United States General Accounting Office

GAO

Testimony

Before the Committee on the Agriculture, Nutrition, and Forestry, U.S. Senate

For Release on Delivery
Expected at 9 a.m., EDT
Wednesday, May 16, 2001

FARM LOAN PROGRAMS

Improvements in the Loan Portfolio but Continued Monitoring Needed

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GAO-01-732T

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify on the U.S. Department of Agriculture's (USDA) farm loan programs. Our testimony today is based on reports that we have issued over the past decade, the most recent of which are our January 10, 2001, report entitled *Farm Service Agency: Updated Status of the Multibillion-Dollar Farm Loan Portfolio* (GAO-01-202) and our January 2001 report entitled *Major Management Challenges and Program Risks: Department of Agriculture* (GAO-01-242). As you know, within USDA, the Farm Service Agency (FSA) is responsible for administering USDA's farm loan programs.

Our testimony today focuses on two areas covered in our reports: (1) an overview of the financial condition of FSA's farm loan portfolio as of September 30, 2000, and (2) our decision to remove the farm programs from our high-risk list. In summary:

- FSA had more than $16.6 billion in outstanding farm loans as of September 30, 2000; direct loans accounted for slightly more than half of this amount and guaranteed loans for slightly less than half. Of the $16.6 billion, about $2.1 billion was owed by borrowers who were delinquent on repaying their FSA loans. Most (87 percent) of the $2.1 billion was owed on direct farm loans. Although the total amount due on the problem loans remains high, this financial position reflects improvement in FSA's direct farm loan portfolio in recent years as well as a continuation of a relatively healthy guaranteed farm loan portfolio.

- In January 2001, we removed the farm loan programs from our high-risk list. We did so because the financial condition of the programs had improved since we first designated the programs as high-risk in 1990 and because actions taken by the Congress and USDA, many of which we recommended, have had a significant positive impact on the operation and condition of USDA's farm loan programs. Specifically, since the end of fiscal year 1995, the amount of outstanding principal owed by borrowers who were delinquent on their direct loans and the percentage of debt owed by such borrowers declined each year—from $4.6 billion, or about 41 percent of the outstanding principal, in fiscal year 1995 to $1.8 billion, or about 21 percent of the outstanding principal, in fiscal year 2000. While we have removed the farm loan programs from our high-risk list, USDA and the Congress need to continue to monitor its performance over time.

Background

FSA's farm loan programs are intended to provide temporary financial assistance for the nation's farmers and ranchers who are unable to obtain commercial credit at reasonable rates and terms. FSA provides various types of both direct and guaranteed farm loans. Direct farm ownership loans can be used to buy farm real estate and make capital improvements. Guaranteed farm ownership loans are made for the same purposes and for refinancing existing debts. Also, direct farm operating loans can be used to buy feed, seed, fertilizer, livestock, and farm equipment; pay family living expenses; and, subject to certain restrictions, refinance existing debts. Guaranteed farm operating loans are made for the same purposes but without restriction on refinancing existing debts. Additionally, direct loans include emergency disaster loans which are made to farmers and ranchers whose operations have been substantially damaged by adverse weather or other natural disasters.[1]

In operating the farm loan programs, FSA faces the conflicting tasks of (1) providing high-risk borrowers with temporary credit so that can stay in farming until they are able to secure commercial credit and (2) ensuring that the taxpayers' investment is protected. When a borrower does not repay his or her direct farm loans, FSA has various tools to resolve the delinquency, including (1) restructuring the loans, which may include reducing (writing down) some of the outstanding debt so that the borrower can continue in farming; (2) allowing a borrower who does not qualify for restructuring to pay an amount that is based on the value of collateral security, which is less than the outstanding debt and results in FSA's forgiving (writing off) the balance; and (3) reaching a final resolution of the debt that may or may not include a payment by the borrower, which also results in forgiving the debt. When a borrower defaults on a guaranteed loan and a commercial lender incurs a loss, FSA reimburses the lender for the guaranteed portion of the loss. FSA's losses on direct and guaranteed loans totaled about $486 million during fiscal year 2000, about 88 percent of which involved losses on direct farm loans.

[1]The Consolidated Farm and Rural Development Act, as amended (P.L. 87-128, Aug. 8, 1961), is the basic authority for the farm loan programs.

FSA's Farm Loan Portfolio Has Improved but Still Contains Many Delinquent Loans

The outstanding principal owed on FSA's direct and guaranteed farm loans totaled more than $16.6 billion as of September 30, 2000. Direct loans accounted for about $8.7 billion of the total amount, and guaranteed loans accounted for almost $8 billion. Borrowers who were delinquent owed slightly more than $1.8 billion, or 20.9 percent, of the outstanding direct loan debt and about $282 million, or 3.5 percent, of the outstanding guaranteed loan debt.[2] Both the total outstanding principal owed on direct farm loans and the amount owed by borrowers who were delinquent were lower at the end of fiscal year 2000 than at the end of fiscal year 1999. Also, while the total outstanding principal owed on guaranteed farm loans was higher at the end fiscal year 2000 than at the end of fiscal year 1999, the amount owed by borrowers who were delinquent was lower. (See table 1.)

Table 1: Outstanding Principal and Amount Owed by Delinquent Borrowers, Direct and Guaranteed Farm Loans, September 30, 2000

Dollars in millions

	Outstanding principal		Owed by delinquent borrowers		Percentage owed by delinquent borrowers[a]	
Loan program	**Amount**	**Number of borrowers**	**Amount**	**Number of borrowers**	**Percentage of debt**	**Percentage of borrowers**
Direct loans	$8,659.0	96,887	$1,812.4	13,930	20.9	14.4
Guaranteed loans	7,967.1	40,679	281.9	1,863	3.5	4.6
Total[b]	**$16,626.1**	**137,566**	**$2,094.2**	**15,793**	**12.6**	**11.5**

[a]Percentages are based on whole numbers.

[b]The total number of borrowers includes some borrowers who are counted more than once because they have both direct and guaranteed loans. Also, the total amount owed by delinquent borrowers does not add because of rounding.

Note: The percent of borrowers who were delinquent on direct loans declined from 23.5 percent to 20.9 percent over fiscal year 2000, and the direct loan losses of $427 million were FSA's least in over 10 years.

Source: GAO's analysis of information in FSA's farm loan automated databases.

All types of direct and guaranteed farm loans had outstanding principal owed by delinquent borrowers at the end of fiscal year 2000, while some types accounted for much more problem debt than others. Of the direct loans, for example, natural disaster emergency loans accounted for the highest amount of principal owed by borrowers who were delinquent—

[2]If a borrower was delinquent on any farm loan, the principal on all farm loans held by the borrower was totaled to calculate the amount owed by the delinquent borrower.

about $811 million; 44.1 percent of the outstanding principal on these emergency loans was owed by delinquent borrowers.[3] Farm operating loans were second in terms of the amount of principal owed by delinquent borrowers—$569.4 million; 20 percent of the outstanding principal on these loans was owed by delinquent borrowers. Of the guaranteed loans, farm operating loans accounted for the highest amount owed by delinquent borrowers, more than $165 million; 3.8 percent of the outstanding principal on farm operating loans was owed by delinquent borrowers. Guaranteed farm ownership loans had about $115 million, or 3.2 percent of the outstanding principal owed by delinquent borrowers. (See table 2.)

Table 2: Outstanding Direct and Guaranteed Farm Loans and Portion Owed by Delinquent Borrowers as of September 30, 2000, by Loan Type

Dollars in millions

	Outstanding principal		Owed by delinquent borrowers		
Loan type	**Amount**	**Percentage of total**	**Amount**	**Percentage of total**	**Percentage owed by delinquent borrowers**
Direct loans					
Ownership	$3,482.4	40.2	$135.7	7.5	3.9
Operating	2,846.9	32.9	569.4	31.4	20.0
Natural disaster	1,838.8	21.2	810.8	44.7	44.1
Other[a]	490.9	5.7	296.5	16.4	60.4
Total	**$8,659.0**	**100.0**	**$1,812.4**	**100.0**	**20.9**
Guaranteed loans					
Ownership	$3,581.9	45.0	$114.9	40.8	3.2
Operating	4,380.7	55.0	165.4	58.7	3.8
Other[b]	4.5	0.1	1.5	0.5	34.2
Total	**$7,967.1**	**100.0**	**$281.9**	**100.0**	**3.5**

Note: percentages are based on whole numbers. Also, totals may not add because of rounding.

[a]Other direct loans are economic emergency and recreation loans, which FSA no longer makes, and soil and water loans.

[b]Other guaranteed loans are economic emergency loans, which FSA no longer guarantees.

Source: GAO's analysis of information in FSA's farm loan automated databases.

[3]Natural disaster emergency loans are inherently riskier than the other types of farm loans that FSA makes because they are made to help farmers recover from losses rather than to generate new income.

Farm Loan Programs Remain Vulnerable to Loss, but High-Risk Status Is No Longer Merited

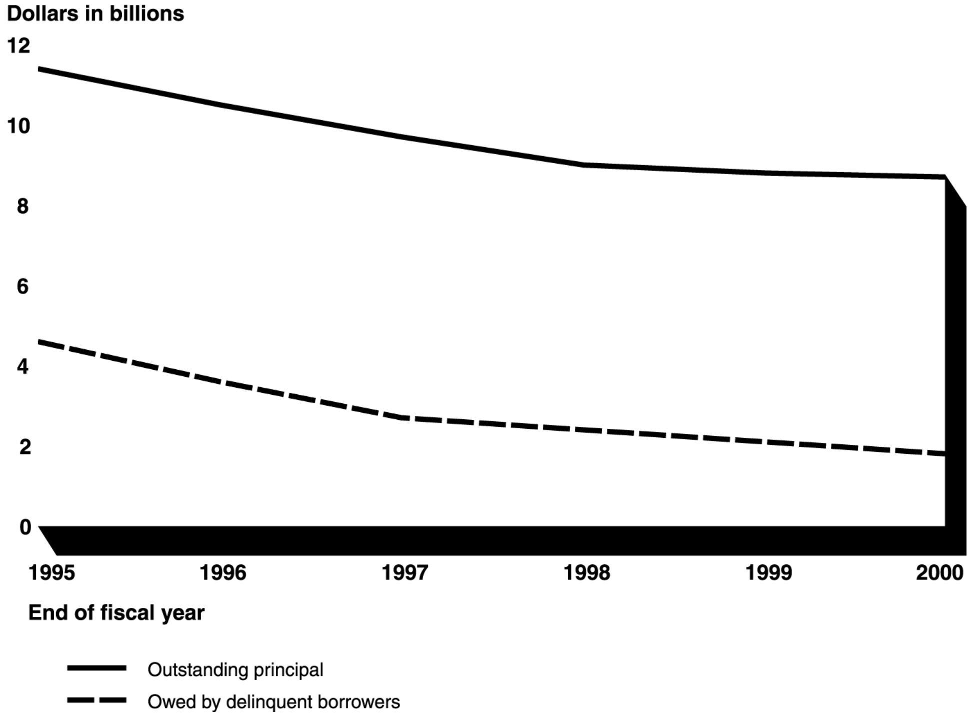
In January 2001, we removed the farm loan program from our high-risk list because (1) the financial condition of the program had improved and (2) there had been improvements in lending and servicing policies that were intended to reduce the risks associated with the farm loan programs. A decade earlier, in 1990, we had identified FSA's farm loan programs as high-risk because of significant program problems primarily with the direct loans. As we had reported in the 1980s, the farm loan programs had experienced a high rate of defaults on repayments: billions of dollars of losses had occurred and were likely to occur, and the Department had evolved into a continuous source of subsidized credit for thousands of borrowers. These problems occurred because of program policies—some of which were congressionally directed—that contributed to financial risks and because the Department's field office officials failed to comply with existing loan and property management standards. For example, the program's policies allowed borrowers who defaulted and caused losses on past farm loans to obtain new loans and allowed borrowers to obtain new direct loans for operating expenses without demonstrating their ability to pay their existing debt. Also, field offices lending officials approved loans on the basis of unrealistic estimates of production, income, and expenses and often failed to verify borrowers' existing debts.

Since the mid-1990s, USDA has addressed management problems, such as the quality controls over loan-making and servicing, and various pieces of legislation have had a significant impact on the operation of FSA's farm loan programs. Specifically, the 1996 Farm Bill made a variety of changes to the lending and servicing policies of FSA that were intended to reduce the risks associated with the farm loan programs. In particular, the 1996 Farm Bill included provisions that (1) prohibit borrowers who are delinquent on FSA direct or guaranteed farm loans from obtaining additional direct farm operating loans, (2) generally prohibit borrowers whose past defaults resulted in loan losses from obtaining new direct or guaranteed farm loans (although an exception provides that a direct or guaranteed farm operating loan for paying annual farm or ranch operating expenses may be made to a borrower whose restructuring resulted in forgiving debt), and (3) limit borrowers to one instance of debt forgiveness on direct loans.

The 1996 Farm Bill also requires borrowers to have or agree to obtain hazard insurance on the property that they acquire with farm ownership and operating loans, and requires applicants, as a condition for getting an emergency disaster loan, to have had hazard insurance on property that was damaged or destroyed. In addition, the 1996 Farm Bill provided direction for many other aspects of FSA's basic lending mission. For example, the 1996 Farm Bill limited the length of time that FSA loan assistance is available by providing that borrowers can receive direct farm ownership loans during a 10-year period that starts when they first obtain farm ownership loans and that borrowers can obtain direct farm operating loans during a total of 7 years, which may be consecutive or nonconsecutive years. The 1996 Farm Bill also enhanced the potential for direct loan borrowers to obtain conventional credit by allowing a 95-percent guarantee on loans made by commercial lenders to refinance the existing direct loans that the borrowers have, up from the previous limit of 90 percent.

We concluded that these actions have helped generate continued improvements in the portfolio in recent years. As of September 30, 2000, delinquent borrowers held more that $1.8 billion (about 21 percent) of the outstanding principal on direct loans. This compares with about $2.1 billion (23.5 percent) in September 1999, $2.4 billion (over 26 percent) in September 1998, and, $4.6 billion (about 41 percent) in September 1995. As figure 1 shows, the outstanding principal and the amounts owed by delinquent borrowers on direct farm loans have declined each year since the end of fiscal year 1995 and the enactment of the 1996 Farm Bill.

Figure 1: Outstanding Principal and Amount Owed by Borrowers Who Were Delinquent on Direct Farm Loans, End of Fiscal Years 1995 Through 2000

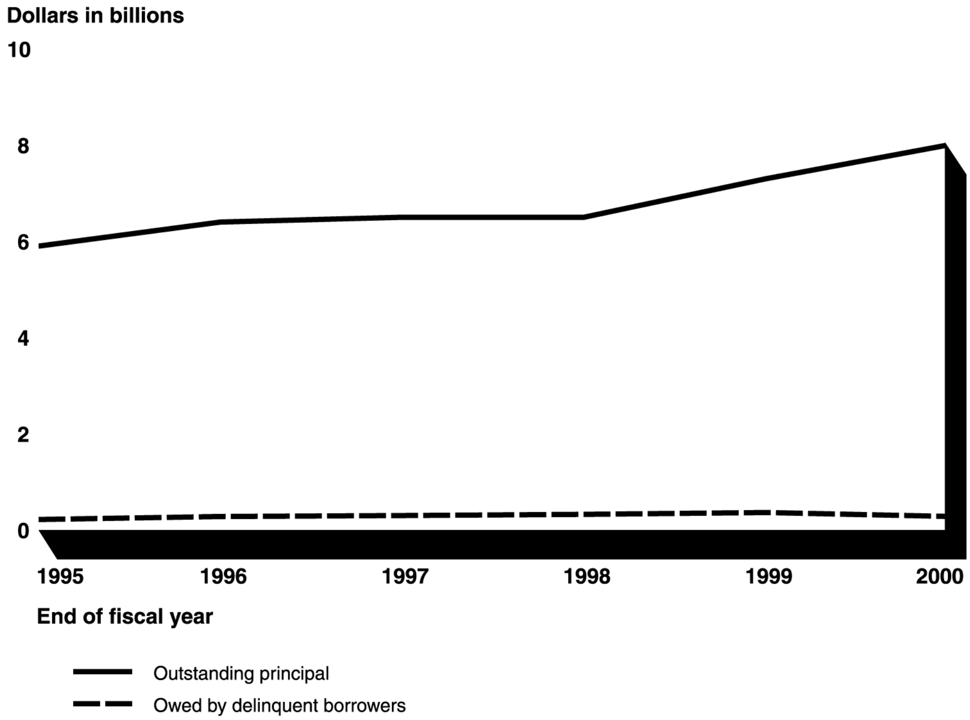


Note: The percentage of outstanding principal owed by delinquent borrowers was as follows: 40.7 percent in 1995, 34.2 percent in 1996, 28.2 percent in 1997, 26.4 percent in 1998, 23.5 percent in 1999, and 20.9 percent in 2000.

Source: GAO's analysis of information in FSA's farm loan automated databases.

In addition, as figure 2 shows, while the total outstanding principal owed on guaranteed farm loans has risen since 1995, the amount owed by borrowers who were delinquent on guaranteed farm loans has remained relatively steady.

Figure 2: Outstanding Principal and Amount Owed by Borrowers Who Were Delinquent on Guaranteed Farm Loans, End of Fiscal Years 1995 Through 2000



Note: The amount and percentage of outstanding principal owed by delinquent borrowers were as follows: $218 million, or 3.7 percent, in 1995; $280 million, or 4.4 percent, in 1996; $300 million, or 4.6 percent, in 1997; $325 million, or 5.0 percent, in 1998; $363 million, or 5.0 percent, in 1999; and $282 million, or 3.5 percent, in 2000.

Source: GAO's analysis of information in FSA's farm loan automated databases.

We believe that the improvements in part reflect actions that the Congress and USDA have taken to address the underlying causes of the programs' past weaknesses.

Although the programs' high-risk designation has been removed, we believe that USDA and the Congress need to continue monitoring the loan portfolio and the effects of the lending and servicing reforms, as well as any future legislation, to ensure that improvements in the financial integrity of the farm loan programs continue. This is particularly important since more recent legislation has eased some lending restrictions that had been put in place by the 1996 Farm Bill. First, Public Law 105-277 (Oct. 21, 1998) provides additional exceptions to the 1996 Farm Bill's general prohibition of new loans to borrowers who caused FSA to incur loan losses. Specifically, this act provides that a guarantee is only prohibited on a loan to a borrower who caused loan losses (1) after April 4, 1996, the date of the 1996 Farm Bill or (2) on more than three occasions on or before the date of the 1996 Farm Bill. The act continued allowing direct and guaranteed farm operating loans to restructured borrowers and also allows such loans to borrowers who are current on payments under confirmed bankruptcy reorganization plans. In addition, the act allows an emergency disaster loan to be made to a borrower who (1) caused not more than one loan loss on or before the date of the 1996 Farm Bill and (2) has not caused a loss after the date of the 1996 Farm Bill. Furthermore, the act specifies that an emergency disaster loan cannot be denied to a borrower who does not have sufficient collateral to secure the loan if the borrower can show the ability to repay the loan. Second, Public Law 106-31 (May 21, 1999) removed a loan-making provision that said that applicants for guaranteed loans needed to show that their expected income would be sufficient to repay their loans and also provide a margin to fund the replacement of capital items, such as a tractor, should that become necessary. Third, Public Law 106-224 specified that the limitation on the number of years in which borrowers can receive farm operating loans—7 years for direct loans and a total of 15 years for direct and guaranteed loans—would not be in effect from the date of enactment (June 22, 2000) and until January 2003. Fourth, under Public Law 106-387 (Oct. 28, 2000) an emergency disaster loan can be made to a poultry farmer to cover the loss of a chicken house on which the farmer did not have hazard insurance at the time of the loss if certain conditions are met. Since these provisions increase the risk of losses, their effects will need close monitoring so that adjustments can be made if the integrity of the loan programs comes under pressure.

Mr. Chairman, this concludes our formal statement. If you or other Members of the Committee have any questions, we will be pleased to respond to them.

Contact and Acknowledgment

For future contacts regarding this testimony, please contact Lawrence J. Dyckman on (202) 512-3841. Individuals making key contributions to this testimony and/or to the reports on which it was based include Charles M. Adams and Patrick J. Sweeney.