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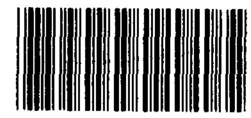

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Issues Surrounding the Role and Mission of the Farmers Home Administration's Farm Loan Programs

Statement of
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Before the
Subcommittee on Conservation, Credit, and Rural Development
House Committee on Agriculture

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our efforts in examining the Farmers Home Administration's (FmHA) farm loan programs and related issues. Since enactment of the Food Security Act in December 1985, we have carried out a number of reviews of FmHA's programs and financial condition. We are issuing our most recent report on FmHA's financial statements today. Appendix I provides information about each of the 17 reports we have issued during this period. Many of these reports include matters for congressional consideration as well as recommendations to FmHA for program improvements.

In summary, the continued deterioration in FmHA's financial condition, despite a general improvement in the overall agricultural economy, and the many problems faced by FmHA in carrying out its mission leads us to believe that the Congress needs to reexamine FmHA's role. Specifically, our work has shown that:

-- The financial condition of FmHA's farm loan portfolio has deteriorated to the point where about one-half of its $23 billion in outstanding direct farm loan principal is owed by delinquent borrowers and vulnerable to future losses. In addition, material internal accounting control weaknesses exist.

-- FmHA's loan making policies have provided farm loans to borrowers who are unable to repay them and, as a result, borrowers require extensive loan servicing actions.

-- Rather than a source of temporary credit, FmHA has become a continuous source of subsidized credit for many farmer program borrowers.

-- While funding emphasis has shifted from direct to guaranteed loans, most guaranteed loans are being made to existing commercial lender customers and few direct farm loan borrowers have shifted to guaranteed farm loans. Consequently, the government's overall financial exposure has increased.

My testimony also includes information about ongoing work, including our recent report examining certain aspects of the Agricultural Credit Act.

Balancing the role of FmHA as both an assistance and a loan-making agency is difficult and 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 any event, we believe a reevaluation of FmHA's role and mission is needed. Without change, the likely outcome is continued deterioration in FmHA's farm loan portfolio and further losses. We have identified several key issues the Congress may wish to consider as it deliberates FmHA's future role and mission in providing farm credit to the nation's distressed farmers.

FINANCIAL CONDITION OF FmHA'S FARM LOAN PORTFOLIO

Our reports on the financial condition of FmHA's farm loan

portfolio[1] show that the outstanding principal in FmHA's direct farm loan programs,[2] as well as delinquencies and loan losses, have increased dramatically since the mid-1970s, placing the federal government and, ultimately the taxpayers, at considerable risk. The deterioration in FmHA's farm loan portfolio has continued despite the improvement in the overall farm economy. In addition, our financial audits of FmHA have uncovered material internal accounting control weaknesses.

Outstanding principal for FmHA's direct farm loan programs was about $5 billion as of June 30, 1976, and about $23.3 billion as of September 30, 1989.[3] Outstanding principal owed by delinquent borrowers was about $723 million in 1976 and about $11.1 billion as of September 30, 1989. Outstanding principal for FmHA guaranteed farm loans was about $484 million as of September 30, 1984, and about $3.2 billion as of September 30, 1989. Outstanding principal owed by guaranteed delinquent borrowers was about $135 million as of September 30, 1987, and about $197 million as of September 30, 1989. Tables 1 and 2 provide further information on FmHA's direct and guaranteed farm loans as of September 30, 1989.

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[1]Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR; Jan. 2, 1986); Farmers Home Administration: Farm Program Debt, Delinquencies, and Loan Losses as of June 30, 1987 (GAO/RCED-88-134BR; May 20, 1988); Financial Audit: Farmers Home Administration's Losses Have Increased Significantly (GAO/AFMD-89-20; Dec. 20, 1988); and Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987 (GAO/AFMD-90-37; Jan. 25, 1990). The last two reports focus on all of FmHA's financial activities, including farm loan programs.

[2]FmHA's current major direct farm loan programs include farm ownership loans to buy and improve farm land and to construct, repair, and improve buildings; farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor; and emergency loans for actual losses caused by natural disasters.

[3]All fiscal year 1989 data used in this testimony is preliminary, unaudited, and subject to audit adjustment at a later date.

Table 1: FmHA Direct Farm Loans and Delinquency Status, September 30, 1989

Dollars in Millions

	Farm ownership	Farm operating	Emergency disaster	Economic emergency[a]	Other[b]	Total[c]
Total borrowers[d]	109,389	98,225	88,575	37,120	13,133	346,442
Delinquent borrowers[d]	23,775	35,006	35,082	17,267	3,607	114,737
Delinquent borrowers as a percent of total	21.7	35.6	39.6	46.5	27.5	33.1
Total outstanding principal	$7,046	$5,229	$7,683	$3,065	$259	$23,282
Outstanding principal owed by delinquent borrowers	$2,015	$1,940	$5,252	$1,818	$104	$11,130
Outstanding principal owed by delinquent borrowers as a percent of total	28.6	37.1	68.4	59.3	40.2	47.8

[a]These loans were authorized from 1978 to 1984; the program has not been authorized since September 30, 1984.

[b]This category includes all other individual direct farm loans, such as soil and water loans to help farmers and ranchers develop, conserve, and properly use land and water resources.

[c]Totals may not add due to rounding.

[d]This table presents data by loan type rather than individual borrower, which results in borrowers being counted in each loan category in which they have a loan.

Source: GAO analysis of FmHA Active Borrowers Delinquent Report data (FmHA report code 616).

Table 2: FmHA Guaranteed Farm Loans and Delinquency Status, September 30, 1989

Dollars in Millions

	Farm ownership	Farm operating	Other[a]	Total
Total borrowers[b]	5,549	23,670	797	30,016
Delinquent borrowers[b]	300	1,063	217	1,580
Delinquent borrowers as a percent of total	5.4	4.5	27.2	5.3
Total outstanding principal	$772	$2,371	$101	$3,244
Outstanding principal owed by delinquent borrowers	$44	$120	$33	$197
Outstanding principal owed by delinquent borrowers as a percent of total	5.7	5.1	32.7	6.1

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

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

Source: GAO analysis of FmHA Analysis of Delinquencies Report data (FmHA report code 4067).

The cumulative results of operations for FmHA's Agricultural Credit Insurance Fund (ACIF)--the revolving fund from which all farmer program loans are made--shows a multibillion dollar accumulated deficit since it was established in 1946. The report we are issuing today--Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987--shows that

the ACIF has incurred cumulative net losses of about $39.6 billion since its inception, while receiving cumulative reimbursements for losses (appropriations from the Congress) of about $11 billion. The cumulative results of operations for the ACIF as of September 30, 1988, was a deficit of $28.6 billion.

A significant portion of the nearly $40 billion in cumulative net losses for the ACIF was recognized by FmHA during fiscal years 1987 and 1988 when FmHA increased its allowances for loan and related interest losses by a net $10.6 billion and $2.9 billion, respectively. During 1987, FmHA initially established an allowance for loan losses, to conform with generally accepted accounting principles, which resulted in unusually high adjustment for losses being charged to fiscal year 1987 expenses. The adjustment for losses in 1987 was not attributable to a single adverse event in 1987, but was the cumulative effect of the declining trend in the agricultural economy over the past several years. Consequently, the 1987 adjustment for losses on loans included both a provision for 1987 and an adjustment for prior years' losses.

As the report we are issuing today shows, in fiscal year 1988, FmHA reported $30.5 billion in unpaid principal and interest on the ACIF's direct farm loan portfolio. The allowance for losses established for the direct farm loan portfolio totaled $19.0 billion, or 62 percent of the unpaid principal and interest. FmHA also reported that the guaranteed unpaid principal on the ACIF's guaranteed farm loans totaled $3.6 billion. The allowance for losses established for the guaranteed farm loan portfolio totaled $1.2 billion, or 33 percent of the guaranteed unpaid principal.

In our latest report on FmHA's system of internal accounting controls, we noted material weaknesses in the loan classification system used to estimate losses on individual farm loans. Changes

are needed to correct these weaknesses so that future loss provisions are properly estimated. Furthermore, our report discloses the following material internal accounting control weaknesses related to acquired property: (1) FmHA's Acquired Property Tracking System contained inaccurate and incomplete information, (2) FmHA has not completed system modifications which would allow it to properly record acquired property at fair market value or to record the associated gain or loss at the time of acquisition, and (3) FmHA has not developed a methodology for determining property holding and disposition cost factors for estimating loan losses and for computing the acquired property balance. Our opinion on FmHA's fiscal year 1988 financial statements is qualified for these reasons. Our report includes recommendations to correct each problem area.

While FmHA has made progress in improving the financial management of its operations, there remain several areas of concern. The agency's financial management systems do not provide the kind of cost information that program managers need to effectively evaluate the results of their decisions. There is also a need for more effective accountability reporting. The preparation and audit of annual financial statements is now in its third year. This provides excellent financial management discipline and deterrence to waste and mismanagement, and we strongly recommend continuance of this practice.

FmHA LOAN-MAKING AND LOAN-SERVICING POLICIES AND PRACTICES

The major report we issued relating to FmHA's loan-making and loan-servicing policies and practices[4] shows that, as directed by congressional action, FmHA has placed heavy emphasis on keeping

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

farmers in business. In short, FmHA is on a loan-making and servicing treadmill. Optimistic loan-making decisions--which are based on a cash flow analysis that does not consider contingencies or equipment replacement and tends to overstate income--are followed in many instances by the need for servicing actions, such as rescheduling, and additional loans, which are also based on optimistic cash flow projections. Often borrowers cannot repay the initial loan or the subsequently serviced loan and the cycle continues.

FmHA was established to serve as the "lender of last resort" for family farmers unable to obtain credit elsewhere at reasonable rates and terms. It has traditionally played a critical role in helping financially stressed farmers stay in business. Assistance is obtained through loans that are expected to be repaid to protect the government's and ultimately the 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.

Recent congressional direction has generally been aimed at keeping financially stressed farmers in business. For example, in July 1987 the Congress directed FmHA to reinstate the "continuation policy" rescinded by FmHA in November 1985. This policy allows existing borrowers to obtain additional FmHA operating loans without showing the ability to repay prior loans. 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 loan foreclosure and liquidating borrowers' assets.

In making loan decisions, FmHA uses a cash flow criterion that requires borrowers' expected revenues to cover projected expenses, including loan repayment. However, we found that 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. For example, although not projectable, a review of 100 of 160 randomly selected borrowers' files (for which sufficient financial data were available) showed that repayment ability and cash farm income had been overstated, on average, by about 24 percent and over 18 percent, respectively.

As a result, borrowers often cannot make their scheduled payments and require extensive servicing actions, such as reducing interest rates or increasing the repayment period. For example, FmHA made a total of 414 loans in 1986 to our sample of 160 borrowers. Of this number, 264 loans, or about 64 percent, were servicing actions on loans originally made prior to 1986. These 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)--the average time between servicing was 2.8 years and the final scheduled payment date was lengthened an average of 8 years. One loan had gone through nine servicing actions over a period of about 4.5 years.

We updated selected data for the 414 loans made to the 160 sampled borrowers. As of September 30, 1989, 116 loans, or 28 percent of the 414 loans, had been serviced by rescheduling, reamortization, or consolidation. Another 41 loans, or 10 percent, were no longer active because the borrowers were in bankruptcy, had debt settled, or, under the provisions of the Agricultural

Credit Act, had bought out of their FmHA debt at the net recovery value of the collateral.

A consequence of extensive loan servicing is that short-term debt that has repayment periods extended several times eventually becomes long-term debt. This long-term debt may no longer be adequately secured. FmHA does not require additional security for serviced loans, even if the original security is no longer adequate. 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. Loan servicing also has a financial impact on the government. FmHA has estimated that implementation of the debt restructuring provisions of the Agricultural Credit Act will result in about $9.4 billion in FmHA farmer program debt being written down or written off.

In January 1987, FmHA proposed revised criteria to improve its loan-making decisions. The proposed criteria, which included a 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 denial of further assistance to many borrowers as a result of the credit scoring

system, 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 of 1987, 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.

On September 28, 1989, FmHA awarded a contract to conduct a study of loan approval and borrower selection criteria. The study is scheduled for completion in May 1990. The agency has indicated that when the study is completed, FmHA will (1) evaluate the results and revise its regulations as appropriate and (2) consult with the Congress early and often on the study to obtain congressional support for the necessary changes in loan approval and borrower selection criteria.

TIME PERIOD FOR PROVIDING CREDIT ASSISTANCE

Our work[5] has also shown that authorizing legislation and implementing regulations governing FmHA's farm loan programs mandate that the agency is to be a temporary source of credit and that borrowers graduate to non-FmHA sources of credit when they are able to do so. However, FmHA has evolved into a continuous source of subsidized credit for nearly one-half of its borrowers. For example, as of December 31, 1986, nearly 112,000 borrowers, about 42.5 percent of all FmHA direct farm loan borrowers at that time, had had at least one active loan continuously for 7 years or more. This included about 57,600 borrowers (about 22 percent) who had had at least one loan continuously for 10 years or more.

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

As table 3 shows, the total percentage of borrowers that have had at least one FmHA loan continuously for 7 years or more has remained unchanged at 42.5 percent. A major change, however, was in the 10 years or more category which increased from about 22 percent in 1986 to about 35 percent in 1989.

Table 3: Number of Years of Involvement in FmHA's Farmer Programs and Number of Loans Received for All Active Borrowers as of September 30, 1989

Years in FmHA	Number of borrowers	Percent of total	Number of loans received	Percent of total
0 to 3	34,079	16.0	76,330	12.4
3 to 5	53,872	25.3	154,615	25.2
5 to 7	34,261	16.1	102,326	16.7
Total under 7	122,212	57.4	333,271	54.3
7 to 10	16,342	7.7	48,298	7.9
10+ over	74,276	34.9	231,943	37.8
Total over 7	90,618	42.5	280,241	45.6
Not determined[a]	224	.1	503	.1
Total	213,054	100.0	614,015	100.0

[a]We excluded from our calculations loans with a closing date prior to 1954 and those where data were not available.

Source: GAO analysis of FmHA data.

Over the past several decades, FmHA's temporary credit role and graduation mandate have been deemphasized in favor of a policy of keeping farmers in business for long periods regardless of their financial condition. This has been accomplished in a variety of ways that involved all three branches of the government. For example, the congressionally approved continuation policy keeps farmers in business with new loans even if they cannot show an ability to repay all outstanding debts. FmHA provides continuous servicing of loans to keep farmers in business. And the courts,

through various orders and injunctions, temporarily suspended FmHA foreclosure actions in the past until FmHA clarified certain notices and procedures for its borrowers.

While FmHA has been successful in keeping farmers in business, it has not been without cost. For example, in our November 1988 report we estimated that during 1986 the government interest rate subsidies received by FmHA farm program borrowers--the difference between the interest rate charged the farmer and the interest cost the government incurred to obtain the funds it loaned--was between $612 million and $1.6 billion. FmHA borrowers also have a financial advantage over other farmers who must pay higher interest rates to borrow money from non-FmHA lenders. We estimated this advantage amounted to between $1.2 billion and $2.2 billion during 1986.

For example, after 15 years in FmHA's farm loan programs, a farmer, raising corn, soybeans, and cattle, had received 39 loans. He had 14 loans with a balance of $435,790 outstanding as of December 31, 1986. For 38 loans on which we could develop reliable histories from FmHA files, FmHA had taken 17 loan servicing actions, including rescheduling, reamortization, and debt set-aside. The 38 loans ranged from $2,500 to $90,524 and totaled $501,357. We estimated in constant 1986 dollars that the borrower had received $49,053 in government interest rate subsidies and $98,141 in financial advantage over non-FmHA farm borrowers. Despite FmHA assistance, the borrower's reported net worth declined from $20,368 in 1971 to a negative $6,635 in 1986.

SHIFT FROM DIRECT TO GUARANTEED FARM LOANS

Since 1984, FmHA has been shifting its farm lending from direct to guaranteed farm loans. This shift was authorized by the Food Security Act and subsequent appropriations. Our September

1989 report[6] showed that the increase in guaranteed lending--from about $71 million to $1.3 billion between fiscal years 1983 and 1988--has resulted primarily from private lenders obtaining loan guarantees for their existing customers who had become financially stressed rather than existing FmHA direct borrowers obtaining guaranteed loans. Our analysis of FmHA loan data showed that only 2 percent of the borrowers with direct farm operating and/or ownership loans between 1985 and 1987 also obtained the same type of guaranteed farm loans.[7] Direct lending declined--from about $2.4 billion to $1.0 billion between fiscal years 1983 and 1988--primarily because of earlier availability of government farm program payments, fewer borrowers, reduced farm operating expenses, and reduced direct farm ownership lending authorizations.

The impact of the shift to guaranteed lending varies among borrowers, lenders, and the government and cannot be easily measured. Although guaranteed loans help high-risk borrowers obtain credit from private lenders on better loan terms, these borrowers have higher costs of money, stricter loan terms, and, at the time of our work, greater likelihood of liquidation because of lender policies than do FmHA direct loan borrowers. These factors are disincentives for direct loan borrowers to seek guaranteed loans. Guaranteed loans benefit lenders by reducing financial risk and loan losses, improving liquidity and profitability from selling the guaranteed portion of loans in the secondary market, and upgrading the classification of their loan portfolios with bank regulators.

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

[7]This analysis was further supported by the U.S. Department of Agriculture's Office of Inspector General in a September 1988 report that projected that about 1 percent of the 15,585 guaranteed farm loans totaling $1.5 billion in its sample universe were used to finance FmHA direct loan borrowers.

The impact of the shift on the government is mixed. The increase in guaranteed lending has helped keep some farm lending in the private sector and reduce budgetary outlays needed to make new direct loans. However, because few direct loan borrowers have switched to guaranteed loans, and most likely will not because of their poor financial conditions, continued substantial budget outlays will probably be needed to provide financing to help them stay in business. In addition, the increase in outstanding principal for guaranteed loans has outpaced the decrease in that for direct loans, by about $570 million between fiscal years 1986 and 1988. Consequently, despite the progress in shifting from direct to guaranteed lending, the government's overall financial exposure has increased.

While FmHA's guaranteed farm operating and ownership loan activity has significantly increased since 1984, losses on these loans have grown at a faster rate. Loan delinquencies are also growing, and FmHA projects that losses on guaranteed loans will increase in the future.

Because lenders generally obtain guarantees on loans for financially stressed farmers, losses on such loans can be expected. Although some loan losses may be attributable to uncontrollable factors, such as adverse weather conditions and a poor farm economy, problems in FmHA's assessment of borrowers' financial conditions prior to guarantee loan approval and in FmHA's oversight of lenders' servicing of guaranteed loans after approval have also contributed to guaranteed loan losses. These problems are similar to those that FmHA has with its direct farm loans. As the shift continues from direct to guaranteed farm loans, correcting the problems with the guaranteed loan program grows in importance: to control the mounting losses, prevent the loss of the shifts' budgetary advantage, and avoid the experience with the direct loan program.

In our September 1989 report we included three case studies on borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies are included as appendix II.

CONTINUING EFFORTS TO EXAMINE SIGNIFICANT FmHA ISSUES

Our work on FmHA issues is continuing. For example, we are examining (1) the planned use of fiscal year 1988 direct and guaranteed farm operating and farm ownership loans (report expected within the next month), (2) implementation of the debt restructuring provisions of the Agricultural Credit Act (report expected in the spring of 1990), (3) farm program debt, delinquencies, and loan losses as of June 30, 1989 (report expected in the spring of 1990), (4) controls for identifying and reporting cases of fraud, waste, and abuse in FmHA's farm loan programs, (5) the selling price for farm inventory properties, and (6) FmHA's fiscal year 1989 financial statements. We plan to report the results of the last three assignments later in 1990.

As part of our work examining the Agricultural Credit Act, we issued Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS; Nov. 29, 1989). This report provides examples of FmHA delinquent borrowers who have acted in bad faith[8] and who have received benefits, or will be eligible to receive benefits, under the provisions of the act.

FmHA determined that borrowers acted in bad faith because of various actions, such as (1) selling or otherwise disposing of

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[8]We use the phrases "borrowers who act in bad faith" and "bad faith borrowers" to refer to those FmHA delinquent borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans.

property securing loans without FmHA approval; (2) repaying other lenders more than required and, at the same time, becoming delinquent on FmHA loans; (3) abandoning the property securing FmHA loans; and (4) having resources available that could have been, but were not, used to make FmHA loan payments. In appendix III we include the eight case examples from our November 1989 report to illustrate FmHA bad faith determinations and how bad faith borrowers benefited, or will be eligible to benefit, under the terms of the Agricultural Credit Act.

In January 1990, FmHA provided members of Congress with a list of 218 bad faith borrowers throughout the country that it said had committed fraud, waste, or conversion of security property and who were involved in net recovery value buyouts. Forty-two of those borrowers had bought out their debt at a net recovery value and 58 other borrowers were in the process of buying out their debt. These 100 borrowers include 8 borrowers who bought out or were in the process of buying out their debt that will result in a write off of more than $1 million each. For example, one borrower with proven fraud owed FmHA $11.8 million and was offered a $1.1 million net recovery value buyout. This borrower will receive a $10.7 million write off of his FmHA debt if he pays the buyout amount. In addition, 118 borrowers on the national list were offered net recovery value buyout, but they did not accept the buyout offer. These borrowers will be eligible to reacquire their farmland, or farm homestead, if FmHA forecloses on their properties.

MATTERS FOR CONGRESSIONAL CONSIDERATION

FmHA has the difficult task of achieving its assistance goals while also employing sound loan-making policies. Although the Congress and FmHA have used existing credit policies as a means of keeping farmers in business and assisting rural communities, the

Congress may want to examine the long-term effect such policies have on borrowers.

FmHA and its borrowers need to realistically assess borrowers' chances of financial recovery before they lose additional equity through continued borrowing. 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. To this end, we recommended that FmHA develop, in consultation with the Congress, a more comprehensive loan-making criteria for both direct and guaranteed farm loans that assess an applicant's financial solvency, profitability, liquidity, and repayment ability prior to making new loans. This will assist borrowers by providing them with a more realistic assesment of their financial condition before they accept additional credit, and also help improve the financial condition of FmHA's farm loan portfolio.

We recognize that the Congress, through its recently passed legislation, wants to continue to assist financially stressed farmers and keep them in business if at all possible. However, the use of a cash flow criterion in loan-making decisions and the trend toward becoming a continuous source of credit raises fundamental questions regarding FmHA's mandate to serve as a temporary source of credit while, at the same time, fulfilling its role as a lender of last resort.

In addition, shifting funding from direct to guaranteed farm loans will not solve FmHA's problems. With the increased credit costs and the greater risk of liquidation associated with guaranteed loans, coupled with direct loan borrowers' poor financial conditions, it is unlikely that significant numbers of direct loan borrowers will shift to guaranteed loans in the future. If direct loan funding continues to decline and delinquent direct loan borrowers continue to request direct loan financing under

recent congressional initiatives, funding may not be sufficient to meet future credit needs of all direct loan borrowers.

As we have reported, the Congress may wish to reevaluate the current and future role of FmHA by examining several key issues, including the following:

-- Are the continuation and debt restructuring policies the best means of assisting already heavily indebted farmers?

-- At what point will the cost of providing continuous credit assistance to financially marginal farmers--including the cost of loan losses, interest rate subsidies, and administrative expenses--outweigh the benefits to the government, rural communities, and the farmer?

-- If FmHA is to serve as a temporary source of credit, should specific criteria be developed--such as time limits and/or measurable financial improvement--to decide when a borrower has had a sufficient opportunity to become financially sound and be in a position to graduate to non-FmHA sources of credit?

-- For those borrowers who, after a period of time, show little or no prospect for succeeding, would it be more appropriate to provide other forms of assistance, such as job training, to aid in possible transition to other employment opportunities?

In the final analysis, decisions concerning FmHA's future role and mission will require congressional judgments about complex, and sometimes competing, objectives. We believe the work we have completed to date and the work that is underway will aid the

Congress as it deliberates how best to provide farm credit assistance to the nation's distressed farmers.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions.

OVERVIEW OF RECENT GAO REPORTS HIGHLIGHTING FmHA ISSUES

Since December 1985, GAO has issued 17 reports that highlight various FmHA issues. The following brief description provides the report title, number, and date, and summary information from each report.

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

As requested by the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, this briefing report provides information on the financial condition of the FmHA loan portfolio for its five major farmer loan programs: farm ownership, operating, emergency disaster, economic emergency, and soil and water. Specifically, this report provides both national and state information on (1) total farm debt and FmHA's portion of that total, (2) total number of loans and borrowers and loan amounts for each of FmHA's major farmer programs, and (3) delinquencies and loan losses occurring in these programs.

The financial condition of farmers and their lenders had deteriorated rapidly between 1980 and 1985. As a result, increasing numbers of farmers were turned down for financing by their private lenders and came to FmHA for credit assistance. FmHA responded to these credit requests by substantially increasing its loan portfolio. At that time, FmHA's major farmer program loan portfolio was increasingly becoming at risk because delinquencies were on the rise and loan losses were mounting.

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

The Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, expressed concern over the American farmers' growing reliance on the resources of FmHA. He noted that FmHA's outstanding farm loan portfolio had increased from about $6 billion in 1978 to almost $28 billion in 1985. With the Congress addressing the issue of financial stress in U.S. agriculture, including FmHA's future role in assisting additional farmers, he asked GAO to inform the Committee of the current financial condition of both FmHA borrowers and the farm loan portfolio. This report and another report entitled Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Losses (GAO/RCED-86-57BR; Jan. 2, 1986) responded to his request.

At the time that this work was performed, FmHA had a computerized data base, the Farmer Program Management Information

System (FARMS), that contained certain financial and general characteristics of borrowers, such as debt load and cash flow, the type and size of farm operations, and demographic data. FARMS,[1] started in 1983, used information obtained from FmHA loan documents on borrowers who had received loans for (1) farm ownership, (2) annual operating expenses, (3) emergency disaster losses, and (4) soil and water development and conservation. Although FARMS did have some limitations, at that time it was the most complete source of financial information available on FmHA borrowers. FmHA said this information was representative of all FmHA farmer program borrowers on a national basis but was not projectable to individual states or counties.

This briefing report presents information on a total of 65,893 FmHA borrowers who received 117,366 farm loans during 1983 and 1984 (about 53 percent of all farm loans made during that period). The report provides information on borrower assets and liabilities, debt-to-asset ratios, and equity positions; discusses the cash flow position of the borrowers; provides general characteristics of borrowers including farm type, size, and demographic data; and provides our observations related to our analyses of the FARMS data.

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

As requested by the Chairman, Subcommittee on Administrative Practice and Procedure, Senate Committee on the Judiciary, and Congressman Cooper Evans, this briefing report provides information on FmHA's debt restructuring activities with private lenders to meet the 1984-85 farm credit crisis.

The report has four major sections and contains (1) a description of FmHA's debt restructuring activities, including the loan programs and types of loans used to help farmers restructure their farm debt; (2) information on the magnitude of FmHA debt restructuring and the substantial increase in this activity between fiscal years 1984 and 1985; (3) case-study profile information on borrowers' farm income, debt-to-asset ratios, average loan amounts, and other related financial statistics in four FmHA county offices; and (4) comments from FmHA officials, national banking associations, and local lending institutions across six states on why private lenders were or were not participating in FmHA's debt restructuring activities.

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[1]The FARMS data base no longer exists.

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

This report is addressed to five congressional requesters and discusses the large number of farms that FmHA had acquired as a result of loan foreclosures and other actions. The report also discusses FmHA's management of this farm property and the procedures used to sell or lease the property.

In the report, GAO projected that FmHA would lose about $190 million on the 1,270 properties in the 6 states reviewed. These losses would occur primarily because the value of the acquired properties will be less than the defaulted-borrowers' unpaid indebtedness and the cost of acquiring, managing, and selling the properties. GAO made several recommendations to the Secretary of Agriculture aimed at improving FmHA's selling efforts for inventory property, reducing the time that reserved properties are held for sale to only FmHA-eligible farmers, and prohibiting farmers from growing surplus crops on FmHA-leased properties.

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

The briefing report is addressed to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and provides information on the extent that FmHA borrowers were continually delinquent on their farm loans (defined as borrowers that were delinquent as of June 30 in each of 3 consecutive years--1984, 1985, and 1986). The report shows the following:

--Of approximately 261,000 total FmHA farm borrowers, 50,033 were continually delinquent. About 34,600 of these borrowers, or 13 percent of the total farm borrowers, accounted for 78 percent of the total $6.8 billion delinquent payments owed FmHA as of June 30, 1986.

--Of the 50,033 continually delinquent borrowers, 8,043 had discontinued or were discontinuing farming as of July 1986. According to FmHA records, 41,983 of the remaining delinquent borrowers were still actively farming. Information was not available on the status of the other seven continually delinquent borrowers.

--Of the 41,983 continually delinquent borrowers actively farming, 25,441 had not made a loan payment on at least one loan since 1983 or earlier, and 1,364 had never made a payment on any of their FmHA loans.

--Emergency disaster loans accounted for 63 percent of the total delinquent amounts owed by the 41,983 active continually delinquent borrowers.

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

This briefing report is addressed to the Chairman, Senate Select Committee on Indian Affairs, and Senator John Melcher and provides information concerning the potential loss through foreclosure of reservation land used by Indians as collateral when obtaining FmHA farm loans. This work resulted in obtaining agricultural credit information from 14 specified reservations in Montana, North Dakota, and South Dakota.

The report provides statistics on past, current, and predicted losses of land pledged by Indian borrowers as security for FmHA farm loans; a description of options available to help Indians avoid the loss of reservation land; historical information about the use of the Indian Tribal Land Acquisition Program and information about tribal interest in its future use; a summary of the working relationship between FmHA and the Bureau of Indian Affairs (BIA) in issuing, servicing, and foreclosing on FmHA farm program loans to Indian borrowers; and FmHA and BIA views on possibly shifting FmHA loan functions to BIA for farm loans made to Indians.

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

This report is addressed to the Ranking Minority Member, Subcommittee on Agriculture, Rural Development, and Related Agencies, Senate Committee on Appropriations, and discusses how the FmHA emergency loan program evolved over the previous several years, why its delinquency rate was so high, what alternatives were available to deal with debt that may be uncollectible, and any changes needed in legislation and/or program regulations to make it function more effectively. The report contains no recommendations for legislative or program changes, in large part, because, at that time, changes in legislation and FmHA loan policies should have resolved many of the program's past problems. The report does include issues for congressional consideration and raises questions about whether credit, particularly liberal credit, is the proper vehicle for providing disaster relief to farmers.

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

This report is addressed to Senator Kent Conrad and provides updated information on FmHA's farm loan program debt, delinquencies, and loan losses that was included in our January 1986 report entitled, Farmers Home Administration: An Overview of Farmer Program Debt, Delinquencies, and Loan Lossess (GAO/RCED-86-57BR; Jan. 2, 1986). The report shows the financial condition of FmHA's farm loan portfolio as of June 30, 1987, for FmHA's five major farm loam programs: farm ownership, operating, emergency disaster, economic emergency, and soil and water. Specifically, the report provides both national and state information on (1) total farm debt and FmHA's portion of that total, (2) total number of loans and borrowers and loan amounts for each of FmHA's major farm programs, and (3) delinquencies and loan losses occurring in these programs.

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

As requested by Senator Jesse Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at the time of his request, this report determines (1) if FmHA is graduating borrowers as intended, (2) whether FmHA has evolved into a long-term source of credit, and (3) the amount of government interest rate subsidy and financial advantage received by FmHA borrowers. The message of this report is discussed in the overall testimony.

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

This report is addressed to the Secretary of Agriculture and presents the results of our examination of FmHA's financial statements for the year ended September 30, 1987, and our reports on internal accounting controls and compliance with laws and regulations.

The financial statements reflect a significantly deteriorating financial condition at FmHA for several reasons: (1) FmHA lends money at interest rates far below what it must pay, (2) many of its borrowers are, by commercial standards, not creditworthy, (3) a severe decline in the agricultural economy over the previous several years has led to congressional initiatives aimed at keeping farmers in business, and (4) many of the loans are delinquent and unlikely to be repaid.

Because of FmHA's operating losses, its accumulated deficit of $36 billion, and its present reliance on Treasury borrowings to continue operations, we are concerned that FmHA will require direct assistance from the Congress at levels significantly greater than the Congress has provided in the past. FmHA borrowed $12 billion from the Treasury in fiscal year 1987 to meet current obligations. The total amount due to the Treasury has steadily increased from about $60 billion in 1982 to $85 billion in 1987, of which $24 billion was due by 1989.

Our opinion on FmHA's statement of financial position reflects our concerns over the agency's inability to repay its borrowings and to meet its current operations without incurring additional debt and the magnitude of its accumulated $36 billion deficit, which includes $22 billion for losses recognized in fiscal year 1987. Furthermore, our opinion is qualified because FmHA does not record property received by voluntary conveyance at fair market value at the time of acquisition in accordance with generally accepted accounting principles for federal agencies.

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

As requested by Senator Jesse Helms, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry at the time of his request, this report determines (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. The message of this report is discussed in the overall testimony.

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

This report is addressed to Representative Leon Panetta and provides information on (1) the extent of use of the interest rate reduction program for guaranteed farm loans, (2) reasons why activity is at its present level and the likelihood of expansion, (3) the potential impact of FmHA-guaranteed farm loans with interest rate reduction on the U.S. budget compared with that of FmHA direct loans, and (4) compliance issues identified by USDA's Office of Inspector General.

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

This report is addressed to the Chairman, House Committee on Agriculture, and provides information on four provisions of the Food Security Act of 1985 designed to help financially distressed farmers with FmHA farm loans: (1) homestead protection, (2) disposition and leasing of farmland commonly referred to as "lease/buy-back," (3) conservation easement, and (4) softwood timber production. The report discusses the extent of program use and whether the provisions were modified by the Agricultural Credit Act of 1987 and identifies several issues the Congress and the Secretary of Agriculture should consider in assessing how the provisions are being implemented.

For example, borrowers could use the same land to benefit from both (1) the conservation reserve program administered by the Agricultural Stabilization and Conservation Service and the conservation easement provision and (2) the conservation reserve program and the softwood timber provision. Our work also showed that FmHA charged interest rates for softwood timber loans, which were generally lower than the maximum permitted by the 1985 act, and calculated interest on a simple, rather than compound, interest basis. As a result, we calculated that at the end of the deferral period the government would receive about $21.4 million less in interest revenues for the 14 approved softwood timber loans (the total number of loans approved at the time of our review) than it would otherwise receive. To illustrate the significance of the potential reduction in interest revenues for the maximum number of acres that can be included in FmHA's softwood timber program, we calculated that the government--under certain assumptions--would receive over $1 billion less in interest revenues than it would otherwise receive at the end of the deferral period if all allowable acreage (50,000 acres) was to be enrolled in the program.

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

This report is addressed to the Acting Administrator, Farmers Home Administration, and provides information on FmHA's planning efforts to redesign, replace, or enhance its automated systems at an estimated cost of at least $100 million over the next 5 to 7 years. The report discusses several issues that are critical to the success of FmHA's moderization plans. Those issues include (1) ensuring that the modernization program addresses the information needs of all agency components, (2) ensuring that the agency has a sufficient number of qualified managers and staff to support its continuing day-to-day operations and to implement the modernization

program, (3) developing and following instructions for preparing complete economic analyses to help ensure cost-effective modernization decisions, and (4) providing for a strong data-administration function to develop and ensure compliance with standards, so that individual systems can easily share information.

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

This report is addressed to the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and provides information on FmHA's progress in shifting from direct to guaranteed farm loans and the financial condition of the guaranteed loan borrowers; the impact of this shift on borrowers, private lenders, and the government; and program problems that contributed to losses on guaranteed loans. The message of this report is discussed in the overall testimony.

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

This report is addressed to the Chairman, Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition, and Forestry, and provides examples of FmHA delinquent borrowers who have acted in bad faith and who have received benefits, or will be eligible to receive benefits, under the provisions of the Agricultural Credit Act of 1987. The message of this report is discussed in the overall testimony.

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

This report is addressed to the Secretary of Agriculture and presents the results of our examination of FmHA's financial statements for the year ending September 30, 1988, and our reports on internal accounting controls and compliance with laws and regulations. The message of this report is discussed in the overall testimony.

CASE STUDIES OF GUARANTEED FARM LOAN PROGRAM BORROWERS WHO HAD DEFAULTED ON THEIR LOANS

In our report entitled Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989) we provide three case studies on borrowers who had defaulted on FmHA-guaranteed loans to illustrate many of the problems we identified. The three case studies from that report follow.

Case Study A

A borrower received an operating loan in April 1986 for about $118,000, which FmHA guaranteed at 90 percent. This loan was for production purposes and to make payments to other creditors for the borrower's son. The borrower listed no debts and total assets of $215,000. The assets consisted of $10,000 in cash, $145,000 in savings, and $60,000 in real estate. It appeared that the borrower had sufficient collateral to obtain a loan without the FmHA guarantee. However, the guaranteed loan was secured only by a crop lien and assignment of ASCS payments on 600 acres of cotton and soybeans. The borrower had no crop insurance and leased land from his son for farming purposes.

The county supervisor indicated on the guaranteed loan evaluation form that the security offered (crops) appeared adequate and that the borrower had been unable to obtain necessary credit without a guarantee. The county supervisor's evaluation of the borrower's inability to obtain credit without a loan guarantee appeared questionable because (1) a letter from the private lender accompanying the loan application did not state that credit would be denied without the guarantee and (2) the borrower had not signed the Conditional Commitment for Guarantee certifying that credit was not available at reasonable rates and terms.

The borrower's repayment estimate showed projected income from crop production of $112,750, government payments of $19,000, and other income of $5,900 for a total projected income of $137,650. Loan records showed the borrower was actually loaned $106,200 of the $118,000 approved and repaid only $72,781. Of this amount, $64,600 was applied to loan principal and $8,181 was for interest on the loan. In March 1987 the lender filed a loss claim with FmHA for $42,286, and in May 1987 FmHA paid the lender $38,409, including accrued interest until date of payment, to honor its 90-percent guarantee.

We identified several problems with this guaranteed loan. First, the loan guarantee request probably should not have been approved because sufficient assets, including cash and savings,

were available to finance the farming operation without a loan guarantee. Second, one of the loan's purposes--payment of the borrower's son's debts--is not a permissible loan purpose under FmHA's regulations. Third, accepting crops as the only collateral without crop insurance and when over $200,000 in unencumbered security was available proved to be a costly mistake because FmHA paid the lender a loss claim of over $38,000. Finally, until our inquiry there was no evidence that either FmHA or the lender pursued recovery of this $38,000 from the borrower despite the apparent existence of ample assets on which to base a recovery.

Case Study B

In April and May 1985 a lender obtained two guaranteed loans for an existing borrower, a 1-year operating loan for $95,000 and a farm ownership loan for $275,000. The operating loan, secured by 1985 crops and guaranteed at 50 percent, was to be used for rent, crop production expenses, and the purchase of feeder pigs. The farm ownership loan, guaranteed at 90 percent, was to cover refinancing of past operating losses and capital expenditures. The farm ownership loan was secured by a third lien position on 400 acres of land and machinery. The lender agreed to write off $30,000 of the borrower's debt to help ensure survival and obtain the farm ownership loan guarantee. The farm ownership loan guarantee was approved by the FmHA state office because the loan amount exceeded the county supervisor's approval authority.

In September 1985 the lender sold the farm ownership loan on the secondary market. By January 1986 the borrower was in default on both loans, and the lender gave FmHA notice of default and proposed liquidation action. FmHA approved the liquidation of the loan accounts in April 1986. In June 1986 the lender advised FmHA that other lenders had claims of $778,000 against the 400 acres of land and that it was unlikely there would be any equity to protect on their lien. The lender obtained sufficient funds from the borrower to pay the balance due on the operating loan but filed a loss claim for the outstanding balance of $234,290 on the guaranteed farm ownership loan. The guaranteed loss amount was $210,861.

In reviewing the case file, the county supervisor found several problems that resulted in a recommendation against loss payment because of lender misrepresentation. Among these problems were the following:

-- The borrower made a major change in his farming operation between the time of loan application and loan closing that was not reported to FmHA, nor was revised financial data submitted to reflect the new operation.

-- An after-the-fact June 1986 lender submission of financial information on the revised farm operation, according to the county supervisor, overstated the projected income and the farmer's capacity to operate at the level indicated.

-- The lender omitted from the loan application a Federal Land Bank debt of $51,000 against the land, resulting in significantly overstating the collateral available to secure the third lien position on the farm ownership loan guarantee.

-- The land value shown in the borrower's January 1985 financial statement was significantly higher than that shown just prior to the liquidation decision in December 1985 ($936,600 versus $550,000), causing the county supervisor to question the reliability of the lender's appraisal submitted with the loan guarantee request.

In countering the county supervisor's recommendation, the lender maintained that the change in operation had been discussed with an FmHA state official, and this state official said that no new cash flow projection or amendment to the application was needed. The state official, however, could not recall such a conversation. The county supervisor maintained that, had he been informed of the change in operation and aware of the additional $51,000 lien against the farm, the loan guarantee request may have been denied.

The dispute over the loss claim continued for about 2 years during which time interest continued to accrue on the outstanding balance of the farm ownership loan. Another complicating factor was that the farm ownership loan note had been sold in the secondary market, and the holder was demanding the payments that the lender was supposed to collect and forward under the servicing agreement. On June 23, 1987, the lender acting on behalf of FmHA notified the holder to surrender to FmHA the guaranteed part of the loan and advised the holder to contact the FmHA county office to arrange for loss payment. On June 25, 1987, the holder demanded that the lender repurchase the unpaid guaranteed portion of the loan. The lender refused this request and again advised the holder to demand payment of the guarantee from FmHA.

According to a state official, FmHA submitted the required paperwork for payment of a loss claim of about $245,200 on May 13, 1988. However, at the time of our review, FmHA apparently still had a dispute with the lender over $6,000 that it believed the lender should pay FmHA. On June 2, 1988, FmHA finally paid the holder $247,735 to settle the loss claim.

This case study illustrates several program problems, including questionable loan approval, possible misrepresentation, questionable collection efforts, and an untimely loan loss payment. The questionable loan approval and other subsequent events resulted in a loss to FmHA of over $200,000, and, in not settling this loss claim promptly, FmHA incurred additional losses of about $40,000 because of interest accrual.

Case Study C

This borrower received two operating loans that FmHA guaranteed at 90 percent in May and June 1986--a $267,580 line of credit for production expenses and a $78,900 loan note guarantee to refinance three pieces of equipment. The line of credit was secured by a crop lien on soybeans, milo, and cotton to be planted on 2,756 acres. The loan note was secured by five pieces of equipment, which had an estimated value of $63,600 according to the borrower's financial statement. The maturity date on the line of credit was December 1, 1986.

The borrower's financial statement showed total assets of $335,200 and total liabilities of $754,667, for a negative net worth of $419,467. At the time of loan application, the borrower had nine outstanding direct loans from FmHA with a total loan amount of about $345,000. Four of the loans were delinquent but were rescheduled and brought current in order to approve the loan guarantees.

In August 1987 the lender requested in a letter to the county supervisor that FmHA pay its 90-percent guarantee on the line-of-credit production loan. The lender advised FmHA that the borrower had paid a total of $208,423 of the $267,272 advanced under the line of credit, but the lender had advanced the borrower an additional $12,674 to cover certain harvesting expenses, resulting in a principal balance shown by FmHA of $71,431 (although the net amount would appear to be $71,523). With accrued interest on the outstanding principal remaining, the amount of loss claim on the line of credit was $74,090, and FmHA paid the lender $66,681 to honor the guarantee.

From the borrower's loan file, the lender's letters to FmHA, and discussions with the loan officer and FmHA officials, we identified the following problems with this case.

-- The loan file contained no county committee certification of loan eligibility and no loan evaluation form.

-- The borrower was technically insolvent with a negative net worth of over $400,000 and had a series of FmHA direct loans, some of which required rescheduling prior to approval of the loan guarantees, indicating that approving an operating loan guarantee with crops as the only security at 90 percent was highly risky.

-- The lender released $12,674 of crop proceeds to the borrower to cover certain harvesting expenses without obtaining the required FmHA approval for making the advance and, contrary to FmHA regulations, included this advance in the loss claim. FmHA included the advance in settlement of the loss claim, which resulted in FmHA's paying a loss that exceeded 90 percent of the unpaid balance of the loan.

-- The lender did not provide FmHA a notice of default or a liquidation plan prior to submitting a loss claim about 8 months after the maturity date of the line-of-credit guarantee.

According to the lender and FmHA officials, the borrower continued to farm in 1987 despite the liquidation of the line-of-credit guarantee and FmHA's payment of a loss claim to the lender. The borrower still experienced financial problems, however, as demonstrated by the fact the he made no payments on his FmHA direct loans or on the guaranteed portion of the line-of-credit loan. In view of the borrower's past and continuing financial problems, we asked FmHA state officials of their rationale for guaranteeing loans at 90 percent to this borrower. Their response follows.

"Our policy is to allow the maximum guarantee in cases involving financial statements such as that produced by the borrower provided the security value and repayment ability are realistically projected as adequate. Cases in this category are often salvable and lenders would not make loans to this type client without a guarantee as additional security. However, in cases projecting more than adequate security and other unencumbered assets with very marginal repayment ability, our policy is to grant less than a maximum guarantee because the lender's exposure is less and the government's protection from losses are needed to a much lesser degree."

This case study illustrates how loan losses can result from inadequate (1) evaluation of a borrower's financial condition prior to approving a loan guarantee request, particularly the assessment of collateral backing the loan and the determination of the percentage of guarantee and (2) monitoring of a lender's servicing activities, particularly approving lender advances to borrowers and

requiring proper and timely submission of default notices and liquidation plans.

EXAMPLES OF FmHA BAD FAITH BORROWERS WHO HAVE RECEIVED BENEFITS, OR WILL BE ELIGIBLE TO RECEIVE BENEFITS, UNDER PROVISIONS OF THE AGRICULTURAL CREDIT ACT

In our report entitled Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS; Nov. 29, 1989) we identified several case examples in one FmHA county office of bad faith borrowers[1] who had benefited, or will be eligible to receive benefits, under provisions of the Agricultural Credit Act. The examples, which demonstrate the reasons for FmHA bad faith determinations and the benefits available to bad faith borrowers, are based on a review of delinquent borrowers' files and discussions with the FmHA county supervisor. The examples were developed during our ongoing debt restructuring work for the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry. These examples do not include all bad faith, or potential bad faith, borrowers who came to our attention during our review. For example, the FmHA county supervisor in another office identified 11 borrowers who may have acted in bad faith, but he did not pursue a formal bad faith opinion from the USDA Office of General Counsel to deny their restructuring request since they qualified for net recovery value buyout and not for restructuring.

BACKGROUND

The Agricultural Credit Act of 1987 directed FmHA to modify the debts of its borrowers who were 180 days or more delinquent through the use of a series of primary loan servicing, or restructuring, options so that loan losses on farmer program loans are avoided and borrowers are able to continue farming or ranching operations. The restructuring options include loan consolidation, rescheduling, or reamortization; interest rate reduction; deferral, set aside, or write down of outstanding principal and accumulated interest; or any combination of these actions. The act contains various conditions that delinquent borrowers must meet to qualify for restructuring.

Borrowers who do not qualify for restructuring are eligible to buy out of their FmHA debt. The buyout amount is based on an adjusted value of the collateral that secures their debt and is referred to as the net recovery value.

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[1]We use the phrases "borrowers who act in bad faith" and "bad faith borrowers" to refer to those FmHA delinquent borrowers whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans.

In addition, borrowers who are not restructured, and those who do not buy out of their debt at the net recovery value, are subject to foreclosure by FmHA on the collateral securing their loans. The Agricultural Credit Act and the Food Security Act of 1985 provide preservation loan servicing options to borrowers whose real property is foreclosed. These options are the right to purchase or lease the farmland back from FmHA and the right to purchase their farm homestead. FmHA delinquent borrowers who act in bad faith are eligible for net recovery value buyout consideration as well as preservation benefits when they do not buy out of their debt and FmHA forecloses on the real estate property securing their FmHA loans.

BORROWERS RECEIVING NET RECOVERY VALUE BUYOUT BENEFIT

Example A. The FmHA county office determined that this borrower was ineligible for loan restructuring because he did not act in good faith in connection with his loan agreements. The county office supervisor told us the borrower sold some farm equipment that was FmHA security property. Also, the borrower subsequently had another family member, who is also an FmHA borrower, sell some additional farm equipment. In addition, a regional attorney in USDA's Office of General Counsel wrote that the borrower had converted numerous items of FmHA security property. The sales of properties were made without county office approval. None of the proceeds from the sales were applied to the borrower's FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring, he was eligible for net recovery value buyout since the net recovery value exceeded the present value of the restructured loans when the county office ran the debt restructuring software program--Debt and Loan Restructuring System (referred to by FmHA as DALR$). At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $625,952 in outstanding principal and unpaid interest. The debt covered six natural disaster emergency loans and two operating loans, valued at a total of $602,560 and $23,392, respectively. The net recovery value was $87,277. In addition, the appeals hearing officer wrote that the borrower is also required to pay FmHA $30,000 for the value of other property not accounted for in the appraisal of the loan security. The total buyout amount, which covers real estate and chattels, is $117,277. The borrower will receive a $508,675 write-off if he pays the buyout amount.

In addition, this borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. For example, the market value of his 311-acre farm, which could be acquired through the leaseback/buyback option, is $44,000.

Example B. The FmHA county office determined that this borrower was ineligible for loan restructuring because he did not act in good faith in connection with his loan agreements. The county office supervisor told us the borrower sold equipment that was FmHA security property. In addition, a regional attorney in USDA's Office of General Counsel wrote that the borrower had converted FmHA security property he owned and other property that was pledged as security for FmHA loans by another member of his family. The sales of properties were made without county office approval. None of the proceeds from the sales were applied to the borrower's FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring, he was eligible for net recovery value buyout since the net recovery value exceeded the present value of the restructured loans when the county office ran the DALR$ program. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $249,811 in outstanding principal and unpaid interest. The debt covered two operating loans (totaling $110,189), one natural disaster emergency loan ($81,580), one rural housing loan ($34,872), and one farm ownership loan ($23,170). The net recovery value, which covers real estate and chattels, was $164,353. The borrower will receive an $85,458 write-off if he pays the buyout amount.

In addition, this borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. For example, the market value of his 636-acre farm, which could be acquired through the leaseback/buyback option, is $153,000.

Example C. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us the borrower had previously applied to FmHA for loans to buy additional land and equipment. The county office did not approve the applications and advised the borrower that the equipment was excessive to his needs. For

example, the county office determined that the equipment purchases resulted in the borrower having $268 per acre worth of equipment, while the state average was $50 per acre. Subsequently, the borrower made the purchases with loans from other lenders. The borrower repaid the other lenders, including making advance principal payments; however, he became delinquent on his FmHA debt.

The borrower appealed the county office's decision. The appeals hearing officer decided that while the borrower was ineligible for restructuring because of his excessive machinery purchases, he was eligible for net recovery value buyout since he did not have a feasible plan of operations, including a positive cash flow, and the net recovery value exceeded the present value of the restructured loans when the county office ran the DALR$ program. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $186,616 in outstanding principal and unpaid interest. The debt covered four natural disaster emergency loans and two farm ownership loans, valued at a total of $117,716 and $68,900, respectively. The net recovery value, which covers real estate, was $134,815. The borrower will receive a $51,801 write-off if he pays the buyout amount.

This borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. However, it will be to his advantage to pay the buyout amount if he wants to keep his farm because the market value of his real estate exceeds his outstanding FmHA debt. He would have to pay the amount of his outstanding debt to exercise the leaseback/buyback option since the market value of his 1,174-acre farm is $188,000.

Example D. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. According to information in the county office records, in 1985 the borrower abandoned the property that had been pledged as security for the FmHA loans, made no effort to maintain the property, and became delinquent on his FmHA debt.

The county office determined that this borrower was eligible for net recovery value buyout since he did not have a feasible plan of operations, including a positive cash flow, and the net recovery value exceeded the present value of the restructured loans. At the time of our review, the borrower had not responded to the county office's net recovery value buyout offer.

According to the DALR$ printout, this borrower owed FmHA $151,605 in outstanding principal and unpaid interest. The debt covered one farm ownership loan and one natural disaster emergency loan, valued at $146,458 and $5,147, respectively. The net recovery value, which covers real estate, was $12,515. The borrower will receive a $139,090 write-off if he pays the buyout amount.

This borrower will be eligible for preservation benefits if he does not pay the buyout amount and FmHA forecloses on his property. However, it will be to his advantage to pay the buyout amount if he wants to keep his farm because the net recovery value buyout amount is less than the $23,000 market value of his 147-acre farm.

BORROWERS RECEIVING PRESERVATION BENEFIT

Example E. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower's application for restructuring showed he had resources available that could have been used to make his FmHA loan payments. According to information in the county office records, the borrower had $83,400 in available income and other assets that were not essential to his farming operation, such as recreational vehicles, while his delinquency was $43,106.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had appealed the county office's decision; an appeal decision had not been made.

According to the DALR$ printout, this borrower owed FmHA $279,890 in outstanding principal and unpaid interest. The debt covered three natural disaster emergency loans. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,840-acre farm, which he could reacquire through the leaseback/buyback option, is $201,000.

Example F. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower rents his farm to his son and claims that the son has not made any rental payments. However, the borrower's restructuring application shows rental

income and the county office has documented that the borrower has been current on payments to other creditors, including advance principal reduction payments.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had appealed the county office's decision; an appeal decision had not been made.

According to the DALR$ printout, this borrower owed FmHA $650,185 in outstanding principal and unpaid interest. The debt covered three natural disaster emergency loans. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 3,140-acre farm, which he could reacquire through the leaseback/buyback option, is $470,000. A prior lien in the amount of $224,906 exists on the borrower's farm real estate.

Example G. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower had resources available that could have been applied to his delinquent debt and that he had paid other lenders more than his loan agreements with them required him to pay. Specifically, documentation in the county office files showed the borrower had $66,400 in income that he could have applied, but did not apply, to his FmHA debt. Also, the borrower repaid two other lenders, including advanced principal payments to both, and became delinquent on his FmHA loans. For example, he repaid the two commercial lenders a total of $74,907; his loans called for payments totaling $24,320.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. At the time of our review, the borrower had not appealed the county office's decision.

According to the DALR$ printout, this borrower owed FmHA $371,604 in outstanding principal and unpaid interest. The debt covered two natural disaster emergency loans and one operating loan, valued at a total of $149,723 and $221,881, respectively. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,480-acre farm, which he

could reacquire through the leaseback/buyback option, is $207,000. A prior lien in the amount of $82,246 exists on the borrower's farm real estate.

Example H. The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us this borrower's application for restructuring showed that he had resources available that could have been used to pay his delinquent amount. Specifically, documentation the borrower submitted to the county office showed he had $91,284 in his checking account when he applied for restructuring; he was $76,269 past due on his scheduled FmHA payments. Also, the borrower may have converted some FmHA security property. A letter in the county office files states that the borrower sold cattle, which was security for an FmHA loan, without county office approval and did not pay any of the sales proceeds to FmHA.

The county office determined that this borrower was not eligible for net recovery value buyout since the DALR$ program showed he would have had a feasible plan of operations with restructuring, including a positive cash flow. The borrower would have been offered restructuring if he had not caused the delinquency. The borrower appealed the county office's decision; an appeals officer upheld the county office's decision.

According to the DALR$ printout, this borrower owed FmHA $348,223 in outstanding principal and unpaid interest. The debt covered two farm ownership loans (totaling $69,631), one operating loan ($242,742), and one natural disaster emergency loan ($35,850). He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 1,163-acre farm, which he could reacquire through the leaseback/buyback option, is $151,000. A prior lien in the amount of $9,000 exists on the borrower's farm real estate.