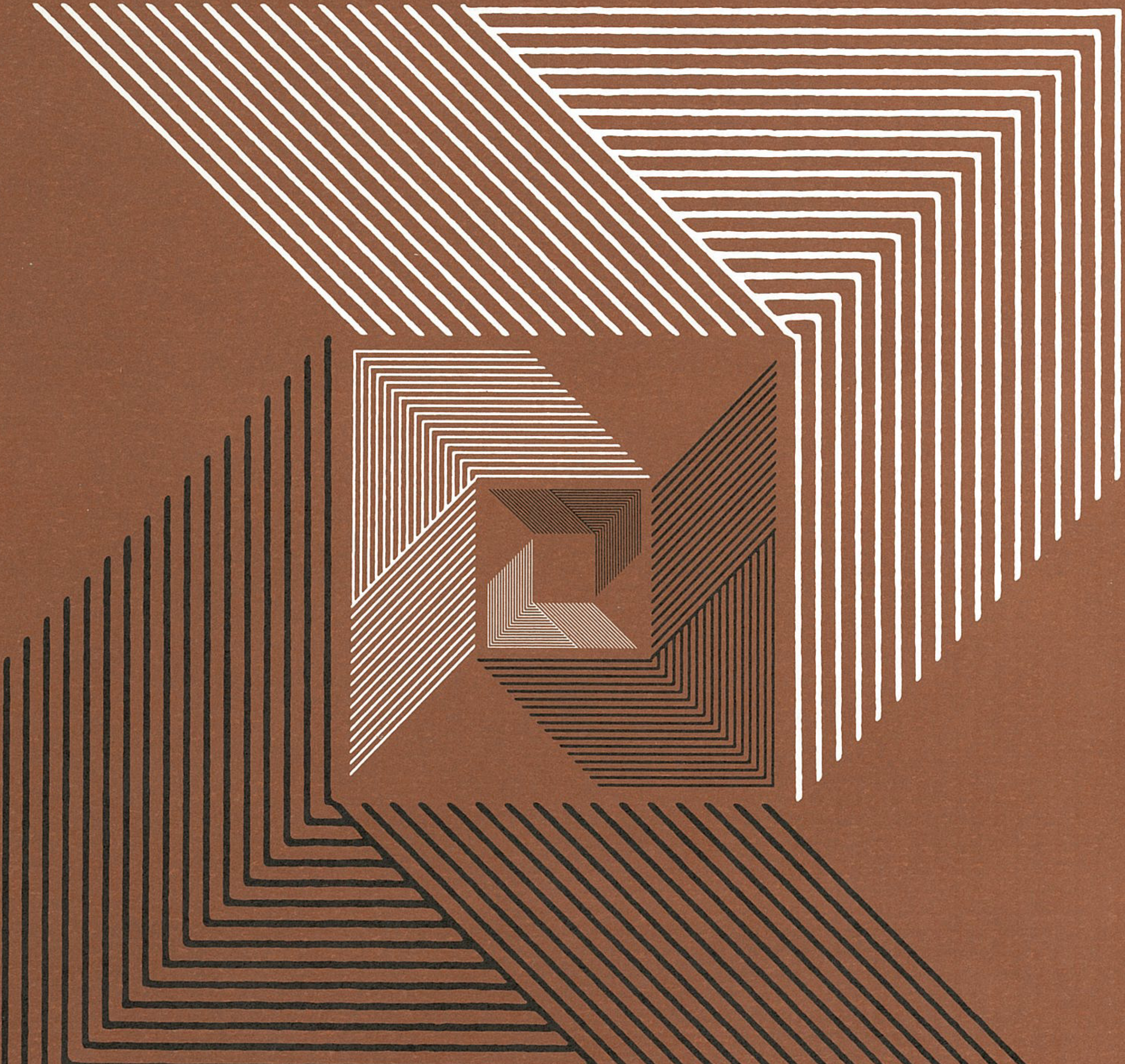
AUDIT REPORT NO. 78-1
FEBRUARY 1978

FINANCIAL AUDIT OF THE LOAN AND GRANT PROGRAMS OF THE DEPARTMENT OF AGRICULTURE

A REPORT TO THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF HAWAII



SUBMITTED BY THE LEGISLATIVE AUDITOR OF THE STATE OF HAWAII

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The office of the legislative auditor is a public agency attached to the Hawaii State legislature. It is established by Article VI, Section 7, of the Constitution of the State of Hawaii. The expenses of the office are financed through appropriations made by the legislature.

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LEGISLATIVE AUDITOR

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FINANCIAL AUDIT OF THE LOAN AND GRANT PROGRAMS OF THE DEPARTMENT OF AGRICULTURE

Conducted by the

Office of the Legislative Auditor

and

Coopers and Lybrand

Certified Public Accountants

A Report to the Governor and the Legislature of the State of Hawaii

Submitted by the

Legislative Auditor of the State of Hawaii

February 1978

Audit Report No. 78—1

FOREWORD

This financial audit report is the result of the examination of the financial statements and operations of the loan and grant programs administered by the department of agriculture. The audit was conducted by the office of the legislative auditor and the CPA firm of Coopers and Lybrand.

This report is divided into three parts. Part I contains an introduction and a brief description of the loan and grant programs and the organizational placement of the programs within the department of agriculture. Part II presents our findings, comments, and recommendations regarding the management practices and operations of the loan and grant programs and displays the financial statements of these programs, including the audit opinion of the CPA firm on the accuracy of the financial statements. We have followed our customary practice of requesting the agency affected by the audit to comment on the findings and recommendations. Part III contains the department of agriculture's response to this report.

The audit disclosed serious deficiencies concerning the loan and grant programs administered by the department. Many of the deficiencies reported in our 1971 audit report of the department still exist, and some of the problems cited in this report are attributable to continuing weaknesses in loan administration. However, a positive sign is that the board of agriculture has been responsive in addressing itself to the needs of the agricultural loan program. Indeed, the board appears now to be alert to the problems of agricultural loan administration and can be expected to exercise closer controls and provide the program with better direction.

We wish to express our sincere appreciation for the cooperation and assistance extended by the officials and staff of the department of agriculture and its farm loan division.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

February 1978

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INTRODUCTION AND BACKGROUND

Chapter 1

INTRODUCTION

This is a report of our financial audit of the State's loan and grant programs administered by the department of agriculture (DOA).

The audit was conducted pursuant to Hawaii Revised Statutes, section 23–4, which requires the state auditor to conduct post-audits of all transactions and of all books and accounts kept by or for all departments, offices, and agencies of the State and its political subdivisions.

Objectives of the Audit

The objectives of the audit were:

1. To provide a basis for an opinion on the fair presentation of the financial position of the loan and grant funds examined.

2. To ascertain whether or not expenditures and other disbursements were made and all revenues and other receipts to which the State is entitled have been collected and accounted for in accordance with state laws, rules and regulations, and policies and procedures.

3. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for financial accounting, reporting, and internal and operational controls, and recommend improvements to such systems and procedures.

4. To determine whether the loan programs are being administered and managed in accordance with sound and accepted principles and practices.

Scope of the Audit

This audit examined the financial statements of DOA's farm loan program, the Hawaii agricultural products program, the aquaculture loan program, and the North Kohala loan and grant program for the period July 1, 1974 to June 30, 1975. The audit opinion as to the reasonable accuracy of the financial statements is that of the independent certified public accounting firm of Coopers and Lybrand.

In addition to the financial statements, the audit examined the management practices and operations of the loan programs, particularly the farm loan program. Our comments on the management practices and operations describe the situation as it existed not only during the base period of the financial audit but also through December 1976.

Organization of the Report

This report is organized into three parts.

Part I (chapters 1 and 2) presents this introduction and background on the loan and grant programs administered by DOA.

Part II (chapters 3, 4, and 5) presents our audit findings and recommendations on the management and operational practices of the loan and grant programs. It also includes the programs' financial statements and the accountants' opinion of such statements.

Part III contains the response of DOA to our findings and recommendations, together with our comments on the department's response.

Chapter 2

BACKGROUND

This chapter describes the loan and grant programs and the organizational placement of the programs within DOA.

Loan and Grant Programs

DOA is responsible for administering four loan and grant programs: farm loan program,[1] Hawaii agricultural products program, aquaculture loan program, and North Kohala loan and grant program.

Farm loan program. The purpose of this program is to promote the agricultural development of the State by assisting qualified farmers[2] to secure needed farm credit. Under chapter 155, HRS, the department is authorized to make three types of loans to qualified farmers: insured loans, participation loans, and direct loans. These loans are available for varying purposes. Section 155–9, HRS, sets forth six classes of purposes for which loans may be made. The following is a brief description of the types of farm loans and the purposes for which the different types of loans may be made.

1. ***Types of loans.*** *Insured loans.* The department may insure up to 90 percent of the principal and interest balance on loans made by private lenders. In return for the guarantee, the department receives from the lender an insurance fee of one half of 1 percent a year on the unpaid, insured principal balance. The interest rate on insured loans made before June 1976 were, by law, limited to not more than 2 percent above the lowest rate charged by all banks on unsecured, short-term loans made to borrowers who have the highest credit rating. Since June 1976, the interest rate has been subject to determination by DOA based on the market rate of interest charged by private lenders for similar types of loans.[3]

Participation loans. The department may participate with private lenders in providing loans to qualified farmers. The department's share of a loan is limited to an amount not exceeding 90 percent of the principal amount of the loan. Each loan bears interest at a rate not more than 2 percent higher than the lowest rate charged by all banks on unsecured, short-term loans made to borrowers who have the

[1]Officially, the farm loan program is now known as the "agricultural loan" program. See Act 22, SLH 1977.

[2]Section 155–1, HRS, defines a "qualified farmer" as a person of proven farming ability who operates his own farm on land owned by him in fee or on land rented or leased from others; and who is presently devoting, has recently devoted, or intends to devote at least one third of his time or derive at least one third of his net cash income from direct participation in farming in its broadest sense. It includes Hawaii partnerships controlled to the extent of 75 percent by persons who would qualify individually and would meet the eligibility requirements of section 155–10. It also includes small corporations where at least 75 percent of each class of stock issued by the corporation is owned by persons who qualify individually and would meet the eligibility requirements of section 155–10 and where 75 percent of the directors are qualified farmers.

Section 155–10, HRS, sets forth the general eligibility requirements for loans. In general, it states that an applicant be (1) a qualified farmer or a person under the new farmer program, (2) a citizen of the United States who has resided in the State for at least three years, (3) a sound credit risk with the ability to repay the money borrowed, and (4) willing to carry out recommended farm management practices.

[3]Act 234, SLH 1976.

highest credit rating. The private lenders' share of a loan may be insured up to 90 percent of the principal balance of the loan.

Direct Loans. Direct loans may be made to qualified farmers who are unable to obtain sufficient funds at reasonable rates from private lenders under the insured or participation loan programs or from the U.S. Department of Agriculture's Farmers Home Administration (FHA). Each loan bears simple interest on the unpaid principal balance. Between 1968 and 1977, the interest rate on a direct loan was either 3 percent or 6 percent, depending on the class of the loan. However, if the money were borrowed by the department, then the interest was not more than 6 percent or 1 percent over the cost to the State of borrowing the money, whichever was greater.

Act 19, first special session, 1977, amended the laws governing interest rate on direct loans. Under Act 19, the interest rate on direct loans is now established at not more than the sum of 1 percent above the lowest rate of interest charged by all banks, either commercial banks or national banks doing business in the State, on unsecured short-term loans made to borrowers who have the highest credit rating with such banks. If the money loaned is borrowed, however, then the interest rate on direct loans is not more than the rate of interest set by BOA or 1 percent over the cost to the State of borrowing the money, whichever is greater.

Act 19 also added a new section to the laws governing direct loans. The act provides that direct loans may be made to independent sugar growers at a rate of not more than 2 percent a year. No collateral is required on these loans, and there is no limit on the amount of a loan made to an independent sugar grower.

2. ***Classes of farm loans.*** The six classes of purposes for which loans may be made are: *Class A*—farm ownership and improvement, *Class B*—soil and water conservation, *Class C*—farm operating, *Class D*—emergency, *Class E*—cooperatives and corporations, and *Class F*—new farmers.

Class A. Farm ownership and improvement loans provide funds for the purchase or improvement of farm land and the purchase, construction, or improvement of essential farm buildings. Class A loans are for an amount not to exceed $100,000 and for a term of not more than 40 years.

Class B. Soil and water conservation loans provide funds for soil conservation practices and for the development, conservation, use, and drainage of water. Class B loans to individuals are for an amount not to exceed $35,000 and for a term of not more than 20 years; loans to associations (nonprofit organizations engaged primarily in extending services directly related to Class B purposes to its members) are for an amount not to exceed $200,000 and for a term of not more than 40 years.

Class C. Farm operating loans provide funds for the purchase of farm equipment and livestock, the payment of production and marketing expenses, including materials, labor, and services, and the payment of living expenses. Class C loans are for an amount of not more than $75,000 and for a term of not more than ten years.

Class D. Emergency loans provide relief and rehabilitation to qualified farmers stricken by extraordinary rainstorms, windstorms, droughts, tidal waves, earthquakes, volcanic eruptions, and other natural catastrophes; livestock diseases; dock strikes; and economic emergencies caused by such things as overproduction and excessive imports. Emergency loan funds may be used for any purpose specified in loan classes A, B, and C. The maximum amount and period of an emergency loan are governed by the purpose to which the loan is to be applied.

Class E. Loans to cooperatives and corporations provide facility and operating funds to farmers' cooperative associations and corporations engaged in marketing, purchasing, processing, and providing farm business services. Facility loans to purchase or improve land, structures, and equipment are limited to

$250,000 and are for a term not to exceed 20 years. Operating loans to finance inventories of supplies, warehousing, shipping of commodities, extension of consumer credit to farmers, members, etc., are limited to $150,000 and are for a term not to exceed three years.

Class F. Loans to new individual farmers provide funds to defray the costs of establishing a new farm enterprise. These loans may be used only for Class A or Class C purposes. After an initial, start-up loan, any subsequent loan must be made under and in accordance with the terms of the other classes of loans (i.e., Class A to Class D). Class F loans are made for an amount of not more than $75,000, or 90 percent of the cost of the project, whichever is less.

3. ***Types and classes of loans made.*** Table 2.1 summarizes the types of loans that may be made by the department and the purposes for which and the terms under which they may be made.

As the table shows, all three types of loans, i.e., insured, participation, and direct, may be made for purposes specified in classes A to E; but for Class F (loans to new farmers), only direct loans may be made.

4. ***Farm loans outstanding.*** At June 30, 1975, farm loans outstanding totaled $9,180,943. This sum represented the statewide total, including principal and interest on 787 loans. A summary of the loans outstanding by island is shown in table 2.2.

Generally, the islands of Hawaii and Oahu have proportionately more loans than the other islands. This is reflected in table 2.2. On June 30, 1975, Hawaii had $4,702,450 or 51.22 percent of the total, and Oahu had $3,726,196 or 40.59 percent. Together, these two islands accounted for almost 92 percent of the total outstanding loans. The islands of Maui, Molokai, and Kauai had $468,211 (5.10 percent), $123,376 (1.34 percent), and $160,710 (1.75 percent), respectively, in loans outstanding.

Hawaii agricultural products program. This program provides allowances and grants to qualified agriculturalists for the development and production of new agricultural products. When the program was first established (Act 75, SLH 1963), the emphasis was on the production of agricultural products for export markets. By Act 205, SLH 1971, the primary purpose of the program was directed toward the general stimulation of the agricultural industry. Crop diversification and production innovations as well as the creation of further marketing areas for Hawaiian agriculture became the stated purpose of the program. The statute provides that, under a joint agreement with agriculturalists, the department may participate in the proceeds derived from the sale of developed crops and products.

There is an advisory committee consisting of six members. The committee's duties include consultation with the department on all matters pertaining to agricultural development crops and products. The chairman of the board of agriculture (BOA), the director of the department of planning and economic development (DPED), the dean of the college of tropical agriculture, or their designated representatives, serve as ex officio, voting members of the committee. The remaining members are from the agricultural industry and are appointed by the governor with the consent of the senate.

All activities of this program are accounted for in the Hawaii agricultural products revolving fund. Since its establishment in 1963, a total of $185,000 has been appropriated to this program and four loans amounting to $97,000 have been granted.

Aquaculture loan program. Act 181, SLH 1971, established the aquaculture loan program "to financially assist in the development of aquaculture in the State." This program provides capital and operating loans to persons or associations engaged in aquaculture farming, aquaculture produce processing, and aquaculture development. The program's activities are accounted for in the aquaculture revolving fund.

Since 1971, two loans totaling $150,000 have been made under this program.

Table 2.1

Summary of Types of Loans by Classes

Class of loan	*Purpose*	*Maximum amount*	*Maximum length [years]*	*Type of loan: Insured*	*Partici- pation*	*Direct*
A	Farm ownership and improvement	$100,000	40	X	X	X
B	Soil and water conservation			X	X	X
	. individual	35,000	20			
	. association	200,000	40			
C	Farm operations	75,000	10	X	X	X
D	Emergency	Dependent upon purposes specified in classes A, B, or C		X	X	X
E	Cooperatives and corporations			X	X	X
	. facility	250,000	20			
	. operations	150,000	3			
F	New farmers	Dependent upon purposes specified in classes A through C. Class F: limitation is $75,000 or 90% of the projects, whichever is less.				X

Table 2.2

Outstanding Loans by Island
As of June 30, 1975

Island	*No. of loans out- standing*	*Amount outstanding: Principal*	*Interest*	*Total*	*% of total*
Hawaii	650	$4,564,634	$137,816	$4,702,450	51.22
Oahu	107	3,586,857	139,339	3,726,196	40.59
Maui	19	462,199	6,012	468,211	5.10
Kauai	9	153,112	7,598	160,710	1.75
Molokai	2	115,779	7,597	123,376	1.34
	787	$8,882,581	$298,362	$9,180,943	100.00

North Kohala loan and grant program. The purpose of this program is to encourage the growth and development of industries in the North Kohala area on the island of Hawaii. The program provides direct loans and grants to qualified persons and associations and its loan- and grant-making activities are under the direction of an advisory body known as the Kohala task force. The task force consists of 13 individuals representing the State, county of Hawaii, labor, and the community of Kohala. The chairman of BOA serves as chairman of the task force.

Loans and grants made by the department are funded by Act 197, SLH 1972, which appropriated $4,650,000 for the purposes of planning and development, feasibility studies, and irrigation water systems. State funds are being matched on a two-to-one basis by the county of Hawaii.

Organizational Placement of the Loan and Grant Programs

The loan and grant programs are managed by DOA's farm loan division. The division's activities are subject to the administrative controls of BOA and its chairman. A brief description of BOA and its relationship to the farm loan division follows.

BOA. The board is the body directly responsible for administering the loan programs under the jurisdiction of DOA. Among other things, the board is responsible for state policies governing loans and grants, final approval and rejection of loan and grant requests, and all actions involving foreclosure and condemnation.

The board is comprised of seven members: four at-large and one each from the counties of Hawaii, Maui, and Kauai. The members of the board are appointed by the governor with the consent of the senate. The governor appoints the chairman of the board from the members. The chairman serves on a full-time basis and performs such duties and exercises such powers as are delegated to him by the board. The chairman of the board of land and natural resources (BLNR) serves as an ex officio, voting member of the board.

Farm loan division. The division is under the direct supervision of the chairman of BOA, and its activities are directed by the farm loan division head who serves as chief farm loan officer for the State. As chief loan officer, he is responsible for planning, coordinating, and integrating the activities of all loan and grant programs. Under the general direction of the chairman, he provides the board with advice and assistance on all matters pertaining to loans and grants. He is also responsible for executing loan contracts and other documents and has general supervision over the board's business and affairs, including the processing, disbursing, collecting, and accounting of all loans made under the program.

Assisting the farm loan officer are five representatives located on Oahu, Hawaii, and Maui. The representatives are responsible for determining the eligibility of applicants for loans and the appropriateness of farm loan requests. Their recommendations are submitted to the farm loan division head, who, in turn, makes his recommendations to the chairman of the board. The loan representatives also establish and administer the supervised loan accounts for disbursement of funds; maintain the records and accounts of borrowers; and recommend compromises, adjustments, and cancellation of accounts.

PART II

FINDINGS AND RECOMMENDATIONS

Chapter 3

AN ASSESSMENT OF THE FARM LOAN PROGRAM

This chapter describes the results being achieved by the farm loan program.

Program results are the focus of this chapter. Specific operational problems are discussed in chapter 4. However, the numerous shortcomings and deficiencies in the operations of the farm loan program noted in chapter 4 relate to the general weakness of the program discussed in this chapter.

Much of the discussion in this chapter and chapter 4 refers to the practices of the farm loan division. The board of agriculture, however, has overall responsibility for all programs administered by the department of agriculture, including the farm loan program. Thus, the references to "DOA" in this report include the board of agriculture as well as the farm loan division. In fairness to the present board of agriculture, it should be emphasized that the deficiencies found in our audit should not be attributed exclusively to the present administration, but are rooted in practices of prior administrations. Indeed, the present board appears to be alert to the problems of agricultural loan administration and can be expected to exercise closer controls and provide the program with better direction.

Summary of Findings

In general, the farm loan program is not reaching the results contemplated by the legislature. What is supposed to be a program to stimulate private and federal financing for farmers has in fact become a program of state subsidy to farmers. To a large degree, this has resulted because of the actions of DOA. Indeed, DOA's conduct in the farm loan program appears to be deliberately intended to remake the loan program into a subsidy program. Thus, we find:

1. DOA has limited its activities to making direct loans to farmers. It has formulated no plans and made little effort to spur the private sector to extend credit to farmers.

2. DOA has made direct loans to farmers even when available financial data and past experience clearly indicated inability to repay; and it has made these loans on insufficient and legally unacceptable security.

3. DOA has not, to any meaningful degree, sought to enforce payment of loans by farmer-borrowers. Rather, it has engaged in the questionable practice of refinancing existing farm loans, and it has otherwise allowed loans to become delinquent and the program to incur losses.

In addition, DOA's refinancing practices have resulted in the farm loan program benefiting but a handful of farmers, when the program is supposed to be one for the benefit of a large number of farmers.

Program Intent Not Being Met

The intent. The farm loan program was originally established by the Farm Loan Act of 1919 (Act 225, SLH 1919). As initially conceived, the program was intended to provide direct government loans to farmers. Thus, the act charged the farm loan board of Hawaii (which the act created)[1] with the responsibility "to encourage the establishment of a rural population by providing loans to assist agricultural development."

This emphasis on direct loans was altered when in 1959 the last territorial legislature completely revised the existing farm loan laws by enacting Act 278. As observed by the senate committee on agriculture, forestry and conservation in Senate Standing Committee Report No. 507, this change in emphasis was necessitated by changing economic and social conditions. The committee recognized that there was a continuing need for credit and financial assistance to be available to farmers if agricultural development in Hawaii was to be effectively promoted. It noted, however, that the higher cost of operating a farm and the State's limited resources made it imperative that greater dependence be had on the commercial sector and the federal government in alleviating the farmers' financial difficulties. It was recognized, however, that in the commercial sector farmers were generally considered to be poor risks. There was thus a need for a program to encourage lending by the private sector as well as to encourage farmers to qualify for federal loans.

Act 278 was designed to accomplish this end of stimulating lending by commercial lending institutions. This stimulation was sought by a program of insuring loans made by such institutions and by a program of participating with the institutions in making loans to farmers.

Act 278 retained the program of direct loans by the State, but limited such direct loans to those instances where farmers were unable to obtain sufficient funds at reasonable rates from private lenders, either independently or under the insured loan or participation loan program, or from the federal Farmers Home Administration (FHA). Moreover, the direct loan program was geared toward assisting farmers develop their farm operations to a point where they would be eligible for private or FHA credit.

Act 278 has continued to this day, essentially in the form enacted in 1959. Thus, the statutory emphasis of the farm loan program today is to encourage farm loans by commercial lending institutions and to maximize use of federal loan programs. Accordingly, the statute charges BOA (the successor to the duties and responsibilities of the farm loan board) with the following specific duties:

> initiate and carry on a continuing research and education program, utilizing and coordinating the services and facilities of other government agencies and private lenders to the maximum, to inform qualified farmers concerning procedures for obtaining loans, and to inform private lenders concerning the advantages of making loans to qualified farmers;
>
> cooperate with private and federal government farm loan sources to increase the amount of loan funds available to qualified farmers in the State;
>
> assist individual qualified farmers in obtaining loans from other sources;
>
> insure loans made to qualified farmers by private lenders;
>
> participate in loans made to qualified farmers by private lenders;

[1] The Hawaii State Government Reorganization Act of 1959 (Act 1, Second Special Session 1959) abolished the farm loan board and transferred the duties and functions of the board to the then department of economic development. Subsequently, Act 132, SLH 1961, transferred the farm loan program to the department of agriculture.

make loans to qualified farmers under the insured program of the FHA; and

make direct loans to qualified farmers who are unable to secure loans from other sources or under the insured loan or participation loan program.

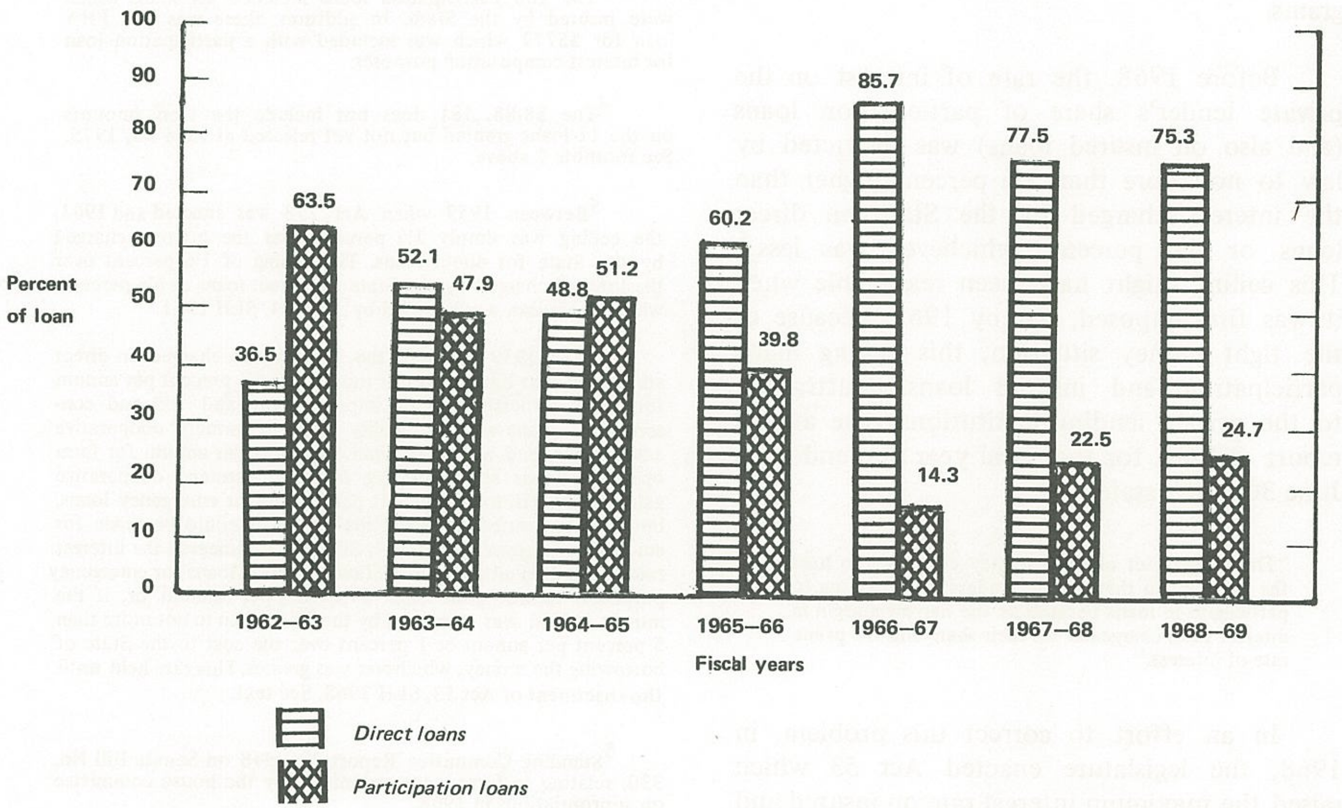
The trends. Shortly before, and for a while after the enactment of Act 278, emphasis appeared to have been given to stimulating financing by private sources as intended by the act. However, since 1963, less and less efforts have been directed toward encouraging lending by the commercial sector. Today, loans from the commercial sector play but a miniscule role in the State's farm loan program. The bulk of the loans is now direct loans from the State.

The shift from private sector participation to direct state loans is illustrated in figure 3.1. The graph shows that, in FY 1962–63, 63.5 percent of all loans made during the year were participation loans. However, in FY 1963–64, the percentage of participation loans declined to about 50 percent. Then, commencing in FY 1965–66, the percentage declined even further. In FY 1966–67, participation loans comprised only 14.3 percent of the total number of loans made during the year.

The decline in the number of participation loans is further evidenced by the fact that, at

Figure 3.1

A Comparison of the Volume of Direct and Participation Loans FY 1963 – FY 1969



June 30, 1975, of the 787 loans outstanding,[2] 679 or 86.28 percent were direct loans. Only 108 or 13.72 percent were participation loans.[3] In dollar terms, of the total $8,882,581 in farm loans outstanding,[4] $7,134,324 or about 80.32 percent constituted direct loans and only $1,748,257 or 19.68 percent represented participation loans. The data are summarized below.

	Loans		Amount	
Type of loan	*No.*	*Percent*	*Total*	*Per-cent*
Direct	679	86.28%	$7,134,324	80.32%
Participation	108	13.72	1,748,257	19.68
Total	787	100.00%	$8,882,581	100.00%

Interest rate difficulties. One of the causes for the decline in the number of participation loans has been the legal restrictions placed upon the amount of interest that private lenders may charge on loans made by them to farmers under the state insured and participation loan programs.

Before 1968, the rate of interest on the private lender's share of participation loans (and also on insured loans) was restricted by law to not more than 1½ percent higher than the interest charged by the State on direct loans or 6½ percent, whichever was less.[5] This ceiling might have been reasonable when it was first imposed, but by 1967, because of the tight money situation, this ceiling made participation and insured loans unattractive to the private lending institutions. The annual report of DOA for the fiscal year that ended on June 30, 1967 stated:

> "The after-effect of tight money continues to hurt the Program in that private lenders are unwilling to participate in loans because of the narrow margin in interest rates chargeable on their share and the prime rate of interest."

In an effort to correct this problem, in 1968, the legislature enacted Act 53 which raised the maximum interest rate on insured and on the private lenders' share of participation loans to 2 percent above the prime interest rate. By this act, the legislature clearly intended that the emphasis of the farm loan program was to continue to be to stimulate loans by the private sector. House Standing Committee Report No. 548, in recommending passage of the act, stated as follows:

> "Due to the limited availability of funds, your Committee believes that participating loans must be encouraged if the Farm Loan Division, Department of Agriculture is to be of any assistance to the agricultural industry. In view of the present tight money situation and the rapid changes which have occurred within the interest structure, maximum flexibility of the interest chargeable by the participating lender must be developed. Your Committee feels that this can best be accomplished by raising to and defining the ceiling as two per cent over 'prime' and has so amended this bill."[6]

Following the passage of Act 53, participation loans rose slightly, from 22.5 percent in

[2]The 787 figure does not include 11 loans which had been granted to recipients who had not yet requested release of the loan funds at June 30, 1975.

[3]The 108 participation loans included six loans which were insured by the State. In addition, there was one FHA loan for $5772 which was included with a participation loan for interest computation purposes.

[4]The $8,882,581 does not include the loan amounts on the 11 loans granted but not yet released at June 30, 1975. See footnote 2 above.

[5]Between 1959 when Act 278 was enacted and 1961, the ceiling was simply 1½ percent over the interest charged by the State for direct loans. The ceiling of 1½ percent over the interest charged by the State for direct loans or 6½ percent, whichever is less, was imposed by Act 104, SLH 1961.

From 1959 to 1961, the interest rate charged on direct state loans was limited to not more than 4½ percent per annum for farm ownership, farm improvement, and soil and conservation loans and for facility loans to farmers' cooperative associations, and not more than 5 percent per annum for farm operating loans and operating loans to farmers' cooperative associations. (It was 3 percent per annum for emergency loans, but neither insured nor participation loans could be made for emergency purposes.) Act 104, SLH 1961, increased the interest rate charged on all direct loans (except direct loans for emergency purposes) to not more than 5 percent per annum or, if the money loaned was borrowed by the State, then to not more than 5 percent per annum or 1 percent over the cost to the State of borrowing the money, whichever was greater. This rate held until the enactment of Act 53, SLH 1968. See text.

[6]Standing Committee Report No. 548 on Senate Bill No. 330, relating to farm loans, submitted by the house committee on appropriations in 1968.

FY 1967–68 to 24.7 percent in FY 1968–69; but, that increase was neither furthered nor sustained in subsequent years. By FY 1974–75, participation loans dropped to 13.72 percent of all loans approved during that year.[7]

The failure of Act 53 to spur lending by the private sector is in part due to the low interest rate charged by the State on direct loans to farmers. The interest rate on direct loans has traditionally been lower than the rate on the private lenders' share of participation loans (and on insured loans). This has often caused private lenders, in order to retain the goodwill of the farmers, to reject the farmers' applications for participation loans, as well as for insured and conventional commercial loans so that the farmers could become eligible for direct state loans.[8]

Although Act 53 was intended to stimulate lending by private lenders by increasing the rate of interest that private lenders could charge for participation and insured loans, the rate increase in effect made direct loans even more preferable to farmers.

Before Act 53, the law limited the interest on the private lenders' share of participation loans (and of insured loans) to not more than 1½ percent over the interest rate charged by the State on direct loans. Thus, the difference in the interest rate for direct state loans and the interest rate for the private lenders' share of participation loans (and insured loans) was 1½ percent. However, upon the adoption of Act 53, the gap widened to 2½ percent. The prime rate to which the act pegged the rate on the private lenders' share of participation loans (and insured loans) was then 6½ percent. The act's allowance of a maximum of 2 percent over the prime rate made the maximum interest rate on the private lenders' share of participation loans (and insured loans) 8½ percent. However, the interest rate on direct loans, although increased by Act 53, was limited to 6 percent. Thus, the gap of 2½ percent. The gap between the interest rate on direct loans and participation loans further widened between 1968 and 1976, since the prime rate increased during the period. Act 53, then, although it was intended to stimulate lending by the private sector, in effect, had the opposite effect.[9]

The legislature in 1977 addressed itself to this situation. It enacted Act 19, Special Session 1977. This act eliminated the 6 percent interest rate on direct loans and reestablished it at "not more than the sum of one percent above the prime rate." In recommending the passage of this act, the house committee on agriculture concluded that "the wide difference between the state's rate and private lenders' rates placed stress on state funds, especially during periods of tight money."[10] The report also noted that pegging the interest rates on direct loans to the prime rate would close the gap in the rates between the State and private lenders and thus encourage more participation loans.

It is doubtful that Act 19 will completely eliminate the competition which exists between direct and participation loans. Since the maximum interest allowable on participation loans is set at 2 percent above the prime rate and the maximum interest on direct loans is set by Act 19 at 1 percent above the prime rate, there is still a 1 percentage point difference in the maximum interest allowable on the two

[7]Note should be taken here that in 1976, by Act 234, the legislature changed the interest rate on insured loans, but not the interest rate on participation loans. The maximum of 2 percent over prime was deleted for insured loans and the interest rate to be charged was left to the determination by the department of agriculture "based on the market rate of interest charged by the private lender for similar type of loan." This change was also intended to encourage lending by private lenders.

[8]House Standing Committee Report No. 198 on House Bill No. 180, "Relating to Farm Loans," March 2, 1977. House Bill No. 180 introduced in the Ninth Legislature, Regular Session 1977, is identical to House Bill No. 6, introduced in the First Special Session 1977. House Bill No. 6 became Act 19.

[9]The gap between the interest rate on direct loans and *insured loans* probably increased even more after the enactment of Act 234, SLH 1976. See footnote 7, this chapter.

[10] House Standing Committee Report No. 198 on House Bill No. 180, "Relating to Farm Loans," March 2, 1977. See footnote 8, this chapter.

types of loans. Since 1 percentage point can make a significant difference in the cost of the money borrowed, it is still to the farmer's benefit to obtain a direct state loan rather than a participation loan.

DOA attitude. The interest rate problem is not the only cause of the decline in the number of participation loans over the years. The decline is also attributable to the attitude of DOA. DOA has made virtually no effort to stimulate lending by private lenders, and it does not appear that DOA intends to do so. Thus, there are in DOA no research programs designed to determine the capital and credit needs of farmers and the alternatives for meeting those needs; there are no educational programs to motivate farmers into associated farming arrangements, i.e., farm cooperatives, incorporated family agricultural businesses, family partnerships, etc., so as to improve their financial potential and their bargaining power; and there are no plans by which farmers might be assisted in obtaining loans from private and federal sources. Then, there are no programs to educate financial lending institutions about the potential benefits of providing services and credit to farmers; and there are no plans and policies to increase the amount of private and federal loan funds available to farmers.

The failure of DOA to encourage financing from private (and also from federal) sources has placed financial burdens on the State. There is a constant shortage of funds although the farm loan program was intended to be self-financing. The monies received in the form of loan interest payments were supposed to cover all operating expenditures, and monies received in the form of loan principal payments were intended to be recycled in the form of new loans. However, there is always never enough monies, and the legislature, out of concern for farmers' need for capital, has been required to appropriate more than $12 million since 1961 to support the farm loan program.

Although the farm loan program is intended to assist those farmers who otherwise would not be able to secure financing at reasonable rates in the private sector, it is not meant to be a subsidy program. Yet, DOA's failure to encourage private (and federal) financing appears deliberately intended to remake the program into a subsidy program. This DOA intent is manifested in the fact that DOA has made loans to farmers of very poor credit risk and on very inadequate security. It has also done little to enforce repayments of loans. In lieu of payment enforcement, it has engaged in the practice of refinancing and extending further credit to farmers who are delinquent on existing loans. The consequence has been a high rate of delinquencies and concentration of loans in a few farmers. The following sections describe this situation.

Loans to Poor Credit Risks

A loan is meant to be repaid. Thus, the prospective ability of the loan applicant to repay the loan is a material factor in granting or refusing a loan. Indicators of loan repayment capability include (1) the projected cash flow of the applicant's farm operations; (2) the applicant's past debt experience; and (3) the applicant's equity. In making loans to farmers, DOA doesn't appear to pay much attention to the negative signals shed by these indicators. It thus has made loans even when the projections have shown insufficient flow of cash to repay the loan applied for, the applicant's past loan experience has shown a chain of delinquencies, and the applicant's equity has been a negative one. Moreover, DOA has made loans upon loans when the indicators have shown inability to repay even existing loans. We illustrate our point with the cases of Farmers A, B, C, D, E, and F.

Farmer A. Table 3.1 demonstrates the case of Farmer A. He received a string of six loans over the period 1962 through 1972. A portion of each of four loans was used either to refinance existing state farm loans or to consolidate trade debts. Refinancing and debt-consolidation loans serve a useful purpose;

Table 3.1

Summary of Loans to Farmer A

				Purpose(s) of loan			
Loan no.	*Class[1] of loan*	*Date loan approved*	*Total amount of loan*	*Consolidate trade debts or refinance existing state farm loan*	*Operations*	*Machinery/ equipment*	*Construction/ improvement*
1	DC	7/62	$ 5,600	$ 1,100	$ 4,500		
2	DC	7/63	12,500		8,100	$4,400	
3	DC	7/66	17,500	12,500	5,000		
4	DA	8/67	17,000	16,000[2]			$1,000
5	DC	4/69	9,000		9,000		
6	DC	6/72	29,000	25,000	4,000		
Total			$90,600	$54,600	$30,600	$4,400	$1,000
Percent of total amount			100%	60.27%	33.77%	4.86%	1.10%

[1] DA – direct class A loan; DC – direct class C loan.

[2] First Hawaiian Bank $ 4,600
Kona Credit Union 6,560
Other creditors 4,840
Total $16,000

they provide farmers with some measure of relief or temporary reprieve by enabling them to make smaller payments spread over a longer period of time. However, in the case of Farmer A, the loans were made not just to refinance existing loans or to consolidate existing debts, but also to supply additional monies for operations, equipment, and improvements, and the additional monies were loaned even when the projected cash flow showed that Farmer A could hardly repay the existing loans or debts, either in their existing state or in a refinanced or consolidated state.

Take, for example, loan No. 5. Before approval of the $9,000 operating loan in April 1969, the farmer had an outstanding loan balance of $32,699, of which $4,898 (excluding interest) was already delinquent and an additional $9,098 (again excluding interest) was to become due in 1969. The projections prepared by the farm loan representative who processed the loan application showed that in 1969–70, the farmer could anticipate sales of $16,800 and expenses of $13,860, leaving him with a net cash profit of only $2,940 ($16,800 – $13,860) for debt repayment. Needless to say, the farmer's estimated cash profits for 1969–70 could not even cover the delinquent amount owing, much less the $9,098 coming due in 1969.

The farm loan representative himself noted that the projections were realistic and "unless gross is increased or expenses lowered, applicant will have difficulty meeting debt repayments. Extreme caution must be exercised." Yet, the farm loan representative recommended approval of the loan and the loan was approved by DOA.

Loan No. 6, in 1972, is another example. When it was applied for, Farmer A owed $37,830 to the State, of which $12,251 had been delinquent since 1970. Of the $29,000 loan applied for in 1972, $25,000 was to be used to consolidate debts. The remaining $4,000 was to be used to sustain current farm operations (see table 3.1). The repayment schedule proposed by the loan representative called for payments totaling $10,700 during 1973.[11] Based on projected sales and expenses, only $11,140 was estimated to be available for debt repayment; thus leaving a negligible balance of $440 ($11,140 – $10,700).

Farmer A's inability to take on another loan in 1972 was also evidenced by another measure. The farmer's financial statement showed that, in the span of ten years, 1962 to 1972, although his assets increased by 187 percent, his liabilities rose by 231 percent. It also showed that although his net worth[12] increased by 85 percent in the ten-year period, his debt to equity ratio increased from 2.32:1 to 4.16:1. (See table 3.2.) This meant that, while ten years ago creditors were providing $2.32 for every dollar supplied by the farmer, in 1972 they were providing $4.16 for every dollar supplied by the farmer. Viewed in another way, the financial statements indicated that a loss of only 20 percent in the value of the farmer's assets could put the farmer in an insolvency status.

Table 3.2

Farmer A's Debt to Net Worth Ratio

		1962	*1972*	*Percent increase*
Total assets	(a)	$18,308	$52,504	186.80%
Total liabilities	(b)	12,800	42,329	230.70
Net worth (a) – (b)	(c)	$ 5,508	10,175	84.73%
Debt to net worth (b) ÷ (c)		2.32:1	4.16:1	

One other indicator suggested denial of the 1972 loan application. In 1971, Farmer A had experienced a net cash loss of $631.20.

Although all factors pointed to rejection of the 1972 loan application, it was nevertheless approved.

The results of the loans made by the State to Farmer A were predictable. As of June 30, 1975, four of the six loans were still outstanding. The remaining balance on all four loans, including principal and interest, amounted to $49,602. As shown in table 3.3, three loans (loans 3, 4, and 6) were seriously delinquent, the delinquency being $22,386, including principal and interest.

By June 30, 1976, all three loans were seriously delinquent, the delinquency amount being $29,973, including principal and interest. This caused the farm loan representative to advise the farmer that if no payment was made "we will have not [sic] alternative but to submit your account to the Board of Agriculture for disposition."[13] In July 1976, in order to obtain some payment on the loans, the loan representative was compelled to enter into an agreement whereby the farmer would make monthly payments of at least $500 a month. At the time of our audit, in November 1976, the farmer could not even comply with this agreement, and all three outstanding loans were still seriously delinquent. In addition, the operating loan for $17,500 had passed its June 30, 1973 maturity date.

Farmer B. Farmer B received a total of eight state farm loans totaling $227,500 during the years 1966 to 1976. Table 3.4 shows the total amount of each loan and the distribution of the proceeds by purpose, class, and year of loan. Although a large portion of each loan

[11] Debt repayment schedule:

Loan No.	*Annual Installments*	
3	$ 2,500	
4	1,700	
5	2,000	
6	4,500	(proposed $29,000 loan)
	$10,700	

[12] Net worth or owners' equity is reported on the balance sheet as the difference between the sum of all assets and total liabilities. Net worth comes from two sources: (a) investments of capital made by the owner(s) and (b) earnings from profitable operations which are retained in the business. The ratio of debt to net worth is computed by dividing total liabilities by net worth.

[13] Memorandum, dated June 23, 1976, from the farm loan representative to the farmer.

except Loan No. 5, was for refinancing existing state loans and/or consolidating farm-related and other debts, a good portion ($70,000 in toto) was also additional loans for farm operations, equipment, construction of farm dwellings, and soil conservation. A review of the loan documents revealed that four of the eight loans were granted even though at the time of each loan request the farmer's financial statements showed that he would not be able to meet even the current loan payments.

Table 3.3

Summary of Farmer A's Outstanding Loans As of June 30, 1975

Loan no.	Type[1] of loan	Loan amount	Maturity date	Amount outstanding: Principal	Amount outstanding: Interest	Amount outstanding: Total	Amount delinquent: Principal	Amount delinquent: Interest	Amount delinquent: Total
3	DC	$17,500	6–30–73	$ 3,305	$ 313	$ 3,618	$ 3,305	$ 313	$ 3,618
4	DA	17,000	12–31–77	10,200	1,533	11,733	5,100	1,280	6,380
5	DC	9,000	6–30–73	27	2	29	27	2	29
6	DC	29,000	12–31–80	29,000	5,222	34,222	8,000	4,359	12,359
Total		$72,500		$42,532	$7,070	$49,602	$16,432	$5,954	$22,386

[1] DC – direct class C loan; DA – direct class A loan.

Table 3.4

Summary of Loans to Farmer B

Loan no.	Class[1] of loan	Date loan approved	Total amount of loan	Re-financing state loan	Purpose(s) of loan: Debt consoli-dation	Current opera-tions	Machin-ery and equip-ment	Con-struction/ improve-ment	Soil
1	PGC	1–28–66	$ 25,000[2]		$23,000	$ 2,000			
2	DC	11– 9–67	10,000	$ 4,000	3,500		$ 2,500		
3	DA	5–16–69	20,000		6,000			$14,000	
4	DC	12–18–70	45,000	30,778	7,000	7,222			
5	DB	6–27–72	2,500						$2,500
6	DC	6–27–72	22,000	12,700		5,000	4,300		
7	DA	2–26–76	82,500	45,500	10,000			27,000	
8	DC	2–26–76	20,500	17,000			3,500		
Total			$227,500	$109,978	$49,500	$14,222	$10,300	$41,000	$2,500
Percent of total			100.00%	48.34%	21.76%	6.25%	4.53%	18.02%	1.10%

[1] PGC – participating-insured class C loan; DA – direct class A loan; DB – direct class B loan; DC – direct class C loan.

[2] Class C participation loan through bank. Bank's share – $12,500, State's share – $12,500. Also made an insurance guarantee advance as required by the bank.

Take the $20,000 Class A loan approved on May 16, 1969 (Loan No. 3). Of the $20,000, $14,000 was new money for the construction of a greenhouse and $6,000 was to consolidate delinquent trade accounts. At the time of the request for the loan, the first two operating loans, i.e., the participation insured loan for $25,000 and the direct operating loan for $10,000, were outstanding. As shown in table 3.5, the outstanding principal balance on these two loans amounted to $26,210 ($18,105 –State, $8,105–bank) of which $4,600 was delinquent. Loan No. 1 was delinquent in the amount of $3,600 for over two years. The farmer's profit and loss statements for the years 1966, 1967, and 1968 showed negative net cash incomes of $1,516, $734, and $1,686, respectively. Since loan payments are usually made out of net cash income, the delinquency was no doubt the result of the farmer's inability to generate sufficient cash from farm operations. The projected income and expenses for 1970 pointed to still another year in which the income from farm operations would not be able to meet all debt amounts becoming due.

Despite the forecast that the farmer would not be able to meet his obligations, his loan request was approved. The loan of $20,000 was to be repayable in annual installments of $2,000 (plus 6 percent interest) over a ten-year period.

By October 1970, Loan No. 3 joined the two farm loans in delinquency.[14] At that time, the total delinquency was $4,948. Of this sum, $1,000 was past due on the $25,000 participation loan (Loan No. 1), $1,948 on the $10,000 operating loan (Loan No. 2), and $2,000 on the $20,000 ownership and improvement loan (Loan No. 3). At this point, Farmer B sought and received still another loan. This time the loan was for a $45,000 Class C operating loan, $30,778 of which was for refinancing all three outstanding and delinquent state loans. The remaining $14,000 was for debt consolidation and farm operations. Table 3.6 summarizes the loan balances and the delinquent amounts on the first three loans before refinancing, the amount of each loan refinanced by Loan No. 4, the principal balance of each of the four loans after refinancing, and the annual amount payable on each of the four loans in each of the years 1971, 1972, and 1973. As shown, prior to refinancing, the outstanding loan balance plus the insurance advance amounted to $53,778. After refinancing, the total loan balance was $68,000. Based on the outstanding loan balance

Table 3.5

Summary of Farmer B's Outstanding Loan Balance and Delinquency Amounts As of May 1969

Loan no.	*Type of loan*	*Total loan amount*	*Amount outstanding* State	*Amount outstanding* Bank	*Amount outstanding* Total	*Amount delinquent (Principal only)*
1	PGC	$25,000	$ 8,105	$8,105	$16,210	$3,600
2	DC	10,000	10,000	--	10,000	1,000
Total		$35,000	$18,105	$8,105	$26,210	$4,600

[14] The amount of the delinquency may be partly attributed to the fact that actual farm income for 1970 was well below that which had been projected by the farmer and the farm representative. According to the farmer's financial statements, he sustained a net loss of $2,747 in 1970 (farm income $6,187 - farm and living expenses $8,934).

Table 3.6

Summary of Farmer B's Outstanding Loan Balances Before and after Loan Number 4

			Prior to refinancing			*After refinancing*			
Loan no.	*Type[1] of loan*	*Loan amount*	*Outstanding loan balance*	*Amount delinquent*	*Amount refinanced*	*Outstanding loan balance*	*Annual amount due 1971*	*1972*	*1973*
1	PGC	$25,000	$ 8,230	$1,000	$ 8,230	--			
2	DC	10,000	9,948	1,948	2,948	$ 7,000	$ 1,000	$1,500	$1,500
3	DA	20,000	20,000	2,000	4,000	16,000	2,000	2,000	2,000
Insurance advance		15,600	15,600		15,600				
4	DC	45,000				45,000	9,000	4,000	4,000
Total			$53,778	$4,948	$30,778	$68,000	$12,000	$7,500	$7,500

[1]PGC – participating-insured class C loan; DA – direct class A loan; DC – direct class C loan.

of $68,000, Farmer B's annual payments for 1971, 1972, and 1973 were $12,000, $7,500, and $7,500, respectively.[15]

Loan No. 4 was made even though the projected income statement for 1971 showed only $4,020 available for debt repayment. Clearly, Loan No. 4 should not have been made. It is interesting to note that, while all information indicated that the farmer would be unable to meet scheduled loan payments, the farm representative stated on the loan request: "With the erection of nine plastic roof greenhouses with Farm Loan funds, the combination of right crops for the area, consolidation of debts, and additional operating loan, applicant is projected to operate farm efficiently and meet his obligations." He noted, however, in the following paragraph that the "[a]pplicant must make every effort to get his program on the road. Otherwise, he faces the possibility of liquidating his farm."

Farmer B, of course, was unable to meet the 1971 payments and his accounts became grossly delinquent by 1972. He, then, requested and received two further loans, a $2,500 Class B loan and a $22,000 Class C loan. Only a part of the Class C loan was to refinance existing debts. Thus, the two loans increased his total indebtedness to the State–from $68,000 to $92,500. The farm loan division chief, while recommending approval of the loan, stated that " . . . we have made some headway but with outstanding debts weighing him down[,] road ahead looks bleak . . . . This may be his last chance if he fails."

At the time of the closing of our audit in 1976, the board had just granted Farmer B two more loans amounting to $103,000: (1) a Class A loan for $82,500 (Loan No. 7) and (2) a Class C loan for $20,500 (Loan No. 8). Of the $103,000, $72,000 was used for refinancing outstanding state loans and debt consolidation. The remaining $31,000 was used to purchase equipment and maintain farm

[15]The repayment provisions for loans 2, 3, and 4 were as follows:

Loan Number 2 ($10,000)–Eight-year repayment, $1,000 annually for first four years and $1,500 for remaining four years, interest at 5 percent.

Loan Number 3 ($20,000)–Ten-year repayment, $2,000 annually, interest at 6 percent.

Loan Number 4 ($45,000)–Ten-year repayment, $9,000 first year, $4,000 for remaining nine years, interest at 6 percent.

operations. The present debt repayment schedule called for annual payments on the Class A loan of $8,495 for 15 years and $4,867 on the Class C loan for five years. Interest on both loans is 6 percent. Foregoing any additional loans, it will take this farmer until 1991 to completely liquidate his obligation to the State.

Farmer C. A farm corporation received two loans in 1973: (1) a ten-year (6 percent interest) Class A loan for $25,000 to purchase land and (2) a three-year (6 percent interest) Class C loan for $25,000 to purchase inventory (i.e., replacement chicks, etc.). Both loans were approved simultaneously by the board on February 5, 1973. At the time the loan request was prepared in December 1972, the corporation had four loans with an outstanding balance of $120,680. Of the four, two were delinquent in the amount of $20,930. Table 3.7 shows the status of the farm loans outstanding at December 1972.

Table 3.7

Status of Farmer C's Outstanding Loans December 1972

Loan no.	*Type of loan*	*Loan amount*	*Outstanding principal balance*	*Amount delinquent: (principal and interest)*
1	DC	$ 50,000	$ 10,000	$ 1,680
2	DA	50,000	41,680	
3	DA	40,000	33,000	
4	DC	36,000	36,000	19,250
		$176,000	$120,680	$20,930

In addition to the $20,930 in delinquent state loans, another $35,580 was past due on two trade loans. At the time of the loan requests, attorneys representing the creditors were threatening the company with legal action. Moreover, the company's financial statements showed it to be in an extremely poor financial condition. The company had sustained heavy losses during previous years and showed an accumulated deficit of about $46,000. The company also showed a negative net worth of approximately $17,000.

The delinquent status of the outstanding obligations and the poor financial condition of the company should have resulted in rejection of the two loan requests. However, the loans were approved.

At June 30, 1975, the corporation had five outstanding loans amounting to $169,686. All five loans were delinquent. The total amount of the delinquency, including principal and interest was $94,253.

Farmer D. In June 1974, Farmer D had six loans outstanding. The principal balance owing was $120,733. Four of these six loans were seriously delinquent. The delinquency totaled $63,689. (See table 3.8.)

Despite this record, in June 1974, Farmer D received two further loans from the State: (a) a 15-year (6 percent interest) Class A loan for $35,000 to construct a greenhouse and (b) a seven-year (6 percent interest) Class C loan for $12,500 to purchase inventory. The

Table 3.8

Status of Farmer D's Outstanding Loans June 1974

Loan no.	*Type of loan*	*Loan amount*	*Outstanding principal balance*	*Amount delinquent: (principal and interest)*
1	DA	$ 43,000	$ 43,000	$10,723
2	DA	2,500	1,930	594
3	DA	17,000	14,527	–0–
4	DC	26,000	20,000	23,004
5	DC	23,000	12,276	8,077
6	DC	29,000	29,000	21,291
		$140,500	$120,733	$63,689

rationale for granting the loans in spite of the fact that the farmer was seriously delinquent in the payment of his existing loans is not readily apparent.

Farmer E. A farm corporation applied for and received a $75,000 (6 percent interest) Class C loan in October 1973. The $75,000, the maximum allowable by law for Class C loans, was for equipment purchases and working capital. The loan was secured by a financing statement on the equipment purchased with the loan, valued at $51,319, a security agreement on all growing crops valued at $44,000, and a first mortgage on state leasehold property valued at $36,734. Repayment of the loan was to be over a six-year period with $36,000 (plus interest) the first year and $7,800 (plus interest) annually for the remaining five years.

This loan was made even though the company's balance sheet at June 30, 1973 showed the firm to be insolvent, i.e., liabilities exceeded assets by $17,921 (see table 3.9). The excess of liabilities over assets, or negative net worth, was partly due to an accumulated deficit or loss over the years of $27,921.

Table 3.9

Farmer E's Balance Sheet
June 30, 1973

Assets:		
Current assets		$10,010
Fixed assets		53,711
Other assets		788
Total assets		$64,509
Liabilities:		
Current liabilities		4,430
Long-term liabilities		78,000
Total liabilities		$82,430
Stockholders' equity:		
Capital stock	$10,000	
Less: accumulated deficit	(27,921)	(17,921)
Total liabilities and stockholders equity		$64,509

Not only was the company insolvent, but the statement of projected income and expenses submitted with the loan request showed that the company would not generate sufficient income to meet the first year's loan payment of $40,500 ($36,000 principal plus $4,500 interest). The statement of the projected income and expenses showed that Farmer E had an outstanding bank loan of $42,900 which was due and payable between July 1, 1973 and July 31, 1974. The amount of net income projected for the first year of the state loan was insufficient even to pay this bank loan in full. (See table 3.10.)

Table 3.10

Farmer E's Projected Income and Expenses
For the Period November 1973 – November 1974

Projected farm income	$247,564
Projected farm expenses	204,931
Amount available for bank loan	42,633
Less: bank loan due	42,900
Excess of bank loan over amount available	$ 267

This company was obviously in dire financial straits and on the basis of negative net worth, losses from operations, and inability to generate sufficient income to meet debt obligations, the loan request should have been rejected. However, the loan was granted.

The results were fairly predictable. The corporation continued to be in financial straits. Indeed, five months after receiving the $75,000 loan, the company was again in need of working capital. This time, it approached the Molokai task force[16] and requested a $10,000 "emergency" loan. The task force through Maui county granted the company a $10,000 one-

[16] The Molokai task force is one of three economic development task forces. The other two are the Kohala task force and the Kauai task force. The Molokai task force is an advisory body consisting of nine members representing the State, county of Maui, labor, and community representatives. The task force is administered by the county of Maui and its chairman is the mayor of Maui.

year loan only after DOA agreed to subordinate the first $10,000 of its security position in the assets pledged to Maui county. DOA could not help but agree to this arrangement. As stated by the farm loan division head in a memorandum to the chairman of BOA recommending that the department subordinate its security position, "Our farm loan is in jeopardy because we have loaned up to our maximum of $75,000 . . . . I recommend that the agreement between the Department and Maui County be executed. This is the only alternative we have next to closing the operation."

The loan from the Molokai Task Force did not end the company's financial woes, nor did it strengthen the State's position. In September 1975, to ward off bankruptcy, the company approached Lokahi Pacific, a nonprofit corporation engaged in economic development, for $10,000 to be used for crop planting and maintenance. The company proposed that Lokahi become a limited partner in the company's farming venture, with the right to have its $10,000 capital contribution redeemed by the company at the end of one year, unless within that period Lokahi chose to convert its limited partnership interest into shares in the company. A flat 10 percent return on the $10,000 investment was promised Lokahi. Lokahi agreed, provided the State subordinated $5,000 of its interest in all machinery, equipment, and growing crops to Lokahi's claim.

DOA found itself in a predicament. It had already subordinated $10,000 of its first position in the assets to Maui county and it feared that an additional $5,000 would further jeopardize its security position. On the other hand, without additional financing the company would face bankruptcy, thereby necessitating liquidation of the secured assets.

Maui county came to the State's rescue. It was evident that the $10,000 from Lokahi would sustain crop maintenance, after planting, for only 60 days, and that the company would require the infusion of further monies for it to stay in operation. Maui county perceived an interest in keeping the company in operation and, thus, worked out an arrangement whereby Lokahi committed an additional $50,000 in equity capital, the Hawaii Production Credit Association[17] loaned $70,000, and the Molokai Task Force purchased the debt position of DOA and guaranteed one half of the Hawaii Production Credit Association's $70,000 loan. The task force purchased DOA's debt position for $66,900—$75,000 less $8,100 (the unpaid balance on the $10,000 task force loan). The $7,779 in interest due on the state loan was written off in the transaction.

DOA agreed to sell its debt position for $66,900 on the reasoning that even though DOA might be able to recover approximately $69,000, or $2,000 more, on foreclosure and liquidation of the security it held, the difference in recovery was too small to worry about. Further, DOA reasoned that "foreclosure would result in a loss of employment of 15–20 people." DOA also was apprehensive about its own estimate of probable recovery on foreclosure of the security it held. It feared that (1) no buyer could be found for the leasehold property, (2) the equipment would have little resale value since most of it was affixed to the land, and (3) the existing crops could not be readily sold.

Farmer F. A farm corporation applied for a state farm loan in 1961. However, because two of its three principal stockholders were nonresidents, the corporation was ruled ineligible under the requirements of the program. The resident farmer, however, after being advised that he could apply for a state farm loan as an individual if he first disassociated himself from the corporation, subsequently applied for and received a $21,500 Class C loan in December 1961. The loan was for the purpose of consolidating debts, purchasing equipment, and providing working capital. Repayment of the loan

[17]The Hawaii Production Credit Association (HPCA) is a cooperative organization established by farmers to provide themselves a source of farm credit. The HPCA is incorporated under the Farm Credit Act established by Congress in 1933. The HCPA is chartered by the governor of the Farm Credit Administration in Washington.

was to be over an eight-year period with interest at 5 percent. The loan was secured by a crop and chattel mortgage on all crops and farm equipment. It was also secured by the personal guarantee of the two nonresidents.

The individual's financial statements submitted at the time of the loan request showed without a doubt that this loan should never have been approved. To begin with, the individual's balance sheet showed assets of $8,150, liabilities of $12,255, and, thus, a negative net worth of $4,105 ($8,150–$12,255). In addition, the projected income and expense statement showed a net cash profit of only about $2,200.

It is not surprising that problems with this borrower began almost immediately after the loan had been approved. Within two months and before all the conditions, including execution of the guarantee agreement by the two mainland guarantors, had been met, two interim advances of $1,000 each on the loan were required to be made in order to keep the borrower's farm in operation. The loan subsequently became delinquent in 1962. In 1968 the farmer, after voluntarily liquidating his equipment and applying the proceeds to the loan, abandoned his farm and accepted a position with the State. The proceeds applied to the loan were insufficient to cover all amounts due on the loan, and DOA sought to collect the balance from the two guarantors on the mainland without success.

In October 1971, the outstanding loan balance including principal and interest totaled $28,537 and, as a last resort, the board voted to garnishee the salary of the borrower in accordance with section 78–12, HRS.[18] In spite of this action, the outstanding loan balance at June 30, 1975, some six and one-half years after the loan matured, still amounted to $22,147 ($21,500 principal and $647 interest).

Negative equity; further illustrations. A number of cases cited above illustrated DOA's loan-making to borrowers having negative equity. Some additional observations on this practice are pertinent here.

Negative equity indicates insolvency. It usually results when the owner has made a small investment of capital in his business and has relied heavily on financing from creditors or when losses from operations have occurred during previous years. Thus, the practice of making loans to farmers with negative equity is questionable. This is particularly so when the negative equity is sizeable. Our review of the records revealed that loans have been made even in cases of large negative equity.

Table 3.11 summarizes a sampling of loans made to farmers with negative equity. As shown, loans have been made to farmers with negative equities as large as –$96,748; and the loan amounts have been as high as $100,000. The case of borrower 2 is an extreme example. His net worth was –$35,652, and yet he received two direct loans, a Class A loan for $100,000, and a Class C loan for $75,000. These amounts are the maximum allowable by law in their respective classes. How DOA could have justified granting $175,000 in additional credit to this farmer when the claim of creditors exceeded the owner's claim by some $35,000 is difficult to understand. Another extreme example is the loan of $60,000 to a farmer (borrower 3) whose net worth was –$96,748.

Inadequate Security

Section 155–11, HRS, requires that all farm loans made by DOA be secured by recorded first mortgages[19] on the following kinds of property located within the State:

[18] Section 78–12, HRS, provides that the State may withhold one quarter of the salary of any person in the service of the State who is indebted to the State.

[19] A first mortgage gives the State prior claim on property used as security for the loan.

Table 3.11

Loans to Farmers with Negative Equities

Borrower	Type of loan	Loan amount	Total assets	–	Total liabilities	=	Owner's equity
1	DC	$ 25,000	$298,565		$304,854		$– 6,289
2	DA DC	100,000 75,000	489,845		525,497		–35,652
3	DC	60,000	206,823		303,571		–96,748
4	DC	67,000	309,645		336,405		–26,760
5	DA	42,000	140,607		167,212		–26,605
6	DC	21,500	8,150		12,255		– 4,105
7	DC	75,000	64,509		82,430		–17,921

. Fee simple farm land

. Leaseholds of farm land where the lease has an unexpired term at least two years longer than the term of the loan

. Crops, livestock, and equipment

. Other chattels

The law also provides that a second mortgage, i.e., a subordinate lien, may be accepted as security when prior mortgages do not contain provisions which might jeopardize DOA's security position or the borrower's ability to repay. Written agreements such as an assignment of income may also be accepted as security.

In addition, to protect the department against possible decline in the value of the property pledged, the law provides that loans used to purchase or improve land, buildings, and equipment as specified in loan classes A, B, and E not exceed 85 percent of the value of the security. For the purposes of Class C and Class E operating loans, the law leaves the ratio of the loan amount to the value of the security offered to the discretion of the department. For Class D loan purposes, i.e., emergencies, DOA may, with the approval of the governor, modify or waive any or all security requirements or any limitation with respect thereto.

The purpose of this security requirement is, of course, to enable the State, in the event of default in the repayment of a loan, to seize the property pledged as security to satisfy its claim against the borrower. The security is to assure that the debt will be paid. Our examination revealed that DOA, in its efforts to aid debt-ridden farmers, has jeopardized the department's security position. It has accepted as security property which is not acceptable as security under the law, and it has failed to provide for sufficient loan-to-security ratios.

Unacceptable security. In numerous cases, DOA has accepted personal assets and other property which do not legally qualify as security under section 155–11, HRS. It has, for instance, received the following types of property as security:

. Shares of stock in a close farm corporation

. Shares of stock in a farming cooperative

. Shares of General Telephone Company stock

. Shares of Hilo Electric Light Company stock

As an illustration, a farmer with four outstanding loans totaling $109,000, one of which had been delinquent for almost one year, requested a Class A loan of $2,500. The loan was to be used to purchase shares of stock in a farm corporation. At that time, the department already held first and second mortgages amounting to $70,000 on his state leasehold farm, a second mortgage on his home and lot, chattel mortgages on all equipment, and an income assignment, i.e., a pledge that income derived from sales would be assigned to the farm loan program for loan repayment. Thus, the farmer had very little, if any, property left to offer as security for the $2,500 loan. Under these circumstances, DOA accepted the shares of stock which the farmer intended to purchase with the $2,500 loan, together with an assignment of his life insurance policy as security for the loan. These properties, of course, did not legally qualify as security under the law. DOA, however, accepted the security and approved the loan on the basis that "[p]urchase [of the stock] is mandatory for borrower to have a voice in the company and to avoid shares getting into the hands of non-producers."

Unacceptable loan to security ratios. DOA has in numerous cases accepted as security property having insufficient value in relation to the amount of the loan. Table 3.12 reflects some of these cases. As shown, in one case, the amount of the loan far exceeded the value of the security.

Table 3.12 reflects the cases of Class C loans. For Class C loans, the loan to security ratio is discretionary with the board. It is obvious, however, that loan to security ratios in excess of 85 percent are suspect. This is particularly so where the property given as security consists of crops. Crops are highly susceptible to changing market prices, and therefore a low, rather than a high, percentage of loan amount to security value would be appropriate.

An adequate margin of safety is required not only to protect the department against possible declines in the market value of the assets pledged but to recover any costs that will be involved in selling the assets, should foreclosure be necessary.

Table 3.12

Loan to Security Ratio

	Loan amount	*Security value*	*Loan to security ratio*
1	$45,000	$52,627	85.51%
2	33,000	34,147	96.64
3	29,000	31,339	92.54
4	30,000	21,000	142.86

Nonenforcement of Repayments; the Practice of Refinancing

Ordinarily, when a loan becomes delinquent, the lender exerts every effort to seek repayment and to keep any loss to a minimum. When the financial condition of the borrower warrants, the lender may assist the borrower who is having difficulty repaying his loan by refinancing the existing debt. Such refinancing permits the borrower to repay his obligation in smaller installment amounts and over a longer period of time. Sometimes a borrower may encounter difficulty paying his debt to a particular lender because the borrower has other debts to pay. In such cases, the lender may, again, when the financial condition of the borrower warrants, assist the borrower by granting to the borrower a consolidation loan. A consolidation loan consolidates all debts into one, such that the borrower will have but one loan to repay rather than several, and the borrower will be able to repay the consolidation loan in installment payments which are smaller than the total of all installment payments which he otherwise would have to pay.

Refinancing loans generally are for an amount equal to the existing debt which is to be refinanced, plus accrued interest, and consolidation loans generally are for an amount equal to the sum of the principal balance of all existing debts which are to be consolidated, plus accrued interest. Additional amounts over and beyond the debt to be refinanced or the debts to be consolidated may be loaned at the same time, but only where the financial circumstances of the borrower justify such an additional loan.

DOA does not follow this usual practice in administering the farm loan program. It makes little effort to enforce payment of past due accounts, even where amounts have been past due for years. One indicator of this non-enforcement policy is the number of foreclosures it has caused over the years. The records at DOA disclose that, since 1959, there has been only one instance of foreclosure, although delinquencies have been substantial. One reason for this lack of foreclosures is the inadequacy and deficiency in the securities DOA accepts. But the larger reason is that one which explains why inadequate and deficient securities are accepted in the first place. DOA is strongly moved to keep farmers in operation, notwithstanding their financial insolvency.

DOA accomplishes its aim of keeping farmers in operation, notwithstanding financial insolvency, through a misuse of the refinancing and debt consolidation scheme. Rather than pursue enforcement remedies, DOA readily grants refinancing and consolidation loans when borrower-farmers fall behind in the repayment of existing loans. Refinancing and debt consolidation are resorted to, not to ensure collection of that which is owed to the State, but simply to keep the farmer going. Refinancing and consolidation loans are thus made even though there is little hope that the new or the existing loans will ever be fully repaid. The misuse of these techniques becomes even more apparent when one examines more closely the way in which DOA utilizes refinancing and debt consolidation.

DOA refinances only that portion of an existing debt which is past due, not the entire amount of the loan. Because the new loan covers only the delinquent amount, the existing loan is not cancelled, but continues in force. The new loan then becomes a second loan, not a substitute loan. That is, the old loan is not refinanced to spread out the repayment over a longer period or to reduce the installment payments. Then, invariably, a refinancing or consolidation loan includes an additional sum for farm operation —a sum in addition to the amount needed to cover the delinquent amounts on an existing loan. Such additional amounts are loaned, even though financial data indicate inability to repay not only the new loan but the existing one as well. Finally, as the unrefinanced portion of the old loan and the installment payments on the new loan become delinquent, another refinancing or consolidation loan is made. And this continues *ad infinitum.* Earlier portions of this chapter are replete with examples of this situation.

As a result, although refinancing and consolidation loans are supposed to assist in easing the financial burden of the farmer, such is not the case in the farm loan program. Because of additional operating monies provided and because the existing debt is not refinanced in its entirety, and because refinancing and consolidation loans are made irrespective of the financial capabilities of the borrower, the farmer's economic plight is generally worsened, not lightened, by the refinancing and consolidation loans.

The only reasonable explanation for this behavior of DOA is its belief that farmers should be kept in operation, no matter what the fiscal consequences may be. Such an approach, however, is alien to the farm loan statute as it is now written.

Consequences

The results of DOA's practices are twofold. *First,* loan-making without concern for ability to repay has resulted in a high rate of delinquencies. *Second,* the practice of refinancing and extending further credit to farmers who are insolvent has caused loans to be concentrated in a few farmers.

Delinquencies. The size of the delinquencies caused by loan-making without concern for ability to repay is illustrated by the following. At June 30, 1975, if only those loans, the entire outstanding amounts of which are required by the rules of DOA to be treated as being delinquent, are considered,[20] the delinquency totaled $2,727,288. This constituted 31 percent of the total $8,882,581 in loans outstanding. (The $8,882,581 is exclusive of loans made but not yet disbursed or advanced at June 30, 1975.) Of the $2,727,288 delinquent amount, approximately $1,318,179 or 50 percent represented loans on which no payment of principal had been received.

Age of delinquency	*Delinquent amount*
Over 2 years	$ 679,121
Over 1 year	798,523
Less than 1 year	1,249,644
Total delinquent loans	$2,727,288

Some delinquencies are to be expected in any loan program. However, 31 percent is excessive. It obviously reflects poor loan-granting and payment enforcement practices.

The amount of the delinquencies has been growing over the years. Table 3.13 summarizes the data on outstanding loans and delinquent loans for the fiscal years 1972 to 1975. As shown, the dollar amount of the delinquencies as a percent of the total dollar amount of loans outstanding nearly doubled between fiscal years 1972 and 1975—from 16 percent to 31 percent. This increase has not been accompanied by any significant increase in the number of farmers to whom loans have been made, nor by any substantial increase in the number of farmers whose loans have become delinquent. This suggests that more and more of the existing loans are becoming delinquent.

Concentration of loans in a handful of farmers. The rapid increase in the dollar amount of delinquencies accompanied by only a modest increase in the number of farmers whose loans are delinquent also suggests that the same farmers appear year after year on the list of delinquent farmers. It is on their loans that the dollar amount of delinquencies increases each year. Because their loans are the ones which become increasingly delinquent, it is to them that the bulk of the refinancing and consolidation loans is given. The dollar amount of delinquencies and the ratio of delinquent amount to total loan outstanding for each year shown in table 3.13 would be higher but for the refinancing and consolidation loans extended to this small group of farmers.

Since it is to this small group of farmers that the bulk of the refinancing and consolidation loans is made and since it is the practice of DOA to make repeated refinancing and consolidation loans and to extend additional credit each time a refinancing or consolidation loan is made, this small group of farmers today has a substantial portion of the state loans outstanding. Note the following statistics.

At June 30, 1975, farm loans totaled $8,882,581 (excluding 11 loans totaling $983,498, which had been granted as of June 30, 1975 but not yet disbursed or advanced). This amount represented 787 loans and was spread out among 661 farmers.[21] On the surface, the number of farmers being assisted at June 30, 1975 appeared impressive. However, only 85 or 12.9 percent of the total number of farmers had $4,296,586 or nearly one half (48.4 percent) of the total $8.9 million outstanding. (See table 3.14.) Each of the 85 had two or more loans. The average loan amount per farmer for this group of 85 farmers was

[20] Section 84 of the *Farm Loan Manual* requires that the entire amount of a loan be considered delinquent even if only a portion of the loan is past due, if the amount or amounts past due are excessive (i.e., six monthly payments are delinquent, a quarterly payment is delinquent for 90 days, a semi-annual or annual payment is delinquent for 60 days). The entire amount of a loan is also required to be considered delinquent if the borrower is in receivership, the borrower has made an assignment for the benefit of creditors, there is a suit against the borrower, or a judgment has been secured against the borrower, etc.

[21] This figure includes individual farmers, farm cooperatives, and corporations.

Table 3.13

Outstanding and Delinquent Loans

Fiscal year	Total outstanding: Amount	Total outstanding: No. of loans	Total delinquent: Amount	Total delinquent: No. of loans	No. of farmers	Delinquent amt as % of total amt outstanding	Delinquent loans as % of total loans outstanding
1974–75	$8,882,581	787	$2,727,288	89	59	30.70	11.31
1973–74	7,670,986	786	1,595,221	73	51	20.79	9.29
1972–73	7,229,511	808	1,161,024	67	50	16.06	8.29
1971–72	5,805,678	392	923,016	60	48	15.90	15.31
Percent increase FY 71–72 through FY 74–75				48.33	22.91		

Table 3.14

Farmers with Two or More Loans

County	No. of farmers	Amount	% of total loans
Hawaii	52	$1,985,402	22.4%
Oahu	25	2,033,354	22.9
Maui	5	186,844	2.1
Kauai	3	90,986	1.0
Total	85	$4,296,586	48.4%

$50,548, as compared to the average loan amount per farmer for the total 661 farmers of $13,438.

The concentration of loans within a limited number of farmers is further illustrated by table 3.15. Fifty-two of the 85 farmers mentioned above were on the island of Hawaii. In table 3.15, the 52 Big Island farmers are broken down by number of loans per farmer. The table reveals that the average loan amount per farmer ranged from a low of $24,514 for farmers with two loans to a high of $130,619 for a farmer with eight loans.

The concentration of loans in a small group of farmers is clearly not intended by the farm loan statute. House Standing Committee Report No. 548, which recommended passage of Act 53, SLH 1968, observed that, "during a tight money situation, all available farm loans should be spread among reasonably efficient farmers rather than concentrated among a few." It thus might be said that, although for all intents and purposes the farm loan program has evolved into a direct loan or subsidy program, even as a direct loan or subsidy program, it has failed miserably, since the benefits of the program have not been spread out among the farmers.

Table 3.15

Farmers with Two or More Loans
Island of Hawaii

No. of loans	No. of farmers	Total amount	Average loan amt per farmer
2	32	$ 784,459	$ 24,514
3	9	253,105	28,123
4	7	526,706	75,243
5	3	290,513	96,838
8	1	130,619	130,619
Total	52	$1,985,402	$ 38,181

Conclusion

If the farm loan program is to remain a *loan* program, then the efforts and activities of DOA will need to be reoriented. Obviously requirements concerning qualification for loans and security to be posted will need to be tightened to ensure reasonably that loans will be repaid and, if not repaid, the security posted will allow the State to recover all or substantially all of the outstanding loan amount. Vigorous action will also be required in cases of default in the payment of loan repayment installments; and the practice of making refinancing and consolidation loans upon loans must be curtailed. Further, affirmative programs to assist farmers to improve their commercial credit standing and to induce private lenders to extend credit to farmers will need to be formulated and executed. In this connection, it would be desirable for interest rates on direct loans to be made identical to the rates on participation and insured loans. (This course of action will require a legislative act.)

Tightening-up the requirements for loans, of course, will need to be done in the context of the state policy to take greater risks than the private lenders. This is the essence of the state loan program. But the requirements must be tightened, nonetheless, if subsidization of farmers is to be avoided. This is not to say that subsidization should not be a state policy. It may well be that a case can be made for subsidization on some economic or other basis. Such a policy, however, requires legislative enunciation, and until the legislature so speaks, the loan program should not be administered in a fashion as to cause subsidization to result.

Chapter 4

LOAN MANAGEMENT

This chapter contains our findings relating to the administration of the farm loan programs. It focuses on the managerial and operational practices followed by DOA. Although the primary focus is on the farm loan program, this chapter also discusses specific deficiencies regarding the administration of the Hawaii agricultural products program and the aquaculture loan program.

Summary of Findings

Our findings here confirm the observation made in the preceding chapter that DOA basically considers the farm loan program as a subsidy, rather than a loan, program; that in making loans, it cares little whether the borrower has the capability to repay the loan. Thus, although DOA is supposed to follow certain procedural requirements to ensure that loans will be repaid, it follows those requirements in a sloppy and perfunctory manner. Specifically:

1. DOA does not insist on the submission of proper financial data to support loan applications.

2. DOA fails to ascertain the value of the property offered as security and the mathematical correctness of the amount of security given.

3. DOA does not properly service the loans it makes. It does not make the required or needed field visits to ensure that the borrower is complying with the terms of his loan. Indeed, DOA fails to keep track of the whereabouts of borrowers.

4. DOA refinances existing loans in a manner violative of statutory requirements.

With respect to the Hawaii agricultural products program and the Hawaii aquaculture program, our finding is that neither program is being effectively implemented.

Farm Loan Approval Process

To provide some perspective to our findings concerning the administration of the farm loan program, we outline here the process that is supposed to be followed in making loans to farmers.

In general, farmers obtain loans through the State's farm loan program in one of two ways: (1) they are referred by a bank which has agreed to participate in a joint bank-state loan or (2) they are unable to obtain financing from any other source and must thus apply for a direct state loan. All prospective borrowers applying for participation loans must show that they have been unable to secure a loan from one other bank and FHA. All those who apply for direct loans must show proof of rejection from two banks and FHA. Should a farmer contact the program without the necessary bank and FHA turndowns, he is directed to contact two private lenders and FHA and discuss his credit needs with them prior to applying for a farm loan. It should be noted that repeat borrowers usually obtain the necessary rejections before contacting the farm loan program.

After the necessary bank and FHA rejections are received, the prospective borrower is screened by a loan representative. The prospective borrower must be a "qualified farmer" within the meaning of statute and otherwise meet the statutorily prescribed requirements such as citizenship and residence.

Once eligibility has been established, the applicant completes the "application for farm loan" (Farm Loan Form No. 9 for individuals, Farm Loan Form No. 13 for farm corporations). The application includes, among other things, the purposes of the loan, the amount requested, and the assets, liabilities, and net worth of the applicant. The applicant also completes a "projection of income and expense statement" (Farm Loan Form No. 32), which includes a one-year projection of farm income and expenses; capital expenditures, if any, which are to be made with the loan proceeds; a cash summary indicating the amount available for debt repayment; and a debt repayment schedule showing all outstanding debts at the time of the loan request. The loan representative may also request that the applicant submit a balance sheet, an income statement, and tax returns from prior years. In the majority of cases, however, the two forms are all that are required for a loan request to be considered and acted upon.

After the two forms are reviewed for accuracy and completeness, the loan representative then performs an analysis of the data contained in the forms. His task is to determine whether the applicant has sufficient debt-paying power and whether the applicant's net worth provides an adequate cushion between assets and total obligations. Through an analysis and interpretation of the figures on projected sales, gross profit, operating expenses, and net profit, he determines whether the applicant will generate sufficient income to repay the proposed loan. In addition, he examines the value of the security offered as collateral to determine if it is adequate to protect the interest of the State.

If the loan representative, based on his interpretation of the data and his own personal judgment, believes the request should be disapproved, he submits all relevant documents, together with his reasons for recommending disapproval, to the farm loan division head for the latter's review and final disposition. If the loan representative believes the applicant to be a "sound credit risk" with the ability to repay the loan, he recommends approval of the request and completes a loan report. The loan report includes his comments on the eligibility of the applicant, a narrative on the farmer's past history, the status of prior farm loans, the purposes of the loan, the value of the security pledged as collateral including the loan to security ratio, and the repayment terms and financial condition of the applicant. The loan representative also completes the "loan approval conditions" (Farm Loan Form No. 10), which sets forth the conditions under which the loan will be approved, i.e., financing statement on collateral pledged, lien search, real estate mortgage on real estate, etc. The loan report together with the application, projection of income and expense statement, and loan approval conditions are then forwarded to the farm loan division head for his review and approval. In the case of participation loans, should the bank require that a portion of its share be insured by the department, the loan representative will also submit the participation agreement between the bank and the State (Farm Loan Form No. 34) indicating the percentage of the bank's share of the loan to be insured.

Upon approval by the division head, the application and all pertinent documents are submitted to the chairman of BOA. If the loan request is for an amount less than $25,000,[1] the

[1] Farm Loan Policy Number 7–14, amended June 13, 1974, states:

> "Loans up to and including $25,000 (including outstanding amounts from previous loans) will be approved administratively by the Chairman of the Board of Agriculture. . . .
>
> "Loans exceeding $25,000 (including outstanding amounts from previous loans) will be submitted to the Board for approval prior to commitment."

chairman may at his discretion grant approval of the loan without presenting it to the full board. All loan requests in excess of $25,000 must be submitted to the full board for final approval.

After the loan receives final approval from either the chairman or the board, the farm loan representative is notified of the decision and is instructed to prepare all necessary documents, i.e., financing statement, promissory note, assignment of crops, etc. These completed documents are then forwarded to the farm loan division head for his review and approval. If the loan is to be secured by a real estate mortgage on fee simple property, the mortgage document is then sent to the state attorney general's office for his review. A title search is also performed to ensure that title to the property is free of any liens or encumbrances.

After all documents have been reviewed, approved, and signed by the parties concerned, they are returned to the loan representative who in turn contacts the applicant. The applicant and the loan representative review the terms and conditions of the loan and the documents are signed and witnessed. The representative and the borrower then initiate a request (Farm Loan Form No. 27) for release of the funds. The request is submitted to the department's accounting office for review and forwarded to the department of accounting and general services (DAGS). DAGS releases the funds to the farm loan division which in turn transfers the funds to the appropriate district office. The funds are deposited into a "supervised account" at a bank selected by the borrower. The account, which bears the name of the borrower and the "state farm loan program," is used like a regular checking account except that all checks drawn on the account must be signed by both the borrower and the loan representative. The individual checkbooks are retained by the loan representative. In the case of participation loans, the State's share is disbursed to the lender for disbursement to the borrower. The lender maintains the account for the borrower and receives out of the interest collected a fee of not more than 1 percent on the unpaid balance of the loan.

The entire loan approval process, from the time the application is submitted until the time the funds are deposited into the supervised account, may take anywhere from 30 days to eight months depending on the loan amount and the availability of loan funds.

Inadequate Review of Financial Data

A part of the loan approval process is the submission of financial data to show ability to repay the loan. Under the procedure outlined above, the data submitted by the applicant are supposed to be carefully reviewed and analyzed to determine the applicant's earning potential and repayment capacity. We find, however, that the analysis performed is inadequate.

Inflated projections. Every applicant is required to complete a "projected income and expense statement" in which he estimates farm income and operating expenses to arrive at net cash profit for the coming year. Since these projections serve as a basis for determining whether or not the applicant has the earning power to repay the proposed loan, one would expect the projections to be carefully scrutinized by DOA to ensure that predicted sales are based on realistic unit prices and volume amounts and that planned expenditures are derived from a realistic cash budget.

It appears, however, that the projections are not given such careful scrutiny. The projections as submitted by the farmer are readily accepted by the farm loan division, even though they are often inflated. The projections of farm income in particular are often inflated. The case of a farmer who received three loans over a five-year period, 1967 through 1971, is an example. The estimates of farm income submitted with each of the three loan requests which were accepted by the farm loan division were extremely unrealistic. In each case, the actual income proved to be considerably lower than what was estimated. Table 4.1 displays this finding.

Table 4.1
Difference Between Projected and Actual Farm Incomes

Period covered by farm income projection (calendar year)	Projected farm income	Actual farm income	Difference	Percent projected over actual
1967	$16,960	$12,230	$ 4,730	38.7%
1969	22,540	4,660	17,880	383.7
1971	20,810	9,134	11,676	127.8

As shown, the disparity between actual farm income[2] and projected farm income ranged from a low of $4,730 to a high of $17,880. In terms of percentage differences, it is obvious that income was grossly overestimated in the loan requests submitted for 1969 and 1971. The differences were 383.7 percent and 127.8 percent, respectively.

While some variations between actual and estimated income are to be expected because of such factors as weather, crop disease, price fluctuations, etc., it is highly unlikely that the large variations shown in table 4.1 could be attributable entirely to natural occurrences. Rather, they appear to have been the result of a desire on the part of the farmer to submit figures which would ensure approval of the loan request.

If projections are to serve as a meaningful guide on which to base loan decisions, then the estimates of income as well as expenses need to be more critically evaluated than they are now. For instance, the anticipated units of the commodity to be produced by the farmer as well as the selling price per unit should be analyzed on the basis of realistic planting or production plans and the farmer's past experience. Then, the estimates of expenses should be viewed in light of the costs of producing a unit of product.

Outdated financial statements. In addition to the projected income and expense statement, some applicants are also required to submit other financial statements, such as a balance sheet and an income statement. These additional statements are usually required of applicants seeking large loans and of repeat borrowers. These statements are supposed to assist in evaluating the applicant's debt-carrying capacity. For example, the balance sheet, which lists the applicant's assets, liabilities, and net worth, provides information on the solvency of the business, i.e., the ability to finance current operations and to meet obligations as they fall due. It also provides information on the relative interests of creditors and investors in the business.

Since these additional statements can and should have a direct bearing on whether or not a loan should be approved, the most current financial statements should be required. However, our examination revealed that substantial loans are often made on the basis of outdated financial statements.

For example, a farm corporation received two loans amounting to $50,000 in February 1973. Both loans were approved on the basis of a balance sheet and income statement dated December 1971. These statements, of course, did not reflect the company's then current financial condition and ability to repay the $50,000.

[2]The figures noted on the applicant's statements as farm income included such non-farm income as income tax refund and patronage dividend from farming cooperative.

As a further example, two loans totaling $47,000 were granted to a farmer in June 1974. Data contained in a 1972 balance sheet were used to justify approval of these loans.

As a postcript, it is noted that in the first example both loans were listed as being delinquent as of June 30, 1975. Although the loans in the second example were not yet past due, four other loans made to this farmer were delinquent at June 30, 1975.

Inattention to Security Matters

If the property offered as collateral is indeed to serve as security, it is incumbent upon DOA to evaluate with care the value of each property offered and to ascertain the correctness of the calculations concerning the securities offered. DOA, however, pays little attention to these matters.

Lack of proper appraisal or documentation of value. DOA does not insist upon proper appraisal or full documentation of the value of the property offered as security for a loan. Rather, with minor exceptions, it accepts the value ascribed to the property by the loan applicant. Where judgments are made by DOA, they are generally the personal judgments of the loan officers and are not based on any hard facts. Note the following example.

DOA made two loans totaling $24,500. It accepted as security for the loans certain crops, equipment, and interest in real estate to which the borrower ascribed the total value of $31,450. The borrower imputed the value of $21,600 to the crops and $9,850 to the equipment and interest in real property, jointly. DOA did not question the propriety of the values assigned to the property by the borrower. It did not ask for documentation of the unit prices upon which the value of the crops was computed, nor did it ask for separate values for the equipment and the interest in real property. When queried on this example, the division head noted that judgment to accept the borrower's valuation was initially made by the loan officer concerned and that "the loan officer [knew] from his experience in farm products and equipment that the valuation [was] good." When asked specifically about documentation for the values assigned to the equipment and interest in real property, the division head stated, "As the farm property and improvements only added collateral on [the] loan, it is believed that supporting documentation was not necessary. The crops [were] the major collateral."

In the next chapter, we note that Coopers and Lybrand, a certified public accounting firm which examined the financial records of DOA concerning the farm loan program, could not attest to the fairness of DOA's financial statements on the program. DOA's failure to substantiate and otherwise document the values assigned to the property pledged as collateral was one of the reasons for Coopers and Lybrand's inability to attest to the fairness of the financial statements.

Errors in calculations. Not only does DOA fail to insist on proper documentation of value, but it fails to ascertain whether the calculations concerning the sum total of the value of all property pledged as security are correct. This failure to review calculations has resulted in gross errors that jeopardize the security position of the department.

To illustrate, security pledged on a $20,000 Class C loan was stated in the loan officer's report to the division head as follows:

> "Leasehold mortgage on 45-year B.P. Bishop Estate lease with growing plants valued at $39,000."

The loan to security ratio was computed by the loan representative as follows:

$$\frac{\$20{,}000}{\$39{,}000} = 51.2\%$$

An examination of the files revealed that the

$39,000 was based on plants growing on 21.5 acres of land, to-wit:

Acres		
8.5	plumeria	$20,000
5.0	coffee and macadamia nuts	15,000
8.0	undeveloped farm	4,000
21.5		$39,000

However, the security agreement executed on account of the loan had in fact assigned as collateral all plants growing or to be grown on 9.4 acres, and not on 21.5 acres of land. When questioned, the division head confirmed that only plants from 9.4 acres had indeed been assigned:

Acres	
8.5	plumeria
.9	coffee and macadamia nuts
9.4	acres assigned

Obviously, then, the value of the security presented in the loan report and used to compute the loan to security ratio was incorrect. The correct value of the security and the loan to security ratio should have been as follows:

	Acres	Value
Plumeria	8.5	$20,000
Coffee and macadamia nuts	.9	2,700
Total acres	9.4	
Total value of security pledged		$22,700

$$\text{Loan to security ratio} \quad \frac{\$20,000}{\$22,700} = 88.1\%$$

Note that there is a difference of $16,300 ($39,000 – $22,700) between the amount of security thought to be pledged and the amount actually pledged, as well as a difference of almost 40 percentage points in the loan to security ratio. While there is no legal loan to security limitation for Class C loans, a ratio of 88.1 percent seems excessive, especially since the major portion of the collateral was flowers, which are extremely perishable.

Another illustration is the case of a farmer who received the following two loans simultaneously: (1) a $43,000 Class A loan and (2) a $26,000 Class C loan. Security for the Class A loan was a first mortgage on a state leasehold property with all improvements and a second mortgage on a house and lot. The value of the house and lot was listed in the loan application at $15,500. The value of the leasehold property was noted at $43,000 (the amount of the Class A loan). Security for the Class C loan was a chattel mortgage on all equipment and young fowl valued at $51,000.

The loan representative derived a 73.5 percent loan to security ratio for the Class A loan. He obtained this ratio as follows:

$$\frac{\text{Amount of loan}}{\text{Total amount of security}} \quad \frac{\$26,000}{\$58,500} = 73.5\%$$

This ratio, of course, was in error. In the first place, the amount of the Class C loan, rather the amount of the Class A loan ($43,000) was used as the numerator in the fraction. Second, in determining the total value of the security, the full value of the house and lot ($15,500) was used, when, in fact, the amount of the first mortgage on the house and lot ($9,196) should have been deducted from the full value. With the amount of the first mortgage deducted from the full value of the house and lot, the total value of the security pledged on the Class A loan was $49,304 ($43,000 + $15,500 – $9,196). The loan to security ratio would then have been as follows:

$$\frac{\text{Amount of Class A loan}}{\text{Total amount of security: amount of loan plus house and lot less first mortgage}} \quad \frac{\$43,000}{\$49,304} = 87.2\%$$

By this loan to security ratio of 87.2 percent, the applicant would have been disqualified for the Class A loan under the provisions of section 155–11(c), HRS, which states that "for purposes of Class 'A' . . . loans, no loan shall exceed 85 percent of the value of the security offered."

The errors in both illustrations could have been detected if there had been a proper review of the calculations.

Poor Loan Servicing

The farm loan manual requires the farm loan representative to make on-farm visits at least twice each year for the duration of the loan. The primary purpose of the field visits is to ensure that the collateral is being maintained in good condition, that the loan funds are being used for the purposes intended, and that the terms and conditions of the loan are otherwise being met. They are also made to assist farmers found to be in violation of loan terms and conditions, to collect from delinquent borrowers, and to generally keep abreast of the borrower's operations and financial status.

There are other loan servicing activities. The farm loan division issues payment due and past due notices to all farmers who have direct state loans and informs the appropriate loan representatives of payments not received from farmers within their respective districts.

Our examination disclosed that the farm loan division has been seriously negligent in performing these loan servicing activities.

Infrequent field visits. The requirement that a minimum of two field visits a year be made by the loan representatives is not being met. This is the case even when loan approval reports specifically state the need for close supervision. For example, a truck crop cooperative received two Class C loans, the first in 1970 for $18,500 and the second in 1971 for $3,000. In recommending approval of the first loan, the loan representative noted that, in view of the applicant's negative net worth and overextended bank credit, "[both] the Extension Service and the Farm Loan Division will be working closely with applicant supervising its finances, planting schedule and cultivation practices. By close supervision we will be able to generate adequate cash flow which would improve their [*sic*] financial position. Applicant's lease arrangement is favorable. No serious problems are anticipated and its repayment program is sound." Then, in 1971, when the second loan for $3000 was approved, the farm loan representative again indicated the need for close supervision to "strengthen [the] applicant financially."

An examination of the farmer's loan file revealed no report of any on-farm visit. Indeed, the file was absent of any form of documentation to indicate that supervision had been provided the farmer. It should be noted that the security pledged for both loans was equipment, machinery, and growing crops, all of which require frequent inspections to ensure that they are being properly cared for and are in satisfactory condition. Furthermore, while the loan representative maintained that the farmer's repayment program was sound, both loans were listed as being delinquent at June 30, 1975. Total amount of the delinquency was $9381.

Another example is the following. A hog farmer received three loans totaling $58,000 over a five-year period. The amount of each loan was $30,000, $8,000, and $20,000, respectively. At the time of the request for the third loan, the two previous loans were delinquent. In recommending approval of the $20,000 loan, the farm loan representative attributed the cause of the delinquency of the first two loans to mismanagement by the farmer and stated:

> ". . . In reviewing operation with applicant and resource people, we believe we are in a position to assist applicant to generate an adequate cash flow to improve his financial condition and farm operation.
>
> "We will be working closely with applicant assisting him in financial and operational management matters . . . ."

The farm loan representative's representations were never fulfilled. The farmer's loan file disclosed no documentation of any field visit or of any assistance in financial and operational matters having been provided to the farmer. At June 30, 1975, all three loans were delinquent in the amount of $19,239.

Failure to keep tab on where-abouts of farmers. If DOA hopes to have the loans it makes repaid, it would seem that DOA would exert every effort to keep tab of the whereabouts of the farmers to whom it makes loans. It appears, however, that DOA does not properly maintain the mailing addresses of borrowers.

During our audit, a survey of farmers with 788 outstanding loans was conducted. Letters requesting confirmation of the loans and the outstanding amounts were mailed by the farm loan division to the borrowers. Thirteen of these letters were returned with the notation "unable to deliver" or "no such address." These 13 letters accounted for a total of 29 loans, amounting to $708,983. When queried as to the reasons for these unknown addresses, the farm loan division offered the following explanations: "The borrower moved and did not inform the division," and "errors had occurred in the addressing." In those few cases where the division had made an error in addressing, the letters were resent with the "corrected" addresses. Even then, at least two letters were returned as being undeliverable. These two borrowers held seven loans totaling $186,619. Since their addresses were apparently unknown, it was not surprising that both farmers were listed on the delinquent loan list as of June 30, 1975. In the case of one farmer, the last payment received by the division was in April 1971.

Improper Refinancing of Loans

Under section 155–9, HRS, loans granted for the purposes of home ownership and improvement (Class A), soil and water conservation (Class B), and farm operations (Class C) may be refinanced with other state farm loans. The statute stipulates, however, that a refinancing loan (or a loan which consolidates several outstanding loans) of a given class refinances only that outstanding loan (or those outstanding loans) of the same class as the refinancing loan. For example, a Class C loan may be used to refinance only an outstanding Class C loan (or a group of outstanding Class C loans), not an outstanding loan (or loans) of another class.

Our examination of the records and files maintained by the farm loan division revealed that numerous loans have been made in violation of this statutory requirement. The case of a farmer who in 1975 received a $30,000 direct Class C loan is an example. The $30,000 was used to liquidate portions of not only outstanding Class C loans, but also portions of outstanding Class A and Class B loans. See table 4.2.

Table 4.2

Disposition of Certain Loan Proceeds

Loan no.	*Loan class*	*Principal balance at Sept. 1975*	*Amount repaid*
1	A	$29,170	$ 4,223
2	A	32,450	6,020
3	A	5,503	26
4	B	3,000	649
5	C	4,807	5,015
Total		$74,930	$15,933

Besides violating the statutory requirements regarding loan purposes, this practice of using one class of loans to refinance loans of other classes could conceivably lead to noncompliance with those statutory requirements regarding repayment terms and loan to security ratios. To illustrate, as established by section 155–9, HRS, the maximum terms of class A and C loans are 40 years and 10 years, respectively. If a a 40-year Class A loan were used to refinance a prior Class C loan, the Class C loan would in effect be extended beyond the legal ten-year limit by some 30 years. In regard to loan to security ratios, section 155–11, HRS, specifies that class A and B loans are not to exceed 85 percent of the value of the security offered. For Class C loans, the loan to security ratio is discretionary with the department. If a Class C loan were used to refinance a Class A or Class B loan, the loan to security ratio could actually exceed the 85 percent limitation imposed by law for class A and B loans.

Recommendations on Operations of the Farm Loan Program

Given the nature of the deficiencies, the recommendations concerning operations of the farm loan program are obvious. Thus DOA should

1. Insist on realistic projections on income and expenses and accurate and most recent financial statements from loan applicants;

2. Require an appraisal report or other documentation on value of property offered as security for a loan;

3. Exercise care in calculating or in examining the calculations submitted for loan purposes;

4. Conduct on-farm inspections at least twice a year as required by the farm loan policy and closely supervise those farmers whose records indicate the need for such close supervision in the operation of their farms, and otherwise properly monitor the loans; and

5. Grant refinancing loans only as stipulated by statute.

These recommendations, of course, are meaningless unless DOA begins to consider the farm loan program as a *loan* rather than a *subsidy* program. After all, the operational deficiencies noted in this chapter are symptomatic of the underlying attitude of DOA described in chapter 3 to treat the farm loan program as a subsidy program for farmers.

Ineffective Implementation of Hawaii Agricultural Products Program and Hawaii Aquaculture Loan Program

By statute, the administration of both the Hawaii agricultural products program and the Hawaii aquaculture loan program is vested in DOA. The agricultural products program is intended to stimulate the agricultural industry. It provides allowances and grants for the development of new crops and agricultural products creating further marketing areas for Hawaiian agriculture. The aquaculture loan program provides capital and operating loans to those engaged in aquaculture farming, aquaculture produce processing, and aquaculture development.

Our general finding is that DOA has made no adequate efforts to effectively implement the two programs. Progress has been negligible in meeting the objectives of developing agricultural products and strengthening the aquaculture industries. Only four agricultural product grants have been approved since the establishment of the agricultural products program in 1963, and only two loans have been made under the Hawaii aquaculture program although it was created in 1971.

Although only small progress has been made in implementing these programs, DOA has been deficient in the things that it has done. The following are the deficiencies.

Nonuse of advisory committee on agricultural products. In 1971, the legislature amended the 1963 act which first established the agricultural products program. The amendments were intended to include the support of practical research in the area of crop diversification, innovative production techniques, and the development of new crops and agricultural products. To accomplish this, the legislature believed that "the program will require coordination and cooperation of efforts between the Department of Planning and Economic Development, the College of Tropical Agriculture, the Department of Agriculture and members in the industry."[3] The legislature thus created an advisory committee consisting of representatives from these groups. Specifically, the legislature decreed that the committee shall consist of the chairman of BOA or his designated representative, the director of DPED or his designated representative, the dean of the college of tropical agriculture or his designated representative, and three members from the agricultural industry appointed by the governor. This six-member committee was charged with the duty to consult with DOA on all matters pertaining to agricultural development crops and products as provided for under the program.

The advisory committee has failed to function as intended. It has not been a viable component of the agricultural products program. Since its establishment in 1971, the committee has formally convened only three times. By being nonoperational, the agricultural products program is not receiving the benefit of the contributions that the legislature thought it could and should receive from the professional, technical, and industrial experiences of the committee members. Moreover, the program is not getting the "proper coordination and cooperation of efforts in the implementation of the program" that the legislature intended the committee to provide.

Recommendations. *We recommend that:*

1. DOA give the advisory committee the necessary support and assistance to make it a viable instrument in the implementation of the Hawaii agricultural products program.

2. The advisory council itself begin to fulfill its role as a coordinating and consultative body as had been intended by the legislature.

Failure to enforce repayment of agricultural products allowances. Grants or allowances approved under the Hawaii agricultural products program are financed through the program's revolving fund. The revolving fund consists of the appropriations made by the legislature to the fund and all sums constituting repayment of allowances and proceeds derived from the sale of any development crop or product under joint venture or participation arrangements with agriculturalists. The success of the program, therefore, depends on ensuring that the revolving fund "revolves." However, our examination revealed that very little effort is directed towards enforcing repayments of allowances. As a result, the fund does not and cannot revolve as intended. We cite as examples the following.

1. A $25,000, one-year grant was approved in May 1966. At June 30, 1975, some eight years after the grant was supposed to have been repaid, the entire principal amount of $25,000 was still outstanding. In addition, $7,138 in interest was also past due. Since the grant was secured by a crop and chattel mortgage valued at $120,000 and guaranteed by an individual, there was no reason why efforts could not have been exerted to collect the outstanding amounts.

2. In another case, a grant of $25,000 was approved in May 1969. It was to have been repaid over a five-year period. However, between 1969 and 1974, the installment payments due were deferred five times. The last request for waiver of payment was approved in August 1973 on the condition that the proceeds of $18,000 from a then contemplated sale of land be assigned to the State. However, this assignment did not materialize and, as of June 30, 1975, the principal balance of $15,000 and interest of $1,561 remained outstanding.

Recommendation. *We recommend that DOA actively pursue a program of collecting on the allowances it grants.*

[3] Standing Committee Report No. 511 on Senate Bill No. 1283, relating to the establishment of a state farming demonstration project, submitted by the senate committee on economic development in 1971.

Chapter 5

FINANCIAL STATEMENTS AND ACCOUNTANTS' OPINION

This chapter reports the results of an examination of the financial statements of the loan and grant programs administered by DOA for the fiscal year July 1, 1974 to June 30, 1975. The examination was conducted by Coopers and Lybrand, a certified public accounting firm. Included in this chapter, although not necessarily in the order named, are a display of the financial statements that were examined, the opinion of Coopers and Lybrand regarding the accuracy of the financial statements, and notes explaining the various kinds of financial statements.

Denial of Audit Opinion

A basic purpose of a financial audit is the issuance of an opinion on the accuracy of the financial statements of the agency examined. Ordinarily, an auditor is able to attest to the accuracy of an agency's financial statements. However, in the case here, because the auditor was unable to ascertain the fairness of the values assigned to the securities pledged as collaterals on loans and because DOA's accounting system does not provide for possible losses on loans made, Coopers and Lybrand was not able to attest to the accuracy and dependability of the 1974–75 financial statements of the loan and grant programs administered by DOA.

Accountants' Opinion

Coopers and Lybrand's statement filed with the legislative auditor is as follows:

"To the Legislative Auditor
State of Hawaii
Honolulu, Hawaii

We have examined the financial statements of the funds of the loan and grant programs administered by the Department of Agriculture, State of Hawaii, as of June 30, 1975 and for the year then ended as follows:

Exhibit A – State Loan Funds and Programs – Combined balance sheet

Exhibit B – State Loan Special Funds – Statement of revenue, expenditures and encumbrances, transfers and changes in fund balances

Exhibit C – North Kohala Loan and Grant Program – Balance sheet

Exhibit D – North Kohala Loan and Grant Program – Statement of changes in program balances

As explained in the general notes to the financial statements, the General, Bond and Special Funds financial statements relating to the State loan and grant programs of the Department of Agriculture are part of the respective State of Hawaii General, Bond and Special Funds and our opinion expressed thereon is limited to the transactions of the programs.

Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraph.

A substantial portion of the loan program assets are represented by outstanding loans of which significant amounts are delinquent and the department does not provide for possible loan losses. Although either first or second mortgages on real estate, equipment or crops are pledged as collateral on these loans, we were unable to ascertain the fairness of the values assigned to the collateral.

Because of the materiality of the matter referred to in the preceding paragraph we are precluded from and we do not express an opinion on the aforementioned financial statements.

/s/ Coopers and Lybrand
Coopers and Lybrand
Certified Public Accountants

Honolulu, Hawaii
October 1, 1975"

Descriptions and Definitions

Description of financial statements. There are a variety of financial statements for any given program. The financial statements of the loan and grant programs administered by DOA which were examined by Coopers and Lybrand are in Exhibits A to D attached at the end of this chapter. A brief description of these statements is as follows.

1. The combined balance sheet (Exhibit A) summarizes the assets, liabilities, reserves, and fund balances, as of June 30, 1975, of the various loan funds and grant programs administered by DOA.

2. The statement of revenue, expenditures and encumbrances, transfers, and changes in fund balances (Exhibit B) summarizes the results of the financial transactions of the state loan special funds during the year.

3. The balance sheet on the North Kohala loan and grant program (Exhibit C) discloses the assets, liabilities, reserves, and program balances of the general obligation bond fund and general fund appropriations relating to the program as of June 30, 1975.

4. The statement of changes in program balances of the general obligation bond fund and general fund appropriations relating to the North Kohala loan and grant program (Exhibit D) summarizes the results of the financial transactions of the bond fund and general fund appropriations of the program during the year.

Definition of terms. Technical terms are used in the financial statements and in the notes to the statements. The more common terms and their definitions are as follows:

1. ***Allotment*** – Authorization by the director of budget and finance to a state agency to incur obligations and to make expenditures pursuant to the appropriation made by the state legislature.

2. ***Appropriation*** – An authorization granted by the state legislature permitting a state agency within established fiscal and budgetary controls to incur obligations and to make expenditures. Appropriations are of two types: (a) funds which are available for use until completely expended and (b) funds which lapse if not expended by or encumbered at the end of the fiscal year.

3. ***Encumbrance*** – The earmarking or setting aside of certain sums of money from an appropriation for payment at a future date.

4. ***Expenditure*** – The actual disbursement of funds for the payment of goods delivered or services rendered, the obligation to pay for such goods or services having been incurred against authorized funds.

5. ***Fund balance*** – The excess of a fund's assets over its liabilities and reserves which is available for future appropriation unless restricted to a specific purpose.

6. ***Lapse of appropriation balance*** – The balance of funds authorized, which is unexpended and uncommitted at the end of a prescribed time period. The balance reverts to the designated fund and is available for appropriation by the state legislature in the ensuing fiscal year.

7. ***Reserve*** – An account which records a portion of the fund balance as being segregated for some future use. The amount so segregated is not available for further appropriations.

8. ***Transfer*** – Transfer of amounts from one fund to another.

9. ***Unallotted appropriation*** – An appropriation balance available for allotment.

General Notes to the Financial Statements

The following are general explanatory notes to the financial statements. They are intended to furnish the reader with a better understanding of the statements and to minimize any misreading of the statements.

Accounting principles. DOA's loan and grant funds are accounted for on a modified cash basis of accounting. The accompanying financial statements, therefore, have been prepared on that basis. Under this method of accounting, revenue is generally recognized when actually received and expenditures are recorded at the time liabilities are incurred, except for vacation pay which is recorded when paid. Interest *receivable* (although not yet collected) is recorded and reflected on the balance sheet as an asset; but a related reserve for the collection of the interest is also recorded and shown on the balance sheet. The net effect of this is for interest revenue to be recognized at the time of collection.

The accounting procedures provide for the recording of commitments at the time contracts are awarded and orders for equipment, services, and supplies are placed. These commitments are represented as encumbrances in the financial statements and are necessary to reflect obligations against the various funds at the end of the fiscal year.

Loans are summarized and reflected as assets in the note receivable account on the balance sheets. Grants are recorded as expenditures when disbursed or encumbered and are reflected as expenditures on the statements of revenue, expenditures, and encumbrances.

The financial statements for the DOA-administered loan and grant programs, except the statement for the farm loan revolving fund, do not reflect as assets "capital assets" such as land, structure, and equipment purchased or constructed by the department to support the programs. In accordance with the practice of the State, applicable generally to all state programs, the cost of any capital asset acquired is recorded as an expenditure of the program to which it applies in the year in which the cost is incurred. Thereafter, the capital asset is accounted for as an asset item only in the statewide general fixed assets group of accounts, and it is so accounted for at cost. Generally, the State does not depreciate any asset on its books and there is no record of depreciation.

Fund categories and descriptions. Monies to finance DOA-administered loan and grant programs are accounted for in several different "funds." These funds have been established by legislative actions, and each fund has a specific purpose or objective to fulfill. Each fund is an independent fiscal and accounting entity and a separate group of accounts is maintained for each to show its assets, liabilities, and reserves as well as its revenues and expenditures. There are three general categories of these funds. The categories and the funds within each are described briefly below.

1. ***Special funds.*** Special funds are

operated to account for revenue and expenditures designated for particular purposes. There are four of these special funds for the loan and grant programs.

a. *Farm loan reserve fund.* This fund accounts for all interest and fees collected on loans made under the farm loan program. The interest and fees are used to pay the expenses necessary to carry on the operations of the program. These expenses include salaries of farm loan division personnel, employee benefits, travel and subsistence, and other operating costs which are related to the administration of the farm loan program. Currently, interest and fees collected under the farm loan program are also being used to pay the operating expenses of other loan and grant programs administered by the department. Excess monies in the fund are transferred to the farm loan revolving fund at the discretion of the department.

b. *Farm loan revolving fund.* This special fund, created by Act 278, SLH 1959, accounts for monies loaned under the farm loan program. All receipts of loan repayments and monies transferred from the farm loan reserve fund are also accounted for in this fund.

c. *Aquaculture revolving loan fund.* This special fund was established by Act 181, SLH 1971, to account for loans made under the aquaculture loan program. All loan payments received on account of principal, interest, and fees are deposited into this fund.

d. *Hawaii agricultural products revolving fund.* Act 75, SLH 1963, established this revolving fund to account for the monies appropriated for the purpose of providing allowances and grants to qualified agriculturalists. All monies received as repayments of allowances and proceeds payments are deposited into this fund.

2. ***General obligation bond fund.*** The general obligation bond fund accounts for the proceeds of the state general obligation bonds issued to finance the North Kohala loan and grant program. In 1972, the legislature authorized, under Act 197, the issuance of $4,650,000 of general obligation bonds for this purpose. (Exhibits C and D are concerned with the North Kohala loan and grant program, and they reflect the status of the general obligation bond fund.) The legislature authorized the proceeds of the general obligation bonds to be used as follows.

a. *Feasibilities studies appropriation.* The legislature appropriated $100,000 to be used for studies to be conducted on the technical and economic feasibility of establishing and developing various industries such as feed grain mill, modular home construction, and tropical fruit processing in the North Kohala region on the island of Hawaii.

b. *Irrigation water system appropriation.* An appropriation of $850,000 was made for the purpose of developing an irrigation water system in North Kohala.

c. *Planning and development appropriation.*[1] The legislature appropriated $3,700,000 for planning and development of North Kohala.

3. ***General Fund.*** The general fund is used to account for all resources not specifically set aside for special purposes. Any activity not financed through another fund is financed through this fund. The budget as adopted by the legislature provides the basic framework within which the resources and obligations of the general fund are accounted. The general fund appropriations to the department are part of the State of Hawaii general fund; thus, none of the financial statements attached as exhibits at the end of this chapter is a statement of the general fund; except that Exhibits C and D reflect the general fund appropriations for and obligations of the North Kohala loan and grant program.

[1]By Act 84, SLH 1973, the legislature authorized the use of general fund revenues, as well as general obligation bonds, for planning and development purposes, up to a combined outlay of $3,700,000. General fund revenues used for planning and development purposes are accounted for separately from the general obligation bond fund in Exhibits C and D.

Notes receivable. The department reflects as notes receivable in its financial statements the total principal amount due on outstanding loans. It gives no consideration to probable losses from uncollectible accounts. This practice leads to an overstatement of the assets of the various funds.

The practice of showing accounts receivable at their face amount is reflected in the $11,005,748 noted in Exhibit A as notes receivable for all loan and grant programs as of June 30, 1975. An aging of notes receivable shows that, of the total $11,005,748 outstanding, $2,767,288 or 25 percent was delinquent at June 30, 1975. A breakdown of the delinquent amount by length of delinquency is shown in table 5.1.

Table 5.1

Notes Receivable Delinquencies
June 30, 1975

Status	*Amount*	*Percentage*
Period delinquent:		
Over 2 years	$ 704,121	6%
Over 1 year	813,523	7
Over 3 months	1,154,644	11
Less than 3 months . . .	95,000	1
Total delinquent	2,767,288	25
Current	8,238,460	75
Total notes receivable	$11,005,748	100%

It would seem that at least a part of those accounts delinquent for more than a year would never be collectible by the State. The further past due an account becomes the greater the likelihood that it will not be collected in full.

If the financial statements are to reflect fairly the financial condition of the various funds, the amount reflected in notes receivable should be reduced by an asset reduction account, i.e., an allowance for uncollectible accounts. The allowance account is an estimate of losses from uncollectible notes which is deducted from gross receivable to arrive at the net realizable value of the department's claims against borrowers.

Value of collateral. It is important that the value of the property assigned as collateral for a loan be sufficient to protect the department in the event of a foreclosure. If the collateral pledged has been properly appraised and if the appraisal, including the methodology used, has been properly documented, then confidence can be placed on the adequacy and sufficiency of the collateral.

No such confidence can be placed on the adequacy of the collaterals pledged for farm loans. As stated in chapter 4, the values assigned to the security are for the most part based on each loan officer's own personal judgment, and these values are accepted even though the methods and procedures used in arriving at stated values are not always documented. As a result, there is no way to determine if the collateral held by the department is sufficient to protect its security position.

Reserves for unrealized interest receivable. The reserves represent contra-accounts to the related asset balances in the interest receivable account.

Unallotted appropriations. The unallotted balances of appropriations in the general obligation bond fund and general fund, as of June 30, 1975, are shown in table 5.2.

In the table, only a total figure, rather than separate figures for bond fund and general fund, are given for appropriation and for unallotted balance for planning and development for the North Kohala loan and grant program—$3,700,000 and $1,620,332, respectively. This is because, although initially Act 197, SLH 1972, appropriated a total of $3,700,000 to be totally funded by the sale of general obligation bonds of the State, subse-

Table 5.2

Department of Agriculture
State Loan Program

Unallotted Balances of Appropriations
As of June 30, 1975

Fund/program	Act/year	Source of financing	June 30, 1975 Appro-priation	Allotted	Unallotted balance
Fund loan revolving fund	87/1972	G.O. bond fund	$2,000,000	$ 938,000	$1,062,000
	167/1975	General fund	1,500,000	--	1,500,000
Total farm loan revolving fund			$3,500,000	$ 938,000	$2,562,000
Aquaculture revolving loan fund	181/1971	General fund	$ 500,000	$ 150,000	$ 350,000
Hawaii agricultural products revolving fund	205/1971	General fund	$ 100,000	--	$ 100,000
North Kohala loan and grant program					
Feasibility studies appropriation	197/1972	G.O. bond fund	$ 100,000	$ 98,596	$ 1,404
Irrigation water system appropriation		G.O. bond fund	850,000	236,500	613,500
Planning and development appropriation:					
Bond fund		G.O. bond fund		666,667	
General fund		General fund		1,413,001	
Total planning and development appropriation			3,700,000	2,079,668	1,620,332
Total North Kohala loan and grant program			$4,650,000	$2,414,764	$2,235,236

quently, Act 84, SLH 1973, provided for funding of the total $3,700,000 from either the sale of general obligation bonds or from the general revenues of the State.

Notes to the Financial Statement of the State Loan Special Funds (Exhibit B)

There are several items in the financial statement of the state loan special funds (Exhibit B) which require special explanations. These explanations are necessary for a complete presentation of the financial statement.

Employee benefits. In accordance with the general practice followed by other state agencies, the department does not reflect in its financial statements certain employee fringe benefits that accrue or that are paid. These benefits include vacation and sick leave and retirement system contributions.

Both vacation and sick leave credits accrue as employees work. Vacation credits accrue at the rate of one and three quarters working days for each month of service. Within certain limitations, employees may, upon termination of employment, receive cash payments for vacation accrued but not taken. As of June 30, 1975, the farm loan division employees had earned vacation leave totaling approximately $39,000. In conformance with the general practice, however, this $39,000 is not reflected in Exhibit B.

Sick leave credits also accumulate at the rate of one and three quarters working days for each month of service without limit, but can be taken only in the event of an illness and is not convertible to pay upon the termination of employment. Like accrued vacation, accrued sick leave does not appear in Exhibit B.

All full-time employees of the department are required by section 88 of the Hawaii Revised Statutes to become members of the state employees' contributory retirement system. The department's and other state agencies' share of the retirement expenses for the fiscal year ended June 30, 1975 is included in the general appropriation bill as an item to be expended by the department of budget and finance.

Cost of operating loan and grant programs. Costs of operating all loan and grant programs administered by the department are charged to the farm loan reserve fund. There is no allocation of costs to the other programs. Exhibit B's display of the operating costs under the farm loan reserve fund must be read in that light.

Special fund assessments. The $35,648 special fund assessment figure noted as an expenditure of the farm loan reserve fund consists of $23,920 to defray central government expenses and $11,728 to reimburse DOA for departmental administrative expenses. These assessments were made in accordance with the provisions of sections 36–27 and 36–30, HRS, respectively.

EXHIBIT A

State of Hawaii
Department of Agriculture
State Loan Funds and Programs

Combined Balance Sheet - June 30, 1975

	Farm loan revolving fund	*Farm loan reserve fund*	*Aquaculture revolving loan fund*	*Hawaii agricultural products revolving fund*	*North Kohala loan and grant program*	*All loan funds and programs (memo only)*
Assets						
Cash with treasury:						
Available for loans	$ 201,717			$ 46,959		$ 248,676
Funds committed to approved loans/grants	330,637				$ 22,685	353,322
Funds earmarked for pending loans	279,500					279,500
Insurance reserve	2,004					2,004
Available for expenditures and encumbrances		$ 19,353	$ 8,080		84,933	112,366
	813,858	19,353	8,080	46,959	107,618	995,868
Receivables:						
Notes	8,882,581		148,017	52,000	1,923,150	11,005,748
Interest		319,057	2,424	8,700	69,975	400,156
	8,882,581	319,057	150,441	60,700	1,993,125	11,405,904
Real estate, at cost	1,152					1,152
Total assets	$9,697,591	$338,410	$158,521	$107,659	$2,100,743	$12,402,924
Reserves and Fund and/or Program Balances						
Reserves:						
Encumbrances		$ 2,165			$ 47,412	$ 49,577
Unrealized interest receivable		319,057	$ 2,424	$ 8,700	69,975	400,156
		321,222	2,424	8,700	117,387	449,733
Fund and/or Program Balances	$9,697,591	17,188	156,097	98,959	1,983,356	11,953,191
Total reserves and fund and/or program balances	$9,697,591	$338,410	$158,521	$107,659	$2,100,743	$12,402,924

The accompanying notes are an integral part of the financial statements.

EXHIBIT B

State of Hawaii
Department of Agriculture
State Loan Special Funds

Statement of Revenue, Expenditures and Encumbrances,
Transfers and Changes in Fund Balances
For the Year Ended June 30, 1975

	Farm loan revolving fund	Farm loan reserve fund	Aquaculture revolving loan fund	Hawaii agricultural products revolving fund
Revenue:				
Interest from notes		$363,627	$ 6,097	
Interest from time certificates of deposit		42,386		
Insurance guarantee fees		227		
Total revenue		406,240	6,097	
Expenditures and encumbrances:				
Salaries		138,092		
Special fund assessment		35,648		
Employee benefits		22,202		
Bank participation fees		11,534		
Travel and subsistence		11,462		
Telephone		3,397		
Office materials and supplies		2,298		
Equipment		2,222		
Utilities		479		
Repairs and maintenance		367		
Rentals		261		
Printing and advertising		105		
Miscellaneous		283		
Total expenditures and encumbrances		228,350		
Excess of revenue over expenditures and encumbrances		177,890	6,097	
Transfers from (to):				
General fund	$ 500,000		75,000	
General obligation bond fund	245,000			
Intra-fund	205,000	(205,000)		
Total transfers	950,000	(205,000)	75,000	
Excess (deficiency) of revenue and transfers over expenditures and encumbrances	950,000	(27,110)	81,097	
Fund balance — July 1, 1974	8,747,591	44,298	75,000	$98,959
Fund balance - June 30, 1975	$9,697,591	$ 17,188	$156,097	$98,959

The accompanying notes are an integral part of the financial statements.

EXHIBIT C

State of Hawaii
Department of Agriculture
North Kohala Loan and Grant Program
General Obligation Bond Fund and General Fund

Balance Sheet — June 30, 1975

	General obligation bond fund			General fund	
	North Kohala feasibility studies	*North Kohala irrigation water system*	*North Kohala planning and development*	*North Kohala planning and development*	*Total North Kohala loan and grant program*
Assets					
Cash in state treasury:					
Committed to approved loans and grants				$ 22,685	$ 22,685
Available for expenditure and encumbrance		$84,933			84,933
	—	84,933		22,685	107,618
Receivables:					
Notes			$666,667	1,256,483	1,923,150
Interest			41,122	28,853	69,975
			707,789	1,285,336	1,993,125
Total assets	—	84,933	707,789	1,308,021	2,100,743
Reserves and Program Balance					
Reserves:					
Encumbrances		47,412			47,412
Unrealized interest receivable			41,122	28,853	69,975
	—	47,412	41,122	28,853	117,387
Program balance (Exhibit D)	—	37,521	666,667	1,279,168	1,983,356
Total reserves and program balance	—	$84,933	$707,789	$1,308,021	$2,100,743

The accompanying notes are an integral part of the financial statements.

EXHIBIT D

State of Hawaii
Department of Agriculture
North Kohala Loan and Grant Program
General Obligation Bond Fund and General Fund

Statement of Changes in Program Balances
For the Year Ended June 30, 1975

	General obligation bond fund			General fund	
	North Kohala feasibility studies	*North Kohala irrigation water system*	*North Kohala planning and development*	*North Kohala planning and development*	*Total North Kohala loan and grant program*
Balance, July 1, 1974	$421	$ 53,001	$666,667	$1,076,667	$1,796,756
Allotments		130,000		229,667	359,667
Total balance and allotments	421	183,001	666,667	1,306,334	2,156,423
Expenditures and Encumbrances:					
Fees for other than personal services	421	145,350			145,771
Grants				27,166	27,166
Printing and advertising		130			130
Total expenditures and encumbrances	421	145,480		27,166	173,067
Balance, June 30, 1975 (Exhibit C)	–	$ 37,521	$666,667	$1,279,168	$1,983,356

The accompanying notes are an integral part of the financial statements.

PART III

RESPONSE OF THE AFFECTED AGENCY

COMMENTS ON AGENCY RESPONSE

A preliminary draft of this report was transmitted on February 16, 1978 to the chairman of the board of agriculture for the board's comments on the recommendations contained in the report. A copy of the transmittal letter is included as attachment 1.

The department, in its response, has suggested that extensive changes be made to the report. Much of the suggestions, however, would alter the substance of the findings. As will be evident by our comments in this part, we do not agree, with a minor exception, with the department's suggested changes.

For each finding or discussion that the department has commented on or suggested changes, we have printed (1) our finding or discussion as presented in this report; (2) the department's response to our finding or discussion, and (3) our comments to the department's response.

The findings and comments have been grouped and are presented in this part in the following order:

1. Program Intent Not Being Met
2. The Farm Loan Program—A Subsidy for Farmers
3. Loans to Poor Credit Risks
4. Negative Equity
5. Inadequate Security
6. Nonenforcement of Repayments; the Practice of Refinancing
7. Delinquencies and Program Losses
8. Concentration of Loans in a Handful of Farmers
9. Errors in Calculation
10. Insufficient Staff
11. Hawaii Agricultural Products Program and Hawaii Aquaculture Loan Program
12. Word Changes Suggested by the Department

Program Intent Not Being Met

Our Report:

On page 11, we stated the finding that:

In general, the farm loan program is not reaching the results contemplated by the legislature. What is supposed to be a program to stimulate private and federal financing for farmers has in fact become a program of state subsidy to farmers. To a large degree, this has resulted because of the actions of DOA. Indeed, DOA's conduct in the farm loan program appears to be deliberately intended to remake the loan program into a subsidy program.

DOA has limited its activities to making direct loans to farmers. It has formulated no plans and made little effort to spur the private sector to extend credit to farmers.

On page 13, we stated:

The Trends. Shortly before, and for a while after the enactment of Act 278, emphasis appeared to have been given to stimulating financing by private sources as intended by the act. However, since 1963, less and less efforts have been directed toward encouraging lending by the commercial sector. Today, loans from the commercial sector play but a miniscule role in the State's farm loan program. The bulk of the loans is now direct loans from the State.

On page 16, we also stated:

DOA attitude. The interest rate problem is not the only cause of the decline in the number of participation loans over the years. The decline is also attributable to the attitude of DOA. DOA has made virtually no effort to stimulate lending by private lenders, and it does not appear that DOA intends to do so. Thus, there are in DOA no research programs designed to determine the capital and credit needs of farmers and the alternatives for meeting those needs; there are no educational programs to motivate farmers into associated farming arrangements, i.e., farm cooperatives, incorporated family agricultural businesses, family partnerships, etc., so as to improve their financial potential and their bargaining power; and there are no plans by which farmers might be assisted in obtaining loans from private and federal sources. Then, there are no programs to educate financial lending institutions about the potential benefits of providing services and credit to farmers; and there are no plans and policies to increase the amount of private and federal loan funds available to farmers.

The failure of DOA to encourage financing from private (and also from federal) sources has placed financial burdens on the State. There is a constant shortage of funds although the farm loan program was intended to be self-financing. The monies received in the form of loan interest payments were supposed to cover all operating expenditures, and monies received in the form of loan principal payments were intended to be recycled in the form of new loans. However, there is always never enough monies, and the legislature, out of concern for farmers' need for capital, has been required to appropriate more than $12 million since 1961 to support the farm loan program.

Although the farm loan program is intended to assist those farmers who otherwise would not be able to secure financing at reasonable rates in the private sector, it is not meant to be a subsidy program. Yet, DOA's failure to encourage private (and federal) financing appears deliberately intended to remake the program into a subsidy program. This DOA intent is manifested in the fact that DOA has made loans to farmers of very poor credit risk and on very inadequate security. It has also done little to enforce repayments of loans. In lieu of payment enforcement, it has engaged in the practice of refinancing and extending further credit to farmers who are delinquent on existing loans. The consequence has been a high rate of delinquencies and concentration of loans in a few farmers.

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"In general, the Agricultural Loan Program has moderately achieved the results contemplated by the legislature. It has stimulated and facilitated private and federal financing for farmers and has provided direct loans to farmers. In accordance with legislative intent, the DOA conducts the Agricultural Loan Program as a farmer assistance loan program.

"The primary activity of the DOA is the making of direct loans to farmers as a supplemental source of credit. It also has policies and procedures to spur the private sector to extend credit to farmers."

The department's justification is that:

"The DOA has in fact stimulated and facilitated private and federal financing for farmers. Specifically, the DOA has been instrumental in establishing loan services of the three farm credit banks. Total outstanding loans as of December 31, 1977 exceeds $95 million.

"The DOA has also been instrumental with supplemental direct loans in the development of diversified agriculture including the expansion of the anthurium industry; establishment of the papaya industry; expansion of the macadamia nut industry; survival of the milk, poultry and coffee industries and independent sugar growers; and expansion of many vegetable crops (lettuce, greenhouse tomatoes, cucumbers, etc.).

"Legislative mandate dictates favorable interest rates for all types of farm loans (including Act 19, 1977 Special Session which establishes a 2 percent interest rate for supplementary loans to sugar growers).

"The degree of DOA's effort and its success in spurring the private sector to extend credit to farmers is reflected by the dramatic expansion of the agricultural credit base with the establishment of new sources of agricultural credit."

The department would want to change the discussion on page 13 to read as follows:

"**The Trends.** Shortly before, and for a while after the enactment of Act 278, emphasis appeared to have been given to stimulating financing by private sources as intended by the act. Since 1963, more and more effort has been directed toward encouraging new lending sources to establish in Hawaii. Today, loans from the ag loan program play but a miniscule role in the overall agricultural credit picture. The bulk of the state loans are now direct loans."

The department's justification is that:

"The shift in farmers' dependence for funds from the ag loan program to private sources is illustrated in figure 3.1.A." [See appendix A.]

The department would want to insert the heading, "Participation Loan" on page 13 immediately before the last full paragraph on that page. The department's justification is that:

"Insertion of 'Participation Loans.' is appropriate to clarify the subject of the ensuing paragraphs."

The department would want to change the discussion on page 16 to read as follows:

"**DOA attitude.** The interest rate problem and the decline in the number of participation loans over the years are mainly attributable to the tight money situation and the rapid interest rate changes nationally. The decline is also attributable to the success of the DOA in its effort to stimulate lending by new credit sources. There are in DOA no research programs designed to determine the capital and credit needs of farmers and the alternatives for meeting those needs; there are no educational programs to motivate farmers into associated farming arrangements, i.e., farm cooperatives, incorporated family agricultural businesses, family partnerships, etc., so as to improve their financial potential and their bargaining power. The DOA provides assistance by which farmers might obtain loans from private and federal sources. There are programs to educate financial lending institutions about the potential benefits of providing services and credit to farmers; and there are policies to increase the amount of private and federal loan funds available to farmers.

"The success of DOA to encourage financing from private (and also from federal sources) has relieved the state of providing some $95 million in ag loans. (See table 3.1.A.) There is, however, a constant shortage of funds in the Agricultural Loan Program which was intended to be self-financing. The monies received in the form of loan interest payments cover all operating expenditures, and monies received in the form of loan principal payments are recycled in the form of new loans. However, there is always never enough monies, and the legislature, out of concern for farmers' need for capital has been required to appropriate more than $10 million since 1961 to support the agricultural loan program and the DOA has transferred $2 million from interest payments since 1959.

"The agricultural loan program is intended to assist those farmers who otherwise would not be able to secure financing at reasonable rates in the private sector. By statute, it operates as an interest subsidy program. The DOA has made loans to farmers of very poor credit risk and on very inadequate security. It attempts to enforce repayment of loans. It has engaged in the practice of refinancing and extending further credit to farmers who are delinquent on existing loans, but who exhibit potential for recovery. The consequence has been a high rate of delinquencies and concentration of loans in a few farmers. The following sections describe this situation."

The department's justification is that:

"More important than the interest rate problem, are these factors that need to be considered: that Hawaii is a capital short state; commercial banks become selective in times of tight money and, with rapid fluctuation in interest rates, they are reluctant to commit funds for term loans.

"While the DOA is empowered to design research programs and educational programs, there is not sufficient staff and fiscal resources to undertake such programs and other agencies who have primary responsibility in this area must be relied upon.

"Assistance to farmers in obtaining loans from private and federal sources is a routine function of the agricultural loan officer. Working with financial lending institutions providing services and credit to farmers is also a routine function of the agricultural loan officer.

"The extent of effort and the success of the DOA in increasing the amount of private and federal loan funds available to farmers have been previously noted.

"The success of the DOA in encouraging financing from new credit sources is evident in Table 3.1.A.

"Deletions are made in order to make the statement a statement of fact rather than supposition. The change from '$12 million' to '$10 million' and the inclusion of $2 million transferred from interest payments are made to correct an inaccurate statement.

"Prior to 1977, by statute, the DOA could not charge more than 6 percent interest on any loans. Private lenders were charging between 10 and 15 percent interest on similar type loans. Clearly, by statute, the agricultural loan is an interest subsidy program.

"The statement that the DOA failed to encourage private financing is deleted for obvious reasons.

"In times of adverse weather, market conditions, shipping strikes and other periods of economic stress beyond the normal control of farmers, the Board has recognized the need to relax the enforcement of loan repayments in order to assist the survival of the farmers during their periods of difficulty. For farmers who exhibit the potential for recovery, the practice of refinancing and extending further credit are important tools of the Agricultural Loan Program."

Our Comment:

We do not agree with the department's response. The department does not take into account its statutory obligation to stimulate lending by commercial institutions through a program of insuring loans made by commercial institutions, and participating with such institutions in making loans to farmers. In fact, the department admits that "the bulk of the State loans are now direct loans." [Emphasis ours.] *The failure of the department to stimulate insured and participation loans is the thrust of our finding.*

The department attempts to justify its suggested changes to our finding on the basis that it has been instrumental in establishing loan services through three farm credit banks in Hawaii, and that the $95 million of outstanding agricultural loans as of the end of 1977 was the result of the department's efforts. While DOA apparently participated in the establishment of these new credit sources for farmers, there were many other individuals and organizations who also actively participated in the process.

Also, the fact that the three farm credit banks have extended more than $95 million in loans means little without relating it to an overall plan for agricultural loans. Indeed, the DOA admits that it has no research programs designed to determine the capital and credit needs of farmers and alternatives for meeting those needs.

The Farm Loan Program—A Subsidy for Farmers

Our Report:

On page 11, we stated the finding that:

Indeed, DOA's conduct in the farm loan program appears to be deliberately intended to remake the loan program into a subsidy program.

On page 16, we stated the finding that:

Although the farm loan program is intended to assist those farmers who otherwise would not be able to secure financing at reasonable rates in the private sector, it is not meant to be a subsidy program. Yet, DOA's failure to encourage private (and federal) financing appears deliberately intended to remake the program into a subsidy program. This DOA intent is manifested in the fact that DOA has made loans to farmers of very poor credit risk and on very inadequate security.

On page 28, we stated that:

The only reasonable explanation for this behavior (providing additional operating monies and refinancing only portions of existing loans, and refinancing and consolidating loans irrespective of the borrowers' financial capabilities) is its belief that farmers should be kept in operation, no matter what the fiscal consequences may be. Such an approach, however, is alien to the farm loan statute as it is now written.

On page 31, we stated:

If the farm loan program is to remain a *loan* program, then the efforts and activities of DOA will need to be reoriented. Obviously requirements concerning qualification for loans and security to be posted will need to be tightened to ensure reasonably that loans will be repaid and, if not repaid, the security posted will allow the State to recover all or substantially all of the outstanding loan amount. Vigorous action will also be required in cases of default in the payment of loan repayment installments; and the practice of making refinancing and consolidation loans upon loans must be curtailed. Further, affirmative programs to assist farmers to improve their commercial credit standing and to induce private lenders to extend credit to farmers will need to be formulated and executed. In this connection, it would be desirable for interest rates on direct loans to be made identical to the rates on participation and insured loans. (This course of action will require a legislative act.)

Tightening-up the requirements for loans, of course, will need to be done in the context of the state policy to take greater risks than the private lenders. This is the essence of the state loan program. But the requirements must be tightened, nonetheless, if subsidization of farmers is to be avoided. This is not to say that subsidization should not be a state policy. It may well be that a case can be made for subsidization on some economic or other basis. Such a policy, however, requires legislative enunciation, and until the legislature so speaks, the loan program should not be administered in a fashion as to cause subsidization to result.

On page 32, we stated the finding that:

Our findings here confirm the observation made in the preceding chapter that DOA basically considers the farm loan program as a subsidy, rather than a loan, program; that in making loans, it cares little whether the borrower has the capability to repay the loan. Thus, although DOA is supposed to follow certain procedural requirements to ensure that loans will be repaid, it follows those requirements in a sloppy and perfunctory manner.

On page 40, we further stated that:

These recommendations, of course, are meaningless unless DOA begins to consider the farm loan program as a *loan* rather than a *subsidy* program. After all, the operational deficiencies noted in this chapter are symptomatic of the underlying attitude of DOA described in chapter 3 to treat the farm loan program as a subsidy program for farmers.

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"In accordance with legislative intent, the DOA conducts the Agricultural Loan Program as a farmer assistance loan program."

The department's justification is that:

"Legislative mandate dictates favorable interest rates for all types of farm loans (including Act 19, 1977 Special Session which establishes a 2 percent interest rate for supplementary loans to sugar growers)."

The department would want to change the finding on page 16 to read as follows:

"The agricultural loan program is intended to assist those farmers who otherwise would not be able to secure financing at reasonable rates in the private sector. By statute, it operates as an interest subsidy program. The DOA has made loans to farmers of very poor credit risk and on very inadequate security."

The department's justification is that:

"Prior to 1977, by statute, the DOA could not charge more than 6 percent interest on any loans. Private lenders were charging between 10 and 15 percent interest on similar type loans. Clearly, by statute, the agricultural loan is an interest subsidy program.

"The statement that the DOA failed to encourage private financing is deleted for obvious reasons."

The department's comment to the finding on page 28 is that:

"We recognize that there exists fundamental differences in philosophy between the Board of Agriculture and the auditor with respect to the purpose of the loan program, however, we believe the DOA's approach is consistent with national policy in keeping farmers on the farm."

The department's comment to the conclusion on page 31 is that:

"While the Board is receptive to divergent points of view based on objective assessment of the loan program and welcomes additional statutory guidelines to implement new directions, it is unable to accept the conclusions as expressed. The Board wishes to note the accomplishments of the Agricultural Loan Program in terms of the expansion of the agricultural credit base through the infusion of capital by new credit sources; new policy directions taken by the Board and the Chairman in compliance with legislative mandate; and the initiation of computerization for loan data."

The department would want to change the finding on page 32 to read as follows:

"Our findings here confirm the observation made in the preceding chapter that DOA basically considers the ag loan program as a subsidized loan program; that in making loans, it cares little whether the borrower has the capability to repay the loan. Thus although DOA is supposed to follow certain procedural requirements to ensure that loans will be repaid, it follows those requirements in a sloppy and perfunctory manner. Specifically:"

The department's justification is that:

"The fact that the Agricultural Loan Program is a subsidized loan program has been previously discussed. With regard to the opinion that the DOA performs its functions in a sloppy and perfunctory manner, the Board feels that this is neither an accurate nor a professional point of view."

The department would want to change the finding on page 40 to read as follows:

"These recommendations, of course, are meaningless because the DOA considers the Agricultural Loan Program as a partial subsidy program. After all, the operational deficiencies noted in this chapter are symptomatic of the underlying attitude of DOA described in chapter 3 to treat the Agricultural Loan Program as a subsidy program for farmers."

The department's justification is that:

"The correction is to clearly state what is fact."

Our Comment:

We do not agree with the department's response. The farm loan statutes as they now stand clearly state that the farm loan program is intended to operate as a self-supporting loan program and not a subsidy program. The law states that to be eligible for loans, an applicant shall be a sound credit risk with the ability to repay the money borrowed, and that all loans must be properly secured by mortgages on certain kinds of property. The law further stipulates the conditions under which the lender is able to foreclose on delinquent loans.

Despite these statutory provisions, the department makes loans without considering the borrowers' ability to repay. It accepts as security property having insufficient value in relation to the amount of the loan and it makes little effort to enforce payment on past due accounts even though delinquencies have been substantial.

The department attempts to justify its poor loan granting practices by stating that the legislature intended the program to be a subsidy program, inasmuch as the interest rate the farm loan program is *allowed (by law) to charge on its loans is less than the private lenders' rates. We note, however, that in 1968 when the interest rate of 6 percent was established, the prime rate charged by commercial banks was around 6 percent.*

One further point needs to be made. Unless the legislature adopts a state subsidization policy for farmers, the department has to refocus the farm loan program and comply with the existing statutes.

Loans to Poor Credit Risks

Our Report:

On page 11, we stated the finding that:

DOA has made direct loans to farmers even when available financial data and past experience clearly indicated inability to repay.

On page 16, we stated that:

A loan is meant to be repaid. Thus, the prospective ability of the loan applicant to repay the loan is a material factor in granting or refusing a loan. Indicators of loan repayment capability include (1) the projected cash flow of the applicant's farm operations; (2) the applicant's past debt experience; and (3) the applicant's equity. In making loans to farmers, DOA doesn't appear to pay much attention to the negative signals shed by these indicators. It thus has made loans even when the projections have shown insufficient flow of cash to repay the loan applied for, the applicant's past loan experience has shown a chain of delinquencies, and the applicant's equity has been a negative one. Moreover, DOA has made loans upon loans when the indicators have shown inability to repay even existing loans. We illustrate our point with the cases of Farmers A, B, C, D, E, and F. [See pages 16 to 25 for illustrations of Farmers A through F.]

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"DOA has made direct loans to farmers even when available financial data and past experience indicated inability to repay.

The department's justification is that:

"Because ability and inability to repay is judgmental and not absolute, 'clearly' should be deleted.

The department's response to illustrations of Farmers A through F is that:

"It should be noted that the cases of Farmers A through F used in illustrations were probably the most serious cases identified in the auditor's research of agricultural loans dating back to 1961. It should be also noted that even in these cases there were extenuating circumstances that were omitted or inaccurately stated. For example, Farmers C and D were poultry farmers who were adversely affected by a shipping strike and shortage of feed, loss of revenue and birds. Later, they were adversely affected by record high feed prices and egg prices falling far below the cost of production.

"In the Department's efforts to help the survival of the poultry industry, actions that were taken by the Board in the cases of Farmers C and D were essential to their economic recovery. Even though in this endeavor the DOA may not be ultimately successful, the Agricultural Loan Program will not suffer substantial losses because the loan funds can be recovered.

"Despite the problems experienced by Farmer B, he is today no longer delinquent. He is making regular payments and is financially solvent.

"It should be noted that in the case of Farmer E, the $75,000 loan cited in the report was actually a second loan. An earlier $50,000 production loan was repaid and, based upon that experience, a second loan was made."

Our Comment:

We do not agree with the department's response. The department states that "the cases of Farmers A through F used in illustrations were probably the most serious cases identified." To be sure, there were many other farmers in our sample of farmers examined who were in much the same financial condition as those illustrated in the report. In addition, the magnitude of the delinquencies, which at June 30 1976 amounted to 37 percent ($3.6 million) of the total amount outstanding ($9.6 million), is an indication that the program has numerous farmers to whom loans should never have been granted.

The department states that there were extenuating circumstances that affected Farmers C and D, and the actions that were taken by the Board were essential to the farmers' economic recovery. The actions were taken despite the fact that the loans were seriously delinquent and Farmer C's financial statements showed negative equity. In December 1977, the state attorney general initiated foreclosure proceedings against Farmer C and the property is presently listed for sale. With respect to Farmer D, at June 30, 1976, all five of the loans were delinquent.

Negative Equity

Our Report:

On page 23, we stated:

Farmer E. A farm corporation applied for and received a $75,000 (6 percent interest) Class C loan in October 1973. The $75,000, the maximum allowable by law for Class C loans, was for equipment purchases and working capital. The loan was secured by a financing statement on the equipment purchased with the loan, valued at $51,319, a security agreement on all growing crops valued at $44,000, and a first mortgage on state leasehold property valued at $36,734. Repayment of the loan was to be over a six-year period with $36,000 (plus interest) the first year and $7,800 (plus interest) annually for the remaining five years.

This loan was made even though the company's balance sheet at June 30, 1973 showed the firm to be insolvent, i.e., liabilities exceeded assets by $17,921 (see table 3.9). The excess of liabilities over assets, or negative net worth, was partly due to an accumulated deficit or loss over the years of $27,921.

On page 25, we stated that:

Negative equity indicates insolvency. It usually results when the owner has made a small investment of capital in his business and has relied heavily on financing from creditors or when losses from operations have occurred during previous years. Thus, the practice of making loans to farmers with negative equity is questionable. This is particularly so when the negative equity is sizeable. Our review of the records revealed that loans have been made even in cases of large negative equity.

On page 28, we stated that:

. . . DOA is strongly moved to keep farmers in operation, notwithstanding their financial insolvency.

On page 28, we also stated that:

DOA accomplishes its aim of keeping farmers in operation, notwithstanding financial insolvency, through a misuse of the refinancing and debt consolidation scheme.

On page 28, we further stated:

The results of DOA's practices are twofold. *First,* loan making without concern for ability to repay has resulted in a high rate of delinquencies. *Second,* the practice of refinancing and extending further credit to farmers who are insolvent has caused loans to be concentrated in a few farmers.

Department's Response:

The department's response to the discussion on page 23 is that:

"It should be noted that in the case of Farmer E, the $75,000 loan cited in the report was actually a second loan. An earlier $50,000 production loan was repaid and, based upon that experience, a second loan was made.

"While accounting practices precluded the inclusion of the investment in the growing crop (which was estimated at $44,000), the growing crop is an asset and, therefore, the farmer was only technically insolvent."

The department would want to change the discussion on page 25 to read as follows:

"Since negative equity indicates technical insolvency, the practice of making loans to farmers with negative equity should be approached with caution. This is particularly so when the negative equity is sizeable. Our review of the records revealed that loans have been made even in cases of large negative equity."

The department's justification is that:

"The change is an important clarification of 'negative equity.' In the consideration of equity, negative equity often results from the undervaluation of assets. While this is not a common practice, negative equity does not automatically bar the individual from securing credit even from private lenders. While negative equity or technical insolvency should be approached with caution, it is not always synonymous with either financial insolvency or bankruptcy."

The department would want to change the statement on page 28 to read as follows:

"DOA is strongly moved to keep farmers in operation, notwithstanding their technical insolvency."

The department would want to change the finding on page 28 to read as follows:

"DOA accomplishes its aim of keeping farmers in operation, notwithstanding technical insolvency, through refinancing and debt consolidation schemes."

The department's justification is that:

"The change from 'financial' to 'technical' insolvency has been previously discussed."

The department would want to change the finding on page 28 to read as follows:

"The results of DOA's practices are two-fold. First, loan making without concern for ability to repay has resulted in a high rate of delinquencies. Second, the practice of refinancing and extending further credit to farmers who may be technically insolvent has caused loans to be concentrated in a few farmers.

"As previously discussed, the practice of refinancing and extending further credit to farmers are important tools of the ag loan program in assisting farmers who exhibit potential for recovery."

Our Comments:

We do not agree with the department's response. The department attempts to make a distinction between "financial insolvency" as used in the report and its suggested change to "technical insolvency." We do not believe that it is critical to make such a distinction in the report.

Inadequate Security

Our Report:

On page 11, we stated the finding that:

It [DOA] has made these loans on insufficient and legally unacceptable security.

On page 25, we stated:

Section 155–11, HRS, requires that all farm loans made by DOA be secured by recorded first mortgages on the following kinds of property located within the State:

- Fee simple farm land
- Leaseholds of farm land where the lease has an unexpired term at least two years longer than the term of the loan
- Crops, livestock, and equipment
- Other chattels

The law also provides that a second mortgage, i.e., a subordinate lien, may be accepted as security when prior mortgages do not contain provisions which might jeopardize DOA's security position or the borrower's ability to repay. Written agreements such as an assignment of income may also be accepted as security.

In addition, to protect the department against possible decline in the value of the property pledged, the law provides that loans used to purchase or improve land, buildings, and equipment as specified in loan classes A, B, and E not exceed 85 percent of the value of the security. For the purposes of Class C and Class E operating loans, the law leaves the ratio of the loan amount to the value of the security offered to the discretion of the department. For Class D loan purposes, i.e., emergencies, DOA may, with the approval of the governor, modify or waive any or all security requirements or any limitation with respect thereto.

The purpose of this security requirement is, of course, to enable the State, in the event of default in the repayment of a loan, to seize the property pledged as security to satisfy its claim against the borrower. The security is to assure that the debt will be paid. Our examination revealed that DOA, in its efforts to aid debt-ridden farmers, has jeopardized the department's security position. It has accepted as security property which is not acceptable as security under the law, and it has failed to provide for sufficient loan-to-security ratios.

On page 26, we stated:

Unacceptable security. In numerous cases, DOA has accepted personal assets and other property which do not legally qualify as security under section 155–11, HRS. It has, for instance, received the following types of property as security:

- Shares of stock in a close farm corporation
- Shares of stock in a farming cooperative
- Shares of General Telephone Company stock
- Shares of Hilo Electric Light Company stock

As an illustration, a farmer with four outstanding loans totaling $109,000, one of which had been delinquent for almost one year, requested a Class A loan of $2,500. The loan was to be used to purchase shares of stock in a farm corporation. At that time, the department already held first and second mortgages amounting to $70,000 on his state leasehold farm, a second mortgage on his home and lot, chattel mortgages on all equipment, and an income assignment, i.e., a pledge that income derived from sales would be assigned to the farm loan program for loan repayment. Thus, the farmer had very little, if any, property left to offer as security for the $2,500 loan. Under these circumstances, DOA accepted the shares of stock which the farmer intended to purchase with the $2,500 loan, together with an assignment of his life insurance policy as security for the loan. These properties, of course, did not legally qualify as security under the law. DOA, however, accepted the security and approved the loan on the basis that "[p]urchase [of the stock] is mandatory for borrower to have a voice in the company and to avoid shares getting into the hands of non-producers."

On page 27, we stated:

Unacceptable loan to security ratios. DOA has in numerous cases accepted as security property having insufficient value in relation to the amount of the loan. Table 3.12 reflects some of these cases. As shown, in one case, the amount of the loan far exceeded the value of the security.

Table 3.12 reflects the cases of Class C loans. For Class C loans, the loan to security ratio is discretionary with the board. It is obvious, however, that loan to security ratios in excess of 85 percent are suspect. This is particularly so where the property given as security consists of crops. Crops are highly susceptible to changing market prices, and therefore a low, rather than a high, percentage of loan amount to security value would be appropriate.

An adequate margin of safety is required not only to protect the department against possible declines in the market value of the assets pledged but to recover any costs that will be involved in selling the assets, should foreclosure be necessary.

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"It [DOA] has made these loans on insufficient security."

The department's justification for deleting the phrase, "and legally unacceptable," is that: "According to the Attorney General's opinion, the determination of security as legally acceptable is discretionary of the DOA and, therefore, 'legally unacceptable' should be deleted."

The department's response to the discussion on page 25 concerning security requirement is that:

"With regard to security requirement, by legislative mandate to promote the development of agriculture the Agricultural Loan Program considers security as an important factor, but mainly to lessen credit risks (whereas, the auditor expects security to guarantee full repayment)."

The department would want to change the finding on page 26 to read as follows:

"**Acceptable security.** In some cases, DOA has accepted personal assets and other chattels which qualify as security under section 155–11, HRS. It has, for instance, received the following types of property as security:

Shares of stock in a closed farm corporation

Shares of stock in a farming cooperative

Shares of General Telephone Company stock

Shares of Hilo Electric Light Company stock

"As an illustration, a farmer with four outstanding loans totaling $109,000, one of which had been delinquent for almost one year, requested a Class A loan of $2,500. The loan was to be used to purchase shares of stock in a farm corporation. At that time, the department already held first and second mortgages amounting to $70,000 on his state leasehold farm, a second mortgage on his home and lot, chattel mortgages on all equipment, and an income assignment, i.e., a pledge that income derived from sales would be assigned to the farm loan program for loan repayment. Thus, the farmer had very little, if any, property left to offer as security for the $2,500 loan. Under these circumstances, DOA accepted the shares of stock which the farmer intended to purchase with the $2,500 loan, together with an assignment of his life insurance policy as security for the loan. These properties qualify as security under the law. DOA accepted the security and approved the loan on the basis that "[p]urchase [of the stock] is mandatory for borrower to have a voice in the company and to avoid shares getting into the hands of non-producers."

The department's justification is that:

"The Attorney General's memo of February 23, 1976 regarding security for ag loans under Chapter 155, HRS, recognizes in-house discretionary policies relative to the sufficiency of the security repayment terms, and credit worthiness of the loan applicant.

"The shares cited would fall under 'other chattels' in accordance with Section 155–11, HRS.

"In this matter, the Board of Agriculture has taken a broad interpretation of the statute in support of agricultural development."

The department's response relating to loan to security ratios is that:

"The auditor questions the discretionary powers of the DOA. Without this power it would have been very difficult for the Department to make crop and livestock production loans.

"The expertise required to exercise this discretionary power makes this a very specialized field of financing."

Our Comment:

We do not agree with the department's response. The department states that the loan program "considers security as an important factor, but mainly to lessen credit risks (whereas, the auditor *expects security to guarantee full repayment)." The very purpose of requiring security is to assure that the debt will be paid in the event of default in the repayment of a loan, not just to lessen credit risks.*

The department refers to an attorney general's memorandum dated February 23, 1976 to justify its acceptance of shares of stock as security. The memorandum, however makes no reference to the acceptability of shares of stock as security. We believe the department has erred in its interpretation of the memorandum.

Nonenforcement of Repayments; the Practice of Refinancing

Our Report:

On page 16, we stated the finding that:

It has also done little to enforce repayments of loans. In lieu of payment enforcement, it has engaged in the practice of refinancing and extending further credit to farmers who are delinquent on existing loans. The consequence has been a high rate of delinquencies and concentration of loans in a few farmers.

On page 28, we stated that:

DOA accomplishes its aim of keeping farmers in operation, notwithstanding financial insolvency, through a misuse of the refinancing and debt consolidation scheme. Rather than pursue enforcement remedies, DOA readily grants refinancing and consolidation loans when borrower-farmers fall behind in the repayment of existing loans. Refinancing and debt consolidation are resorted to, not to ensure collection of that which is owed to the State, but simply to keep the farmer going. Refinancing and consolidation loans are thus made even though there is little hope that the new or the existing loans will ever be fully repaid. The misuse of these techniques becomes even more apparent when one examines more closely the way in which DOA utilizes refinancing and debt consolidation.

Department's Response:

The department would want to change the finding on page 16 to read as follows:

". . . It attempts to enforce repayment of loans. It has engaged in the practice of refinancing and extending further credit to farmers who are delinquent on existing loans, but who exhibit potential for recovery. The consequence has been a high rate of delinquencies and concentration of loans in a few farmers."

The department's justification is that:

"In times of adverse weather, market conditions, shipping strikes and other periods of economic stress beyond the normal control of farmers, the Board has recognized the need to relax the enforcement of loan repayments in order to assist the survival of the farmers during their periods of difficulty. For farmers who exhibit the potential for recovery, the practice of refinancing and extending further credit are important tools of the Agricultural Loan Program."

The department would want to change the finding on page 28 to read as follows:

"DOA accomplishes its aim of keeping farmers in operation, notwithstanding technical insolvency, through refinancing and debt consolidation schemes. Rather than pursue enforcement remedies, DOA readily grants refinancing and consolidation loans when borrower-farmers fall behind in the repayment of existing loans. Refinancing and debt consolidation are resorted to, not to ensure collection of that which is owed to the State, but simply to keep the farmer going. Refinancing and consolidation loans are thus made even though there is little hope that the new or the existing loans will ever be fully repaid. The use of these techniques becomes even more apparent when one examines more closely the way in which DOA utilizes refinancing and debt consolidation."

The department's justification is that:

"The DOA is strongly committed to keeping farmers in operation. Similar to USDA policy, DOA's policy is consistent with national policy in that we will not foreclose on a farmer or deny him new credit when he is eligible, as long as there is reasonable chance that he can stay on his farm (with the exception of those who have flagrantly disregarded payment or are clearly headed for failure)."

In addition, the department states that:

"Considering the total number of loans made, refinancing is not a common practice."

Our Comment:

We do not agree with the department's response. The department attempts to give the impression that loans are refinanced and enforcement of loan repayments relaxed only when farmers are adversely affected by conditions beyond their control. This is not the case. While payment waivers may be justified in some situations, the size of the delinquency ($3.6 million) at June 30, 1976 indicates that the department is relaxing loan repayments for more than those farmers affected by such conditions as weather and shipping strikes.

The department attempts to justify its practice of refinancing and extending further credit to farmers who are delinquent on existing loans on the basis that these farmers exhibit potential for recovery. As shown by the farmer illustrations used in the report, however, refinancing has been extended to farmers with multiple delinquent loans who show little, if any, chance of recovery.

Finally, the department states that refinancing is not a common practice. This is incorrect. A review of the 62 loans granted in FY 1974–75 shows that 11 (17.7 percent) of the 62 loans were granted, in part for the purpose of refinancing outstanding loans. In terms of the dollar amount, $500,475 or 19.1 percent of the total amount of loans approved ($2,616,250) were used to refinance existing state farm loans.

Delinquencies and Program Losses

Our Report:

On page 11, we stated the finding that:

DOA has not, to any meaningful degree sought to enforce payment of loans by farmer-borrowers. Rather, it has engaged in the questionable practice of refinancing existing farm loans, and it has otherwise allowed loans to become delinquent and the program to incur losses.

On page 29, we stated that:

Some delinquencies are to be expected in any loan program. However, 31 percent is excessive. It obviously reflects poor loan-granting and payment enforcement practices.

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"DOA has not, to any meaningful degree, sought to enforce payment of loans by farmer-borrowers. Rather, it has engaged in the questionable practice of refinancing existing farm loans, and it has otherwise allowed loans to become delinquent."

The department's justification is that:

"Since 1959, $23,013,259 in loans were made with a writeoff of only $35,031 in principal up through June 30, 1975. This 0.15% loss is very insignificant."

The department would want to change the discussion on page 29 to read as follows:

"Some delinquencies are to be expected in any loan program. While 31 percent is excessive, Hawaii's 11.3 percent delinquency compares favorably with the national average of 21 percent delinquency in farm operating loans outstanding."

The department's justification is that:

"The change is in order to make a more meaningful comparison of the loan granting and loan enforcement practices with comparable programs."

Our Comment:

We do not agree with the department's response. The loss to the program has been small only because the department has failed to foreclose or write off its seriously delinquent loans. Instead, the department refinances delinquent loan amounts, and extends further credit in an attempt to keep farmers in operation. At June 30, 1976, the amount of delinquencies totaled $3,578,163. If the uncollectible loans were written off, the real loss to the program would be much greater.

Concentration of Loans in a Handful of Farmers

Our Report:

On page 11, we stated the finding that:

In addition, DOA's refinancing practices have resulted in the farm loan program benefiting but a handful of farmers, when the program is supposed to be one for the benefit of a large number of farmers.

On page 29, we stated that:

The rapid increase in the dollar amount of delinquencies accompanied by only a modest increase in the number of farmers whose loans are delinquent also suggests that the same farmers appear year after year on the list of delinquent farmers. It is on their loans that the dollar amount of delinquencies increases each year. Because their loans are the ones which become increasingly delinquent, it is to them that the bulk of the refinancing and consolidation loans is given. The dollar amount of delinquencies and the ratio of delinquent amount to total loan outstanding for each year shown in table 3.13 would be higher but for the refinancing and consolidation loans extended to this small group of farmers.

On page 30, we also stated:

The concentration of loans in a small group of farmers is clearly not intended by the farm loan statute. House Standing Committee Report No. 548, which recommended passage of Act 53, SLH 1968, observed that, "during a tight money situation, all available farm loans should be spread among reasonably efficient farmers rather than concentrated among a few." It thus might be said that, although for all intents and purposes the farm loan program has evolved into a direct loan or subsidy program, even as a direct loan or subsidy program, it has failed miserably, since the benefits of the program have not been spread out among the farmers.

Department's Response:

The department would want to change the finding on page 11 to read as follows:

"In addition, DOA's refinancing practices have been directed to assist a comparatively small group of higher risk farmers."

The department's justification is that:

"By statute, the Agricultural Loan Program is limited to assisting a small group of farmers who cannot get credit at reasonable rates and terms from other credit sources."

The department's comments on the discussion on page 29 is that:

"With the increase in activity of new credit sources, the more successful farmers are being accommodated by them, leaving to the Agricultural Loan Program the farmers with higher risks. Therefore, high delinquencies and probable need for refinancing and consolidation can be expected. Because of increased loan limits since 1969, it can be expected that there would be a greater concentration of loans in a comparatively small group of farmers."

The department would want to restate the last sentence on page 30 to read as follows:

". . . It thus might be said that, for all intents and purposes the ag loan program as a supplement to other new credit sources, has evolved into a direct loan and interest subsidy program that has benefited Hawaii's farmers."

The department's justification is that:

"Correction of erroneous view to a statement of fact."

Our Comment:

We do not agree with the department's response. The thrust of the discussion is that a small group of farmers has a substantial portion of the state loans outstanding, contrary to legislative intent. The department itself admits to this fact. The department attempts to rationalize the situation by stating that the agricultural loan program serves as a supplement to other credit sources. This, however, does not relieve the department from its obligation to spread the loans to as many farmers as possible.

Errors in Calculation

Our Report:

On page 32, we stated the finding that:

DOA fails to ascertain the value of the property offered as security and the mathematical correctness of the amount of security given.

On page 36, we stated that:

If the property offered as collateral is indeed to serve as security, it is incumbent upon DOA to evaluate with care the value of each property offered and to ascertain the correctness of the calculations concerning the securities offered. DOA, however, pays little attention to these matters.

On page 36, we stated:

Errors in calculations. Not only does DOA fail to insist on proper documentation of value, but it fails to ascertain whether the calculations concerning the sum total of the value of all property pledged as security are correct. This failure to review calculations has resulted in gross errors that jeopardize the security position of the department.

Department's Response

The department would want to change the finding on page 32 to read as follows:

"In some specific instances, the DOA failed to ascertain the value of the property offered as security and has made mathematical errors in the amount of security given."

The department's justification is that:

"The DOA has ascertained the value of property offered as security and the mathematical correctness of the security given; however, in some specific instances, errors may have been made."

The department would want to delete the last sentence from our finding on page 36.

The department's justification is that:

"While the DOA does not consider security to guarantee repayment; nevertheless, security is seriously considered to lessen risk."

The department would want to delete the word "gross" in the last sentence of our finding on page 36.

The department's justification is that:

"The deletion of 'gross' is to correct a distortion of fact. It should also be noted that in the two illustrations, the borrower of the first illustration has proven to be a very successful farm operator."

Our Comment:

We do not agree with the department's response. The department has indeed made "gross" errors in calculating the value of the security and the loan to security ratio as evidenced by the two examples presented in our report. In the first example, there was a difference of almost 40 percentage points in the loan to security ratio. In the second case, the correct loan to security ratio actually exceeded the statutory limit for Class A loans and thus the loan should not have been approved.

DOA further notes that in the first illustration the borrower has proven to be very successful. The inference is, of course, that because the borrower is successful, the error should be overlooked. On the other hand, the department fails to mention the second borrower whose loans are delinquent.

Insufficient Staff

Our Report:

Our report makes no reference to insufficient staff. The department, however, has attributed several deficiencies cited in our report to insufficient staff. These deficiencies and the department's comments relating to the lack of staff are grouped under this section.

On page 29, we stated the finding that:

The amount of delinquencies has been growing over the years. Table 3.13 [see page 30 of report] summarizes the data on outstanding loans and delinquent loans for the fiscal years 1972 to 1975. As shown, the dollar amount of the delinquencies as a percent of the total dollar amount of loans outstanding nearly doubled between fiscal years 1972 and 1975—from 16 percent to 31 percent. This increase has not been accompanied by any significant increase in the number of farmers to whom loans have been made, nor by any substantial increases in the number of farmers whose loans have become delinquent. This suggests that more and more of the existing loans are becoming delinquent.

On page 32, we stated:

DOA does not properly service the loans it makes. It does not make the required or needed field visits to ensure that the borrower is complying with the terms of his loan. Indeed, DOA fails to keep track of the whereabouts of borrowers.

On page 36, we also stated:

Lack of proper appraisal or documentation of value. DOA does not insist upon proper appraisal or full documentation of the value of the property offered as security for a loan. Rather, with minor exceptions, it accepts the value ascribed to the property by the loan applicant. Where judgments are made by DOA, they are generally the personal judgments of the loan officers and are not based on any hard facts.

On page 38, we also stated:

The farm loan manual requires the farm loan representative to make on-farm visits at least twice each year for the duration of the loan. The primary purpose of the field visits is to ensure that the collateral is being maintained in good condition, that the loan funds are being used for the purposes intended, and that the terms and conditions of the loan are otherwise being met. They are also made to assist farmers found to be in violation of loan terms and conditions, to collect from delinquent borrowers, and to generally keep abreast of the borrower's operations and financial status.

On page 38, we further stated:

Our examination disclosed that the farm loan division has been seriously negligent in performing these loan servicing activities.

Department's Response:

The department's comment on the finding on page 29 is as follows:

"We recognize that the delinquencies over the years are increasing and an important factor has been the constraints of a limited staff."

The department would want to change the finding on page 32 to read as follows:

"DOA does not have the staff to properly service all the loans it makes. It does not make the required or needed field visits to ensure that the borrower is complying with the terms of his loan. The DOA failed to keep track of the whereabouts of certain borrowers."

The department's justification is that:

"The severe constraints due to the size of staff have resulted in a drain on the level of services offered to the farmer clients.

"The Department may not have kept current their mailing list for 13 of its borrowers in its total loan accounts, but the whereabouts of the borrowers were never in question. This does not warrant the general statement that the DOA fails to keep track of its borrowers."

The department would have a sentence of the fourth paragraph on page 36 restated to read as follows:

"Where judgments are made by DOA, they are generally the personal judgments of experienced officers and are not based on any hard facts. Note the following example."

The department's justification is that:

"Full documentation may be neither practical nor realistic. The experienced judgment of loan officers is the key to the effective implementation of the Agricultural Loan Program, especially, when crop and livestock production loans are involved. Also a factor to be considered is the comparison of workload and range of responsibility to size of staff."

The department's comment on the discussion on page 38 is as follows:

"As previously discussed, constraints on staff resources resulted in a drain in the level of services provided to the borrowers in some instances."

The department would want to change the finding on page 38 to read as follows:

"Our examination disclosed that the Agricultural Loan Division has been seriously constrained in performing these loan servicing activities."

The department's justification is as follows:

"Again, as previously discussed, staff limitations resulted in serious constraints."

Our Comment:

We do not agree with the department's response. The department implies that the lack of sufficient staff limits its ability to: (1) curtail the rising delinquencies, (2) fully document the value of security offered on loans, and (3) properly service the loans it makes. In each situation, there is nothing to suggest that the deficiency would be remedied by the addition of more staff personnel.

Hawaii Agricultural Products Program and Hawaii Aquaculture Loan Program

Our Report:

On page 40, we stated the finding that:

Our general finding is that DOA has made no adequate efforts to effectively implement the two programs. Progress has been negligible in meeting the objectives of developing agricultural products and strengthening the aquaculture industries. Only four agricultural product grants have been approved since the establishment of the agricultural products program in 1963, and only two loans have been made under the Hawaii aquaculture program although it was created in 1971.

In the preliminary draft of our audit report submitted to the department, we discussed the statutory dollar limitation on aquaculture loans. We questioned the department's computation of the loan limitation and recommended that it seek legal counsel for clarification.

Department's Response:

The department's comment to the finding on page 40 is that:

"The response to the ag products and aquaculture program depends upon the initiative of agriculturists and aquaculturists. The low level of grants made reflects the level of that initiative and capability. The risk factor in financing developing commodities is much higher than established commodities.

"The demand level for loans, to a large extent, also reflects the initial development stage of new industries."

The department's comment concerning the dollar limitation on aquaculture loans is that:

"Act 212, SLH 1977, amended Chapter 219, Aquaculture Loan Program, and clarified loan limits. Also by memorandum dated April 7, 1977, the Attorney General clarified loan limitations as to legislative intent."

Our Comment:

The necessary change has been made to account for the 1977 statutory amendment to the loan limits of the aquaculture loan program.

Word Changes Suggested by the Department

The department suggests numerous word changes to the report findings. The findings and the department's suggested changes and comments are grouped under this section.

Our Report:

On page 32, we stated the finding that:

DOA does not insist on the submission of proper financial data to support loan applications.

On page 32, we stated that:

DOA does not properly service the loans it makes. It does not make the required or needed field visits to ensure that the borrower is complying with the terms of his loan. Indeed, DOA fails to keep track of the whereabouts of borrowers.

On page 32, we stated the finding that:

DOA refinances existing loans in a manner violative of statutory requirements.

On page 33, we stated the finding that:

The loan representative may also request that the applicant submit a balance sheet, an income statement, and tax returns from prior years. In the majority of cases, however, the two forms are all that are required for a loan request to be considered and acted upon.

On page 34, we stated:

A part of the loan approval process is the submission of financial data to show ability to repay the loan. Under the procedure outlined above, the data submitted by the applicant are supposed to be carefully reviewed and analyzed to determine the applicant's earning potential and repayment capacity. We find, however, that the analysis performed is inadequate.

On page 34, we stated the finding that:

It appears, however, that the projections are not given such careful scrutiny. The projections as submitted by the farmer are readily accepted by the farm loan division, even though they are often inflated. The projections of farm income in particular are often inflated.

On page 35, we stated:

Outdated financial statements. In addition to the projected income and expense statement, some applicants are also required to submit other financial statements, such as a balance sheet and an income statement. These additional statements are usually required of applicants seeking large loans and of repeat borrowers.

On page 36, we stated:

If the property offered as collateral is indeed to serve as security, it is incumbent upon DOA to evaluate with care the value of each property offered and to ascertain the correctness of the calculations concerning the securities offered. DOA, however, pays little attention to these matters.

On page 39, we stated the finding that:

Our examination of the records and files maintained by the farm loan division revealed that numerous loans have been made in violation of this statutory requirement. The case of a farmer who in 1975 received a $30,000 direct Class C loan is an example. The $30,000 was used to liquidate portions of not only outstanding Class C loans, but also portions of outstanding Class A and Class B loans. See table 4.2.

Department's Response:

The department would want to change the finding on page 32 to read as follows:

"In some instances, the DOA has failed to acquire proper financial data to support loan applications."

The department's justification is that:

"The DOA requires the submission of proper financial data to support all loan applications. There may have been some instances in the past where the Department failed to acquire the necessary data; however, the present Board corrected the situation and has insisted that this requirement be complied with."

The department would want to change the last sentence of the finding on page 32 to read as follows:

". . . The DOA failed to keep track of the whereabouts of certain borrowers."

The department's justification is that:

"The Department may not have kept current their mailing list for 13 of its borrowers in its total loan accounts, but the whereabouts of the borrowers were never in question. This does not warrant the general statement that the DOA fails to keep track of its borrowers."

The department would want to change the finding on page 32 to read as follows:

"DOA refinanced certain existing loans in a manner violative of statutory requirements."

The department's justification is that:

"The change is required for clarification since DOA refinancing is not a common practice."

The department would want the last sentence of the second paragraph of page 33 to be restated as follows:

". . . In some cases, however, the two forms are all that are required for a loan request to be considered and acted upon."

The department's justification is that:

"The statement 'in the majority of cases' is inaccurate. For smaller recurrent production-type loans, where the ag loan officer is experienced with the borrower, two forms may suffice; however, those would be the exceptions."

The department would want to change the last sentence of the fourth paragraph on page 34 to read as follows:

". . . We find, however, that the analysis performed was inadequate on certain loans."

The department's justification is that:

"While it may be true that the analysis performed on certain loans may have been inadequate, this is not generally the case and it should not be construed that all the analyses performed are inadequate."

The department would want to change the finding on page 34 to read as follows:

"It appears, however, that the projections as submitted by the farmer are sometimes accepted by the Agricultural Loan Division, even though they may be inflated. The projections of farm income in particular are often inflated."

The department's justification is that:

"The change is made to correct an inaccurate statement of fact."

The department would want to change the finding on page 35 to read as follows:

"**Outdated financial statements**. In addition to the projected income and expense statement, applicants are required to submit financial statements, such as a balance sheet and an income statement. These statements are supposed to assist in evaluating the applicant's debt-carrying capacity."

The department's justification is that:

"The changes are required to reflect what are normal practices and requirements of the Agricultural Loan Program."

The department would want to change the last sentence of the finding on page 36 to read as follows:

"If the property offered as collateral is indeed to serve as security, it is incumbent upon DOA to evaluate with care the value of each property offered and to ascertain the correctness of the calculations concerning the securities offered."

The department's justification is that:

"While the DOA does not consider security to guarantee repayment; nevertheless, security is seriously considered to lessen risk."

The department would want to change the finding on page 39 to read as follows:

"Our examination of the records and files maintained by the Agricultural Loan Division revealed that some loans have been made in violation of this statutory requirement. The case of a farmer who in 1975 received a $30,000 direct Class C loan is an example. The $30,000 was used to liquidate portions of not only outstanding Class [C] loans, but also portions of outstanding Class A and Class B loans. See table 4.2."

The department's justification is that:

"This change is made to correct a distortion of fact."

Our Comment:

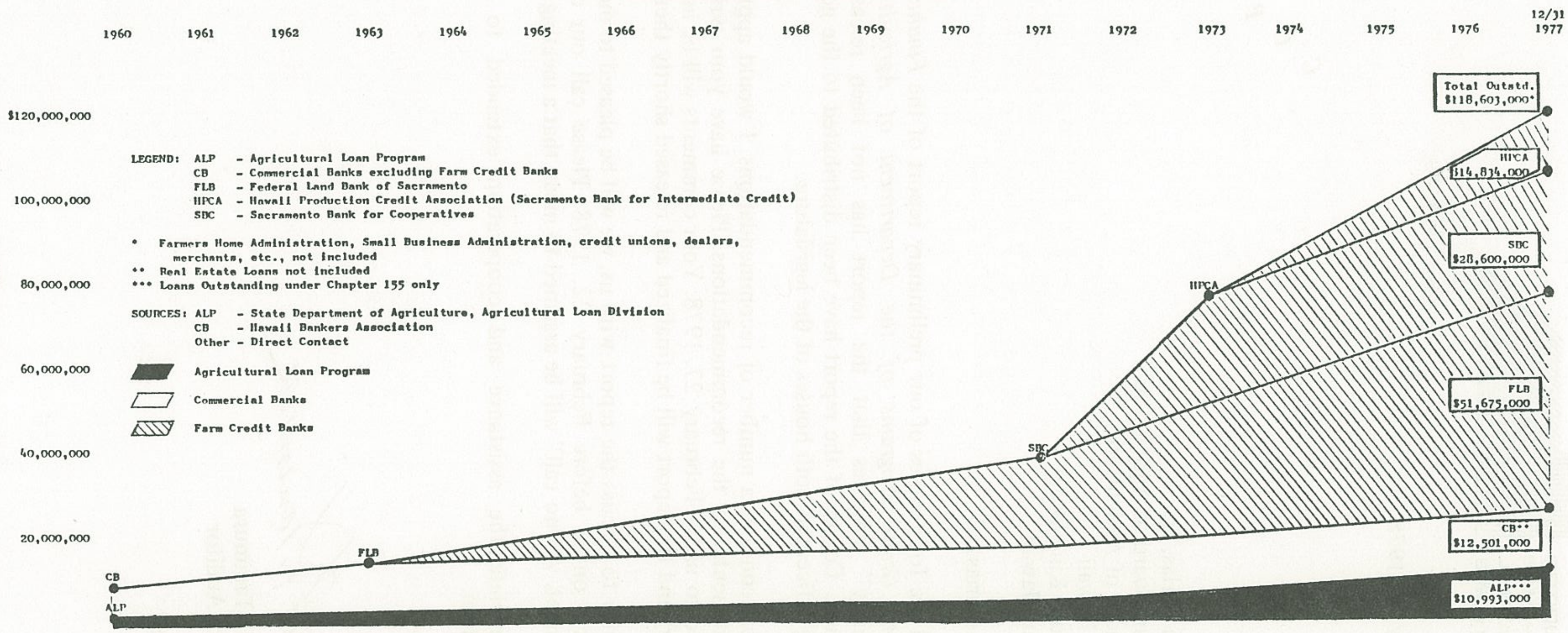
We do not agree with the department's response. The department suggests the insertion of words, such as "some" and "certain," to the findings in an attempt to indicate that the deficiencies occur infrequently. The audit did not find this to be the case. In certain instances, the mere existence of a deficiency requires it to be brought to the attention of the agency being audited. For example, we find that DOA fails to keep track of the whereabouts of its borrowers. The department would want to change this finding to read that it has failed to keep track of the whereabouts of "certain borrowers." It is imperative, however, that the department know the whereabouts of all its borrowers if it is to enforce the repayment of loans.

APPENDIX A

Figure 3.1.A

FARM LOANS OUTSTANDING FOR PERIOD 1960 THROUGH 1977

State Agricultural Loan Program and Private Lenders



THE OFFICE OF THE AUDITOR
STATE OF HAWAII
STATE CAPITOL
HONOLULU, HAWAII 96813

CLINTON T. TANIMURA
AUDITOR
RALPH W. KONDO
DEPUTY AUDITOR

February 16, 1978

C O P Y

Mr. John Farias, Jr.
Chairman, Board of Agriculture
Department of Agriculture
State of Hawaii
1428 South King Street
Honolulu, Hawaii

Dear Mr. Farias:

Enclosed are four copies of our preliminary report of the *Financial Audit of the Loan and Grant Programs of the Department of Agriculture.* The term "preliminary" indicates that the report has not been released for general distribution. Copies of the report have been distributed to the governor and the presiding officers of both houses of the legislature.

The report contains a number of recommendations. I would appreciate receiving your comments on the recommendations. Please have your written comments submitted to us by February 27, 1978. Your comments will be incorporated into the report and the report will be finalized and released shortly thereafter.

If you wish to discuss the report with us, we will be pleased to meet with you, at our office, on or before February 22, 1978. Please call our office to fix an appointment. A "no call" will be assumed to mean that a meeting is not required.

We appreciate the assistance and cooperation extended to us during the examination.

Sincerely,

Clinton T. Tanimura

Clinton T. Tanimura
Legislative Auditor

Enclosures

PUBLISHED REPORTS OF THE LEGISLATIVE AUDITOR

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1966 1. Examination of the Office of the Revisor of Statutes, 66 pp. (out of print).

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3. Financial Audit of the Department of Regulatory Agnecies for the Fiscal Year Ended June 30, 1967, v.p. (out of print).

4. Financial Audit of the Department of Hawaiian Home Lands for the Fiscal Year Ended June 30, 1967, 54 pp.

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9. Financial Audit of the Hawaii Visitors Bureau for the Period July 1, 1967 to June 30, 1968, 42 pp.

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3. Financial Audit of the State Department of Budget and Finance for the Fiscal Year Ended June 30, 1968, v.p.

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6. Financial Audit of the Honokaa Hospital for the Fiscal Year Ended June 30, 1968, 41 pp.

7. Financial Audit of the Kohala Hospital for the Fiscal Year Ended June 30, 1968, 34 pp.

8. Financial Audit of the Kona Hospital for the Fiscal Year Ended June 30, 1968, 44 pp.

9. Financial Audit of the Kauai Veterans Memorial Hospital for the Fiscal Year Ended June 30, 1968, 30 pp.

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