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Guaranteed Farm Loans by the Farmers Home Administration

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

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss guaranteed farm loans by the Farmers Home Administration (FmHA), including the implications of the shift in farm lending emphasis from direct to guaranteed farm loans. Our testimony today is based primarily on our two most recent reports covering FmHA's guaranteed farm loans.[1] We will also discuss some preliminary results from our ongoing work covering FmHA farm loan programs--an area of "high risk" within the federal government.

In summary, we are concerned about the expansion of the guaranteed farm loan program from the standpoint of the federal government's exposure to financial risks. More specifically, our past work has identified the following:

-- Some commercial lenders are using guaranteed loans to "bail out" their financially stressed borrowers, effectively shifting risks from the lender to the federal government.

-- FmHA is not always adequately overseeing loan making and servicing activities of commercial lenders. We found, for example, that FmHA has little assurance that lenders are adequately assessing borrowers' financial conditions prior to loan guarantee approval and that FmHA has guaranteed some loans that do not meet the agency's credit quality standards.

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[1]Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers (GAO/RCED-90-95BR, Feb. 8, 1990) and Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86, Sept. 11, 1989).

These and related concerns about the risks associated with the guaranteed loan program take on even greater significance, given that FmHA has about $21 billion in guarantee loan authority over the fiscal year 1991-95 period.

In addition, we believe that it is important to recognize that the program may not serve the borrowers currently receiving direct loans because the poor financial condition of many of these borrowers may make commercial lenders reluctant to finance them even with loan guarantees. As a result, these borrowers are likely to require continued direct loan funding if they are to remain in farming. However, the shrinking budget authorization for direct loans will tighten the availability of credit for direct loan borrowers who cannot qualify for guaranteed loans. The reduced funding will also increase the urgency of making difficult policy decisions concerning the extent to which FmHA should continue to assist these borrowers.

BACKGROUND ON 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 owners or operators of family farms who are unable to qualify for credit from commercial agricultural lenders without a loan guarantee. In guaranteeing farm loans, FmHA agrees to reimburse the private lender for up to 90 percent of lost principal, interest, and liquidation costs if the borrower defaults on the loan. In practice, most guaranteed loans (about 81 percent) have been made at the 90-percent level regardless of their risk.

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 to buy and improve farm land and construct, repair, and improve 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 of direct loans. Guaranteed loans differ, however, in that (1) the interest rate lenders charge is generally higher, (2) loan limits are higher ($400,000 versus $200,000 for operating loans and $300,000 versus $200,000 for farm ownership loans), and (3) lenders are responsible for servicing the loans.

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 legislation supported FmHA's shift from direct to guaranteed farm loans.

Attachment I provides borrower and financial information on FmHA guaranteed farm loans as of September 30, 1990.[2] Attachment II provides additional information on the legislation promoting the shift in lending emphasis from direct to guaranteed loans. Attachment III provides information on FmHA's direct and guaranteed lending authority over the 1991-95 period.

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[2]All fiscal year 1990 data used in this testimony are preliminary, unaudited, and subject to audit adjustment at a later date.

COMMERCIAL LENDERS USE GUARANTEED LOANS TO REFINANCE THEIR EXISTING CUSTOMERS' DEBTS

The guaranteed loan program allows commercial lenders an opportunity to refinance the debts of their financially troubled borrowers with guaranteed loans, thereby, effectively shifting up to 90 percent of the risk for such borrowers to FmHA. Our past work indicates that lenders are in fact using the program for such purposes, thus enhancing their loan security on existing borrowers' debts rather than expanding borrowers' operations or providing credit to new customers.

Our September 1989 report noted that, according to officials from FmHA state and county offices as well as private lending institutions, lenders were primarily interested in obtaining loan guarantees to cover loans made to their financially stressed customers who have either marginal loan security, marginal cash flow, poor debt-to-asset ratios, and/or insufficient net worth.

We discussed the scope of refinancing activities in our February 1990 report, which analyzed, based on sampling, the use of guaranteed loans during fiscal year 1988. Specifically, we reported that the existing customers of private lenders received about 80 percent of the guaranteed farm ownership loan funds and about 79 percent of the guaranteed farm operating loan funds. In total in fiscal year 1988, existing customers received $980 million of the $1.2 billion in guaranteed loan obligations.

Additionally, about 69 percent of the guaranteed farm ownership loan funds were used to refinance existing debts of those who borrowed from the private lenders. Twenty percent were used to purchase farm property. Furthermore, while most guaranteed farm operating loan funds (55 percent) were used for farm operating expenses, a significant part (34 percent) was used to refinance existing debts of those who borrowed from the private lenders. In total, refinancing the existing debts that borrowers had with private lenders comprised almost $550 million of the $1.2 billion in guaranteed loan funds.

We are currently following up on the delinquency status of the guaranteed loans we analyzed in our February 1990 report. Preliminary information indicates that delinquency rates were higher for borrowers who used guaranteed loans entirely or in part for refinancing existing debt than for borrowers who did not use any part of the loans for refinancing.

LOAN MAKING AND SERVICING STANDARDS ARE NOT ALWAYS FOLLOWED

As of the end of fiscal year 1990, FmHA had established an allowance for guaranteed loan losses of about $1.2 billion of the $4.1 billion in outstanding guaranteed farm loan principal. Although loan losses may be the result of uncontrollable factors, such as adverse weather, losses can also be attributed to problems in approving guaranteed loans and in servicing approved loans. Our past work and the preliminary results of our FmHA high-risk review have disclosed weaknesses in both of these areas.[3]

USDA's internal control review processes have also identified guaranteed loan making and servicing problems. For example, one type of internal control review, referred to as the Coordinated Assessment Review (CAR), has documented that credit quality with guaranteed loans has deteriorated each year during the past 3 fiscal years. Specifically, compliance with credit quality standards ranged from 78 percent in 1988 to 77 percent in 1989 and

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[3]These problems are similar to those we found with FmHA's direct loan programs, which, as of September 30, 1990, had $19.5 billion in outstanding principal, $8 billion of which was held by delinquent borrowers.

71 percent in 1990. Stated another way, noncompliance increased from 22 percent in 1988 to 29 percent in 1990.

Actual guaranteed loan losses have been relatively low over the past few years, averaging about $70 million per year during fiscal years 1986 through 1990. However, as the shift in lending emphasis continues from direct to guaranteed farm loans, correcting the problems with the guaranteed loan program grows in importance to control losses, prevent the loss of the shift's budgetary advantage, and avoid the experience with the direct loan program.

Problems in FmHA's Approval of Guaranteed Loans

Our September 1989 report, as well as USDA's Office of Inspector General (OIG) March 1990 and September 1988 reports,[4] disclosed several problems that FmHA has in assessing borrowers' financial conditions prior to loan guarantee approval. Of particular concern was poor assessment of borrowers' repayment ability. The primary problems regarding repayment ability were understatements and/or overstatements of expense and income amounts on the borrowers' applications and insufficient verification by lenders of applicants' nonfarm income and debts. For example, the OIG's March 1990 report disclosed that 9 of the 24 borrowers reviewed were ineligible for guaranteed loans because they failed to meet cash-flow standards.

Our ongoing FmHA review has documented that this area continues to be a problem. For example, some FmHA county offices have approved guaranteed loans that do not meet the agency's credit

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[4]Farmers Home Administration Guaranteed Loan Interest Rate Buydown Program (USDA/OIG Audit Report 04600-7-At, Mar. 29, 1990) and Farmers Home Administration Management of Farmer Program Guaranteed Loans Needs Improvement (USDA/OIG Audit Report 04665-2-Te, Sept. 29, 1988).

quality standards. Specifically, loans were made that did not meet cash-flow requirements and financial information in loan applications was not verified.

Also, the fiscal year 1990 CAR summary disclosed that about 20 percent of the reviewed loans did not demonstrate the ability to repay all debts. Furthermore, about 44 percent of the loans reviewed had no documentation to support borrowers' claimed financial and production histories.

<u>Problems in FmHA's and Lenders' Servicing of Guaranteed Loans</u>

Lenders are responsible for servicing guaranteed loans and protecting loan collateral, and FmHA is responsible for overseeing lenders' servicing activities. However, our September 1989 report and the OIG September 1988 report documented guaranteed loan servicing problems. Lenders and/or FmHA were (1) not always obtaining periodic financial statements from borrowers or performing required collateral inspections, (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.

Our ongoing FmHA review shows that guaranteed loan servicing continues to be a problem area. For example, some FmHA county offices and some commercial lenders have not complied with credit standards in servicing loans. Specifically, some county offices have not monitored lenders' servicing of guaranteed loans and some lenders have not monitored borrowers' operations or maintenance of security property. Additionally, the fiscal year 1990 CAR summary disclosed that FmHA county office supervisors did not monitor lenders' servicing involving about 48 percent of the loans reviewed.

Federal Managers' Financial Integrity Act Reports Have Identified Significant FmHA Program Weaknesses

In 1982, the Congress enacted the Federal Managers' Financial Integrity Act in an attempt to strengthen internal controls in federal agencies and to ensure that programs are properly designed and implemented. The Secretary of Agriculture reported in December 1990, as had been reported in previous years, that there were a large number of uncorrected internal control and accounting weaknesses within USDA's various agencies and programs, including FmHA's guaranteed farm loan program. As a result, the Secretary could not assure the President and the Congress that the Department met the act's requirements.

Material internal control weaknesses with FmHA's guaranteed farm loan program include, among other things, (1) continued nonconformance with credit quality standards in making and servicing such loans and (2) the failure to ensure that loans with subsidized interest rates are not made to ineligible borrowers. FmHA's accounting, servicing, and reporting system for guaranteed loans does not adequately monitor credit management performance or accurately reflect the condition of the guaranteed portfolio.

FEW DIRECT BORROWERS HAVE OBTAINED GUARANTEED LOANS

Our past work also showed that few 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 a result, direct loan borrowers likely will need continued direct loan financing to remain in farming. However, the recent decreases in funding for direct loans may restrict credit availability for them. This increases the urgency of the need to make policy decisions concerning the extent to which FmHA should continue to assist direct loan borrowers.

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. Our February 1990 report disclosed that only about 3 percent of the borrowers who obtained 1988 guaranteed farm ownership loans had an FmHA direct loan but did not have a loan with the lender. The OIG September 1988 report presented similar results. According to the OIG, about 1 percent of the 15,585 guaranteed farm loans in its sample universe were used to finance FmHA direct loan borrowers.

FmHA direct loan borrowers were not obtaining loan guarantees primarily because most were in worse financial condition than were private lender borrowers and could not 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 eight 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 that security be adequate at the time the loan is made. These 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.

ACTIONS NEEDED TO CORRECT PROBLEMS IN GUARANTEED FARM LOAN PROGRAM

We recommended in our September 1989 report that the Secretary of Agriculture direct the Administrator, FmHA, to take a number of actions to help control losses on guaranteed farm loans and to improve the management and effectiveness of the guaranteed farm loan program. USDA generally agreed with most of our findings and recommendations; however, as we reported and previously testified,[5] some of USDA's actions planned or under way may not fully resolve some of the problems that led to our recommendations.

In addition to actions FmHA should take, we continue to believe, as discussed in our February 1990 report, that the Congress needs to consider the use of guaranteed farm loan funds as it deliberates FmHA's role and mission. Issues to be addressed should include the extent to which assistance continues to be used by commercial lenders' existing customers versus new customers and the level to which such assistance is used to refinance existing debts versus new credit purchases. We believe that consideration of these issues continues to be extremely important in light of the recently enacted Omnibus Budget Reconciliation Act of 1990, which stresses the Congress' continuing emphasis on guaranteed as opposed to direct lending.

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As we complete our ongoing review of FmHA farm loan programs as a high-risk area, we will make additional recommendations, if warranted, to the Secretary of Agriculture and to the Congress to help control losses on guaranteed farm loans and to improve the management and effectiveness of the guaranteed farm loan program.

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

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[5] The Farmers Home Administration's Guaranteed Farm Loan Program (GAO/T-RCED-90-31; Feb. 20, 1990).

FmHA GUARANTEED FARM LOANS AND DELINQUENCY STATUS, SEPTEMBER 30, 1990

Dollars in Millions

	Farm ownership	Farm operating	Other[a]	Total
Borrowers[b]				
Total	9,356	38,570	679	48,605
Number delinquent	369	1,351	160	1,880
Percentage delinquent	3.9	3.5	23.6	3.9
Outstanding principal				
Total	$1,287	$2,775	$78	$4,140
Amount owed by delinquent borrowers	$58	$120	$23	$201
Percentage owed by delinquent borrowers	4.5	4.3	29.5	4.9
Allowance for loan losses	$327	$798	$26	$1,151
Allowance as a percentage of total	25.4	28.8	33.3	27.8

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

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

Source: GAO's analysis of data from the FmHA Analysis of Delinquencies Report (FmHA report code 4067) and information obtained from FmHA Finance Office officials.

SHIFT IN LENDING EMPHASIS FROM DIRECT TO GUARANTEED LOANS

The Food Security Act of 1985 promoted the use of guaranteed farm loans by authorizing FmHA to implement an interest rate reduction (IRR) program for such loans. Under this program, private lenders receive subsidy payments from FmHA as an incentive to provide credit to family farmers who are unable to project a positive cash flow on all income and expenses without a reduced interest rate. However, as discussed in our June 1989 report,[6] use of the IRR program had been much less than authorized primarily because lenders (1) are reluctant to loan money to borrowers who are unable to project a positive cash flow without IRR assistance and (2) do not want to be burdened with the paperwork required to obtain the IRR. Our June 1989 report and an OIG October 1987 report[7] also stated that program participation would have been much lower had FmHA county offices adhered to regulations when approving IRR requests. These reports disclosed that over 50 percent of the recipients should have been declared ineligible because they failed to meet the IRR program cash-flow criteria. In the March 1990 followup, the OIG reported that 22 of 24 borrowers who received loans under the program were similarly ineligible.

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. Additionally, this act required FmHA to promote the development of a secondary market for buying and selling the guaranteed portions

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

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

of its farm loans. This market was intended to give rural lenders access to a predictable source of funds so that they could meet an anticipated increased demand for such loans. However, this market was not established because of, among other reasons, Office of Management and Budget and USDA concerns over its cost and its effect on the federal budget. Subsequently, the Food, Agriculture, Conservation, and Trade Act of 1990 transferred authority to promote this market to the Federal Agricultural Mortgage Corporation, a government-sponsored enterprise that is also in the process of establishing a program for a secondary market for agricultural real estate and rural housing loans. We will soon be issuing a report on the difficulties in establishing a secondary market for FmHA guaranteed farm loans.

Finally, the Omnibus Budget Reconciliation Act of 1990 further encouraged the use of guarantees by reducing direct lending authority each year over the fiscal year 1991-95 period and authorizing the use of the reduced funds for guaranteed loans. This act authorizes about $21 billion in guarantee loan authority over the fiscal year 1991-95 period. The act also revised the federal subsidy formula to provide further incentives for lenders to participate in the IRR program. Specifically, when lenders reduce interest rates, up to a maximum of 4 percentage points, they receive payments from FmHA equal to the amount of the reduction. While the act provides that payments can be provided for the term of a loan, FmHA has administratively determined that the maximum term of the interest subsidy on a loan is 10 years. Also, beginning in fiscal year 1992, the Federal Credit Reform Act of 1990 will require FmHA to recognize all subsidies, such as those in the IRR program, and losses in its budget prior to incurring these costs.

FmHA DIRECT AND GUARANTEED FARM LENDING AUTHORITY, FISCAL YEARS 1991-95

Dollars in Millions

Fiscal year	Direct loans	Guaranteed loans	Total
1991	$ 537	$ 3,638	$ 4,175
1992	446	3,897	4,343
1993	342	4,174	4,516
1994	288	4,409	4,697
1995	285	4,600	4,885
Total	$1,898	$20,718	$22,616

Note: This table reflects the $3.622 billion reduction in direct lending authority over the 5-year period and the availability of the reduced amounts for guaranteed loans under the IRR program.

Source: Omnibus Budget Reconciliation Act of 1990.

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FmHA Guaranteed Farm Loan Program

Farm inc stab prog
Loan acctng sys
Loan defs
Farm credit
Agricul assis
Dir. loans
Govt guar loans
Lending inst
Loan int rates
Loan repays

Farm subs
Fin mgmt
Banking reg
Elig. deters