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**An Audit Report on
Texas Agricultural Finance Authority**

May 3, 1999

Members of the Legislative Audit Committee:

The Texas Agricultural Finance Authority (Authority) has improved its processes for making agricultural loans since our previous audit. However, we continue to have concerns about the financial viability and effectiveness of the Authority's main loan program, the Loan Guaranty Program, given its losses and low loan volume. The Commissioner of Agriculture has begun several initiatives to increase the quality and volume of loans. She also has worked with the Texas Legislature on legislation to restructure the programs.

If the Loan Guaranty Program does not improve its financial position, appropriations may be required in the future to meet its general obligation debt. Twenty-two of the program's 83 loans have defaulted since 1993. As a result of the defaults, the program had a negative fund equity of \$6.9 million as of August 31, 1998. An additional \$4.5 million, associated with loans currently in default, may have to be written off.

Key findings and conclusions from our follow-up review are as follows:

- Recent loans appear less likely to default than loans granted previously. None of the defaulted loans were approved within the past two years. The Authority has implemented sound credit policies and procedures, and its credit analysts are diligent in reviewing new loan applications.
- Few businesses and individuals have participated in the Authority's financial programs. (See the attachment for information on the number and dollar value of loans for each program.)
- Marketing of the programs is problematic since a well-qualified applicant probably will not need the Authority's participation and guarantee. Because it provides loans that otherwise would not be made, the Authority has had difficulty attracting good loans to act as a buffer against its riskier loans. A certain volume of good loans is needed to ensure that losses are offset and that the programs are self-sustaining; however, the Authority has not yet developed financial projections to identify that volume.

The Authority complies with significant requirements contained in the resolution that provides for the issuance of taxable commercial paper.

SAO Report No. 99-034

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The attachment provides descriptive and financial information on the Authority and each of its programs. In a separate management letter to the Commissioner of Agriculture (the Commissioner is a statutory member of the Authority's governing board), we have recommended minor adjustments to policies and procedures that we believe will help the Authority better manage the risks associated with each loan.

We appreciate the assistance and cooperation of numerous agency staff members throughout the project. Please call Susan Riley, Audit Manager, at 479-4700 if you have any questions about this report.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

Objective, Scope, and Methodology

The objective of this follow-up audit was to determine whether the Authority has implemented significant recommendations from a previous management control audit regarding its loan guidelines: *A Management Control Audit at the Texas Department of Agriculture* (SAO Report No. 97-032, January 1997). We also conducted a limited follow up on *A Statutory Report on the Texas Agricultural Finance Authority* (SAO Report No. 98-016, January 1998).

To accomplish our objective, we interviewed agency staff and reviewed agency documentation such as Credit Policies and Procedures, Program Rules, annual financial reports, and prior audit reports. We tested all loans approved between November 1996 and the present for the following three loan programs: Loan Guaranty, Young Farmer, and Farm and Ranch. We did not test the Linked Deposit Program because the program poses no direct risk to the State. We tested compliance with the significant requirements contained in the resolution that provides for the issuance of taxable commercial paper. We developed various ratios and trends from the Authority's annual financial reports.

This follow-up audit was conducted in accordance with generally accepted government auditing standards.

cc: Department of Agriculture
Ms. Susan Combs, Commissioner of Agriculture
Mr. Martin Hubert, Deputy Commissioner
Mr. Lee Deviney, Assistant Commissioner for Finance and
Agribusiness Development
Mr. Robert Kennedy, Deputy Assistant Commissioner for Finance
Mr. Gilberto Mendoza, Director of Internal Audit

Texas Agricultural Finance Authority, Ms. Jane Anne Stinnett, Chair

About the Texas Agricultural Finance Authority (Authority)

The 70th Legislature created the Authority in 1987 to provide financial assistance for the expansion, development, and diversification of production, processing, marketing, and exporting of Texas agricultural products. The Authority is a public authority within the Department of Agriculture (Department). It is governed by a board of directors composed of the Commissioner of Agriculture, the director of the Institute for International Agribusiness Studies at Prairie View A&M University, and seven members appointed by the Governor with the advice and consent of the Senate. The appointed members serve staggered two-year terms.

Under its various financial programs, the Authority can:

- Make or acquire loans to eligible agricultural businesses
- Make or acquire loans to lenders to enable those lenders to make loans to eligible agricultural businesses
- Insure, coinsure, and reinsure, in whole or in part, loans to eligible agricultural businesses
- Guarantee, in whole or in part, loans to eligible agricultural businesses
- Administer or participate in programs established by another person to provide financial assistance to eligible agricultural businesses

To implement the programs, the Authority may adopt and enforce bylaws, rules and procedures, and perform other necessary functions. The rules establish criteria for businesses or individuals to participate in the Authority's programs.

The Authority's Loan Programs

The Authority administers the following financial programs: Loan Guaranty Program, Farm and Ranch Program, Linked Deposit Program, and Young Farmer Loan Program. The Agricultural Diversification Program and the Microenterprise Support Program are currently inactive. Table 1 provides descriptive information and requirements for each program.

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Table 1

The Authority's Programs		
Program	Description	Requirements
<p>Loan Guaranty Program</p> <p>(Texas Agriculture Code, Chapter 58)</p>	<p>Provides guaranteed loans for businesses that engage in innovative, diversified or value-added production, processing, marketing, or exporting of agricultural products. According to Section 58.023 of the Agriculture Code, the Authority is to provide financial assistance to eligible agricultural businesses that otherwise would not be made and that the board considers to present a reasonable risk and have a sufficient likelihood of repayment.</p>	<ul style="list-style-type: none"> • Guarantees up to 90 percent of the loan amount to eligible lenders that are required to sell the Authority no more than 80 percent of the guaranteed loan amount. • Eligible lenders must be institutions that make commercial loans and have the Authority's approval. • Funds may be used for working capital, equipment, real estate, or improvements and inventory. • Guarantees range from \$30,000 to \$2,000,000 (guarantees of up to \$5,000,000 with a two-thirds vote by the board). • Loans are generally priced at the Low Wall Street Journal Prime plus 2.00 percent, floating. • Loan terms are based on the use of proceeds with frequency of payments to be determined on a case-by-case basis.
<p>Farm and Ranch Program</p> <p>(Texas Agriculture Code, Chapter 59)</p>	<p>Provides loans through lending institutions to individuals for purchasing farm or ranch land.</p>	<p>Evidence that the borrower:</p> <ul style="list-style-type: none"> • Has at least three years of relevant experience in agricultural production • Has a net worth of \$400,000 • Has a 5 percent minimum down payment
<p>Linked Deposit Program</p> <p>(Texas Agriculture Code, Chapter 44)</p>	<p>Provides low interest rate loans through eligible lenders for individuals or businesses who:</p> <ul style="list-style-type: none"> • Process and market agricultural crops or livestock • Produce alternative crops • Produce agricultural crops using water conservation equipment for agricultural production purposes • Produce agricultural crops, the production of which has declined because of natural disasters • Construct water conservation projects <p>Under this program, state funds in the amount of the loan are wired to the lending institution rather than held in the State Treasury. The lender pays the State 2 percent below the treasury rate on the deposited funds and passes along part of the savings to the borrower. State funds are repaid as the loan is repaid. The State is not liable for the loan.</p>	<ul style="list-style-type: none"> • An eligible lender must be a financial institution that makes commercial loans and has been approved by the Office of the Comptroller of Public Accounts. • Funds may be used for purchasing land, machinery, equipment, seed, fertilizer, plants, inventory, or professional services. • Production loans up to \$250,000 for alternative crops, water conservation equipment, and for crops in an area declared a natural disaster area by the U.S. Department of Agriculture or the President of the United States. • Processing and marketing loans up to \$500,000. • All other terms and conditions are negotiated by the lender and borrower.
<p>Young Farmer Loan Guaranty Program</p> <p>(Texas Agriculture Code, Chapter 253)</p>	<p>Provides guaranteed loans through lending institutions to individuals who wish to establish their first farm or ranch operation in Texas.</p>	<ul style="list-style-type: none"> • Funds may be used only for working capital for the operation. • Maximum guarantee shall not exceed the lesser of \$100,000 or 90 percent of the loan amount. • Interest rate, term, and frequency of payments to be determined on a case-by-case basis. <p>An eligible applicant must be at least 18 years of age, but younger than 40 years of age and have at least four years of practical farm or ranch experience.</p>

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The Authority's Programs concluded		
Program	Description	Requirements
Agricultural Diversification Program (Texas Agriculture Code, Chapter 44)	In the past, this program had been funded by a direct appropriation from the Texas Legislature, but it was not funded for the current biennium.	N/A
Microenterprise Support Program (Texas Agricultural Code, Chapter 44)	This program would provide financial assistance to any eligible business, either agricultural or nonagricultural, to start or expand business in rural areas of Texas. It has not yet been activated.	N/A

Source: Texas Agricultural Finance Authority

Overview of the Authority's Financial Position

The following paragraphs provide descriptive statistics on the Authority's financial programs. *The primary sources of the data are the Authority's 1998 Annual Financial Report and internal loan tracking systems.* While the data are unaudited, we cross-checked them and made adjustments as appropriate.

Table 2 shows the number and amount of loans for the four active programs. It indicates that the Linked Deposit Program has had the most transactions, while the Loan Guaranty Program has had the largest dollar volume.

Table 2

Number and Amount of Loans by Program and Year, Texas Agriculture Finance Authority 1988-1998								
	Loan Guaranty ^a		Linked Deposit		Young Farmer ^b		Farm and Ranch	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1988	-	-	2	\$ 292,000	-	-	-	-
1989	-	-	27	3,401,858	-	-	-	-
1990	-	-	14	872,610	-	-	-	-
1991	4	\$ 5,397,000	6	276,000	-	-	-	-
1992	32	22,354,538	10	1,000,050	-	-	-	-
1993	5	1,270,000	6	425,020	-	-	-	-
1994	11	6,067,597	12	1,196,000	3	\$ 150,000	-	-
1995	9	2,512,500	9	1,359,541	0	0	-	-
1996	7	6,351,860	5	1,272,829	2	150,000	1	\$ 92,535
1997	6	3,069,500	3	448,000	3	226,000	0	0
1998	9	3,713,809	13	779,040	2	215,000	1	42,750
Total	83	\$ 50,736,804.00	107	\$11,322,948.00	10	\$ 741,000.00	2	\$ 135,285.00

^a Several borrowers received more than one loan. The 83 loans shown represent 56 total projects, 69 term loans, and 14 revolving lines of credit. The total does not match the Authority's latest annual financial report because the report omitted a restructured loan for \$1,018,000.

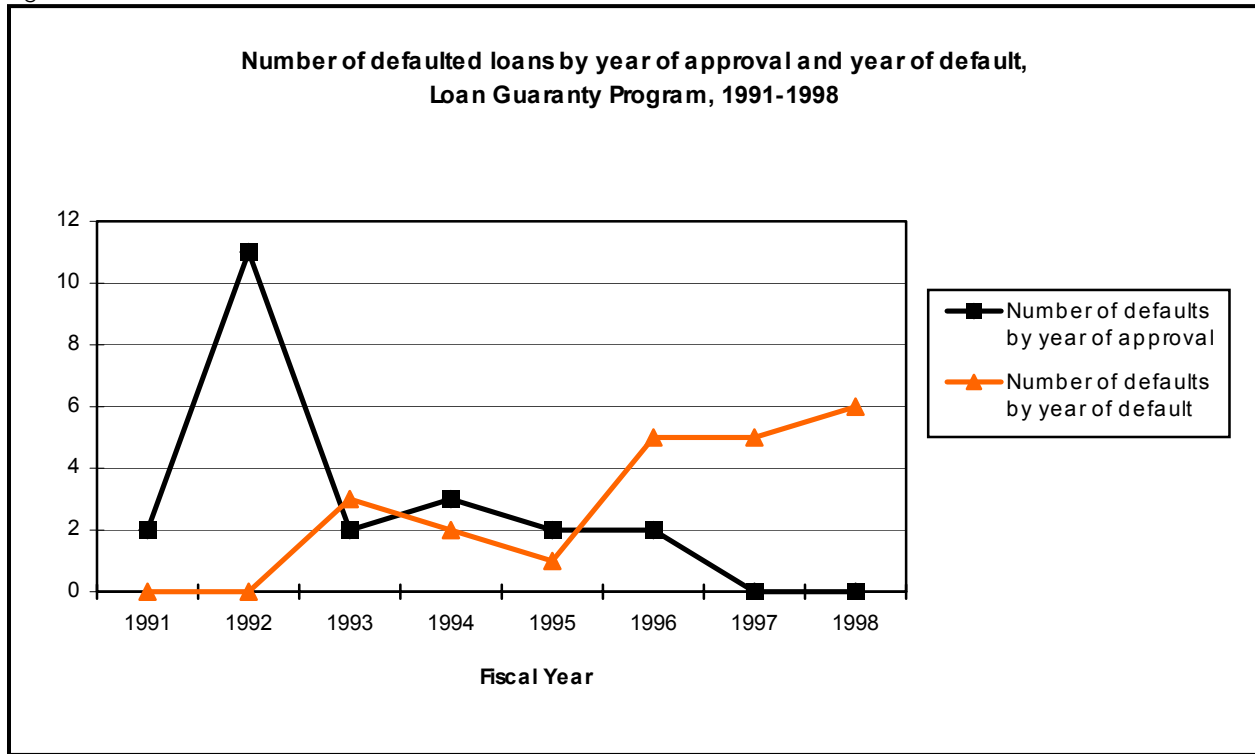
^b The 10 loans represent eight projects.

Source: Texas Agricultural Finance Authority

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Figure 1 shows the number of Loan Guaranty Program Defaults since 1991. Twenty-two of the program's 83 total loans have defaulted. It illustrates that although no recent loans have defaulted, defaults from loans made in previous years have continued to increase. For example, in fiscal year 1992, no loans defaulted; however, 11 loans that the Authority *approved that year* eventually defaulted. In fiscal year 1997, five loans defaulted, but no loans approved that year have defaulted.

Figure 1

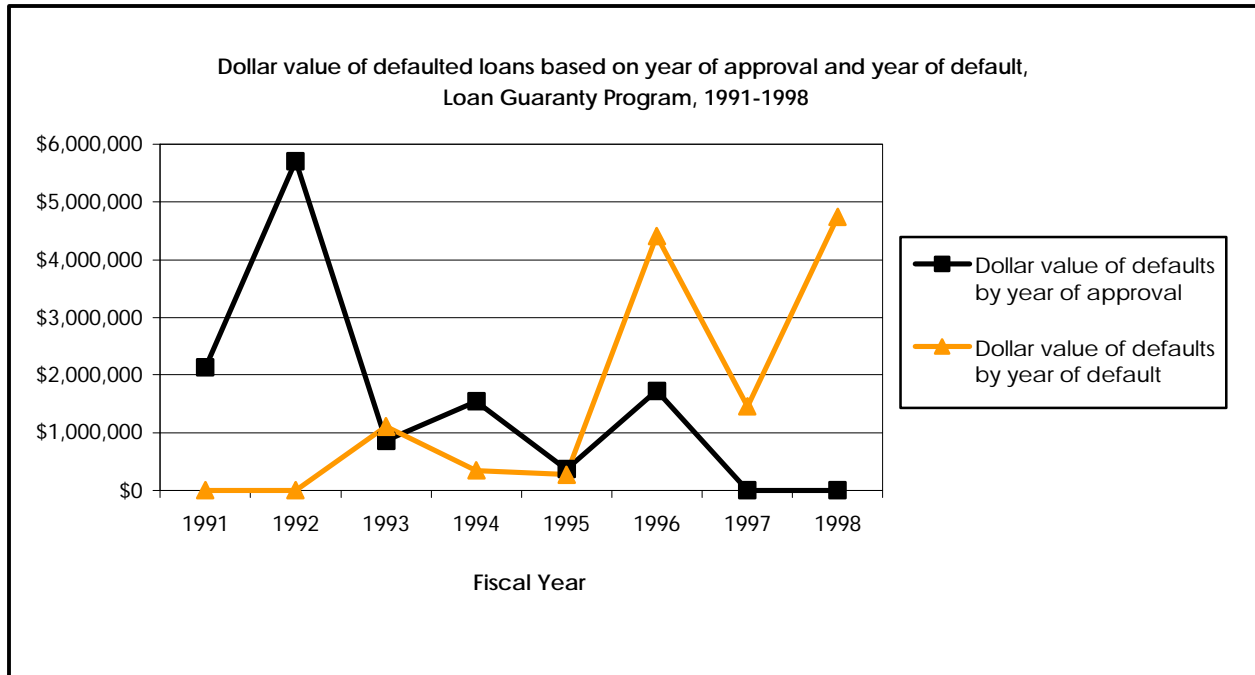


Fiscal Year	By Year of Approval	By Year of Default
1991	2	0
1992	11	0
1993	2	3
1994	3	2
1995	2	1
1996	2	5
1997	0	5
1998	0	6

Source: Texas Agricultural Finance Authority

Figure 2 shows the dollar value of Loan Guaranty Program defaults by the year in which the loan was approved and the year in which the loan defaulted. It illustrates the same general trend as the previous graph. For example, more than \$4 million in loans defaulted in fiscal year 1996; however, only \$1.7 million in loans *approved that year* have defaulted.

Figure 2



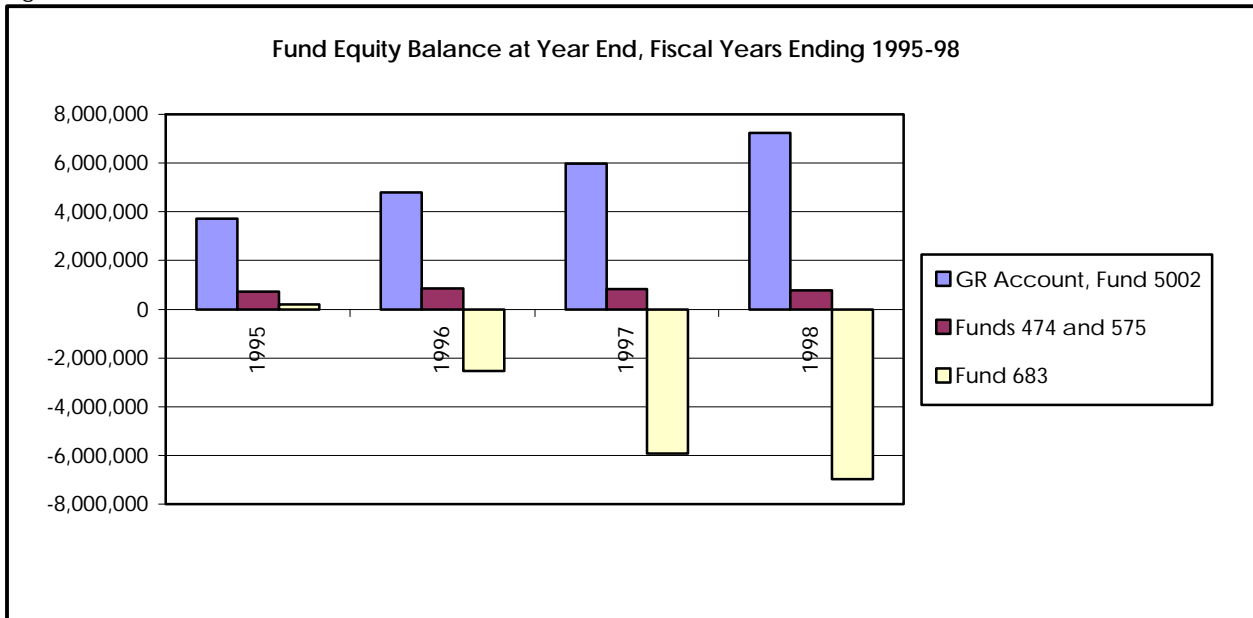
Fiscal Year	By Year of Approval	By Year of Default
1991	\$ 2,132,102.25	-
1992	5,710,100.59	-
1993	861,038.93	\$ 1,105,894.93
1994	1,538,005.96	343,838.43
1995	368,321.85	273,222.00
1996	1,723,284.84	4,415,314.09
1997	-	1,453,230.96
1998	-	4,741,354.01

Source: Texas Agricultural Finance Authority

Since August 31, 1998, two of the six defaulted loans in fiscal year 1998 totaling approximately \$3.9 million have been restructured and are currently considered performing. Other loans that have been in default have been liquidated, and the proceeds offset the amounts written off as bad debt expense in the financial statements. This has had the effect of reducing the Authority's exposure from these defaulted loans to approximately \$4.5 million.

Figure 3 shows a trend of fund equity for the Authority's three main funds. In the figure, a General Revenue Fund account and Fund 5002 are combined into the current Young Farmer Fund, Funds 474 and 575 are combined into the current Farm and Ranch Fund, and Fund 683 is the Loan Guaranty Fund. The figure illustrates that the surplus in the Young Farmer Fund, which has a separate fee-based funding source, is roughly equal to the losses in the Loan Guaranty Fund.

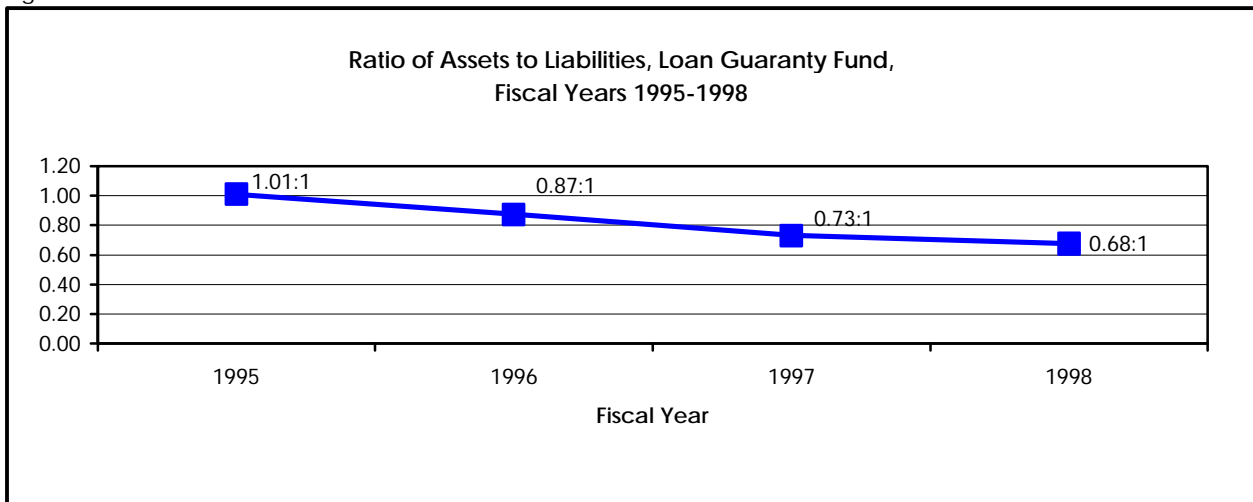
Figure 3



Source: Texas Agricultural Finance Authority

Figure 4 shows the ratio of Assets to Liabilities for the Loan Guaranty Program. This ratio is an indicator of the entity's ability to cover its debts. Ideally, the ratio should be 1:1 or higher.

Figure 4



Source: Texas Agricultural Finance Authority, *Annual Financial Report, 1998*

Audit History

The Authority has undergone several audits or studies in recent years. The following paragraphs briefly summarize the findings or conclusions from those reports.

A Management Control Audit of the Texas Department of Agriculture, (SAO Report No. 97-032), January 1997. This audit of the Department of Agriculture addressed the Authority specifically in section one of the report. The relevant findings of the report were as follows:

- Some Authority loans have not been made in accordance with lending guidelines.
- Some Authority programs may not be active enough to meet their objectives, and not all authorized programs have been implemented.
- Authority program promotion is not based on adequate research, and promotion efforts directed toward lenders need reassessment.
- Authority effectiveness has not been evaluated.

A Statutory Report on the Texas Agricultural Finance Authority, (SAO Report No. 98-016), December 1997. This financial and compliance audit was conducted at the request of the Authority. Relevant findings were as follows:

- Authority was in material compliance with the significant requirements contained in the resolution that provides for the issuance of taxable commercial paper.
- The fund equity position had declined from \$2.3 million to \$5.7 million over the prior fiscal year. This signaled a concern, and the report suggested that “the feasibility of the program should be reassessed if the Authority’s fund equity position continues to deteriorate.”
- The State Auditor's Office recommended that the Board continue to implement corrective actions intended to improve the position of the Authority.

Final Report, Texas Agricultural Finance Authority Loan Programs: Review Analysis, & Cost-Benefit Study, Uniserv Financial Services, December 1996. Under Section 58.017 of the Texas Agriculture Code, the Authority Board was required to perform a biennial cost-benefit study of the Authority’s active and inactive programs, including an examination of the number of jobs created or retained in the State as a result of the programs. The Board contracted with Uniserv to analyze the Authority’s Programs through August 31, 1996.

The study found that the Loan Guaranty and Farm and Ranch Programs have sustained a loss in operations, while the Linked Deposit and Young Farmer Programs have accrued a net benefit to the Authority and the State. On a combined basis, the Authority’s programs have operated without an actual net cost to the Authority or the State. Uniserv stated that the two primary programs, Loan Guaranty and Linked Deposit, were responsible for creating and/or retaining over 5,000 jobs at an estimated net fiscal cost of \$2,264,917 or approximately \$412 per job. In fiscal year 1996 the

entities in the programs contributed approximately \$600 million to economic demand and approximately \$130 million to total wage earnings. The programs contributed a positive impact to the Texas economy and operated in a cost-effective manner.

Review of the Texas Agricultural Finance Authority (TAFE) Biennial Cost Benefit Study, SAO Report 97-303, January 1997. This report addressed the cost/benefit study. The objective of the audit was to comment on the methodology used in the cost/benefit study; it concluded that the study was of limited usefulness. Limitations resulted from the following:

- The study used poor quality borrower data.
- The aggregated presentation in the conclusion section of the report was misleading.
- The methodology applied was deficient because it lacked standard components of a cost-benefit analysis and included an unrealistic assumption.

Management's Response

April 27, 1999

Larry F. Alwin, State Auditor
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SUSAN COMBS, COMMISSIONER

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Dear Mr. Alwin:

I have reviewed the report on the follow-up audit that my office requested on the Texas Agricultural Finance Authority (TAFA.) We are pleased that your office recognizes the efforts of TAFA to improve the quality of loans over the last two years. Since January of this year this office has undertaken the following additional initiatives to further improve the loan programs:

- Upon the appointment of Ms. Jane Anne Stinnett as Board Chair and the appointment four new directors by the governor, the TAFA board implemented a monthly meeting schedule for the TAFA Board of Directors, to provide efficient and reliable services to the programs' applicants and partner lending institutions. I would like to note that three of the new board members have extensive agriculture and/or rural lending experience and the fourth new board member is a rural county judge;
- The Texas Department of Agriculture (TDA) and TAFA are developing procedures to enhance loan monitoring activities to protect state funds from exposure to borrower defaults;
- TDA and TAFA have also sought advice and recommendations from the Texas Banking Commissioner and the Independent Bankers of Texas for the redevelopment of program rules to better conform with the practices and documentation requirements of the lending community of Texas;
- TDA and TAFA have also assisted the Legislature in developing new legislation, Senate Bill 1430 and its companion House Bill 3050, which will revamp the programs to remove existing impediments as well as provide access to a larger pool of eligible and creditworthy applicants;
- TDA and TAFA have also developed, and will be publishing, amended program rules under current law, which will allow greater access to the programs for Texas agricultural producers and rural agribusinesses while ensuring better accountability;
- TDA and TAFA have begun the process of simplifying the TAFA programs' application processes to better serve our constituents; and
- TDA and TAFA are developing and implementing a joint promotional effort for the TAFA programs in cooperation with the Texas Agricultural Extension Service. Furthermore, the Texas Farm Bureau and other

*Making Texas the nation's
leader in agriculture while
providing efficient and
extraordinary service*

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Larry Alwin
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economic development groups across the State have agreed to assist in this effort.

This office will give careful consideration to the management letter recommendations when the letter is received. We feel confident that TAFSA staff will further improve the operation of the program.

I appreciate the hard work by your audit staff during the past few months and the courtesy extended to this office. If you have any further questions, please do not hesitate to call.

Sincerely,

A handwritten signature in black ink, appearing to read "Susan Combs", with a long horizontal flourish extending to the right.

Susan Combs
Commissioner

SC/GM/bjf