



U.S. Department of Agriculture
Office of Inspector General
Midwest Region
Audit Report

Rural Development's Processing Of
Loan Guarantees To Members Of The
Western Sugar Cooperative



Report No.
34601-0003-Ch
MARCH 2003



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: March 11, 2003

REPLY TO

ATTN OF: 34601-0003-Ch

SUBJECT: Rural Development's Processing of Loan Guarantees to Member of the
Western Sugar Cooperative

TO: Thomas C. Dorr
Under Secretary
Rural Development

THROUGH: John Purcell
Director
Financial Management Division

This report represents the results of our audit of Rural Development's Processing of Loan Guarantees to Members of the Western Sugar Cooperative. Rural Development's response to the official draft, dated February 10, 2003, is included in its entirety as exhibit A, with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report.

Based upon the information contained in the response, we have reached management decision on all the recommendations in the report. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer.

/ s /

RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL DEVELOPMENT'S PROCESSING OF LOAN GUARANTEES TO MEMBERS OF THE WESTERN SUGAR COOPERATIVE

AUDIT REPORT NO. 34601-0003-Ch

RESULTS IN BRIEF

We performed this audit based on a hotline complaint, which alleged that Rural Development officials had improperly waived regulatory provisions and had accepted an incomplete feasibility study in approving the \$10.3 million in loan guarantees for 467 members of the Western Sugar Cooperative. Around the same time that we received the complaint, the Deputy Under Secretary for Rural Development requested that we examine the procedures used by the agency to approve that loan guarantee, and provide recommendations for improving the process for similar applications in the future. Accordingly, our audit objectives were to determine if the use of waivers was appropriate, to ensure that the actions taken to process the guarantees were in the best interests of the Government, and to evaluate Rural Development's approach to processing and approving loan applications under the Cooperative Stock Purchase Program (CSPP).

We concluded that Rural Development officials inappropriately waived procedures that were established to ensure that exception authority was used in accordance with agency regulations, and to ensure the credit quality of borrowers. According to one Rural Development official, the procedures were waived to relieve staff of burdensome and complex procedures that would delay loan guarantee approval and jeopardize the sale of sugar processing facilities to the cooperative. The waivers expedited the approval process. However, they also undermined controls intended to prevent misuse of waiver authority and determine the credit quality of the cooperative and its members applying for loan guarantees.

The misuse of waiver authority has been a recurring problem within Rural Development and the Business and Industry (B&I) Program. We issued a report in January 2001, which also disclosed abuse of exception authority and recommended corrective actions that were immediately included by

the agency into its instructions.¹ However, these provisions were waived for the Western Sugar Cooperative loan guarantee application.

Our review found that Rural Development officials did not fulfill their obligation of evaluating the financial viability of the cooperative and its members. They did not require the completion of a feasibility study even though there were serious concerns within the agency itself and officials within the Department about the financial health of the cooperative and the state of the sugar industry. A complete feasibility study would have provided valuable insight into the financial condition of the cooperative and the sugar industry. As for evaluating the creditworthiness of the borrowers, Rural Development officials waived responsibilities to perform credit analysis on them. As a result, Rural Development officials did not fulfill their regulatory² obligations to determine if the borrowers have the ability to repay the loans.

Rather, Rural Development officials relied solely on the lender's certification. Two officials informed us that the lender's certification that borrowers met established credit quality standards would be sufficient to protect the Government's interests in the event of default. This statement may be flawed for two reasons. First, if the lender complied with terms of the conditional commitments, then Rural Development will have no recourse against the lender. Second, Rural Development officials excused the lender from performing most of the analysis required by agency regulations. For example, in the conditional commitments, the lender was not required to properly assess financial history, profit projections or current business equity in its analysis of borrowers' creditworthiness and repayment ability. As a result, Rural Development officials may have no recourse against the lender in the event of default by a borrower who met the lower credit quality standards.

Rural Development officials need to establish specific procedures for the CSPP. The agency used B&I Program regulations³ to process this loan guarantee. While this approach worked in the past for smaller cooperatives, it did not work well in this instance because of the large number of guarantees (467). Rural Development officials should develop specific policies and procedures under CSPP to better evaluate stock purchase loan guarantees in the future. Many credit quality procedures can be extracted from applicable B&I regulations. However, officials should also develop additional procedures unique to this type of loan guarantee such as establishing threshold levels for individual borrower

¹ Rural Development Instruction Part 4279, Subpart A, Section 4279.15, "Exception Authority", dated July 25, 2001.

² 7 CFR, Part 4279, Subpart B, Section 165, dated January 1, 2002.

³ 7 CFR, Part 4279, Subparts A & B, dated January 1, 2002.

reviews (individual Western Sugar Cooperative loans ranged from \$750 to over \$180,000).

KEY RECOMMENDATIONS

We recommend that Rural Development officials do not circumvent exception authority requirements in the future. We also recommend that procedures be developed for the CSPP that recognize the importance of the cooperative as a viable business in the guarantee process, and to accommodate a wide range of possibilities in terms of applicants and loan requests.

AGENCY RESPONSE

In its response dated February 10, 2003, Rural Development agreed with all of the findings and recommendations contained in the report. We have incorporated applicable portions of Rural Development's response along with our position in the Findings and Recommendations section of the report. The agency's response is included as exhibit A of the report.

OIG POSITION

We agree with Rural Development's proposed corrective actions and have reached management decision on the recommendations.

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INTRODUCTION

BACKGROUND

The Rural Business–Cooperative Service (RBS), an agency within the Rural Development mission area, is responsible for administering the Business & Industry (B&I)

Loan Program and the Cooperative Stock Purchase Program (CSPP). RBS administers these programs through its national office in Washington, D.C., and through 48 Rural Development State offices. The purpose of these programs is to improve the economic and environmental climate in rural communities.

The RBS National Office allocates the guarantee loan funding to each State for the year. State Directors are authorized to approve loan guarantees up to \$5 million. Guarantee requests for more than \$5 million must be forwarded to the RBS National Office for approval. The total amount of guaranteed loans to one borrower cannot exceed \$10 million without the concurrence of the Under Secretary, and no loan can exceed \$25 million.

State offices must follow loan underwriting procedures and processes in accordance with regulations and associated administrative guidance disseminated from the national office. When an application is approved a conditional commitment is issued to the lender establishing the terms that must be met before Rural Development will close the loan. The lender signs and agrees that it will meet the terms of the conditional commitment. The lender must certify in writing that it has met the terms of the conditional commitment before Rural Development will issue the Loan Note Guarantee.

The Office of the Inspector General (OIG) received a hotline complaint on March 29, 2002, alleging violations by Rural Development officials in the handling and approval of guaranteed loans to the Rocky Mountain Sugar Growers Cooperative, now known as the Western Sugar Cooperative (WSC). The hotline complaint stated that loan approval actions were contrary to regulations and agency recommendations. About the same time, the Deputy Under Secretary for Rural Development requested that we review the procedures used by the agency to approve the WSC loan guarantees and provide recommendations to improve the process for start-up cooperative ventures using the CSPP.

The CSPP was initiated in the 1996 Farm Bill, Public Law 104-127. The 1996 bill authorized the Secretary to guarantee loans to individual (family) farmers for the purpose of purchasing start-up capital stock of a cooperative established to process an agricultural commodity into a value-added product.

On January 2, 2001, the Rural Development Colorado State Office Business Program Director responded to an inquiry from the Farm Service Agency on behalf of WSC, regarding the appropriate procedures to apply for a B&I loan guarantee. This was the beginning of the WSC loan guarantee request process. During the period between March 2001 and March 2002, Rural Development received two pre-applications and five applications from WSC. The first four applications requested a loan guarantee for an ineligible loan purpose. In February 2002, WSC agreed to file a new application that utilized the CSPP. WSC was a start-up cooperative with the intent to purchase six sugar beet processing facilities in four different States. The purchase was concluded on May 1, 2002. There was political interest in support of the loans and the Secretary's use of waiver authority. On May 10, 2001, the Secretary received a letter signed by seven Senators and four members of the House of Representatives. Similar letters were received over the course of the next year requesting the Secretary to grant waivers to WSC.

On March 7, 2002, a Rural Development official issued three waivers that eliminated 18 requirements for the approval of guaranteed loans to WSC. The waivers were instrumental in finalizing the deal for the issuance of conditional guaranteed loan commitments to 467 sugar beet farmers in Colorado, Montana, Nebraska and Wyoming. The aggregate value of the expected guarantees is \$10.3 million. The conditional commitments to make loan guarantees were issued under the CSPP for the purpose of purchasing stock in WSC. Loan values to individual cooperative members ranged from \$750 to \$180,000.

Audit Report No. 34-001-03-HQ, dated January 2001, Rural Business-Cooperative Service National Office Processing in the Business and Industry Loan Program, specifically addressed national office internal controls and uses of exception authority. The audit determined that regulations intended to protect the Government's interest were bypassed through the use of exception authority.

OBJECTIVES

The audit objectives were to determine if Rural Development officials had the authority to waive guaranteed loan program requirements, adequately met the conditions to waive requirements, and if the actions taken to process the WSC guarantees were in the best interest of the Government. In addition, we evaluated Rural Development's approach to processing and approving applications under the CSPP.

SCOPE

We performed audit fieldwork at the RBS National Office in Washington, D.C., and at Rural Development State offices in Colorado and Montana. We selected these States because they had the highest number and largest dollar value of WSC loan guarantees. We also telephonically interviewed personnel at the Michigan, Minnesota, and Nebraska State offices. We did not contact the Wyoming State office because of the limited number of loan guarantees issued (20) and the State Business Program Director was not able to participate in the CSPP loan processing. The States of Michigan and Minnesota were contacted because they had previously issued loan guarantees using the CSPP.

Our audit coverage focused on issues relating to the hotline complaint, the request of the Deputy Under Secretary, and the application of laws and regulations with regards to these guaranteed loans. This effort encompassed WSC's two pre-applications, and five full applications submitted from March 2001 to March 2002, valued as high as \$25 million to the final request of about \$10 million. Fieldwork was performed from May to August 2002. We conducted our audit in accordance with Government Auditing Standards.

METHODOLOGY

To accomplish our objectives, we reviewed: (1) Rural Development regulations, instructions, and procedures related to the B&I Guaranteed Loan Program; (2) RBS National Office records of the WSC and other CSPP loans; and (3) related State office records. We also interviewed RBS National Office staff, officials with the Office of the General Counsel (OGC), the Office of the Chief Economist (OCE), and Rural Development personnel in five State offices.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	EXCEPTION AUTHORITY AND CREDIT QUALITY PROCEDURES WERE INAPPROPRIATELY WAIVED
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FINDING NO. 1

Rural Development officials inappropriately waived procedures that were designed to prevent misuse of exception authority and they waived controls that were designed to determine borrower creditworthiness. Key officials such as the Administrator and the State Director(s), who were the most knowledgeable about this loan application, were excluded from the process. A Rural Development official stated that the procedures were waived to relieve staff of burdensome and complex procedures that would delay loan approval and jeopardize the sale of sugar processing facilities to a cooperative. While the waivers expedited the approval process, they also undermined controls intended to determine the credit quality of borrowers and to prevent misuse of exception authority. In addition, Rural Development set a legal precedent for future cooperative stock purchase loans.

Agency regulations⁴ provide exception authority guidelines and policy for B&I guaranteed loans. The regulations state that, "The Administrator may, in individual cases, grant an exception to any requirement or provision of this subpart which is not consistent with any applicable law provided the Administrator determines that application of the requirement or provision would adversely affect USDA's interest."

Agency instructions⁵ also include administrative procedures that specifically address the use of exception authority. The instructions require that requests must be supported with documentation to explain the adverse effect on the USDA's interest and show how the adverse effect will be eliminated or minimized if the exception is granted. The instructions also require that an Informational Memorandum outlining the reasons for the exception, the recommendation of the State Director and the National Office Executive Loan (NOEL) Committee, and the reasons

⁴ 7 CFR Part 4279, Subpart A, Section 15, dated January 1, 2002.

⁵ Rural Development Instructions Part 4279, Subpart A, Section 4279.15, "Exception Authority", dated July 25, 2001.

for granting the exception, if inconsistent with recommendations of the State Director and NOEL Committee, were to be provided to the Under Secretary and to OGC.

In January 2001, we issued a report that highlighted our concerns about the misuse of waiver authority by the prior Administrator of RBS. That Administrator authorized waivers without legal authority and approved numerous questionable loans. We recommended that NOEL committee and OGC reviews be implemented to prevent further abuse of exception authority. Rural Development agreed with our recommendation, and included these procedures into its instructions. However, Rural Development officials did not comply with these instructions when they waived the NOEL Committee and OGC review.

On March 7, 2002, the Deputy Under Secretary issued a letter to the Colorado, Wyoming, Nebraska, and Montana State Directors waiving 18 regulatory provisions for the Western Sugar Cooperative (WSC) application for over \$10 million in guaranteed loans. The letter stated that “existing B&I regulations were excessively burdensome and complex for small loans such as those made under a stock purchase program.” The Deputy Under Secretary’s letter added that since there were no specific regulations for the stock purchase program, the procedures used for WSC could be the model for new cooperative stock purchase loans. The Deputy Under Secretary waived existing B&I regulations on WSC loans to implement the model.

Rural Development officials did not prepare an Informational Memorandum as prescribed by agency instructions. They also did not address adverse impact on USDA as required by agency regulations. One official told us that they intended to waive only procedural issues, and not substantive regulations. This was done because the prior Administrator had misused his exception authority by waiving substantive regulations.

The Deputy Under Secretary’s letter to the State Directors affirmed that regulatory requirements were waived to relieve staff of burdensome and complex procedures. We agree, in part, with that statement. Some of the procedures waived, such as requiring business plans and the completion of a worksheet for awarding priority points, were not applicable to the farmers requesting the loan guarantees. In addition, the requirement to perform site visits for each loan is impractical because of the number of farmers involved (almost 500), and the small amount of some loans (as low as \$750).

Some of the requirements, however, were substantive regulations that were established to ensure the credit quality of borrowers and constituted critical internal control procedures. For example, Rural Development officials waived the requirements to have the lender perform a written analysis and provide to Rural Development copies of credits report for each borrower. It also waived requirements to perform credit analysis on all the loan applicants. While it may have been difficult to evaluate each of the 467 borrowers, the larger loan applications should have been reviewed by Rural Development field staff. The average loan was about \$22,000, and some loans were as much as \$180,000. These requirements were designed to ensure the creditworthiness of individual borrowers and should not have been waived. (See Finding No. 2 for a more detailed discussion of credit quality issues.)

The Deputy Under Secretary's letter also waived the NOEL Committee and OGC review requirements which were included as agency instructions as a result of our prior audit. While these procedures were not substantive regulations, they were critical internal controls that were implemented to prevent misuse of exception authority. According to the administrative procedures in Rural Development Instruction 4279.15, "...All general exceptions being considered by the Administrator will be reviewed by the National Office Executive Loan (NOEL) Committee to determine consistency with applicable regulations..." By waiving this requirement, a critical part of the review process was removed, and one that may have objected to the use of waivers in this instance. For example, prior to being removed from the review process, the NOEL Committee ruled against the use of waivers on WSC's December 4, 2001, loan application.

In waiving the OGC review requirement, the Rural Development officials removed the last control to prevent the misuse of waiver authority. The administrative procedures section of Rural Development Instruction 4279.15 states, "An Informational Memorandum outlining the reasons for the general exceptions; recommendation of the State Director and the NOEL Committee; and reasons for granting the general exception, if inconsistent with recommendations of the State Director and NOEL Committee, will be provided to the Under Secretary and to the Office of the General Counsel (OGC). The Administrator will address any concerns raised by either the Under Secretary or the OGC prior to issuing the exception."

On October 6, 1999, OGC issued a legal opinion on the use of Administrator's exception authority. This opinion stated, "In order to utilize the Administrator's exception authority there must be a determination that application of the regulatory requirement or provision would adversely affect the USDA's interest." It went on to say, "Without this finding, there

is no authority to exercise the exception authority.” We discussed the WSC waivers with an OGC official who confirmed that the legal opinion, as presented on October 6, 1999, remained valid. Consequently, it is unlikely that the waivers would have ever received approval from OGC without justification in the record as to how USDA would be adversely affected if the regulations were enforced as written.

During our review, several Rural Development officials informed us that it was their opinion that the waivers were granted to assist farmers who would not have had an outlet to sell their sugar beets if the sugar processing plants had been closed. This is more likely the reason for the waivers than cumbersome and complex regulations because the procedures had been used to process other CSPP loans in Minnesota and Michigan. While we agree that it is the Department’s responsibility to assist farmers whenever possible, it is also crucial that internal controls (established in agency regulations and instructions) be in place to ensure that waiver authority is used appropriately.

In our opinion, the use of waiver authority increased USDA’s loss exposure. In addition, according to an OGC official, this set a legal precedent for future cooperative stock purchase loans. Thus, borrowers requesting guarantees in the future for such loans may seek similar waivers from Rural Development.

To this end, Rural Development should develop a process that includes key officials, documents its determination of adverse impact on the USDA, and obtains OGC’s legal opinion on the use of exception authority to waive specific requirements. (The foundation of our recommendation is already included in agency instruction 4279.15.)

RECOMMENDATION NO. 1

Ensure that internal procedures are followed when using the exception authority that: (1) documents the adverse impact on USDA and incorporates the written concurrence or non-concurrence of the State Director(s), the Administrator, and the NOEL Committee; (2) includes OGC’s written opinion on the legal and regulatory sufficiency of the agency’s request; and (3) presents the documentation and OGC’s opinion to the Under Secretary for Rural Development for approval or disapproval.

Agency Response

In its response dated February 10, 2003, Rural Development agreed with the recommendation and will comply by following 7 CFR 4279.15 and RD Instruction 4279.165 (e). Also, RBS will obtain any Office of the General Counsel written comments prior to forwarding to the Under Secretary. Provisions of the agency's response have been put in place and will be followed on any future exception authority waiver request.

OIG Position

Based on the corrective action planned, we accept Rural Development's management decision on this recommendation.

CHAPTER 2

QUALITY OF THE WSC AND INDIVIDUAL BORROWERS IS QUESTIONABLE

FINDING NO. 2

Rural Development officials did not adequately evaluate the financial viability of the cooperative and the creditworthiness of individual borrowers who received over

\$10 million in loan guarantees. This occurred because WSC initially applied for the loan guarantees under the B&I Program and did not submit an application under the CSPP until after missing a scheduled deadline with the seller. This action increased the urgent nature of the situation, and left insufficient time to perform all required analyses. Consequently, there is an increased risk that WSC was not a viable operation and that loan guarantees were made to marginal or substandard borrowers.

Regulations⁶ state that loan guarantees are not to be made to substandard or marginal borrowers. The regulations⁷ also have procedures designed to provide reasonable assurance that the borrower is creditworthy, and has the ability to repay the loan. As part of these procedures, an assessment of the credit quality should cover the borrower's cash flow and business equity, the sufficiency of collateral (cooperative stock for the WSC loan), the financial stability of the industry, and the education, experience and motivation of management. Both Rural Development and the lender are responsible for ensuring that these requirements are met. Rural Development may also request an independent feasibility study to supplement its review, but regulations⁸ do not require a study to be obtained.

Although instructions⁹ state that loan approval or denial should occur within 60 days, over seven months elapsed during the WSC loan process. During this time WSC kept postponing its purchase of the sugar processing company. However, WSC considered it to be critical to meet the January 31, 2002, purchase deadline to prevent the deal from collapsing.

⁶ 7 CFR Part 4279, Subpart B, Section 101(b), dated January 1, 2002.

⁷ 7 CFR Part 4279, Subpart B, Sections 131 and 161, dated January 1, 2002.

⁸ 7 CFR Part 4279, Subpart B, Section 150, dated January 1, 1992.

⁹ Rural Development Instruction Part 4279, Subpart B, Section 166, dated December 23, 1996.

Cooperative's Credit Quality was Questionable

Rural Development officials did not receive and evaluate an adequate feasibility study. The study was inadequate because it did not provide Rural Development officials with a comprehensive opinion on whether WSC was feasible. It also did not resolve Rural Development officials concerns regarding WSC's credit quality. A feasibility study is needed to determine the financial viability of the cooperative. Some Rural Development officials did not believe that WSC submitted an adequate feasibility study, without which, they were "unable to assess the credit worthiness of the application." An additional study was needed to address these concerns, yet no further work was performed to determine the cooperative's viability.

The cooperative's viability is important in a stock purchase because the cooperative members are the cooperative's owners and share in the gain or loss of the enterprise. Therefore, the cooperative's failure or lack of profits could adversely impact the 467 members' ability to repay their loans. Rural Development's position on February 1, 2002, reflects this importance... "A comprehensive feasibility study is imperative to protecting the interests of the farmers involved in the project, and the taxpayer." As further evidence of this point the lender's analysis states... "The loan is reliant on the solvency of the cooperative and its ability to pay growers for the beets delivered." As a result, it was necessary to obtain a comprehensive feasibility study which evaluated the cooperative's financial viability.

WSC's feasibility study addressed individual segments of the operation, and did not provide a comprehensive opinion on whether or not the overall operation was feasible. An acceptable study should include, but not be limited to economic, market, technical, financial, and management feasibility. WSC submitted separate information for the first four areas and management's resumes for the last. WSC's position was that the individual analyses were sufficient to determine the cooperative's viability. Plus, it did not have time to do a comprehensive study. Rural Development officials considered releasing grant funds to complete the study, and contracting with an outside expert to review current materials. On January 29, 2002, the Deputy Under Secretary wrote that a comprehensive study was "critical and non-negotiable" and that "we owe it to the producers to make every effort to ensure the operation is viable before we support it."

Rural Development officials should have obtained a comprehensive feasibility study to resolve credit quality concerns. The individual State offices and the RBS National Office evaluated WSC financial and

feasibility information. A major concern was whether WSC had sufficient cash flow to sustain its operations. WSC projected turning the seller's \$13 million loss in 2001 into a first year profit of \$9 million, and forecasted cost of goods sold at 89 percent of revenues. However, this did not appear realistic to Rural Development officials because the seller had recorded operating losses the last two years, its cost of goods sold had averaged 99 percent of revenues over the past three years, and it had recorded an additional business loss in excess of \$100 million. Rural Development Instructions¹⁰ state that the ability to repay a loan from cash flows is the most important consideration of the loan process. In addition, Rural Development officials were concerned about WSC not meeting the minimum equity requirement, and management's inability to control costs in recent years. Management was a concern because WSC retained the seller's management to run the cooperative.

WSC also provided an independent sugar industry analysis to Rural Development that projected a substantial increase in acreage and price, even though the sugar market was oversupplied. In August 2001, Rural Development consulted with the Office of the Chief Economist (OCE) regarding WSC's sugar industry projections. Based on the conditions at that time, the OCE concluded that WSC's projections were unrealistic.

Borrower Credit Quality is Unknown

Rural Development officials did not meet their regulatory obligation¹¹ to determine if individual borrowers had the ability to repay the loans. Rural Development officials needed to perform their own credit analyses in conjunction with a review of the lender's efforts to determine borrower creditworthiness. This was not accomplished because an application under the CSPP was not submitted until after a scheduled deadline with the seller was missed. Rural Development officials relied solely on the lender's certification that farmers' met credit quality guidelines. Rural Development officials allowed the lender to obtain and review significantly less material than is required by the regulations. As a result, Rural Development officials may have no recourse against the lender on credit quality issues should the borrowers default.

Rural Development officials did not perform credit analyses to ensure that the loans were not marginal or substandard. Under normal circumstances, Rural Development receives the loan package from the lender, and perform its own analyses to determine that borrowers have the ability to repay the loans. For WSC loans, Rural Development officials did

¹⁰ Rural Development Instruction Part 4279, Subpart B, section 4279.131 (a), dated December 23, 1996.

¹¹ 7 CFR, Part 4279, Subpart B, Section 165, dated January 1, 2002.

not perform their own analyses but relied on the lender's certification. Waiver implementation instructions stated, "...State Specialists are not expected to... conduct credit analyses on these applicants". We asked the three State Program Directors involved with the loan approval process whether the 467 loans were good, marginal, or substandard loans; each replied that they did not know.

To facilitate the WSC loan process, Rural Development granted exceptions which allowed the lender to deviate from normal application procedures. The required analysis is quite substantial in comparison to what Rural Development allowed the lender to execute under the terms of the conditional commitments. Ordinarily the lender's review should assess: 3 years of balance sheets and income statements, a current (less than 90 days old) balance sheet, 2 years of projected financial statements, the borrower's management, the borrower's cash-flow, the borrower's debt repayment history, the borrower's necessity of any debt refinancing, and the credit reports of the borrower. Rural Development granted an exception to the lender to perform these tasks. To determine credit quality on the 467 WSC loans, the lender only used a credit report and a non-current (1-year old) balance sheet.

We concluded that the lenders' efforts to determine the borrowers credit quality were inadequate. The lender was responsible for determining that there was reasonable assurance of repayment ability based on the borrowers history, projections, equity, and the collateral to be obtained. However, with the limited information that Rural Development required the lender to review, the lender could not adequately address these topics. For instance, the borrowers' cash flows cannot be analyzed from balance sheet data. Agency instructions state, "The ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. You should not approve loan guarantee requests that do not show repayment ability. Historical operation reports are the best basis to evaluate cash flow."

By its actions, Rural Development officials not only guaranteed the borrower investments in a questionable cooperative, but also failed to determine whether the borrowers had the individual capacity to repay the loans. These actions are contrary to the purpose of the B&I Loan Program; increase the risk of loss to Rural Development, and the risk that the farmers may not benefit if the cooperative fails. As a result, Rural Development officials may have no recourse against the lender unless they can show that the lender did not comply with the terms of the conditional commitments.

RECOMMENDATION NO. 2

Obtain a comprehensive feasibility study on every cooperative and determine if individual borrowers are good credit risks until CSPP loan guarantee procedures are developed.

Agency Response

Rural Development agreed with the recommendation and will reissue Administrative Notice 3702 (4279-B) "Purchase of Startup Cooperative Stock," by April 30, 2003. The Administrative Notice will require a comprehensive feasibility study on future requests to use the CSPP. The agency also intends to use the Administrative Notice to clarify standards at 7 CFR 4279.131. These standards are used to determine whether B&I Guaranteed Loan Program borrowers (and CSPP borrowers) are good credit risks.

OIG Position

Based on the corrective action planned, we accept Rural Development's management decision on this recommendation.

CHAPTER 3**RURAL DEVELOPMENT NEEDS TO DEVELOP
PROCEDURES FOR THE COOPERATIVE STOCK
PURCHASE PROGRAM****FINDING NO. 3**

Rural Development officials need to develop specific CSPP regulations. Rural Development officials have not implemented regulations, even though it has had the

authority to guarantee CSPP loans since the 1996 Farm Bill. This has not previously been a problem because the CSPP has only had limited use. As a result, procedures were not in place to properly accommodate WSC stock purchase loan applications.

Rural Development officials issued program brochures for the CSPP and issued Administrative Announcements to answer questions about the program but did not implement CSPP regulations. However, the program has had little use. We reviewed two other CSPP loan guarantees in which Rural Development officials did not waive regulations to process loans. The largest of these cooperatives received 18 guaranteed loans, plus a separate loan guarantee for its processing plant. WSC had up to 467 loan applications. The B&I regulations were not designed to handle so many applications, so Rural Development officials used the exception authority to model procedures for WSC.

Rural Development officials intend to implement procedures for the CSPP and requested OIG evaluate Rural Development officials approach to processing and approving loan applications under the CSPP. We reviewed the B&I regulations that served as a basis for the loan guarantees, and concluded that these regulations need some modification to achieve the CSPP purposes. In the following sections, we provide our conclusions about procedures necessary to ensure the proper evaluation of the cooperative and a large number of cooperative members.

Cooperative Analysis Procedures are Needed

Procedures are needed that distinguish between requirements for the cooperative and its members. In some instances, some of the B&I regulations on WSC loans are applicable while others are not. The cooperative procedures should include the feasibility study, environmental site assessments, business plan and priority points worksheet.

Rural Development officials also need to implement procedures directed to the analysis of the cooperative. There currently are no provisions in the B&I regulations for Rural Development or lender officials to obtain financial statements or to perform credit analysis on the cooperative. These documents were available and analyzed by Rural Development for WSC because of the non-CSPP loan applications. Rural Development officials should also consider the importance of the cooperative in terms of its annual servicing procedures. An annual evaluation of the cooperative's health would provide insight into its members continued repayment ability and reduce the need to perform similar analysis on all cooperative members.

Procedures are needed to ensure that an adequate feasibility study is obtained, and that it is properly evaluated. The current regulations were a source for problems on the WSC loans. (See Finding No. 2.) The regulations state that a feasibility study "may be required" and "should include economic, market, technical, financial, and management feasibility." An OGC official concluded that the regulations were weak because of terms such as "may" and "should" which are not conclusive and do not make obtaining a study or the listed contents mandatory. A positive facet in the WSC loan process was Rural Development's effort to consult with the Farm Service Agency and OCE. However, it was not clear what weight if any, was attributed to these viewpoints. Rural Development needs to develop procedures that require a feasibility study, establish minimum requirements, and ensure that personnel with the appropriate level of knowledge evaluate the materials.

Cooperative Member Analysis

The quality loan standards present in the B&I Program dictate that a credit quality determination be made on each loan. However, it is impractical to perform identical procedures or require the same level of collateral on small and large loans, as was the case with the 467 WSC loans. In the WSC loan guarantee process, we agreed with certain determinations that were made for the cooperative members including: the waiver of GAAP, individual appraisals and environmental site assessments, business plan, priority points worksheets, obtaining a solitary Form 1980-19 "Guaranteed Loan Closing Report", and conducting site and borrower visits (although a representative sample could be considered).

The Deputy Under Secretary's March 7, 2002, waiver letter states, "...B&I regulations were overly burdensome and complex for small loans such as those made in a stock purchase program," and we agree, for small loans. On WSC, the Colorado State office issued over 60 conditional commitments of \$10,000 or less. However, there is no dollar limitation or

definition to ensure that the CSPP is used for only small loans. Since the program's authorization in 1996, CSPP loans have been issued for as much as \$400,000.

Rural Development should develop procedures that apply thresholds to reflect the different levels of risk of loss on CSPP loans. With WSC, the same standard was used to process 467 loans that ranged from \$750 to \$180,000. A Department official proposed having a dollar range or threshold that adjusted collateral and other procedures according to loan value. The official stated that for loans up to \$20,000, more reliance could be placed on the lender's certification because of the likelihood of repayment or collection. However, he made an equal argument that most or even all of the existing B&I procedures need to be applied for higher CSPP loan amounts. We agreed with the essence of this approach, and believe that these measures could alleviate some of the processing burden for small CSPP loans, as referred to in the Deputy Under Secretary's March 7, 2002, letter. These procedures would also provide a level of fairness and consistency with the rest of the B&I Program.

RECOMMENDATION NO. 3

Issue interim instructions and develop CSPP regulations that include provisions to conduct a credit quality analysis of the cooperative and obtain and assess a comprehensive feasibility study. Additional provisions should establish dollar threshold levels for the cooperative members which increase the extent of credit analysis and collateral requirements in relation to a loan's dollar value.

Agency Response

Rural Development agreed with the recommendation and intends to issue Administrative Notice(s) by April 30, 2003, if determined legally permissible. The agency will also publish a proposed rule that includes the suggested CSPP provisions in the B&I regulations by February 27, 2004.

OIG Position

Based on the corrective action planned, we accept Rural Development's management decision on this recommendation.

EXHIBIT A – RURAL DEVELOPMENT’S RESPONSE TO DRAFT REPORT



United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

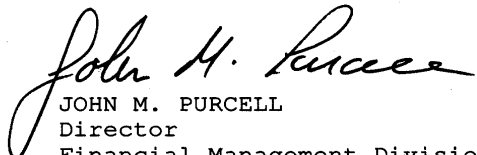
FEB 10 2003

SUBJECT: Rural Development’s Processing of Loan
Guarantees to Members of the Western
Sugar Cooperative
(Audit Number 34601-003-CH)

TO: Richard D. Long
Assistant Inspector General
for Audit
Office of Inspector General, USDA

Attached is a memorandum dated February 7, 2003, from
Thomas C. Dorr, Under Secretary, Rural Development
concerning Recommendations 1, 2, and 3 in the above subject
audit. This response is being submitted for your
consideration to reach management decision.

If you have any questions or need additional information,
please contact Rochelle Diamond of my staff at 692-0077.


JOHN M. PURCELL
Director
Financial Management Division

Attachment

Rural Development is an Equal Opportunity Lender. Complaints of
discrimination should be sent to: Secretary of Agriculture,
Washington, DC 20250





United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

FEB 7 2003

SUBJECT: Rural Development's Processing of Loan Guarantees
to Members of the Western Sugar Cooperative
Audit Report No. 34601-0003-Ch

TO: John M. Purcell
Director
Financial Management Division

This is in response to the official draft findings and recommendations of the above-captioned Office of Inspector General audit.

Recommendation No. 1:

Ensure that internal procedures are followed when using the exception authority that:
(1) documents the adverse impact on USDA and incorporates the written concurrence or nonconcurrence of the State Director(s), the Administrator, and the NOEL Committee;
(2) includes OGC's written opinion on the legal and regulatory sufficiency of the agency's request; and (3) presents the documentation and OGC's opinion to the Under Secretary for Rural Development for approval or disapproval.

Agency Response

The Rural Business-Cooperative Service (RBS) agrees with the recommendation and will comply by following 7 C.F.R. 4279.15 and RD Instruction 4279-B, section 4279.165 (e). RBS will obtain any Office of the General Counsel (OGC) written comments prior to forwarding to the Under Secretary. Provisions of the Agency's response have been put in place and will be followed on any future exception authority waiver requested.

A management decision is requested for this recommendation.

Recommendation No. 2:

Obtain a comprehensive feasibility study on every cooperative and determine if individual borrowers are good credit risks until the CSPP loan guarantee procedures are developed.

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Secretary of Agriculture, Washington, DC 20250

Agency Response

RBS agrees to reissue Administrative Notice (AN) 3702 (4279-B), "Purchase of Startup Cooperative Stock," dated January 28, 2002, to continue to require a comprehensive feasibility study on every cooperative whose members request assistance through the Cooperative Stock Purchase Program (CSPP). In the AN, the Agency will also clarify that 7 C.F.R. 4279.131, regarding standards by which all Business and Industry (B&I) Guaranteed Loan Program borrowers are determined to be good credit risks, also includes CSPP borrowers.

The Agency will issue the AN by April 30, 2003. A management decision is requested for this recommendation.

Recommendation No. 3:

Issue Administrative Notices and develop CSPP regulations that include provisions to conduct a credit quality analysis of the cooperative and obtain and assess a comprehensive feasibility study. Additional provisions should establish dollar threshold levels for the cooperative members which increase the extent of credit analysis and collateral requirements in relation to a loan's dollar value.

Agency Response

RBS will issue ANs, if legally permissible, regarding credit quality of the cooperative, including an assessment of a comprehensive feasibility study. Section 6019 of the 2002 Farm Bill requires a simplified application for loans of \$400,000 or less, with the provision that this level will increase to \$600,000 in fiscal year 2004 if the Secretary of Agriculture determines that there is no increased risk to the Agency. The Agency will use these thresholds to evaluate all B&I Guaranteed Loan program borrowers, including those requesting CSPP assistance. Establishing a wide variety of such gradations of analysis would be both confusing and difficult to administer. Credit analysis should be based primarily on the projected and/or actual cash flow of the borrower. Furthermore, Office of Management and Budget OMB Circular A-129, paragraph III, (A)(3)(b), provides that loans should not exceed the value of the collateral. It would seem to be overly burdensome to require collateral in excess of this standard.

The Agency will issue the proposed AN, if determined legally permissible, by April 30, 2003, and publish a proposed rule including the suggested CSPP provisions in its B&I Guaranteed Loan regulations by February 27, 2004. A management decision is requested for this recommendation.

If you have any questions, please contact Dwight Carmon, Director, Special Projects/
Programs Oversight Division, (202) 690-4100.

A handwritten signature in black ink, appearing to read "Thomas C. Dorr". The signature is fluid and cursive, with a large initial "T" and "D".

THOMAS C. DORR
Under Secretary
Rural Development

Informational copies of this report have been distributed to:

Agency Liaison Officer, Rural Development (5)

General Accounting Office (2)

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)

Rural Development, (Colorado) Office of the State Director (1)