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The Farmers Home Administration's Guaranteed Farm Loan Program

Statement of
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Senate Committee on Agriculture,
Nutrition, and Forestry

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work on the Farmers Home Administration's (FmHA) guaranteed farm loan program.[1] In our past work and previous testimonies on FmHA farm loan programs, we broadly assessed the problems facing FmHA. Today, we would like to highlight our concerns about FmHA's guaranteed farm loan program and the implications of the shift from direct to guaranteed farm loans.

In summary, our work on FmHA's guaranteed farm loan program showed that even though guaranteed farm loans have increased, most loans are being made to commercial lenders' existing customers who had become financially stressed. Few direct loan borrowers have obtained guaranteed loans with private lenders, or are likely to, because their poor financial conditions make private lenders reluctant to finance them even with loan guarantees. As a result, continued direct loan financing--despite the administration's fiscal year 1991 budget request to severely reduce such financing--will likely be required if existing direct borrowers are to stay in business.

Guaranteed loan losses are increasing at a faster rate since 1984 than has the amount of guaranteed loans. Also, the increase in outstanding principal for guaranteed loans has outpaced the decrease in that for direct loans. Consequently, the government's overall financial exposure has increased.

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[1]We have issued three reports focusing on various aspects of FmHA's guaranteed farm loan program: (1) Farmers Home Administration: Status of Participation in the Interest Rate Reduction Program (GAO/RCED-89-126BR; June 15, 1989), (2) Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86; Sept. 11, 1989), and (3) Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR; Feb. 8, 1990).

FmHA has contributed to guaranteed loan losses by inadequately assessing borrowers' financial conditions before approving guaranteed loans and by insufficiently overseeing lenders' servicing of loan guarantees after approval. As guaranteed loan losses increase, so will budget outlays. Thus, correcting the problems causing the increasing losses grows in importance. In our September 1989 report, we made several recommendations to help control losses and improve management of FmHA's guaranteed farm loan program.

FmHA's GUARANTEED FARM LOAN PROGRAM

Until the early 1970s FmHA, an agency of the U.S. Department of Agriculture (USDA), provided credit directly to farmers through government-funded (direct) loans. Then, in 1972 the Rural Development Act authorized FmHA to guarantee farm loans made by private lenders. By design, the guaranteed loan program makes credit available to family farm owners or operators who are unable to qualify for adequate credit from commercial agricultural lenders without a loan guarantee. The financial conditions of these borrowers are normally slightly better than would qualify them for FmHA's direct loans. Eligibility criteria for direct loans stipulate that borrowers must not be able to obtain private financing at reasonable rates and terms. In guaranteeing farm loans, FmHA agrees to reimburse the private lender for up to 90 percent of lost principal, interest, and reasonable liquidation costs if the borrower defaults on the loan.

In fiscal year 1984, FmHA began emphasizing guaranteed farm operating and ownership loans to help keep lending in the private sector, reduce budget outlays, and better service a growing but deteriorating direct loan portfolio. The Food Security Act of 1985 and subsequent appropriations legislation supported FmHA's shift from direct to guaranteed farm loans. The Agricultural Credit Act of 1987 also emphasized the use of guaranteed loans by stating that the Secretary of Agriculture should issue guarantees to the maximum extent practicable to assist eligible borrowers whose loans are being restructured by lenders.

As a further incentive to promote guaranteed loans, FmHA was authorized by the Food Security Act of 1985 to implement an interest rate reduction (IRR) program for guaranteed farm loans through September 30, 1988, with funding not to exceed $490 million. The Agricultural Credit Act of 1987 extended the program through September 30, 1993. The IRR program helps private lenders provide credit to family farmers who are temporarily unable to project a positive cash flow on all income and expenses without a reduced interest rate. 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. These payments cannot be provided past the outstanding term of the loan, or 3 years, whichever is less.

FmHA's two principal types of guaranteed farm loans are (1) farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor and (2) farm ownership loans for buying and improving farm land and constructing, repairing, and improving buildings. Both types of loans can be used to refinance existing debts.

FmHA's guaranteed loan requirements regarding borrower eligibility, loan purpose, loan repayment periods, and security are similar to those for direct loans. Guaranteed loans differ, however, in that (1) the interest rate private lenders charge is generally higher, (2) the loan limits are higher ($400,000 versus $200,000 for farm operating loans and $300,000 versus $200,000 for farm ownership loans), and (3) lenders are responsible for servicing the loans. Appendix I provides further information on guaranteed farm loans as of September 30, 1989.[2]

GUARANTEED LENDING HAS INCREASED, BUT FEW DIRECT BORROWERS OBTAINED GUARANTEED LOANS OR HAVE AN INCENTIVE TO SEEK GUARANTEED LOANS

Although FmHA's farm lending is shifting 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. Few FmHA direct loan borrowers have switched to guaranteed loans with private lenders, or are likely to, because their poor financial conditions make private lenders reluctant to finance them even with loan guarantees.

As we reported in September 1989, our analysis of FmHA loan data disclosed that of 107,232 borrowers with direct farm operating and/or direct farm ownership loans in 1985 through 1987, only 2,195 (about 2 percent) obtained a guaranteed loan of the same type during the same period. USDA's Office of Inspector General (OIG), in a September 1988 report,[3] presented similar results. According to the OIG, about 1 percent of the 15,585 guaranteed farm loans totaling $1.5 billion in its sample universe were used to finance FmHA direct loan borrowers.

The FmHA state and county and private lending officials we interviewed said private lenders are primarily obtaining loan guarantees to cover loans made to their financially stressed customers who have either marginal loan security, marginal cash

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

[3]Farmers Home Administration Management of Farmer Program Guaranteed Loans Needs Improvement (USDA/OIG Audit Report 04665-2-Te, Sept. 29, 1988).

flow, or poor debt-to-asset ratios and insufficient net worth. Some lenders also obtain guarantees to avoid having bank examiners classify the loans as substandard.

The use of guaranteed loans for the existing customers of private lenders and for refinancing purposes was also described in our February 1990 report on the use of FmHA loan funds. We reported that the existing customers of private lenders received about 80 percent of the fiscal year 1988 guaranteed farm ownership loan funds and about 79 percent of the guaranteed farm operating loan funds. In addition, about 69 percent, or about $250 million, of the $363 million of fiscal year 1988 guaranteed farm ownership loan funds were used to refinance existing debts of those who borrowed from private lenders. Only 20 percent, or about $73 million, of these farm ownership loan funds were used to purchase farm property. Although most of the guaranteed farm operating loan funds were used for farm operating expenses, we reported that about 34 percent, or $299 million, was used to refinance existing debts of those who borrowed from private lenders.

FmHA direct loan borrowers are not obtaining loan guarantees primarily because most are in worse financial condition than are private lender borrowers and cannot qualify for private lender credit. As shown in our September 1989 report, about 40 percent (15 out of 38) of the private lending officials we interviewed in 8 states said their institutions were not willing to extend credit to FmHA direct loan borrowers--even with an FmHA guarantee. Of the 23 lending institutions willing to provide credit to FmHA direct loan borrowers, 21 would require the borrowers to meet more stringent loan eligibility criteria than FmHA's direct loan criteria, which requires only that income be at least equal to expenses and security be adequate to ensure loan repayment. These private lending institutions require borrowers to have higher cash flow margins (income exceeding expenses), security valued at more than the loan amount, and lower debt-to-asset ratios.

Private lenders can, and normally do, charge higher interest rates for higher-risk borrowers and may restrict credit when borrowers' collateral values decline. Under FmHA regulations, however, lenders cannot charge guaranteed loan borrowers a higher interest rate than they charge their average farm customers, which can be several percentage points lower than the lenders would normally charge high-risk farm loan borrowers. Lenders also generally pass on to borrowers FmHA's 1 percent guaranteed loan origination fee as part of the loan amount. FmHA does not charge such a fee for direct loans.

The guaranteed portion of guaranteed loans can be sold in the secondary market, thus providing an additional source of loan funds to the lender. As a result, the lender may be able to finance more high-risk borrowers during periodic liquidity shortages when credit may otherwise need to be rationed to better-risk borrowers. Further, during periods of economic stress that may cause collateral values to decline, borrowers who can demonstrate repayment ability may obtain guaranteed loans from their private lenders because the guarantees support the collateral.

Although guaranteed loans enable borrowers to obtain credit from private lenders at interest rates lower than they would normally have to pay as high-risk borrowers, the interest rates on guaranteed loans can range from about 3 to 7 percent higher than FmHA direct loan interest rates. As shown in our September 1989 report, from a random sample of 67 borrowers selected from 14 FmHA county offices in 8 states, the median interest rate that private lenders charged on guaranteed operating loans was 11.9 percent. In contrast, during fiscal year 1987 the FmHA regular direct loan interest rates ranged from 7.5 to 9.25 percent; the direct loan limited resource interest rate, which is a government subsidized rate, ranged from 4.5 to 5.75 percent. In October 1989, FmHA's regular direct ownership loan interest rate was 8.75 percent and the limited resource rate was 5 percent.

FURTHER SHIFT TO GUARANTEED LENDING MAY RESTRICT CREDIT AVAILABLE TO DIRECT LOAN BORROWERS

Over the past several years, FmHA direct farm operating loan credit has generally been made available to large numbers of borrowers even when FmHA direct operating loan funding availability became a problem. At such times, the Secretary of Agriculture made additional funds available by transfering funds between loan programs. In addition, FmHA helped some direct loan borrowers obtain private operating credit by subordinating its security or lien position to private lenders on collateral backing direct loans to these borrowers. For example, in fiscal year 1988 FmHA helped about 23,400 borrowers obtain $769 million in operating credit from private lenders through subordinations. Current direct loan borrowers are not shifting to guaranteed loans and requests for direct loans may not decline as anticipated because of congressional actions in 1987 and 1988 which made more borrowers eligible for direct loans. Further shifts from direct to guaranteed farm operating loan funding--the fiscal year 1991 budget proposes a reduction from $932 million for direct operating loans in 1990 to $500 million in 1991--may restrict credit available for direct loan borrowers in future years.

In contrast to the availability of direct farm operating loan funding, FmHA direct farm ownership loan funding has not been adequate in some years to meet loan requests. One reason for this inadequacy is that FmHA has attempted to curtail its direct farm ownership lending to make more direct loan funds available for what it considered to be higher priority operating loans and to emphasize guaranteed ownership loans. However, as in the case of operating loan funds, the Secretary of Agriculture transferred additional funds to the farm ownership loan program in some years, and the Congress provided supplemental appropriations for farm ownership loans in fiscal years 1983 and 1984.

FmHA has also assisted some direct loan borrowers to obtain private farm ownership credit through subordinations. For example, in fiscal year 1988 FmHA helped about 3,400 borrowers obtain about $90 million in private farm ownership credit through subordinations. However, further shifts from direct to guaranteed farm ownership lending may restrict credit availability for borrowers requesting direct farm ownership loans in future years.

Two congressional initiatives to help keep FmHA borrowers in business further affect future credit availability for direct loan borrowers. Both these initiatives will make direct loan credit from declining direct loan funds available to borrowers who, without these initiatives, would not be eligible for direct loans. These actions force direct loan borrowers who are current on existing loans to compete for declining direct loan funds with delinquent borrowers who were previously ineligible for continued financing.

First, in 1987 the Congress reinstituted the "continuation policy" which allows delinquent borrowers to reschedule or defer outstanding indebtedness to FmHA and to obtain additional operating loans without proving their ability to repay prior loans. This policy had been in effect from February 1982 to November 1985. Second, the debt restructuring provisions of the Agricultural Credit Act of 1987 provide for substantial revisions in FmHA's loan-servicing policies including debt write-down. FmHA will be required to write down debt if it is less costly to the government than foreclosure on borrowers who cannot make scheduled loan payments.

USE OF INTEREST RATE REDUCTION PROGRAM HAS BEEN MUCH LESS THAN AUTHORIZED

Although IRR obligations--the amount FmHA expects to pay lenders for reducing interest rates on guaranteed farm loans--more than doubled between fiscal years 1986 and 1987, obligations have declined in both fiscal years 1988 and 1989. FmHA estimated obligations of $100 million for fiscal year 1989, but actual obligations were about $14.2 million. Of the $490 million authorized for the IRR program, FmHA obligated only about $62 million on 9,371 guaranteed farm loans from program implementation in February 1986 through the end of fiscal year 1989. Moreover, as we estimated in our February 1990 report on the use of loan funds, in fiscal year 1988 about 70 percent of the guaranteed farm operating loans with interest rate reductions were used for refinancing debts of those who borrowed from private lenders.

In June 1989, we reported that according to national, state, and county FmHA officials and representatives of the banking community, a wide variety of reasons explained why IRR program participation by private lenders had not been greater. The most frequently cited factors were (1) the high risk of financial failure of borrowers unable to project a positive cash flow without IRR assistance and (2) the paperwork required to obtain the IRR. Our June 1989 report and the OIG October 1987 report[4] also stated that program participation would have been much lower had FmHA county offices adhered to regulations in approving IRR requests. Our limited review of IRR recipients in two states, and the OIG's more extensive review in three states, found that over 50 percent of the recipients should have been declared ineligible because they failed to meet the IRR program cash-flow criteria.

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[4]Farmers Home Administration's Guaranteed Loan Interest Rate Reduction Program (USDA/OIG Audit Report 04666-1-At, Oct. 22, 1987).

FmHA amended its regulations in January 1989 to require that a borrower show a cash flow of 110 percent--borrower's income exceeds all anticipated cash outflows by at least 10 percent--to gain approval for a guaranteed farm loan without IRR. However, if a borrower shows a projected cash flow between 100 and 110 percent, then regulations allow for IRR to be used on guaranteed loans. Despite these changes, however, IRR obligations were about $1.8 million, or 11 percent, less in fiscal year 1989 than in fiscal year 1988, and about $8 million less than the peak of $22 million in fiscal year 1987.

GOVERNMENT'S FINANCIAL EXPOSURE HAS INCREASED

Current direct loan borrowers have not shifted to guaranteed loans and most likely will not because of their poor financial conditions. Therefore, substantial budgetary outlays will probably be needed to finance these borrowers for the foreseeable future--if the government continues to help them stay in business as intended by 1987 and 1988 congressional actions. In addition, as we reported in our September 1989 report, the increase in outstanding principal on guaranteed farm ownership and operating loans had outpaced a corresponding decrease in such direct loans by about $570 million between fiscal years 1986 and 1988. Consequently, the government's overall financial exposure has increased.

GUARANTEED LOANS SIGNIFICANTLY BENEFIT LENDERS

FmHA's guaranteed farm loan program provides significant benefits to lenders. Loan guarantees enable lenders to continue financing borrowers who are poor credit risks because the guarantees protect lenders against potential loan losses. Further, the guaranteed portion of loans can be sold in the secondary market, thereby improving a lender's liquidity, enabling a lender to make long-term loans, and increasing a lender's profitability by charging the holder loan-servicing fees on the sold portion of the loan. Variable interest rates may be charged on guaranteed loans, thus shifting the risk of sharp changes in the lender's cost of funds. For banking institutions, the guaranteed portion of the loan does not count against the lender's legal lending limit, which enables the lender to make more loans, and bank regulators generally do not classify an FmHA-guaranteed loan as a weak loan if the bank properly services the loan. Although the private lending officials we interviewed were concerned about confusing program regulations and the amount of time and paperwork necessary to obtain an FmHA farm loan guarantee, 52 percent of the officials responding said such problems had little or no effect on their willingness to request guarantees.

To obtain loan guarantees and the benefits of those guarantees, lenders must agree to meet certain responsibilities. Additional paperwork and loan-processing time may be required. FmHA's regulations must be followed from the initial application, to final approval of the guarantee, to servicing the loan after the guaranteed loan is made. FmHA must approve any changes in the terms of the original loan--such as rescheduling or changing interest rates--and the loan must be serviced properly. Negligence or failure to meet these responsibilities can result in a reduction of the amount guaranteed by FmHA in the event of a loss.

PROGRAM PROBLEMS CONTRIBUTE TO LOAN LOSSES

Since 1984, losses on guaranteed loans have grown at a faster rate than guaranteed loan activity. FmHA has established an allowance for guaranteed loan losses of about $1.2 billion of the $3.6 billion in outstanding guaranteed farm loan principal as of the end of fiscal year 1988. Although loan losses may be caused by such uncontrollable factors as adverse weather, losses can also be attributed to problems in FmHA's assessment of borrowers' financial conditions prior to loan guarantee approval and in FmHA's oversight of lenders' servicing of loan guarantees after approval. These problems are similar to those FmHA has with its direct farm loans. As the shift continues from direct to guaranteed farm loans, correcting the problems with the guaranteed loan program grows in importance to control the mounting losses, prevent the loss of the shifts' budgetary advantage, and avoid the experience with the direct loan program.

Problems in Assessing Borrowers' Financial Conditions Prior to Loan Guarantee Approval

Our September 1989 report, as well as the September 1988 OIG report, disclosed three basic problems that FmHA has in assessing borrowers' financial conditions prior to loan guarantee approval: (1) poor assessment of borrowers' repayment ability, (2) insufficient determination of collateral securing guaranteed loans, and (3) unclear guidance for determining the appropriate percentage of guarantee.

The primary problems regarding repayment ability were understatements and/or overstatements of expense and income amounts on the borrowers' applications and insufficient lender verification of applicants' nonfarm income and debts. Regarding insufficient loan collateral, FmHA regulations are unclear as to what constitutes proper and adequate security for guaranteed loans. Because the regulations allow for county supervisors to use subjective judgment in determining what is adequate security, inconsistencies arise among county offices in ensuring and documenting security backing the guaranteed loans.

Regarding the percentage of guarantee, FmHA regulations allow for guaranteeing a maximum of 90 percent of the loan principal and interest and describe various factors to consider in determining the percentage of guarantee. However, the regulations do not address how these factors should be used in either increasing or decreasing the percentage. Consequently, the unclear guidance has led to inconsistencies in percentage determinations among state and county offices, ranging from providing lower guarantees as the risk of loan loss increased, to providing maximum guarantees as the risk of loan loss increased. In addition, the unclear guidance did not result in a percentage of guarantee that (1) considered lenders' varying risks and (2) provided lenders the incentive to properly process and service guaranteed loans.

Problems in Overseeing Loan Guarantees After Approval

Lenders are responsible for servicing guaranteed loans and protecting loan collateral, and FmHA is responsible for overseeing lenders' servicing activities. However, we and the OIG found problems with FmHA's oversight of loan guarantees after approval. Lenders and/or FmHA were (1) not always obtaining periodic financial statements from borrowers nor always performing the required collateral inspections during the life of the loan, (2) making unauthorized loan advances to borrowers and including them under the guarantee, (3) not submitting timely default notices and/or liquidation plans, and (4) not pursuing recovery of losses after liquidation and FmHA's guaranteed loan loss payment to the lender. These problems have hindered FmHA's ability to identify problem loans early and to efficiently manage the liquidation process to minimize guaranteed loan losses.

Lenders and FmHA could not adequately determine borrowers' financial conditions and ensure that loans were adequately secured because periodic financial statements were not being obtained from the borrowers and collateral inspections were not being made. Further, lenders sometimes made and included advances under the guarantee when loss claims were submitted, causing FmHA to incur higher losses than should have been authorized--as much as $50,000 in one case. This occurred despite FmHA regulations stipulating that lenders should not make additional expenditures, new lines of credit, or new loans to borrowers with FmHA guaranteed credit without first obtaining written FmHA approval, even when such expenditures or lines of credit or loans will not be guaranteed.

FmHA regulations require lenders to notify FmHA in a timely manner when borrowers are in default and to work with FmHA and the borrowers to attempt to cure the defaults. The regulations also require timely notification when lenders decide to liquidate loan accounts and FmHA's concurrence in the liquidation decisions. As we reported in our September 1989 report, lenders were not (1) submitting timely default notices and/or liquidation plans and (2) adequately documenting disposition of loan security.

FmHA's current regulations do not require either lenders or FmHA to try to recover from borrowers the loss claims paid by FmHA to lenders. FmHA regulations only require that once liquidations occur and FmHA has made final loss payments, any funds recovered in the future by the lenders must be prorated between FmHA and the lenders on the basis of the percentage of guarantee. FmHA does not consider guaranteed loan loss claims paid to lenders to be indebtedness owed FmHA by borrowers. Because lenders only liquidate security property and are paid a percentage of any loss by FmHA in accordance with the guarantee, lenders have no real incentive--and FmHA does not require them--to pursue future recovery of loan losses. Consequently, loss amounts that might be recovered, at least to some degree, are not recovered, and borrowers can continue to operate using assets not liquidated under the guaranteed loan. Further, the defaults do not prevent these borrowers from obtaining future FmHA guaranteed or direct loans.

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

IMPROVED MANAGEMENT OF FmHA'S GUARANTEED FARM LOAN PROGRAM IS NEEDED

To help control losses and improve management of the guaranteed farm loan program, we recommended in our September 1989 report that the Secretary of Agriculture direct the Administrator, FmHA, to

-- develop, in consultation with the Congress, and implement more comprehensive guaranteed loan-approval criteria that assess an applicant's financial solvency, profitability, liquidity, and repayment ability prior to approving loan guarantees;

-- establish in regulations the type and amount of security required for a guarantee and, if crops are accepted as the only security, require that crop insurance be obtained;

-- establish a range of loan guarantee percentages based on loan risk, with the higher guarantee percentages going to lower risk loans;

-- enforce FmHA requirements for lender servicing of guaranteed loans and place greater emphasis on establishing the extent to which lenders' negligent servicing caused loan losses before determining the amounts to be paid as loss claims; and

-- establish in regulations procedures for recovering from defaulted borrowers amounts the government paid to lenders for guaranteed loan losses.

We also recommended that the Secretary of Agriculture direct the Administrator, FmHA, to provide (1) county supervisors with training in credit analysis to better acquaint them with what constitutes adequate financial data on which to base a guaranteed loan-approval decision and (2) guidance and training to state, district, and county officials that would enhance the monitoring of lenders' guaranteed loan-servicing activities, especially guaranteed loan liquidations.

USDA generally agreed with most of our findings and recommendations. However, some of its actions planned or underway may not fully resolve some of the problems that led to the recommendations. USDA disagreed on the need to establish procedures for recovering government losses from defaulted borrowers, but agreed to further study the issue. We continue to believe that recovery action should be pursued against borrowers who may have assets available to reimburse the government's losses. According to USDA, a contracted study of the program's loan approval and borrower selection criteria will consider most of our recommendations, including the recovery of loan losses. This contract, which covers both direct and guaranteed farm loans, was awarded on September 28, 1989.

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USDA recently announced its farm credit proposals for the 1990 Farm Bill. USDA proposes to modify the guaranteed farm operating loan program to (1) facilitate the transition of existing direct loan borrowers to guaranteed loans and ultimately to private sector credit and (2) provide a source of assistance to private lending institutions' current borrowers who can no longer continue with those lenders on commercial terms. USDA also proposes to modify the guaranteed farm ownership loan program to target it to beginning farmers and those who wish to expand family farms. Another proposal will create a new interest subsidy program for guaranteed loans as a further incentive to encourage the shift from direct lending to private lending guaranteed by FmHA.

These proposals assume that commercial lenders will vastly increase their participation in the guaranteed farm loan program. Our previous work on FmHA's guaranteed farm loan program and the IRR program, as highlighted in my testimony today, raises doubts about whether this will occur. We believe it is extremely important for the Congress to examine these proposals closely to evaluate the likelihood that the commercial lending community will support such proposals.

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

FmHA Guaranteed Farm Loans and Delinquency Status, September 30, 1989[a]

Dollars in Millions

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

[a]According to FmHA's Finance Office, the information presented in this table does not include IRR program data.

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

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

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

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

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

Case Study A

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

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

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

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

Case Study B

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

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

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

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

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

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

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

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

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

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

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

Case Study C

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

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

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

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

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

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

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

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

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

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

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