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FARMS LOANS

Actions Needed to Safeguard Taypayers' Interests

Statement of John W. Harman, Director
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GAO/T-RCED-95-147

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the risks associated with the Farmers Home Administration's (FmHA)[1] farm loan programs. Our testimony is based primarily on reports we have issued since April 1992 that examined FmHA's management of its direct and guaranteed farm loan programs and of farm properties obtained as a result of defaults on federal loans. (See attachment I.) These reports were issued as part of GAO's special effort to review federal program areas considered to be especially vulnerable to waste, fraud, abuse, and mismanagement. As you also requested, we are providing information on the status of FmHA's efforts to centralize servicing of its housing loans. (See attachment II.)

In summary, FmHA's farm loan programs have resulted in large losses of taxpayer dollars--$12.5 billion during fiscal years 1989-94. About 98 percent of the losses, or $12.2 billion, have occurred in the direct loan program. Substantial additional losses can be expected because delinquent borrowers held about 26 percent of the agency's $18 billion direct and guaranteed loan portfolio as of September 30, 1994. Again, most of these delinquencies, $4.6 billion out of $4.8 billion, were in the direct loan program.

Several factors have contributed to the direct farm loan program's financial vulnerability. First, FmHA's field offices have not consistently implemented lending, servicing, and property management standards that are intended to protect the government's loan interests. Second, certain of the agency's loan policies expose the program to losses. For example, a borrower can obtain a new loan despite being delinquent on another loan.

A third, and perhaps a more fundamental source of program problems, can be traced to conflicting program objectives. FmHA's mission--to provide temporary credit to high-risk farmers--is often at odds with normal fiscal controls designed to minimize risk and financial losses. No clear guidelines enable FmHA to balance its responsibilities as a lender of last resort with its responsibilities as a fiscally prudent lender.

In recent years, FmHA and the Congress have taken actions intended to address some of these problems. However, more can be done to move the agency toward a more fiscally responsible position. This would include strengthening loan policies as well as further clarifying the agency's basic mission.

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[1]Within the U.S. Department of Agriculture (USDA), farm loans have been historically administered by FmHA. In October 1994, the responsibility was transferred to the newly created Consolidated Farm Service Agency. Because of the general familiarity with the agency's earlier name, we refer to FmHA throughout this testimony.

In the remainder of my statement, I will discuss the results of our work in more detail. Let me begin by providing a brief background.

BACKGROUND

FmHA provides credit to farmers who are unable to obtain funds elsewhere at reasonable rates and terms. The agency provides credit assistance through direct loans, which are funded by the government, and through guaranteed loans, which are made by commercial lenders to farmers and guaranteed for up to 90 percent by the government. FmHA's assistance is intended to be temporary; once farmers have become financially viable, they are to graduate to commercial sources of credit.

When borrowers have trouble repaying their loans, FmHA's direct loan policies provide various types of relief assistance that result in losses to the federal government. Two such options are provided under the Agricultural Credit Act of 1987: (1) "writing down" (reducing) portions of restructured debt so that the borrowers can continue farming and remain FmHA clients and (2) allowing borrowers to satisfy the debt in its entirety by paying an adjusted amount based on the value of the loan collateral and "writing off" the remaining debt--referred to as net recovery value buy-out with "write-off." A third direct loan servicing option--the debt settlement process--also results in writing off debt. This process essentially represents the government's last chance to collect on loans and avoid losses.

TAXPAYERS' INVESTMENT IN FARM LOANS IS AT RISK

FmHA's loan programs, in particular its direct loan program, have incurred large loan losses. During fiscal years 1989-94, FmHA losses totaled about $12.5 billion, of which $12.2 billion resulted from its direct loan program. Table 1 shows the type and amount of loss in each category of direct and guaranteed farm loans.

Table 1: Amount of FmHA Farm Program Losses, Fiscal Years 1989-94

Dollars in billions

Loss category	Loss amount
Direct loans	
Restructure with write-down	$ 1.6
Net recovery value buy-out with write-off	2.3
Debt settlement with write-off	8.4

Subtotal	12.2[a]
Guaranteed loan loss payments	0.3
Total	$12.5

[a]Does not add due to rounding.

Potential for substantial losses continue. As of September 30, 1994, FmHA's outstanding direct and guaranteed loans to farmers totaled $18 billion. Almost $5 billion, or 26 percent, of the farm loan portfolio is at risk because it is held by delinquent borrowers. By far, the largest percentage of these delinquencies are in the direct loan program, where 36 percent of the program's $12.6 billion portfolio is held by delinquent borrowers. Even this figure may not reflect the true risks associated with direct loans because it does not include loans that are held by borrowers who are technically current but have had loans rescheduled or debts reduced in response to past repayment problems. Table 2 shows the amount of outstanding principal on FmHA's loans and the amount owed by delinquent borrowers.

Table 2: Total Outstanding and Delinquent Debt, September 30, 1994

Dollars in billions

Loan program	Outstanding principal	Owed by delinquent borrowers	Percent owed by delinquent borrowers
Direct	$12.6	$4.6	36.2
Guaranteed	5.4	0.2	3.6
Total	$18.0	$4.8	26.4

FmHA's FIELD OFFICE LENDING OFFICIALS HAVE FREQUENTLY FAILED TO FOLLOW THE AGENCY'S ESTABLISHED STANDARDS

Some of the troubled condition of FmHA's direct loan portfolio reflects the failure of the agency's lending officials in field offices to implement standards intended to safeguard federal financial interests. In April 1992,[2] we reported that agency officials had approved loans that, contrary to agency loan-making standards, were not based on realistic estimates of production,

[2]Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk (GAO/RCED-92-86, Apr. 3, 1992).

income, and expenses. We also reported that, according to FmHA's internal reviews of direct loans made from 1988 through 1991, 13.5 percent of the sampled loans did not demonstrate repayment ability. The report also identified problems concerning adherence to loan-servicing standards, such as conducting required annual inspections of the loan collateral.

In recent years, FmHA has improved compliance with certain loan-making standards. For example, only 7 percent of the loans that FmHA reviewed for compliance with lending standards during fiscal years 1993 and 1994 failed to demonstrate repayment ability. These improvements may be linked to the extensive training in credit and financial analysis FmHA has provided to its field office lending officials and the emphasis it has placed on having new loans meet agency standards.

However, progress in better adhering to loan-servicing standards has been mixed. While we have noted improvements in implementing servicing standards for guaranteed loans, we have not seen similar improvements in implementing certain of the direct loan servicing standards. For example, noncompliance with requirements for annual supervisory visits increased from 11 percent of the direct loans reviewed in 1991 to 21 percent in 1994.

Other servicing-related standards that continue to pose compliance problems concern the agency's debt settlement process. In October 1994,[3] we reported that field office officials failed to follow procedures intended to reduce losses during debt settlement. For example, the report noted that FmHA's own internal reviews, while limited in scope, indicated that field officials frequently did not develop a complete inventory of a borrower's financial resources. As a result, they may not have been aware of assets or income that could have been used to offset loan losses. The report also pointed out that even when FmHA had a complete inventory of a borrower's financial resources, it did not always use them to offset losses.

CERTAIN FmHA LENDING AND PROPERTY MANAGEMENT POLICIES INCREASE THE AGENCY'S EXPOSURE TO LOSS

Lenient loan-making policies, some congressionally directed, increase the risk to the taxpayers' investment. For example:

-- The agency makes or guarantees additional loans to borrowers despite having reduced or forgiven substantial amounts of their previous loans. During fiscal years 1989-94, FmHA made or guaranteed $377 million in new loans to borrowers after it had lost $800 million on their prior

[3] Debt Settlement: FmHA Can Do More to Collect on Loans and Avoid Losses (GAO/RCED-95-11, Oct. 18, 1994).

loans.

-- Under a policy known as the continuation policy, FmHA makes loans to borrowers who are delinquent on direct loans. For fiscal years 1989-94, FmHA made $126 million in new direct loans to borrowers who were delinquent on their existing loans.

-- FmHA's guaranteed loan practices allow commercial lenders to shift risk to the government. Specifically, FmHA allows commercial lenders to refinance existing high-risk debt and routinely guarantees most loans at the maximum rate (90 percent). Almost 40 percent of the $1.6 billion that was guaranteed in fiscal year 1992 was used to refinance existing debt.

Certain loan-servicing policies have also contributed to FmHA's direct loan losses. For example:

-- Forgiving debt through writing down or writing off the debt invites potential abuse because borrowers may intentionally default on loan payments to qualify for debt reduction. In fact, some nondelinquent borrowers told us that they felt penalized for paying their debts.

-- Routinely rescheduling loan terms and conditions can burden borrowers with excessive debt, making it even more difficult for them to repay their loans. This can occur because when FmHA reschedules loan terms, it often extends the payment period and adds the unpaid interest to the outstanding loan principal without increasing the loan security. These actions often result in large debts and loss of equity for borrowers and undersecured loans for the government. Although the Consolidated Farm and Rural Development Act limits borrowers to $200,000 in new direct loan obligations, it does not limit the debt they can accumulate through rescheduling or reamortizing existing loans. As we reported in December 1992,[4] 1,940 borrowers had accumulated debts totaling about $67 million above the individual limit of $200,000, as of June 30, 1992.

Finally, FmHA's policies governing the sale of properties it acquires from borrowers who do not repay their loans limits the agency's ability to recoup loan losses. Specifically, instead of being able to sell properties to the "highest bidder," FmHA must first offer most properties to selected buyers at fixed prices. As a result, properties may not be sold at the highest attainable prices.

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[4]Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1, Dec. 1992).

CONFLICTING GOALS INHIBIT EFFECTIVE MANAGEMENT OF THE FARM LOAN PROGRAMS

Because legislation has not established clear priorities for FmHA's mission, the agency has tried simultaneously to meet two conflicting objectives: (1) to be a fiscally prudent lender and protector of the taxpayers' investment and (2) to assist high-risk borrowers by providing temporary credit so that they can stay in farming until they secure commercial credit. Arguably, FmHA has not successfully fulfilled either responsibility.

As we discussed earlier, FmHA has not been a prudent lender. The poor condition of FmHA's direct loan portfolio in part reflects congressional and agency actions emphasizing the agency's assistance responsibilities over its responsibility for fiscal prudence. Similarly, questions can be raised concerning how effectively FmHA has fulfilled its mission as a temporary source of credit. In fact, it has evolved into a continuous source of credit for many of its borrowers, some of who could obtain commercial credit. As we reported in November 1994,[5] field office lending officials do not always take action to identify direct loan borrowers with potential to move to commercial credit. And, when they do identify potential candidates, they often fail to take actions to move them to commercial credit. For example, in the field offices we visited, FmHA should have reviewed 1,160 borrowers for possible graduation. However, FmHA either did not review, or removed from consideration without explanation, about 500 of these borrowers.

The Congress clarified FmHA's role with respect to beginning farmers through the Agricultural Credit Improvement Act of 1992. This legislation directed the agency to establish programs for, and target a certain portion of its loan funds to, beginning farmers. Specifically, the Congress required FmHA to establish a farm ownership loan program aimed at enhancing the financial viability of new farmers by enabling them to build equity in their farming operations. The Congress also required FmHA to establish a farm operating loan program that targets loan funds to individuals with 5 or fewer years of farming experience. In this program, FmHA assistance is limited to no more than 10 years.

FURTHER ACTION NEEDED TO PROTECT TAXPAYERS' INVESTMENT

Since April 1992, we have made numerous recommendations to the Secretary of Agriculture and to the Congress aimed at improving compliance with standards intended to protect the federal loan investment and strengthening FmHA's lending and servicing policies. While only limited action has been taken on those recommendations,

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[5]Farmers Home Administration: The Guaranteed Farm Loan Program Could Be Managed More Effectively (GAO/RCED-95-9, Nov. 16, 1994)

we continue to believe that they would make the loan programs more fiscally sound. However, in the final analysis, we recognize that the extent to which FmHA moves in this direction will depend upon difficult congressional decisions that will better define the agency's basic mission--just how fiscally prudent should FmHA be as the nation's lender of last resort? Clarifying the agency's mission could include establishing guidance in such areas as (1) the length of time that borrowers may receive assistance from FmHA and (2) the type of assistance, if any, that should be made available to help unsuccessful borrowers who want to leave farming.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions that you or Members of the Committee may have.

RELATED GAO PRODUCTS

High Risk Series: Farm Loan Programs (GAO/HR-95-9, Feb. 1995)

Farmers Home Administration: The Guaranteed Farm Loan Program Could Be Managed More Effectively (GAO/RCED-95-9, Nov. 16, 1994).

Debt Settlements: FmHA Can Do More to Collect on Loans and Avoid Losses (GAO/RCED-95-11, Oct. 18, 1994.)

Farmers Home Administration: Farm Loans to Delinquent Borrowers (GAO/RCED-94-94FS, Feb. 8, 1994).

Farm Finance: Number of New Farmers Is Declining (GAO/RCED-93-95, May 3, 1993).

High Risk Series: Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1, Dec. 1992).

Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk (GAO/RCED-92-86, Apr. 3, 1992)

STATUS OF CENTRALIZED SERVICING FOR FmHA'S HOUSING LOANS

In September 1993,[6] we reported that FmHA's studies and our analysis showed that the benefits of centralized servicing of the agency's single-family housing loans outweigh the disadvantages.[7] In a modern, private, loan-servicing operation, all servicing actions after a loan is closed are handled at one central location. Centralized servicing operations typically include holding funds in escrow, reviewing interest credit, applying and collecting late payment fees, counseling on credit issues, and handling delinquent accounts. The private sector has shown that centralized servicing, using highly specialized personnel to perform loan-servicing functions, results in greater productivity and efficiency. Benefits include lower delinquency rates, greater efficiencies gained through staff specialization, and escrow capability that helps borrowers budget their payments and protects the government interest by ensuring that taxes and insurance are paid. Analysis indicates that centralized servicing should also lower FmHA's servicing costs of about $240 per loan by 50 percent or more, thereby saving over $100 million annually.

In addition to explaining the benefits of centralized servicing, the September 1993 report discussed FmHA's 5-year effort to centralize servicing operations for direct housing loans. We reported that, while the agency had undertaken three studies, three plans, and a pilot project since 1988 and had set a number of target dates for implementing centralized servicing, it was undecided in September 1993 on whether to adopt the practice. We also noted that FmHA had expended considerable resources in examining centralized servicing questions. The unsuccessful pilot project and one study alone cost about $1.6 million.

In December 1994, FmHA officials agreed to proceed with centralized servicing and issued a request for proposals for FmHA to purchase an off-the-shelf commercial loan-servicing system with modifications to handle their particular loan-servicing requirements. FmHA has received proposals in response to its solicitation and plans to award a contract by July 1995. FmHA projects budget costs of $39 million for the system and expects to begin phasing it in by October 1996. FmHA also plans to phase in about 700 new centralized servicing employees in its St. Louis

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[6]U.S. Department of Agriculture: Centralized Servicing for FmHA Single-Family Housing Loans (GAO/RCED-93-231BR, Sept. 23, 1993)

[7]As of Sept. 30, 1994, FmHA's single-family housing direct loan portfolio consisted of 765,345 loans with an outstanding principal balance of $18.6 billion.

Finance Center to supplement the 300 employees currently working on housing portfolio servicing issues.

Our September 1993 report also identified 700 FmHA county offices that had 75 percent or more of their farm and housing loans in single-family housing. With centralized servicing on the horizon, we reported that such offices should be studied for consolidation or closing. Likewise, a 1991 FmHA study found that 742 low-workload offices would need to be consolidated or closed after servicing is centralized. The Congressional Budget Office reported that closing these offices would produce about $171 million in outlay savings from the associated reductions in full-time employees in fiscal years 1999 and 2000. However, we have found that FmHA is not considering the impact of centralized servicing in its office-closing plans. The head of FmHA's reorganization task force told us that closing plans are still being made on the basis of geographic criteria--such as distance from towns, road systems, and mountain ranges--without fully considering technological factors currently used in the private sector, including 800 telephone numbers, automatic dialers to call delinquent accounts, and on-line computerized credit reporting.

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