U.S. Department of Agriculture

Office of Inspector General

FSA Farm Loan Security

Audit Report 03601-18-Ch
August 2010

U.S. Department of Agriculture
Office of Inspector General
Washington, D.C. 20250

DATE: August 10, 2010

REPLY TO
ATTN OF: 03601-18-Ch

TO: Jonathan W. Coppess
Administrator
Farm Service Agency

ATTN: Philip Sharp
Acting Director
Operations Review and Analysis Staff

FROM: Gil H. Harden /s/
Assistant Inspector General
for Audit

SUBJECT: FSA Farm Loan Security

This report presents the results of the subject audit. Your written response to the official draft report is included at the end of the report. Excerpts from the response and the Office of Inspector General's (OIG) position are incorporated into the relevant sections of the report. Based on the information in your written response, we have reached management decision on all five recommendations. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

We appreciate the courtesies and cooperation extended to us by members of your staff during the review.

Table of Contents

Executive Summary

This report presents the results of our audit of the Farm Service Agency's (FSA) controls and oversight of farm loan security (hereinafter referred to as loan collateral) for direct operating loans. Through its operating loans, FSA provides temporary financial assistance to farmers and ranchers who are unable to secure commercial credit at reasonable rates and terms. Our objective was to assess FSA's control and oversight of loan collateral to ensure that its operating loans were adequately secured. Specifically, we assessed agency controls to ensure that loan collateral inspections were conducted as required, that borrowers were properly maintaining loan collateral, that required annual assessments of borrowers' farm operations were properly completed by FSA personnel, and that appropriate servicing and enforcement actions were taken when borrowers sold or otherwise disposed of loan collateral.

In the 3 States[1] we visited, FSA maintained a portfolio of over 8,200 direct operating loans with a total obligation value of more than $332 million as of May 31, 2008. Our audit found that, for the 71 loans we reviewed and the site visits we conducted, FSA's direct operating loans were adequately secured. This was due to FSA's requirement to over-collateralize loans to ensure FSA's interests were protected, when possible. However, we found unauthorized removals of loan collateral by 18 of the 71 borrowers we visited (25 percent).[2] We also identified loan servicing issues that needed to be corrected by FSA officials in order to protect FSA's interests as described below. The uncorrected loan servicing issues could encourage borrowers to not follow FSA requirements when disposing of loan collateral. This, in turn, could reduce FSA's assurance that its loans are adequately secured.

- We found that FSA county officials did not always take required enforcement actions, such as placing the borrowers in non-monetary default status, when they became aware that borrowers had sold or otherwise disposed of loan collateral without FSA's knowledge or approval. For instance, FSA personnel at the county offices post-approved the loan collateral dispositions in 17 of the 18[3] unauthorized disposition cases identified, even though 7 of the borrowers had not met the regulatory requirements needed to justify this action.

- FSA county officials did not perform required inspections of loan collateral to verify the borrowers' possession of property listed on the security documents for 15 of the 71 sample loans reviewed. We found loan collateral missing for 6 of these 15 loans. However, this missing collateral did not affect the security of the loans because the loans were over-collateralized. County officials stated they either did not have time to conduct the reviews or did not believe the borrowers were at risk to default.

[1] Arkansas, Kentucky, and Michigan.
[2] In each of 12 of the cases of unauthorized disposition, the items disposed of had a value of less than $3,000.
[3] One of the direct operating loans selected and reviewed had recently been the subject of an OIG investigation. The case had been adjudicated, and the borrower found guilty of converting FSA loan collateral. The loan was retained as part of our random sample so we could confirm the status of the remaining collateral property.

- FSA county officials had not completed required annual assessment reviews of borrowers' farm operations for 13 of the 71 loans reviewed. Additionally, in eight cases the FSA county officials had not properly completed the more extensive yearend analyses that were required due to the borrowers' circumstances (such as a distressed financial condition). FSA county personnel attributed this to inadequate staff or to misinterpretations of the regulatory requirements.

- FSA's oversight review processes did not disclose post-approvals of unauthorized dispositions of loan collateral for borrowers who were not eligible for such servicing, as we found during the audit. The results of District Director reviews are not accumulated or analyzed on a national basis to identify the extent of deficiencies noted by the reviews. The County Operations Review Program did not disclose post-approvals of unauthorized dispositions as a finding for fiscal year 2008, and the 27 Farm Loan Program Risk Assessment reports we analyzed disclosed that the issue of post-approvals of unauthorized dispositions were not addressed during the reviews.

One of our objectives was to evaluate whether loan collateral released for essential family living and farm operating expenses was made in accordance with the regulations. We reviewed 17 loans with a total of 35 releases of loan collateral for essential family living and farm operating expenses. Our audit found that FSA county personnel properly implemented the requirements, and we are not reporting any exceptions in this area.

Recommendation Summary

We recommended that FSA remind field offices to document shortages of loan collateral found during farm visits and properly follow post-approval procedures. We also recommended that FSA officials (1) ensure appropriate enforcement actions are implemented upon discovery of unauthorized loan collateral dispositions; (2) design and implement a system to record all unauthorized dispositions found and, in the interim, instruct county offices to maintain manual logs; (3) strengthen the oversight review processes to ensure post-approvals of unauthorized dispositions are identified and evaluated; and (4) establish controls to ensure the performance of required loan collateral inspections, borrower assessments, and yearend analyses.

Agency Response

In their response dated June 30, 2010, FSA officials agreed with the findings and recommendations contained in this report. FSA officials stated that District Directors would be given responsibility for overseeing cases involving unauthorized dispositions of loan collateral, and would be responsible for reviewing all post-approvals or borrower repayments. FSA handbook revisions to implement additional reporting and tracking of unauthorized dispositions of collateral, including oversight of post-approvals and enforcement actions, would be implemented by June 30, 2010. While a manual system will be established in the interim, FSA officials also stated that a function for tracking unauthorized dispositions of collateral will be incorporated into FSA's Direct Loan Servicing automated system in 2013, as part of its Phase III implementation. This system will also be used to track the performance of required collateral inspections, borrower assessments, and yearend analyses, with oversight to be provided by the District Directors.

We have incorporated applicable portions of the response, along with our position, after each recommendation. FSA’s response, in its entirety, is included at the end of this report.

OIG Position

We agree with the actions FSA has taken, or has underway, in response to our recommendations. We have reached management decision on all five of the recommendations.

Background & Objectives

Background

The Farm Service Agency (FSA) makes direct loans to family farmers and ranchers to purchase farmland and finance agricultural production. FSA also guarantees loans made by banks to family farmers and ranchers to similarly purchase farmland and finance agricultural production; however, we did not review guaranteed loans as part of this audit. FSA's Farm Loan Programs (FLP) are designed to help family farmers who are temporarily unable to obtain private commercial credit. Eligibility requirements for a direct loan include demonstrating the managerial ability needed to succeed in farming, being unable to obtain credit elsewhere, having an acceptable credit history, and not being delinquent on any Federal debt.

FSA's direct loans include Farm Ownership Loans (FO) and Operating Loans (OL). Eligible applicants may obtain an FO or OL up to a maximum indebtedness of $300,000. The maximum repayment term is 40 years for an FO. In general, FO funds may be used to purchase farm real estate, enlarge an existing farm, construct new farm buildings and/or improve structures, and improve the environmental soundness of the farm. The repayment term may vary for OLs, but typically will not exceed 7 years for intermediate-term purposes. Annual OLs are generally repaid within 12 months or when the commodities produced are sold. In general, loan funds may be used for normal operating expenses, machinery and equipment, real estate repairs, and refinancing debt.

Borrowers are required to maintain all loan collateral pledged for FSA loans.[4] FSA officials are required to inspect the loan collateral periodically. The purpose of the inspection, which must be done at least once every 2 years for direct OLs and at least once every 3 years for direct FOs, is to confirm that the borrower retains possession of all the property listed in the security instrument and that it is being properly maintained. At inspection, FSA officials are also to update the security instrument to ensure it reflects the actual property securing the debt. All inspections must be recorded in the borrower's case file.[5]

If a borrower disposes of loan collateral without FSA approval, or misuses the sale proceeds, it is considered an unauthorized disposition. The borrower must either make restitution to FSA or provide the necessary information to enable FSA to consider post-approval of the disposition within 30 days of agency notification.[6] FSA can post-approve these dispositions of loan collateral provided that specific requirements are met.[7] The failure of a borrower to resolve a first unauthorized disposition, or a second unauthorized disposition whether resolved or not, constitutes a non-monetary default. A non-monetary default may adversely impact the borrower's future eligibility for FSA loans and programs and could result in civil or criminal actions.[8]

---

[4] 7 *Code of Federal Regulations (*CFR*) §* 765.202(b), dated January 1, 2008.
[5] *FSA Handbook 4-FLP*, Amendment 1, paragraph 96, dated December 31, 2007.
[6] 7 CFR § 765.304, dated January 1, 2008.
[7] *FSA Handbook 4-FLP*, Amendment 1, paragraph 182, dated December 31, 2007.
[8] 7 CFR § 765.304, dated January 1, 2008.

FSA is also responsible for providing credit counseling and supervising direct loan borrowers through an assessment of each borrower's farming operations. The initial assessment is completed after a borrower, who is not currently indebted to FSA, is determined eligible for a direct loan. This assessment determines the loan applicant's financial condition, organizational structure, management strengths and weaknesses, appropriate levels of agency oversight, credit counseling needs, and training needs.[9]

This initial assessment is to be reviewed at least annually to determine the borrower's progress and to evaluate the effectiveness of FSA's supervisory assistance. This annual review must address any significant changes to the borrower's farming operation, expenses, or financial condition that have occurred since the most recent assessment or annual review.[10] FSA may also conduct a yearend analysis, at its discretion. However, FSA is required to conduct the yearend analysis if the borrower has received either a direct loan, loan collateral subordination, or primary loan servicing action within the last year, is financially distressed or delinquent, has a loan deferred, or is receiving a limited resource interest rate on any loan.[11] The yearend analysis identifies and evaluates significant changes in the borrower's operations, compares actual performance to projections, and analyzes how performance can be improved. The yearend analysis provides an opportunity for borrowers and FSA to discuss and evaluate a borrower's financial and production performance, progress toward goals, effectiveness of operational management, and FSA supervision and oversight.

As needed, FSA may release "normal income security" for "essential family living and farm operating expenses" under certain conditions. FSA Handbook 4-FLP defines "essential family living and farm operating expenses,"[12] "normal income security,"[13] and "basic security."[14] Proceeds from the sale of "basic security" may not be used for any family living or farm operating expenses. These proceeds are to be used to repay the loan or to purchase property better suited to the borrower's needs if FSA acquires a lien on the purchased property.

Objectives

The objective of the audit was to assess FSA's control and oversight of farm loan collateral to ensure that its operating loans were adequately secured. Specifically, we assessed controls to ensure that inspections were conducted as required, unauthorized dispositions of loan collateral were properly dealt with, and annual assessments of borrowers' operations were properly completed. We also assessed the controls over releases of loan collateral for essential family living and farm operating expenses to ensure they were made in proper amounts and were supported, with particular focus on those releases made for the following year's operating expenses.

---

[9] *FSA Handbook 1-FLP* (Revision 1), Amendment 1, paragraph 221, dated December 31, 2007.
[10] *FSA Handbook 1-FLP* (Revision 1), Amendment 1, paragraph 223, dated December 31, 2007.
[11] 7 CFR § 761.105, dated January 1, 2008.
[12] "Essential family living and farm operating expenses" are those that are basic, crucial, and indispensable; are determined by FSA based on the borrower's operations; and include, but are not limited to, essential household operating expenses, health and medical expenses, and specified farm operating expenses such as feed for animals.
[13] "Normal income security" is defined as all security that is not considered "basic security" and includes property covered by FSA liens that is sold in conjunction with the operation of the farm (i.e., crops, livestock, poultry products, etc.).
[14] "Basic security" includes all farm machinery, equipment, vehicles, breeding livestock, and real estate.

Section 1: FSA Needs to Strengthen Loan Servicing Efforts

Finding 1: FSA Loan Collateral Enforcement Actions Need Improvement

Our review of 71 direct OLs in 3 States disclosed that 18 of 71 borrowers we visited disposed of FSA loan collateral without the required prior approval. We also found that loan servicing needed improvement in order to protect FSA's interests. We found that FSA county personnel did not always take required enforcement actions when they became aware that borrowers had disposed of loan collateral but instead routinely post-approved unauthorized dispositions by borrowers who did not qualify, and who should instead have been the subject of enforcement actions by FSA. If uncorrected, these servicing issues could encourage borrowers to not follow FSA requirements when disposing of loan collateral, which in turn could reduce FSA's assurance that its loans are adequately secured.

Improper Servicing Actions by FSA County Office Personnel

In our visits to 36 county offices in 3 States, we found that FSA personnel routinely post-approved borrowers' unauthorized loan collateral dispositions. FSA requires that borrowers meet certain conditions before such approvals are issued. We found that FSA county office personnel did not follow this requirement because they believed that even after the unauthorized dispositions, the loans were still adequately collateralized and FSA's security interests were protected. In all, we and/or FSA discovered unauthorized dispositions of loan collateral on 18 of 71 randomly-selected OLs we reviewed, 17 of which were post-approved by county office personnel.[15] We determined that the borrowers' actions in 7 of the 17 instances did not meet the criteria for post-approvals and should instead have caused enforcement actions to be taken.[16] While FSA's policy of obtaining additional collateral on its loans protected its security interest on the 17 disposition cases we reviewed, this practice of post-approving all unauthorized dispositions could encourage other borrowers to fail to follow FSA requirements when making dispositions of loan collateral. This, in turn, could reduce FSA's assurance that its nationwide loan portfolio is backed by sufficient collateral to ensure the agency's security interest.

Regulations require borrowers to maintain all collateral securing their loans[17] or to obtain FSA's consent before disposing of loan collateral.[18] If a borrower disposes of loan collateral without FSA's approval or misuses the proceeds of that disposal, the borrower must either make restitution to FSA or provide information to enable FSA to consider post-approval within 30 days of FSA becoming aware of the disposition.[19] Loan officials may post-approve the disposition provided that the borrower (1) remits the proceeds from the sale of the loan collateral

---

15 One of the direct operating loans selected and reviewed had recently been the subject of an OIG investigation. The case had been adjudicated and the borrower found guilty of converting FSA loan collateral. The loan was retained as part of our random sample so we could confirm the status of the remaining collateral property.

16 Enforcement actions include placing the borrower in non-monetary default status, which may adversely affect his or her eligibility to participate in FSA programs and can also result in civil or criminal penalties, according to 7 CFR 765.304(b), dated January 1, 2008.

17 7 CFR § 765.202(b), dated January 1, 2008.

18 7 CFR § 765.302(d), dated January 1, 2008.

19 7 CFR § 765.304, dated January 1, 2008.

to FSA or (2) uses the proceeds to purchase property better suited to the borrower's operations and in which FSA will acquire a lien at least equal in value to that held on the disposed loan collateral.[20]

At a borrower's first unauthorized disposition, there are no consequences if the requirements for post-approval are met. However, failure to meet these requirements places the borrower in non-monetary default status, which may adversely affect his or her eligibility to participate in FSA programs and can also result in civil or criminal penalties. If a borrower is found to have committed a second unauthorized disposition, FSA is required to place the borrower in non-monetary default status.[21]

We randomly selected 71 direct OLs in 3 States and made farm visits to the borrowers, accompanied by FSA county officials. We found 18 cases where borrowers did not have all of the loan collateral listed on security documents and had failed to report the disposition of the loan collateral to FSA county personnel. Items found missing included loan collateral such as tractors and wagons. The borrowers in these cases told us they had either forgotten to report the dispositions or were not aware they had to report them.

We referred 17 of these 18 borrowers (one borrower had already been the subject of an OIG investigation) to the applicable county officials for enforcement action, but in each case FSA personnel post-approved the unauthorized dispositions of loan collateral. In reviewing the circumstances of the dispositions, we agreed that in 10 of the 17 cases the post-approvals appeared to be justified because the borrowers had purchased equipment better suited to their operations or paid FSA the proceeds after the unauthorized disposition was discovered. FSA county personnel believed that the new items purchased with the sales proceeds would serve as loan collateral for the operating loans even when, as happened in one case, FSA had to take a subordinate security position because the new item was purchased using loan funds from a source other than FSA.[22]

In the remaining seven cases, however, we disagreed with FSA's determinations to post-approve the dispositions because the borrowers failed to meet regulatory requirements. In these cases, according to the borrowers' case files, the proceeds from the dispositions were neither remitted to FSA nor used to purchase items better suited to the borrower's operation in which FSA would have a security interest. FSA county officials stated that in all of these cases, the loans had been over-collateralized because of FSA's requirement to take all available collateral as loan security.[23] As a result, they determined that FSA's security position was not jeopardized and there was no need for further action against the borrower. However, the regulations do not cite this among the criteria for determining whether or not a post-approval is justified. We discussed this issue with FSA officials at the three State offices we visited. The officials concurred that borrowers who commit unauthorized dispositions of loan collateral should not be given post-approvals unless they meet the requirements outlined in the regulations.

---

[20] *FSA Handbook 4-FLP*, Amendment 1, paragraphs 182 and 163, dated December 31, 2007.
[21] 7 CFR § 765.304(b), dated January 1, 2008.
[22] We did not take exception to this because FSA began taking appropriate action upon discovery of the disposition. In response to FSA's actions, the borrower paid FSA in full within 30 days.
[23] 7 CFR § 764.103, dated January 1, 2008.

During interviews with FSA county personnel, we also found that they could not always be certain whether a borrower who had disposed of loan collateral without authorization may have committed previous unauthorized dispositions, which would require servicing the borrower for non-monetary default. FSA lacks an automated system to track unauthorized dispositions, and none of the county offices had implemented a system for recording and tracking this information for each borrower. Other than manually going through the borrower's case file(s), which could be voluminous for borrowers who have had relationships with FSA going back many years, FSA had no way to identify any prior occurrences. On one of our borrower farm visits, for instance, we found that a cultivator listed as loan collateral was missing. According to the borrower, this was not a recent disposition as it had actually been sold in 2002. FSA personnel could not locate the borrower's loan file from that year and were unable to determine whether this disposition had been approved or why the cultivator had not been removed from FSA's loan security agreement. Without a system to record and track unauthorized dispositions, FSA cannot reliably determine whether long-time borrowers have histories of unauthorized dispositions that would constitute a non-monetary default, which could adversely impact future requests for FSA assistance and could result in civil or criminal action.[24]

We discussed these issues with FSA Headquarters officials, who likewise stated that county officials should not post-approve unauthorized dispositions unless the regulatory requirements have been met, even if the borrower still has enough collateral to secure FSA's loan position. They agreed that the agency needs to improve its ability to track whether borrowers have histories of noncompliance that might affect current servicing, enforcement, or future eligibility decisions. They stated that FSA is working on a new system that could incorporate such a feature in the future.

Oversight Processes Need Improvement

FSA utilizes a system of oversight reviews and assessments to maintain the efficiency and integrity of its programs. We identified three of these that could be expected to detect unauthorized dispositions of loan collateral, as specified below.

- As the Farm Loan Manager's first-line supervisor who manages the FLP activities, it is incumbent upon each District Director (DD) to monitor program delivery to ensure compliance with applicable requirements. The DD oversight process provides a consistent reporting format and a means by which DDs can monitor and follow up on actions taken by county office staff.[25] According to an FSA Headquarters official, DDs are to annually review county offices' accounting for loan collateral security. This review is based on a sample of loans. If a sampled loan folder includes a documented case of an authorized or unauthorized disposition, the DD should review the circumstances of the disposition and the use of any sale proceeds. FSA Headquarters officials' oversight responsibilities for DD reviews are limited to ensuring that they are performed; they do not include accumulating or analyzing the results of DD reviews on a national basis to identify the extent of deficiencies noted by the reviews.

[24] *FSA Handbook 4-FLP*, Amendment 1, paragraph 183, dated December 31, 2007.
[25] *FSA Handbook 1-FLP* (Revision 1) Amendment 18, paragraph 441, dated December 19, 2008.

- The Farm Loan Program Risk Assessment (FLPRA) is the primary tool FSA's FLP staff uses for ongoing reviews and oversight of field office operations. FLPRA evaluates the FLP using a risk-based approach, and its objectives include ensuring compliance with applicable requirements. FSA's national office is required to review 10-12 States per year, and each State office is required to review at least one-third of its FLP service centers annually. Each service center must be reviewed at least once every 5 years.[26] Our review of 27 completed FLPRA reviews disclosed that post-approvals of unauthorized dispositions were not addressed.
- The County Operations Review Program (CORP) was implemented to conduct targeted reviews of high risk programs and activities in field offices and to conduct followup reviews to ensure corrective actions were properly made and continued. In fiscal year (FY) 2008, a total of 1,138 CORP reports were issued. The reports only address "common findings," defined as procedural errors applicable to an operation or program in at least 15 percent of the reports issued for that operation or program in a fiscal year. Post-approvals of unauthorized dispositions were not included as a common finding.

Overall, we analyzed the 27 FLPRA State reviews performed by FSA Headquarters staff from FYs 2005 to 2008 (those completed through April 2008). We also reviewed the nationwide CORP Report for FY 2008, issued in December 2008. We found that none of the reviews had disclosed the problem of unsupported post-approvals of unauthorized loan collateral which our own visits disclosed. While we did not have access to the FSA on-line system to review DD reports, we did assess the DD oversight review instructions. DDs are to coordinate and plan oversight review visits with State office officials, and to report any apparent problems that may require immediate attention to the appropriate State office official. Reporting of oversight review results is to be completed quarterly using FSA's on-line District Director Oversight Reporting System (DDORS). DDs are responsible for using DDORS to document specific findings for each case file or operational file reviewed, to complete all quarterly review items for each county office, and to submit oversight reports. FSA State Executive Directors (SEDs) are to ensure that timely DD oversight reviews are completed in DDORS. Farm Loan Chiefs (FLC) are required to review DDORS reports, discuss concerns with the DDs and the SEDs, and to fully document actions taken to remedy identified deficiencies.[27] We interviewed FSA Headquarters officials regarding these reviews, and they agreed to revise the DD review instructions to include evaluation of the handling of unauthorized loan collateral dispositions, along with the appropriate followup. We believe this would be a practical way of addressing the improper post-approval of unauthorized dispositions.

In all, over 25 percent of our randomly-sampled borrowers had disposed of loan collateral without prior FSA authorization and, based on this, we believe that these unauthorized dispositions are not rare occurrences. We also concluded that FSA's policy of over-collateralizing its loans is effective in protecting the agency's security interest, since none of the unauthorized removals we found had resulted in FSA being under-secured. However, other

---

[26] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, paragraph 401, dated December 31, 2007.
[27] *FSA Handbook 1-FLP* (Revision 1), Amendments 18 and 34, dated December 19, 2008, and December 29, 2009, respectively.

borrowers could be encouraged to sell or otherwise dispose of loan collateral if they become aware that they can do this with no fear of consequences from FSA.

We believe that FSA needs to remind its county officials to ensure that appropriate actions are taken when unauthorized removals are identified, whether or not they appear to directly affect FSA's security position. In addition, we believe that FSA should implement a means of tracking such occurrences, so that county personnel can readily identify cases where borrowers' past histories constitute non-monetary default and require different servicing actions. We also believe that FSA should strengthen its oversight processes to include reviews of post-approvals of unauthorized loan collateral dispositions, and that the processes should implement followup procedures to ensure compliance with the applicable criteria in order to mitigate future non-compliance. FSA Headquarters officials agreed that tracking unauthorized dispositions and strengthening DD reviews are viable options for improving the FLP.

Recommendation 1

Remind field offices to document shortages of loan collateral found during farm visits and to properly follow post-approval procedures.

Agency Response

FSA officials agreed with this recommendation. The agency will require Farm Loan Managers to report all discoveries of unauthorized dispositions to DDs, who have been made responsible for ensuring all required regulations are followed. FSA officials stated changes would be made in the appropriate handbooks to address these revisions by June 30, 2010, and that a notice will be issued to DDs and Farm Loan Managers to call their attention to the revisions.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Design and implement an automated system capable of recording unauthorized dispositions for tracking purposes, or incorporate this capability into an existing system. In the interim, require county officials to maintain a manual log of all cases where unauthorized dispositions are disclosed by inspections or other means.

Agency Response

FSA officials agreed with this recommendation and stated this function would be incorporated into the Direct Loan Servicing automated system in 2013. In the interim, FSA handbook revisions to be issued by June 30, 2010, will establish a manual system to log all cases where unauthorized dispositions are disclosed. A notice will be issued to DDs and Farm Loan Managers to call their attention to these changes.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Strengthen the oversight review process to ensure that post-approvals of unauthorized dispositions are being identified and reviewed to evaluate whether these post-approvals are justified. Implement a followup process to ensure that any required corrective actions are taken.

Agency Response

FSA officials concurred with this recommendation and stated that handbook revisions, which are expected to be issued by June 30, 2010, will require DDs to review post-approvals for compliance with applicable procedures. A notice will be issued to DDs and Farm Loan Managers to call their attention to these changes.

OIG Position

We accept management decision for this recommendation.

Finding 2: Loan Collateral Inspections Were Not Always Performed

We found that FSA had not conducted the required loan collateral inspections for 15 of the 71 borrowers we visited. Although these inspections are required to be made annually unless justified in the borrower's file, at the time of our visits these borrowers had gone without inspections for periods ranging up to 30 months without documented justification. FSA county personnel attributed this to their workloads and to other priorities. We found that unauthorized dispositions of loan collateral had occurred in 6 of these 15 cases, which might have been identified earlier if inspections had been made on the required basis.

Loan collateral for direct OLs must be inspected annually, except in cases where the authorized official has justified in the annual review of the assessment or yearend analysis of the borrowers' operations that no undue risk exists. However, all loan collateral for direct OLs must be inspected at least every 2 years. The purposes of the inspections are to (1) verify that the borrowers possess all property listed in the security agreement, (2) determine that the borrowers are properly maintaining the loan collateral, and (3) update the security agreements, as necessary.[28]

For one sampled loan, for instance, FSA officials had not performed an inspection in over 30 months. For another sampled loan, we found that 25 months had elapsed since FSA performed a loan collateral inspection. In neither case did the borrower's assessment or running record in the loan file justify not conducting a yearly inspection, which would then have

[28] *FSA Handbook 4-FLP*, Amendment 1, paragraph 96C, dated December 31, 2007.

warranted an inspection only every 2 years. In both instances, our farm visits, accompanied by FSA county officials, found that the borrowers disposed of the loan collateral without FSA's knowledge or approval. Overall, we found unauthorized dispositions at 6 of these 15 cases.

FSA county officials stated that their workload of making and servicing loans, as well as limited staffing, prevented them from always completing loan collateral inspections. One FSA county office employee told us that loan teams did not always complete inspections each year because each county office was responsible for servicing a large geographic area and did not always have adequate staff to complete inspections. Other FSA personnel stated that they put a lower priority on performing inspections of borrowers who had consistently made timely loan payments and with whom they had not had problems in the past, but had not documented these determinations in the borrowers' loan files.

FSA State office officials stated that they were aware that inspections were not always performed as required, and that the idea of setting priorities for conducting inspections would be helpful, by allowing for borrowers who needed more frequent checks to receive them. At one State office, the FLC stated that he believed that performing all required inspections was not too much to ask of the farm loan officials and that, even though more time is spent on making new loans, servicing is just as important as loan making.

Recommendation 4

Establish controls to ensure that FSA county officials perform required annual inspections of loan collateral.

Agency Response

FSA officials concurred with this recommendation and stated that the ability to track annual inspections of loan collateral to determine compliance was implemented in the Direct Loan Servicing automated system in April 2010. In cases where FSA personnel determine and document that insufficient resources (personnel or travel funding) are available to ensure completion of required annual inspections, FSA will prioritize their completion based on risk and will document the basis for each low-risk priority determination. The appropriate FSA handbook will be revised by September 1, 2010, to implement these changes.

Subsequent to our receipt of the FSA written response, dated June 30, 2010, we sought clarification from FSA regarding the controls established to ensure timely completion of the required inspections of loan collateral. On July 12, 2010, an FSA official explained that beginning in April 2010, the Direct Loan Servicing system now provides county office staffs with monthly task calendars that include any required inspections of loan collateral. If these inspections cannot be completed because of the lack of resources, county office staffs are required to prioritize and complete these as outlined in the written response. To provide the necessary control, DDs are responsible for reviewing the county office staffs' actions during their annual operations reviews.

OIG Position

We accept management decision for this recommendation.

Finding 3: Loan Teams Did Not Complete Annual Assessments and Yearend Analyses

For 13 of the 71 OLs we reviewed, we found that FSA county officials did not annually review the borrowers' farm assessments as required. The purposes of these reviews are to update the operations and goals outlined in the initial assessment, completed after a new applicant is initially determined eligible for a loan, and to document the borrower's progress toward meeting those goals. In addition, FSA officials did not timely perform the more detailed yearend analyses (see below for assessment differences) for 8 of the 21 borrowers who had required them.[29] In some cases, FSA personnel attributed this to a lack of sufficient staff, while others stated that they had misunderstood the regulatory requirement for FSA personnel to conduct the reviews. Without making timely reviews and analyses of the borrowers' assessments, FSA officials may not always be aware of changes to a borrower's situation that could necessitate different loan making or servicing decisions. In some instances, the results of such reviews could warn FSA of situations which, if uncorrected, could eventually lead to defaults on a borrower's OLs.

The farm assessment describes the borrower's operations and evaluates the goals for the operation, the adequacy of real estate and other property used to conduct the farming operation, historical performance, the farm operating plan, the supervisory plan, and the training plan. Federal regulations[30] require FSA to review each borrower's farm assessment at least annually to update any progress made. The review can be in the form of an office visit, field visit, letter, telephone conversation, or yearend analysis, as determined by the agency. The FSA Handbook[31] reiterates this requirement, stating that the annual review must address any significant changes to the borrower's farming operations, expenses, or financial condition that have occurred since the most recent annual review and assessment update was completed. It also serves as a gauge for measuring the borrower's progress and the effectiveness of FSA assistance. During the annual assessment, FSA officials evaluate each borrower and determine if the borrower requires a yearend analysis.

The yearend analysis is to identify and evaluate significant changes in the borrower's operations, compare actual performance to projections and calculate the variances, analyze how performance can be improved, and prepare an updated farm operating plan.[32] The yearend analysis must be performed in as much detail as the farm operating plan,[33] which was prepared by the borrower and documents the farm operation's financial position, cash flow, and repayment ability.[34] The farm operating plan includes actual and projected income and expenses; assets and liabilities;

[29] A yearend analysis is required for borrowers who received any direct loan, loan collateral subordination, or primary loan servicing within the last year, is financially distressed or delinquent, has a loan deferred, or is receiving a limited resource interest rate on any loan, according to 7 CFR § 761.105, dated January 1, 2008.
[30] 7 CFR § 761.103(d), dated January 1, 2008.
[31] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, paragraph 223, dated December 31, 2007.
[32] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, paragraph 263, dated December 31, 2007.
[33] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, paragraph 261, dated December 31, 2007.
[34] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, paragraph 241, dated December 31, 2007.

and borrower training.[35] The yearend analysis may be performed at FSA's discretion, except that it must be performed if the borrower has received any direct loan, loan collateral subordination, or primary loan servicing action within the last year; is financially distressed or delinquent; has a loan deferred; or is receiving a limited resource interest rate on any loan.[36] According to the FSA Handbook,[37] the yearend analysis provides an opportunity for the borrower and FSA to discuss and evaluate a borrower's financial and production performance, progress toward goals, effectiveness of operational management, and FSA supervision and oversight. It also provides an opportunity for FSA to modify the plan of supervision and to address other changes in the borrower's operations or financial situation.

We found that FSA county officials did not conduct required annual assessment reviews for 13 (18 percent) of the 71 loans reviewed, nor did they conduct yearend analyses for the 8 of 21 (38 percent) borrowers for whom these analyses were required. We found various reasons for this. For instance, personnel in one county office misinterpreted the requirements[38] for the yearend analyses and mistakenly attempted to prepare one for every borrower in the county instead of limiting them to those instances where they were required or deemed necessary. As a result, they performed analyses for some borrowers that did not need them, while at the same time failing to do others that were required. Personnel in another FSA county office stated that they did not have adequate staff to complete the required assessments and analyses. In a third instance, county personnel stated that they performed the assessments but failed to document them in the loan files.

Officials at the three State offices visited stated that they were aware of this servicing deficiency, but that staffing shortages had created known servicing deficiencies, such as annual assessments, yearend analyses, and loan collateral inspections not being performed as required. One FLC stated that he believed the farm loan team members are not completing enough loan servicing, and that servicing is just as important as making new loans even though more time is spent on making new loans. Another FLC mentioned that the FSA State office personnel were planning on conducting State-wide training based on the deficiencies noted during our audit.

Our review of the 27 FLPRA reviews of State offices performed by FSA Headquarters officials between FYs 2005 and 2008, disclosed that annual review and assessment updates were not one of the issues addressed as a deficiency. Seven of the 27 FLPRA reviews did disclose that yearend analyses were not performed before the required dates or were not performed at all. However, there was a lack of initiated or planned corrective actions by the States where the problems were acknowledged. FSA Headquarters officials were aware that yearend analyses were not performed as required, but admitted that staffing levels do not always enable everything to be performed as required.

The FY 2008 CORP Report did not disclose findings related to annual assessment reviews and updates or yearend analyses. The FYs 2006 and 2007 combined CORP Report, issued April

---

[35] *FSA Handbook 1-FLP* (Revision 1) Amendment 1, Exhibit 15, dated December 31, 2007.
[36] 7 CFR § 761.105, dated January 1, 2008.
[37] *FSA Handbook 1-FLP* (Revision 1), Amendment 1, paragraph 261, dated December 31, 2007.
[38] *FSA Handbook 1-FLP* (Revision 1), Amendment 1, paragraph 263, dated December 31, 2007.

2008, indicated that assessments were not completed when required. According to this CORP Report, which summarized the 2,172 individual CORP Reports FSA issued in FY 2006 and FY 2007, this deficiency was noted in 28 percent of the individual county reports issued in FY 2006 and in 16 percent of the individual reports issued in FY 2007.

The timely completion of annual assessment reviews and yearend analyses helps loan teams better manage their loan portfolios and assist borrowers to meet their loan objectives and goals. Without this oversight, FSA officials may not be aware of changes in borrower operations that could adversely impact the financial success of the borrower.

Recommendation 5

Establish controls to ensure that annual assessments and yearend analyses are performed as required.

Agency Response

FSA officials agreed with this recommendation and stated that the ability to track annual assessments and yearend analyses to determine compliance was implemented in the Direct Loan Servicing automated system in April 2010. In cases where insufficient resources (personnel or travel funding) to ensure completion of required annual assessments and yearend analyses are identified and documented, FSA will prioritize the completion based on highest to lowest risk and document the basis for each low risk priority determination. To implement these revisions, FSA will revise the appropriate handbook by September 1, 2010.

Subsequent to our receipt of the FSA written response, dated June 30, 2010, we sought clarification from FSA regarding the controls established to ensure timely completion of the required annual assessments and yearend analyses. On July 12, 2010, an FSA official clarified that effective in April 2010, the Direct Loan Servicing system began providing county office staffs with monthly task calendars that included any required assessments and yearend analyses. If these tasks cannot be completed because of the lack of resources or other reasons, county office staffs would prioritize and complete these as outlined in the written response. To provide the necessary control, DDs are responsible for reviewing the county office staffs' actions during their annual operations reviews.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We performed our audit fieldwork from April 2008 through September 2009 at the FSA national office in Washington, D.C.; 3 FSA State offices located in Arkansas, Kentucky, and Michigan; and 36 county offices in the 3 States. (See exhibit A.)

We judgmentally selected the States of Arkansas, Kentucky, and Michigan for review because we wanted to include a variety of crops and property used for loan collateral. Direct OL volume and delinquency rates were also used as criteria to select the States. The 3 States combined maintained a portfolio of over 8,200 direct OLs with a total obligation value of more than $332.7 million as of May 31, 2008. A total of 71[39] direct OLs were randomly selected for review.[40] The 71 loans we reviewed totaled more than $3.1 million in FSA-obligated funds. We visited the FSA county offices that serviced the selected loans to interview appropriate FSA officials and to review borrowers' loan files. We reviewed the applicable borrowers' loan files to determine whether (1) loan collateral inspections were performed as required, (2) unauthorized dispositions of loan collateral were properly serviced and required enforcement actions taken, (3) assessments of borrowers' operations were completed as required, and (4) releases of loan security for essential family living and farm operating expenses were proper. We also visited the borrowers' farms associated with each selected loan to inspect the loan collateral. Additionally, we evaluated the loan servicing and loan collateral for any FO loans that were held by any of the selected borrowers by reviewing the borrowers' loan files and visiting the borrowers' farms to inspect the loan collateral. This resulted in the review of 26 FO loans totaling approximately $2.5 million in FSA-obligated funds. The audit covered FYs 2007 and 2008. We included previous fiscal years when determined necessary.

We interviewed agency officials and reviewed regulations, policies, and procedures to gain an understanding of FLP requirements, including loan collateral requirements. At the FSA national office, we identified and assessed controls and oversight responsibilities relating to loan collateral. At the FSA State and county offices, we evaluated controls to ensure that releases of loan collateral were made in accordance with regulatory requirements, and we determined whether inspections were timely conducted and annual assessments of borrowers' operations were properly completed. We performed 71 onsite farm visits to verify loan collateral. In the 18 identified cases where borrowers had sold or otherwise disposed of loan collateral without FSA authorization, we evaluated the adequacy of FSA's servicing and enforcement actions and assessed agency officials' compliance with the applicable regulations. We also reviewed FSA's oversight processes to determine their effectiveness at disclosing noted deficiencies.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards issued by the Comptroller General of the United States, and in accordance

[39] One of the direct operating loans selected had recently been the subject of an OIG investigation. The case had been adjudicated and the borrower found guilty of converting FSA loan collateral. The loan was retained as part of our random sample so we could confirm the status of the remaining collateral property.

[40] We statistically selected an unrestricted random sample, also called a simple random sample, from the combined listing of operating loans in the three states tested. Since we are not making any statistical projections based on this sample, we did not include the full statistical sampling methodology as an exhibit to the report.

with the Office of Inspector General policies and procedures in IGM-7314 (September 2007). Those standards required that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on the audit objectives.

Abbreviations

CFR	*Code of Federal Regulations*
CORP	County Operations Review Program
DD	District Director
DDORS	District Director Oversight Reporting System
FLC	Farm Loan Chief
FLP	Farm Loan Programs
FLPRA	Farm Loan Program Risk Assessment
FO	Farm Ownership Loan
FSA	Farm Service Agency
FY	Fiscal Year
OL	Operating Loan
SED	State Executive Director

Exhibit A: Summary of Loan Reviews

	Arkansas	Kentucky	Michigan	Totals
Number of Loans Sampled	23	28	20	71
County Offices Visited	10	15	11	36

Findings:				
Missing Loan Collateral	3	5	10	18[41]
Lack of FSA Inspection	5	7	3	15
No FSA Assessment	7	3	3	13
No FSA Yearend Analysis	4	2	2	8

The table above details the number of county offices and number of loans sampled in each of the three States visited. It also details the specific deficiencies we identified in each State.

[41] One of the direct operating loans selected and reviewed had recently been the subject of an OIG investigation. The case had been adjudicated and the borrower found guilty of converting FSA loan collateral. The loan was retained as part of our random sample so we could confirm the status of the remaining collateral property.

USDA’S

FARM SERVICE AGENCY

RESPONSE TO AUDIT REPORT

United States Department of Agriculture

Farm and Foreign Agricultural Services

Farm Service Agency

Operations Review and Analysis Staff

1400 Independence Ave, SW
Stop 0540
Washington, DC 20250-0540

DATE: June 30, 2010

TO: Assistant Inspector General for Audit
Office of Inspector General

FROM: Philip Sharp
Agency Liaison Officer
for the Farm Service Agency

SUBJECT: Response to Audit 03601-18-CH: Controls and Oversight of Farm Loan Collateral

This is the Farm Service Agency's (FSA) response to your May 4 memorandum requesting comments on the official draft report of the subject audit.

Recommendation 1

Remind field offices to document shortages of loan collateral found during farm visits and to properly follow post-approval procedures.

Agency Response

Changes are being implemented in Handbooks 1-FLP-1 and 4-FLP to make oversight of unauthorized disposition of collateral a part of the District Director's regular duties. Farm Loan Managers will be required to report all discoveries of such dispositions to the District Director, who will be responsible for following up by reviewing post-approvals and/or borrower repayments to ensure that all applicable regulations have been followed. These Handbook revisions are expected to be issued before the end of June, and FLP will also issue a Notice to call the attention of all District Directors and Farm Loan Managers to these changes.

Recommendation 2

Design and implement an automated system capable of recording unauthorized dispositions for tracking purposes, or incorporate this capability into an existing system. In the interim, require county officials to maintain a manual log of all cases where unauthorized dispositions are disclosed by inspection or other means.

Agency Response

In the short term, a manual system will be established through the Agency actions noted in (1), above. This function is scheduled for incorporation into the Direct Loan Servicing (DLS) automated system during Phase III of the DLS implementation, in 2013.

Recommendation 3

Strengthen the oversight review process that post-approvals of unauthorized dispositions are being identified and reviewed to evaluate whether these post-approvals are justified. Implement a follow-up process to ensure that any required corrective actions are taken.

Agency Response

As noted in (1), above, this is being made an oversight responsibility of FSA District Directors, who will review post-approvals for compliance with applicable regulations.

Recommendation 4

Establish controls to ensure that FSA county officials perform required annual inspections of loan collateral.

Agency Response

The ability to track and determine compliance with required annual inspections was made available to FSA in April 2010 as part of the DLS automated system. This system allows State Executive Directors and Farm Loan Chiefs to determine compliance by County Offices in their respective States. In situations where non-compliance is identified, FSA will ensure county officials complete required annual inspections. However, in cases where FSA has documented insufficient resources (personnel or travel funding) to ensure completion of all identified noncompliant annual inspections, FSA will:

- Prioritize the completion of annual inspections based on highest to lowest risk and ensure completion of all annual inspections in the order of risk priority, subject to the resources available.

- Instruct field staff to document the basis for a low priority determination in the file for those cases determined to be a low priority for review.

These changes will be implemented by revisions to the appropriate FSA handbook by September 1, 2010.

Recommendation 5

Establish controls to ensure that annual assessments and year-end analyses are performed as required.

Agency Response

The ability to track and determine compliance with required annual assessments and year-end analyses became available with implementation of the routine servicing module of

DLS automated system in April, 2010. The required updates of annual assessments are documented in the Farm Business Plan for each borrower, and that information will be capture in the DLS system by the end of 2010. To the extent resources will allow, FSA will ensure annual assessments and year-end analyses are completed. In situations where non-compliance is identified, FSA will ensure county officials complete required annual assessments and year-end analyses. However, in cases where FSA has documented insufficient resources (personnel or travel funding) to ensure completion of all identified noncompliant assessments and year end analyses, FSA will:

- Ensure completion of all annual assessments and use the assessments to establish priorities for the completion of year-end analyses based on the established handbook criteria.

- Instruct field staff to document the basis for a low priority determination for year-end analyses in the annual assessment.

These changes will be implemented through revisions to the appropriate FSA handbook by September 1, 2010.