The USDA has had some type of guaranteed farm loan program for more than 30 years. Through the years these programs have evolved to the point that many bankers find them to be an essential link between the world of commercial agricultural credit and those producers who have some type of credit difficulty that cannot be overcome without a guarantee.

ABA's FSA Loan Loss Survey Results – The Proof Is in the Pudding

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Anyone who is familiar with the guaranteed loan programs, now administered by USDA's Farm Service Agency (FSA), knows that theprograms have some "quirks" which require bankers to be actively engaged in managing the risk that is built into the agreements that bankers execute with FSA before the guarantee is granted. Long gone are the days when a banker mistakenly thought that once he had secured a guarantee from FSA he could put servicing of the loan on cruise control. FSA guarantees require close and diligent loan servicing by the originating bank, and close communication with FSA on virtually every detail of the customer's financial conditions.

Why service the loan so closely? Anyone who has had the experience of suffering a loss on a guaranteed loan knows that one of the most unique "quirks" about the FSA program is that FSA does not pay a

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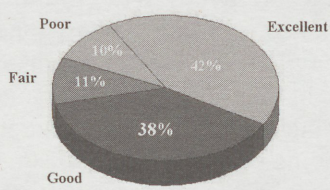
loss claim until the originating bank liquidates all of the pledged assets of the borrower, accounts for all proceeds and reports, in detail, to the local FSA office.

For many reasons, liquidating a guaranteed farm loan is not a happy situation. In most cases, someone has lost their farm or ranch operation, gone through a liquidation sale or bankruptcy, and a bank has lost money. After all this unhappiness, the banker then turns to FSA officials who are charged with making sure that the interests of the federal government have been protected. The opportunities for conflict arising are many.

FSA Guaranteed Loan Program Has Grown Rapidly

The ABA Agricultural and Rural Bankers Committee recognized that, given the poor state of the farm economy, and the rapid growth in the FSA guaranteed loan program, conditions exist that could lead to an increase in liquidations of more FSA guaranteed loans than in the recent past. *It should be noted that there has not been any measurable up-tick in liquidations or losses on these loans.* In fact, the guaranteed loan portfolio has performed remarkably well.

The Quality of Communication Between Lender and FSA Office During Claim Process



*Sums to more than 100 percent due to rounding.

In FY 01 banks and other lenders originated $2.314 billion in loans that were guaranteed by FSA (FY 01 was the third year in a row where obligations exceeded $2 billion). Some 41,000 farmers and ranchers owed $7.73 billion in loans originated by banks and guaranteed by FSA at year-end FY 01. Despite the dramatic growth of the program in recent years, losses paid by FSA were modest at $51 million in FY 01.

Because the guaranteed loan programs are such an important tool that banks use to deliver credit and manage risk, we decided that it was important to survey those banks and other lenders who had recently suffered a loss to determine if the program was working as advertised. Were loss claims being paid? How long did it take to get a final loss settlement? How did lenders rate the experience they had with FSA in trying to collect on the guarantee? Did bankers have recommendations about how to improve the process?

Finding a Sample

The first thing we had to do was find the institutions that had a recent loss claim on a guaranteed loan. Given the low number of claims filed annually, we decided to survey lenders who had received a loss payment in the last 36 months. The only place where we were going to get that information was USDA. As it turned out, USDA could not supply us with an electronic list. They sent a large (5,000 institutions listed) paper list that had the institution's name and address, but mysteriously was lacking zip code information. Many thanks to Barbara McCoy at ABA, who looked up all the zip codes and created an electronic mailing list for us. We randomly selected approximately 10 percent of the institutions on the list.

The Survey

During February 2002, almost 550 questionnaires were mailed with 161 surveys returned. Of those, 119 were usable. The survey instrument inquired about the size of the institution and its agricultural loan portfolio. Additionally, the survey asked about the number of loss claims filed in the last 36 months, the type of loan with a loss, the length of time for settlement, and whether the lender received full settlement. The survey also asked lenders about their loan loss claim process experience and asked them to recommend ways to improve the process.

The typical agricultural lender that responded to the survey had an average asset size of $137.2 million and an agricultural loan portfolio of $44.9 million. The average lender held 29 FSA guaranteed loans worth $4.1 million in portfolio. In general, most lenders had filed one to three claims in the last 36 months.

Lender Satisfaction

In general, eight out of 10 lenders thought their claims were settled satisfactorily, with slightly less than 3 out of 4 lenders recovering what they expected from FSA. A lender's view as to whether a claim was settled satisfactorily is closely linked to recovering what was expected, the speed of payment, and the quality of communication.

More than 60 percent of the lenders stated that their most recent loss claims were settled in less than 120 days (from the time the claim was filed until payment received). Only 11 percent of the lenders responded that the claim process lasted more than one year. But the longer it took to get a claim resolved the more dissatisfied the lender became with the process.

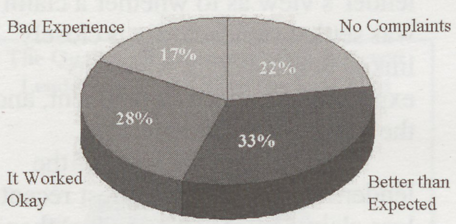
Generally, farm lenders found the quality of the communication from FSA to be good to excellent during the claim process, with 38 percent rating the quality of communications as good and 42 percent as excellent.

Where Lenders Had Problems

The fairly high satisfaction rate of lenders was a good indication that the guaranteed loan programs are working well. Twenty-five percent of the lenders who responded reported that they did not have any problems with the process. However, not every loan loss claim is settled without some problem. We asked lenders to rate the areas where they had problems and found accounting for collateral to be the highest ranked. Because the majority of the loans that lenders suffered a loss on were OL loans, we expected that there would be problems accounting for collateral because assets that can frequently walk away, die or disappear in the middle of the night secure these loans.

Lenders can mitigate these problems by doing an accurate collateral check on an annual basis (more frequently if there are serious concerns) and notify FSA, in writing, of material changes. Frequently, lenders encounter collateral accounting problems because some machinery wears out and is junked by the borrower. Failure to report these changes to FSA in a timely manner can result in an extensive junk pile search by lenders when a loan is liquidated.

How Would You Rate the Loan Loss Claim Process?



Recommendations for Improvements by Survey Respondents

Three-quarters of the respondents recommended that FSA's policy of not paying accrued interest after 90 days be modified. Lenders recommended that FSA pay accrued interest past 90 days if FSA was the primary reason why the delay in payment occurred.

Fifty-four percent of lenders recommended that the process be streamlined by establishing a minimum dollar loss limit that would not require a lengthy period of investigation by USDA before a settlement is made. This way, small dollar loss claims could be handled in an expedited manner.

Forty-five percent of lenders recommended that a defined settlement period be established. FSA is required to act on loan applications within a specified period of time, so it makes sense that they be required to settle claims within a specified period of time.

Partial Loss Claim Applications AWOL

Surprisingly, only slightly more than half of the respondents were advised by FSA that they could file for a partial loss claim payment during the loan liquidation process. Of those notified, 52 percent filed for partial payment. There is a strong positive correlation between lenders who rated FSA's communication as excellent and being notified by FSA that they could apply for partial payment.

This result indicates to us that the partial loss claim process is a future joint training need between bankers and FSA personnel.

The Proof is in the Pudding

Fifty-five percent of the lenders found the loss claims process exceeded their expectations, or had no complaints, and an additional 28 percent gave the process a passing grade. While this whopping 83 percent gave the process a passing grade, FSA still received a failing grade from 17 percent of the respondents. While it would be unrealistic for anyone to expect complete customer satisfaction on a program of this magnitude, there does seem to be room for improvement. Communication seems to be the key.

Some states seem to have more problems than others. Texas, which registered a higher than average dissatisfaction rate, is aggressively working to solve its problems. Last summer the Texas Bankers Association and Texas FSA held their first "stakeholders" meeting, a day-long seminar designed to encourage communication and mutual understanding. Texas FSA also has implemented some innovative loan making and loan servicing policies, including centralization of processing of applications at one location, and processing loss settlements at another center.

If a lender had a bad experience during the claim process, there is a strong likelihood that the lender will not be an active participant in the future. This is an unfortunate outcome because it limits credit opportunities for producers served by that lender, and it limits that institution's credit risk management program. Bankers and FSA must recognize that this program requires the full participation and cooperation of lenders and FSA personnel. Future joint training should focus on improving communications, and on creating ways to increase mutual trust and respect. **jal**