USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

DATE: JAN 14 2004

REPLY TO
ATTN OF: 34001-1-At

SUBJECT: Audit of Rural Development Business and Industry Guaranteed Loan Program – Non-Traditional Lenders

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: John M. Purcell
Director
Financial Management Division

We have completed our review of non-traditional lenders participating in the Business and Industry (B&I) Guaranteed Loan Program. Our objective was to determine whether Rural Development (RD) had sufficient controls over the lending activity of non-traditional lenders to ensure regulatory compliance and to minimize risk exposure.

Our review showed that while non-traditional lenders had proportionately higher delinquency and default rates than traditional lenders, RD had taken appropriate actions to evaluate and strengthen controls over the lending activity of these lenders. Because of the increased participation by non-traditional lenders in the B&I Guaranteed Loan Program, RD increased its oversight of these lenders by (1) contracting with the Farm Credit Administration (FCA) to conduct periodic examinations of non-traditional lenders and (2) updating regulations to improve lender accountability and require periodic re-evaluation of lender eligibility. While these controls should provide better oversight over the unregulated lenders, we noted that RD needed to ensure timely followup on corrective action plans and to timely follow through on its plans to revise its regulations.

During fiscal year (FY) 2001, RD entered into an interagency agreement under the Economy Act of 1932 with FCA to conduct examinations of non-traditional lenders and to assess their lenders' lending practices and regulatory compliance, as well as to express opinions on the lenders' overall performance regarding its B&I Guaranteed Loan portfolio. FCA identified weaknesses regarding credit administration deficiencies and regulatory compliance.

The FCA examinations of 16 lenders and 3 State agencies indicated that risk exposure existed in the loans made by the non-traditional lenders and a need for improved oversight and monitoring by RD. These examinations showed that the lender's loan portfolios were not effectively managed, which led to credit administration deficiencies and instances of regulatory noncompliance. Credit administration deficiencies included weak analysis of new loans and inadequate control and servicing of existing loans. Weaknesses identified in old or new loans included incomplete calculations of financial ratios or insufficient financial ratios for determining eligibility, over reliance on borrower-supplied projections, and a lack of liquidation or collection plans for severely delinquent loans. The examinations also found that the lenders were not complying with tangible equity requirements, liquidation plans were not completed in a timely manner, borrower financial statements were not submitted quarterly, and borrower business plans were missing.

Subsequent FCA examinations of these lenders showed that substantial progress had been made in addressing the previously identified weaknesses, but that other deficiencies cited by FCA required further improvement in credit administration and regulatory compliance. From the initial and subsequent examinations, FCA concluded that RD could enhance the B&I loan program by revising its regulatory guidance, strengthening the existing approval process, and improving program oversight and monitoring. FCA recommended that RD require the lenders to formally respond with corrective action plans to address the specific deficiencies cited. Although RD implemented procedures to request corrective action plans for each lender with cited deficiencies, it did not follow through to ensure that the lenders responded. For example, of the 16 lenders examined as of April 30, 2003, only 6 responded to RD's request for a corrective action plan. Even though RD requested that each lender respond within 30 days of the request, it had taken no further actions for those lenders that did not respond.

Considering that the loan activity of non-traditional lenders shows a considerable risk (i.e., a higher level than traditional lenders of non-performing loans, unsatisfactory credit administration, and deficient regulatory compliance in the loans of these lenders), RD needs to ensure prompt and proper resolution and implementation of the findings and recommendations.

During FY 2002, RD initiated the process to revise its regulations to improve lender accountability and require periodic re-evaluation of lender eligibility. The proposed rewrite would remove insurance companies as eligible lenders and limit the term of non-traditional lender approval to a period of 3 years as opposed to the current indefinite period. Current regulations require balance sheet equity of 7 percent with no loss reserve, while the proposed revisions would require balance sheet equity of 10 percent with a loss reserve of 5 percent, and would require that delinquent/historic losses not exceed 5 percent as compared to the current 10 percent. The non-traditional lenders will also be required to submit annual audited financial statements. RD informed us that the proposed rewrite of the regulations are currently under review at the Deputy Administrator's Office but they do not anticipate the revisions being published for comment for another 6 months. When implemented these revisions should improve the overall approval process and help to deter potential problem loans.

We appreciate the cooperation provided by your staff. If you have any questions, please call me at (202) 720-6945, or have a member of your staff call Phillip T. Cole, Director, Rural Development and Natural Resources Division, at (202) 720-6805.

Robert W. Young

ROBERT W. YOUNG
Assistant Inspector General
for Audit