate the interest cost borne by the government, we assumed all payments would be made on time and then calculated the present value of interest income the government would receive from the loans and the interest expense the government would pay when it borrowed funds to provide the loans. The difference between these two present value interest amounts was considered to be the interest rate subsidy cost to the government. For calculating the government's borrowing cost, we used an average interest rate of 7.7 percent on intermediate-term Treasury securities, which approximated the average term for FmHA loans.

Our work also included reviewing FmHA regulations, announcements, congressional testimony, articles, studies, and other documents relating to loan making. We also reviewed all of the Secretary of Agriculture's annual statements and reports as required by the Federal Managers' Financial Integrity Act of 1982 to identify internal control weaknesses and actions taken or planned to resolve them. We obtained information on FmHA's loan-making activities by interviewing agency officials at USDA headquarters and at the state and county levels. We coordinated our work with USDA's Office of Inspector General (OIG) and reviewed its reports on loan-making activities. We also reviewed a report on FmHA's loan-making procedures prepared for USDA by a private accounting firm. We conducted our review from December 1986 through April 1988 in accordance with generally accepted governmental auditing standards.

At the request of the Senate Committee on Agriculture, Nutrition, and Forestry, on March 11, 1987, we testified on the financial condition of FmHA's farm loan portfolio as of June 30, 1986, and the potential impact on borrower eligibility of FmHA's proposed revisions to its loan-making criteria.[4]

[4] The Status of the Farmers Home Administration's Farm Loan Portfolio and Farm Loan-Making Criteria and Policies (GAO/T-RCED-87-6, Mar. 11, 1987).

Chapter 2 of this report discusses the adequacy of both FmHA's loan-making activities and loan security, as well as how borrower equity has been affected by FmHA loan-making policies. Chapter 3 discusses the impact of the proposed criteria on FmHA borrowers, and chapter 4 provides our views and observations on issues the Congress may wish to consider in addressing FmHA loan-making policies.

We obtained written USDA comments on the results of our work, which are contained in appendix IV.

Cash Flow Analysis Used by FmHA Is Inadequate for Determining Loan Repayment Ability

A cash flow analysis, when properly used, can be a reliable method for determining a borrower's ability to repay a loan. However, the cash flow analysis as used by FmHA is not reliable because it tends to overstate the borrowers' repayment ability. Because repayment ability is overstated, FmHA makes loans to borrowers who are often unable to repay as scheduled. When this occurs, FmHA attempts to make repayment easier by changing loan terms through loan servicing. However, frequent loan servicing and additional loans based on optimistic repayment ability often lead to extensive borrower indebtedness, and when combined with declining land values and lower commodity prices, borrowers' net worth decreases. As assets lose their value and debts increase, the government's security position is jeopardized.

FmHA has, in the past, recognized the problem of overstated borrower repayment ability, and as recently as December 1987, directed its lending officials to use more realistic estimates of farm income and expenses in determining repayment ability. However, this directive, even if properly implemented, will still not ensure that borrowers can repay their debt because it does not include unexpected expenses or replacement of equipment in the cash flow analysis.

FmHA Cash Flow Analysis Overstates Repayment Ability

The cash flow analysis used by FmHA is not a good indicator of a borrower's repayment ability. Specifically, the cash flow analysis

- tends to be optimistic in its projection of farm income and expenses,
- does not uniformly use past operating data to evaluate performance, and
- does not provide for contingencies or replacement of equipment.

In addition, FmHA combines both business and personal financial information—specifically farm and nonfarm income—when analyzing a borrower's ability to show a positive cash flow. Although this does not directly affect repayment ability, it does mask the actual profitability of the farming operation.

Cash Flow Positions Are Overstated by Optimistic Financial Information

According to FmHA regulations (7 C.F.R. 1924), borrowers' should project income and expenses when preparing their Farm and Home Plans on the basis of proven records of production and financial management. FmHA has further stressed this requirement in various annual announcements to its state offices. Therefore, the information should be realistic and reflect the actual overall financial condition of the farm operation.

Borrowers' projections, however, are often optimistic to show a favorable cash balance and a positive cash flow for loan approval. Our analysis of the 100 borrowers in our sample whose Farm and Home Plans included both planned and actual financial data for 1986 revealed the following:

- Planned repayment ability was overstated by an average of about $13,700, or 24 percent, for these 100 borrowers. The average planned balance available to pay principal and interest was about $71,300. However, the average actual balance available was about $57,600. Overall, 70 of the 100 borrowers overstated their repayment ability when compared to the actual amounts.
- Borrower estimates of total cash farm income[1] were overstated on the average by more than $15,000, or 18 percent. The average planned income for these borrowers was $101,600, but the actual income averaged $86,400. Overstated income occurred in 65 of the 100 cases.
- Borrowers underestimated their family living expenses, on the average, by about 10 percent. The average planned amount for these expenses was $11,400, but the actual expenses averaged $12,600. Understated family living expenses occurred in 51 of the 100 cases.

The importance of complete and accurate financial information for determining repayment ability is further illustrated in USDA-OIG audit reports. The OIG found a number of instances where borrowers' cash flow positions were incorrectly determined because certain data required by the Farm and Home Plan were not recorded or were inaccurately recorded. For example, borrowers overlooked social security taxes, overstated government crop payments, and misstated crop income. Because of these types of omissions or errors, farm incomes were overstated, favorable cash flow positions calculated, and loans approved. In three audit reports covering 88 loans, the OIG reported that 43, or 49 percent, of these loans had negative cash flows based on the audited figures, which would have precluded loan approval.

Our analysis and that of the OIG confirm the observations made by FmHA in a July 1986 report on loan classification. FmHA reviewed the files of more than 4,000 borrowers as part of a pilot project for the purposes of classifying loan accounts and assessing the quality of credit administration. From its assessment of credit administration, FmHA found that borrowers frequently do not provide complete or accurate information on

[1]Total cash farm income includes cash receipts from the sale of all farm products, government payments, and farm-related income

the loan application or the Farm and Home Plan. The report stated that many of the projections of production, income, and expenses were unrealistic and that wide discrepancies between the projections and actual outcomes were chronic. Concerning the credit information obtained from the borrowers, FmHA reviewers commented that the Farm and Home Plans were, as a whole, very optimistic.

Recognizing that the Farm and Home Plans contain optimistic projections, FmHA issued announcements (FmHA AN 1492 [1924] and FmHA AN 1686 [1924]) to state directors on October 30, 1986, and December 4, 1987, respectively. Both announcements stressed the importance of developing sound, realistic farm operating budgets to support loan-making and/or servicing actions. The December 4, 1987, announcement directed the state offices to establish annual commodity price lists for use by county office personnel in reviewing a loan applicant's projected income. It also required the use of actual production and financial records whenever they are available. Any benefits from government price-support programs must also be considered when developing the plans. In addition, the announcement instructed approving officials to review the plans for accuracy and proper documentation and required state directors to ensure an annual post review of at least 5 percent of all loans approved in each county office.

FmHA's Deputy Assistant Administrator for Farmer Programs stated some county supervisors continue to use optimistic data in Farm and Home Plans because they want to give the borrower every benefit possible in order to qualify them for new loans and keep them in business. According to the Deputy Assistant Administrator, such supervisors do not understand that they are not really helping borrowers when they provide them with a loan that cannot be repaid. The Deputy Assistant Administrator stated that this lack of understanding occurs primarily because the county supervisors have not been adequately trained in credit analysis.

Actual Operating Data Are Not Being Recorded or Used

One of the purposes of the Farm and Home Plan is to compare planned performance to actual performance. These analyses are made to develop information for sound lending and supervisory decisions and to assist borrowers in using sound business and management practices. FmHA regulations (7 C.F.R. 1924.61) direct county supervisors to assist borrowers in completing the actual financial data on the Farm and Home Plans. However, our review of files for 160 sampled borrowers disclosed that actual data had not always been provided or included on the plans. For the 1985 plans, actual data were missing in 66, or 41 percent, of the borrowers' files. Actual data for 1986 were missing in 60, or 38 percent, of the files. Without this type of information, FmHA county supervisors cannot fully assist or counsel borrowers, nor can the borrowers' performance be evaluated.

The results of our file analysis parallel those contained in the July 1986 FmHA report on loan classification referred to above. FmHA reviewers reported that within the area of credit administration, failure to conduct prescribed year-end analyses of the borrowers' farm operations was the most prevalent deficiency, and only a small proportion of borrowers had actual income, expense, and debt repayment data in their loan files.

FmHA has attempted to emphasize the need for completing year-end analyses through the issuance of administrative notices and the performance of internal compliance reviews. FmHA's Assistant Administrator for Farmer Programs stated that county supervisors nevertheless often do not record actual performance data at the end of the year because of other more pressing duties and inadequate credit analysis training, which has resulted in a general lack of understanding of the importance of such data. The Assistant Administrator stated that many FmHA loan officials overlook the regulations and have forgotten what is required of the county supervisor under the concept of supervised credit.

FmHA's Cash Flow Analysis Does Not Provide for Contingencies or Replacement of Equipment

The cash flow analysis used by FmHA does not provide reserves for unforeseen expenditures or equipment replacement. If unforeseen expenses do materialize, borrowers may not have sufficient income to pay them. In contrast, other lenders, such as the Farm Credit System (a federally chartered and regulated private network of lending institutions that make agricultural loans), require that incomes exceed expenses by a specified percentage—such as 10 percent—to cover unforeseen expenses. The Farm and Home Plan also does not factor in an amount for future machinery or equipment replacement. By not reserving or setting aside income to cover replacement costs, cash reserves are not accumulated and expenses are understated.

If equipment replacement were considered, many of our sampled borrowers would not have had adequate income to cover expenses. For the 160 borrowers in our sample, the average cash flow amount (the amount by which income exceeded expenses) was about $3,600. This figure represents less than 5 percent of the average farm operating expenses for these borrowers. Using a 7-year replacement schedule, which is a standard period of time over which to depreciate farm machinery according to the Deputy Director of FmHA's Loan Making Division, we determined that 122 of the 160 borrowers would have been placed in a negative cash flow situation had machinery replacement been considered. The average amount of this negative cash flow was almost $9,000.

FmHA's Debt Set-Aside Program, discussed in chapter 1, did require borrowers to have a 10-percent margin in their cash flow projection to be eligible for program participation. However, this requirement did not apply to any other farm loan program. FmHA's Assistant Administrator for Farmer Programs stated that the agency has, in the past, attempted to recognize the need to allow for contingencies in farm operating budgets. For example, in January 1987, FmHA's proposed revision of its loan-making criteria intended for borrowers to have a cash flow margin of 15 percent or greater to avoid penalty points in determining loan eligibility. This requirement would have applied to all borrowers requesting any farm program loan. However, as discussed in chapter 3, FmHA withdrew these proposed regulations. Again, in May 1988, FmHA provided for a 5-percent contingency margin in its proposed implementing regulations for the Agricultural Credit Act of 1987. This was also withdrawn because of adverse public comments.

Cash Flow Analysis Includes Income Not Related to the Farming Operation

The Farm and Home Plan combines both business and personal financial information, specifically farm and nonfarm income, to determine repayment ability. This practice raises a question about the actual profitability of the farming operation. In a March 1986 report on its study of the Farm and Home Plan for FmHA, a private accounting firm stated that it was inappropriate to combine business and personal financial data in one statement. The report pointed out that in reviewing operations and making loan assessments and approvals, the information should be presented separately. The reasons given for this separation were to

- determine how much financing the business requires and whether it can be repaid from business operations,
- determine if the business can support itself and become a profitable venture,
- determine if the business has adequate financial resources to operate, and
- protect the owner's investment under adverse conditions.

Of the borrowers in our sample, we found that 106 showed planned nonfarm income averaging about $11,500. If nonfarm income were not included as part of the cash flow analysis, 6 of the 106 borrowers would not have been able to show a positive cash flow. Therefore, some borrowers in our sample relied on income earned off the farm to repay their loans and meet other expenses, because the actual farming operation did not generate sufficient income to cover all costs.

According to FmHA's Assistant Administrator for Farmer Programs, to qualify for FmHA financing, new applicants should have a very high percentage of their income derived from the farm operation. This is a judgmental determination made by the county committee, and no specific guidance exists on what percent is enough. The Assistant Administrator stated that the intent of this restriction is to avoid FmHA financing of hobby farmers. Only FmHA's economic emergency loan program, which expired in September 1984, required that a set percentage (75 percent) of a borrower's income be from farming. FmHA attempted to have nonfarm income restrictions placed on all applicants for farm program loans under the January 1987 proposed revision of its loan-making criteria. However, as stated earlier and discussed in chapter 3, FmHA withdrew this proposal.

Inadequate Repayment Ability Results in Frequent Loan Servicing

Because overly optimistic financial data can result in overstated cash flow positions, many borrowers cannot make scheduled loan payments and thus become delinquent. When this occurs, or when FmHA recognizes borrowers will be unable to make payments, it can use loan-servicing options to make accounts current. These options, which include the consolidation, rescheduling, and reamortization of loans, typically involve reducing interest rates and/or extending loan repayment periods. While servicing may bring borrowers' loans current on scheduled payments, extensive and repetitive loan servicing is often not a long-term solution to the borrowers' repayment problems. Extensive loan servicing has negative consequences that affect both borrowers and the government. These include

- increasing the borrower's total debt,
- turning the borrower's short-term debt into long-term debt,
- increasing government costs by providing, among other things, loans at interest rates below the government's borrowing cost,
- eroding borrowers' equity, and
- jeopardizing the government's security position.

Loans Are Frequently Serviced

FmHA frequently services loans, primarily by consolidating, rescheduling, or reamortizing. These techniques involve (1) making a new loan that combines two or more loans into one, (2) stretching out the repayment period, (3) reducing the interest rate, or (4) using any combination of these actions. To decide if servicing will help borrowers, FmHA uses its cash flow analysis to determine if borrowers can repay the serviced loan. Therefore, the weaknesses of the cash flow analysis apply equally to serviced loans, which comprise a large portion of the loans made.

The frequency with which FmHA provides loan servicing was evident from the files we reviewed. In our sample, FmHA made a total of 414 loans to the 160 borrowers during 1986. Of this number, 264 loans, or about 64 percent, were actually servicing actions on loans originally made prior to 1986. However, when examining these 264 prior loans, we found that 205 of them had already been serviced at least once before 1986. Therefore, the 264 prior loans involved a total of 469 servicing actions—264 actions in 1986 and 205 actions before 1986 (each servicing action resulted in a new loan). In some cases the loans serviced in 1986 had been previously serviced numerous times. For example, one loan had gone through nine servicing actions over a period of about 4.5 years. The average time between servicing for the 469 loans was 2.8 years, and these servicing actions lengthened the final scheduled payment date an average of 8 years. The following cases illustrate the extent of FmHA servicing actions on prior loans for two borrowers in our sample.

Case Study A

In June 1982 FmHA made an $89,300 loan to a Louisiana farmer to pay operating and family living expenses and to purchase machinery and equipment. The interest rate was set at 14.25 percent, and the final scheduled payment date was 1989. Less than a year later, in February 1983, the unpaid principal and interest amounting to $62,021 was rescheduled. At this time the interest rate was reduced to 10.25 percent and the final payment date extended to 1990. In January 1985 the balance of the unpaid principal and interest was $60,158, and the loan was again rescheduled to provide a lower interest rate of 7.25 percent and to increase the repayment period to 15 years, or the year 2000. A third rescheduling took place in May 1986. By this time the unpaid principal and interest had risen to about $66,000. FmHA further reduced the interest rate to 5.625 percent and extended the repayment period by an additional year. Overall, the initial 1982 loan was rescheduled three times, reducing the interest rate from 14.25 percent to 5.625 percent and extending the scheduled repayment date originally set for 1989 to 2001.

Case Study B

An Iowa farmer borrowed $75,000 from FmHA in January 1979 for farm operating expenses and livestock, machinery, and equipment purchases. The loan carried an 8.5-percent interest rate and was to be fully repaid in 1986. In August 1984 the unpaid principal and interest outstanding was $65,173, and FmHA rescheduled the loan, lowering the interest rate to 7.25 percent and extending the repayment period to 1991. Then, in August 1986, the loan was consolidated with another farm operating loan initially made in 1984 and rescheduled in 1985. Together the unpaid principal and interest amounts for these two loans totaled $76,886 at the time of consolidation. As part of the consolidation, FmHA again reduced the interest rate, to 5 percent, and extended the final scheduled payment date to 2001. In all, this loan was rescheduled once and consolidated once. which together extended the repayment period by 15 years and reduced the interest rate from 8.5 percent to 5 percent.

The frequency of loan servicing is further illustrated by the servicing actions subsequently performed on 1986 loans for borrowers in our sample. By June 30, 1987, 102 loans, or 25 percent of the 414 loans made in 1986, had been serviced again—rescheduled, reamortized, or consolidated.

The regularity with which FmHA performs servicing actions and the short length of time between them indicate the precarious financial condition of many borrowers and the optimism of the cash flow projections. Many borrowers are current on their loans not by making scheduled payments, but through servicing actions.

Loan Servicing Increases Outstanding Principal and Creates Long-term Debt

When FmHA services loans, the outstanding principal amount can increase and the repayment schedule can be lengthened. Principal amounts can increase because FmHA adds (capitalizes) the unpaid interest associated with the loan to the outstanding principal amount. In effect, borrowers receive additional loans to pay the unpaid interest. FmHA then charges interest on the new principal amount. Another effect of loan servicing is that rescheduling the repayment over a longer period of time converts short-term debt for operating purposes to long-term debt.

Unpaid interest can add significant amounts to outstanding principal. The amount of unpaid capitalized interest increased on all of the 469 loans in our sample that were involved in servicing actions and totaled more than $1.5 million. When originally made these loans had a total principal amount of $18.7 million. At the time of servicing the principal had been paid down by 29 percent—to $13.2 million. However, with the capitalized interest of more than $1.5 million, the total new loan principal was almost $14.7 million.

Beside capitalizing interest, servicing actions can convert short-term operating loans that should be repaid from income generated during the annual production cycle into long-term debt. Servicing or rescheduling of annual operating debt indicates that borrowers are unable to repay their loans from current production income. When operating loans are rescheduled, unpaid loan amounts are carried over into subsequent years, with the expectation that future income will cover both past due amounts and any additional operating loans.

Loan amounts for operating or family living expenses are often rescheduled to ease repayment. Of the 469 loans in our sample that involved servicing actions, 198 included funds for current operating or family living expenses. These 198 loans had principal amounts totaling almost $10.4 million. About $7.7 million of the total amount was designated for current farm operating or family living expenses, and the rest for other purposes such as machinery purchases. More than half—$5.5 million—of the $10.4 million total principal was rescheduled. About $3.2 million of the $5.5 million rescheduled was for operating or family living expenses.

The following case example illustrates the capitalization of interest and conversion of short-term operating debt to long-term debt.

Case Study C

In February 1984 a Texas farmer borrowed $61,000 from FmHA to pay farm operating and family living expenses. The loan, with an interest rate of 12.5 percent, was to be repaid the following year. Had the farmer repaid the loan as scheduled, the interest on the principal would have amounted to $7,625. However, the loan went through three servicing actions from 1985 through 1987 and unpaid interest of $15,830 was capitalized into principal. In effect, the borrower received a $15,830 loan to pay interest. The final scheduled payment date was ultimately extended 17 years. Table 2.1 details the servicing actions and their effects on the final payment dates, interest, and outstanding principal.

Table 2.1: Effects of Servicing Actions on Final Payment Date, Interest, and Outstanding Principal for Case Study C

Date	Interest rate	Final payment	Rescheduled amounts: Principal	Rescheduled amounts: Capitalized interest	Outstanding principal
02/22/84	12.5	1985	[a]	[a]	$61,000.00
10/01/85	12.5	2000	$54,324.28	$3,749.72	58,074.00
04/11/86	12.0	2001	58,074.00	3,818.57	61,892.57
05/22/87	11.0	2002	61,892.57	8,261.39	70,153.96
Total				**$15,829.68**	

[a]First year of loan; no rescheduling required.

Source: FmHA borrower loan file

Lower Interest Rates Reduce Borrower Operating Expenses, but at a Cost to the Government

FmHA borrowers receive the benefit of lower interest rates through government financing of their loans rather than commercial financing. In addition, many of these borrowers also qualify for a lower "limited resource" rate when their operations cannot achieve a positive cash flow without this special subsidized interest rate. By receiving these lower rates, borrowers incur less expense than if their loans had been financed through other sources. However, the benefits accruing to the borrowers come at the expense of the government, which, in effect, subsidizes the cost of their borrowing. By obtaining lower government rate loans, FmHA borrowers also receive a financial advantage over commercial borrowers.

We prepared two analyses of the 1986 loans made to our sample of 160 borrowers. The first analysis compared the borrowers' interest expense on their FmHA loans with the interest expense they would have incurred had they qualified for a commercial loan. We assumed a commercial interest rate of 10.4 percent which, FmHA officials agreed, was comparable to the commercial interest rate in effect for agricultural loans made during 1986. The second analysis compared actual FmHA borrower interest expense with the government's interest cost of borrowing the loan funds from the Treasury. We assumed, and FmHA agreed, a 7.7-percent interest rate as the government's cost of borrowing, which represents the average rate paid on government intermediate-term securities during 1986. Both analyses used present value interest calculations and covered the 150 loans in our sample that had additional loan funds disbursed in 1986. We did not include loans serviced solely to refinance existing FmHA debt in either analysis, because these loans did not involve new loan funds and therefore did not require additional borrowing by the government.

The comparison of FmHA borrowers' interest expense with commercial rate interest showed that FmHA borrowers will pay about $4,300 less in interest on each loan. The average FmHA interest rate for all 150 loans was about 6.2 percent, and the average repayment period was 4.8 years. Our cost analysis showed that the government pays an interest subsidy of about $1,600 for each loan over a 4.8-year period—or a total subsidy of $240,000 for the 150 loans.

Loan Servicing Erodes Borrowers' Equity and Jeopardizes Security

As discussed earlier, loan servicing is intended to facilitate repayment but can add to the borrowers' debt load. The increased debt, in turn, reduces the borrowers' overall net worth, or equity position. At the same time, between 1980 and 1986, farm asset values declined dramatically, which, combined with increased borrower debt load, adversely affected the government's security position.

Net Worth Is Declining

Equity (net worth) of the farm operation measures the value of assets owned above the amount of debt associated with it. The financial data shown on the Farm and Home Plans revealed that net worth had declined for many borrowers in our sample. An analysis of 106 borrowers for whom Farm and Home Plan information was available for a 3-year period, 1984 through 1986, showed that their average net worth dropped from a positive position of about $84,100 to $31,500—more than 62 percent. This decline is due to a combination of events that decreased assets an average of about $24,700 per borrower, from $275,600 to $250,900, and increased debts an average of about $26,800, from $193,300 to $220,100.

For many, a major contributor to the decrease in asset values was the decrease in real estate values. Relevant information was available for 85 of the sampled borrowers that showed the value of their real estate dropped more than $29,000 on the average over the 3-year period—1984 through 1986—from $200,000 to $171,000. However, this decline may actually be even greater because the real estate values for FmHA borrowers in the counties we visited appeared to be significantly overstated.

For example, we compared USDA's data on the 1986 average farm real estate values for the counties included in our sample with the values recorded on the borrowers' Farm and Home Plans. Our analysis showed that of 87 borrowers owning 10 acres or more, real estate may have been overvalued in 74 instances, on the basis of the county averages.

The overvaluation ranged from as much as 73 percent for counties in Louisiana to 23 percent for counties in Texas. USDA's Economic Research Service, which studies farm real estate values, agreed that the methodology used in this analysis was reasonable.

The degree to which net worth and real estate have declined can be illustrated by a case example of one of our sample borrowers.

Case Study D

An Iowa farmer who has been an FmHA borrower since 1972 experienced a significant decline in net worth during the 1984-1986 period—69 percent. The value of the borrower's assets declined by 21 percent, and debt increased by 22 percent. Real estate value, which dropped by $64,000, accounted for more than half of the decline in total assets. Table 2.2, which contains data taken from the borrower's Farm and Home Plans, details the declining financial condition.

Table 2.2: Example of Declining Net Worth and Real Estate Value for Case Study D

Assets/debts	1984	1986	Difference	Percent change
Total assets	$485,978	$382,191	$(103,787)	−21
Total debts	252,901	308,788	55,887	+22
Net worth	233,077	73,403	(159,674)	−69
Real estate value	298,100	234,000	(64,100)	−22
Acres owned	300	300	0	0

Source: FmHA borrower loan file

Security Is Inadequate on Many Loans

The three factors discussed previously—declining asset values, increasing debt loads from loan servicing, and the resulting decrease in net worth—have led to situations where the value of borrowers' collateral is no longer equal to or greater than their outstanding loans. In addition, FmHA does not have specific security requirements when servicing an existing loan and allows outstanding principal to exceed available security. If these borrowers had their farming operations liquidated, FmHA would incur a loss.

FmHA regulations for new operating and farm ownership loans (7 C.F.R. 1941 and 1943 respectively) state that before a new loan can be approved, security must be adequate in the opinion of the loan approval official to ensure repayment of the loan if the borrower defaults. However, similar security requirements do not apply when FmHA services an existing loan. As a result, FmHA allows a borrower's outstanding principal to exceed loan security, and if such a borrower defaults on a loan, the collateral that secured the initial loan may no longer be adequate and FmHA will incur a loss. As a hypothetical example, FmHA reschedules a 1-year operating loan, secured by a borrower's crop, for repayment over 7 years. The borrower, with FmHA's permission, has sold the crop to pay various non-FmHA expenses. FmHA does not require the borrower to provide additional collateral to cover the extended loan repayment period. If the borrower is liquidated, FmHA will not have adequate security on the rescheduled loan and will incur a loss.

In its 1986 loan classification study referred to earlier, FmHA estimated the extent to which it would incur losses from those borrowers in the three loan classes having the greatest degree of risk. Together these 3 groups accounted for almost 23 percent of the more than 4,000 sampled borrowers and almost 40 percent of the $472 million total debt for all groups. FmHA estimated that the loss from the three high-risk groups would amount to $114.5 million. This equates to about 61 percent of the debt carried by the three groups.

Inadequate loan security was also revealed when we compared the total value of loan security with the total outstanding secured loan principal for our 160 sampled borrowers. The results of this analysis showed that the government would incur significant losses in the event of borrowers' liquidations. For security in the form of chattel property,[2] the total outstanding secured debt exceeded the security value for 95 of the borrowers. The average shortfall for borrowers in this group was about $67,000 and ranged from about $800 to more that $380,000. For loans secured by real estate, the security values were negative for 16 borrowers, averaging about $28,000 and ranging from $2,800 to $120,000.

According to the Deputy Director of FmHA's Loan Making Division, the agency attempted to improve its security position under the January 1987 proposed revision of its loan-making regulations. The proposed regulations would have required FmHA loan approval officials to obtain the best lien available on all of a borrower's assets before approving any farm program loan. This requirement could have been applied to serviced loans as well as new loans if the county supervisor felt the existing security was inadequate. However, as discussed in chapter 3, the proposed regulations were withdrawn by FmHA.

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

Conclusions

By using optimistic financial data, FmHA's cash flow analysis has frequently proved to be an unreliable tool for determining loan repayment ability. As a result, FmHA is on a loan-making and servicing treadmill. The cash flow analysis does not consider contingencies or equipment replacement and tends to overstate income, making it inadequate for determining repayment ability. The resulting loans often require servicing actions. The treadmill continues when the cash flow analysis is used in servicing actions, such as rescheduling, to determine repayment ability. Often borrowers cannot repay the initial loan or the subsequently serviced loan.

Sound loan decisions can be made using a cash flow analysis, but the financial data used must be complete and realistic. Actual financial performance data disclosed in year-end analyses and the development of realistic farm operating budgets could temper optimistic projections and improve FmHA's loan-making decisions. Frequently, however, FmHA does not obtain these data because responsible officials are not sufficiently aware of their importance.

Loan servicing provided by FmHA has helped borrowers in the short run by making loans current and resolving delinquencies. However, in the long run, FmHA loan servicing has increased many borrowers' long-term debt. In addition, this long-term debt may no longer be adequately secured because FmHA does not require additional security for serviced loans, even if the original security is no longer adequate, which can increase government losses.

Allowing for unexpected expenses and equipment replacement in FmHA's cash flow analysis would make some existing borrowers ineligible for further financial assistance, as would requiring adequate security on serviced loans. The actual impact on borrowers would depend on the stringency of the specific cash flow criteria imposed and the security position of each borrower, which we did not determine. However, in many of the cases we reviewed, the additional credit provided as a result of the current criteria did not improve FmHA borrowers' repayment ability or financial strength. Borrowers' equity was often diminished not only because of declining asset values but also because of the increased debt loads that resulted from the measures intended to assist the borrowers. Diminished borrower equity, in turn, weakened the government's security position.

Recommendations to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the Administrator, FmHA, to develop regulations, in consultation with appropriate congressional committees, that

- improve the cash flow analysis used in loan-making decisions by incorporating an allowance to cover contingencies and equipment replacement and
- protect the government's financial interests by requiring that, when servicing loans, county supervisors obtain security of equal or greater value than the serviced loan's outstanding principal or the best security interest available on all of the borrower's assets.

We also recommend that the Secretary of Agriculture direct the FmHA Administrator to provide adequate credit analysis training to county supervisors. The training should stress the importance of preparing required year-end analyses of farm operations for all borrowers, including actual performance data and the development of realistic farm operating budgets for nondelinquent borrowers.

Agency Comments and Our Evaluation

In commenting on a draft of this report, USDA agreed that including a miscellaneous item under farm operating expenses to cover contingencies and equipment replacement would provide flexibility in a borrower's cash flow situation. USDA stated that FmHA had tried to incorporate such a reserve requirement into the proposed revision of its regulations to implement the Agricultural Credit Act (published in the Federal Register on May 23, 1988). However, USDA noted that because of adverse comments from the general public, farm advocacy groups, and members of Congress, FmHA deleted the proposal from the final rule.

Our report recognizes that FmHA has, in the past, proposed incorporating a reserve requirement into its cash flow analyses but withdrew the proposal because of adverse comments. We believe, however, that this report provides additional information demonstrating the adverse effects of not having a reserve requirement. Specifically, FmHA's current cash flow analysis, without a reserve requirement, does not adequately determine borrower repayment ability and as such permits FmHA to make loans to borrowers who cannot repay them. In many cases, these loans do not improve the financial strength of borrowers but only diminish their equity, which in turn weakens the government's security position. With this information, FmHA can demonstrate that a reserve requirement will not only decrease government loan losses by improving loan repayment but also better ensure that FmHA loans actually assist borrowers. Accordingly, we believe it is appropriate for FmHA to again propose that a reserve requirement be included in its cash flow analysis.

Concerning our recommendation that FmHA require security of equal or greater value than the outstanding principal of serviced loans, USDA stated that the majority of FmHA farm program borrowers have already pledged all of their farm-related assets as security for existing debts owed other creditors and FmHA. USDA stated that such a requirement would be pointless in that many of FmHA's borrowers could not comply in view of their financial condition.

We recognize, as stated in our report, that requiring adequate security on serviced loans would make some existing FmHA borrowers ineligible for further assistance. The actual impact of such a requirement would depend on the number of borrowers that had additional assets available to use as loan collateral. Currently, this is unknown. Our report points out that when implementing the debt restructuring provisions of the Agricultural Credit Act, USDA has estimated that FmHA will lose $8.7 billion on existing farm loans because of inadequate loan security. As such, we believe it is desirable for FmHA to have adequate security on all loans, not only initial loans. However, we also recognize that many FmHA borrowers have already pledged all their farm-related assets as security for existing debt and agree with USDA that requiring full loan security in such cases would not be practical. Accordingly, we have modified our recommendation to state that when servicing loans, county supervisors should obtain security of equal or greater value than the loan's outstanding principal or, if full security is not available, obtain the best security interest available on all of the borrower's assets. We believe borrowers can comply with this recommendation without going out of business and, at the same time, FmHA will improve its security position to the maximum extent feasible.

Finally, concerning our recommendation that FmHA provide adequate credit analysis training to county supervisors, USDA stated that FmHA has and will continue to emphasize the importance of borrower year-end analysis and development of realistic farm operating budgets, based on the operator's actual yields and costs of production. USDA also stated that FmHA has initiated an ongoing pilot project in five states that tests the effectiveness of a voluntary self-study course entitled "Agricultural Lending/Credit Analysis." USDA noted that this program covers the skills and techniques necessary to evaluate and make sound credit decisions and that FmHA's intent is to make this course available nationwide.

We believe that if FmHA continues to emphasize the importance of an annual analysis of borrowers' farm operations, actually performs the needed analyses, and makes applicable training, such as the pilot program it is currently testing, available to all county supervisors, FmHA should improve the credit analysis skills of its county supervisors and fulfill the intent of our recommendation.

FmHA Unsuccessfully Tried to Improve Its Loan-Making Criteria

To speed up loan processing and screen out high-risk borrowers, FmHA proposed revised loan-making criteria in January 1987. The proposed criteria attempted to identify financially troubled farmers who could be helped with additional credit and those who could not. The criteria, which would include FmHA's present cash flow analysis, would have made many borrowers—about 56 percent of our 160 sampled borrowers—ineligible for assistance. FmHA's decision not to publish a study on the impact of the proposed regulations, congressional and public concern over the potential denial of further financial assistance to many borrowers, and the short period provided to assess the regulations eventually led FmHA to withdraw the proposal in the fall of 1987.

The criteria proposed by FmHA expanded the measurement of borrowers' financial viability by using a two-stage credit-scoring system—first in determining borrower eligibility and then in approving individual loans. For both eligibility and loan approval decisions, financial ratios and risk indexes would measure the degree of risk. Borrowers with acceptable risk values would be provided assistance and those with unacceptable values denied assistance. The proposed credit scoring system used financial ratios in a manner similar to the way FmHA recently initiated action to comply with Office of Management and Budget (OMB) requirements that lending agencies assess the risk associated with their loan portfolios and estimate future loan losses. OMB also requires federal agencies to improve the financial management of their loan programs. Without improved loan-making criteria, it will be difficult for FmHA to do so.

Proposed Criteria Would Have Expanded Measurement of Borrowers' Financial Viability

The proposed FmHA eligibility and loan-risk criteria[1] would have significantly expanded the measurement of applicants' financial viability in FmHA's loan-making process. The criteria would have assessed the overall financial strength of an applicant's farming operation and the individual loan risk facing FmHA by assessing an applicant's financial solvency, profitability, overall liquidity, and repayment ability. FmHA's current cash flow analysis is designed to assess only repayment ability and, as shown in chapter 2, is an unreliable method. The cash flow analysis does not consider a borrower's overall financial condition and does not directly address solvency, profitability, and overall liquidity.

FmHA's proposed credit scoring system, which would have included the present cash flow requirement, consisted of a two-stage review process

[1] 52 Fed. Reg. 1727.

to determine an applicant's creditworthiness. In the first, or eligibility stage, three financial ratios were to be calculated from the borrower's application to determine an eligibility-risk index. This index would have reflected borrowers' overall financial condition at the time they were applying for a loan. Only those applicants with acceptable eligibility-risk indexes would have been permitted to submit a Farm and Home Plan for a specific new loan or loans. In the second, or loan application stage, local agency officials using the Farm and Home Plan would have computed a cash flow analysis and three financial ratios to determine a loan-risk index. This index would have reflected the borrower's financial condition and repayment ability with the new loan. Applicants with acceptable eligibility and loan-risk indexes would have been approved for a loan.

FmHA expected the revised criteria to speed up loan processing, assist in meeting statutory requirements for prompt loan approval, and identify applicants who had a high degree of potential for loan failure. The revised loan criteria would also have identified those borrowers who are financially sound and could have been encouraged to seek loans through sources other than FmHA. By quickly eliminating high-risk applicants, FmHA hoped to be able to speed up processing for applicants with acceptable risk and to decrease government losses by minimizing the number of high-risk loans.

Proposed Eligibility-Risk Index Would Have Screened Out High-Risk Applicants

The eligibility-risk index would have screened out high-risk applicants by measuring the general financial strength of applicants' current farm operations—not their ability to repay a specific loan. The eligibility-risk index would be computed from data provided by the potential borrower's loan application prior to completing the Farm and Home Plan.

The eligibility-risk index would be generated from three computations: debt-to-asset ratio, return on assets, and current ratio, which measure solvency, profitability, and liquidity, respectively. Specifically, the debt-to-asset ratio measures whether applicants have enough assets to pay off all debts immediately upon liquidation of the farming operation. This ratio is calculated by dividing total debts by total assets and is expressed as either a quotient or percentage. A debt-to-asset ratio greater than 1.0, or 100 percent, means the applicant's debts exceed assets, and therefore the applicant is technically insolvent.

The second ratio in the eligibility-risk index—return on assets—indicates the rate of return that applicants are receiving on their investments. A higher rate of return is an indication of less risk, while a lower rate of return indicates a lack of profitability and a corresponding higher loan risk. Return on assets is calculated by dividing net cash farm income by total assets. FmHA defines net cash farm income (before interest payments) as the gross cash farm income from the farm operation minus cash operating expenses.

The third ratio in the eligibility-risk index is the current ratio, which measures whether borrowers can generate enough cash from the sale of assets normally sold within 1 year to pay all liabilities due within the same year. The current ratio is calculated by dividing current assets by current debts. A current ratio of greater than one indicates that an applicant has more current assets than current liabilities.

Under FmHA's proposed regulations the results of each of these three calculations—debt-to-asset ratio, return on assets, and current ratio—were to be assigned a value of 1 through 4, with 1 representing the strongest financial situation and 4 the weakest financial situation. Specific eligibility-risk index values for corresponding ratios are shown in appendix II. The three assigned values were then to be added together to determine the eligibility-risk index. The eligibility-risk index could range from a minimum of 3, reflecting the best borrower financial condition, to a maximum of 12, reflecting the worst condition. Table 3.1 illustrates the computation of an eligibility-risk index value of 9. FmHA determined that an eligibility-risk index of 9 or more was an extremely high risk index and not acceptable. Therefore applicants with indexes of 9 or more would not have received further loan consideration.

Table 3.1: FmHA Eligibility-Risk Index Computation Example

	Ratio values				
	Least risk 1	2	3	Highest risk 4	Assigned ratio value
Ratio 1 Debt-to-asset ratio			X		3
Ratio 2 Return on assets		X			2
Ratio 3 Current ratio				X	4
Computed eligibility-risk index					**9**

Proposed Loan-Risk Index Would Have Identified High-Risk Loans

If applicants had acceptable eligibility-risk indexes, FmHA's proposed criteria required that a loan-risk index would be calculated. This index measured the applicants' financial position with the new loan and ability to repay that new loan as well as all existing debt. The loan-risk index was based on two of the same ratios used for the eligibility-risk index—debt-to-asset and return on assets—and a third, repayment ability ratio. The debt-to-asset and return on assets ratios were to be calculated using information from the Farm and Home Plan and assigned values in the same manner as in the eligibility index.

The third ratio—repayment ability—would be similar to cash flow and measures the relative amount of cash available to pay current debts. Borrowers with large cash carryovers after paying current debts are better loan risks than borrowers with small or nonexistent cash carryovers. Calculation of the ratio involves taking the amount available to make current debt payments and dividing it by the total current debt and interest payments due. The resulting quotient or percentage was assigned a value of 1 through 4, with 1 representing the strongest financial situation and 4 representing the weakest financial position. FmHA stressed that applicants who did not have a positive cash flow would be disapproved no matter what the other ratios showed. Specific loan-risk index values for corresponding ratios are shown in appendix II.

The repayment value was added to the debt-to-asset and return on assets values to determine the loan-risk index. As with the eligibility-risk index, the loan-risk index could have ranged from a minimum of 3 to a maximum of 12. Table 3.2 illustrates the computation of a loan risk index value of 9. FmHA considered a loan-risk index of 9 or more unacceptable, and applicants would not have received a farm program loan or loans. According to FmHA, applicants with an index of 9 or more lack a reasonable prospect of being successful in their farming operation and have a high degree of potential loan failure.

Table 3.2: FmHA Loan-Risk Index Computation Example

	Ratio values				
	Least risk 1	2	3	Highest risk 4	Assigned ratio value
Ratio 1 Debt-to-asset ratio			X		3
Ratio 2 Return on assets		X			2
Ratio 3 Repayment ability margin (Cash flow for planned year)				X	4
Computed loan-risk index					**9**

Many Financially Weak Borrowers Would Not Have Received Loans Under the Proposed Criteria

Many financially weak borrowers—about 56 percent of the 160 we sampled—would not have received loans under the January 1987 proposed criteria. The proposed eligibility index would have initially screened out over half—54 percent—of the borrowers, and the loan-risk index would then have screened an additional 2 percent of the borrowers. While the screening appears severe, local FmHA county supervisors familiar with the borrowers' operations stated that the indexes accurately reflected the financial situation for most of the sampled borrowers. They also believed that about 25 percent of these borrowers, even though they received new loans in 1986, would liquidate their farm operations by the end of 1988. The majority of these borrowers would have been screened out under the proposed criteria but were provided assistance under the cash flow criteria.

Eligibility Index Would Have Screened Out Majority of Borrowers in Sample

The eligibility index would have screened out 86, or 54 percent, of the 160 borrowers we sampled receiving 1986 loans. These borrowers had weak debt-to-asset and/or current ratios that raised their eligibility indexes to 9 or more. The great majority, or 143 of the 160 sampled borrowers, had current ratios of 1.00 or less—the borrowers' current liabilities equaled or exceeded their current assets, resulting in the maximum ratio value (4) assigned to the eligibility index. The current ratio is a measure of short-term liquidity, which is of interest to short-term creditors who must collect their borrowers' debts within a year's time.

Borrowers with current ratios of less than 1.00 will probably have trouble meeting current obligations to their creditors, such as payments on FmHA farm program loans. For all the borrowers sampled, the average current ratio was 0.45. In other words, the average FmHA borrower sampled had more than $2 of current debt for every $1 of current assets. Sampled borrowers were frequently having difficulty meeting their FmHA payments as indicated by the servicing actions discussed in chapter 2.

Many FmHA borrowers are deeply indebted, which raises their debt-to-asset ratios and their eligibility indexes. A debt-to-asset ratio of 1.0, or 100 percent, or more means that borrowers' debts exceed their assets and would have resulted in the maximum value (4) assigned to the ratio for the eligibility index. Debt-to-asset ratios equaled or exceeded 100 percent—technically insolvent—for 51 (32 percent) of the 160 borrowers we sampled. The debt-to-asset ratio is a measure of long-term solvency and is an indicator of how well borrowers will be able to meet future long-term debt obligations. For the 160 borrowers sampled, the average debt-to-asset ratio was 95 percent.

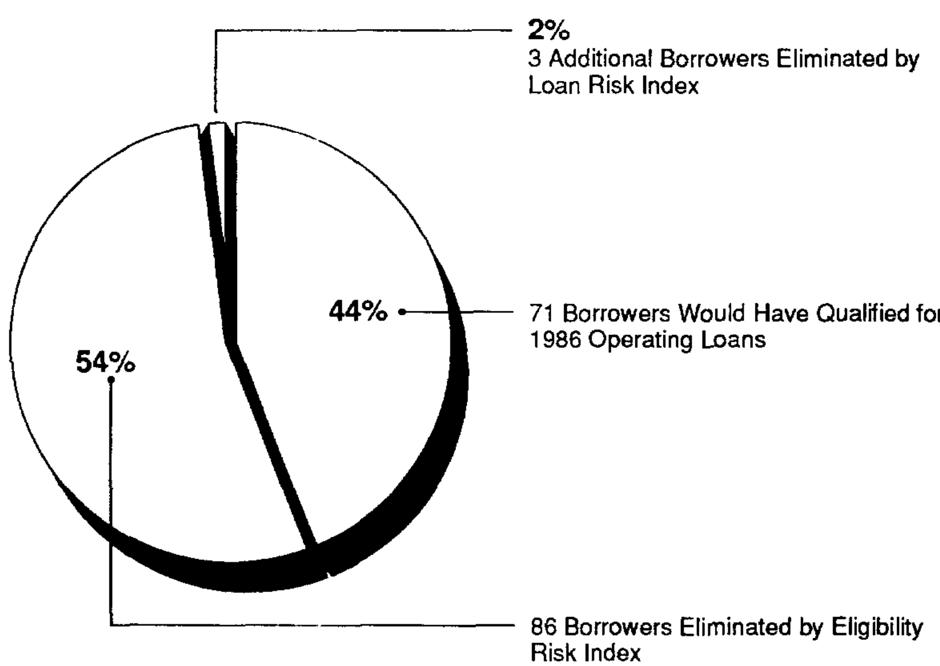
In contrast to the current ratio and debt-to-asset ratio, the third component of the eligibility index—return on assets—did not have much effect on borrowers' eligibility for FmHA assistance under the proposed criteria. The vast majority, 81 percent, or 129 of the 160 sampled borrowers, had a rate of return on assets of at least 5 percent, which avoided the worst value (4) assigned for the eligibility index. About half of the sample—81 of the borrowers—had a return of 10 percent or greater, which resulted in the best value (1) assigned for the index. Return on assets was used to calculate both the eligibility and loan-risk indexes, and our work indicated that FmHA borrowers were generally getting a good return on their assets. Thus, for the 3 eligibility index ratios, heavy debt, not return on assets, would have prevented many of the 160 borrowers from qualifying for FmHA assistance.

Loan-Risk Index Would Have Screened Out Few Additional Borrowers

Applying the loan-risk index to borrowers with acceptable eligibility indexes would have screened out another 3 borrowers, bringing the total number of borrowers that would be considered unacceptable financial risks, to 89, or 56 percent of our sample. As noted above, the debt-to-asset and the return on assets calculations are used in the eligibility index, and only the repayment ability ratio was added to calculate the loan-risk index.

In our sample more than half the borrowers, 90 of the 160, had a repayment ability ratio of 1.04 or less, which resulted in the worst value (4) used in computing the loan-risk index (see app. II). Repayment abilities of 1.04 or more would indicate borrowers could repay all debt due that year, including the FmHA loan or loans being applied for, plus having a 4-percent cushion to cover variances or other unforeseen circumstances. Strong repayment ability ratios also indicate that borrowers would be in a better financial position to pay unforeseen expenses, such as machinery repair, without needing additional credit. The average repayment ability ratio for all borrowers sampled was 1.09. However, as stated in chapter 2, borrower repayment ability was overstated by an average of about 24 percent for the 100 borrowers in our analysis whose Farm and Home Plan included both planned and actual financial data for 1986. This would also tend to overstate the overall average repayment ability ratio for all 160 sampled borrowers. Appendix III contains the eligibility and loan-risk indexes for the sampled borrowers, and figure 3.1 illustrates the number of borrowers who would have been eliminated by the indexes.

Figure 3.1: Borrowers in GAO's Sample That Would Have Been Eliminated by FmHA's Proposed Eligibility-Risk Index and Loan-Risk Index



Both the eligibility and loan-risk indexes provided a numeric value that could have been used to illustrate borrowers' relative financial positions. This was more comprehensive than the cash flow analysis and would have identified borrowers who, although they may have a positive cash flow for 1 more year, are in serious financial difficulty. The criteria could have been used to assess borrowers' future repayment abilities beyond the year in which borrowers applied for their loans. Strong debt-to-asset and return on assets ratios are good indicators that borrowers will be able to continue to repay their FmHA debt in future years.

County Supervisors Generally Agreed With Indexes' Results

County supervisors responsible for loans to the 160 borrowers in our sample stated that the indexes accurately reflected the financial situations for 150, or 94 percent, of the borrowers. They also expected 40 of the 160 borrowers who received new FmHA loans on the basis of 1986 cash flow to liquidate their farming operations by the end of 1988. In general, additional debt to these borrowers will result only in the loss of additional equity if they go out of business and potentially increase FmHA losses if loan security is inadequate. Of the 40 borrowers expected to liquidate, 30 had unacceptable eligibility or loan-risk indexes. Nine of the other 10 borrowers had eligibility or loan-risk values of 8—1 away from being unacceptable, and the other borrower had already liquidated his operation. An example of a borrower, with an unacceptable index, who is expected to liquidate follows:

- A borrower who received a $5,100 farm operating loan in June 1986 scored 9—unacceptable—on both the eligibility and loan-risk indexes. The county supervisor agreed that the indexes reflected the borrower's financial risk, but under the cash flow requirement, the loan had been approved because the borrower's planned operation showed a positive cash flow of $37. The borrower had unacceptable indexes primarily because his current assets were $500 compared with his current liabilities of $35,500, and he was technically insolvent with total liabilities exceeding total assets by about $66,800 because of excessive debt. The county supervisor stated he believed the borrower would liquidate by the end of 1988 because of excessive debt.

FmHA county supervisors disagreed with the indexes for only 10 borrowers in our sample. In two of the cases, the supervisors thought the borrowers' financial situations were worse than the indexes indicated although both borrowers had indexes greater than 9 and would not have qualified for FmHA loans under the proposed criteria. One of these cases follows:

- In March 1986 a borrower received a $95,000 farm operating loan and in April 1986 had two existing farm operating loans rescheduled, one for $17,307 and another for $23,007. The borrower scored 9—unacceptable—on both the eligibility and loan-risk indexes, but the loan had been approved because the borrower's planned operation showed a positive cash flow of $1,011. The borrower had unacceptable indexes primarily because his current assets were only about $35,000 and his current liabilities were about $175,000 and he was technically insolvent, having a negative net worth of about $148,000. The county supervisor stated that the borrower filed for bankruptcy in May 1987.

In another two cases the supervisors believed the borrowers were acceptable risks because they had nonfarm income that was not reflected in the eligibility-risk index. In another three cases, the supervisors stated that, based on their personal knowledge of the abilities of the borrowers and the quality of their farm operations, the borrowers were satisfactory FmHA loan risks although the indexes indicated otherwise.

In the remaining three cases, borrowers' indexes were acceptable but the county supervisor disagreed with the calculations because in two cases the supervisors thought the borrowers' financial conditions were better than the indexes indicated and in the third case, the county supervisor felt the borrower's poor farm management, which was not shown by the indexes, would result in the liquidation of the farm operation before the end of 1988.

New Criteria Withdrawn but Requirement for Improving Loan Quality Continues

FmHA withdrew the proposed loan-making criteria mainly because of concerns expressed by the public and various members of the Congress over the number of farmers that may be denied credit and forced out of business. FmHA is still required, however, by OMB Circular A-129 to improve the management of its loan program and loan-making process. The congressionally directed reinstatement of FmHA's continuation policy and recent enactment of debt restructuring legislation will likely keep many delinquent farmers in business but may also add loans of questionable value to FmHA's portfolio. If so, without improved loan-making criteria, it will be difficult for FmHA to improve the financial management of its loan programs.

FmHA Withdraws Proposed Loan Criteria

In January 1987 FmHA published proposed regulations in the Federal Register that would revise, among other things, its loan-making criteria. Interested parties were given 30 days to comment on the proposal before it was finalized. Subsequently, FmHA received numerous requests to extend the comment period based on the belief that these proposed regulations would constitute major changes in the way FmHA operated and a comment period of 30 days was insufficient to properly assess the impact of the proposal. Of particular concern was that FmHA had not published a study on the impact the proposed regulations would have on its borrowers. As a result, the Secretary of Agriculture extended the comment period another 30 days.

During the extended comment period, the Senate Committee on Agriculture, Nutrition, and Forestry held a hearing on the proposed regulations. At that hearing, various witnesses, including GAO, testified that the number of FmHA borrowers who would not qualify for new loans under the proposed credit scoring system could be as high as half of the existing farm portfolio. FmHA estimated that the proposed regulations would preclude about 18 percent of its existing borrowers who had a positive cash flow from obtaining further financial assistance. Such estimates led to a request by several committee members for FmHA to withdraw its proposal. Further, some committee members questioned whether FmHA was doing enough to assist borrowers and expressed their views that FmHA was acting to the detriment of borrowers. In the fall of 1987, FmHA withdrew its proposed revision of the loan-making criteria.

In expressing their concern about the impact of the proposed regulations, members of Congress did not preclude FmHA from using financial ratios and standards as part of its loan application process for determining the degree of potential loan risk. The Congress did, however, with the passage of the Agricultural Credit Act of 1987, enact legislation that provided that if such a proposal was pursued, the Secretary of Agriculture must study the effects such a proposal would have on borrowers or potential borrowers and report the results to the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture not later than 60 days before issuance of final regulations. FmHA's Deputy Assistant Administrator for Farmer Programs stated that FmHA is currently giving top priority to implementing the legislatively mandated requirements of the Agricultural Credit Act and as such has not pursued this option. However, the Deputy Assistant Administrator believed that FmHA would try to revise its loan-making criteria again in the future.

In the absence of new loan-making criteria, FmHA will continue making loans under its cash flow requirement as modified for existing borrowers by the continuation policy. The continuation policy requires FmHA to make new operating loans to borrowers who cannot repay existing debt as long as the borrowers can demonstrate the ability to repay only the new loan. The reinstatement of the continuation policy was directed by the Congress in legislation making supplemental appropriations for fiscal year 1987 (P.L. 100-71, July 11, 1987).

As previously discussed in chapter 1, FmHA rescinded the continuation policy in November 1985 because of the deteriorating financial condition of FmHA's farm loan program portfolio. For example, the total outstanding principal on farm program loans was about $22.8 billion as of June 30, 1981, of which about 7 percent, or $1.6 billion, was delinquent. The delinquency rate climbed to 12.2 percent in 1982, 17.0 percent in 1983, 21.3 percent in 1984, 23.0 percent in 1985, and 24.6 percent in 1986. By June 30, 1987, about 26.7 percent of $26.2 billion in outstanding principal was delinquent. Actual annual losses on direct loans increased from $76.8 million in fiscal year 1981 to over $1.1 billion in fiscal year 1987.

The reinstated continuation policy will likely again add loans of questionable value to FmHA's portfolio. FmHA has estimated that the continuation policy will increase government costs by about $717 million in fiscal year 1988 alone. These costs arise from estimated losses on continuation loans, deteriorating collateral values, interest accruing on existing debt, and reduced payments on other outstanding loans.

With the January 1988 enactment of the Agricultural Credit Act of 1987, the Congress took further steps to keep borrowers who cannot repay FmHA farm loans in business. As discussed in chapter 1, the act directs FmHA to give priority consideration to reducing loan principal and interest of delinquent borrower debt when all other loan-servicing options are not sufficient to allow the borrower to show a positive cash flow. The loan-restructuring provisions provide that FmHA must first write down delinquent debt to the recovery value of the collateral if the return to the government is at least as great as the return it would receive if the borrower was liquidated. The act does not stipulate how often delinquent borrowers may have their debt reduced. It is logical to assume that as long as FmHA does not have adequate security for its loans, it will be more advantageous to the government to write down borrowers' debt than liquidate their farm operations.

FmHA's Assistant Administrator for Farmer Programs stated that the net effect of the act's debt restructuring provisions and continuation loans could be that FmHA will be unable to liquidate many existing borrowers who cannot make scheduled loan payments. Instead, FmHA may be required to continue to make new loans to such borrowers by (1) writing down existing debt to a point where they have a positive cash flow and are no longer delinquent or (2) deferring payments on existing debt if the borrower can repay a new continuation loan.

FmHA Is Required to Improve Loan Quality

While attempting to keep financially troubled farmers in business, FmHA is also required to comply with the May 1985 OMB Circular A-129, which provides guidelines for improving the quality of federal agencies' loan-making activities. The circular states that agencies should establish procedures for an annual risk assessment of their portfolio in order to assist in determining loan loss estimates.

In September 1987 FmHA initiated actions to comply with the circular by classifying accounts into five categories—commercial, standard, substandard, doubtful, and loss. The classification methodology is based on borrowers' loan security positions and the same four financial ratios that were used in FmHA's proposed loan-making criteria: debt-to-asset, return on assets, current ratio, and repayment ability. FmHA completed classification of all farm program loans in September 1988.

OMB Circular A-129 also requires federal agencies to improve the financial management of their loan programs. The circular states that although some federal loan programs extend credit to high-risk applicants, in general, there must be a reasonable expectation that the borrower will repay the loan. Further, it states that because an agency has a statutory role of "lender of last resort," the need to determine the degree of risk involved in making loans is not eliminated. FmHA's proposed credit-scoring system attempted to screen out high-risk borrowers before they received a loan by using the same financial ratios that classify the degree of risk the agency faces on loans already in its portfolio. Without such improved loan-making criteria, FmHA will have difficulty improving the financial management of its loan programs.

Conclusions

By dropping the proposed loan-making criteria and implementing the continuation policy and debt-restructuring provisions required by statute, FmHA finds itself pursuing competing goals. As a lender, FmHA must make loans that have a reasonable chance of repayment to improve the financial management of federal loan programs as well as protect the government's, and ultimately the taxpayers', financial interests. On the other hand, as the federal government's lender of last resort, FmHA must keep financially stressed borrowers farming by making high-risk loans.

The proposed credit-scoring system attempted to ensure that FmHA made loans to borrowers who had a reasonable chance of repaying their debt. Current loan-making criteria, as modified by the continuation policy, do not attempt to sort out or adequately identify existing borrowers who will likely not survive financially even with additional FmHA assistance.

While the credit-scoring system as originally proposed could have denied assistance to a large percentage of existing FmHA borrowers, it attempted to draw the line between those financially troubled farmers who could be helped and those who could not be helped with FmHA loans. It also identified the degree of risk associated with each borrower and loan, something not disclosed under the cash flow requirement.

Congressional concern over the potential adverse effect of credit scoring, the lack of a published impact study, and the relatively short comment period that FmHA provided interested parties eventually led to FmHA's withdrawal of the proposed criteria. However, in the Agricultural Credit Act, the Congress allows for future revision of certain FmHA loan-making criteria if the agency adequately studies the impact of such a revision on its borrowers and provides appropriate congressional committees with sufficient time to review the results.

While recent actions by the Congress are directed at keeping financially stressed farmers in business by providing them credit assistance, we believe the Congress could benefit from better information on the long-term effect such assistance may have on borrowers. We also believe FmHA and its borrowers need to realistically assess their chances of financial recovery before they lose additional equity through continued borrowing. A well thought out credit-scoring system can help fulfill this goal.

Recommendation to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the Administrator, FmHA, to pursue the development of more comprehensive loan-making criteria that assess an applicant's financial solvency, profitability, liquidity, and repayment ability prior to making new loans. After FmHA develops new criteria and studies the effects on borrowers, as required by the Agricultural Credit Act, we recommend that FmHA, in consultation with appropriate congressional committees, determine where to draw the line between those financially troubled farmers who could be helped and those who could not be helped with FmHA financial assistance. This will improve the financial condition of FmHA's loan portfolio and assist borrowers by providing them with a more realistic assessment of their financial condition before they accept additional credit.

Agency Comments and Our Evaluation

In commenting on a draft of this report, USDA agreed that the use of loan-making criteria that assess an applicant's/borrower's solvency, profitability, and repayment ability is desirable and would improve FmHA's farm loan portfolio, especially from the standpoint of sounder lending. USDA pointed out, however, that FmHA had attempted to incorporate such criteria into its regulations in January 1987 but withdrew the proposal because of adverse comments received from the general public, farm advocacy groups, and members of Congress. These parties were concerned that the revised criteria would deny needed credit to a large number of farmers and force them out of business.

USDA also stated that county supervisors generally have the information, experience, and knowledge to make logical/sound loan decisions, which frequently have been negated by statute or administrative policy, such as continuation loans mandated by the Supplemental Appropriations Act for fiscal year 1987. USDA stated that FmHA has and will continue to work with and carry out Congress' mandate to use loans and supervisory assistance to help eligible farmers and ranchers remain on their farms, with the ultimate goal of achieving viable agricultural operations. However, USDA also concluded that many existing farmers cannot be salvaged even with existing FmHA loan programs and servicing options and that these farmers will have to make a transition from agriculture.

Our report recognizes that FmHA has, in the past, attempted to implement more comprehensive loan-making criteria but withdrew the proposal because of adverse comments. However, we believe this report provides additional information demonstrating the adverse effect of not revising the current loan-making criteria. Specifically, FmHA's current cash flow requirement, as modified by the continuation policy and debt restructuring, allows additional loans to farmers who cannot repay them. Such loans often put the farmer into a worse debt position with decreased equity. Eventually, the increased debt no longer allows the borrowers' farm operation to show a positive cash flow and these borrowers fail financially. As a result, FmHA farm program loan losses increase.

With the new information provided in this report, we believe FmHA can better work with the Congress and the public to develop more comprehensive loan-making criteria that assess an applicant's financial condition prior to making new loans. We believe such criteria will assist borrowers by providing them with a more realistic assessment of their ability to recover financially, while at the same time reducing federal loan losses by ensuring that loans are made to borrowers who have a reasonable chance of repaying them. Accordingly, we believe that FmHA should again propose such a revision to its regulations.

Observations and Matters for Consideration by the Congress

During the declining agricultural economy of the 1980s, the Congress and the administration provided FmHA borrowers with additional assistance through loans and extensive loan servicing to facilitate loan repayment and help keep farmers in business. This assistance helped borrowers obtain additional credit from FmHA or other lenders and liberalized terms on existing debt. However, when combined with the continued decline in the agricultural economy, it also resulted in many borrowers becoming so deeply indebted that they were unable to repay their loans. Consequently, borrowers' equity positions declined, the financial condition of FmHA's farm loan portfolio deteriorated, and government loan losses mounted.

FmHA is required by legislation to provide credit to farmers who cannot obtain it elsewhere. This assistance is obtained through loans that are expected to be repaid to protect the government's and taxpayers' interests. FmHA must balance how much credit, if any, should be provided while maintaining fiscal responsibility. If FmHA makes loans to borrowers with little chance of repayment, it lessens its fiscal responsibility. In addition, the resulting loans may erode borrower equity and ultimately lead to the financial failure of the borrower and government losses. Conversely, if FmHA's loan-making criteria are too stringent, the agency will limit assistance to financially stressed farmers and perhaps force many out of business.

Has FmHA's mission been equally balanced between providing credit assistance and maintaining fiscal responsibility? The financial status of FmHA's farm loan portfolio indicates that during the 1980s its mission has been weighted more towards credit assistance than fiscal responsibility. When the farm economy began deteriorating in the early 1980s, FmHA emphasized credit assistance by using extensive loan servicing to keep existing borrowers in business and by providing additional assistance to more borrowers. FmHA rescheduled, reamortized, consolidated, deferred, or set aside many borrowers' loans and frequently subordinated its lien position to allow borrowers to secure additional commercial credit. FmHA used lower, limited resource, interest rates extensively to decrease borrowers' interest costs. The continuation policy adopted by FmHA in 1982 departed from sound lending practices by providing additional operating loans to borrowers when they could not show repayment ability on all existing debt.

During this time, many borrowers became deeply indebted, and the quality of FmHA's portfolio deteriorated, reflecting both the impact of difficult economic times on high-risk borrowers and FmHA's loan-making and servicing policies. The total outstanding principal on farm program loans on June 30, 1981, was about $22.8 billion of which about 7 percent, or $1.6 billion, was delinquent. By June 30, 1987, about 26.7 percent of $26.2 billion in outstanding principal was delinquent. Actual annual losses on direct loans increased from $78.9 million in 1981 to over $1.1 billion in fiscal year 1987.

Alarmed by the condition of the portfolio, and mounting loan losses, FmHA rescinded the continuation policy in 1985 and instituted new servicing policies to resolve borrowers' delinquencies systematically. These actions reflected FmHA's move towards greater fiscal responsibility and sound lending practices. In January 1987, FmHA also proposed additional eligibility and loan-making criteria as further steps towards fiscal responsibility and compliance with OMB Circular A-129.

Congressional and borrower reaction to FmHA's fiscal responsibility efforts was largely negative. The 1985 servicing actions were challenged in federal court and declared void because they did not fully inform borrowers of their rights. The proposed loan-making criteria generated concerns in the Congress because of the potential adverse impact on credit availability to a large number of borrowers. Many members of Congress believed that FmHA should provide more credit assistance to farmers, as illustrated by the additional servicing options contained in the Food Security Act of 1985, the reinstatement of the continuation policy in P.L. 100-71, and the debt write-down provisions in the Agricultural Credit Act of 1987.

We recognize that the Congress, through this legislation, wants to continue to assist financially stressed farmers and keep them in business if at all possible. Such actions provide benefits to the local rural communities, not just to the family farmer. However, such additional assistance comes with an associated cost. For the continuation policy, FmHA estimated that the increased government costs will be about $717 million in fiscal year 1988 alone. FmHA also estimated that implementing the provisions of the Agricultural Credit Act will ultimately result in about $8.7 billion of debt being written off as a loss. The servicing assistance already provided borrowers makes up a large portion of the loss.

There is also the cost to the borrowers for whom these provisions were established. Farmers who stay in business by obtaining additional loans and loan repayment extensions, without a corresponding increase in revenues, go deeper and deeper into debt. Eventually their farm operations no longer have positive cash flows, and they are sent notices of intent-to-take-adverse action (such as foreclosure). When this occurs, not only are farmers forced out of business, but their equity positions in the farm operation have been eroded by debt.

FmHA's cash flow loan-making criteria, as modified by the continuation policy, and provisions for debt write-down will keep the agency's mission weighted toward credit assistance. Loans will continue to be based on overly optimistic farm operation financial data unless contingencies are allowed for and FmHA's recent directive for use of realistic farm operating data is effectively implemented. Frequent servicing will continue if optimistic data are used because borrowers will not be able to make scheduled payments. By providing existing borrowers new loans without the ability to repay existing debt, FmHA will eventually be required to write off such debt if it is not adequately secured. FmHA's lack of security requirements when servicing existing loans could result in write-down as the only viable option to pursue when borrowers cannot repay their debt. FmHA may then make these borrowers new loans, which they, more than likely, cannot repay and the cycle begins again.

Prospects for improvement in the financial condition of many FmHA delinquent borrowers are not good, at least in the short run. They can only hope to continue with increased debt and then debt forgiveness while waiting for a dramatic improvement in the agricultural economy. While this approach will keep borrowers in business another year, it may put them in a hopeless debt position and increase FmHA farm program loan losses.

Matters for Consideration by the Congress

The Congress and FmHA have used existing credit policies as a means of keeping farmers in business and assisting rural communities. We recognize that balancing the role of FmHA as both an assistance and a loan-making agency requires basic policy decisions that can be made only by the Congress. These decisions should consider such factors as budgetary impacts, the extent to which farmers who are facing extreme financial stress can be helped by credit assistance, the length of time that such credit should continue, the impact of continued credit on farmers' financial viability, and the implications of these decisions on rural communities.

FmHA has the difficult task of achieving its assistance goals while also employing sound loan-making policies. With the continued decline of the agricultural economy, additional loans to farmers who cannot repay them have resulted in a decline in the borrowers' equity position, the deterioration of the financial condition of FmHA's farm loan portfolio, and increased government loan losses. Given these long-term negative effects and costs, the Congress may want to reconsider whether the continuation and debt restructuring policies are the best means of assisting already heavily indebted farmers.

Request Letter From the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry

United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, DC 20510-6000

October 24, 1986

The Honorable Charles Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Bowsher:

Thank you for the outstanding work you have provided me in the past, especially on my requests relating to the Farmers Home Administration.

This Committee has always been supportive of the efforts of the Farmers Home Administration to assist financially stressed farmers regain self-sufficiency and make a living on the family farm. In recent years however, it is evident that pressure from Congress has encouraged FmHA to make some policy decisions which, though well intentioned and compassionate, have led to substantial agricultural loan losses. One example of such a decision was FmHA's establishment of a farm loan "continuation policy" which allowed farmers to obtain additional (new) FmHA financing without showing the ability to repay existing debt. This policy was terminated in November 1985, but not before putting over half of FmHA's $28 billion farm loan portfolio in jeopardy of default and seriously deteriorating the financial position of individual farmers.

The aim of this Committee is to ensure that FmHA financial assistance actually helps the family farmer survive difficult economic conditions rather than leading to an inevitable financial demise. Toward this end, I am requesting that your office review FmHA's current loan-making policies and practices to determine if they result in financially sound loans. I would be most interested in any recommendations that you may have which would improve FmHA's ability to provide the type of assistance that will protect both the farmers' and taxpayers' financial interests. We

The Honorable Charles Bowsher
October 24, 1986
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will be glad to discuss this issue with your staff at any time.

With kindest regards.

Sincerely,

Jesse Helms

JESSE HELMS
Chairman

FmHA Eligibility-Risk Index and Loan-Risk Index Calculations

Eligibility-Risk Index Calculation

		Percentage		Assigned ratio value
Debt-to-asset ratio: Total all debts ÷ Total property owned	=		=	
(Values: 1 for = or < .40, 2 for .41-.69, 3 for .70-.99, 4 for = or > 1.00)				
Return on assets ratio: + Net cash farm income + Interest - Family living expenses = Return on assets				
Return on assets ÷ Total property owned	=		=	
(Values: 1 for = or > .10, 2 for .09-.05, 3 for .04-.01, 4 for = or < .01)				
Current ratio:				
Total current assets[a] ÷ Total current liabilities[b]	=		=	
(Values: 1 for = or > 1.5, 2 for 1.49 - 1.25, 3 for 1.24 - 1.01, 4 for = or < 1.00)				
Eligibility-risk index (Debt-to-asset + return on assets + current ratio)				
(Index equal to or greater than 9 is unacceptable.)				

[a]Defined as total other personal property minus automobile minus household goods plus livestock for sale.

[b]Defined as annual installments plus amount delinquent plus all other debts plus taxes due.

Loan-Risk Index Calculation

		Percentage		Assigned ratio value
Debt-to-asset ratio:				
Total all debts ÷ Total property owned	=	______	=	______
(Values: 1 for = or < .40, 2 for .41-.69, 3 for .70-.99, 4 for = or > 1.00)				
Return on assets ratio:				
+ Net cash farm income + Interest - Family living expenses = Return on assets				
Return on assets ÷ Total property owned	=	______	=	______
(Values: 1 for = or > .10, 2 for .09-.05, 3 for .04-.01, 4 for = or < .01)				
Repayment ability ratio:				
Balance available ÷ Principal and interest to be paid	=	______	=	______
(Values: 1 for = or > 1.15, 2 for 1.14-1.10, 3 for 1.09-1.05, 4 for = or < 1.04)				
Loan-risk index (Debt-to-asset + return on assets + repayment ability)				
(Index equal to or greater than 9 is unacceptable.)				

Computed Values for Eligibility and Loan-Risk Indexes for 160 Borrowers Sampled by GAO

Index value	Borrowers computed by eligibility-risk index	Borrowers computed by loan-risk index[a]
3	3	1
4	3	5
5	3	14
6	6	18
7	17	30
8	42	31
Subtotal Index values 3 through 8	74	99
9	57	37
10	19	16
11	7	5
12	3	3
Subtotal index values 9 through 12	86	61
Total borrowers	**160**	**160**

[a]Loan-risk index values for purposes of this appendix were computed independently of eligibility-risk index value calculations

Comments From the Acting Under Secretary for Small Community and Rural Development, U.S. Department of Agriculture

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

NOV 4 1988

Mr. John W. Harmon
Associate Director
Resources, Community, and Economic
Development Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Harmon:

A review has been made on the proposed GAO report entitled, "Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria." We offer the following general comments and responses to the recommendations:

CHAPTER 2 - CASH FLOW ANALYSIS USED BY FmHA IS INADEQUATE FOR DETERMINING LOAN REPAYMENT ABILITY

Recommendation Pg. 50 (1) ... FmHA should issue regulations to improve the cash flow analysis used in loan-making decisions by incorporating an allowance to cover contingencies and equipment replacement.

Response: It is generally agreed that including a miscellaneous item under farm operating expenses to cover contingencies and equipment replacement would provide a limited flexibility in the operator's cash flow situation. Presently this allowance is not mandated by law or required administratively.

FmHA has attempted to incorporate a reserve requirement into applicable instructions during proposed revisions to FmHA regulations when implementing provisions of the Agricultural Credit Act of 1987, that were published as a proposed rule in the Federal Register on January 15, 1987, and May 23, 1988. In view of adverse comments from the general public, farm advocacy groups, and members of Congress, the proposed reserve requirement was deleted from the procedural instructions in the final rule.

Recommendation Pg. 50 (2) ... FmHA should protect the Government's financial interests by requiring that, when servicing loans, the value of loan security be equal to or greater than the serviced loans' outstanding principal.

Response: It should be pointed out that FmHA now gives primary consideration to cash flow as opposed to equity/security in providing financial assistance to family farmers and ranchers. Unfortunately, this has not always been the Agency's policy in past years.

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FmHA regulations have always required that initial Farmer Programs (FP) loans be adequately secured as a loan approval condition. Adequately secured means the best lien obtainable on hard security plus a first lien on the income producing security being financed, i.e., livestock increases and crops.

The majority of FmHA FP borrowers have pledged all of their farm related assets as security for existing debts owed other creditors and FmHA; and as such, the FmHA by requiring that hard security value be equal to or greater than the outstanding principal of serviced FmHA loans would be pointless as it is a requirement with which many borrowers could not comply, in view of their financial condition.

At the outset, FmHA did not make unsecured loans, nor did the Farm Credit Administration (FCA) and other lenders. Loans that are presently undersecured resulted from a prolonged depressed farm economy and natural disasters, which was reflected by low farm commodity prices and severe depreciation in land/chattel values. As it turned out, the policy of making subsequent annual operating loans to delinquent borrowers (continuation policy), through the operating (OL) and emergency (EM) loan programs, did not improve FmHA's security position as was orginally intended.

The Congress has mandated, through the Agricultural Credit Act of 1987, that FmHA place the highest priority on the preservation of the borrower's farming operation. This is contingent on, but not limited to, the borrower's rights with respect to: security income release, debt restructuring, and loan servicing options which include loan rescheduling, interest rate reduction, loan deferral, debt write down, homestead protection, and farmland leaseback/buyback.

Recommendation Pg. 50 (3) ... FmHA should provide adequate credit analysis training to County Supervisors. The training should stress the importance of preparing required year-end analyses of farm operations for all borrowers, including actual performance data and the development of realistic farm operating budgets for nondelinquent borrowers.

<u>Response</u>: County Supervisors are required to conduct an annual analysis on those borrowers who:

(1) are experiencing financial and/or production management problems.

(2) are reorganizing or implementing a major change in operations which has not been completed.

(3) received an initial loan, and each crop year thereafter, until the County Supervisor determines the borrower is conducting the operation satisfactorily.

(4) have had loans restructured in accordance with Section 1951.906 of FmHA Instruction 1951-S.

Mr. John W. Harmon 3

FmHA has and will continue to emphasize the importance of borrower year-end analysis and the development of realistic farm operating budgets, based on the operator's actual yields, and costs of production. This will be accomplished through State Office field training, at the State and District levels; Administrative Notices (ANs); State Loan Program Reviews; Coordinated Assessment Reviews (CARs); and encouragement of employee self-improvement, through applicable courses offered by USDA and the private sector on a self-study or instructor basis.

The majority of County Supervisors and Assistant County Supervisors have farm backgrounds and a college degree in Agricultural Economics/Business or related fields. Many of the supervisors have taken the basic and advanced courses in Credit/Financial Analysis offered by Dunn and Bradstreet.

FmHA initiated a pilot project in five States during 1986, consisting of a voluntary self-study course titled, "Agricultural Lending/Credit Analysis," requiring six months for completion. This program covers the skills and techniques necessary for a lender to evaluate and make sound credit decisions. To date, over 400 FmHA employees have completed this course. The intent is to make this course available nationwide after assessing the effectiveness of the pilot project.

CHAPTER 3 - FmHA UNSUCCESSFULLY TRIED TO IMPROVE ITS LOAN-MAKING CRITERIA

Recommendation Pg. 69 (4) ... FmHA should pursue the development of more comprehensive loan-making criteria which would assess applicants' financial solvency, profitability, liquidity and repayment ability prior to making new loans.

After the development of new criteria, FmHA should work with the Congress to determine where to draw the line between those financially troubled farmers who could be helped and those who could not be helped with FmHA financial assistance.

Response: We agree the use of loan-making criteria which assess the applicant's/borrowers's solvency, profitability and repayment ability is desirable and would improve the FmHA Farmer Programs loan portfolio, especially form the standpoint of sounder lending. FmHA attempted to incorporate criteria in the applicable instructions which would have evaluated loan risk on initial FP applications. The FP Pre-Application Loan Risk Evaluation process was based on the use of 3 ratios, i.e.: (1) Total Liabilities/Total Assets; (2) Net Cash Farm Income (before interest payments - family living expenses) Total Assets; and (3) Current Assets/Current Liabilities. These criteria were published in the Federal Register as a proposed rule on January 15, 1987. In view of adverse comments from the general public, farm advocacy groups, and members of Congress, the proposed Loan Risk Evaluation process was removed from the procedural instructions. The concern was that, by screening applications for loan risk, it would deny a large number of farmers needed credit and would force them out of business. As indicated below, there are considerations other than loan feasibility for assisting financially distressed farmers.

Mr. John W. Harmon 4

FmHA loan officials are not required by law or policy to work with established loan risk ratios in the initial and subsequent application process. However, they do, during the evaluation process give consideration to the relationships between debts and assets, operating expense to gross farm income, short and intermediate debts to total debts, family living expense to total gross farm income, and total interest expense to total gross income. These relationships are considered during initial loan determinations on feasibility and during annual analyses of borrowers' operations prior to approving subsequent loans. FmHA County Supervisors are required to maintain Form FmHA 1960-12, "FINANCIAL ANALYSIS SUMMARY," on existing borrowers, which reflects trends in financial progress, income, expenses and debt payment history over a 6-year period. County Supervisors generally have the information, experience and knowledge to make logical/sound loan decisions, which frequently have been negated by Statute or administrative policy, e.g., continuation loans mandated by the Supplemental Appropriations Act for FY 1987 (P.L. 100-71).

FmHA being the "lender of last resort" has the mission of working with farmer and rancher applicants who have financial and/or production management problems as a result of inadequate resources, adverse weather or price related problems. In carrying out this mission, FmHA recognizes that many American farmers are in their present unfavorable financial position for reasons beyond their control.

FmHA has and will continue to work with and carry out the mandate of Congress relative to assisting eligible farmers and ranchers, through loan and supervisory assistance, to remain on their farm, with the ultimate goal of achieving viable agricultural operations. It is recognized that many existing farmers cannot be salvaged even with existing FmHA loan programs and servicing options available; and therefore, will have to make a transition from agriculture.

Sincerely,

LA VERNE AUSMAN
Acting Under Secretary
for Small Community
and Rural Development

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