United States General Accounting Office

GAO

Briefing Report to the Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate

February 1990

FARMERS HOME ADMINISTRATION

Use of Loan Funds by Farmer Program Borrowers

GAO/RCED-90-95BR

GAO

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

Resources, Community, and
Economic Development Division

B-227691

February 8, 1990

The Honorable Patrick J. Leahy
Chairman, Committee on Agriculture,
Nutrition, and Forestry
United States Senate

Dear Mr. Chairman:

This report responds to your September 22, 1988, request for information on the use of Farmers Home Administration (FmHA) loan funds by farmer program borrowers.[1] As you requested, we focused on the use of funds for four major types of farmer program loans during fiscal year 1988, the extent to which loan funds were used to refinance farmers' existing debts, and lenders' views on using FmHA loan guarantees.

FmHA obligated more than $2 billion, or about 98 percent of total farmer program obligations, in fiscal year 1988 on four major types of farmer program loans: direct farm ownership loans, direct farm operating loans, guaranteed farm ownership loans, and guaranteed farm operating loans. Direct loans are government-funded loans provided directly to farmers while guaranteed loans are provided by commercial lenders and guaranteed by FmHA. Farm ownership loans—direct and guaranteed—are made for buying and improving farm land and for constructing, repairing, and improving farm buildings. Farm operating loans—direct and guaranteed—are made for buying feed, seed, fertilizer, livestock, farm equipment, and for living expenses. Refinancing borrowers' existing debts is an authorized use of funds in the farm ownership and farm operating loan programs.

In summary, we found that the use of most fiscal year 1988 farm loan funds was for farm operating expenses ($1.1 billion, or 50 percent of the total loan funds) and refinancing existing debt ($665 million, or 30 percent). The third major use of loan funds was for purchasing farm property ($131 million, or 6 percent). Most of the direct loan funds were provided to existing FmHA loan borrowers and most of the guaranteed loan funds were provided to existing commercial lender borrowers.

For each major type of loan, our analysis of the uses of fiscal year 1988 loan funds generally showed the following: (1) direct farm ownership

[1] Loan use information presented in this report is based on borrowers' planned uses of loan funds. Report statements regarding use of loan funds refer to planned use of loan funds.

more loan decisions and the use of loan funds may shift further to commercial-oriented lending purposes, such as refinancing existing debt or making loans to sell on the secondary market. Consequently, FmHA direct loan borrowers--those farmers unable to obtain commercial credit with or without a guarantee—may be assisted less, and fewer funds would be used for targeting assistance to limited resource operations, new operators, and low-income operators.

We recognize that the percentage of funding that goes to existing or new borrowers and the purposes for which funding is used change over time as economic, financial, and climatic conditions change. The distribution of funds in 1 year may or may not be typical. Further, we recognize that FmHA has kept farmers in business—one of its principal legislative mandates—by providing direct funds to existing borrowers and by using funds for refinancing. This situation, however, raises questions as to whether limited federal assistance should be directed to (1) certain types of borrowers, such as new or limited resource operators, or (2) certain credit purposes, such as purchasing farm property or funding farm operating expenses.

Matter for Consideration by the Congress

In a period of budgetary pressures, we believe the Congress should consider the use of funds as they deliberate on how FmHA fulfills its mission as the "lender of last resort" to the nation's farmers in the upcoming debate on the 1990 Farm Bill or other FmHA-related legislation. Issues that should be considered include the extent to which assistance continues to be used by FmHA and commercial lender existing customers versus new customers, and the level to which such assistance is used to refinance existing debts versus new credit purchases.

This briefing report contains six sections. The first provides a detailed summary covering the uses of fiscal year 1988 loan funds, our observations on loan fund uses, and matters for consideration by the Congress. The second provides background information on FmHA farmer loan programs. The third and fourth discuss the use of FmHA farmer program loans for direct loans and guaranteed loans, respectively. The fifth presents lenders' views on guaranteed loans. The last section describes our objectives, scope, and methodology in conducting this study and preparing this briefing report.

In conducting our study, we obtained loan use information from FmHA using a random sample of fiscal year 1988 loan obligations for the four

FmHA's farm operating and farm ownership loan programs. Funds are authorized for specific uses in each program. For example, purchasing livestock is an authorized use of farm operating loans and constructing buildings is an authorized use of farm ownership loans. Also, refinancing existing debt is an authorized use for direct and guaranteed operating and ownership loans.

Beginning in 1984 FmHA began placing greater emphasis on guaranteed loans as opposed to direct loans, and the Food Security Act of 1985 (P.L. 99-198, Dec. 23, 1985) authorized funding levels that supported this shift in emphasis. For example, direct loan obligations decreased from $2.6 billion in fiscal year 1984 to $1 billion in fiscal year 1988. On the other hand, guaranteed loan obligations increased from $153 million in fiscal year 1984 to almost $1.3 billion in fiscal year 1988. Congress also indicated in the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) that loan guarantees should be used to the maximum extent practical to assist eligible borrowers whose loans are restructured by commercial lenders.

This report presents data on the use of loan funds based on estimates from a random sample of fiscal year 1988 loan obligations. The estimated obligation amounts differ from the actual obligation amounts because they are based on a statistical sample of FmHA loans. Therefore, the estimated total loan obligations can be expected to differ from the actual total loan obligations for each loan type. Table 1.1 shows the actual and our estimated fiscal year 1988 obligations for the four major types of farmer program loans.

Table 1.1: FmHA Farmer Loan Program Actual and Estimated Obligations, Fiscal Year 1988

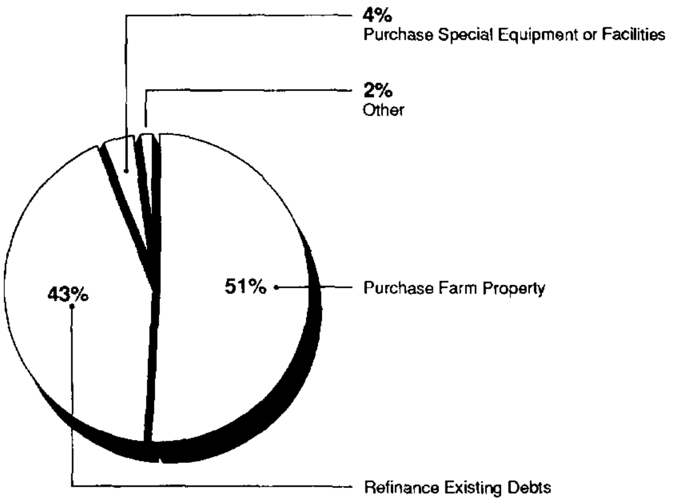
Dollars in millions

	Obligations	
Loan type	**Actual**	**Estimated**
Direct farm operating	$900	$871
Guaranteed farm operating	893	879
Guaranteed farm ownership	362	363
Direct farm ownership	115	114
Total	**$2,270**	**$2,226[a]**

[a]Total does not add due to rounding.

Source: FmHA budget records for actual obligations and GAO estimated obligations as of September 30, 1988.

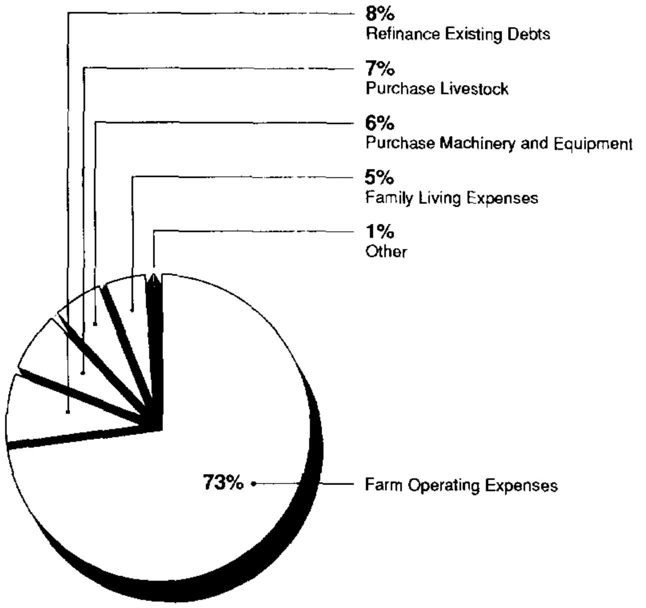
Figure 1.1: Percent of Direct Farm Ownership Funds Used for Various Purposes, Fiscal Year 1988



Note: Percentages based on the projected universe of direct farm ownership funds.

Source: GAO projection based on a sample of FmHA loans.

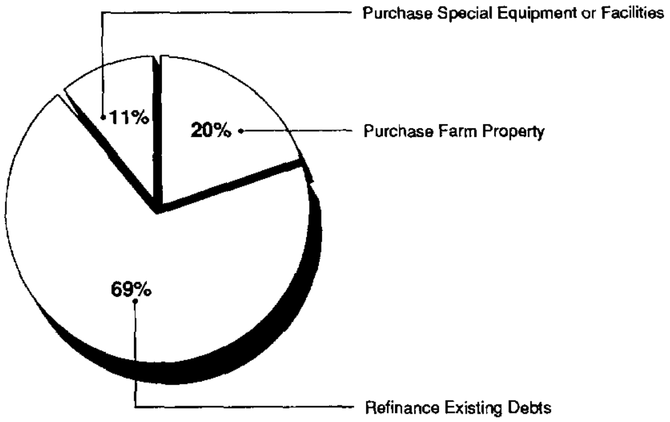
Figure 1.2: Percent of Direct Farm Operating Funds Used for Various Purposes, Fiscal Year 1988



Note: Percentages based on the projected universe of direct farm operating funds.

Source: GAO projection based on a sample of FmHA loans.

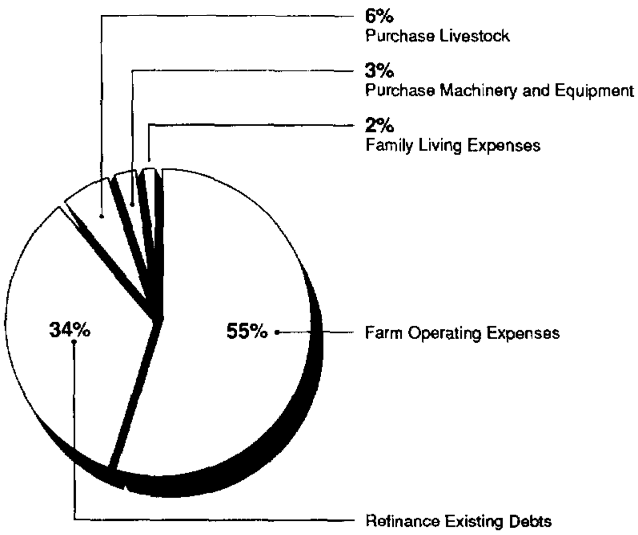
Figure 1.3: Percent of Guaranteed Farm Ownership Funds Used for Various Purposes, Fiscal Year 1988



Note: This figure excludes other minor uses of loan funds which accounted for less than 1 percent of total funds, such as improving pasture land. Also, percentages based on the projected universe of guaranteed farm ownership funds.

Source: GAO projection based on a sample of FmHA loans.

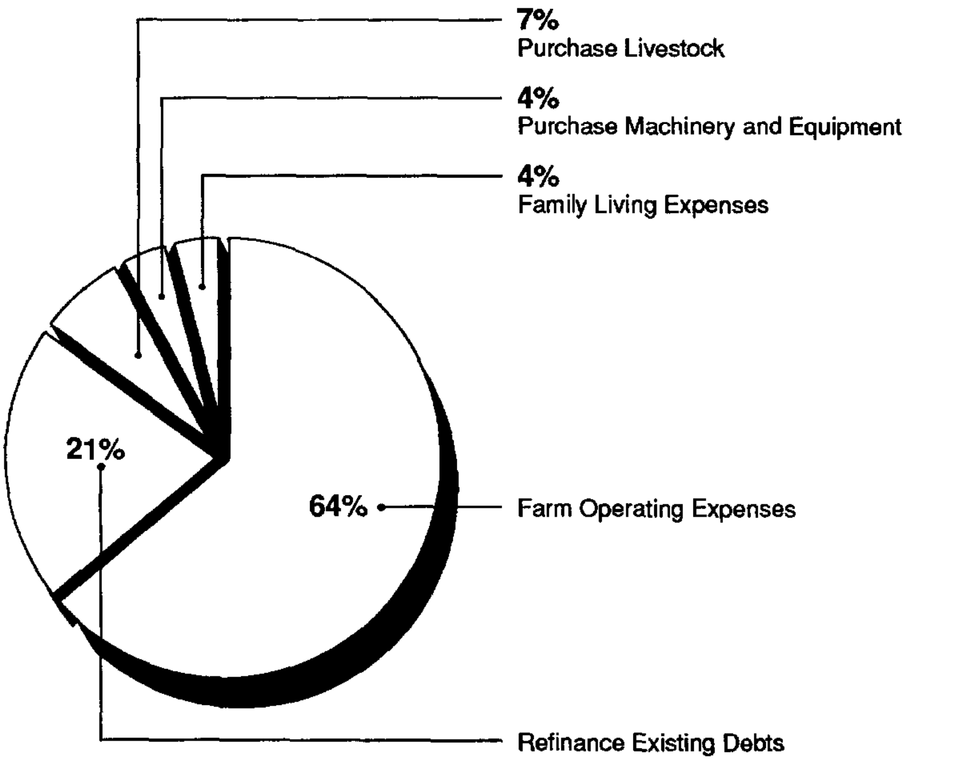
Figure 1.4: Percent of Guaranteed Farm Operating Funds Used for Various Purposes, Fiscal Year 1988



Note: This figure excludes other minor uses of loan funds which accounted for less than 1 percent of total funds, such as real estate improvements. Also, percentages based on the projected universe of guaranteed farm operating funds.

Source: GAO projection based on a sample of FmHA loan.

Figure 1.6: Percent of Total Direct and Guaranteed Farm Operating Funds Used for Various Purposes, Fiscal Year 1988



Note: This figure excludes other minor uses of loan funds which accounted for less than 1 percent of total funds, such as real estate improvements. Also, percentages based on the projected universe of total direct and guaranteed farm operating funds.

Source: GAO projection based on a sample of FmHA loans.

Combined Use of Loan Funds

Combining the four types of FmHA farmer program loans shows that a significant portion of loan funds was used for refinancing purposes—30 percent of total estimated obligations, or $665 million. In addition, table 1.2 shows that a significant portion of loan funds were provided to existing FmHA and commercial lender borrowers—81 percent of total estimated obligations, or $1.8 billion.

guarantees when refinancing loans in order to compensate for credit weaknesses of existing customers who have repayment ability but are unable to meet the bank's lending standards. Also, some lenders—five of those we contacted—said they seek an FmHA guarantee on either all or most of their farm loans because of the added risk of farm lending or because of a desire to sell the loans on the secondary market. Section 5 of this briefing report provides detailed information on lenders' views on using the guaranteed farm loans.

Observations on the Use of Loan Funds

FmHA farm ownership and operating loans are authorized for a variety of purposes without prioritization or preference for a particular purpose. As a result, loan funds are used for any authorized purpose if eligibility, repayment ability, and security requirements are met. While there is no preference in the processing of applications, use of funds, or the recipient of funding, the FmHA Deputy Director, Loan Making Division, told us that FmHA has emphasized to its county offices that approved loans for certain types of borrowers, such as limited resource borrowers, may receive funds before other types of borrowers. FmHA obligated an estimated $2.2 billion on four types of farmer loans in fiscal year 1988. The vast majority of the loan funds were provided to existing FmHA and commercial lender borrowers, and a significant portion were used for refinancing borrowers' existing debts.

Direct and guaranteed farm loans serve relatively distinct groups of borrowers. Direct loan funds were used primarily by FmHA to serve its existing borrowers. The loans were used primarily to fund operating expenses and purchase farm property, and to refinance existing debts. Direct farm ownership loans served the largest percentage of new borrowers, who used almost half of the loan funds they received to refinance existing debts.

On the other hand, guaranteed loan funds were used primarily by commercial lenders to serve their existing customers having financial difficulties. For example, commercial lenders used guaranteed farm ownership funds as a loan servicing tool when refinancing existing debts. Also, the level of refinancing occurring in fiscal year 1988 indicates that lenders are using guaranteed loans to enhance their loan security on existing debts rather than to expand borrowers' operations. In addition, while some commercial lenders use the guaranteed programs for new customers, this use is limited. Some commercial lenders do not make guaranteed loans, and consequently their customers are not

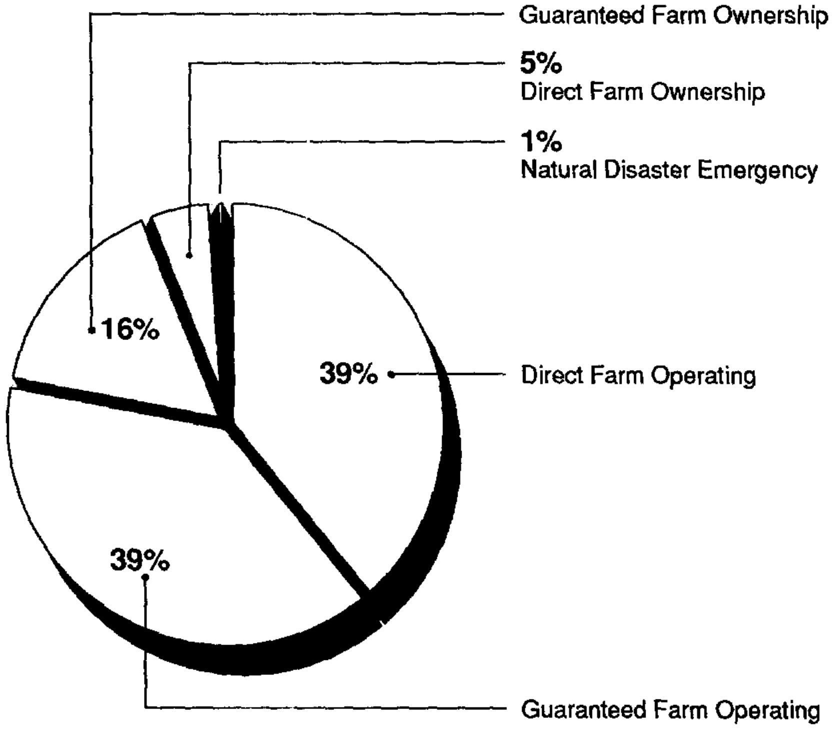
Further, the use of loan funds will be determined by commercial lenders more than by FmHA if the shift from direct to guaranteed lending continues. Commercial lenders will be making relatively more loan decisions than FmHA. FmHA direct loan borrowers—those farmers who are unable to obtain commercial credit with or without a guarantee—may be assisted less by FmHA in the future. FmHA may have fewer direct loan funds to accomplish its objective of targeting assistance to limited resource operations, new operators, and low-income operators. Also, the use of FmHA farmer program loan funds may shift further to more commercial-oriented lending purposes, such as refinancing existing debt or making guaranteed loans that can be sold on the secondary market. Under this scenario, farmers who are not existing customers of commercial lenders using guaranteed loans may be effectively excluded from participating in FmHA's farmer loan programs. This may include farmers starting operations or low-income farmers.

Matter for Consideration by the Congress

Direct and guaranteed farm loans primarily serve existing borrowers, and, with the exception of direct farm operating loans, are used in many instances for refinancing existing debt. We recognize that the percentage of funding that goes to existing or new borrowers and the purposes for which funding is used change over time as economic, financial, and climatic conditions change. The distribution of funds in 1 year may or may not be typical. Further, we recognize that FmHA has kept farmers in business—one of its principal legislative mandates—by providing direct loans to existing borrowers and by using funds for refinancing. This situation, however, raises questions as to whether limited federal assistance should be directed to (1) certain types of borrowers, such as new or limited resource operators, or (2) certain credit purposes, such as purchasing farm property or funding farm operating expenses. There is no such prioritization on the use of funds or the recipient of funds; loans are available to eligible borrowers for any authorized purpose, however, certain types of borrowers may receive funds before other types of borrowers.

In a period of budgetary pressures, however, we believe the Congress should consider the use of funds as they deliberate on how FmHA fulfills its mission as the "lender of last resort" to the nation's farmers in the upcoming debate on the 1990 Farm Bill or other FmHA-related legislation. Issues that should be considered include the extent to which assistance continues to be used by FmHA and commercial lender existing customers versus new customers, and the level to which such assistance is used to refinance existing debts versus new credit purchases.

Figure 2.1: Percent of FmHA Obligations, by Farm Loan Type, Fiscal Year 1988



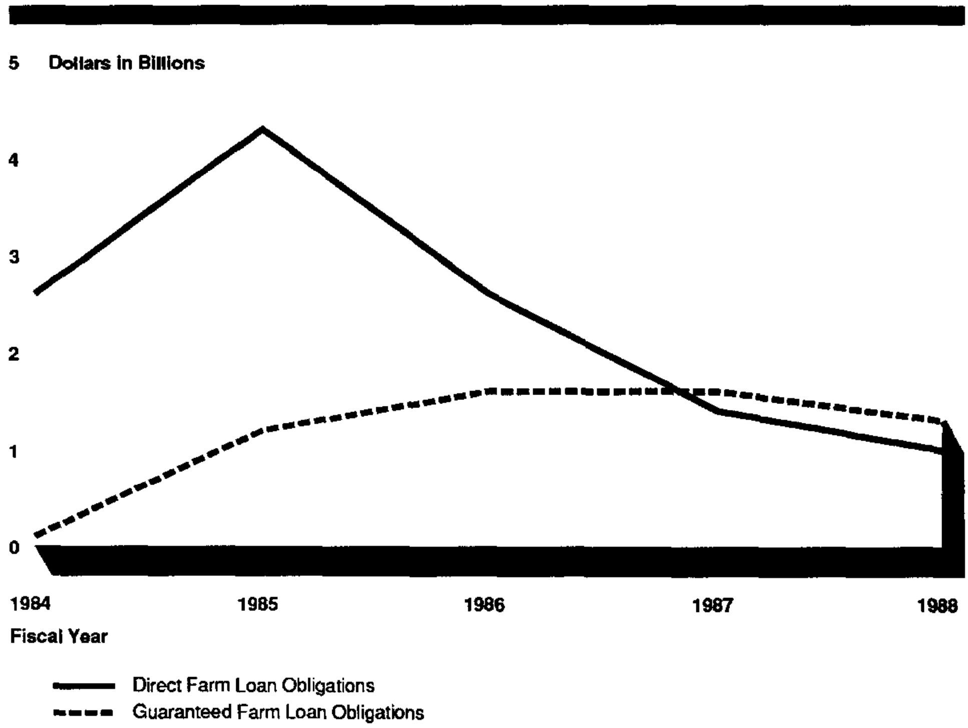
Note: This figure excludes other FmHA farmer loan programs which accounted for less than 1 percent of the total obligations, such as the soil and water program.

Source: FmHA.

Farm Ownership and Operating Program Authorization

Direct FmHA farm ownership and operating loans are authorized by the Consolidated Farm and Rural Development Act (P.L. 87-128, Aug. 8, 1961, as amended). The Rural Development Act of 1972 (P.L. 92-419, Aug. 30, 1972) amended the act and provided FmHA discretionary authority to guarantee farm loans made by other agricultural lenders. In making direct farm loans, FmHA provides loan funds to farmers and requires them to sign a note promising loan repayment and to provide collateral, such as farm property, for security. In guaranteeing loans, FmHA agrees to reimburse the lending institution a specified percentage of any loss—up to 90 percent of principal, interest, and liquidation costs—it may incur if the borrower defaults on the loan.

Figure 2.2: FmHA Direct and Guaranteed Farm Loan Obligations, Fiscal Years 1984-88



Source: FmHA.

Farm Ownership Loan Objectives and Obligations

The objectives of farm ownership loans include assisting eligible applicants to become owner-operators of family farms; making efficient use of land, labor and other resources; carrying on sound and successful farming operations; and enabling farm families to have a reasonable standard of living. Loans are provided for various purposes to accomplish these objectives, including purchasing or enlarging a farm; constructing, buying, or improving buildings; refinancing debts; and paying loan closing expenses.

Direct and guaranteed ownership loans are limited to a maximum amount of $200,000 and $300,000, respectively, including any outstanding principal on other farm ownership loans, soil and water loans, and recreation loans. Loan amounts are further limited to the value of the farm or other loan security. Also, the repayment period may not exceed operating loans may not exceed $400,000 total outstanding loan principal. The repayment period for direct and guaranteed operating loans may not exceed 7 years, and collateral must be provided to secure each loan. Interest rates charged to borrowers may be reduced on direct loans to a limited resource rate. On guaranteed loans rates may be reduced through the IRR program.

In addition, guaranteed operating line of credit loans are provided for specific, limited purposes, such as paying annual operating expenses, or purchasing foundation livestock or feeder cattle. A borrower's total farm operating loans and lines of credit cannot exceed $400,000 at any one time. Also, lines of credit are limited to 3-year terms.

During the 1984 through 1988 period, obligations for direct operating funds decreased from $2.0 billion to $900 million, and obligations for guaranteed operating funds increased from $111 million to $893 million. Figure 2.4 shows the trend in direct and guaranteed operating loan obligations during this 5-year period.

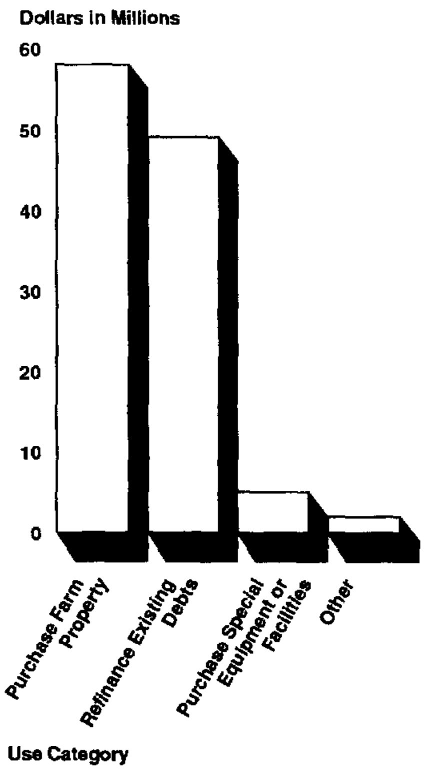
Direct Loans Assisted Borrowers to Fund Operating Expenses, Refinance Debts, and Buy Farm Property

FmHA direct ownership loans were used primarily in fiscal year 1988 for purchasing farm property and refinancing borrowers' existing debts. Direct operating loans were used primarily for funding operating expenses, such as purchasing seed, fuel, and fertilizer. Most direct loan funds were provided to FmHA's existing borrowers.

Use of Direct Farm Ownership Loan Funds

Direct ownership funds were used primarily for purchasing farm property and refinancing existing borrower debts. An estimated 51 percent, or about $58 million, of the estimated total $114 million (see table 1.1) of farm ownership loan funds were for purchasing farm property. Another 43 percent, or about $50 million, were for refinancing borrowers' existing debts. The remaining 6 percent of the loan funds were for purchasing special equipment or facilities (4 percent, or about $5 million) or for other purposes (2 percent, or about $2 million). (See fig. 3.1.)

Figure 3.1: Amount of Direct Farm Ownership Funds Used for Various Purposes, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

farmer program loan—new direct borrowers to FmHA—received 44 percent, or about $50 million, of the loan funds.

Existing and new direct ownership borrowers used loan funds primarily for purchasing farm property and refinancing debts. However, while existing borrowers used more funds for purchasing farm property than for refinancing debts, new direct borrowers used more funds for refinancing debts than for purchasing farm property. Of the estimated $64 million that existing FmHA borrowers received, 56 percent was used for purchasing farm property and 39 percent for refinancing. On the other hand, of the $50 million that new direct borrowers received, 49 percent was for refinancing and 45 percent for purchasing farm property.

Most direct ownership loans were initial direct loans that a borrower received under the farm ownership program. An initial loan is the first loan that an existing or new borrower receives in a particular FmHA loan program, such as the farm ownership loan program. Eighty-three percent, or an estimated $94 million of the total $114 million in direct ownership funds were for initial loans. The remaining 17 percent, or about $20 million, were for subsequent loans. A subsequent loan is an additional loan that a borrower receives when the borrower has had a previous loan of the same type.

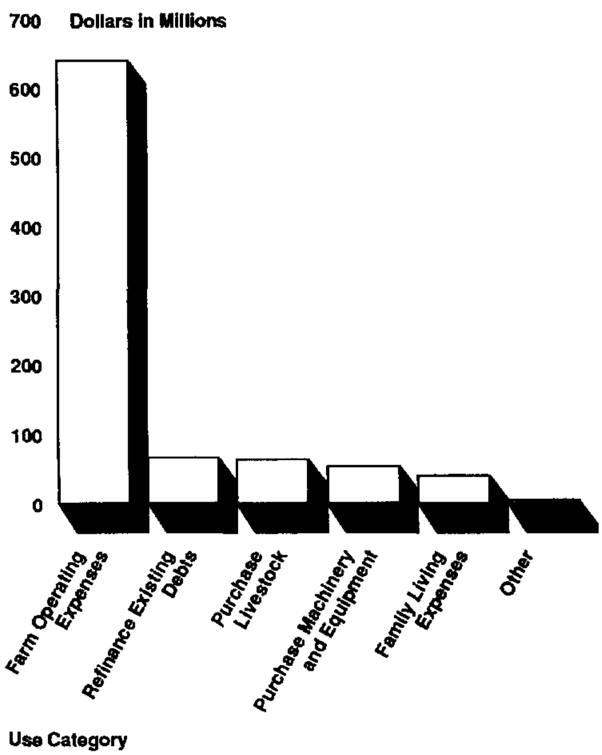
The following two loan cases in our sample illustrate the use of direct farm ownership loan funds.

Case Study A—Purchasing Farm Property

An Arkansas grain farmer received a subsequent $104,000 direct ownership loan to purchase 160 acres of farmland. The loan was made in March 1988 at FmHA's regular interest rate of 9.5 percent, with a 40-year repayment period. Security for the loan was the purchased farmland and additional farm property. The farmer was an existing FmHA borrower, receiving an initial direct ownership loan in 1971 and subsequently receiving several direct ownership and operating loans. The farmer's financial statement accompanying the loan application indicated he had total assets of $286,314, and total debts of $170,664, for a net worth of $115,650.

The farmer had been renting the 160 acres until the owner placed the property for sale. The 160 acres were in an area of limited available farmland for rent. To continue farming the 160 acres the borrower had to purchase the property. The purchase increased the farmer's owned land to 333 acres from 173 acres. The local FCS lender was unwilling to

Figure 3.3: Amount of Direct Farm Operating Funds Used for Various Purposes, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Funds used for refinancing borrowers' existing debts primarily involved debts owed to commercial banks and trade creditors. Figure 3.4 shows that of the estimated $67 million of loan funds used for refinancing borrowers' existing debts:

- 44 percent, or about $29 million, were for debts owed to commercial banks;
- 31 percent, or about $21 million, were for debts owed to trade creditors;
- 16 percent, or about $11 million, were for debts owed to the FCS; and,
- 9 percent, or about $6 million, were for debts owed to other lenders.

Case Study C—Purchasing Operating Inputs

An Iowa dairy and livestock producer, who was an existing FmHA borrower, received a subsequent $13,000 direct operating loan in March 1988 for operating expenses. Seed, feed, fuel, and fertilizer credit needs amounted to $9,600, or 74 percent, of the total loan amount while machinery expenses, livestock care, supplies, and utilities comprised the remaining loan amount. The loan was made at the limited resource interest rate of 6 percent for operating loans with a repayment period of 1 year. Security for this subsequent loan consisted of 1988 crops, machinery, and livestock. The farmer's net worth was $7,130 with assets totaling $138,546 and liabilities totaling $131,416, according to the loan application information.

The farmer was unable to obtain commercial financing for his operating expenses and possibly would not have operated in 1988 unless he obtained credit from some source. The farmer's operation—consisting of 40 owned and 120 rented acres—barely survived due to low equity and high debt, according to a commercial lender. The limited resource interest rate on his FmHA direct operating loan was needed to enable the farmer to establish a positive cash flow.

Case Study D—Refinancing Debt and Purchasing Livestock

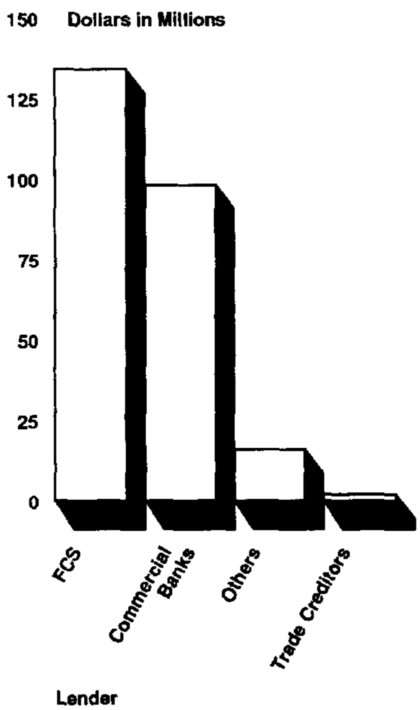
A Louisiana cattle operator with no prior FmHA loans received a $110,000 direct operating loan in April 1988 to refinance a commercial bank loan for $75,000 and to purchase additional cattle for $35,000. The operator received the loan with a repayment period of 7 years at the limited resource interest rate of 6 percent for operating loans. Security for the loan consisted of the additional cattle purchased and existing cattle that the operator owned. The operator had total assets of $249,500 and total debts of $150,000, for a net worth of $99,500, at the time of the loan application.

The FmHA direct operating loan allowed the operator to refinance his bank loan with more favorable terms and expand his cattle operation by purchasing 43 additional head of cattle to supplement his existing 252 head of cattle. The FmHA loan permitted a longer term and a lower interest rate than the commercial lender would provide. The operator was unable to get a FmHA guaranteed loan, and his existing bank loan carried a 12.5 percent interest rate with a repayment period of 1 year. With the direct loan limited resource interest rate and the income from the additional cattle, the borrower was able to project a positive cash flow of $2,119.

Funds used for refinancing borrowers' existing debts primarily involved debts owed to FCS and to commercial banks. Figure 4.2 shows that of the estimated $250 million of loan funds used for refinancing borrowers' existing debts:

- 54 percent, or about $134 million, were for debts owed to the FCS;
- 39 percent, or about $98 million, were for debts owed to commercial banks;
- 6 percent, or about $16 million, were for debts owed to other lenders; and
- 1 percent, or about $2 million, were for debts owed to trade creditors.

Figure 4.2: Amount of Guaranteed Farm Ownership Funds Used to Refinance Existing Debts, by Debt Sources, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Guaranteed ownership loans were generally obtained by existing customers of the lenders making the guaranteed loan, and the loan funds were used for refinancing the borrowers' existing debts with those lenders. An estimated 80 percent, or about $289 million of the estimated total $363 million of guaranteed ownership loan funds were provided to farmer had an overall positive net income from operations after considering family living expenses.

Case Study F—Purchasing Farm Property

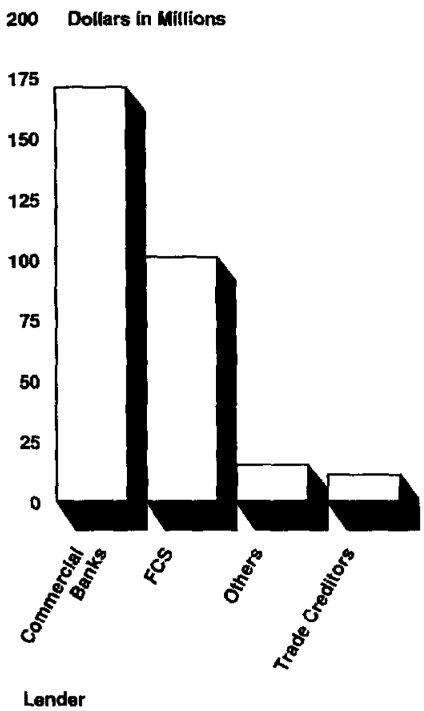
A $150,000 ownership loan guaranteed for 90 percent was obligated in June 1988 to an Iowa cash grain farmer for purchasing 160 acres of land. A commercial bank made the 25-year loan with a 10-percent interest rate for the first 3 years with the rate adjustable thereafter. Security for the loan was the land to be purchased. The farmer was not an existing bank customer and had assets of $53,540 at the time of application and total liabilities of $1,950 for a net worth of $51,590. Most of the farmer's assets were machinery and equipment, with $8,600 in cash or its equivalents. The farmer's loan application indicated that his net cash farm income was about $12,000 in 1987, before living expenses or equipment depreciation were considered.

The loan enabled the farmer to purchase land his family had been renting for over 60 years. The seller was willing to extend a 10-year noninterest-bearing down payment loan to the farmer. However, the seller would have sold the land on the open market to another buyer, and the farmer may have discontinued farming if he had not received the guaranteed loan. The FmHA guarantee was needed because the farmer lacked sufficient equity for a commercial loan. The guaranteed loan application indicated that the farmer did not need the IRR program to establish a positive cash flow, but the lender characterized the loan terms as advantageous.

Use of Guaranteed Farm Operating Loan Funds

Guaranteed operating funds were used primarily for purchasing operating inputs, such as seed, feed, and fuels, and for refinancing existing debts. An estimated 55 percent, or $480 million, of the estimated total $879 million (see table 1.1) of farm operating loan funds were for farm operating expenses. Another 34 percent, or $299 million, were for refinancing borrowers' existing debts. The remaining 11 percent were for: purchasing livestock (6 percent, or $54 million); purchasing equipment (3 percent, or $22 million); family living expenses (2 percent, or $20 million); and, other purposes (less than 1 percent, or $2 million). (See fig. 4.3).

Figure 4.4: Amount of Guaranteed Farm Operating Funds Used to Refinance Existing Debts, by Debt Sources, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Most guaranteed farm operating loan funds—an estimated 79 percent, or about $691 million—were obtained by existing customers of the lender making the guaranteed loans.

The type of operating loans that lenders funded were divided between loan note guarantees and line-of-credit guarantees, which accounted for an estimated 55 percent and 45 percent of the funds, respectively. Also, refinancing accounted for 61 percent of the funds used for loan note guarantees. Operating inputs, on the other hand, accounted for 86 percent of the line-of-credit guarantee funds.

In addition, the IRR program was used for an estimated 17 percent, or about $147 million, of the guaranteed farm operating funds. Seventy percent, or $104 million, of the loan funds were used for refinancing when the IRR program was used. This compares with 27 percent, or $195 million, of the loan funds that were used for refinancing when the IRR program was not used.

restructured and consolidated the corporation's FCS real estate and intermediate debts in a separate farm ownership loan. According to the FCS lender, the corporation's past financial management had been a problem as evidenced by the large debt and negative net worth and capital investments that were too high for the operation's size.

34 percent of the guaranteed farm operating loan funds. Also, the lenders' existing customers received about 80 percent of the guaranteed farm ownership funds and 79 percent of the guaranteed farm operating funds (see section 4).

According to nine lenders, another lender benefit is that the guarantee improves the lenders' security position and overall loan portfolio quality. Since loan portfolio quality is supervised by bank regulatory agencies, adverse loan evaluation findings can negatively affect a lending institution. Five lenders specifically said that obtaining a guarantee provides regulatory benefits that help lenders. Capital requirements for guaranteed loans are reduced because an allowance for loan losses does not have to be made on the guaranteed portion of a guaranteed loan. According to one FCS lender, moreover, the costs of obtaining funds to lend can be reduced by improving loan portfolio quality.

Twenty-one of the 26 lenders we interviewed told us they did not have goals for obtaining FmHA guarantees, such as a specific dollar amount of FmHA guaranteed loans. For example, two Iowa lenders stated they use guaranteed loans as the need arises for their financially troubled customers. On the other hand, five lenders stated they had goals for obtaining guaranteed loans. They told us the reasons for establishing goals included stabilizing or improving their portfolio credit quality and using loan guarantees to increase loan volume.

In 1986 the American Bankers Association developed a guide entitled FmHA Guaranteed Lending Manual, which assisted bankers in using loan guarantees. The guide highlighted some additional benefits lenders can obtain from using guarantees for farm loans:

- Continued service to customers through periods of stress;
- The service of a broader range of community credit needs by a bank due to its reduced farm loan risk with FmHA guarantees;
- The potential for selling guaranteed loans in the secondary market which would provide lenders with a greater ability to convert loans to cash and to obtain loan servicing fee income; and
- The potential increase of bank deposits because of the multiplier effect that additional farm loans may have on the local economy.

risk in farm lending and the desire to sell guaranteed loans in the secondary market for cash and service fees were the reasons for this policy.

Guaranteed Loan Use Expected to Continue

Generally, the lenders we interviewed expected guaranteed loan usage to either increase or remain constant through 1990. Thirteen of the lenders we interviewed expected an increase in guarantee applications. Several reasons were cited for the expected increase. An Iowa commercial bank official told us that he expected guaranteed farm operating loan activity to increase as prior guaranteed farm operating loans mature and replacement guaranteed loans are made. An Arkansas commercial bank official told us that his bank wanted to increase the size of its agricultural portfolio and that part of the bank's plan includes increasing the number of guaranteed loans. Officials at an Oklahoma, a Louisiana, and at a Texas bank told us they expected an increase in guaranteed loan activity since their banks require an FmHA guarantee as a condition for all new farm loan customers.

In addition, while 6 of the lenders we interviewed expected a constant level of guaranteed farm loan activity, 6 other lenders expected decreased activity. Several reasons were cited for the expected decrease. Officials at two different Iowa banks told us that they made guaranteed loans for borrowers who were adversely affected by the severe 1988 drought and that they do not plan to make additional guaranteed loans unless there is further adverse weather. An Iowa bank official told us he expected a decrease since his bank intends to limit its risk exposure on all new farm loans so that guarantees will no longer be needed. A Wisconsin bank official told us that state-provided loan guarantees are easier to manage than FmHA guarantees and that a state drought assistance program limits the need for FmHA guarantees.

The final lender we interviewed expected an increase in guaranteed farm ownership applications, but a decrease in guaranteed farm operating applications. Also, according to various lenders who expected a decrease in activity, the demand for guarantees could increase if adverse weather negatively affects borrowers' crop production and income.

Objectives, Scope, and Methodology

In September 1988, the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, requested that we gather information on the use of farmer program loan funds by FmHA's borrowers during fiscal year 1988. We specifically focused on the planned use of funds for four major types of farmer program loans, the extent to which loan funds were used to refinance farmer's existing debts, and lenders' views on using FmHA loan guarantees. In January 1989 we met with committee staff to provide information on the scope of our work and in July 1989 briefed committee staff on the preliminary results of our work.

To gather information on borrowers' planned uses of FmHA farmer program loan funds in fiscal year 1988, we obtained data on FmHA loan obligations for the fiscal year. The source of this data, used as our universe of FmHA farm program loans, was the automated tape that produced the FmHA Status of Loan and Grant Obligations Allotments or Distribution report (FmHA report code 205). The report covered loan information for fiscal year 1988. Actual total obligations for all farmer programs was $2.3 billion as of September 30, 1988. Using this data tape we identified the obligations for the four major types of FmHA farmer program loans—direct farm ownership loans accounting for $115 million; direct farm operating loans, accounting for $900 million; guaranteed farm ownership loans, accounting for $362 million; and guaranteed farm operating loans, accounting for $893 million.

We developed a data collection instrument (DCI) to collect standardized information on borrowers' planned uses of loan funds. In developing this DCI we visited three FmHA county offices, one each in Wisconsin, Minnesota, and Georgia. At these county offices we reviewed borrowers' files and identified source documents that contained loan use information. After identifying the available information, we developed DCI questions for each of the four types of loans with the intention that FmHA county office personnel would review borrowers' files and record the loan use information onto the DCI. The four types of DCIs were reviewed by the three FmHA county supervisors and appropriate changes were made.

To determine the borrowers' use of loan funds, we selected a random sample of 450 loans from each of the four types of loans. Each sample was stratified based on the loan amount. We randomly selected 200 lower valued loans and 250 higher valued loans.

Table 6.1 shows the universe, sample and completed DCI information.

were interpreted correctly, 62 loan files for completed DCIs were reviewed in 12 FmHA county offices—2 counties each in Texas, Louisiana, Arkansas, Oklahoma, Iowa, and Wisconsin. The DCI information was entered into an automated data base. To verify data accuracy, 50 DCIs for each loan type were randomly selected and the information verified to the DCIs returned by FmHA. One error was found and corrected. Appendix I contains our estimates and the 95 percent confidence intervals calculated from the sample.

During our DCI verification visits to county offices, we judgmentally selected 26 guaranteed loan lenders in the 6 states to gather additional information on the use of guaranteed loan funds. The lenders were selected because they had made loans that were in our sample. Four lenders were interviewed in each state except Oklahoma and Wisconsin, where we interviewed five lenders in each state. During our lender interviews we asked standard questions on the benefits of guaranteed loans, conditions under which lenders use guarantees, and their anticipated use of guarantees. The lender responses were summarized and are presented in section 5 of this report.

Various analyses were performed including tabulations and percentage computations to develop information from the data base. Information from these analyses and the responses from our guaranteed lender interviews were presented in a briefing to the committee staff in July 1989, and are contained in this report.

Table I.1: Sampling Errors and Confidence Intervals for Key Estimates From the Fiscal Year 1988 Sample

Dollars in thousands; percentage of estimated amounts

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval: Lower limit	95 percent confidence interval: Upper limit
Direct farm ownership loan funds	$114,150	$3,112	$111,038	$117,262
Fund uses				
Purchase property	$58,237	$4,806	$53,431	$63,042
	51.0%	4.0%	47.0%	55.0%
Refinance debts	$49,518	$4,855	$44,663	$54,373
	43.4%	4.0%	39.4%	47.4%
Purchase special equipment and facilities	$4,627	$1,569	$3,058	$6,196
	4.1%	1.4%	2.7%	5.4%
Other purposes	$1,768	$585	$1,183	$2,354
	1.6%	0.5%	1.0%	2.1%
Refinancing debts by lender				
FCS lenders	$17,622	$3,430	$14,192	$21,052
	35.6%	5.8%	29.8%	41.4%
Other lenders	$15,575	$2,972	$12,604	$18,547
	31.5%	5.3%	26.1%	36.8%
Commercial banks	$15,174	$3,098	$12,076	$18,273
	30.6%	2.8%	27.9%	33.4%
Funds by borrower type				
Existing	$64,004	$4,818	$59,186	$68,822
	56.1%	4.1%	52.0%	60.1%
New	$50,146	$4,946	$45,201	$55,092
	43.9%	4.1%	39.9%	48.0%
Existing borrower fund uses				
Purchase property	$35,686	$4,390	$31,295	$40,076
	55.8%	5.2%	50.5%	61.0%
Refinance debts	$24,767	$3,787	$20,980	$28,554
	38.7%	5.1%	33.6%	43.8%
New borrower fund uses				
Purchase property	$22,551	$3,657	$18,894	$26,207
	45.0%	6.1%	38.9%	51.0%
Refinance debts	$24,751	$4,065	$20,686	$28,816
	49.4%	6.2%	43.2%	55.6%

(continued)

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval Lower limit	Upper limit
Existing borrowers using funds for operating expenses	$602,345	$45,828	$556,516	$648,173
	69.2%	4.2%	65.0%	73.4%
Guaranteed farm ownership loan funds	$362,942	$8,711	$354,230	$371,653
Fund uses				
Purchase property	$73,111	$11,710	$61,401	$84,821
	20.1%	3.3%	16.9%	23.4%
Refinance debts	$249,692	$16,010	$223,682	$265,702
	68.8%	3.9%	64.9%	72.7%
Purchase special equipment and facilities	$38,788	$9,433	$29,355	$48,222
	10.7%	2.6%	8.1%	13.3%
Other purposes	$1,350	$810	$540	$2,160
	0.4%	0.2%	0.2%	0.6%
Refinancing debts by lender				
FCS lenders	$134,307	$15,814	$118,493	$150,121
	53.8%	5.1%	48.7%	58.9%
Commercial banks	$97,511	$13,945	$83,566	$111,456
	39.1%	5.0%	34.0%	44.1%
Other lenders	$16,113	$4,570	$11,543	$20,683
	6.5%	1.8%	4.6%	8.3%
Trade creditors	$1,761	$978	$783	$2,739
	0.7%	0.4%	0.3%	1.1%
Loan funds to borrowers having existing loan with lender	$288,906	$14,884	$274,022	$303,790
	79.6%	3.5%	76.1%	83.2%
Existing loan with lender and for refinancing debts	$222,321	$16,744	$205,577	$239,065
	77.0%	3.9%	73.0%	80.9%
Existing loan with lender and no direct FmHA loan	$232,991	$16,823	$216,168	$249,815
	80.7%	3.9%	76.8%	84.5%
Refinancing loan use	$177,189	$17,139	$160,050	$194,328
	76.1%	4.5%	71.5%	80.6%
Direct FmHA loan and no existing loan with lender	$10,687	$5,215	$5,472	$15,903
	2.9%	1.4%	1.5%	4.4%
Refinancing loan use	$5,534	$3,527	$2,007	$9,061
	51.8%	22.2%	29.6%	73.9%

(continued)

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval Lower limit	Upper limit
Regular loan notes used for refinancing	$295,027	$48,410	$246,617	$343,437
	61.0%	6.8%	54.2%	67.8%
Line of credit used for operating expenses	$337,904	$44,034	$293,870	$381,939
	85.6%	3.9%	81.8%	89.5%
Loan funds with IRR	$147,327	$36,827	$110,500	$184,154
	16.8%	4.1%	12.7%	20.9%
Used for refinancing	$103,604	$32,272	$71,331	$135,876
	70.3%	10.7%	59.7%	81.0%
Loan funds without IRR	$731,212	$50,340	$680,872	$781,552
	83.2%	4.1%	79.1%	87.3%
Used for refinancing	$195,320	$41,546	$153,774	$236,867
	26.7%	5.3%	21.5%	32.0%
Used for farm operating expenses	$450,504	$47,863	$402,642	$498,367
	61.6%	5.1%	56.5%	66.8%
Both direct loan funds	$984,756	$40,735	$944,021	$1,025,491
Fund uses				
Refinance debts	$116,798	$25,425	$91,373	$142,224
	11.9%	2.5%	9.3%	14.4%
Both guaranteed loan funds	$1,241,481	$43,636	$1,197,845	$1,285,116
Fund uses				
Refinance debts	$548,616	$51,003	$497,613	$599,619
	44.2%	3.8%	40.4%	48.0%
Both operating loan funds	$1,749,145	$58,973	$1,690,172	$1,808,118
Fund uses				
Operating expenses	$1,119,658	$64,799	$1,054,860	$1,184,457
	64.0%	3.1%	60.9%	67.1%
Refinance debts	$366,204	$54,478	$311,727	$420,682
	20.9%	3.0%	18.0%	23.9%
Purchase livestock	$117,766	$27,051	$90,716	$144,817
	6.7%	1.5%	5.2%	8.3%
Family living expenses	$61,684	$8,251	$53,433	$69,935
	3.5%	0.5%	3.1%	4.0%
Purchasing machinery and equipment	$76,368	$18,442	$57,925	$94,810
	4.4%	1.1%	3.3%	5.4%
Other purposes	$3,045	$2,804	$240	$5,849
	0.2%	0.2%	0.0%	0.3%

(continued)

Recent General Accounting Office Reports on FmHA Programs and Activities

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

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

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

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

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

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

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

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

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

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

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Major Contributors to This Briefing Report

Resources, Community, and Economic Development Division, Washington, D.C.

John P. Hunt, Jr., Assistant Director
Patrick J. Sweeney, Assignment Manager
Patrick B. Doerning, Operations Research Analyst

Chicago Regional Office

John A. Wanska, Evaluator-in-Charge
Mark J. Huber, Evaluator
Francis W. Crowley, Evaluator
Francis M. Zbylski, Operations Research Analyst

Dallas Regional Office

Harold G. Dighton, Regional Assignment Manager
Reid H. Jones, Site Senior

Kansas City Regional Office

Robert C. Sommer, Computer Analyst

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

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

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

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval: Lower limit	95 percent confidence interval: Upper limit
Both ownership loan funds	$477,092	$9,251	$467,841	$486,342
Fund uses				
Purchase property	$131,348	$12,658	$188,690	$144,006
	27.5%	2.7%	24.8%	30.2%
Refinance debts	$299,210	$16,730	$282,480	$315,940
	62.7%	3.1%	59.6%	65.8%
Purchase special equipment and facilities	$43,416	$9,563	$33,853	$52,978
	9.1%	2.0%	7.1%	11.1%
Other purposes	$3,119	$999	$2,119	$4,118
	0.7%	0.1%	0.5%	0.8%
All four loan types	$2,226,237	$59,694	$2,166,542	$2,285,931
Fund uses				
Operating expenses	$1,119,658	$64,799	$1,054,860	$1,184,457
	50.3%	2.5%	47.8%	52.8%
Refinance debts	$665,414	$56,989	$608,425	$722,403
	29.9%	2.4%	27.5%	32.3%
Purchase property	$131,348	$12,658	$118,690	$144,006
	5.9%	0.6%	5.3%	6.5%
All other uses	$309,817	$34,968	$274,849	$344,784
	13.9%	1.5%	12.4%	15.5%
Loans to existing borrowers	$1,810,814	$72,035	$1,738,778	$1,882,849
	81.3%	2.2%	79.1%	83.6%

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval Lower limit	Upper limit
Guaranteed farm operating loan funds	$878,539	$42,757	$835,782	$921,296
Fund uses				
Operating expenses	$480,011	$47,611	$432,400	$527,622
	54.6%	4.9%	49.8%	59.5%
Refinance debts	$298,924	$48,425	$250,499	$347,349
	34.0%	5.1%	28.9%	39.1%
Purchase livestock	$54,193	$17,426	$36,767	$71,619
	6.2%	2.0%	4.2%	8.1%
Family living expenses	$20,364	$4,148	$16,216	$24,511
	2.3%	0.5%	1.8%	2.8%
Purchasing machinery and equipment	$22,178	$8,307	$13,872	$30,485
	2.5%	1.0%	1.6%	3.5%
Other purposes	$2,325	$2,595	$(270)	$4,919
	0.3%	0.3%	(0.0%)	0.6%
Refinancing debts of lender				
FCS lenders and commercial banks	$272,185	$45,996	$226,189	$318,180
	91.1%	2.9%	88.2%	94.0%
FCS lenders	$100,861	$31,140	$69,721	$132,001
	33.7%	8.6%	25.2%	42.3%
Commercial banks	$171,323	$37,931	$133,392	$209,255
	57.3%	8.8%	48.5%	66.1%
Trade creditors	$11,347	$5,280	$6,067	$16,626
	3.8%	1.7%	2.1%	5.5%
Other lenders	$15,393	$7,535	$7,858	$22,927
	5.2%	2.4%	2.7%	7.6%
Loan funds to borrowers having existing loan with lender	$690,690	$53,153	$637,537	$743,843
	78.6%	4.1%	74.5%	82.8%
Loan funds to borrowers not having existing loan with lender	$187,850	$36,019	$151,830	$223,869
	21.4%	4.1%	17.3%	25.5%
Loan type				
Regular	$483,871	$54,377	$429,494	$538,248
	55.1%	5.4%	49.7%	60.4%
Line of credit	$394,668	$49,430	$345,239	$444,098
	44.9%	5.4%	39.6%	50.3%

(continued)

Loan type and planned use of funds	Estimate	Sampling error	95 percent confidence interval Lower limit	Upper limit
Funds by loan type				
Initial loans	$94,312	$4,336	$89,796	$98,649
	82.6%	2.7%	79.9%	85.3%
Subsequent loans	$19,838	$3,063	$16,775	$22,901
	17.4%	2.7%	14.7%	20.1%
Direct farm operating loan funds	$870,606	$40,616	$829,990	$911,222
Fund uses				
Operating expenses	$639,647	$43,955	$595,692	$683,602
	73.5%	3.8%	69.7%	77.3%
Refinance debts	$67,280	$24,958	$42,323	$92,238
	7.7%	2.8%	4.9%	10.5%
Purchase livestock	$63,573	$20,690	$42,883	$84,263
	7.3%	2.4%	4.9%	9.7%
Purchase machinery and equipment	$54,189	$16,465	$37,724	$70,654
	6.2%	1.9%	4.3%	8.1%
Family living expenses	$41,320	$7,133	$34,187	$48,453
	4.8%	0.8%	4.0%	5.5%
Other purposes	$4,596	$2,713	$1,882	$7,309
	0.5%	0.3%	0.2%	0.8%
Refinancing debts by lender				
Commercial banks	$29,482	$15,474	$14,008	$44,956
	43.8%	16.8%	27.0%	60.7%
Trade creditors	$20,872	$11,022	$9,850	$31,894
	31.0%	12.8%	18.2%	43.8%
FCS lenders	$11,063	$9,478	$1,585	$20,542
	16.4%	11.9%	4.5%	28.4%
Other lenders	$5,863	$6,611	$(748)	$12,474
	8.7%	9.2%	(0.5%)	17.9%
Funds by borrower type				
Existing	$767,214	$46,033	$721,181	$813,248
	88.1%	3.6%	84.5%	91.7%
New	$103,391	$32,075	$71,316	$135,466
	11.9%	3.6%	8.3%	15.5%
Funds by loan type				
Subsequent loans	$685,559	$47,049	$638,510	$732,608
	78.8%	4.6%	74.1%	83.4%
Initial loans	$185,046	$42,519	$142,527	$227,566
	21.3%	4.6%	16.6%	25.9%

(continued)

Sampling and Data Analysis Methodology

In this review, we collected data on borrowers' planned use of loan funds. Our sampling methodology enabled us to make statistical estimates of the planned use of the loan funds for the four FmHA farm loan programs in fiscal year 1988. We estimated both the amount and percent of total loan funds for each planned use. This appendix provides the sampling errors and 95 percent confidence intervals for the estimates in the report.

Because we reviewed a statistical sample of FmHA loans, each estimate developed from the sample data has a measurable precision, or sampling error. The sampling error is the maximum amount by which the estimates obtained from a statistical sample can be expected to differ from the true universe value estimated. Sampling errors are usually stated at a certain confidence level; in this case, it is 95 percent. This means the chances are 19 out of 20 that if we reviewed all the FmHA loans in fiscal year 1988, the results of our review would differ from the estimates obtained from our samples by less than the sampling errors of such estimates.

Table I.1 shows the sampling errors and the upper and lower confidence intervals of key estimates for planned uses of FmHA loans. While the individual key estimates add to the totals reflected in the tables, adding the related sampling errors or confidence limit estimates will not equal the totals.

Table 6.1: Universe and Sample Size, and Completed Data Collection Instruments for the Four Major Types of FmHA Loans, Fiscal Year 1988

Loan type and amount	Universe size	Sample size	Completed DCIs	Completion percent[a]
Direct farm ownership				
Less than $80,000	752	200	197	98.5
$80,000 or more	613	250	247	98.8
Total	**1,365**	**450**	**444**	**98.6**
Direct farm operating				
Less than $40,000	14,890	200	197	98.5
$40,000 or more	8,363	250	247	98.8
Total	**23,253**	**450**	**444**	**98.6**
Guaranteed farm ownership				
Less than $140,000	1,220	200	198	99.0
$140,000 or more	1,212	250	249	99.6
Total	**2,432**	**450**	**447**	**99.3**
Guaranteed farm operating				
Less than $80,000	5,629	200	200	100.0
$80,000 or more	4,222	250	246	98.4
Total	**9,851**	**450**	**446**	**99.3**
Total: 4-loan types	**36,901**	**1,800**	**1,781**	**98.9**

[a]Completion rates were calculated using the appropriate weights.

The 1,800 sample loans were located in 913 FmHA county offices, with each county office having from 1 to 11 loans. Loans were located in each state with the exception of Alaska and Rhode Island.

After selecting the sample, we prepared the DCIs for mailing. We recorded information for each loan to individual DCIs to provide the 913 county offices with basic information for identifying selected loans. This information included the borrowers name, loan amount, interest rate, the obligation date and other identifying information. Two transmittal letters—one from FmHA and one from our office—were prepared. These letters provided instructions, asked for cooperation in completion of the DCI, and requested that copies of source documents be provided. The transmittal letters and DCIs were mailed to the county offices on February 9, 1989, and a follow-up mailing for non-respondents was mailed March 17, 1989.

A total of 1,781 usable DCIs was returned for a response rate of 99 percent. Each DCI was reviewed for accuracy and completeness, and data entries were verified against the source documents provided to ensure accuracy of the returned DCI information. To verify that DCI questions

Lenders Had Mixed Experience Getting Guaranteed Loan Applications Approved

FmHA denied guaranteed loan applications that were submitted by about one-half of the lenders we interviewed. The most common reasons cited by these lenders for the denial were that the borrowers were ineligible for the guarantee due to size of their farming operation or the amount of their non-farm income. Cash flow or security problems were mentioned as additional reasons. Despite the application denials, lenders generally expressed satisfaction with the program and FmHA's administration of it. For example, a lender with an initial denial due to the borrower's inability to establish a positive cash flow acknowledged that revising the application and using the IRR program resulted in sufficient repayment ability for FmHA to approve the loan application. Also, another lender said that FmHA had reduced the percent of guarantee on some loans but that the reductions reflected appropriate levels of risk.

Benefits to Borrowers When Obtaining an FmHA Guaranteed Loan

The primary benefit that borrowers obtain from an FmHA loan guarantee, according to 15 of the lenders we contacted, is the opportunity to receive commercial financing and continue their farming operations. A related benefit cited by eight of the lenders was that the guarantee permits the borrower to receive beneficial loan terms, such as lower interest rates. Also, the lenders might have imposed more stringent repayment terms or increased interest rates without the guarantee to compensate them for the relatively higher risks that most borrowers receiving guaranteed loans present. Another advantage cited by two lenders was that guarantees can increase lenders' willingness to assure the borrower of financing for a longer period. According to one lender, a larger loan can be made with a guarantee because the bank's lending limits do not apply to the guaranteed portion of the loan.

The American Bankers Association guaranteed lending guide listed some additional benefits that borrowers and the farm community can receive from FmHA loan guarantees:

- Credit at reasonable terms;
- Expansion of existing business or attraction of new business; and
- Expansion of the local economy and job creation.

Conditions in Which Lenders Will Use a Loan Guarantee

Lenders often seek a guarantee to compensate for excessive risk in providing a particular loan. Twenty-one of the 26 lenders we interviewed told us they seek a guarantee to compensate for excessive loan risk when a borrower does not meet their credit standards for a regular commercial loan. Specific credit standards that are not always met include a specified debt-to-asset ratio, security or collateral values, net worth or equity requirements, or cash flow. Borrowers who are deficient in one or more of these credit standards, however, may qualify for a loan with a guarantee if they are able to show the potential for positive cash flow and adequate security.

In addition, 17 of the lenders we contacted stated that they rather than the borrower initiate action to obtain an FmHA loan guarantee. Nine said that both the lender and borrower initiate action to obtain a guarantee. None of the lenders we interviewed said that borrowers solely initiate the action to obtain a guarantee.

Further, five of the lenders stated that they generally seek FmHA loan guarantees on either all or most of their farm loans. They said that the

Commercial Lenders' Views on Using Guaranteed Loans

Commercial lenders told us they view guaranteed loans primarily as a way of increasing the security of their agricultural loan portfolios. The use of a guarantee on a loan ensures that lenders are repaid most of the money they loan to borrowers and thus their losses are minimized. Specifically, guaranteed loans are used by lenders for their borrowers who are experiencing some financial difficulties, and as a mechanism for lenders to continue serving their existing customers. Generally, lenders seek an FmHA loan guarantee for borrowers with credit weaknesses or borrowers needing credit terms outside the bank's lending standards. Some lenders require guarantees for new customers, for beginning farmers, or for all farm loans. In addition, lenders stated that the opportunity to receive commercial financing and continue farming is the primary benefit borrowers obtain from guaranteed loans.

To obtain additional information on the use of guaranteed farm ownership and operating loans, we contacted 26 lenders in 6 states —Texas, Louisiana, Arkansas, Oklahoma, Iowa, and Wisconsin—who had made loans that were guaranteed by FmHA. This section of the report is based on our discussions with these lenders and presents their views on the benefits to lenders and borrowers for obtaining a guarantee. It also discusses when lenders will use a loan guarantee, their expectations on future use of guarantees, and their experience in having guaranteed applications denied. The results of the information gathered from these lenders cannot be used to estimate various lending characteristics about the universe of lenders who participate in FmHA loan programs.

Benefits to Lenders for Obtaining a FmHA Guarantee

The primary reason for obtaining an FmHA guarantee, as stated by 12 of the lenders we contacted, was that lenders can make loans to borrowers who had repayment ability but did not meet their lending criteria. With an FmHA guarantee, lenders continue to finance borrowers who otherwise might have credit curtailed or denied, and, therefore, lenders are better able to sustain their agricultural loan volume and interest income. Also, the use of a guarantee on a loan ensures that lenders are repaid most of the money they loan to borrowers and thus their losses are minimized.

Continuing with borrowers often involves refinancing, and 19 of the lenders we interviewed used guarantees for refinancing existing loans. Using guarantees for refinancing is done frequently as evidenced by the estimated amount of fiscal year 1988 loan funds that were used for refinancing—69 percent of the guaranteed farm ownership loan funds and

The following two loan cases in our sample illustrate the use of guaranteed farm operating loan funds.

Case Study G— Refinancing Existing Debt, and Purchasing Livestock, Machinery and Equipment

An Oklahoma dairy farmer obtained a 90-percent guaranteed commercial bank operating loan of $320,000 in May 1988 to refinance prior debts ($205,000), purchase dairy cows ($80,000), and purchase machinery and equipment ($35,000). The loan interest rate was 13.4 percent, which was reduced by the IRR program to 9.4 percent for 3 years. The loan repayment period was 7 years with a balloon payment due at the end of the period. Loan security consisted of the farmer's livestock, machinery and equipment, crops on hand, and growing crops. The farmer reported total assets of $503,860, total liabilities of $199,358, and a net worth of $304,502.

The farmer, with more than 10 years of farming experience, needed a longer term and a reduced interest rate to show repayment ability for the loan. With the guarantee the lender was able to refinance the farmer's existing operating debt with a repayment period of 7 years instead of annual 1-year operating loans. The loan also allowed the borrower to expand his dairy operation by 80 cows and purchase additional milking equipment.

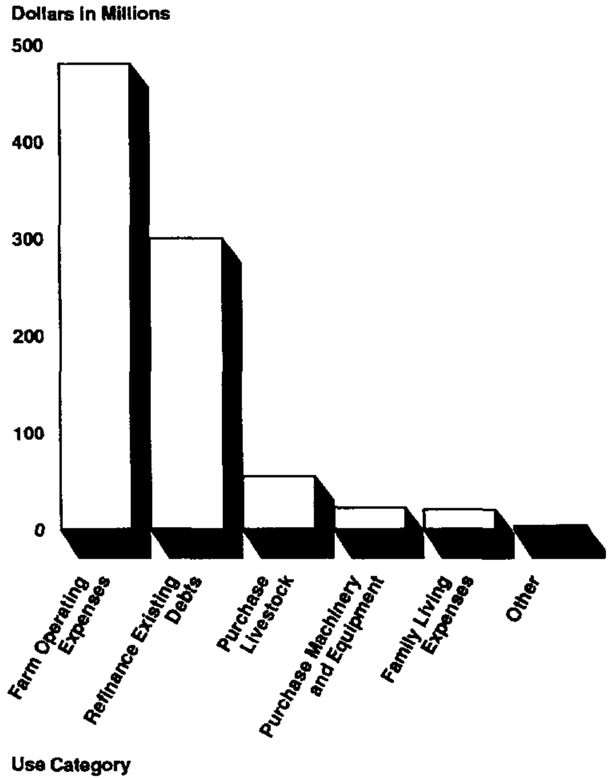
Case Study H— Refinancing Existing Debt

In March 1988, FmHA provided a FCS lender with a 90-percent guarantee on the $400,000 operating loan that refinanced a Wisconsin family corporation's existing FCS operating debts. The loan had a 10.4-percent interest rate and a 7-year repayment period. The guaranteed loan was the first assistance the dairy operation had received from FmHA. The operation consisted of 585 owned acres and 236 rented acres. Security for the loan consisted of cattle, machinery, and real estate.

The corporation listed total assets of $1,077,599 and total liabilities of $1,384,975, for a negative net worth of $307,376, according to the December 1987 guaranteed loan application. At that time, the FCS lender advised FmHA that the corporation was taking steps to deal with their financial problems and they were current on their secured debts. The corporation showed a positive cash flow for 1986 and 1987 and projected a positive cash flow for 1988.

With the FmHA guarantee, the FCS lender reduced its interest rate on the loan by 1 percent to help the corporation's cash flow. The FCS lender also

Figure 4.3: Amount of Guaranteed Farm Operating Funds Used for Various Purposes, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Funds used for refinancing borrowers' existing debts primarily involved debts owed to commercial banks and to the FCS. Figure 4.4 shows that of the estimated $299 million of loan funds used for refinancing borrowers' existing debts:

- 57 percent, or $171 million, were for debts owed to commercial banks;
- 34 percent, or $101 million, were for debts owed to FCS;
- 5 percent, or $15 million, were for debts owed to other lenders; and,
- 4 percent, or $11 million, were for debts owed to trade creditors.

borrowers who had an existing farm loan with the lender making the guaranteed loan. Seventy-seven percent, or $222 million of the $289 million, was used for refinancing. Also, about 81 percent, or $233 million of the $289 million went to borrowers who did not have an existing FmHA direct loan.

Unlike borrowers who did not have an existing loan with the commercial lender but had an FmHA direct loan borrowers who had an existing farm loan with the commercial lender but not an FmHA direct loan used funds extensively for refinancing rather than for other purposes. Borrowers who had an existing loan with the commercial lender but not with FmHA received a total estimated $233 million in loan funds and used 76 percent, or about $177 million, for refinancing existing debts. In comparison, borrowers who did not have an existing loan with the guaranteed lender but had an FmHA direct loan received a estimated $11 million in loan funds; these borrowers used 51 percent, or about $6 million, for refinancing.

The following two loan cases in our sample illustrate the use of guaranteed farm ownership loan funds.

Case Study E—Refinancing Existing Debt

A $300,000 ownership loan, guaranteed for 90 percent, was obligated in September 1988 to refinance a Wisconsin dairy farmer's existing FCS debts. The repayment period for the loan was 30 years, and the loan's 12 percent variable interest rate was reduced by the FmHA's IRR program to a fixed 8 percent rate for a 3-year period. Security for the farm ownership loan was the farmer's 294 acre farm.

The guaranteed loan with the interest rate reduction was needed because the farmer was having cash-flow troubles resulting from a large debt and related high interest costs. Without the FmHA guarantee and the reduced interest rate, the farmer's operation would not survive financially, according to a lending official. The farmer had previously borrowed to expand and improve his buildings and equipment, but was having trouble servicing the debt. Despite a record of good crop and dairy productivity, the farmer had experienced a large net worth reduction from 1986 to 1988. In 1986, the farmer had total assets of $876,300 and liabilities of $522,036 for a net worth of $354,264. By 1988, the farmer's assets were valued at $667,650 and liabilities were $536,462, leaving a net worth of $131,188. Although net worth was decreasing, a summary of income statements from 1983 to 1987 indicated that the

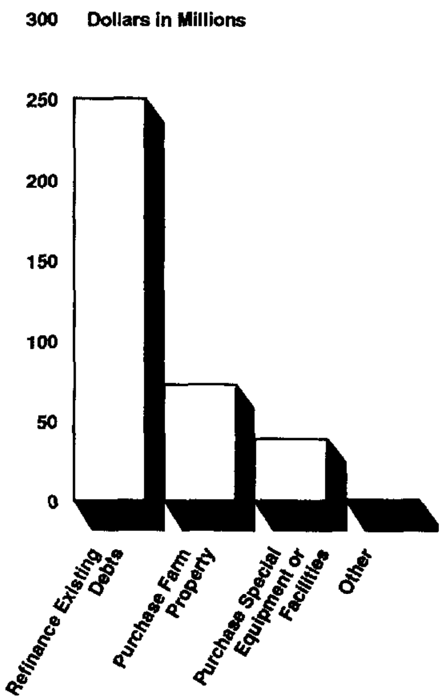
Guaranteed Loans Assisted Borrowers to Refinance Debts, Fund Operating Expenses, and Buy Farm Property

FmHA guaranteed ownership and operating loans were used in fiscal year 1988 primarily for refinancing the existing debts of commercial lenders' customers. Other major uses of guaranteed loan funds included purchasing operating inputs with operating loans and purchasing farm property with ownership loans. Also, guaranteed loan funds were provided primarily to existing customers of commercial lenders who generally did not have direct FmHA loans.

Use of Guaranteed Farm Ownership Loan Funds

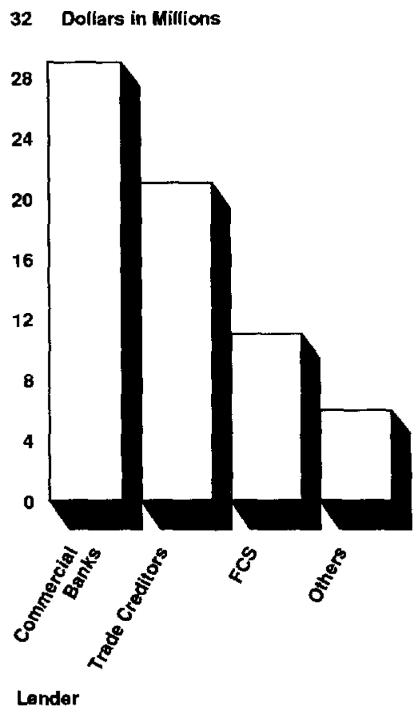
Guaranteed ownership loan funds were used primarily for refinancing existing borrower debts which accounted for an estimated 69 percent, or about $250 million, of the estimated total $363 million (see table 1.1) of farm ownership funds. Another 20 percent, or about $73 million, were for purchasing farm property. The remaining 11 percent were for purchasing special equipment or facilities (11 percent, or about $39 million) and for other purposes, such as improving pastures (less than one percent, or about $1 million). (See fig. 4.1.)

Figure 4.1: Amount of Guaranteed Farm Ownership Funds Used for Various Purposes, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Figure 3.4: Amount of Direct Farm Operating Funds Used to Refinance Existing Debts, by Debt Sources, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

Existing FmHA borrowers received an estimated 88 percent, or about \$767 million, of the total estimated \$871 million in direct operating funds. New direct borrowers received 12 percent, or about \$103 million, of the funds. Existing borrowers using funds for operating expenses represented an estimated 69 percent, or about \$602 million, of the total program funds.

Seventy-nine percent, or about \$686 million, of the farm operating funds were for subsequent loans. The remaining 21 percent, or about \$185 million, were for loans to borrowers who were receiving an initial direct operating loan.

The following two loan cases in our sample illustrate the use of direct farm operating loan funds.

provide the needed financing for purchasing the property due to the farmer's marginal repayment ability in 1988. The farmer had accumulated debts with other creditors, and FmHA's cash-flow projection indicated a $516 positive cash flow for the farmer's operation with the new loan. The farmer's FmHA loan history indicated that FmHA had used loan servicing techniques, such as stretching out the repayment period, to keep the farmer current on prior FmHA direct loans.

Case Study B—Refinancing Debt

A Wisconsin dairy farmer and cattle dealer received an initial $200,000 direct ownership loan in April 1988. The farmer was a new FmHA borrower and the loan was to refinance existing FCS loans. The loan was made at the limited resource interest rate of 5 percent for ownership loans and had a 40-year repayment period. Security for the loan was real estate owned by the farmer. The farmer's operation consisted of about 368 owned acres and 150 rented acres. A financial statement accompanying the direct loan application listed total assets of $594,500 and total debts of $429,000, for a net worth of $165,500.

The loan was needed because the farmer could not pay his existing debts after milk and cattle prices declined. The farmer was trying to restructure his FCS debts and had originally applied for a direct ownership loan in June 1986. His application was denied by the county committee because his gross income was too high to qualify as a family farm operation. However, the loan was approved after the farmer successfully appealed the committee's decision. While the application was being appealed the borrower filed for bankruptcy. The direct ownership loan, and a $135,500 FCS operating loan guaranteed by FmHA for outstanding operating debts which was made in July 1988, reduced the borrowers monthly principal and interest cost from about $7,500 to about $3,900.

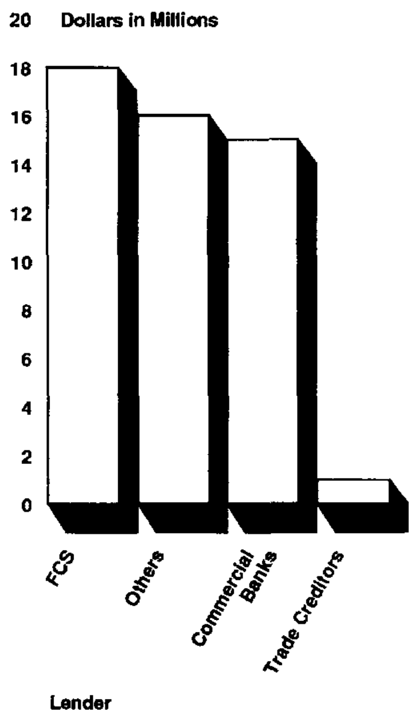
Use of Direct Farm Operating Loan Funds

Direct operating funds were used primarily for purchasing operating inputs such as seed, fuel, and fertilizer. An estimated 73 percent, or about $640 million, of the estimated total $871 million (see table 1.1) of operating funds were for operating expenses. The remaining 27 percent of the loan funds were for: refinancing borrowers' existing debts (8 percent, or about $67 million); purchasing livestock (7 percent, or about $64 million); purchasing machinery and equipment (6 percent, or about $54 million); family living expenses (5 percent, or about $41 million); and, other purposes (1 percent, or about $5 million). (See fig. 3.3.)

Funds used for refinancing borrowers' existing debts primarily involved debts owed to three types of lenders. Figure 3.2 shows that of the estimated $50 million of loan funds used for refinancing borrowers existing debts:

- 36 percent, or about $18 million, were for debts owed to the Farm Credit System (FCS);
- 31 percent, or about $16 million, were for debts owed to other lenders, such as individual land contract holders or credit unions; and
- 31 percent, or about $15 million, were for debts owed to commercial banks.

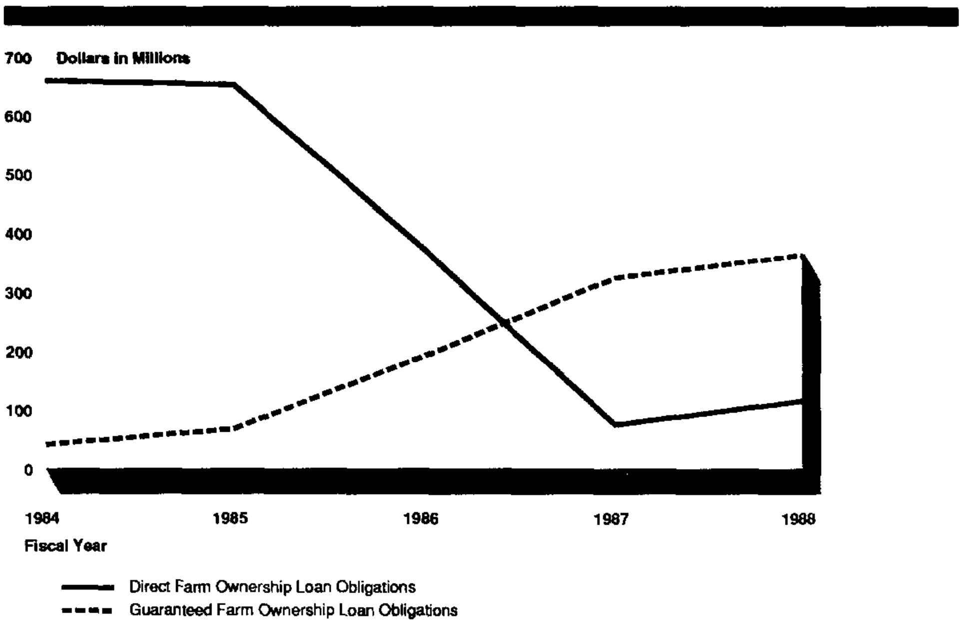
Figure 3.2: Amount of Direct Farm Ownership Funds Used to Refinance Existing Debts, by Debt Sources, Fiscal Year 1988



Source: GAO projection based on a sample of FmHA loans.

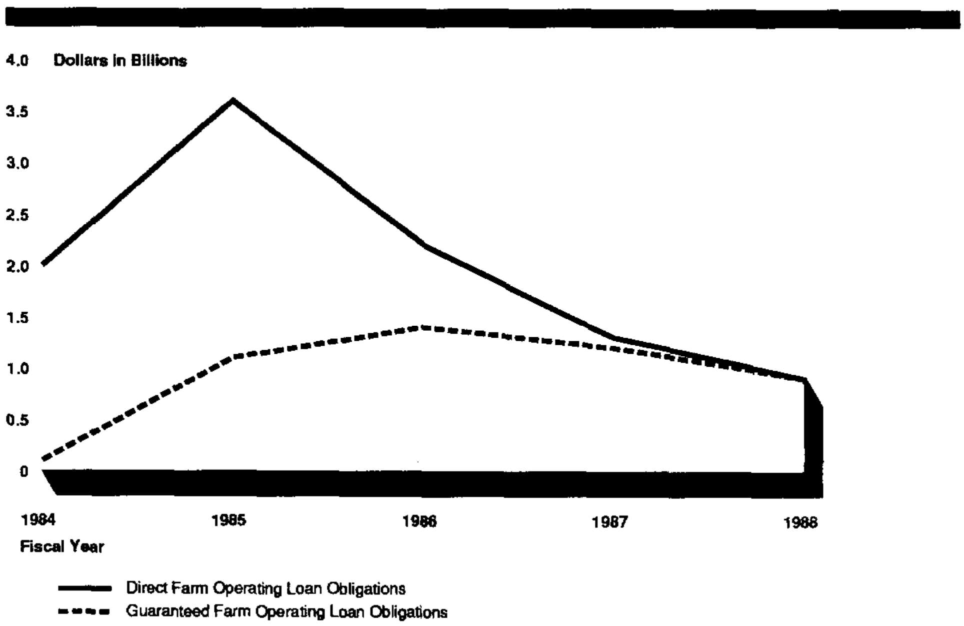
Existing FmHA borrowers—for example, those having an existing direct farm ownership or farm operating loan—received an estimated 56 percent, or about $64 million, of the estimated total $114 million direct ownership loan funds. Borrowers not having an existing FmHA direct

Figure 2.3: FmHA Direct and Guaranteed Farm Ownership Loan Obligations, Fiscal Years 1984-88



Source: FmHA.

Figure 2.4: FmHA Direct and Guaranteed Farm Operating Loan Obligations, Fiscal Years 1984-88



Source: FmHA.

40 years, and each loan must be secured by real estate or a combination of real estate and chattel property.[2]

In addition, interest rates charged to borrowers for direct loans may be reduced to a "limited resource" interest rate if borrowers' operations cannot achieve a positive cash flow without the lower rate. For example, the limited resource rate for direct ownership loans was 5 percent in October 1989 while the regular FmHA interest rate was 8.75 percent. Guaranteed loans are not reduced by a limited resource rate but may have interest rates reduced under FmHA's interest rate reduction (IRR) program. When lenders reduce interest rates up to a maximum of 4 percentage points, they receive payments from FmHA in amounts equal to not more than 50 percent of the reduction. In addition, these payments cannot be provided past the outstanding term of the loan, or 3 years, whichever is less.

During the 1984 through 1988 period, obligations for direct ownership loans decreased from $659 million to $115 million, and obligations for guaranteed ownership loans increased from $42 million to $362 million. FmHA has curtailed direct ownership lending to make more direct loan funds available for direct operating loans and to emphasize guaranteed ownership loans. Figure 2.3 shows the trend in direct and guaranteed ownership loan obligations during this 5-year period.

Farm Operating Loan Objectives and Obligations

The overall objectives of farm operating loans are to provide farmers with the credit needed to conduct successful operations and enable them to make efficient use of their land, labor, and other resources; and, to improve their living conditions and economic situations. Loans are made for various purposes to accomplish these objectives, including purchasing farm machinery and equipment, livestock, and poultry; paying annual operating expenses and family living expenses; refinancing debts; limited improving or repairing of real estate; and making payments to other creditors. Additionally, for direct operating loans, FmHA targets assistance to limited resource operations, new operations, and low income operations. It also provides management assistance to these operators.

Direct operating loans may not exceed $200,000, including any outstanding principal on other direct farm operating loans. Guaranteed

[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.

Shift From Direct Loans to Guaranteed Loans

In fiscal year 1984 FmHA began placing greater emphasis on guaranteed loans and less on direct loans in order to: encourage farm lending from private lenders, reduce budget outlays for direct loans, and devote more effort to servicing its own growing and increasingly delinquent direct accounts. The Food Security Act of 1985, which authorized FmHA farm lending levels for fiscal years 1986 through 1988, supported the shift from direct loans to loan guarantees by decreasing authorizations for direct loans and increasing authorizations for guaranteed loans. The Agricultural Credit Act of 1987 also indicated that loan guarantees should be used to the maximum extent practical to assist eligible borrowers whose loans are restructured by commercial lenders.

In September 1988, FmHA reemphasized the shift from direct loans to guaranteed loans in an administrative guidance notice to its state directors. This guidance stated that every possible effort should be made to get first-time loan applicants financed with guaranteed loans, and that direct funds should be used only for essential operating purposes. The guidance also provided that refinancing of debts should only be done with the guaranteed loans or, when absolutely necessary, to keep a farmer in business.

FmHA's lending has shifted from direct to guaranteed loans. Direct loan obligations have decreased and guaranteed loan obligations have increased considerably from 1984 to 1988. For example, direct loan obligations decreased from $2.6 billion in fiscal year 1984 to $1 billion in fiscal year 1988. On the other hand, guaranteed loan obligations increased from $153 million in fiscal year 1984 to almost $1.3 billion in fiscal year 1988. Figure 2.2 shows the trend in direct and guaranteed loan obligations during this 5-year period.

The decrease in direct loan obligations has occurred partly because other forms of government financial assistance have been available, such as USDA Commodity Credit Corporation cash deficiency and disaster payments, and, consequently, borrowers needed less direct FmHA credit to finance their operations. The increase in guaranteed loans is attributed to private lenders who obtained guaranteed loans for their existing borrowers experiencing financial problems.[1]

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

Background on FmHA Farmer Program Loans

FmHA, the credit agency for agriculture and rural development in the U.S. Department of Agriculture (USDA), provides loans to farmers who are unable to obtain credit from other lenders at reasonable rates and terms. The agency is often referred to as the "lender of last resort" because it may be the last opportunity that farmers have to obtain credit. FmHA loans are intended to be a temporary credit source for borrowers who are starting a farming operation or continuing their operation after a financial setback. Also, the loans often supplement other credit obtained by farmers.

Four Major Types of FmHA Loans Assist Farmers

Four types of FmHA loans provide the majority of the agency's credit assistance to farmers. Two of these—direct farm ownership loans and direct farm operating loans—provide borrowers direct government-funded loans, and two other types—guaranteed farm ownership loans and guaranteed farm operating loans—provide guarantees of loans from other lenders. Other FmHA loans, such as emergency disaster loans and soil and water loans, also assist farmer program borrowers but to a lesser extent. Emergency disaster loans are made to farmers in counties declared as emergency disaster areas to restore production. Soil and water loans are made to farmers for land and water development, use, and conservation.

FmHA had about $2.3 billion in actual farmer program obligations in fiscal year 1988. The four major types of loans accounted for 98 percent of the total obligated funds. The remaining 2 percent went to other types of farmer program loans, such as emergency disaster loans and soil and water loans. Direct farm ownership funds accounted for $115 million, direct farm operating funds for $900 million, guaranteed farm ownership funds $362 million, and guaranteed farm operating funds $893 million (see fig. 2.1).

offered the option of a guaranteed loan for refinancing existing debts or for other purposes.

A recent GAO report concluded that existing FmHA borrowers rely on FmHA as a continuous source of credit, and few have graduated to other credit sources because they are not financially capable and other lenders are reluctant to refinance them.[5] A 1989 GAO report on FmHA loan-making concluded that if direct loan borrowers experience repayment problems, FmHA provides extensive financial assistance to them, which results, in many instances, in heavier debt loads and reduced equity.[6] In the long run, FmHA's existing borrowers have become more dependent on FmHA credit assistance and continue to remain as FmHA customers.

A 1989 GAO report on FmHA guaranteed loans concluded that although FmHA's farm lending emphasis has shifted to guaranteed loans, the increase in guaranteed lending has resulted primarily from private lenders obtaining loan guarantees for their existing customers who had become financially stressed.[7] The report adds that few FmHA direct loan borrowers have switched to guaranteed loans with private lenders, or are likely to do so, because their poor financial conditions make private lenders reluctant to finance them even with loan guarantees. Also, the report states that the overall continuing shift from direct to guaranteed lending has helped the government keep some farm lending in the private sector and, assuming that some guaranteed loan borrowers would have qualified for direct loans, has helped reduce budget outlays for new direct loans. However, because few direct loan borrowers have switched to guaranteed loans, continued substantial budget outlays will probably be needed to help direct loan borrowers stay in business.

In addition, the use of loan funds is influenced by the lender—FmHA for direct loans and commercial lenders for guaranteed loans. FmHA influences the use of direct loans by trying to shift new borrowers and loans for refinancing to guaranteed loans. Although FmHA approves loan guarantees, commercial lenders decide whether or not to seek a guarantee on loans they make. Therefore, the use of guaranteed loans is largely determined by commercial lenders.

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

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

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

Table 1.2: Amount and Percent of FmHA Farmer Program Loan Funds Used for Refinancing and by Existing Borrowers, Fiscal Year 1988

Dollars in millions

Loan type	Total loan funds used for refinancing: Amount	Total loan funds used for refinancing: Percent	Total loan funds used by existing borrowers: Amount	Total loan funds used by existing borrowers: Percent
Direct farm operating	$67	8	$767	88
Guaranteed farm operating	299	34	691	79
Guaranteed farm ownership	250	69	289	80
Direct farm ownership	50	43	64	56
Total	**$665**[a]	**30**	**$1,811**	**81**

[a]Total does not add due to rounding.

Source: GAO estimated amounts

Sections 3 and 4 of this briefing report provide detailed information on the use of fiscal year 1988 direct and guaranteed loan funds, respectively.

Lenders' Views on FmHA Guaranteed Loans

FmHA guaranteed loans benefit both borrowers who obtain a guaranteed loan and lenders who make the guaranteed loan. We discussed FmHA guaranteed loans with 26 lenders in 6 states who had made loans that were guaranteed by FmHA.[4] Fifteen of the lenders told us that the primary guaranteed loan benefit to borrowers is the opportunity to receive commercial financing that they otherwise would not have received to continue farming. Likewise, twelve of the lenders said lenders benefited because they could make or continue loans to borrowers who had repayment ability but did not meet their lending criteria. Another lender benefit was that the FmHA guarantee improves the lenders' security position and overall loan portfolio quality. The use of a guarantee on a loan ensures that lenders are repaid most of the money they loan to borrowers and thus their losses are minimized.

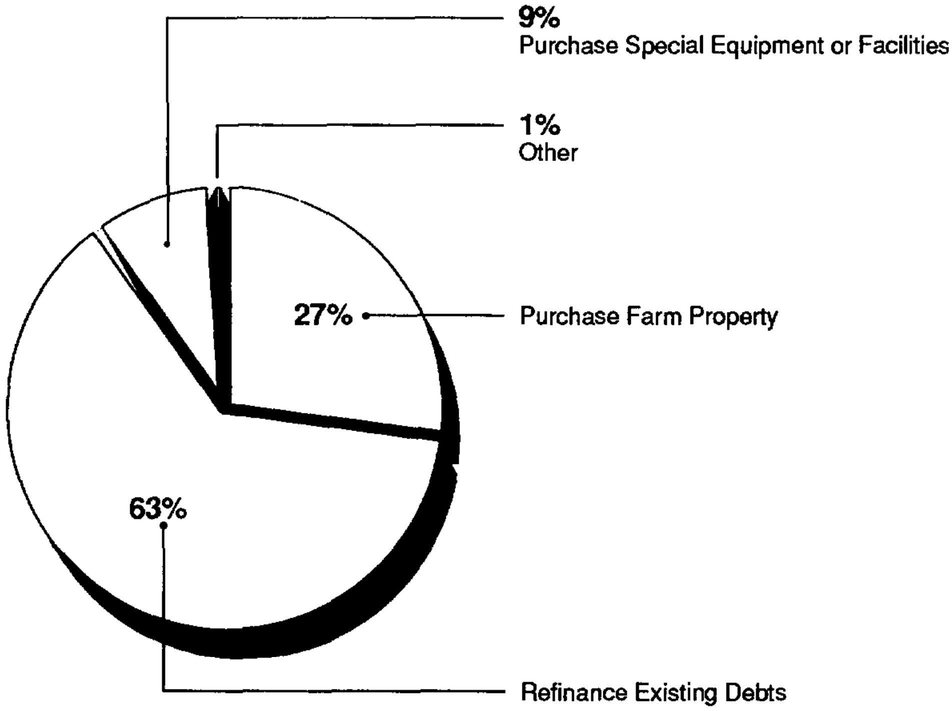
Lenders seek a guarantee for loans under certain lending conditions and, therefore, these conditions influence the extent to which loan guarantees are used. Furthermore, most lenders—17 of those we contacted—rather than borrowers initiate the process to obtain a guaranteed loan. Twenty-one of the lenders said the primary reason for having FmHA guarantees on loans they make was to compensate for the excessive risk in providing a particular loan. Accordingly, 19 lenders said they seek

[4]This information cannot be used to estimate various lending characteristics about the universe of lenders who participate in FmHA loan programs. Section 6 of this report discusses the geographic locations of lenders and how we selected them.

Use of Direct and Guaranteed Farm Ownership Funds

Of the combined direct and guaranteed farm ownership program loan funds, 63 percent of the ownership loan funds were used for refinancing existing debts and 27 percent were used for purchasing property (see fig. 1.5).

Figure 1.5: Percent of Total Direct and Guaranteed Farm Ownership Funds Used for Various Purposes, Fiscal Year 1988



Note: Percentages based on the projected universe of total direct and guaranteed farm ownership funds.

Source: GAO projection based on a sample of FmHA loans.

Use of Direct and Guaranteed Farm Operating Funds

Of the combined direct and guaranteed farm operating program loan funds, 64 percent of the operating loan funds were used for operating expenses and 21 percent were used for refinancing (see fig. 1.6).

Use of Guaranteed Farm Ownership and Operating Funds

Our analysis of the fiscal year 1988 loans showed that guaranteed loan funds were used primarily to assist commercial lenders' existing customers in refinancing existing debts, funding operating expenses, and purchasing farm property. Specifically, we estimate that 69 percent of the guaranteed farm ownership funds were used for refinancing existing debt and 20 percent were used for purchasing property (see fig. 1.3). Also, we estimate that 55 percent of the guaranteed farm operating funds were used for farm operating expenses and 34 percent were used for refinancing existing debts (see fig. 1.4).

Section 2 of this briefing report provides detailed information on FmHA's farm loan programs. Also, our detailed sampling and estimating procedures are discussed in section 6 and appendix I.

Use of Farmer Program Loan Funds

Our analysis of FmHA's fiscal year 1988 loans showed that for the estimated total $2.2 billion[3] in farm operating and ownership loan funds, approximately

- 50 percent, or $1.1 billion, was used for farm operating expenses;
- 30 percent, or $665 million, was used to refinance existing debts; and
- 6 percent, or $131 million, was used to purchase farm property.

The remaining 14 percent, or $310 million, was used for a variety of other purposes, such as purchasing machinery, equipment, and livestock, and improving real estate.

Use of Direct Farm Ownership and Operating Funds

Direct loan funds were used primarily to assist FmHA's existing borrowers in funding operating expenses, refinancing borrowers' existing debts, and purchasing farm property. Specifically, we estimate that 51 percent of the direct farm ownership funds were used for purchasing farm property and 43 percent were used for refinancing existing debts (see fig. 1.1). Also, we estimate that 73 percent of the direct farm operating funds were used for farm operating expenses (see fig. 1.2).

[3]Actual fiscal year 1988 obligations totaled $2.3 billion. See section 6 for estimating methodology and sampling errors.

Report Summary

This report presents information on the use of fiscal year 1988 loan funds by FmHA farmer program borrowers.[1] The loan use information is based on a randomly selected sample of loans which was used to estimate various loan characteristics about the universe of fiscal year 1988 loan obligations for four major types of FmHA farmer program loans—direct farm ownership loans, direct farm operating loans, guaranteed farm ownership loans, and guaranteed farm operating loans. These four types of loans had actual obligations[2] totaling approximately $2.3 billion, which accounted for 98 percent of total farmer program obligations in fiscal year 1988. Other types of farmer program loans, such as emergency disaster loans and soil and water loans, accounted for the remaining 2 percent.

Refinancing existing debts is a major use of loan funds for three of the four loan types. Also, most of the direct loan funds were provided to existing FmHA direct loan borrowers and most of the guaranteed loan funds were provided to existing commercial lender borrowers. Commercial lenders and their borrowers mutually benefit from loans guaranteed by FmHA. Lenders benefit by being able to make loans that are guaranteed by FmHA to borrowers who normally would not meet their lending criteria, and borrowers benefit because they are able to continue farming. Also, the use of a guarantee on a loan ensures that lenders are repaid most of the money they loan to borrowers and thus their losses are minimized. This report complements information contained in other GAO reports on FmHA's farmer loan programs. A listing of these reports is contained in appendix II.

FmHA Farmer Loan Programs

FmHA provides loans to farmers who are unable to obtain credit elsewhere at reasonable rates and terms. As a result, FmHA is often referred to as the "lender of last resort" because it may be the farmers' last opportunity to obtain credit.

FmHA credit assistance is provided through either direct government-funded loans or through guarantees of commercial lenders' loans to farmers. Both direct loans and guaranteed loans are provided through

[1] Loan use information presented in this report is based on borrowers' planned uses of loan funds. Report statements regarding use of loan funds refer to planned use of loan funds.

[2] When a conditional commitment is issued for a guaranteed farm ownership or operating loan, it is reflected in FmHA's accounting records as an obligation, in order to maintain control over the individual program-authorized loan level. This is somewhat different from an obligation for a direct farm loan or for a payment of loss claim on a guaranteed farm loan, both of which lead to an expenditure of funds from a different account.

Abbreviations

DCI	Data Collection Instrument
FCS	Farm Credit System
FmHA	Farmers Home Administration
GAO	General Accounting Office
IRR	Interest Rate Reduction
USDA	U.S. Department of Agriculture

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types of FmHA farmer program loans. The results of this sample were used to estimate various loan characteristics about the universe of loan obligations and these projections are contained in the report. We also obtained additional specific and general information on guaranteed loans by interviewing selected FmHA officials and commercial lenders who had made guaranteed loans. However, the results of the information gathered in these interviews cannot be used to estimate various lending characteristics about the universe of lenders who participate in FmHA loan programs. We conducted our work from October 1988 through July 1989 and performed our work in accordance with generally accepted government auditing standards.

USDA officials reviewed a draft of this briefing report for technical accuracy and changes were made where appropriate. However, as requested by your office, we did not obtain official agency comments.

As arranged with your office, we are sending copies of this briefing report to appropriate Senate and House committees; interested members of the Congress; the Secretary of Agriculture; the acting Administrator, FmHA; the Director, Office of Management and Budget; and to other interested parties. Copies will also be made available to other parties who request them.

This work was performed under the direction of John W. Harman, Director, Food and Agriculture Issues, (202) 275-5138. Other major contributors are listed in appendix III.

Sincerely,

J. Dexter Peach
Assistant Comptroller General

loans were used for purchasing farm property and refinancing; (2) direct farm operating loans were used for farm operating expenses, refinancing, purchasing livestock, and purchasing machinery; (3) guaranteed farm ownership loans were used for refinancing, purchasing farm property, and purchasing special equipment or facilities; and (4) guaranteed farm operating loans were used for farm operating expenses and refinancing.

Our analysis showed that some commercial lenders use an FmHA guarantee to refinance the existing debts of their borrowers who are unable to meet their loan standards. Guarantees improve lenders' security position and overall loan portfolio quality. Also, lenders generally initiate the process of obtaining a loan guarantee for borrowers. These results are similar to our September 1989 report that showed guaranteed loans benefit private 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 bank regulators' classifications of their loan portfolios.[2] Refinancing that occurred in fiscal year 1988 indicates lenders are using guaranteed loans to enhance their loan security on existing debts rather than to expand borrowers' operations.

Observations

FmHA farm ownership and operating loans are authorized without prioritization or preference for a particular use or purpose. However, the use of loan funds is influenced by the lender—FmHA for direct loans and commercial lenders for guaranteed loans. FmHA influences the use of direct loans by trying to shift new borrowers and loans used for refinancing to guaranteed loans. Also, certain types of borrowers, such as limited resource borrowers, may have approved loans funded before other types of borrowers. For FmHA guaranteed loans, commercial lenders decide whether or not to seek a guarantee on loans they make. As a result, the use of guaranteed loans is largely determined by commercial lenders.

Direct and guaranteed farm loans serve relatively distinct groups of borrowers. Direct loan funds primarily serve FmHA existing borrowers and guaranteed loan funds primarily serve commercial lenders' existing customers having financial difficulties. If the shift from direct to guaranteed lending continues, commercial lenders will be making relatively

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