

GAO

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

August 1990

**FARMERS HOME
ADMINISTRATION**

**Changes Needed in
Loan Servicing Under
the Agricultural Credit
Act**





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

**Resources, Community, and
Economic Development Division**

B-239540

August 2, 1990

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

Dear Mr. Chairman:

This report responds to your September 22, 1988, request for a review of the Farmers Home Administration's (FmHA) implementation of the debt servicing requirements as set forth by the Agricultural Credit Act of 1987. We are recommending a variety of legislative changes to improve the results of FmHA's implementation of the act. In addition, we recommend that the Secretary of Agriculture take action to improve borrowers' financial situations after restructuring.

As arranged with your office, we are sending copies of this report to appropriate Senate and House committees; interested members of the Congress; the Secretary of Agriculture; the Administrator, FmHA; the Director, Office of Management and Budget; and to other interested parties. We will also make copies available to others upon request.

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

Sincerely,

A handwritten signature in cursive script that reads "J. Dexter Peach".

J. Dexter Peach
Assistant Comptroller General

Several changes need to be made to the act. First, legislative action needs to be taken to ensure that bad faith borrowers—those whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loans—do not unduly benefit from the act. Second, amendments need to be made to allow FmHA to consider unsecured assets in its loan servicing decisions. Such a change would reduce the debt relief for those delinquent borrowers who have sufficient assets to satisfy some or all of their delinquency.

Furthermore, the act may have created an incentive for nondelinquent borrowers to intentionally become delinquent since the debt reduction provisions apply only to borrowers who default on their loan payments. Although borrowers who intentionally become delinquent are not to receive the act's benefits, FmHA may be unable to deny servicing to them because concluding that they caused their delinquency is difficult.

Principal Findings

Borrower Participation in Debt Servicing

At the county offices GAO reviewed, 63 percent of the borrowers were offered net recovery value buy-out, producing debt write-offs of \$78 million; 18 percent were offered restructuring, producing debt write-downs of \$13 million; and 19 percent were offered restructuring, involving no debt write-downs. Forty percent of the borrowers had FmHA debt in the \$250,000 to \$999,999 range. For example, one borrower, who had not made any loan payments since 1985, was offered a write-off of \$738,928 through net recovery value buy-out.

Restructured Borrowers Financially Weak After Servicing

After restructuring, 91 percent of the borrowers analyzed by GAO at the FmHA county offices had such high debt-to-asset ratios and/or low cash flow margins for the upcoming year that their potential for successful farming operations appeared limited. Almost 50 percent of the borrowers had debts which exceeded their assets and about 59 percent had a cash flow margin of less than \$100 after projecting income and expenses for the upcoming year. FmHA does not have a cash flow reserve requirement for its restructured borrowers. One restructured borrower, for example, had a \$2 positive cash flow for the upcoming year, a 222 percent debt-to-asset ratio, and a \$246,000 negative net worth. Furthermore, some of the restructured borrowers interviewed by GAO doubted

are contained in the proposed 1990 Farm Bill, which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

Recommendations

GAO recommends that the Secretary of Agriculture direct the FmHA Administrator to (1) revise regulations implementing the Agricultural Credit Act to provide restructured borrowers with a 10-percent cash flow margin after servicing, (2) alert county offices that borrowers may attempt to intentionally become delinquent to qualify for debt relief, and (3) notify farmer program borrowers that intentionally causing delinquencies could disqualify them from obtaining debt relief.

Further, GAO recommends that the Congress amend the Agricultural Credit Act to address several issues including making it clear that bad faith borrowers are prevented from receiving debt relief benefits and authorizing FmHA to consider all assets of delinquent borrowers who are being considered for debt relief.

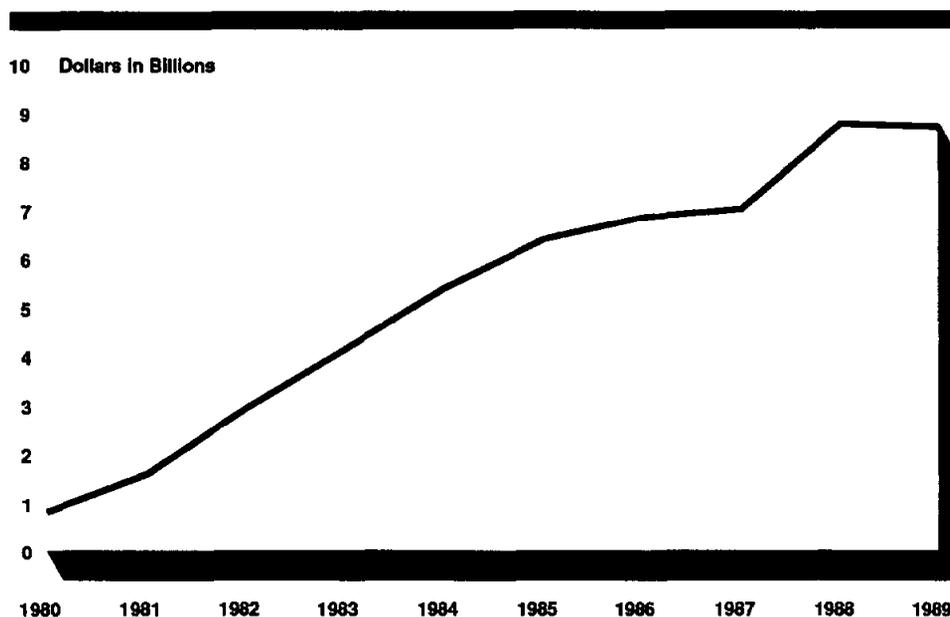
Agency Comments

USDA agreed with two of GAO's recommendations addressed to the Secretary. However, although agreeing with the recommendation that the cash flow margin should be increased, USDA commented that it supports a 5-percent, rather than a 10-percent, margin. GAO believes that a 10-percent margin, which is consistent with FmHA's guaranteed farm loans, is needed to provide restructured borrowers with the ability to cover unforeseen expenses. USDA also offered some technical comments, which GAO considered in finalizing this report. USDA did not comment on the recommendations addressed to the Congress. USDA disagreed with GAO's view that the net recovery value buy-out option is available only to good faith borrowers. USDA's position is that the net recovery value buy-out authority of the act is separate from the restructuring authority and therefore net recovery value buy-out is not subject to the eligibility provisions of the act. GAO has not modified its position. GAO questions USDA's interpretation because the net recovery value buy-out authority is an integral part of the overall statutory scheme to provide benefits only to good faith borrowers and, in GAO's view, it is not a separate and distinct authority. Nevertheless, as stated in the report, GAO supports legislative action to ensure that borrowers who act in bad faith do not receive the act's benefits. USDA's comments and GAO's evaluation are discussed in chapters 3, 4, and 5.

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Figure 1.1 shows that FmHA past due loan payments grew steadily during the 1980s.¹

Figure 1.1: FmHA Past Due Payments as of June 30, 1980-89



Source: FmHA's Active Borrowers Delinquent Report (Report code 616) for each year

The increase in FmHA's delinquent loans can be attributed partly to the high risk farmers to whom FmHA loans money and to the stressed financial condition of agriculture during the 1980s. When the farm economy experienced a downturn in the early 1980s, FmHA continued to carry delinquent borrowers by using existing loan servicing policies, including subordination of FmHA loan security, debt set-asides and deferrals, and rescheduling loans at reduced or limited resource interest rates.

FmHA's loan-making policies, congressional directives, and judicial decisions during the 1980s also contributed to the increase in delinquencies. For example, FmHA's continuation policy between 1983 and 1985 kept farmers in business by extending additional credit to those who were unable to repay existing debt. FmHA rescinded the continuation policy in

¹FmHA reports loan delinquencies as only the total payments (principal and interest) that are past due rather than the total principal on which the payments are past due. The latter definition is used by other major institutional lenders to the nation's farmers.

for delinquent borrowers.² If a delinquent borrower does not qualify for restructuring, the act also provides for a mediation meeting between the borrower, FmHA, and the borrower's other creditors in a further attempt to develop a feasible restructuring plan.

Good faith borrowers who are unable to develop a feasible restructuring plan may be eligible to pay FmHA an amount equal to the net recovery value of collateral securing their loans, thereby ending their debt obligation to FmHA. FmHA takes into account the estimated costs of foreclosing, holding, and disposing of security property in determining net recovery value. The payment in many cases is substantially less than (1) the market value of property securing the FmHA debt or (2) the amount of total outstanding debt a borrower owes FmHA. The term "net recovery value buy-out" is used to describe this payment. FmHA writes off the difference between a borrower's total outstanding debt and the buy-out amount when a borrower makes this payment.

The act provides that FmHA recover part of a write-down or write-off under some circumstances. For example, under a shared appreciation agreement FmHA will recover part of a write-down from borrowers whose debt is restructured if within 10 years borrowers sell or otherwise convey the real property securing their loans, cease farming, or repay the debt. Likewise, under a recapture agreement FmHA will recover part of a write-off from borrowers who buy out their debt if within 2 years they sell their real property. However, the act does not provide for recovery when a borrower's loan security is chattel property.³

Borrowers whose loans are not restructured and those who do not buy out their debt at net recovery value are subject to foreclosure by FmHA on the collateral securing their loans. The Agricultural Credit Act and the Food Security Act of 1985 (P.L. 99-198, Dec. 23, 1985) provide that borrowers whose real property is foreclosed have an option of leasing or purchasing the property back from FmHA (referred to as leaseback/buyback). Also, borrowers are permitted to purchase their farm homesteads, including farm buildings and up to 10 acres of land (referred to

²It is also possible for a nondelinquent borrower experiencing financial stress to be eligible for all primary loan service programs, except debt write-down. Such borrowers, however, must be unable to pay their debt as scheduled before FmHA will use a primary loan service program.

³Chattel property, as opposed to real estate, is personal property used in farming operations for the production of income, including property such as trucks, tractors, and other major equipment.

instructions on how to apply for loan servicing. FmHA required borrowers to apply for servicing in writing within 45 days after receiving their notices. FmHA was to determine whether each borrower who returned a completed application qualified for servicing and to provide a written servicing offer within 60 days after receiving an application to each qualifying borrower.

FmHA designed its DALR\$ computer program to assist county offices in determining how borrowers could be serviced. The computer program compared the present value of borrowers' restructured loans with the net recovery value of the collateral securing the loans and determined the servicing option to be offered.

Borrowers who received restructuring or net recovery value buy-out offers had 45 days to accept the offers. However, borrowers who received buy-out offers could delay their decisions by (1) requesting mediation in a further attempt to develop a plan that would qualify them for restructuring, (2) appealing the FmHA decision that they did not qualify for restructuring, or (3) requesting an independent appraisal of their collateral.

When all efforts to develop a feasible financial plan for an FmHA borrower had been exhausted, and when borrowers did not buy out their loans at the net recovery value, FmHA was to notify them of its intent to "accelerate" the loans and foreclose on the collateral. When a loan is accelerated, it becomes due immediately. Acceleration is, in effect, the last step before foreclosure proceedings. However, prior to acceleration, borrowers could request:

- a meeting with FmHA to provide additional information concerning the servicing decision,
- an appeals hearing,
- an independent appraisal of the property securing the FmHA debt,
- a consideration for preservation loan service options, or
- the voluntary conveyance of their security property to FmHA and a debt settlement agreement.

Objectives, Scope, and Methodology

On September 22, 1988, the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry requested that we review FmHA's implementation of the debt servicing provisions of the Agricultural Credit Act of 1987. In doing so, we

office records and discussed with county office officials the status of an additional 627 borrowers in an attempt to determine these borrowers' reasons for not applying. We did not analyze records for 41 borrowers who had not completed the application process.

At the time of our review, county office staffs had determined that of the 569 applicants, 474 qualified and 87 did not qualify for servicing. Additionally, eligibility decisions and offers were pending for eight borrowers. To determine various financial characteristics of delinquent borrowers who were offered servicing, we reviewed county office records for 434 of the 474 qualified borrowers. In two county offices we did not analyze 40 qualified borrowers because they were in mediation or had declined FmHA's servicing offer. We included such borrowers in our analysis of debt servicing for the other eight county offices. For the 434 borrowers analyzed, we determined the amount of debt that was restructured without write-down, restructured with write-down, and written off with net recovery value buy-outs. We also determined the types and sizes of loans held by delinquent borrowers who qualified for servicing.

In analyzing FmHA's implementation of the act and the act's impact on borrowers, we determined (1) who was and who was not sent a servicing notification and application package, (2) whether application packages were received, (3) whether borrowers responded to the packages, (4) why borrowers did not respond, (5) which and how many borrowers requested servicing, (6) why borrowers did not request servicing, (7) whether FmHA's process or eligibility rules restricted borrower participation, (8) whether FmHA denied servicing to some borrowers and why, and (9) the type of servicing FmHA offered borrowers.

We made three other analyses in response to the Chairman's request for an assessment of the act's impact on FmHA borrowers. First, regarding delinquent borrowers to whom FmHA offered restructuring, we assessed whether the act restored their financial strength to a point at which they could potentially operate successful farms or ranches. Specifically, we compared projected annual cash flows and debt-to-asset ratios for restructured borrowers to financial indicators for successful farming operations used by USDA and FmHA. Further, we analyzed other data that could indicate ability to operate successful farms, including FmHA's loan restructuring and lending practices, and the opinions of FmHA borrowers and county and state office staffs.

In November 1989, we issued a fact sheet to the Chairman, Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition, and Forestry, entitled Farmers Home Administration: Loan Servicing Benefits for Bad Faith Borrowers (GAO/RCED-90-77FS, Nov. 29, 1989). The fact sheet provided information on delinquent borrowers who acted in bad faith and who had received benefits, or were considered eligible to receive benefits, under the provisions of the Agricultural Credit Act. The fact sheet was based on some of the information contained in chapter 4 of this report. In addition, we testified in March 1990 before the Subcommittee on Agricultural Credit, Senate Committee on Agriculture, Nutrition, and Forestry on the preliminary results of our work on this review.¹

On March 6, 1990, H.R. 4077, a bill to amend certain aspects of the Agricultural Credit Act, passed the House of Representatives and was referred to the Senate. This bill addresses various issues that are discussed in this report including limits on the number of times a borrower may have debt written down or written off, a good faith requirement to be eligible for net recovery value buy-out and preservation servicing, and consideration of unsecured assets in servicing decisions. As of June 28, 1990, the Senate had not passed a similar bill. However, various changes to the act are contained in the proposed 1990 Farm Bill which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

USDA's written comments on the results of our work are contained in appendix III. Various technical changes to the report were made on the basis of those comments.

¹Farmers Home Administration's Implementation of the Agricultural Credit Act of 1987 and Sales of Farm Inventory Property (GAO/T-RCED-90-38, Mar. 5, 1990)

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because of uncertainty about whether or not borrowers who had filed for Chapter 7 bankruptcy were eligible to apply. FmHA amended the guidance for bankrupt borrowers after county supervisors mailed notification packages in November 1988. However, county office staff told us they are still unclear about sending notification packages to borrowers in bankruptcy. Excluding the seven bankruptcy cases, the other borrowers who had been overlooked were furnished notification packages subsequent to our review.

In addition, an error in record keeping resulted in one of the county offices we reviewed offering debt restructuring with a substantial write-down to a borrower who was ineligible. In this instance, the county supervisor notified the borrower, who was not delinquent, of the act's servicing benefits, and the borrower applied for restructuring. The county office staff processed the borrower's application and offered to restructure his FmHA loans, including writing down \$201,181 of his \$329,026 FmHA debt. After we briefed the county supervisor on the error, he rescinded the offer before the borrower's debt was rewritten.

About Half of Notified Borrowers Applied

Nationally, about 50 percent of the 66,400 notified delinquent borrowers applied for loan servicing. At the county offices we reviewed, 45 percent of the 1,272 notified borrowers applied for servicing. Table 2.1 shows that 49 percent to 65 percent of the delinquent borrowers in nine of the county offices applied for servicing. In the tenth office, only 14 percent of the delinquent borrowers applied for servicing. Most of the 86 percent in this office who did not apply chose to negotiate a settlement of their FmHA debt or were inactive farmers with little or no remaining collateral.

Borrowers Chose Debt Settlement Rather Than Servicing

Some borrowers chose to apply for settlement of their FmHA debts rather than Agricultural Credit Act servicing. In the county offices we reviewed, 155 delinquent borrowers, or 22 percent of those who did not apply, requested debt settlement. Debt settlement is a negotiated agreement between a borrower and FmHA in which the borrower agrees to repay FmHA a specified amount to settle the outstanding debt.

FmHA state and county office officials told us that borrowers who requested debt settlement usually were no longer farming. According to one county supervisor, borrowers requested debt settlement because it eliminated the need to complete FmHA's application package. Also, he said debt settlement results were frequently comparable to servicing under the act.

Borrowers Chose to Pay Debts Current or in Full

Some borrowers chose to pay their FmHA loans current or to pay them off after receiving FmHA's notification package. In the county offices we reviewed, 67 delinquent borrowers, or about 10 percent of those who did not apply, chose to make a payment to FmHA rather than request servicing. We did not tabulate the total amount paid by these 67 borrowers.

Borrowers chose to pay their FmHA debts current or to pay them off for a variety of reasons. For example, one borrower told us she paid her debt current because FmHA's notification package reminded her that she was delinquent. Another borrower paid current because she had the money and was uncertain how she would benefit if serviced under the act. However, this borrower, who recently became delinquent again, told us she planned to apply for servicing when she received the next servicing notification because FmHA had reduced her neighbors' debt. According to one county supervisor, many borrowers at his county office who paid current had low-valued loans that were secured by high-valued assets. These delinquent borrowers paid when they realized FmHA would not reduce their debts.

Few Borrowers Confused by FmHA Application Process

Delinquent borrowers generally were not confused or overwhelmed by FmHA's application package. Only five borrowers, or 14 percent of the 35 we interviewed who did not apply for servicing, said that the package was confusing. One borrower said he was confused by the large notification and application package. He also said he had another job and did not have the time to study and complete the package nor the money to hire a lawyer to submit an application for him.

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Table 2.2: Borrowers Offered Loan Servicing Within 60 Days of Application in 10 FmHA County Offices

County	Total borrowers	Offers at 60 days	Percentage offered at 60 days
1	28	28	100.0
2	38	28	73.7
3	37	1	2.7
4	58	55	94.8
5	34	1	2.9
6	58	58	100.0
7	44	44	100.0
8	81	22	27.2
9	68	50	73.5
10	28	28	100.0
Total	474^a	315	66.5

^aServicing offers or eligibility determinations were pending for eight additional borrowers, and servicing was denied for 87 borrowers

Borrowers Did Not Apply on Schedule

Many FmHA delinquent borrowers in the county offices we reviewed did not complete applications within the 45-day time period specified by the act. For example, 143 of 450 borrowers, or about 32 percent, in eight of the county offices we reviewed did not complete their applications within the 45-day application period. The county supervisor in a ninth county told us none of his borrowers submitted complete applications within the 45-day period. According to the tenth county supervisor, while some applications were complete, most were incomplete.

In response to low application rates, complaints from farmer advocates, and congressional concerns, FmHA lengthened the application period by allowing borrowers to apply under a "good faith" rule of reason. Depending on the date that the county offices mailed notices, borrowers were originally allowed from about mid-November 1988 to mid-January 1989 to apply for servicing. FmHA's "good faith" rule extended the application period into March 1989.

Under FmHA's "good faith" policy, borrowers could submit four of nine required documents within the 45-day application period and complete the application during the FmHA 60-day processing period with county office assistance. In practice, however, 2 of the county offices accepted as a "good faith" application a simple oral or written statement from borrowers, within 45 days after being notified, that they wished to be serviced. At another county office, a signed farm and home plan was accepted as a "good faith" application. After receiving "good faith"

Although implementation problems delayed application processing and servicing decisions, borrower participation in servicing was not restricted. Despite the schedule delays, FmHA continued processing applications for servicing, and county supervisors told us they intended to process all applications for qualified borrowers regardless of the time schedule.

FmHA Offered Servicing to Most Borrowers Who Applied

The FmHA county offices we reviewed offered debt servicing to most borrowers who applied. The county offices offered servicing to 474 delinquent borrowers, or 83 percent of the 569 borrowers who applied for servicing. About 35 percent of the borrowers were offered restructuring, with and without debt write-down, and about 65 percent were offered net recovery value buy-out. Also, servicing offers or eligibility determinations were pending for eight additional borrowers, or less than 2 percent, at the time of our visits to the county offices. County staffs denied servicing for 87 borrowers, or 15 percent of those who applied, for a variety of reasons; the primary reason was that the borrowers submitted incomplete applications.

Servicing Offered Through June 30, 1989

Nationally, as of June 30, 1989, FmHA offered restructuring with debt write-down and buy-out with debt write-off to 7,509 borrowers. At that time, FmHA had not compiled national statistics showing the number of borrowers who were restructured without debt write-down. In January 1990, FmHA reported that, as of November 30, 1989, the number of serviced borrowers had increased to 9,637 borrowers—4,608 borrowers were offered restructuring with debt write-down and 5,029 borrowers were offered buy-out with debt write-off. An additional 9,599 borrowers were offered restructuring without debt write-down. Further, 6,341 borrowers received debt settlement rather than servicing under the act.

The county offices we reviewed, as of June 30, 1989, had made servicing offers to 474 of the 482 borrowers who qualified for servicing—166 borrowers, or 35 percent, received primary servicing and 308 borrowers, or 65 percent, received net recovery value buy-out offers. Five borrowers had servicing offers pending and three borrowers had eligibility determinations pending. Table 2.3 shows that, as of June 30, 1989, the county offices had completed servicing 191 borrowers, or about 40 percent of the qualified borrowers.

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farm operating loan. While 15 percent of the borrowers had only emergency loans, 24 percent did not have emergency loans. We did not compile summary data on loan size and type for serviced borrowers nationwide.

Borrowers Serviced Had Large, Moderate, and Small Amounts of FmHA Debt

Borrowers with all sizes of FmHA debt benefited from the act. As table 2.4 shows, in the county offices we reviewed FmHA offered restructuring or net recovery value buy-out to 19 borrowers, or 4 percent of the borrowers we reviewed, whose total FmHA debt before servicing exceeded \$1 million. One county office, for example, offered net recovery value buy-out to a borrower who owed FmHA more than \$4 million. Also, FmHA offered restructuring or net recovery value buy-out to 172 borrowers, or 40 percent of those we reviewed, whose total FmHA debt before servicing was in the \$250,000 to \$999,999 range, and to 243 borrowers, or 56 percent of those we reviewed, whose total FmHA debt before servicing was less than \$250,000.

Table 2.4: Borrowers by Range of Debt Prior to Loan Servicing in 10 FmHA County Offices

County	Total borrowers ^a	Range of debt (Dollars in thousands)						
		\$1 to 49	\$50 to 99	\$100 to 249	\$250 to 499	\$500 to 999	\$1,000 to 2,999	\$3,000 and over
1	28	0	3	12	13	0	0	0
2	38	7	8	8	11	4	0	0
3	37	1	4	10	11	6	4	1
4	58	6	5	20	19	8	0	0
5	34	2	4	9	13	6	0	0
6	29	1	3	14	7	2	1	1
7	33	3	4	13	12	1	0	0
8	81	16	14	10	17	14	9	1
9	68	9	11	25	18	4	1	0
10	28	1	4	16	6	0	1	0
Total	434	46	60	137	127	45	16	3

^aWe did not record debt prior to servicing for 29 and 11 eligible borrowers in counties 6 and 7, respectively, who had declined FmHA's servicing offer or were in mediation. We included such borrowers in our compilations for the other counties. We also did not record information for the eight borrowers in four counties who had not received offers.

Borrowers Serviced Had a Variety of FmHA Loan Types

FmHA offered restructuring or net recovery value buy-out to delinquent borrowers with most types of farmer program loans, including farm operating, farm ownership, natural disaster emergency, economic emergency, and soil and water loans. Also, some serviced borrowers had

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Table 2.5: Borrowers by Type of Loans in 10 FmHA County Offices

County	Total borrowers ^a	Borrowers with no emergency loans		Borrowers with only emergency loans		Borrowers with a combination of loans	
		Number	Percent of total	Number	Percent of total	Number	Percent of total
1	28	4	14.3	6	21.4	18	64.3
2	38	8	21.1	8	21.1	22	57.9
3	37	4	10.8	7	18.9	26	70.3
4	58	17	29.3	15	25.9	26	44.8
5	34	12	35.3	3	8.8	19	55.9
6	29	7	24.1	3	10.3	19	65.5
7	33	14	42.4	2	6.1	17	51.5
8	81	18	22.2	12	14.8	51	63.0
9	68	20	29.4	4	5.9	44	64.7
10	28	2	7.1	4	14.3	22	78.6
Total	434	106	24.4	64	14.7	264	60.8

^aWe did not determine loan type for 29 and 11 eligible borrowers in counties 6 and 7, respectively, who had declined FmHA's servicing offer or were in mediation. We included such borrowers in our compilation for the other counties. We also did not record information for the eight borrowers in four counties who had not received offers.

Borrowers Received Loan Servicing at Substantial Cost to FmHA

In March 1988, FmHA estimated that debt forgiveness for delinquent borrowers through write-downs and write-offs would total about \$9.4 billion. This estimate excluded any potential future recovery through recapture agreements. Nationally, as of June 30, 1989, FmHA had approved write-downs or write-offs that total almost \$1.4 billion. In January 1990, FmHA reported that, as of November 30, 1989, approved debt forgiveness had increased to a total of almost \$1.8 billion. In addition, another \$933 million in write-offs resulted from FmHA's debt settlement activities.

By June 30, 1989, the FmHA county offices we reviewed had offered to write down or write off over \$91 million of the \$126 million owed by 350 delinquent borrowers. FmHA also offered restructuring without write-down to an additional 84 borrowers who owed FmHA almost \$13 million. The debt forgiveness received by the 350 borrowers represents about two-thirds of the total debt owed FmHA by the 434 borrowers offered restructuring or net recovery value buy-out that we reviewed. FmHA will incur additional losses on some restructured loans because of restructuring features such as interest rate reductions and term extensions. However, we did not calculate the additional losses associated with restructured loans.

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Table 2.7: Borrowers by Range of Write-Downs and Write-Offs in 10 FmHA County Offices

County	Total borrowers ^a	Range of debt reduction (Dollars in thousands)						
		\$1 to 49	\$50 to 99	\$100 to 249	\$250 to 499	\$500 to 999	\$1,000 to 2,999	\$3,000 and over
1	26	1	6	10	9	0	0	0
2	18	3	4	7	4	0	0	0
3	30	2	4	8	8	4	3	1
4	50	11	12	14	11	2	0	0
5	25	2	2	6	12	3	0	0
6	23	1	6	12	1	2	1	0
7	30	6	6	13	5	0	0	0
8	66	17	8	10	13	14	4	0
9	67	12	12	27	12	3	1	0
10	15	3	3	8	0	1	0	0
Total	350	58	63	115	75	29	9	1

^aWe did not compile servicing information for 29 and 11 eligible borrowers in counties 6 and 7, respectively, who had declined FmHA's servicing offer or were in mediation. We included such borrowers in our compilations for the other counties. We also did not record information for the eight borrowers in four counties who had not received offers.

Examples of Serviced Borrowers

The following case studies illustrate borrowers serviced under the Agricultural Credit Act. The cases cannot be projected to the county offices or the states we reviewed, or to the nation overall.

Borrower A: A soybean and wheat farmer bought out his \$29,000 FmHA debt for the \$4,726 net recovery value of his collateral. The borrower had four outstanding FmHA loans: a farm ownership loan, a natural disaster emergency loan, and two farm operating loans. The borrower had not made a loan payment on any of the four FmHA loans since May 1984.

Borrower B: A dairy farmer, who owed FmHA over \$489,000, had his debt restructured with rescheduling, reamortization, and a write-down of over \$256,000. The borrower had two farm ownership and three farm operating loans. The borrower became delinquent when his cattle herd developed a contagious disease, which forced him to dispose of them and go out of business for two months. FmHA county office staff characterized the borrower as a "good, hard-working dairy farmer." Nevertheless, they told us the borrower probably would become delinquent on the restructured debt.

Borrower C: This farmer had been borrowing from FmHA for 13 years. He is a peanut, soybean, corn, and hog farmer, who owes FmHA about

Chapter 2
Implementing the Agricultural Credit Act
Resulted in Many Delinquent Borrowers' Not
Being Serviced and Substantial Costs for
the Government

servicing, full payment on one \$44,000 emergency loan was due and FmHA had deferred payments on a \$17,000 emergency loan. The borrower had made no payments on any of his debts. As a result of restructuring, the borrower's \$42,000 annual loan payment was reduced to \$24,000.

classifies farm operations with positive cash flow margins into two income/solvency categories:²

- Favorable farm operations have a positive net cash income and a debt-to-asset ratio of 40 percent or less.
- Marginal solvency farm operations have a positive net cash income but a debt-to-asset ratio above 40 percent.

In addition, ERS considers farm operations with a debt-to-asset ratio greater than 100 percent to be technically insolvent because the sale of farm assets, if required, would be insufficient to retire the debt.

Few Borrowers Financially Sound After Restructuring

On the basis of USDA's criteria, most borrowers who received debt restructuring offers in the county offices we reviewed will still be financially weak even after their debt is serviced. Financial data for borrowers whose debt FmHA offered to restructure indicated that only 9 percent had favorable financial potential for successful farming operations. Financial data indicated that the remaining 91 percent had limited potential for successful farming operations without continued FmHA financial assistance—additional loans and restructuring.

FmHA stopped analyzing a borrower's restructuring options as soon as a positive cash flow was reached. This approach minimized the government's losses but is a primary reason many borrowers had very low cash flow margins following restructuring. Additionally, FmHA based its restructuring decision on a borrower's projections of income and expenses, and such projections may not accurately reflect financial conditions. FmHA state and county officials expressed concerns about the ability of some restructured borrowers to continue farming operations without continued FmHA financial support. Some restructured borrowers expressed concern about their ability to repay their restructured debt and to continue farming without additional FmHA financial assistance.

Restructured Borrowers Had High Debt-To-Asset Ratios

Few of the 160 restructured borrowers in the county offices we reviewed had debt-to-asset ratios indicating favorable farming operations. Only six restructured borrowers in the county offices we reviewed had positive cash flows and debt-to-asset ratios of 40 percent or less,

²ERS classifies farms with negative net cash income into two income/solvency categories. We have not included those categories in this report since a borrower must show a positive cash flow to qualify for restructuring under the act.

**Chapter 3
Restructured Borrowers Financially Weak
After Servicing**

Additionally, table 3.2 shows that the 160 restructured borrowers had average assets and FmHA debts of \$229,128 and \$229,322, respectively, for an average net worth of negative \$194 and an average debt-to-asset ratio of 100.1 percent.

Table 3.2: Average Financial Data for Restructured Borrowers by Income/Solvency Category in 10 FmHA County Offices

Income/ solvency category	Assets	Before servicing			Debt write- down	After servicing		
		FmHA debt	D/A ratio	Net worth		FmHA debt	D/A ratio	Net worth
Favorable ^a	\$221,275	\$106,600	48.2%	\$114,675	\$54,146	\$52,454	23.7%	\$168,821
Marginal ^b	\$284,775	\$285,313	100.2%	\$(538)	\$69,030	\$216,282	75.9%	\$68,493
Marginal ^c	\$176,895	\$341,903	193.3%	\$(165,008)	\$86,461	\$255,135	144.2%	\$(78,240)
Overall average ^d	\$229,128	\$306,553	133.8%	\$(77,424)	\$77,079	\$229,322	100.1%	\$(194)

^aAverage for 6 borrowers who had a debt-to-asset ratio of 40 percent or less after servicing

^bAverage for 75 borrowers who had a debt-to-asset ratio between 41 and 100 percent after servicing

^cAverage for 79 borrowers who had a debt-to-asset ratio greater than 100 percent after servicing. Also, debt before servicing less write-down does not equal debt after servicing because one borrower in this category made a payment to FmHA during the servicing process.

^dAverage for 160 borrowers after servicing. Excludes one borrower whose financial data was not available at the time of our review and five borrowers who did not accept restructuring offers. Also, debt before servicing less write-down does not equal debt after servicing because one borrower made a payment to FmHA during the servicing process.

**Restructured Borrowers
Had Low Cash Flow
Margins**

Implementing regulations for the act required FmHA to restructure delinquent borrowers' loans until borrowers were able to project a feasible plan of operations for the upcoming year. In designing the DALR\$ computer program for determining servicing entitlement, FmHA considered that a feasible plan existed when a positive cash flow was reached, even if the positive cash flow was as small as one dollar. Also, the restructuring analysis excluded consideration for unplanned expenses, equipment replacements, and new investments.

Such a small cash flow margin equals the one FmHA requires for its direct farm loans, but it is substantially less than the margin FmHA requires on farm loans made by private lenders that are guaranteed by FmHA. In a 1989 report on FmHA's loan-making policies, we recommended the need for a reserve requirement in FmHA's direct farm loans.³ FmHA's guaranteed farm loan regulations require borrowers to have cash flow margins that meet or exceed all anticipated farm and family living expenses, plus

³Farmers Home Administration. *Souder Loans Would Require Revised Loan-Making Criteria* (GAO/RCED-89-9, Feb. 14, 1989)

example, when a borrower has a yearly cash flow of \$100 or less, unexpected expenses, such as equipment failure, could quickly deplete cash reserves.

Borrowers' Projections May Represent Unrealistic Cash Flow Estimates

FmHA based its restructuring decisions on borrowers' projections of income and expenses, and such projections may not always accurately reflect borrowers' farming activity and financial conditions. For example, five county supervisors told us they generally accepted a borrower's estimates of farm operating and family living expenses unless the estimates deviated significantly from the borrower's previous five-year history. Also, borrowers' reports on the amount of land they would farm need not be based on the amount they own or have previously farmed. Further, county supervisors did not verify that borrowers reported all assets and debts.

County and state FmHA staffs told us that borrowers could manipulate the financial data, such as income and expenses, for input into the DALRS computer program in order to influence servicing outcomes. For example, five county supervisors said that borrowers who want to qualify for restructuring could provide farm and home plans showing operating expenses that are less than projected farm income. The DALRS computer program would then show a positive cash flow, which qualifies borrowers for restructuring. Likewise, they said that if borrowers wanted to buy out their debt at the net recovery value of collateral, they could design their farm and home plans to show that they were farming a small amount of available land and generating income that was less than expenses. The DALRS computer program would then show a negative cash flow, which qualifies borrowers for buy-out. However, borrowers may not get the servicing they seek if county supervisors determine that inaccurate or unrealistic information has been submitted. FmHA guidance provides for county offices to determine whether income and expense information submitted by borrowers is realistic.

The February 1989 GAO report on FmHA's loan-making policies showed that borrowers often included unrealistic income and expense projections in their farm and home plans. This practice results in overstating borrowers' cash flow positions and financial strengths. A farm and home plan is the basic financial statement provided to FmHA by borrowers when they request new or additional loans and loan servicing. We did not validate farm and home plan projections for borrowers who were restructured under the Agricultural Credit Act since we had previously reported on problems with their validity, and USDA's Office of

Restructured Borrowers Can Obtain Additional Loans and Restructuring

The Agricultural Credit Act does not preclude borrowers from obtaining additional loans at the same time their delinquent debt is being restructured. We found that borrowers had taken advantage of this possibility by requesting and obtaining new funds at the same time their delinquent debt was being restructured. In addition, restructured borrowers who become delinquent again are eligible for repeated loan servicing. Under the act, the future creditworthiness of a borrower whose loans are restructured is to be determined without regard to the restructuring.

Borrowers Obtained New FmHA Loans at Same Time Delinquent Debt Was Being Restructured

Over 14 percent of the 569 borrowers applying for servicing in the county offices we reviewed requested additional FmHA loans when they applied for servicing. The county offices considered delinquent borrowers to be eligible for additional loans if they qualified for restructuring. The following example illustrates one borrower who received approval for additional FmHA loan money at the same time FmHA was restructuring his prior delinquent loan.

Example C: FMHA offered to restructure a delinquent borrower's \$85,000 debt with a \$75,000 write-down. At the same time, the county supervisor approved the borrower's request for a \$48,300 operating loan. The county supervisor noted in his request for the state director's approval that while the borrower had submitted a marginal farming proposal for the \$48,300 loan, he believed the borrower could pay the loan because the borrower and his wife were personable and industrious.

Act Allows Repeated Loan Servicing

The Agricultural Credit Act does not preclude borrowers from returning to FmHA for additional loan servicing in the future. For example, restructured borrowers may farm a year or longer, become delinquent on their FmHA restructured loans, and then request additional loan servicing. At that time, borrowers could qualify for additional restructuring, with or without debt write-down, or net recovery value buy-out with debt write-off. Borrowers whose debts are restructured may continue to be restructured an unlimited number of times as long as they remain in FmHA's portfolio.

FmHA regulations require county supervisors to keep borrowers technically current by using any of the primary servicing options, except debt write-down, as soon as they become 30 days past due on a loan payment. While these actions will keep borrowers technically current on their loan payments for a period of time, unpaid interest could continue

lender of last resort” for the nation’s high risk farm borrowers. We expect such borrowers to request additional direct loans and loan servicing from FmHA in the future. The Agricultural Credit Act does not preclude this from happening again and again in the future. In fact, the act provides that the future creditworthiness of a borrower whose loans are restructured is to be determined without regard to the restructuring. Thus, these borrowers, and FmHA, are likely to continue on what we have referred to in past reports as a loan-making and loan-servicing treadmill.

Recent Congressional Initiatives

On March 6, 1990, the House of Representatives passed and referred to the Senate H.R. 4077 which would, in addition to doing other things, (1) limit a borrower to one write-down or write-off, (2) limit a borrower to no more than a \$250,000 write-down or write-off, and (3) preclude a write-down or write-off on loans made on or after January 6, 1988. We agree with these amendments to the Agricultural Credit Act. Also, we recognize that limiting the write-down amount will preclude some borrowers from qualifying for restructuring. For example, 20 of the 77 borrowers who qualified for restructuring with a debt write-down at the county offices we reviewed had write-downs that exceeded \$250,000. These borrowers may not have qualified for restructuring if the servicing consideration stopped with a \$250,000 write-down. All 20 of these borrowers were in a weak financial condition after servicing: their cash flow margins ranged from \$2 to \$25. As of June 28, 1990, the Senate had not passed a bill similar to H.R. 4077. However, various changes to the act are contained in the proposed 1990 Farm Bill, which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

Recommendation to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the FmHA Administrator to revise existing regulations implementing the debt restructuring provisions of the Agricultural Credit Act to provide restructured borrowers with a 10-percent cash flow margin after servicing. This margin should provide restructured borrowers with the minimum ability to meet unplanned expenses and equipment replacements.

Recommendation to the Congress

In order to (1) improve the quality of loans in FmHA’s farmer loan program portfolio and the results of FmHA’s debt servicing actions, (2) prevent FmHA’s borrowers from repeatedly obtaining debt relief, (3) promote fiscal accountability by FmHA’s borrowers, and (4) limit the amount of debt relief provided to borrowers who receive primary loan

Changes Needed to Preclude and Limit Benefits for Certain Delinquent Borrowers

USDA has interpreted the Agricultural Credit Act as requiring that bad faith borrowers—those whose delinquency was due to circumstances within their control or who did not act in good faith in connection with the terms of their FmHA loan agreements—be allowed to buy out at the net recovery value of their collateral and receive substantial debt write-offs. The basis for USDA's interpretation of the act is not apparent. We believe present law does not require that bad faith borrowers receive net recovery value buy-out. In our view, the net recovery value buy-out option is available only to good faith borrowers—those whose delinquency was due to circumstances beyond their control and who acted in good faith in connection with the terms of their FmHA loans.

Also, the act permits some benefits for delinquent borrowers that are not in the government's or taxpayers' best interest. First, present law does not limit preservation benefits to only good faith borrowers. As a result, bad faith borrowers may reacquire their farms or farm homesteads under preservation servicing options if FmHA forecloses on their farm properties. Second, the act permits FmHA county supervisors to offer restructuring without considering borrowers' unsecured assets, which could be used to reduce the amount of debt relief. Also, the act does not allow FmHA to include such assets in computing the net recovery value buy-out amount. Excluding unsecured assets increases the amount of debt relief and thus reduces the government's recovery when borrowers' loans are restructured with debt write-down or bought out at the net recovery value of collateral.

In March 1990, the House of Representatives passed and referred to the Senate a bill which would, in addition to doing other things, require borrowers to act in good faith to be eligible for net recovery value buy-out and to reacquire their farms through preservation servicing, and allow FmHA to consider a borrower's assets in its servicing decisions. As of June 28, 1990, the Senate had not passed a similar bill. However, various changes to the act are contained in the proposed 1990 Farm Bill, which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

in process of referring 66 other borrowers to USDA's Office of General Counsel for a bad faith opinion.

The FmHA supervisor at one of the county offices we reviewed told us he had determined borrowers eligible for servicing even though he believed they had acted in bad faith. This supervisor identified 15 borrowers to whom he did not attempt to deny servicing although he believed they had acted in bad faith. Eleven of these 15 borrowers qualified for net recovery value buy-out, and three qualified for restructuring. The remaining borrower did not apply for servicing. The county supervisor did not attempt to obtain a USDA Office of General Counsel opinion to deny primary servicing to the 14 borrowers who applied. Instead, he serviced the borrowers as if no potential bad faith activity had been observed. The supervisor serviced the 14 borrowers because he believed they could not project a positive cash flow, and they would have received net recovery value buy-out offers even if a formal Office of General Counsel opinion showing bad faith had been obtained.

Another FmHA supervisor at one of the county offices we reviewed considered borrowers to have acted in bad faith if they (1) disposed of security property without FmHA approval; (2) repaid other lenders more than required while becoming delinquent on FmHA loans; (3) abandoned property securing FmHA loans; or (4) had resources available that could have been, but were not, used to make FmHA loan payments. This supervisor had offered, or was in process of offering net recovery value buy-out to 6 of 13 bad faith borrowers. The remaining seven borrowers would have been offered primary servicing but were disqualified because of their bad faith actions. These seven borrowers will be eligible for preservation servicing if FmHA forecloses on their property.

FmHA uses the same servicing process for borrowers who act in bad faith that it uses for other borrowers in determining eligibility for restructuring and net recovery value buy-out options. When a county supervisor determines that a borrower is not eligible for loan restructuring because the borrower acted in bad faith, the DALR\$ computer program is used to analyze the borrower's application. Net recovery value buy-out is offered after FmHA state office approval, even though a borrower has acted in bad faith, when the DALR\$ program shows the borrower does not qualify for restructuring. Conversely, buy-out is not offered when the DALR\$ program shows the borrower would have qualified for restructuring. In this case, the collateral securing the loans is subject to foreclosure by FmHA.

According to the DALRS printout, this borrower owed FmHA \$625,952 in outstanding principal and unpaid interest. The debt covered six natural disaster emergency loans and two farm operating loans, valued at \$602,560 and \$23,392, respectively. The net recovery value was \$87,277. In addition, the appeals officer decided that the borrower was also required to pay FmHA \$30,000 for the value of other property not accounted for in the appraisal of loan security. The total buy-out amount, which included real estate and chattels, was \$117,277. The borrower will receive a \$508,675 write-off if he pays the buy-out amount.

This borrower will be eligible for preservation benefits if he does not pay the buy-out amount and FmHA forecloses on his property. The market value of his 311-acre farm, which could be acquired through the leaseback/buyback option, is \$44,000.

Example B: The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us the borrower had previously applied to FmHA for loans to buy additional land and equipment. The county office did not approve the applications and advised the borrower that the equipment was excessive to his needs. For example, the county office determined that the equipment purchases resulted in the borrower having \$268 per acre worth of equipment, while the state average was \$50 per acre. Subsequently, the borrower made the purchases with loans from other lenders. The borrower repaid the other lenders, including making advance principal payments; however, he became delinquent on his FmHA debt.

The borrower appealed the county office's decision. An appeals officer decided that while the borrower was ineligible for restructuring because of his excessive machinery purchases, he was eligible for net recovery value buy-out since he did not have a feasible plan of operations, including a positive cash flow, and the net recovery value exceeded the present value of the restructured loans when the county office ran the DALRS computer program. At the time of our review, the borrower had not responded to the county office's net recovery value buy-out offer.

According to the DALRS printout, this borrower owed FmHA \$186,616 in outstanding principal and unpaid interest. The debt covered four natural disaster emergency loans and two farm ownership loans, valued at \$117,716 and \$68,900, respectively. The net recovery value, which covers real estate, was \$134,815. The borrower will receive a \$51,801 write-off if he pays the buy-out amount.

showed he had \$91,284 in his checking account when he applied for restructuring. At that time, he was \$76,269 past due on his scheduled FmHA payments. Also, the borrower may have converted some FmHA security property. A letter in the county office files states that the borrower sold cattle, which was security for an FmHA loan, without county office approval and did not pay any of the sales proceeds to FmHA.

The county office determined that this borrower was not eligible for net recovery value buy-out since the DALR\$ computer program showed he would have had a feasible plan of operations with restructuring. The borrower would have been offered restructuring if he had not caused the delinquency. He was not eligible for net recovery value buy-out because he qualified for restructuring. The borrower appealed the county office's decision: an appeals officer upheld the county office's decision.

According to the DALR\$ printout, this borrower owed FmHA \$348,223 in outstanding principal and unpaid interest. The debt covered two farm ownership loans (totaling \$69,631), one farm operating loan (\$242,742), and one natural disaster emergency loan (\$35,850). He will be eligible for preservation servicing consideration if FmHA forecloses on his property. The market value of his 1,163-acre farm, which he could reacquire through the leaseback/buyback option, is \$151,000. A prior lien of \$9,000 exists on the borrower's farm real estate.

Assets Not Securing FmHA Debt Are Not Considered in Servicing Decisions

FmHA county supervisors did not include assets that were not pledged as security for FmHA debts when computing the type and amount of debt relief for delinquent borrowers. The act permits FmHA county supervisors to offer restructuring without considering borrowers' unsecured assets which could be used to reduce the amount of debt relief. However, the act does not allow FmHA to include such assets in computing the net recovery value buy-out amount. Excluding unsecured assets increases the amount of debt relief and thus reduces the government's recovery when borrowers' loans are restructured with debt write-down or bought out at the net recovery value of collateral. At the county offices we reviewed, we identified two borrowers to whom FmHA offered net recovery value buy-out without considering their unsecured farm and nonfarm assets when calculating the buy-out amounts. In both instances, the borrowers had reported their unsecured assets to FmHA. In addition, some borrowers had not identified all assets in their servicing application.

those assets. In determining servicing options and the resulting write-off amount, FmHA's county office did not consider unsecured assets of \$21,000 in cash and 19 acres of land that the borrower had reported in his servicing application. Subsequently, the borrower paid FmHA the \$72,405 net recovery value buy-out amount to settle his \$166,000 outstanding debt and received a \$93,595 debt write-off.

FmHA would have saved at least \$21,000 if it could have applied the cash to reduce the borrower's debt in processing his servicing application. The borrower would still have qualified for net recovery value buy-out, but the government's loss would have been less. Also, FmHA might have realized additional savings if it could have considered the value of the borrower's 19 acres of unsecured land.

Borrower F: This borrower reported unsecured assets that FmHA did not consider in processing his servicing application. The amount of debt that FmHA wrote off would have been less if FmHA could have considered those assets. In determining servicing options and the resulting write-off amount, FmHA's county office did not consider unsecured land that the borrower had reported in his servicing application. Subsequently, the borrower paid FmHA the \$83,714 net recovery value buy-out amount to settle his \$580,706 outstanding debt. As a result, he received a debt write-off of about \$500,000.

The borrower reported to FmHA that he owned 683 acres of land. County office records showed FmHA had liens on 400 acres of this land. FmHA might have realized a savings if it could have considered the value of the borrower's remaining 283 acres of unsecured land when computing the debt write-off.

In addition, FmHA county office staff told us this borrower had sold an unknown amount of land to a trust and then rented 1,000 acres back from the trust. The borrower did not use proceeds from the sale to pay his FmHA debt. According to a USDA Office of General Counsel regional attorney, the borrower apparently was trying to conceal assets from FmHA in the trust.

Conclusions

Some loan servicing under the Agricultural Credit Act, such as writing off substantial amounts of debt for borrowers who acted in bad faith and not considering the value of unsecured assets in servicing decisions, are not in the government's or taxpayers' best interest. According to USDA, the Agricultural Credit Act provided FmHA no alternative but to

also believe that (1) there should be a good faith requirement for a borrower to reacquire the farm homestead through preservation servicing and (2) FmHA needs to take into consideration all assets of a borrower in determining the net recovery value buy-out amount. As of June 28, 1990, the Senate had not passed a bill similar to H.R. 4077. However, various changes to the act are contained in the proposed 1990 Farm Bill, which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

Recommendations to the Congress

To make it clear that bad faith borrowers cannot receive debt relief benefits and to discourage other borrowers from acting in bad faith, we recommend that the Congress amend the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988). This can be done by enacting provisions similar to sections 2 and 5 of H.R. 4077 which require borrowers to act in good faith to be eligible to reacquire their farms through preservation servicing and to be eligible for net recovery value buy-out. Also, we recommend that the Congress amend the Agricultural Credit Act to require borrowers to act in good faith to be eligible to reacquire their farm homestead through preservation servicing. This can be done by adding the following new paragraph "(g)" to 7 U.S.C. 2000 (c)(1) and redesignating existing paragraph "(g)" to "(h)":

"(g) have acted in good faith, as defined in regulations issued by the Secretary, in connection with the loan of such borrower-owner for which such property served as security."

To provide FmHA with authority to consider all assets of delinquent borrowers under consideration for debt reduction and to reduce the cost of debt write-downs and write-offs, we recommend that the Congress amend the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988). This can be done by enacting a provision similar to section 4 of H.R. 4077, which allows FmHA to consider all assets of a borrower, other than those necessary for family living or farm operating expenses, in determining the value of restructured loans. Also, we recommend that the Congress amend the Agricultural Credit Act to allow FmHA to take into consideration all assets of a borrower in determining the net recovery value buy-out amount. This can be done by amending 7 U.S.C. 2001 (c)(6) by inserting after the phrase "an amount equal to the recovery value" the following:

"plus any other amount the Secretary determines based on consideration of the borrower's other unsecured assets, . . ."

Agricultural Credit Act May Encourage Loan Defaults by Solvent Borrowers

Under the Agricultural Credit Act some delinquent borrowers received debt reduction that borrowers who kept their loans current are not eligible to receive. This has raised equity questions, and, in fact, some current borrowers told us they were considering becoming delinquent on their FmHA loans so as to qualify for debt relief, but it is too early to tell if they will actually do so.¹ Borrowers who intentionally become delinquent may not get the benefits of the act they seek because their actions may disqualify them from the primary loan servicing and net recovery value buy-out options. However, county supervisors may be unable to deny debt servicing to such borrowers because of difficulties in concluding that borrowers caused their own delinquencies.

Cost of Farming Reduced for Serviced Borrowers

The act, through various debt relief options such as restructuring with write-down and net recovery value buy-out with write-off, decreased the cost of farming for delinquent borrowers by reducing or eliminating their loan payments. Nondelinquent borrowers, on the other hand, could not obtain similar reductions in their expenses. They had to continue to make their loan payments even though they lived in the same community and faced the same general farming conditions as delinquent borrowers. Such conditions can include a depressed farm economy, adverse weather, and decreased real estate values.

The following examples show how FmHA's restructuring and net recovery value buy-out actions reduced or excused payments for some borrowers.

Example A: A borrower who was current on his \$330,552 FmHA debt had an annual payment of \$161,641, including \$142,000 owed at year-end on a farm operating loan. A delinquent borrower in the same community had a similar FmHA debt of about \$332,228, with an annual payment of about \$20,053. The delinquent borrower, who had not made any payments on three of his four loans, was \$24,595 behind in payments. FmHA restructured the delinquent borrower's debts by reamortizing payments, lowering interest rates, and writing down \$152,641. Through restructuring, FmHA reduced the delinquent borrower's FmHA debt to \$179,647 and his annual payment to \$11,095.

¹As mentioned in ch 1, nondelinquent borrowers experiencing financial stress may be eligible for all primary loan service programs, except debt write-down. Such borrowers, however, must be unable to pay their debt as scheduled before FmHA will use a primary loan service program.

FmHA Nondelinquent Borrowers Question Equity of the Agricultural Credit Act

Most borrowers that we interviewed who were current on their FmHA loan payments—18 of 30 current borrowers at the county offices we reviewed—questioned the equity of the Agricultural Credit Act. Some current borrowers expressed concern that certain borrowers who had mismanaged their farming operation had their debt reduced, while other borrowers who struggled in order to make their loan payments received no debt relief. Some current borrowers who said their debts should have also been reduced told us they were looking for ways to become delinquent so they could qualify for a reduction of their FmHA debt. Also, several county office staff members told us that although borrowers in their communities farmed under similar economic and climatic conditions, some paid their FmHA debt while others did not.

Similar Farming Conditions

Delinquent and nondelinquent borrowers in the same community operate under similar economic and climatic conditions. However, while one borrower may have been able to pay his FmHA debt, another may have become delinquent for a variety of reasons, including ineffective or expensive farming and management techniques. For example, some current borrowers told us they farmed the land themselves and bought used equipment, while some delinquent borrowers in the same area paid others to farm their land or bought new equipment.

The following example shows that one borrower repaid his commercial debt, while another borrower in the same community became delinquent on his FmHA debt.

Example D: One borrower told us he and his neighbor bought a parcel of farmland and divided it in half. This borrower obtained his loan from a commercial lender while his neighbor obtained an FmHA loan. The commercial borrower farmed his half of the land himself and repaid his commercial loan. However, the neighbor, he told us, hired someone to farm the other half of the land, bought a boat, and became delinquent on the FmHA loan. FmHA's county office records showed the FmHA delinquent borrower had a \$477,396 outstanding balance on his FmHA loans when he applied for servicing, including \$40,245 on the farm ownership loan that he obtained to purchase the land. Subsequently, FmHA offered to write off the delinquent borrower's debt to the \$164,242 net recovery value of collateral. The delinquent borrower will receive a \$313,154 debt write-off if he pays the buy-out amount.

The borrower told us he has been searching for a way to qualify for restructuring or net recovery value buy-out. The county supervisor did not provide such servicing because the borrower had been current on his FmHA loan payments.

The borrower told us he would become delinquent except that it would make him ineligible for an FmHA guaranteed farm operating loan. He said that he would probably become delinquent on his FmHA direct loans if he could farm without a 1990 guaranteed loan. He hoped to generate sufficient income from his 1989 farm operation to finance his 1990 farm operation without a guaranteed loan.

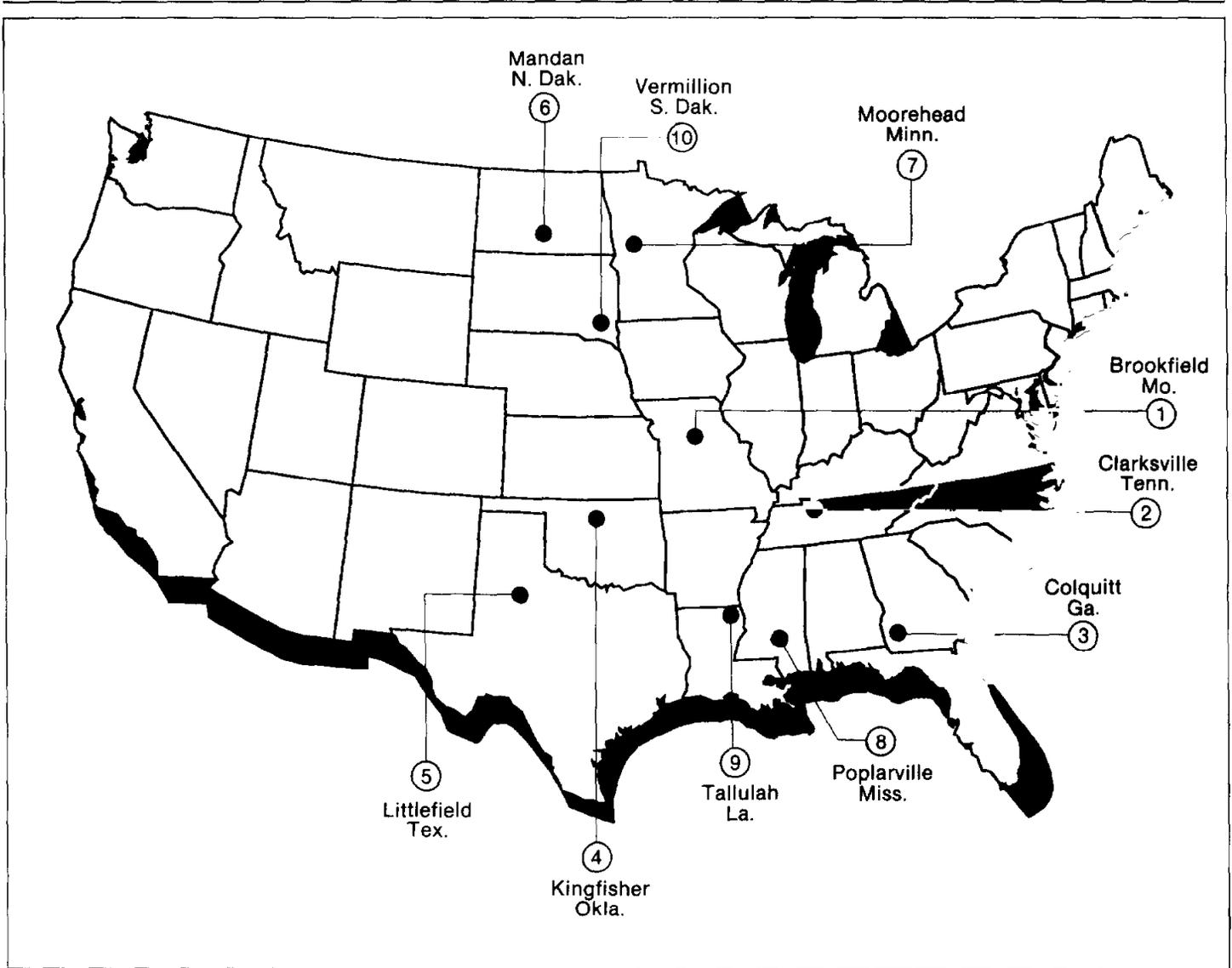
Example F: A peanut, corn, wheat, and soybean farmer who has participated in FmHA loan programs for over 12 years repaid 14 FmHA loans and as of November 1988 was current on his three remaining loans. These loans had an outstanding balance of \$62,043. The borrower told us he had informed the county supervisor that he would not make his 1989 annual payment until late in 1989. The county supervisor offered to reschedule the borrower's payment. However, the borrower said he still would not make the payment because he wanted to become delinquent so he could qualify for restructuring with a debt write-down.

Example G: A soybean, corn, and wheat farmer who has participated in FmHA loan programs for 10 years was current on his two remaining loans as of November 1988. These two loans had an outstanding balance of \$142,004. The borrower told us he could continue paying his debt on schedule, but he intended to become delinquent so that he could apply for debt relief under the act. He expected a large wheat harvest in 1989, but rather than use the proceeds from the wheat sale to make his FmHA payment he was going to use the proceeds to finance his 1990 farming operation. County office records showed that this borrower became delinquent in January 1989, and FmHA provided him a notice of servicing availability in August 1989.

Conclusions

The Agricultural Credit Act provided an opportunity for delinquent borrowers to receive debt reductions. Because loan payments were reduced or eliminated for some delinquent borrowers, the cost of farming for them is less than that for FmHA borrowers who made their loan payments. As a result, some current borrowers perceive themselves as penalized for paying their debt, and some of those we interviewed expressed plans to default on their loans so they could qualify for future debt relief under the act.

FmHA County Offices Reviewed by GAO



Appendix III
Comments From the Under Secretary for
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deferral relief. See Coleman v. Block, 580 F. Supp. 194, 211 (D.N.D. 1984) and United States v. Hamrick, 713 F.2d 69 (4th Cir. 1983). Moreover, we understand that GAO has testified before the Senate Agriculture Committee's Credit Subcommittee that their own counsel agree with this view. Also, the assertion on page 39 that certain borrowers did not qualify for net recovery buy-out because they acted in bad faith seems inconsistent with the report's primary assertion that bad faith borrowers do qualify for net recovery buy-out.

(D) On pages 20 and 21 the report asserts that after acceleration the borrower can request a meeting, an appeals hearing, an independent appraisal, consideration of preservation loan servicing and a voluntary assignment. In accordance with FmHA regulations these procedures occur prior to acceleration. Also, on page 21 the report states that borrowers can request a voluntary assignment of their security property to FmHA. We assume this means that borrowers may request to voluntarily convey their property to FmHA. FmHA accepts voluntary assignments as a method of paying loans, in particular dairy assignments, and assignments of agricultural program benefits. However, the context of the statement in the report suggests the writer mean a voluntary conveyance of FmHA real estate security.

(E) On page 39 the report appears to limit preservation loan servicing options to situations where FmHA forecloses on collateral. FmHA has an additional program whereby borrowers may enter into a preacquisition contract with FmHA to receive preservation loan servicing if FmHA acquires the property. These contracts are authorized by §610 and 614 of the ACA. Also, FmHA offers preservation loan servicing whenever it acquires loan security regardless of whether FmHA conducted the foreclosure.

(F) On page 62 the report asserts that the ACA does not preclude additional loan making after a borrower receives loan servicing. We recommend that the assertion be revised to state that the ACA requires the borrower's creditworthiness be evaluated without regard to whether the borrowers' loan account has been serviced. This is what §353 (k) of the ACA requires.

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(G) On page 81 the report asserts that a borrower who is current in his or her loan payments cannot receive debt relief. This is only true for debt write-down. Current borrowers experiencing financial stress may be eligible to receive a rescheduling (with or without best rates and terms) of their loan payments, loan deferrals, conservation easements and softwood timber restructuring.

The recommendations are discussed as follows:

RECOMMENDATION 1. Revise regulations implementing the Agricultural Credit Act to provide restructured borrowers with a 10-percent cash flow margin after servicing.

RESPONSE: FmHA agrees and supports legislation being proposed in the 1990 Farm Bill to require a 5 percent debt service margin. If this is passed, FmHA will implement as quickly as possible.

RECOMMENDATION 2. Alert County Offices that borrowers may attempt to intentionally become delinquent to qualify for debt relief.

RESPONSE: FmHA agrees with this recommendation. Legislation has been proposed that addresses the issue in the ACA that currently allows borrowers to take advantage of the law. As changes in the law pass, FmHA will implement as quickly as possible.

RECOMMENDATION 3. Notify farmer program borrowers that intentionally causing delinquencies could disqualify them from obtaining debt relief.

RESPONSE: FmHA agrees and is considering revising regulations to require a notice outlining borrowers' responsibilities and accountability be sent to all borrowers.



ROLAND R. VAUTOUR
Under Secretary
for Small Community
and Rural Development

Attachment

Comments From the Under Secretary for Small Community and Rural Development, USDA



DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

JUN 14 1990

SUBJECT: GAO Draft Report RCED-90-169, "FmHA: Changes Needed in Loan Servicing Under the Agricultural Credit Act"

TO: John W. Harman
Director
Food and Agriculture Issues
Resources, Community, and Economic
Development Division

THROUGH: La Verne Ausman *LA*
Administrator
Farmers Home Administration

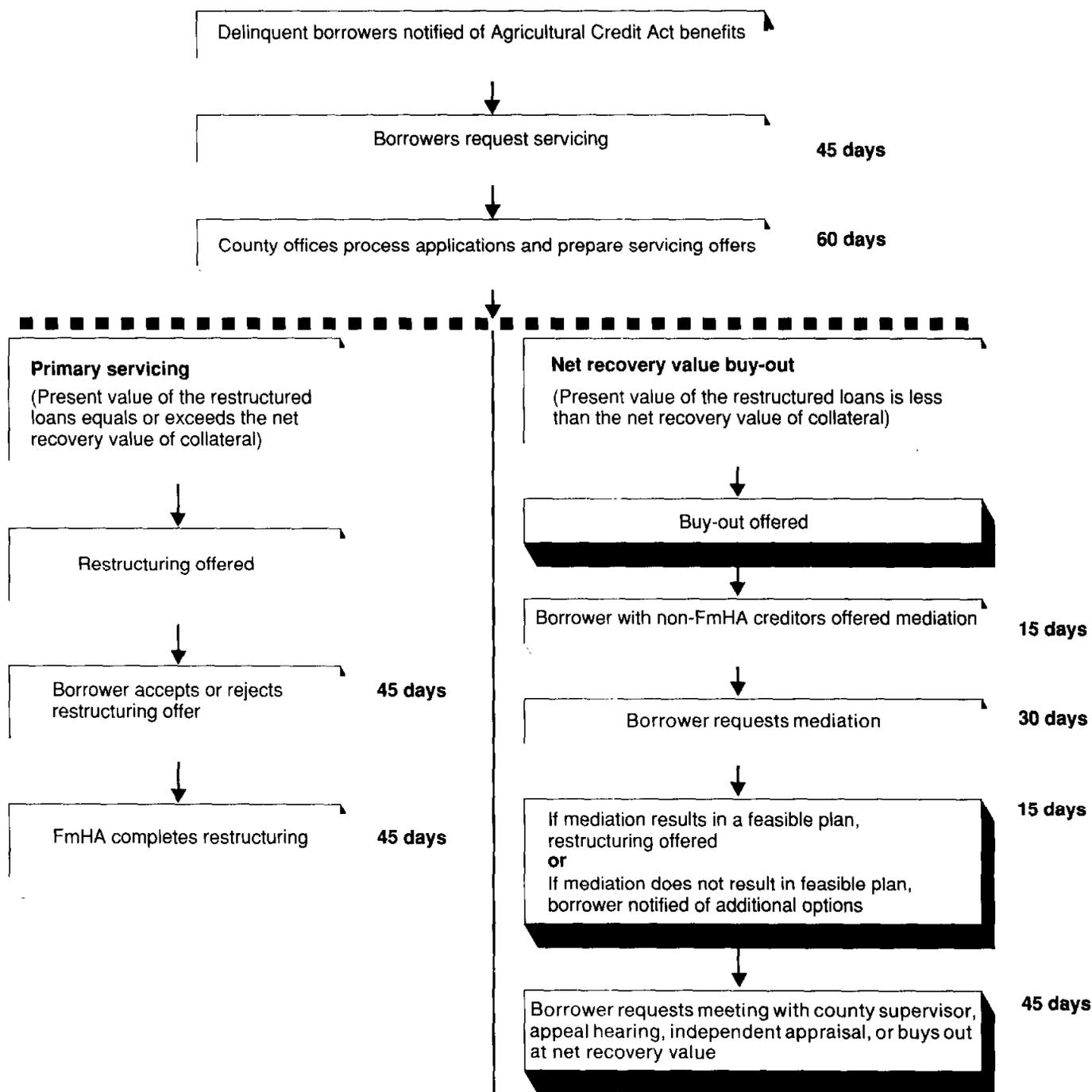
Comments to the subject draft report are as follows:

(A) On page 3 the report states in the last paragraph that only one-third of those who qualified for servicing in the counties examined were offered restructuring, and the remaining two-thirds qualified for net recovery buy-out. We recommend that these sentences be reviewed to state that FmHA determined that one-third of the borrowers were eligible for servicing, and that two-thirds were not eligible for servicing and were offered net recovery buy-out. In accordance with §353 (c) (6) of the Agricultural Credit Act (ACA) only those borrowers determined ineligible for servicing can be offered net recovery buy-out.

(B) On page 17 the report asserts that the borrower must be 180 days delinquent to qualify for debt write-down. Borrowers may qualify for debt write-down so long as their account is delinquent.

(C) On pages 7, 17, 64 and 76 the report states that USDA's and FmHA's rationale for offering net recovery buy-out to borrowers who acted in bad faith is not apparent. Please find attached an Office of General Counsel's memorandum dated January 31, 1990, on this subject. Our position is the §353 (b) of the ACA sets out eligibility requirements for primary loan servicing, and includes good faith as an eligibility requirement. Section 353 (b) states that the requirements apply to primary loan servicing, which is explicitly defined in §602 of the ACA, and does not include net recovery buy-out. Therefore, in accordance with well established legal precepts, a statutory scheme which sets out details in one section, does not apply to a different program which contains different requirements in its statutory authorization. Also, our advice considered the protracted litigation involving loan deferrals and the court opinions which found that borrowers who had converted FmHA loan security are entitled to apply for loan

Agricultural Credit Act's Implementation Schedule



Source: GAO Analysis of FmHA's Interim Regulations for the Agricultural Credit Act of 1987

We understand why borrowers who have paid their FmHA debts would desire the same debt reduction benefits as those received by borrowers who have defaulted on their loans. However, current borrowers who take intentional actions to cause their becoming delinquent may be disqualified from the benefits they seek to obtain, such as restructuring with debt write-down and net recovery value buy-out with debt write-off. While FmHA may deny primary debt servicing if it determines borrowers have intentionally defaulted on their loans, detecting such action will be difficult for county supervisors who rely primarily on borrowers' farm and home plan financial data as a basis for servicing decisions. To the extent that borrowers causing their own delinquency are not detected, the future cost of debt servicing under the act will likely be compounded.

Recommendations to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the FmHA Administrator to (1) alert county offices that borrowers may intentionally become delinquent in an attempt to qualify for debt relief under the act and (2) notify farmer program borrowers that intentionally causing delinquencies could disqualify them for debt relief under the act.

Agency Comments and Our Evaluation

In commenting on a draft of this report, USDA agreed with our recommendations and stated that FmHA will take appropriate implementation actions.

Incentives to Become Delinquent

Some borrowers and FmHA officials told us that since the act provides debt reduction benefits only to delinquent borrowers it has created an incentive for current borrowers to become delinquent on their FmHA debt. For example, three FmHA borrowers who were current on their loan payments told us they were considering becoming delinquent so they could apply for servicing. Also, four FmHA county supervisors, the chiefs of farmer programs in four FmHA state offices, and one state office director believe some borrowers who made their loan payments on time in the past may attempt to become delinquent so they can apply for servicing.

Eighteen of the 30 borrowers we interviewed who were current on their FmHA debt told us they felt penalized for paying their debt. They stated that delinquent borrowers can use available income after FmHA reduces or eliminates their debt to expand their farming operation by purchasing additional farmland or new equipment, or on personal items, such as new automobiles. On the other hand, borrowers whose FmHA debts were not reduced or eliminated continued to use their available income to repay their debts.

In addition, one county supervisor expressed opinions similar to those of the borrowers we interviewed. He stated that serviced borrowers will use income that is no longer needed to pay FmHA debt to rent additional farmland, purchase new equipment or farm stock, and buy new cars.

Borrowers who intentionally become delinquent may be disqualified from the benefits that they seek to obtain, such as primary loan servicing with debt write-down and net recovery value buy-out with debt write-off. For example, since the act precludes primary servicing benefits for borrowers who caused their own delinquencies, county supervisors may deny primary servicing to borrowers whom they determine to have caused their delinquencies by not using available resources to pay their FmHA debts. In addition, borrowers may not qualify for net recovery value buy-out. However, according to five county supervisors, borrowers could, without detection by county office staffs, easily misrepresent their income and expenses and qualify for debt relief.

The following three examples show how borrowers who have paid their FmHA loans are looking for a way to become delinquent.

Example E: A soybean, wheat, and corn farmer who has participated in FmHA loan programs for the past five years was current on his three FmHA loans as of November 1988. His outstanding balance was \$288,278.

Example B: A borrower who was current on his \$215,518 FmHA debt had an annual payment of \$17,909. A delinquent borrower in the same community, with a \$203,758 FmHA debt, had an annual payment of \$61,001, including \$46,405 on a mature loan. The delinquent borrower had not paid on his FmHA loans since 1985 and was \$90,277 behind in payments. FmHA forgave the delinquent borrower's entire debt when he bought out at \$0 net recovery value and, as a result, he has no annual FmHA loan payment.

Example C: A borrower who was current on his \$451,028 FmHA debt had an annual payment of \$48,765. A delinquent borrower in the same community, with a \$932,940 FmHA debt, had an annual payment of \$81,625. The delinquent borrower was about \$163,250 behind in payments. FmHA forgave the delinquent borrower's entire debt when he bought out at \$0 net recovery value and, as a result, he has no annual FmHA loan payment.

Additionally, some borrowers remained current on their loan payments and received no loan servicing benefits under the act even though their loan security decreased in value. In February 1989, we reported that farm real estate values declined 38 percent nationally from a 1981 peak of \$844 billion to \$523 billion in December 1987.² In some midwestern states, average land values declined over 50 percent between 1982 and 1987.

Some borrowers owe FmHA more than their land is worth because of the decline in land values. For example, an FmHA borrower, who is current on his FmHA loan payments, has farmland which secures his FmHA debt. The borrower purchased the farmland during the 1983-84 period at \$1,150 per acre. The borrower, who estimated the 1989 value of the land at \$350 to \$400 an acre, told us he owes FmHA more than the land is worth, on the basis of farm real estate market values in the community. The county supervisor, who agreed with the borrower's assessment of the land value, said the borrower had requested debt relief. According to the supervisor, such relief was not provided because the borrower was current on his loan payments. The borrower told us he felt that he was being penalized for making his loan payments.

²Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria (GAO/RCED-89-9, Feb. 14, 1989).

Agency Comments and Our Evaluation

In commenting on a draft of this report, USDA disagreed with our view that the net recovery value buy-out option is available only to good faith borrowers. USDA's position is that the eligibility requirements of the act apply solely to primary loan service programs and not to the net recovery value buy-out option. The basis for USDA's interpretation is that the net recovery value buy-out authority of the act is separate from the primary loan servicing authority and therefore net recovery value buy-out is not subject to the eligibility provisions of the act since it is not a primary loan service program.

We question this interpretation because the net recovery value buy-out authority is an integral part of the overall statutory scheme to provide benefits only to good faith borrowers and, in our view, it is not a separate and distinct authority. Nevertheless, we support legislative action to ensure that borrowers who act in bad faith do not receive the act's benefits.

consider net recovery value buy-out for borrowers who acted in bad faith. The basis for USDA's position is not apparent to us. In our view, the act's net recovery value buy-out option is only available to good faith borrowers as an alternative to loan restructuring. Nevertheless, legislative action would ensure that borrowers who act in bad faith do not receive the act's benefits. These borrowers, under present law, are also eligible for preservation benefits.

The government's losses in servicing delinquent borrowers has also increased because the act does not require FmHA to consider unsecured assets in its loan restructuring decisions and does not allow it to include unsecured assets in calculating net recovery value buy-out amounts.

We recognize that many FmHA borrowers have become delinquent in recent years because of factors beyond their control, such as the effects of adverse weather on production and a depressed farm economy during the early and mid-1980s. However, borrowers have a responsibility for complying with the terms and conditions of their loan agreements. We believe that when borrowers cause their delinquency or do not act in good faith, they need to be held responsible for repaying the full amount of their outstanding debt to the federal government. Giving debt relief to such borrowers sets a precedent that other borrowers may attempt to follow and provides no incentive for borrowers who are not delinquent to abide by their loan agreements and pay their FmHA debts.

Further, borrowers receive substantial benefits by having debt written down or written off. We believe that when delinquent borrowers have available unsecured assets, FmHA needs to consider the value of those assets in its servicing decisions so as to decrease the overall loss that the federal government incurs as a result of servicing.

Recent Congressional Initiatives

On March 6, 1990, the House of Representatives passed and referred to the Senate H.R. 4077 which would, among other things, (1) require borrowers to act in good faith to be eligible for net recovery value buy-out and to reacquire their farms through preservation servicing; (2) allow FmHA to consider all assets of a borrower, other than those necessary for family living or farm operating expenses, in determining the value of restructured loans; and (3) require FmHA to consider the value of all property listed on a borrower's security agreements for loans in determining the net recovery value buy-out amount. We agree with the good faith requirement for the act's benefits and that FmHA needs to consider all assets in determining the value of restructured loans. However, we

Asset Disclosure Requirements

The act does not require FmHA to consider unsecured assets in its loan restructuring decisions and does not allow it to include unsecured assets in calculating net recovery value buy-out amounts. As a result, FmHA does not consider borrowers' assets that are not pledged as security for FmHA loans when computing the type and amount of debt relief to offer delinquent borrowers. However, the act requires borrowers who apply for servicing to present FmHA with information showing a plan of operations and how farm operating, family living, and debt servicing expenses will be met. FmHA requires borrowers who apply for servicing to submit a current farm and home plan, which includes projected income and expenses and a statement of assets and liabilities. County offices use borrowers' farm and home plans in computing the amount and type of servicing.

FmHA county offices are supposed to review borrower applications and determine completeness and accuracy of the reported financial information. In April 1989, FmHA provided to its county staffs policy guidance stating that borrowers should use available assets to repay their FmHA debts—including assets that are not used as security for FmHA loans. However, the notice confused, rather than clarified, FmHA's policy on whether or not to include unsecured assets when computing servicing for delinquent borrowers. While focusing on the treatment of cosigners' assets when computing servicing benefits for delinquent borrowers, the notice provided that borrowers' unsecured assets should be considered in determining how, and to what extent, borrowers can be serviced. FmHA's Director of Loan Servicing and Property Management agreed the notice was confusing because it covered cosigners' and borrowers' unsecured assets. He told us FmHA plans to rewrite the guidance to clarify when county offices should use unsecured assets in determining debt servicing benefits.

Examples of Borrowers Who Had Assets That FmHA Did Not Use to Reduce Losses on Delinquent Loans

The following cases illustrate how considering unsecured assets could have reduced government losses in servicing borrowers under the act. Both borrowers in the case examples paid FmHA the buy-out amount, which was substantially less than the amount of their FmHA loans. Also, according to one FmHA state office chief of farmer programs, excluding unsecured assets increases the amount of debt write-down when borrowers' loans are restructured.

Borrower E: This borrower reported unsecured assets that FmHA did not consider in processing his servicing application. The amount of debt that FmHA wrote off would have been less if FmHA could have considered

This borrower will be eligible for preservation benefits if he does not pay the buy-out amount and FmHA forecloses on his property. However, it will be to his advantage to pay the buy-out amount if he wants to keep his farm because the market value of his real estate exceeds his outstanding FmHA debt. He would have to pay the amount of his outstanding debt to exercise the leaseback/buyback option since the market value of his 1,174-acre farm is \$188,000.

The following two cases illustrate bad faith borrowers who will be eligible for preservation servicing.

Example C: The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us the borrower rents his farm to his son and claims that his son has not made any rental payments. However, the borrower's restructuring application showed rental income and the county office documented that the borrower had been current on payments to other creditors, including advance principal reduction payments.

The county office determined that this borrower was not eligible for net recovery value buy-out since the DALR\$ computer program showed he would have had a feasible plan of operations with restructuring. The borrower would have been offered restructuring if he had not caused the delinquency. He was not eligible for net recovery value buy-out because he qualified for restructuring. At the time of our review, the borrower had appealed the county office's decision, but an appeal decision had not been made.

According to the DALR\$ printout, this borrower owed FmHA \$650,185 in outstanding principal and unpaid interest. The debt covered three natural disaster emergency loans. He will be eligible for preservation benefits if FmHA forecloses on his property. The market value of his 3,140-acre farm, which he could reacquire through the leaseback/buyback option, is \$470,000. A prior lien of \$224,906 exists on the borrower's farm real estate.

Example D: The FmHA county office determined that this borrower was ineligible for loan restructuring because the delinquency was due to circumstances within his control. The county office supervisor told us the borrower's application for restructuring showed that he had resources available that could have been used to pay his delinquent debt. Specifically, documentation the borrower submitted to the county office

A USDA Assistant General Counsel told us that, under the Agricultural Credit Act, FmHA is required to give net recovery value buy-out consideration to bad faith borrowers since buy-out is not primary loan servicing. He also said that bad faith borrowers are not subject to the restructuring eligibility provisions of the act. He further told us that to qualify for net recovery value buy-out, borrowers simply must be 180 days or more delinquent on their FmHA loans and be unable to show a feasible plan of operations for the upcoming year. The basis for USDA's position on the bad faith borrower eligibility issue is not apparent to us. In our view, the act's net recovery value buy-out option is only available to good faith borrowers as an alternative to loan restructuring when the net recovery value exceeds the present value of the restructured loans.

Further, according to FmHA's Deputy Assistant Administrator for Farmer Programs, bad faith borrowers are eligible for preservation servicing if FmHA forecloses on the real estate property securing their FmHA loans since the Agricultural Credit Act and the Food Security Act of 1985 do not preclude preservation benefits for borrowers who act in bad faith. We agree that present law does not limit preservation benefits to only good faith borrowers.

Examples of Bad Faith Borrowers Eligible for Servicing Benefits

The following two cases illustrate bad faith borrowers who were offered net recovery value buy-out.

Example A: The FmHA county office determined that this borrower was ineligible for loan restructuring because he did not act in good faith in connection with his loan agreements. The county office supervisor told us the borrower sold some farm equipment that was FmHA security property. Also, the borrower subsequently had another family member, who is also an FmHA borrower, sell some additional farm equipment. In addition, a regional attorney in USDA's Office of General Counsel wrote that the borrower had converted numerous items of FmHA security property. The sales of properties were made without county office approval. None of the proceeds from the sales were applied to the borrower's FmHA debt.

The borrower appealed the county supervisor's decision. An appeals officer decided that while the borrower was ineligible for restructuring, he was eligible for net recovery value buy-out since the net recovery value exceeded the present value of the restructured loans when the county office ran the DALR\$ computer program. At the time of our review, the borrower had not responded to the county office's net recovery value buy-out offer.

Borrowers Who Acted in Bad Faith Received Net Recovery Value Buy-Out and Preservation Benefits

FmHA borrowers who act in bad faith are not eligible for the primary loan servicing options. However, according to USDA, they are eligible for net recovery value buy-out consideration. Also, they are eligible for preservation servicing benefits. In January 1990 FmHA identified 218 bad faith borrowers nationwide who had bought out or were in the process of buying out at the net recovery value, or had declined buy-out offers. At one of the FmHA county offices we reviewed, we identified six FmHA-determined bad faith borrowers who were offered net recovery value buy-out and seven others who were considered for net recovery value buy-out but were not offered it because they did not qualify. Bad faith borrowers who decline buy-out offers and those not offered buy-out may be eligible to reacquire their farms or farm homestead under FmHA's preservation program if FmHA forecloses on the real estate securing their loans.

Bad Faith Determinations and Servicing Procedures

FmHA requires county supervisors who believe borrowers have committed fraud or waste, or have disposed of property securing FmHA loans without approval (referred to as conversion) to obtain a written USDA Office of General Counsel legal opinion before denying primary servicing. However, county supervisors who determine that borrowers caused their own delinquency do not need a USDA Office of General Counsel opinion before denying primary servicing.

In January 1990, FmHA provided members of Congress with a list of 218 bad faith borrowers throughout the country who, it said, had committed fraud, waste, or conversion of security property and who were involved in net recovery value buy-outs. Forty-two of those borrowers had bought out their debt at a net recovery value and 58 other borrowers were in the process of buying out their debt. These borrowers have bought out, or have the opportunity to buy out, their debt for much less than the amount of their outstanding debt. These 100 borrowers include 8 borrowers who bought out or were in the process of buying out their debt and whose buy-outs will result in write-offs of more than \$1 million each. For example, one borrower who, according to FmHA, committed fraud owed \$11.8 million and was offered a \$1.1 million net recovery value buy-out. This borrower will receive a \$10.7 million write-off of his FmHA debt if he pays the buy-out amount. Further, 118 borrowers on the national list were offered net recovery value buy-outs, but they did not accept the buy-out offers. These borrowers will be eligible to reacquire their farmland or farm homestead if FmHA forecloses on their properties. In addition to these 218 bad faith borrowers, FmHA had referred or was

servicing and net recovery value buy-out, we recommend that the Congress amend the Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988). This can be done by enacting provisions similar to sections 5 and 6 of H.R. 4077 which provide limitations on the net recovery value buy-out and restructuring options of the Agricultural Credit Act.

Agency Comments and Our Evaluation

In commenting on a draft of this report, USDA agreed with the need for a cash flow margin for FmHA's restructured borrowers and stated that it supports legislation proposed in the 1990 Farm Bill which requires a 5-percent cash flow margin. USDA did not agree to implement a 5-percent margin or the 10-percent margin we recommended without legislative change. USDA stated that FmHA would implement a margin requirement as quickly as possible if such a change is enacted.

As we show in this report, most FmHA restructured borrowers remained financially weak after restructuring. We believe their potential for farming successfully would be better assured if FmHA restructured their debt until cash flow margins of at least 10 percent, to cover unforeseen expenses, were achieved. Also, a 10-percent margin is consistent with FmHA's guaranteed farm loans.

to compound, increasing borrowers' overall debt and weakening their financial position.

If borrowers do not pay their debt, primary loan service programs, such as reamortizing and rescheduling payments, will not produce positive cash flow indefinitely. These primary servicing tools may simply delay future debt write-down or write-off. Ultimately, delinquent borrowers will become eligible for the additional loan servicing authorized by the Agricultural Credit Act of 1987, including debt write-down and write-off.

Conclusions

A primary objective of the Congress in passing the Agricultural Credit Act was to ensure that FmHA delinquent borrowers were able to continue their farming or ranching operations. That is not occurring. A very large majority of the borrowers remained financially weak after FmHA restructured their delinquent debts. These borrowers are maintaining a high debt load coupled with low cash flow margins. Considering their weak financial condition, FmHA's restructuring provided the borrowers with only minimal potential for farming successfully without continued debt assistance. Their success could have been better assured if FmHA had designed the DALRS computer program to continue considering restructuring options until a borrower projected a cash flow margin of at least 10-percent above expenses. This restructuring practice would have provided borrowers a cash reserve that is consistent with FmHA's criteria for its guaranteed loans and would have improved restructured borrowers' potential for farming successfully with less dependence on FmHA for continued financial assistance.

Requiring a larger cash flow margin, however, would force FmHA to restructure borrowers' loans even more than it did. Such a restructuring practice would likely result in write-downs for some borrowers who did not receive write-downs, and greater write-downs for some borrowers who did receive write-downs. Likewise, a larger cash flow margin would likely result in an increased number of net recovery value buy-out offers because the act prohibits writing down borrowers' debts past the net recovery value of collateral. However, considering the weak financial condition of most restructured borrowers, FmHA's primary servicing has provided only minimal potential for successful farming operations.

Further, because most restructured borrowers were only marginally solvent, at best, they more than likely will continue to need financial assistance. This assistance will probably come from FmHA because it is "the

Inspector General plans a review in this area as part of its audits on FmHA restructuring activities.

FmHA Officials and Restructured Borrowers Expressed Doubts About Chances for Success

FmHA county and state office officials in each selected state expressed concern to us about the ability of many restructured borrowers to continue farming operations without continued FmHA financial support. For example, one county supervisor said that loan servicing will not keep all restructured borrowers farming and, for many, servicing was only delaying their inevitable failure. According to the chief of farmer programs in one state, additional loans or debt servicing will be necessary to keep many restructured borrowers farming because they operate on tight cash flow margins. He also said that, as long as FmHA continues to lend delinquent borrowers money, they will continue farming even though it is not profitable because they have no alternative jobs. Conversely, supervisors said that some restructured borrowers will succeed without additional financial assistance from FmHA. One county supervisor said that payments from USDA's Conservation Reserve Program will help keep some borrowers farming.

Because of projected low cash flows, some borrowers also expressed concern about their ability to repay their restructured debt and continue farming without future FmHA assistance. The following two cases illustrate borrowers' concerns.

Example A: FmHA's restructuring of a delinquent soybean and cattle farmer's \$1.3 million debt included writing down over \$700,000 and deferring payments on \$400,000. Prior to servicing, this borrower owed \$257,880, which was due immediately on three fully matured loans, in addition to annual payments of \$137,248 on nine other loans. His annual payments declined to \$19,000 with restructuring. However, the borrower told us he would be unable to make the payments on the restructured debt with his next year's farm income. Further, he said he may not try to make the payment.

Example B: FmHA restructured a delinquent soybean farmer's \$97,000 debt by reamortizing and rescheduling payments. This servicing reduced his annual payments from \$9,733 to \$9,421, or by \$312. The borrower wrote the county office that he accepted the restructuring offer even though his income was unchanged and he had been unable to make payments in the past. In expressing concern about his ability to repay the restructured debt, the borrower noted that restructuring had only slightly lowered his annual payments.

a 10-percent reserve. FmHA expected that borrowers would use the reserve for new investments and for contingencies or emergencies associated with their farming operations. In May 1988, FmHA proposed a 5-percent margin in restructuring delinquent borrowers' debts but withdrew the proposal because of adverse public comments.

Because the DALRS analysis includes consideration of projected income and expenses for the upcoming year, the restructuring decision may allow borrowers to continue farming for at least one year—assuming the projections are accurate and there are no major unplanned expenses or crop failures. However, in our opinion, the likelihood that borrowers with minimal cash flow margins will be able to continue farming over a longer term without additional FmHA loans or servicing seems minimal.

Most of the 160 borrowers in the county offices we reviewed had low cash flow margins for the upcoming year. For example, as table 3.3 shows, 59 percent of the restructured borrowers had cash flow margins of \$100 or less.

Table 3.3: Borrowers by Cash Flow Margin After Restructuring in 10 FmHA County Offices

County	Positive cash flow margin					Total borrowers ^a
	\$0 to 10	\$11 to 100	\$101 to 1,000	\$1,001 to 10,000	Over \$10,000	
1	2	3	1	1	0	7
2	11	4	2	9	1	27
3	1	4	1	3	2	11
4	18	3	0	2	4	27
5	3	1	2	4	2	12
6	4	3	1	4	0	12
7	10	3	1	1	0	15
8	2	7	6	3	3	21
9	4	3	0	0	1	8
10	8	1	1	3	7	20
Total	63	32	15	30	20	160

Note: Margin based on borrowers' projected income and expenses for the upcoming year.

^aExcludes one borrower whose financial data was not available at the time of our review and five borrowers who did not accept restructuring offers.

A low cash flow margin by itself does not always mean financial failure; however when a low cash flow margin is combined with high debt, the financial strength of farm borrowers can deteriorate rapidly. For

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which is USDA's criterion indicating a favorable financial condition for farming. Generally, restructured borrowers with debt-to-asset ratios greater than 40 percent indicate potential for a marginally solvent farming operation. However, their potential could be improved with a high cash flow margin. Nine other borrowers had debt-to-asset ratios of between 41 and 70 percent, but they also had positive cash flows that provided greater than a 10-percent reserve. Consequently, we considered these nine borrowers to also have potential for successful farming.

Table 3.1 shows that the remaining 145 borrowers had such high debt-to-asset ratios that even when considering their positive cash flows, they had limited potential for successful farming in the near future without continued FmHA loan assistance, such as new loans or the servicing of existing loans. For example, one restructured borrower had a 222 percent debt-to-asset ratio, a \$2 cash flow margin, and a \$246,000 negative net worth after FmHA rescheduled, reamortized, deferred and wrote down about \$50,000 of his \$180,850 debt. Further, even though some restructured borrowers had a positive cash flow after restructuring that provided at least a 10-percent reserve, they had debt-to-asset ratios above 70 percent, thus limiting their potential for successful farming operations without FmHA assistance.

**Table 3.1: Borrowers by Farm Income/
Solvency Categories After Restructuring
in 10 FmHA County Offices**

County	Favorable	Marginal solvency			Total borrowers ^a
	0-40%	41-70%	71-100%	Over 100%	
1	0	1	2	4	7
2	2	5	6	14	27
3	0	2	1	8	11
4	1	4	10	12	27
5	1	1	1	9	12
6	0	6	4	2	12
7	0	2	8	5	15
8	2	7	5	7	21
9	0	0	2	6	8
10	0	2	6	12	20
Total	6	30^b	45	79	160

^aExcludes one borrower whose financial data was not available at the time of our review and five borrowers who did not accept restructuring offers

^bNine of these 30 borrowers had high cash flow margins, suggesting a more favorable potential for successful farming operations than indicated solely by their debt-to-asset ratio. Combining these nine borrowers with the six borrowers in the favorable category results in a total of 9 percent of the 160 restructured borrowers having the potential for successful farming operations

Restructured Borrowers Financially Weak After Servicing

Most delinquent borrowers whose debt FmHA offered to restructure in the county offices we reviewed will remain financially weak even after their debt is serviced. A primary purpose of the act's debt restructuring option was to keep borrowers on the farm or ranch to the maximum extent possible. However, we determined that only 15 borrowers, or about 9 percent of the 160 borrowers we reviewed in the FmHA county offices, projected the financial strength for successful farming operations after restructuring. The other 91 percent have such high debt-to-asset ratios and/or low cash flow margins¹ for the upcoming year that their potential appeared limited for successful farming operations without continued FmHA financial assistance.

The act does not preclude borrowers who were restructured and who become delinquent again from getting additional loans or returning for further loan servicing, including restructuring with or without debt write-down or net recovery value buy-out with debt write-off. In March 1990, the House of Representatives passed and referred to the Senate a bill which would, among other things, limit a borrower to one write-down or write-off, limit the write-down or write-off amount to \$250,000, and preclude a write-down or write-off on loans made on or after January 6, 1988. As of June 28, 1990, the Senate had not passed a similar bill. However, various changes to the act are contained in the proposed 1990 Farm Bill, which passed the Senate Committee on Agriculture, Nutrition, and Forestry on May 17, 1990.

Act Aimed to Continue Borrowers' Operations

Section 615 of the Agricultural Credit Act of 1987 directed FmHA to modify delinquent farmer program loans to ensure that borrowers would be able to continue farming or ranching operations. Continued farming operations would require operating capital and sufficient income to cover all operating, family living, and debt servicing expenses. If borrowers could not generate sufficient funds from their farm and nonfarm operations, they might then require debt assistance to continue farming.

USDA's Economic Research Service (ERS) has developed criteria that can be used to indicate whether or not serviced borrowers will be able to continue operations. ERS classifies the financial condition of farm operations on the basis of an analysis of income and leverage position. ERS

¹Cash flow margin is the difference between income and expenses, including farm operating, family living, and debt servicing expenses.

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\$4.2 million on seven natural disaster emergency loans and one soil and water loan. His last payment to FmHA was made in 1981. The borrower reported few assets to FmHA when applying for restructuring, except a late model, luxury automobile. The county supervisor told us he suspected the borrower had transferred assets to his son. However, the county supervisor had not pursued a formal, legal opinion on conversion. FmHA offered this borrower an opportunity to buy out his debt for the \$496,000 net recovery value of his collateral. The borrower will receive a \$3.7 million debt write-off if he pays the buy-out amount.

Borrower D: A farmer who grows soybeans, corn, wheat, cotton, and oats, had his total \$900,000 FmHA debt written off through net recovery value buy-out. The borrower had four natural disaster emergency loans. County office staff told us the borrower had not made a payment on any of the loans since November 1986. The FmHA district director declined a \$15,000 offer from the borrower in 1987 to settle his debt because the borrower had \$174,950 in intermediate assets with no liens, fixed assets of \$535,000 with liens of \$483,765, and a net income of \$30,000. Also, the county supervisor had documented that the borrower's production expenses and standard of living were very high.

Borrower E: A borrower, who was no longer farming, owed FmHA almost \$805,000 on 10 natural disaster emergency and three farm operating loans. The borrower had about \$73,000 worth of equipment as collateral for the 13 FmHA loans. He had not made a payment to FmHA on the emergency loans since 1983 or on the farm operating loans since 1985. FmHA offered to write off \$738,928 of his debt through net recovery value buy-out.

Borrower F: This farmer has been borrowing from FmHA since 1979. The borrower formerly grew barley and corn but now raises horses. He owed FmHA over \$449,000 on four natural disaster emergency and economic emergency loans. While the borrower made a payment on one loan in 1988, he had not made a payment on the other three since 1983. FmHA offered to write off over \$248,000 of the borrower's debt if he paid the \$201,000 net recovery value of his collateral. Also, the county supervisor told us the borrower lives above community standards and had built a race track to train horses.

Borrower G: A soybean, corn, cattle and grain farmer who owed FmHA \$269,000 had his debt restructured with rescheduling and interest rate reduction. The borrower had six outstanding FmHA loans including four natural disaster emergency and two farm operating loans. At the time of

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Table 2.6 shows that 273 borrowers, or about 63 percent of the 434 borrowers we reviewed, received net recovery value buy-out offers with debt write-off. The remaining 161 borrowers, or 37 percent, received restructuring offers with or without debt write-down. The financial condition of the borrowers after restructuring is analyzed in chapter 3.

Table 2.6: Borrowers, Debt Amount, and Debt Reduction, by Servicing Category in 10 FmHA County Offices

Dollars in millions

County	Primary servicing without write-down		Primary servicing with write-down			Net recovery value buy-out		
	Number of borrowers	Debt before servicing	Number of borrowers	Debt before servicing	Amount of write-down	Number of borrowers	Debt before servicing	Amount of write-off
1	2	\$0.3	5	\$1.6	\$1.0	21	\$5.6	\$4.6
2	20	3.4	7	3.2	1.4	11	2.0	1.5
3	7	1.4	4	2.4	1.4	26	18.4	14.7
4	8	1.7	19	5.6	2.7	31	8.7	5.7
5	9	2.0	3	1.2	0.8	22	7.9	6.7
6	6	0.6	6	1.3	0.5	17	8.5	6.5
7	3	0.2	12	2.8	1.1	18	4.4	3.5
8	15	1.2	7	4.4	2.3	59	28.7	21.3
9	1	0.1	7	2.2	1.2	60	13.3	12.0
10	13	2.1	7	1.6	0.6	8	2.3	1.7
Total^a	84	\$13.0	77	\$26.2^b	\$13.0	273	\$99.7^b	\$78.2

^aWe did not compile servicing information for 29 and 11 eligible borrowers in counties 6 and 7, respectively, who had declined FmHA's servicing offer or were in mediation. We included such borrowers in our compilations for the other counties. We also did not record information for the eight borrowers in four counties who had not received offers.

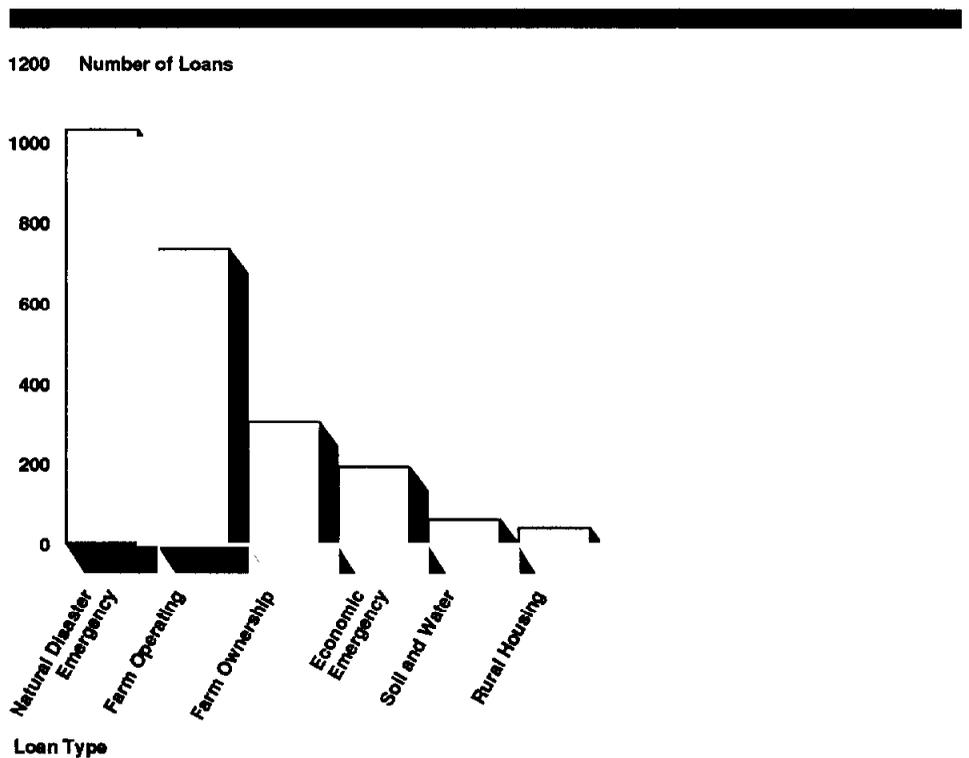
^bTotals do not add due to rounding.

Nationally, as of June 30, 1989, 82 percent of FmHA's delinquent borrowers were offered write-downs and 76 percent were offered write-offs of less than \$250,000. Also, 92 borrowers were offered write-downs or write-offs in excess of \$1 million. As table 2.7 shows, at the county offices we reviewed FmHA offered to reduce the debt of 236 borrowers through write-downs or write-offs of less than \$250,000. The county offices also offered to reduce the debt of ten borrowers by more than \$1 million.

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FmHA rural housing loans. Figure 2.1 shows the number and type of FmHA loans held by borrowers who were offered servicing in the county offices we reviewed.

Figure 2.1: Number and Type of Loans Held by Borrowers Who Were Offered Servicing in 10 FmHA County Offices



Note: We did not compile loan type data for 40 eligible borrowers in two counties who had declined FmHA's servicing offer or were in mediation. We also did not compile data for the eight borrowers who had not received offers.
 Source: GAO analysis of serviced borrowers' files

Table 2.5 shows that 264 borrowers, or about 61 percent of the 434 borrowers we reviewed, had a combination of loan types which included an emergency loan (economic and/or disaster) and at least one other loan type, such as a farm ownership or farm operating loan. For example, one borrower owed \$406,812 on a combination of five different FmHA loan types—farm operating, farm ownership, natural disaster emergency, economic emergency, and rural housing. Also, while 106 borrowers, or 24 percent, had no emergency loans, 64 borrowers, or 15 percent, had only emergency loans, covering either natural disasters or economic emergencies.

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Table 2.3: Borrowers Who Had Debt Servicing Offered and Completed in 10 FmHA County Offices as of June 30, 1989

County	Total borrowers	Primary servicing		Percentage completed	Net recovery value buy-out		Percentage completed
		Offered	Completed		Offered	Completed	
1	28	7	7	100.0	21	10	47.6
2	38	27	25	92.6	11	8	72.7
3	37	11	5	45.5	26	1	3.9
4	58	27	20	74.1	31	11	35.5
5	34	12	4	33.3	22	1	4.5
6	58	13	5	38.5	45	2	4.4
7	44	19	6	31.6	25	14	56.0
8	81	22	1	4.4	59	5	8.5
9	68	8	3	37.5	60	38	63.3
10	28	20	20	100.0	8	5	62.5
Total	474^a	166	96	57.8	308	95	30.8

^aServicing offers or eligibility determinations were pending for eight additional borrowers, and servicing was denied for 87 borrowers.

**FmHA Denied Servicing to
 Some Borrowers**

FmHA denied servicing to 87 borrowers, or 15 percent of the 569 borrowers who applied in the county offices we reviewed. County staffs denied servicing to 65 borrowers who, according to the county staffs, did not submit complete applications, and to 7 borrowers whose delinquencies were due to circumstances within their control or who did not act in good faith in terms of their FmHA loan agreements. These seven borrowers did not qualify for net recovery value buy-out. In addition, county staffs determined that the estates of eight deceased borrowers were ineligible for primary servicing, and seven other borrowers did not meet various other FmHA eligibility requirements, such as the need to reaffirm their FmHA debt after bankruptcy. These 87 borrowers, who were denied eligibility for primary loan servicing and net recovery value buy-out, may qualify for preservation servicing in the event of foreclosure on the collateral that secures their FmHA debt.

**Borrowers Offered
 Servicing Varied by
 Loan Size and Type**

FmHA offered loan servicing to borrowers with large, moderate, and small amounts of debt and with most types of FmHA loans. In the county offices we reviewed, 4 percent of the borrowers had an FmHA debt of \$1 million or more before servicing, 40 percent had an FmHA debt in the \$250,000 to \$999,999 range, and 56 percent had an FmHA debt of less than \$250,000. Also, 61 percent of the borrowers had a combination of loan types which included an emergency loan (economic and/or disaster) and at least one other type of loan, such as a farm ownership or

applications, county supervisors met with borrowers to obtain additional information needed to complete application packages during the following 60-day period.

County Staff Generally Unprepared to Process Large Volume of Applications

County office supervisors provided us with several reasons explaining why they did not process applications and complete servicing decisions on schedule. First, the large volume of applications overwhelmed some county office staffs, which were simultaneously processing new loan requests and servicing applications. County and state personnel in these counties told us that new loan applications were heaviest during the January to April period, when servicing requests were also being processed. FmHA attempted to service borrowers by authorizing overtime, hiring temporary staff, and detailing staff to counties with heavy workloads.

Second, FmHA implemented the act with interim regulations that have not been finalized and operating instructions that were frequently revised. Between September 1988 and June 1989, FmHA sent its county and state offices an extensive series of notices that provided new implementing guidance or revisions to previous guidance. According to some county supervisors, the lack or revision of guidance caused uncertainty and duplication of work in processing applications. For example, FmHA issued revised guidance in May 1989 for calculating net recovery value. One county supervisor told us he had to recalculate the net recovery value for 12 borrowers when he received the revised guidance.

Third, FmHA's key computer software programs for processing applications, computing servicing decisions, and tracking progress were not fully operational when restructuring began. These programs required revisions after servicing began, and the tracking program was not operational at some county offices as late as August 1989. For example, the DALR\$ program, which allowed county offices to process applications in a short time in comparison to manual processing, was revised during implementation on the basis of reviews by USDA's Office of Inspector General and testing and validation of the program by a private accounting firm.

Finally, servicing completion was delayed because some borrowers chose to participate in mediation with FmHA and other lenders in a further attempt to develop a feasible plan of operations and qualify for restructuring. Other borrowers appealed various FmHA servicing decisions, such as their ineligibility for primary loan service programs.

Another borrower said he did not request servicing because of the size of the notification package. He told us he did not understand what he was supposed to do with the material and he believed some of the information in the package did not apply to him. A third borrower told us he did not request servicing because he was waiting for FmHA to provide instructions on filling out the application. This borrower expected someone from FmHA to come to his house to assist him in completing the application.

Act's Implementation Schedule Not Met

FmHA did not fully meet the act's implementation schedule. For example, about one-third of the qualified borrowers at the county offices we reviewed were not serviced within the act's required time frames. Borrowers were not serviced on schedule because they did not apply on schedule and because county office staffs were unprepared to process the large volume of applications. However, FmHA's failure to strictly comply with the act's deadlines increased, rather than restricted, borrower participation.

Borrowers Not Serviced as Scheduled

FmHA provided delinquent borrowers with notice of the act's benefits and application packages in mid-November 1988. Based on this beginning date there were specific deadlines for (1) borrowers to apply for servicing; (2) FmHA to process applications and make servicing offers; (3) borrowers to accept, reject, and appeal offers, or request mediation with their creditors; and (4) FmHA to complete servicing of qualified borrowers (see app. I).

FmHA county offices should have completed making servicing offers by mid-March 1989 and completed servicing by June 1989, if borrowers applied on time and did not appeal a servicing decision or request mediation. Table 2.2 shows that the county offices we reviewed had made offers to 315 borrowers, or 66 percent of the 474 qualified applicants at the end of the 60-day processing period.

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Table 2.1: Notified Borrowers Who Applied for Servicing in 10 FmHA County Offices

County	Borrowers eligible to receive packages	Borrowers initially sent packages	Borrowers applied for servicing	Percentage of borrowers applying for servicing ^a
1	56	56	28	50.0
2	85	84	50	59.5
3	114	114	59	51.8
4	93	92	60	65.2
5	319	311	45	14.5
6	123	115	71	61.7
7	92	92	47	51.1
8	197	196	97	49.5
9	166	164	83	50.6
10	48	48	29	60.4
Total	1,293	1,272	569	44.7

Note All tables in this report are based on our analysis of information obtained in the FmHA county offices we reviewed.

^aPercentage based on borrowers initially sent notification packages

At the county offices we reviewed, borrowers did not apply for servicing primarily because they (1) were inactive borrowers and generally no longer farming or (2) chose to negotiate a settlement of the FmHA debt rather than servicing under the act (referred to as debt settlement). In addition, some borrowers chose to pay their FmHA debts current or to pay them off.

Borrowers No Longer Actively Farming

Many delinquent borrowers who did not apply for servicing in the county offices we reviewed were inactive borrowers. According to FmHA, inactive borrowers include those who are no longer farming and those in bankruptcy, foreclosure, or collection-only status with little or no collateral. In the county offices we reviewed, 309 delinquent borrowers, or 44 percent of those who did not apply for servicing, were considered inactive by FmHA county office staffs.

Delinquent borrowers we interviewed gave similar reasons for not applying for servicing. Twenty borrowers, or 57 percent of the 35 delinquent borrowers we interviewed, did not apply for servicing because they were no longer actively farming. For example, one borrower who owed FmHA about \$102,000 on six loans quit farming several years ago and now works in construction. Another borrower who owed FmHA about \$126,000 on three loans did not apply because he no longer farms and has sold his farm equipment.

Implementing the Agricultural Credit Act Resulted in Many Delinquent Borrowers' Not Being Serviced and Substantial Costs for the Government

FmHA notified virtually all borrowers who were 180 days or more delinquent on their loans of available Agricultural Credit Act servicing benefits. In evaluating the results of FmHA's efforts to implement the act, we found the following:

- On a national basis, only about 50 percent of the notified delinquent borrowers applied for servicing. Only 45 percent of the notified borrowers applied at the 10 county offices we reviewed; borrowers at these offices did not apply primarily because they were inactive farmers or because they chose to negotiate a settlement of their FmHA debt.
- FmHA serviced about 83 percent of the borrowers who applied at these county offices including borrowers with large, moderate, and small amounts of debt. Also, while emergency loans were the most prevalent loan type for serviced borrowers, most borrowers held a combination of FmHA loan types.
- The cost of debt relief has been substantial and will increase as FmHA continues servicing under the act. Nationally, FmHA estimated it would write down and write off \$9.4 billion of delinquent debt. At the county offices we reviewed, \$91 million, or almost two-thirds of the total \$139 million debt of delinquent borrowers who were offered servicing, was written down or written off.

Most Eligible Borrowers Notified of Servicing

In mid-November 1988, FmHA notified more than 66,400 delinquent borrowers across the nation of the availability of loan servicing. FmHA informed delinquent borrowers of debt restructuring and other servicing benefits available under the act and how to apply for servicing. At the 10 county offices we reviewed, county supervisors sent notices of servicing availability, including application forms, to 1,272 borrowers.¹ However, 21 additional delinquent borrowers at the selected county offices should have been, but were not, initially notified of the act's servicing.

These borrowers were not notified primarily because of administrative errors and FmHA county office staffs' confusion about notification requirements. For example, some delinquent borrowers were incorrectly shown on FmHA reports as being less than 180 days delinquent on their loan payments. Also, when mailing notification packages, FmHA county office staff overlooked other borrowers who were 180 days or more delinquent. Further, one county office failed to notify seven borrowers

¹The 10 county offices actually mailed more than 1,272 notices because cosigners, partners, and corporate shareholders were also notified. However, we eliminated duplicate notices for our analysis.

Second, we assessed whether or not changes to the act are needed to protect the government's and taxpayers' interests. In doing so, we analyzed the act's requirements and FmHA's implementing regulations for offering servicing. Specifically, we analyzed the act and its legislative history to determine if the Congress intended for FmHA to offer net recovery value buy-out and preservation service options to delinquent borrowers who had caused their delinquencies or otherwise acted in bad faith. We also analyzed delinquent borrowers' financial reports, maintained by FmHA county offices, to determine if serviced borrowers had other assets that could have been used to reduce their FmHA debts.

Third, we analyzed the act's potential impact on FmHA borrowers who were not 180 days or more delinquent on their loans when FmHA mailed application packages in November 1988. We compared loan payments for serviced delinquent borrowers with those for selected nondelinquent borrowers who (1) had similar outstanding FmHA loan balances and (2) farmed in the same community under similar economic and climatic conditions. We also interviewed 30 selected nondelinquent borrowers, FmHA state and county officials, and 17 county committee members to obtain their opinions on the act's impact.

To determine FmHA's policies, plans, and practices for servicing delinquent borrowers, we reviewed FmHA regulations, announcements, congressional testimony, articles, studies, and other documents relating to servicing under the Agricultural Credit Act. We also obtained information on FmHA's servicing activities by interviewing agency officials at FmHA headquarters and at each selected state and county office. Further, to determine the reliability of FmHA's DALRS computer program for calculating servicing entitlements, we reviewed a report by a private accounting firm on testing and validation of the program.

Finally, we reviewed the USDA Office of Inspector General's technical audit reports on FmHA's implementation of the act. We discussed our review objectives and coordinated our work with Office of Inspector General personnel to maximize audit coverage and minimize duplication of effort.

We conducted our review from December 1988 through November 1989. To assure comparability of data obtained at county offices, we compiled data on FmHA's servicing decisions through June 30, 1989. We performed our work in accordance with generally accepted governmental auditing standards.

- compiled information on borrower participation in debt servicing authorized by the act,
- determined if borrowers whose debts FmHA restructured had financial strength to operate potentially successful farm operations after servicing,
- determined whether changes to the act are needed to protect the government's and taxpayers' interest by precluding and limiting benefits for certain borrowers, and
- determined the act's potential impact on borrowers who were ineligible for servicing because they had kept their FmHA debts current.

We performed our work at FmHA headquarters and at 10 FmHA county offices and their respective state offices. Appendix II shows the states and county offices included in our review. We selected the 10 states with the largest number of servicing notification packages sent by FmHA to delinquent borrowers in November 1988. The 10 states, in order of the number of notification packages, were: Texas, Mississippi, Louisiana, Georgia, Minnesota, Missouri, Oklahoma, North Dakota, Tennessee, and South Dakota. The results of our work apply only to the offices we reviewed and cannot be projected to the 10 states or the nation overall.

We selected a county office in each state with a relatively high number of borrowers and a relatively high delinquency rate. For example, only 16 of 670 county offices in the 10 states, or about 2.4 percent, had more borrowers and a higher delinquency rate than the county offices we selected. All selected county offices except one had over 200 borrowers, and all except one had a delinquency rate greater than 51 percent. One county office had 133 borrowers, and another had a delinquency rate of 42 percent. We used FmHA's February 10, 1989, Farmer Program Delinquency Report to determine, by state and county office, the number of farmer program borrowers and the rate of loan delinquency. While we did not always select county offices with the highest delinquency rates, our process allowed us to avoid selecting FmHA offices with minimal Agricultural Credit Act activity.

To assess FmHA's implementation of the act and to determine the impact of debt servicing on FmHA delinquent borrowers, we analyzed FmHA records and reports for 569 borrowers who applied for servicing in the selected county offices. FmHA had provided notification packages to an additional 703 borrowers, but they did not apply for servicing. We interviewed 35 of these 703 borrowers who did not apply for servicing to determine their reasons for not applying. Also, we reviewed county

as homestead protection). These two options make up what is known as the preservation loan service program.

The Agricultural Credit Act also grants extensive appeal rights to delinquent borrowers who disagree with FmHA decisions in implementing the act. Borrowers are entitled to appeal each decision that FmHA makes in the loan servicing process. For example, borrowers may appeal FmHA county office decisions on (1) their eligibility for restructuring and (2) the appraised value of their collateral.

Loan Servicing Eligibility Requirements

To qualify for primary loan service programs, the act requires that (1) a borrower's delinquency must have been due to circumstances beyond the borrower's control and (2) a borrower must have acted in good faith in connection with the loan agreements. USDA has interpreted the act to require that delinquent borrowers who do not meet these conditions are eligible for FmHA net recovery value buy-out consideration. Such borrowers may also be eligible for preservation service options.

The act also provides that a borrower must present a preliminary plan, based on reasonable assumptions, showing that the borrower can meet farm operating and family living expenses and pay all debt, including any restructured debt. Borrowers who do not have a feasible plan are eligible for net recovery value buy-out. Such borrowers may also be eligible for preservation service options.

The act further requires that the restructured debt of borrowers result in a net recovery to the government that equals or exceeds the recovery from an involuntary liquidation or foreclosure on the property securing a loan. The value of a restructured loan is based on the present value of payments that a borrower would make if loan terms were modified under any combination of primary loan service programs. The act provided for restructuring when the present value of a borrower's restructured debt equaled or exceeded the recovery value of the collateral. Conversely, the act provided for net recovery value buy-out when the present value of the restructured loans was less than the recovery value of collateral.

Loan Servicing Process

The act required FmHA to notify all borrowers who were 180 days or more delinquent on an FmHA loan about the availability of loan servicing. Through a November 1988 mailing, FmHA notified more than 66,400 borrowers of the types of services available under the act and provided

November 1985; however, the Congress, in making supplemental appropriations for fiscal year 1987 (P.L. 100-71, July 11, 1987), directed FmHA to reinstate the policy. Also, the liberal eligibility for emergency loans, which represent the largest source of FmHA delinquent loans, increased delinquencies. Further, judicial decisions in 1984 and in 1987 prevented FmHA from foreclosing on delinquent borrowers.

Loan Servicing Under the Agricultural Credit Act

The Agricultural Credit Act required FmHA to notify borrowers who were delinquent 180 days or more of various debt relief measures. The act allowed FmHA to use several loan servicing options to restructure or reduce the debts of its delinquent farmer program borrowers. Each FmHA delinquent borrower was required to apply for servicing within a specific period of time to be eligible for the act's benefits. Also, each borrower had to meet specific eligibility requirements to qualify for restructuring. Further, the act required FmHA to process applications within a time-phased schedule (see app. I). FmHA designed a computer program—Debt and Loan Restructuring System (referred to by FmHA as DALRS)—to analyze borrowers' financial conditions to determine the servicing option for which they qualified.

Loan Servicing Options

The act provided FmHA three major options for servicing delinquent borrowers. First, it provided primary loan servicing (restructuring) options for good faith borrowers—those whose delinquency was due to circumstances beyond their control and who acted in good faith in connection with the terms of their FmHA loans—in which loan terms, interest rates, and amounts, were revised so the borrowers could continue farming. These borrowers remained in FmHA's loan portfolio. Second, it provided an option allowing such borrowers to buy out their debts at an adjusted value of the collateral securing their loans. Third, it provided preservation loan servicing options allowing borrowers to reacquire their farms or farm homesteads from FmHA in the event of foreclosure.

Primary loan service programs restructure a delinquent borrower's debt until the borrower demonstrates the ability to repay the loans. The act defines primary loan service programs as loan consolidation, rescheduling, or reamortization; interest rate reduction; debt set-aside, deferral, or write-down of outstanding principal and accumulated interest; or any combination of these options. The act's principal change to FmHA's loan servicing was the addition of the debt write-down option

Introduction

The Agricultural Credit Act of 1987 (P.L. 100-233, Jan. 6, 1988) allowed for substantial revisions in the Farmers Home Administration's (FmHA) loan servicing procedures. In particular, the act's debt restructuring provision allowed for a write-down of debt to the recovery value of the collateral securing the debt for delinquent farmer program borrowers. If delinquent borrowers could not project a feasible plan for their farm operations with debt restructuring, they could buy out their debt at the net recovery value of collateral and end their FmHA debt obligation. These changes were intended to preserve borrowers' farming or ranching operations while minimizing the government's losses on farmer program loans.

FmHA is the credit agency in the U.S. Department of Agriculture (USDA) for agriculture and rural development. FmHA serves as a temporary source of credit for family farmers whose financial situation prevents their obtaining credit elsewhere at reasonable rates and terms. FmHA is commonly referred to as the "lender of last resort" for farmers. As such, FmHA's loan portfolio can be categorized as "high risk."

FmHA assists farmers through direct loans and guarantees on loans made by other lenders for purchasing, expanding, and operating farms. FmHA's major farm loan programs include

- farm ownership loans to buy and improve farm land and to construct, repair, and improve buildings;
- farm operating loans for feed, seed, fertilizer, livestock, farm and home equipment, living expenses, and seasonal hired labor;
- emergency loans for losses caused by natural disasters; and
- soil and water loans to help farmers and ranchers develop, conserve, and properly use land and water resources.

Delinquency Status of FmHA's Loan Portfolio

In January 1988, when the Agricultural Credit Act was enacted, FmHA estimated that delinquent borrowers were past due on about \$9.6 billion in principal and interest payments. The outstanding principal balance on loans to delinquent borrowers was \$11.4 billion of the agency's total \$26 billion direct loan portfolio. According to the agency, about 85,000 of its 242,000 farmer program borrowers were delinquent and another 33,000 were in bankruptcy, foreclosure, or some other "inactive" status.

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Abbreviations

DALRS	Debt and Loan Restructuring System
ERS	Economic Research Service
FmHA	Farmers Home Administration
GAO	General Accounting Office
USDA	U.S. Department of Agriculture

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their ability to repay their loans and continue farming even after FmHA servicing. Also, FmHA officials in nine county offices anticipated that restructured borrowers will become delinquent again and return for debt relief. Existing law allows unlimited restructuring.

Benefits Need to Be Precluded and Limited for Certain Borrowers

Under USDA's interpretation of the act, bad faith borrowers are eligible for net recovery value buy-out. FmHA reported in January 1990 that 218 borrowers who acted in bad faith in fulfilling their loan agreements received net recovery value buy-out offers. One hundred of these borrowers had bought out, or were in the process of buying out, their debt. The remaining 118 borrowers did not accept the buy-out offers. The basis for USDA's interpretation of the act is not apparent. In GAO's view, the net recovery value buy-out option is available only to good faith borrowers. Nevertheless, legislative action would ensure that borrowers who act in bad faith do not receive the act's benefits.

The act also permits some benefits for delinquent borrowers that are not in the government's or taxpayers' best interest. First, bad faith borrowers may reacquire their farms or farm homesteads under preservation servicing options if FmHA forecloses on their farm properties. Second, the act permits FmHA to offer restructuring without considering borrowers' unsecured assets. Also, the act does not allow FmHA to include such assets in computing the net recovery value buy-out amount. Excluding unsecured assets increases the amount of debt relief, and thus reduces the government's recovery when loans are restructured with write-down or bought out at the net recovery value of collateral.

Agricultural Credit Act May Encourage Defaults by Nondelinquent Borrowers

Most nondelinquent borrowers interviewed by GAO questioned the equity of the act because it provided debt relief only for borrowers who defaulted on their FmHA loans. Some nondelinquent borrowers stated they intended to become delinquent to qualify for debt relief. While county supervisors can deny servicing for borrowers who cause their delinquencies, it is difficult for them to do because they rely primarily on borrower-submitted information as a basis for decisions.

Recent Congressional Actions Aimed at Debt Servicing Problems

In March 1990, the House of Representatives passed a bill, H.R. 4077, to amend the Agricultural Credit Act to prevent bad faith borrowers from receiving loan write-offs and authorize FmHA to consider all borrower assets in making loan servicing decisions. As of June 28, 1990, the Senate had not passed a similar bill. However, various changes to the act

Executive Summary

Purpose

The Farmers Home Administration (FmHA) had billions of dollars of delinquent farm loans in its portfolio when the Agricultural Credit Act of 1987 was enacted. The act was designed not only to help delinquent borrowers continue farming, but to minimize the government's losses. However, FmHA estimated the act's implementation will result in its forgiving about \$9.4 billion in delinquent farm loans.

In response to a request of the Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, GAO (1) examined borrower participation in debt servicing, (2) determined if borrowers whose debts FmHA restructured had the financial potential to operate successful farms, (3) determined whether changes to the act are needed to preclude and limit benefits for certain borrowers, and (4) determined the act's potential impact on nondelinquent borrowers.

Background

FmHA—the “lender of last resort” in the U.S. Department of Agriculture (USDA)—provides loans to farmers who are unable to obtain credit elsewhere at reasonable rates and terms. In January 1988, FmHA estimated that the outstanding principal balance on delinquent loans was \$11.4 billion of its \$26 billion direct farm loan portfolio. The act required FmHA to notify borrowers who were delinquent 180 days or more of various debt relief measures, such as restructuring loan terms and writing down debt, or allowing borrowers to pay FmHA an amount equal to the adjusted value of the collateral securing the debt—referred to as net recovery value buy-out—to end their FmHA debt obligations.

Results in Brief

As of November 30, 1989, FmHA-approved debt forgiveness totaled \$1.8 billion for 9,637 delinquent borrowers who were serviced under the provisions of the act. FmHA approved restructuring the farm loans of an additional 9,599 delinquent borrowers without debt forgiveness. Also, 6,341 other borrowers received debt settlement—costing an additional \$933 million in debt write-offs—rather than servicing under the act.

GAO seriously doubts that the act's objective of keeping borrowers on the farm or ranch will be achieved. First, only half of the delinquent borrowers who were notified of the act's benefits applied for servicing. Second, only one-third of those who qualified for servicing in the 10 counties GAO visited were offered restructuring. Third, slightly over 90 percent of those whose debt FmHA offered to restructure in the counties GAO visited will remain financially weak after their debt is serviced.

