ALASKA STATE LEGISLATURE
LEGISLATIVE BUDGET AND AUDIT COMMITTEE
Division of Legislative Audit

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SUMMARY OF: A Special Report on the Department of Natural Resources, Agriculture Revolving Loan Fund, Selected Issues, June 24, 2013

## PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Agriculture Revolving Loan Fund (fund or ARLF). The purpose of this audit is to examine the fund's performance and administration and compare fund administration to other loan programs and industry best practices. The goal of the evaluation is to identify how the fund's performance could be improved and how efficiencies could be gained with an emphasis on whether the fund should be administered by a different state agency.

## REPORT CONCLUSIONS

We conclude that ARLF's fiscal condition is the result of agricultural policy decisions made over the past 30 years by executive and legislative branches of government. Many lending and management decisions were made in favor of supporting the agricultural industry over maintaining the fund's fiscal health. Since inception, ARLF's fund equity has declined by 69 percent, and it annually loses over $118,000 from operating Mount McKinley Meat and Sausage Company (MMM&S).

Although ARLF's default rate was found to be reasonable at the program level when compared to other agricultural loan programs, the audit identified numerous administrative deficiencies that, if not corrected, will likely contribute to future losses. Examples of deficiencies include ineffective and inefficient processes for loan evaluation and approval, property management, and loan management. Additionally, this audit found regulations do not promote fiscally responsible decisions on a consistent basis.

Our review of comparable loan programs found that boards similar to the Board of Agriculture and Conservation (BAC) are not commonly used for lending decisions. It is more common for lending decisions to be made by professional lending staff or by a committee with lending expertise. Based on administrative deficiencies and opportunities for increased efficiency, we conclude that moving ARLF administration and loan decisions to the Division of Economic Development may improve the loan program's efficiency and effectiveness, and help ensure the fund's future solvency.

## FINDINGS AND RECOMMENDATIONS

### Recommendation No. 1

The legislature should consider moving the ARLF administration to the Department of Commerce, Community, and Economic Development’s Division of Economic Development.

Report conclusions outline examples of deficiencies in the Division of Agriculture’s processes for evaluating and approving loans, managing property, and managing loans. Decisions to promote agriculture and support Alaskan farmers through the use of ARLF assets have not always been fiscally prudent. While BAC diligently works to serve the agricultural industry, improvements have not effectively eliminated the types of deficiencies noted in the audit.

### Recommendation No. 2

ARLF administrators should revise ARLF’s regulations to promote industry best practices.

ARLF’s regulations do not promote consistent fiscally responsible decisions. Specifically, regulations do not include criteria for approving loans and do not provide sufficient guidelines for evaluating collateral.

### Recommendation No. 3

ARLF administrators should pursue disposal of business properties and revise property leasing rates to provide a return on ARLF assets.

ARLF currently owns two active business properties, the MMM&S and the Alaska Farm Cooperative (cooperative). Operating businesses such as the MMM&S and the cooperative is not within ARLF’s statutory authority. ARLF’s statutory purpose is to promote more rapid development of agriculture as an industry by means of long-term low-interest loans.

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August 19, 2013

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF NATURAL RESOURCES
AGRICULTURE REVOLVING LOAN FUND
SELECTED ISSUES

June 24, 2013

Audit Control Number
10-30071-13

This performance audit examines the administration and performance of the Agriculture Revolving Loan Fund (fund). The audit identifies how the fund's performance could be improved and how efficiencies could be gained with an emphasis on whether the fund should be administered by a different state agency.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the conclusions, findings, and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

Kris Curtis, CPA, CISA
Legislative Auditor

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# OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Department of Natural Resources (DNR), Division of Agriculture's (DoAg) Agriculture Revolving Loan Fund (fund or ARLF).

## Objectives

The primary audit objectives were:

- Evaluate ARLF's performance.
- Identify ARLF loan types and the degree to which each loan type is performing.
- Identify the duties performed by DNR employees in administrating ARLF.
- Identify areas where efficiencies could be gained to improve ARLF administration.
- Compare ARLF's program structure, including the Board of Agriculture's (BAC) involvement in lending decisions, to other Alaskan and non-Alaskan governmental lending programs.
- Identify potential changes that could improve the program.
- Determine whether there are inherent conflicts with respect to BAC members approving ARLF loans.
- Determine whether DNR should continue to administer ARLF or whether all or part of ARLF's administration should be carried out by a different state department, agency or private entity to improve performance, reduce costs, or both.

## Scope

The audit reviewed ARLF's administration and decision-making processes from FY 09 through February 2013. The audit evaluated fund performance over the fund's life, 1953 to February 2013. The audit also reviewed the current lending practices employed by comparable loan programs.

## Methodology

ARLF's program structure was compared to Alaskan and non-Alaskan lending programs to identify industry best practices and potential changes that could improve the program. When selecting lending programs for comparison, in-state programs that offered a majority of agricultural loans in Alaska were selected. These included the Alaska Rural Rehabilitation Corporation and the United States Department of Agriculture's Farm Service Agency. One State of Alaska lending program, the Commercial Fishing Revolving Loan Fund, was selected as a means of comparing ARLF to a different state-administered loan program. Comparable non-Alaskan lending programs were selected based on traits similar to Alaska in terms of total agricultural receipts, size and number of farms, climate, or remoteness, and the existence of an agricultural state loan program. Hawaii,[1] Maine,[2] and Connecticut[3] were selected.

Representatives from comparable Alaskan and non-Alaskan lending programs were interviewed to gain an understanding of the programs. Pertinent program statutes, regulations, and policy and procedure manuals were reviewed for industry best practices and as a basis for comparison.

To evaluate ARLF's performance:

- ARLF capitalizations and fund changes were identified through inquiry with DNR and DoAg staff and examining agency and state accounting records. The validity of DNR financial and loan records were assessed by tracing accounts receivable from the state accounting system to DNR's receipting system and by tracing the monthly payment information from DoAg loan files to DNR's receipting system.

- Each loan type's delinquency and default rates for the last five years were computed and compared to rates reported by comparable loan programs. *Delinquency* is defined as a loan with no payments over 90 days. To identify these loans, copies of delinquency notices sent to ARLF borrowers and maintained in DNR's financial records were examined. *Default* is defined as a loan forwarded to the assistant attorney general for collection. To identify these loans, a list of loans sent for collection from the assistant attorney general was requested and validated by confirming the information with DNR's accountant.

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[1]The selection of Hawaii was based on the low dollar amount of agricultural receipts. Also, the remoteness of farms (located on different islands) creates challenges with loan servicing similar to Alaska. Finally, as with ARLF loans, the majority of loans issued by the State of Hawaii were given to small farming businesses.
[2]The selection of Maine was based on the similarity of the state's agricultural industry and climate to Alaska. The majority of Maine's agricultural loans were given to small farming businesses: dairy businesses in the Northern region and potato farmers in the Western region.
[3]The selection of Connecticut was based on its relatively small agricultural industry primarily comprised of family farmers.

To identify duties performed by DNR employees in administrating ARLF, the department's organization chart was examined, and job descriptions were obtained and evaluated. Additionally, significant and direct employees involved in ARLF administration were identified and interviewed regarding their duties and the percentage of time incurred on ARLF administration.

To identify areas where efficiencies could be gained to improve ARLF administration:

- ARLF personal service expenditures for the last five years were computed using state accounting and state payroll systems' records to identify the total personal service expenditures for administrating the fund, including personnel spending time administering ARLF but not recording costs to ARLF.

- Twenty-two[4] loan files were examined to determine whether ARLF loans were made in accordance with statutes, regulations, policies and procedures, and industry best practices described by representatives of comparable Alaskan and non-Alaskan lending programs.

- ARLF regulations were evaluated for compliance with laws and industry best practices of comparable Alaskan and non-Alaskan lending programs.

- ARLF asset management practices were reviewed by examining DNR's asset and property documentation for five ARLF assets and inquiring with DNR and Department of Law employees regarding the status and management of the assets.

To determine whether there are inherent conflicts with respect to BAC members approving ARLF loans:

- BAC's composition was analyzed in conjunction with Alaska Statutes and regulations describing BAC authority.

- Interviews with DNR and Department of Law employees were conducted; board meeting minutes and ethics and conflicts of interest disclosure forms from FY 09 through December 2012 were examined; and four BAC meetings were attended to evaluate whether BAC members recused themselves from voting and discussing matters that could lead to conflicts of interest.

To determine whether ARLF administration should be carried out by a different state department, the results of the audit work performed to address other audit objectives were evaluated, including audit work on fund performance, asset management practices, loan

[4]Out of 88 outstanding loans files as of February 2013, eight random and 11 judgmentally selected files were tested. Additionally, three judgmentally selected closed loan files were tested.

program inefficiencies, decision-making process, conflicts of interest, and regulations. Additionally, the following was performed.

- Other state departments with loan programs were evaluated to determine if ARLF administration could be carried out by another state department.
- Department of Commerce, Community, and Economic Development (DCCED) representatives were interviewed, and pertinent Alaska Statutes and regulations were reviewed to gain an understanding of DCCED's administration of state lending programs.
- DNR, DCCED, DoAg, and BAC representatives were interviewed to gain an understanding of potential benefits and challenges of retaining or moving ARLF to another department.

Additional audit procedures necessary to address the audit objectives included:

- Interviewing Department of Corrections representatives to gain an understanding of their role in administering the Mount McKinley Meat and Sausage Company.
- Gaining an understanding of DNR's receipting system to determine how it is used for ARLF administration.
- Reviewing results of prior legislative audits and other ARLF related studies.
- Assessing internal control procedures related to various audit objectives including controls that ensured the following:
    - ✓ Completeness and validity of DNR financial records maintained in DNR's receipting system and in the state accounting system;
    - ✓ Compliance with Alaska Statutes and regulations in the loan evaluation and approval processes;
    - ✓ An accurate description of DNR employee job duties matched the job description and duties performed were not duplicated; and
    - ✓ BAC members recused themselves from voting and discussing topics that might lead to potential conflicts of interest.

# ORGANIZATION AND FUNCTION

The Department of Natural Resources' (DNR) mission is to responsibly develop Alaska's resources by making them available for maximum use and benefit consistent with the public's interest. The Division of Agriculture (DoAg) is organized within DNR. DoAg promotes and encourages development of the agricultural industry in the State.

The Board of Agriculture and Conservation (board or BAC) is responsible for administering the Agriculture Revolving Loan Fund (ARLF), approving and administering agricultural loans, adopting regulations, and authorizing the disposal of agricultural land acquired by ARLF. In exercising its duties, BAC encourages and promotes development of the agricultural industry throughout the State. DoAg staff processes and services loans approved by BAC. The board holds at least eight official meetings per year.

BAC is composed of seven public members appointed by the governor and confirmed by the legislature in joint session. Board members serve staggered three-year terms. The board is required to be comprised of:

- One member having general business or financial experience;
- One member who is part of a statewide agriculture promotion organization;
- One member who is part of a soil and water conservation district and engaged in commercial production agriculture; and
- Four members engaged in commercial production agriculture, representing different agricultural enterprises.

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# BACKGROUND INFORMATION

Alaska's Unique Agriculture

Alaskan agriculture is unique when compared to other states. The long daylight hours and short growing season produce certain crops that grow to enormous size. Alaskan farmers sell the least amount of agricultural products in the United States, despite Alaska being the largest state, and supply less than two percent of food consumed in the State.

According to the United States Department of Agriculture[5] (USDA), of 686 Alaskan farms, over 80 percent sell less than $50,000 in products; livestock sales account for 57 percent, and crop sales account for 43 percent. Families or individuals operate 80 percent of farms. The majority of farm land is used as pastures.

Agricultural Loan Programs in Alaska

Agricultural credit options in Alaska are limited to four entities: Alaska Rural Rehabilitation Corporation, USDA's Farm Service Agency, Alaska Commercial Fishing and Agriculture Bank, and the Agriculture Revolving Loan Fund (fund or ARLF).

*1. Alaska Rural Rehabilitation Corporation (corporation)*

The corporation is a nonprofit organization dedicated to permanent development of the Alaskan agricultural industry. Originally created to support the 1935 Matanuska Valley colonization project, it now provides financing for Alaskan agricultural producers. The corporation is governed by a seven-member board comprised of agricultural industry representatives and other business professionals. The corporation's one office is located in Palmer.

*2. United States Department of Agriculture's Farm Service Agency (FSA)*

FSA's mission is to equitably serve all farmers, ranchers, and agricultural partners by delivering effective, efficient agricultural programs to all Americans. FSA's organizational structure is determined by Congress and overseen by the secretary of agriculture. FSA is funded by federal appropriations.

FSA makes and guarantees loans to farmers and ranchers to promote, build, and sustain family farms to support an agricultural economy. FSA headquarters are maintained in Washington, D.C. with offices located in each state. There are two Alaskan offices: one in Palmer and one in Delta Junction.

[5] Alaskan agricultural statistics were obtained from the USDA Census of Agriculture statistics (2007).

FSA has historically been considered the lender of "*last resort*," but recently rebranded itself as the lender of "*first opportunity*" which provides loans to individuals ineligible for loans from other sources. FSA's loan programs are intended to graduate its borrowers to commercial credit.

*3. Alaska Commercial Fishing and Agriculture Bank (bank or CFAB)*

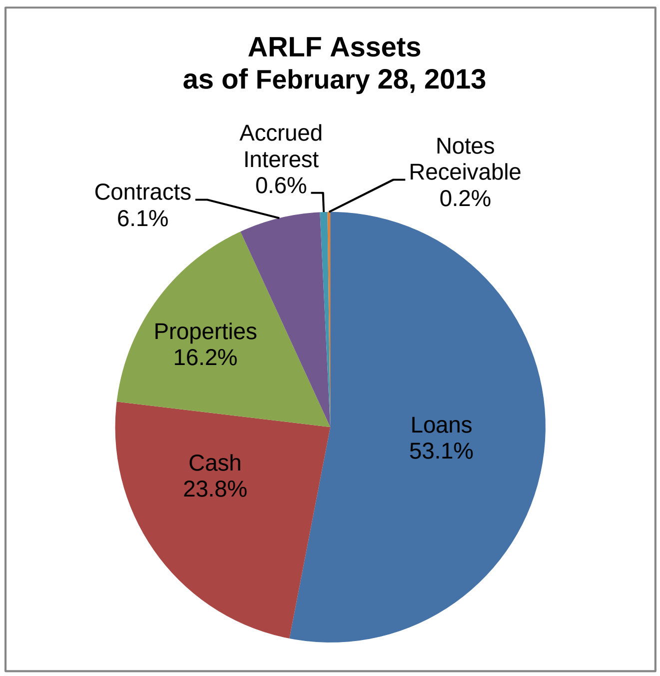
CFAB's vision is to be the premier lender to Alaskan commercial fishing, agricultural, timber, tourism, and resource based industries and to provide prompt, courteous service and financing customized to meet specific borrower needs. The bank was modeled after the Federal Farm Credit System and is organized as a cooperative owned by its customers. The bank is governed by a seven-member board of directors that hires professional management and staff to operate the program. CFAB's one office is located in Anchorage.

While CFAB offers agricultural loans, agricultural loans do not constitute a significant part of its portfolio due to competition from public lenders such as ARLF and FSA that offer lower interest rates. Interest rates offered by the bank vary depending on a borrower's risk and the "*base rate*" established annually by the board.

*4. Agriculture Revolving Loan Fund*

ARLF is a State of Alaska sponsored loan fund whose objective is to promote the rapid development of agriculture as an industry throughout the State by means of long-term low-interest loans. ARLF is administered out of the Division of Agriculture's (DoAg) Palmer office by the Board of Agriculture and Conservation (BAC). BAC is composed of seven public members.

**Exhibit 1**




ARLF was established by the territorial legislature in 1953. The fund's enabling legislation is codified in AS 03.10. ARLF's objective is to promote more rapid development of agriculture as an industry throughout the State by means of long-term low-interest loans. ARLF is administered out of DoAg's Palmer office.

<u>ARLF Assets</u>

As shown in Exhibit 1, ARLF assets, totaling approximately $22 million, consist of loans, properties, contracts, notes receivable, cash, and accrued interest. A detailed description of each asset type follows.

*Loans ($11,560,000 or 53.1 percent)*

ARLF offers six types of agricultural loans.

- Short term – loans to finance annual operating expenses such as seed, feed, fertilizer, harvesting, or planting activities.
- Chattel – loans to purchase equipment or livestock.
- Farm development – loans to purchase real property and construct non-residential improvements for agricultural purposes.
- Irrigation – loans to purchase and install irrigation systems.
- Product processing – loans to build and equip facilities to process Alaskan agricultural products.
- Clearing – loans to clear land.

Exhibit 2 lists the number of ARLF loans approved each fiscal year. Excluding 2003, BAC approved an average of 21 loans per year between FY 01 and FY 12. According to DoAg management, mining, land, and water loans were allowed to be refinanced by ARLF in 2003 because of ARLF's low interest rates.

The average number of outstanding loans for the last five years was 97. Farm development loans comprise the largest number and amount of total outstanding loans. In 2013, there were 61 outstanding farm development loans totaling almost $11 million.

**Exhibit 2**

**Number of Approved ARLF Loans by Fiscal Year**

| Fiscal Year | Number of Loans Issued | Total Amount of Loans Issued |
|---|---|---|
| 2001 | 36 | $ 2,961,100 |
| 2002 | 22 | 1,637,760 |
| 2003 | 69 | 11,370,586 |
| 2004 | 19 | 2,544,500 |
| 2005 | 14 | 1,014,400 |
| 2006 | 13 | 1,108,500 |
| 2007 | 11 | 834,500 |
| 2008 | 11 | 1,147,600 |
| 2009 | 28 | 4,393,800 |
| 2010 | 33 | 5,710,650 |
| 2011 | 19 | 2,460,750 |
| 2012 | 20 | 2,495,546 |

Source: DNR financial documents.

*Properties ($3,540,000 or 16.2 percent)*

ARLF owns five properties that were generally acquired as a result of borrowers' defaulting on loans or contracts. Exhibit 3 reports the properties' estimated market values as of February 28, 2013.

**Exhibit 3**

| ARLF Properties<br>Market Value Estimates<br>As of February 28, 2013<br>(Unaudited) | |
|---|---|
| Property Description | Market Value Estimate[6] |
| Alaska Farm Cooperative – preferred stock | $ 1,742,732 |
| Alaska Farm Cooperative – land | 883,680 |
| Mount McKinley Meat and Sausage Company – land and business | 429,200 |
| Palmer Feed Mill - land, building, and equipment | 401,600 |
| Umnak Slaughter Facility - building | 50,000 |
| Kenai Peninsula Land | 32,600 |
| | $ 3,539,812 |

*Source*: DNR Support Services staff.

1. Alaska Farm Cooperative (cooperative)

According to DoAg staff, a group of Delta Junction farmers formed the cooperative, and in 1981, built a 400,000-bushel grain facility. Today, the cooperative includes farmer-members who use the facility to store crops.

The cooperative obtained multiple ARLF and general fund loans. In the early 1990's, the cooperative defaulted on eight of these loans, totaling approximately $6.5 million. Despite the defaults, ARLF administrators determined it was in the State's best interest to keep the cooperative operational. The loan amounts were forgiven in exchange for three parcels of land and shares of non-voting preferred stock. One parcel was sold, and the two remaining were leased to the cooperative for $1 a year for 25 years with an option to renew. The lease term ends in 2018 and is subject to termination if the cooperative ceases to operate.

2. Mount McKinley Meat and Sausage Company (MMM&S)

The MMM&S is one of six USDA inspected slaughtering facilities in Alaska[7] and the only facility in the Matanuska Valley. The MMM&S was constructed in the early 1980s by a private party with a $2 million General Fund loan. In the mid-1980s, the MMM&S owner went into default, and ARLF, being in second position to the private lender, had no rights to the collateral. However, ARLF purchased the meat plant in a foreclosure sale for $740,840 for the benefit of the agricultural industry.

[6]Properties are based on market value estimates and do not consider depreciation. Estimates provided DNR Support Services staff.

[7]The other five USDA inspected slaughter facilities are located at Sitkinak Island near Kodiak Island (Sitkinak Cattle Range), Delta Junction (Delta Meat and Sausage), North Pole (Mid State Meats), Umnak Island (Umnak Slaughter Facility), and Mekoryuk on Nunivak Island (Nuniwarmiut Reindeer and Seafood).

The MMM&S was reopened in the late 1980's under a memorandum of agreement between DNR and the Department of Corrections (DOC). DOC managed the plant for DoAg, using it as a training program for inmates, while continuing to provide slaughter services to farmers.

In FY 03, plant management was transferred from DOC to DoAg; however, inmates continue to work in the facility. DoAg manages the facility using ARLF funds to pay all MMM&S operating expenditures. MMM&S operating expenditures include wages for three correctional industries production manager positions; wages of DOC inmates working in the facility; costs for transporting inmates to and from prison; and costs of capital improvements necessary to keep the plant running. DOC is the primary MMM&S customer purchasing 60 to 70 percent of total MMM&S products at market rates.[8]

Due to ongoing operating losses, several unsuccessful attempts were made to sell the MMM&S. During the last attempt in 2006, the request for proposal required bidders to keep the slaughter facility open and to accept all healthy Alaskan livestock for slaughtering regardless of quality. There were no responsive bidders.

3. Palmer Feed Mill

In the 1980's, ARLF acquired the Palmer Feed Mill property as a result of the Matanuska Maid bankruptcy. Several attempts were made to sell the property. In August 2012, BAC entered into an agreement to sell the Palmer Feed Mill property to the City of Palmer. The sale is still pending due to potential asbestos contamination.

4. Umnak Slaughter Facility

The Umnak Slaughter Facility is a USDA-inspected slaughter facility on Umnak Island. In the 1970's, ARLF received the slaughter facility as a result of a loan default. The facility is situated on 6,598 acres of land owned by Department of Transportation and Public Facilities. ARLF has a perpetual agreement for use of the land. Both the facility and the land were leased to several private parties between 1982 and 2008 under different lease term agreements. In September 2008, BAC signed a new lease agreement for 25 years at $3,926 per year with a possible lease adjustment every five years.

5. Kenai Peninsula Land

Due to a loan default, ARLF acquired two parcels of land on the Kenai Peninsula: one with improvements and another without. The land with improvements was sold.

[8]Based on the estimate from the MMM&S plant processing manager.

DoAg staff attempted to dispose of the second parcel; however, no offers were received. As of February 2013, the land was posted for sale on DNR's website.

*Contracts ($1,326,000 or 6.1 percent) and Notes Receivable ($48,000 or 0.2 percent)*

As of February 28, 2013, ARLF had four contracts and two notes receivable. Contracts were comprised of leases converted to sales or financed repossessed property sales. Notes receivable were comprised of two special financing agreements for land sales.

*Cash ($5,194,000 or 23.8 percent) and Accrued Interest ($121,000 or 0.6 percent)*

As of February 28, 2013, ARLF's cash balance comprised almost a quarter of its assets. The cash allows ARLF to continue issuing low-interest loans to promote and grow the agricultural industry. The interest accrued on loans, contracts, and notes receivable represents interests earned but not received.

The State of Alaska Loan Programs

In addition to ARLF, the State administers at least 17 other loan programs.[9] These programs are structured under four state departments: Department of Revenue; Department of Education and Early Development; Department of Environmental Conservation; and Department of Commerce, Community, and Economic Development (DCCED).

Thirteen state loan programs are administered by DCCED. The Financing Section of DCCED's Division of Economic Development (DED) is responsible for administering the diverse loan programs. Examples of DED loan programs include: Capstone Avionics, Commercial Charter Fisheries, Commercial Fishing, Fisheries Enhancement, Mariculture, Microloan, and Small Business Economic Development.

[9]The number of state loan programs was determined by reviewing the state website and *Alaska State Legislature 2013 Standards of Conduct Handbook*, Appendix C: State Benefit and Loan Program Disclosures under AS 24.60.050(c).

# REPORT CONCLUSIONS

This audit examines the Agriculture Revolving Loan Fund's (fund or ARLF) performance and administration and compares fund administration to other loan programs and industry best practices. The goal of the evaluation is to identify how the fund's performance could be improved and how efficiencies could be gained with an emphasis on whether the fund should be administered by a different state agency.

We conclude that ARLF's fiscal condition is the result of agricultural policy decisions made over the past 30 years by executive and legislative branches of government. Many lending and management decisions were made in favor of supporting the agricultural industry over maintaining the fund's fiscal health. Since inception, ARLF's fund equity has declined by 69 percent, and it annually loses over $118,000 from operating Mount McKinley Meat and Sausage Company (MMM&S).

Although ARLF's default rate was found to be reasonable at the program level when compared to other agricultural loan programs, the audit identified numerous administrative deficiencies that, if not corrected, will likely contribute to future losses. Examples of deficiencies include ineffective and inefficient processes for loan evaluation and approval, property management, and loan management. Additionally, the audit found regulations do not promote fiscally responsible decisions on a consistent basis.

Our review of comparable loan programs found that boards similar to the Board of Agriculture and Conservation (BAC) are not commonly used for lending decisions. It is more common for lending decisions to be made by professional lending staff or by a committee with lending expertise. Based on administrative deficiencies and opportunities for increased efficiency, we conclude that moving ARLF administration and loan decisions to the Division of Economic Development (DED) may improve the loan program's efficiency and effectiveness, and help ensure the fund's future solvency.

Detailed conclusions are presented below.

<u>ARLF's equity has declined 69 percent over the life of the fund</u>.

Since creation in 1953, ARLF has been capitalized with over $71 million.[10] The last significant capitalization of $2.5 million occurred in 1986. As of February 2013, fund equity totaled approximately $22 million. The primary reasons for the decrease in ARLF's balance are:

- Twenty-nine million dollars in defaulted loans and contracts were written off. Division of Agriculture (DoAg) staff reported that of this amount, $18 million were

[10]Based on the DoAg financial records.

associated with the rapid development of agricultural projects in Delta Junction and Point McKenzie areas in the 1970s and 1980s.

- Thirteen million dollars were used to fund DoAg administrative expenditures between FY 89 and FY 08.

- Ten million dollars were appropriated back to the General Fund between FY 87 and FY 89 as an additional General Fund revenue source.

- Three and a half million dollars were used to purchase the MMM&S and fund its operating losses and improvements between 1981 and 2013.

<u>ARLF's default rates were similar to other lending programs</u>.

Over the past five years, ARLF's average default rate of approximately two percent was similar to other agriculture lending programs that reported rates ranging from zero to 2.5 percent. ARLF's delinquency rate ranged from one percent to 9.2 percent over the same time period. Delinquency rates could not be compared to other agricultural loan programs because programs did not consistently report delinquency rates. For review purposes, a *delinquent loan* is defined as a loan with payments not made for over 90 days. A *defaulted loan* is defined as a loan sent to the assistant attorney general for collection.

Three types of ARLF loans were in delinquent and in default status – farm development, short term, and chattel. At the loan type level, delinquency and default rates were as high as 28.6 percent for short term loans. However, short term loans represent only 8 percent of total loans outstanding as of February 28, 2013.

Appendix A provides additional details on ARLF delinquency and default rates by loan type and fiscal year.

<u>Deficiencies were found in ARLF administration</u>.

In analyzing ARLF assets and evaluating loan processes and procedures,[11] several administrative deficiencies were identified that negatively impact fund performance. If not corrected, the deficiencies will jeopardize the fund's fiscal health. Deficiencies primarily resulted from not using industry best practices in asset and loan management. Deficiencies identified in the loan evaluation and approval processes, and property and loan management are described below.

*Loan Evaluation and Approval Processes*

- Loan collateral values were not independently verified prior to approving loans.

[11]Twenty-two loans, two contracts, and five property assets were reviewed.

- Personal property was accepted as loan collateral.
- Corporate and limited liability company borrowers were not consistently required to provide personal guarantees as individual loan co-signers.
- One restructured loan amount increased beyond the amount allowed by regulations.
- Additional loans were given to borrowers who experienced substantial financial losses and had difficulty meeting prior loan obligations.
- New loans were given to borrowers without prudent consideration of prior ARLF loan defaults.
- Short-term loans were restructured into new short-term loans to inappropriately extend loan terms beyond the statutory time limit.

*Property Management*

- Assets and loan collateral were not regularly inspected.
- One repossessed property was not properly maintained which resulted in unnecessary and preventable property deterioration.
- Business properties lacked sufficient oversight.
- Lease rates provided little return on investment.
- Real estate property and cash were given to a contractor with no oversight over contract performance which resulted in a loss to the fund in property and cash.
- The financial status of one significant ARLF asset was unknown because neither financial nor operating information about the business property asset was requested by DoAg or BAC in the last five years.

*Loan Management*

- The required property insurance for collateral on two loans expired and no follow up was performed by DoAg.
- Loan collateral was sold by a borrower without BAC approval and no follow up was performed by DoAg staff for five years.

To improve the fund's asset and loan administration, we recommend the legislature consider moving ARLF administration to the Department of Commerce, Community, and Economic Development (DCCED) as discussed in Recommendation No. 1.

<u>ARLF annually loses approximately $118,000 from its MMM&S investment</u>.

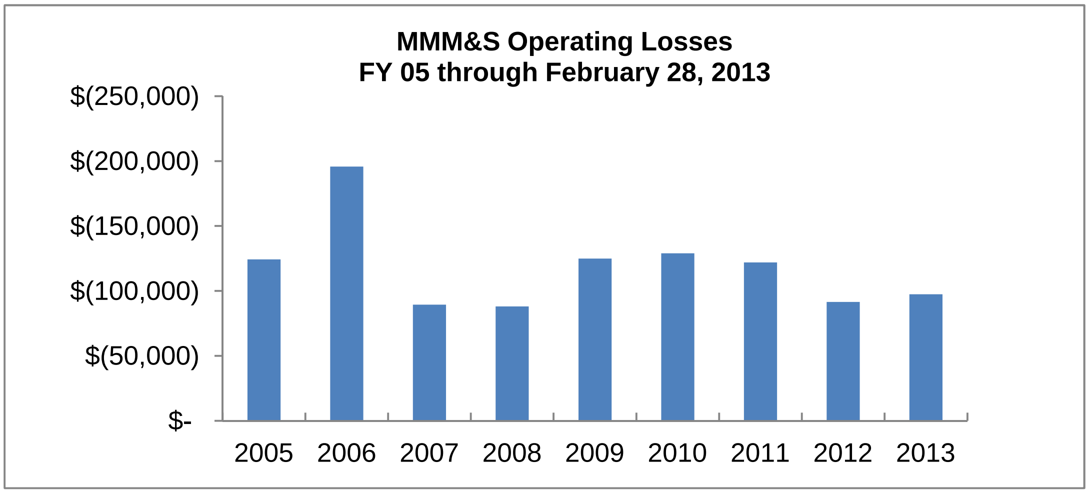
As described in the Background Information section, the MMM&S is a meat slaughtering facility acquired by ARLF and managed for the benefit of Alaskan farmers.

Although operated for the benefit of Alaskan farmers, only 20 percent of meat processed in the facility comes from Alaskan grown animals. The remaining 80 percent is purchased from local wholesalers in the form of boxed meats. Boxed meats are cuts of meat in sub-primal form shipped from areas outside Alaska to the MMM&S in Palmer for further processing and packaging.

The MMM&S was designed to slaughter 100 hogs per day or 50 head of cattle; however, capacity cannot be reached due to design flaws. As of February 2013, the slaughter facility operated at approximately five percent of capacity.[12] The MMM&S is an old facility with deteriorating equipment. Despite multiple attempts to improve MMM&S efficiency and cost cutting measures,[13] the plant continues to incur losses.

Since 1981, building and operating the MMM&S has resulted in state losses of approximately $3.5 million from ARLF and $2 million from the General Fund. ARLF currently incurs an average loss of approximately $118,000 a year[14] from MMM&S operations. Exhibit 4 shows MMM&S operating losses reported since FY 05. (See Recommendation No. 3.)

**Exhibit 4**




<u>Personal services for ARLF administration were not fully recorded as ARLF expenditures</u>.

Nine state positions collectively administer ARLF (six DoAg staff, two Department of Natural Resources (DNR) Administrative Services staff, and one Department of Law employee). Appendix B summarizes the job duties for each of the nine positions.

There is a discrepancy between personal services recorded as ARLF expenditures by six of the nine positions and time actually spent by these employees on ARLF administration. Over the last five years, ARLF-related personal services recorded as General Fund expenditures

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[12]There were a total of 626 animals slaughtered between July 1, 2012, and February 28, 2013.
[13]The improvement measures reported by the plant processing manager included operating four days a week, 10 hours a day; discontinuation of paying for inmate meals; and reducing the temperature of the slaughter facility to decrease heating costs.
[14]Losses were estimated based on financial information recorded in the state accounting system.

totaled approximately $171,000. Appendix C shows the estimated percentages of employees' time administering ARLF and the percentages charged to ARLF.

Inefficiencies were identified in ARLF's administration.

Analysis of ARLF's administration identified the following inefficiencies.

- The $50 application fee charged to ARLF borrowers is not sufficient to cover the costs associated with processing and closing loans even though regulations require borrowers pay all costs for loan processing and closing.

- ARLF administrators do not use an automated lending system for loan processing, monitoring, and reporting. The current loan filing and reporting system is archaic and inefficient. Loan files lacked documentation to adequately support the loan application evaluation process. Furthermore, DNR's payment receipting system cannot readily provide historical default and delinquency data.

- Duties are not properly segregated in ARLF's payment receipt process.

- ARLF administrators have not obtained the United States Department of Agriculture's (USDA) Farm Service Agency (FSA) loan guarantees for ARLF loans to mitigate potential loan losses. In accordance with the federal regulation,[15] ARLF is eligible for USDA FSA loan guarantees.

To gain efficiencies, we recommend ARLF administration be transferred to DCCED as discussed in Recommendation No. 1.

ARLF regulations contribute to poor fund administration.

When compared to other loan programs, ARLF's regulations do not promote consistent fiscally responsible decisions. Specifically, ARLF's regulations do not include criteria for approving loans and do not provide sufficient guidelines for evaluating collateral. Additionally, regulations do not describe leasing requirements and do not provide guidance for setting lease rates on properties to ensure appropriate returns on investments. Appendices D and E provide examples of the evaluation and approval process for comparable loan programs.

Below are examples of regulations that should be clarified to better enforce ARLF-related statutes.

- Alaska Statute 03.10.030(a)(2) states that total loans issued by ARLF may not exceed $1 million. However, because there is no guidance in regulations, BAC does not apply this statute to contracts. A single borrower may have a contract in excess of

[15]Title 7 of the Code of Federal Regulations, Section 762, Subsection105.

$1 million and loans up to $1 million. Thus, the total ARLF risk of loss to a single borrower may exceed $2 million or nine percent of ARLF's total assets for FY 13. One borrower has $1.8 million in total ARLF debt including a contract issued by ARLF.

- Alaska Statute 03.10.033(a) allows BAC to restructure loans made after 1987 only if a borrower was affected by declared agricultural or farm disasters. However, 11 AAC 39.660 is more inclusive and includes factors that are broader than statutory requirements. The regulation allows BAC to approve loan restructuring if the borrower cannot repay the loan according to its existing terms from agricultural and non-agricultural income and liquidation of assets if the board determines that, based on the financial information, (a) the borrower can repay the loan if restructured and (b) restructuring the loan is expected to increase the State's return.

- Alaska Statute 03.10.030(c) states that BAC may extend the term of a short-term loan for up to three years. However, lack of clear regulatory guidance allows BAC to restructure a short-term loan into another short-term loan that, in effect, permits the term to be extended beyond three years.

- Alaska Statute 03.10.020 specifies the type of loans that can be offered by BAC. Only four of seven types are covered in ARLF regulations.

To improve ARLF administration, we recommend ARLF regulations be revised to promote industry best practices and better support statutory compliance as discussed in Recommendation No. 2.

<u>There are inherent conflicts with respect to BAC members approving loans</u>.

Alaska Statutes require one of seven BAC members to have general business or financial experience; one member to be from a statewide agricultural promotion organization; one member to be from a soil and water conservation district and engaged in commercial production agriculture; and four members to represent different agricultural enterprises. Because statutes require the majority of the board to be involved in agriculture, there will always be an inherent conflict of interest with respect to board members approving ARLF loans. The small size of Alaska's agricultural community further contributes to conflicts of interests.

Review of board meeting minutes showed board members and DoAg's director routinely recused themselves from voting on loans and, in some cases, recused themselves from loan discussions in their agricultural areas of expertise due to potential conflicts of interest.

Boards similar to BAC are not commonly utilized for approving loans.

Analysis of six comparable loan programs found boards such as BAC are not commonly used to approve loans. Only two of six programs use boards for loan approval: the Alaska Rural Rehabilitation Corporation (corporation) and the State of Hawaii agricultural loan programs. Furthermore, the two programs differ from BAC by having a more balanced membership. The corporation includes non-agriculture business professionals, and the Hawaiian board is not required to be comprised of agricultural industry representatives.

The other four comparable loan programs use different administrative mechanisms for making lending decisions. The descriptions of these mechanisms and different program structures are summarized below. A more detailed description of the six comparable loan programs is included as Appendices D and E of this report.

1. *State of Maine*. Loans are approved by the Maine Department of Agriculture commissioner based on the recommendation from an eight-member loan evaluation committee. The loan evaluation committee is appointed by the commissioner and is comprised of bankers and financial experts with lending and agricultural experience. The loan evaluation committee bases its recommendations on the credit risk evaluation performed by credit officers from the Financial Authority of Maine.

2. *State of Connecticut*. Connecticut Department of Economic and Community Development staff is responsible for loan decision-making. The decision-making process is comprised of three steps. First, a project manager determines that an applicant meets basic program eligibility requirements. Second, loan processing staff performs due diligence reviews by verifying applicable licenses; reviewing credit histories, financials, and business plans; calculating financial ratios; and assessing cash flows. Third, if approved, the information is forwarded to the department's attorney for legal review and closing.

3. *USDA FSA*. Loan approvals lie with the loan officers. Each loan officer is delegated approval authority up to a certain threshold based on pay grade and experience. If a loan exceeds the threshold, the loan officer submits the reviewed loan application with a recommendation to another loan officer with the appropriate approval authority. The state FSA director has the highest loan approval authority.

4. *DCCED Commercial Fishing Revolving Loan Program*. Loan requests are approved, denied, and modified by a loan committee. The loan committee is comprised of senior loan officers. Decisions are made based on application evaluations and recommendations provided by a loan officer.

Transferring ARLF administration to DCCED's DED may improve efficiency and effectiveness.

Many of the administrative deficiencies and inefficiencies noted in this audit have been reported previously as part of prior Division of Legislative Audit reports. In a 2002 audit report,[16] it was recommended that ARLF loan approval and servicing as well as ARLF fund management and custody be reassigned to DCCED (formerly known as the Department of Commerce and Economic Development). Based on the results of the current audit, we again recommend the legislature consider moving ARLF administration to DCCED as discussed in Recommendation No. 1.

Transfering ARLF adminstration to DED may benefit the fund in the following ways:

1. DED already administers 13 state loan programs. ARLF would benefit from economies of scale[17] offered by DED which could improve the efficiency of lending and collections. While it is difficult to estimate the actual costs associated with transferring ARLF, the incremental costs of adding ARLF to other DED lending programs would likely be less than the annual administrative costs of approximately $385,000[18] incurred by DoAg.

2. DED uses an automated loan program for loan accounting and servicing that may improve ARLF's operational efficiency.

3. ARLF would benefit from DED's lending expertise including uniform loan evaluations and processing procedures that may result in less defaults and write-offs as well as potentially decrease the severity of loan losses.

Transferring administration from DoAg may include the following challenges.

1. DED does not have experience with agricultural loans. However, agriculture-related questions can be directed to DoAg similarly to how DED administers its other lending programs. Furthermore, DED loan and collection officers are accustomed to working with specialized loan programs experiencing wide economic fluctuations and secured by atypical collateral.

2. DED currently does not have an office in the Matanuska Valley where 60 percent[19] of current ARLF borrowers are located. Thus, new loan applicants and existing

[16]Special Audit of Division of Agriculture, Selected Issues, November 29, 2002, audit control no. 10-30017-03 .
[17]*Economies of scale* are the cost advantages obtained from DED's processing and servicing a larger number of loans which should in turn, reduce per loan cost by spreading total costs over the increased number of loans administered by DED.
[18]Administrative costs include personal services, travel, and contractual services charged to ARLF and the General Fund; however, the costs do not include the MMM&S and loan losses.
[19]As of March 29, 2013, per DNR financial documents.

borrowers would have to become familiar with different personnel, lending practices, and office locations.

3. DED does not manage businesses. An analysis of the cost versus benefit of retaining or disposing the two ARLF business properties (the MMM&S and the cooperative) would be necessary.

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# FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The legislature should consider moving the Agrigulture Revolving Loan Fund's (fund or ARLF) administration to the Department of Commerce, Community, and Economic Development's (DCCED) Division of Economic Development (DED).

Report conclusions outline deficiencies in the Division of Agriculture's (DoAg) processes for evaluating and approving loans, managing property, and managing loans. The Division of Legislative Audit (DLA) has issued numerous recommendations over the past 20 years to improve the fund's administration. Many of the prior recommendations have not been addressed and are still applicable.[20]

The deficiencies can be partially attributed to the competing priorities of assisting Alaska's agricultural industry and maintaining the fund's fiscal health. Alaska Statute 03.10.010 requires the Board of Agriculture and Conservation (BAC) to promote more rapid development of agriculture as an industry throughout the State by means of long-term low-interest loans. Decisions to promote agriculture and support Alaskan farmers through the use of ARLF assets have not always been fiscally prudent. While BAC diligently works to serve the agricultural industry, improvements have not effectively eliminated the types of administrative deficiencies noted in this report.

If the deficiencies described in this report persist, ARLF's equity may continue to decline, and the fund's ability to promote agricultural development through long-term low-interest loans may diminish.

We recommend the legislature consider transferring ARLF's administration and lending decisions to DCCED's DED. ARLF's small number of loans would be more efficiently administered by DED who has existing expertise in lending and loan servicing. Furthermore, the transfer to DED may reduce ARLF administrative costs. ARLF performance would also benefit from DED's automated system that may help improve the effectiveness and efficiency of administration.

[20]For example, the conclusion about ARLF not adequately managing its properties appears in the DLA March 1998 (audit control number 10-4557-98) and December 2002 (audit control number 10-30017-03) reports. The conclusions about DoAg's noncompliance with statutes and regulations for the loan evaluation and incomplete documentation in the loan files appear in DLA's February 1984 (audit control number 10-4170-84-S), November 1988 (audit control number 10-1303-89-R), and January 1991 (audit control number 10-4359-91) reports.

Recommendation No. 2

ARLF administrators should revise ARLF's regulations to promote industry best practices.

ARLF's regulations do not promote consistent fiscally responsible decisions. Specifically, regulations do not include criteria for approving loans and do not provide sufficient guidelines for evaluating collateral. Below are specific examples of industry best practices included in comparable loan programs, but not in ARLF regulations:

- Borrower's eligibility evaluation;
- Independent verification of collateral value and acceptable collateral types;
- Borrower's credit history evaluation;
- Loan feasibility analysis;
- Borrower's repayment ability analysis; and
- Asset leasing requirements.

Current ARLF regulations were adopted to give BAC and DoAg staff broad latitude and substantial discretion for evaluating and approving loans. However, the broad regulations do not encourage consistent loan decisions and prudent fiscal management practices which contribute to poor fund performance. For example, BAC relied on collateral values reported by borrowers as opposed to independent verifications in over half of the loans reviewed.

Alaska Statute 03.09.040(a) allows BAC to adopt regulations to carry out its duties. Regulations should utilize industry best practices to ensure the fund's future solvency.

We recommend ARLF administrators revise ARLF's regulations to ensure industry best practices are applied in the administration of ARLF.

Recommendation No. 3

ARLF administrators should pursue disposal of business properties and revise property leasing rates to provide a return on ARLF assets.

ARLF currently owns two active business properties, the Mount McKinley Meat and Sausage Company (MMM&S) and the Alaska Farm Cooperative (cooperative). Operating businesses such as the MMM&S and the cooperative is not within ARLF's statutory authority. ARLF's statutory objective is to promote the more rapid development of agriculture as an industry by means of long-term low-interest loans.

Alaska Statute 03.10.050 states that the property acquired by ARLF through foreclosure, default or other action should be disposed of to maximize the State's return. Instead of pursuing disposal of the MMM&S and the cooperative, which could have adverse affects on the agricultural industry,[21] policy decisions continue to be made to operate or maintain ownership of these businesses. The MMM&S continues to incur annual losses to the fund, and the cooperative provides no financial return. The cumulative effect is a reduction of ARLF assets.

We recommend ARLF administrators pursue disposal of business properties and revise leasing rates to provide an adequate return on ARLF assets.

[21] In 2002, BAC adopted regulation (11 AAC 39.700(b)) which requires the board before the disposal of the property to hold public hearings and address public comments if disposal could have a significant effect on the agricultural industry.

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## Appendix A

## Number of Delinquent and Defaulted ARLF Loans
## As of February 28, 2013

| | *Number of Outstanding Loans at Fiscal Year-End* | | | | | | |
|---|---|---|---|---|---|---|---|
| **Fiscal Year** | **Farm Development** | **Short Term** | **Chattel** | **Land Clearing** | **Irrigation** | **Product Processing** | **Total** |
| 2009 | 59 | 10 | 20 | 3 | - | 3 | 95 |
| 2010 | 63 | 12 | 20 | 2 | - | 5 | 102 |
| 2011 | 59 | 13 | 22 | - | - | 4 | 98 |
| 2012 | 61 | 14 | 19 | - | - | 5 | 99 |
| 2013[22] | 61 | 7 | 16 | - | - | 4 | 88 |

| | *Number of Delinquent Loans* | | | | *Percentage of Delinquent Loans to Total Number of Outstanding Loans per Category* | | | *Delinquency Percentage to Outstanding Loans* |
|---|---|---|---|---|---|---|---|---|
| **Fiscal Year** | **Farm Development** | **Short Term** | **Chattel** | **Total** | **Farm Development** | **Short Term** | **Chattel** | |
| 2009 | 3 | - | - | 3 | 5.1% | - | - | 3.2% |
| 2010 | 1 | - | - | 1 | 1.6% | - | - | 1.0% |
| 2011 | 5 | 2 | 2 | 9 | 8.5% | 15.4% | - | 9.2% |
| 2012 | 3 | 4 | 1 | 8 | 4.9% | 28.6% | 5.3% | 8.1% |
| 2013[22] | 2 | 1 | 1 | 4 | 3.3% | 14.3% | 6.3% | 4.5% |
| Total | 14 | 7 | 4 | 25 | | | | |

| | *Number of Defaulted Loans* | | | | *Percentage of Defaulted Loans to Total Number of Outstanding Loans per Category* | | | *Default Percentage to Outstanding Loans* |
|---|---|---|---|---|---|---|---|---|
| **Fiscal Year** | **Farm Development** | **Short Term** | **Chattel** | **Total** | **Farm Development** | **Short Term** | **Chattel** | |
| 2009 | - | - | - | - | - | - | - | - |
| 2010 | 1 | - | - | 1 | 1.6% | - | - | 1.0% |
| 2011 | - | - | - | - | - | - | - | - |
| 2012 | 1 | 1 | - | 2 | 1.6% | 7.1% | - | 2.0% |
| 2013[22] | 1 | 2 | 2 | 5 | 1.6% | 28.6% | 12.5% | 5.7% |
| Total | 3 | 3 | 2 | 8 | | | | |

[22] As of February 28, 2013.

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# Appendix B

## Duties Performed by State Employees
## In Administering ARLF

| Position Title | Description of ARLF Duties |
|---|---|
| ***Department of Natural Resources, Division of Agriculture*** | |
| Director | • Oversees BAC<br>• Ensures compliance with BAC-related statutes and regulations<br>• Provides leadership and management for ARLF support services<br>• Presents and monitors ARLF's budget<br>• Supervises all division staff, including the loan/collection officer<br>• Reviews loan applications for completeness<br>• Attends BAC meetings |
| Administrative Officer II | • Acting director when director may have a conflict or when not present<br>• Prepares budget for BAC review<br>• Approves leave, timesheets, and travel<br>• Oversees major purchases and contracts |
| Administrative Officer I | • Annually updates some ARLF budget components<br>• Coordinates travel and BAC meetings<br>• Records, transcribes, and publishes board meeting minutes<br>• Notarizes BAC disclosures<br>• Performs human resource management<br>• Trains division staff<br>• Monitors expenditures |
| Loan/Collection Officer I | • Assists applicants in applying for loans and reviews applications<br>• Denies applications that do not meet requirements<br>• Performs reference, credit, and lien checks<br>• Obtains appraisals on collateral<br>• Prepares BAC reports on each loan applicant with specific recommendations<br>• Prepares BAC reports on loan collectability and delinquencies<br>• Prepares annual interest rate analysis<br>• Contacts borrowers about delinquencies<br>• Manages and protects ARLF's assets from deterioration and prepares sales<br>• Assists the Attorney IV with collateral liquidation and legal documentation |
| Office Assistant II | • Helps prepare BAC packets<br>• Receives and processes ARLF payments |
| Administrative Assistant I | • Receives and processes ARLF and MMM&S payments |
| ***Department of Natural Resources, Division of Support Services*** | |
| Accountant III | • Sets up loans in DNR's revenue and billing system<br>• Processes borrowers' loan disbursements<br>• Monitors payments received from customers<br>• Generates and mails out default notices<br>• Prepares annual financial statements and other financial reports<br>• Attends BAC meetings<br>• Supervises the Accounting Technician I<br>• Certifies and reviews the Accounting Technician I's work |
| Accounting Technician I | • Receives and processes ARLF payments |
| ***Department of Law*** | |
| Attorney IV | • Provides legal advice to BAC and DoAg regarding ARLF administration<br>• Attends all BAC meetings<br>• Facilitates the liquidation process and negotiates with delinquent and default borrowers |

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# Appendix C

## Time Incurred and Charged to ARLF by State Employees

| Title | Percentage of Employee Time Working on ARLF | Percentage of Employee Time Charged to ARLF |
|---|---|---|
| ***Department of Natural Resources, Division of Agriculture*** | | |
| Director | 5-10% | 0% |
| Administrative Officer II | 5-10% | 0% |
| Administrative Officer I | 30-40% | 0% |
| Loan/Collection Officer I | 100% | 100% |
| Office Assistant II | 75% | 100% |
| Administrative Assistant I | 5% | 0% |
| ***Department of Natural Resources, Division of Support Services*** | | |
| Accountant III | 30-40% | 50% |
| Accounting Technician I | 20% | 20% |
| ***Department of Law*** | | |
| Attorney IV | 40% | 40% |

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# Appendix D

## Comparison of ARLF
## to Instate Lending Programs

| | ARLF | Commercial Fishing Revolving Loan | Alaska Rural Rehabilitation Corporation | Farm Service Agency |
|---|---|---|---|---|
| **Loan Program Description** | A state fund that promotes the development of the agricultural industry throughout the State by means of low interest rate loans | A state fund that promotes fisheries rehabilitation, resident fisheries development, and fishing gear and vessel maintenance through-term low interest loans | A private nonprofit organization that offers loans to farmers and others involved in agricultural pursuits | A federal agency that serves farmers, ranchers, and agricultural partners by delivering effective and efficient agricultural programs |
| **Number of Employees Involved in Processing an Application** | 1 loan officer | 8 to 9 employees (including clerical staff and loan officers) | 1 loan manager<br>1 administrative staff | 1 loan officer<br>1 program technician |
| **Number of Loans Issued Per Year** | 25 | 215 | 18 | 40 to 45 |
| **Loan Types** | • Short term<br>• Chattel<br>• Farm development<br>• Irrigation<br>• Product processing<br>• Land clearing | • For purchasing limited entry permits, quota shares, vessels, or gear | • Chattel<br>• Real estate<br>• Future farmers assistance<br>• Line of credit | • Farm ownership<br>• Operations<br>• Emergencies<br>• Conservation<br>• Land |
| **Interest Rates** | 3% to 4.5% | 5.25% | 5 to 9% | 1.375% to 8% |
| **Loan Approvers** | Board of Agriculture and Conservation | Loan committee | Loan manager and board | Loan officer |
| **Loan Evaluating Factors Per Regulations** | • Collateral<br><br>(credit, agricultural experience, financial statements, and expenditure projections are part of the ARLF policy and procedure manual) | • Eligibility<br>• Collateral<br>• Credit<br>• Financial history<br>• Operating plan<br>• Repayment ability | • Collateral<br>• Credit<br>• Bankruptcy<br>• Financial statements<br>• Agricultural experience<br>• Business/marketing plan<br>• Repayment ability | • Eligibility<br>• Collateral<br>• Credit<br>• Bankruptcy<br>• Financial statements<br>• Agricultural experience<br>• Managerial ability<br>• Education/training<br>• Repayment ability |
| **Collateral Requirements** | • 75% loan to collateral ratio, minus any lien<br>• Loans exceeding $500,000 must be secured by first mortgage | • 100% loan to collateral ratio for entry permit loans, minus any lien<br>• 80% loan to collateral ratio for all other loans, minus any lien<br>• Mortgage or other security instrument<br>• Vessels must be inspected to be accepted<br>• First lien position | • 70% loan to collateral ratio, minus any lien<br>• First lien position<br>• Insurance for real property<br>• No livestock, crops, or produce | • 67% to 100% loan to collateral ratio<br>• Certified appraisals for real property, all other collateral valued at current market value<br>• No tide land leases, reindeer, or personal items |

## Attachment D
(*Continued*)

## Comparison of ARLF
## to Instate Lending Programs

| | ARLF | Commercial Fishing Revolving Loan | Alaska Rural Rehabilitation Corporation | USDA FSA |
|---|---|---|---|---|
| **Collateral Inspections** | Performed based on the loan officer availability | Performed in the event of a default or other problems | Performed annually | Performed on 40% of all properties each year |
| **Collateral Value Assessment** | Relies on borrowers' reported value or internal evaluations | Relies on independent appraisals | Relies on internal evaluations and outside appraisals | Relies on independent appraisals |
| **Personal Guarantees or Co-signers** | At the discretion of the Board of Agriculture and Conservation | Required for all loans | Required for all loans | Required for all loans |
| **Loan Processing Costs** | $50 application fee and some direct costs | 1% of loan value | $100 application fee and some direct costs | Direct costs (i.e. credit report, closing agent, and UCC filings) |
| **Average Default Rate** | 1.8% | 1.5% to 2.5% | 0% | 0%[23] |
| **Lending Software** | No | Yes | No | Yes |

[23] FSA has a primary loan servicing program that delinquent borrowers can apply for. If the borrower is eligible for this program, FSA uses loan restructuring, loan reamortization, deferrals, and debt write-down to assist the borrower in bringing the account current.

# Appendix E

## Comparison of ARLF
## to Out-of-State Lending Programs

| | ARLF | Hawaii | Maine | Connecticut |
|---|---|---|---|---|
| **Loan Program Description** | A state fund that promotes the development of the agricultural industry throughout the State by means of low interest rate loans | State funds that promote agricultural development by providing credit at reasonable rates; a program that is the last resort for borrowers | State funds that promote innovative technologies and processes to improve and expand the manufacturing, marketability, and production of agricultural products through low interest loans | A state fund that promotes the dairy industry by providing grants, loans and access to credit to offset costs incurred by federal price controls and high energy costs |
| **Number of Employees Involved in Processing an Application** | 1 loan officer | 4 loan officers | 15 employees, including credit officers, loan officers, and assistants | 7 employees, including program manager, loan manager, staff, and attorney |
| **Number of Loans Issued Per Year** | 25 | 30 to 35 | 3 to 12 | 9 loans issued in total since 2006 |
| **Loan Types** | • Short term<br>• Chattel<br>• Farm development;<br>• Irrigation<br>• Product processing<br>• Land Clearing | • Emergency<br>• Farmer ownership<br>• Operating<br>• Facility<br>• Farm operation | • Agricultural assistance<br>• Storage retrofit<br>• New facilities | • Studies/appraisals<br>• Purchases/leases<br>• Construction<br>• Business support<br>• Working capital |
| **Interest Rates** | 3% to 4.5% | 3.375% to 5% | 5% | 3% |
| **Loan Approvers** | Board of Agriculture and Conservation | Board of Agriculture | Commissioner of Department of Agriculture | Loan staff |
| **Loan Evaluating Factors Per Regulations** | • Collateral<br><br>(credit, agricultural experience, financial statements, and expenditure projections are part of the ARLF policy and procedure manual) | • Eligibility<br>• Collateral<br>• Credit<br>• Management ability<br>• Financial position<br>• Agricultural experience<br>• Repayment ability<br>• Past performance | • Eligibility<br>• Collateral<br>• Credit<br>• Management experience<br>• Sufficient resources<br>• Financial position<br>• Financial projection<br>• Business plan<br>• Shared risk<br>• Project feasibility<br>• Repayment ability | • Eligibility<br>• Collateral<br>• Credit<br>• Financial condition<br>• Business plan<br>• Cash flow |

## Appendix E
(*Continued*)

## Comparison of ARLF to Out-of-State Lending Programs

| | ARLF | Hawaii | Maine | Connecticut |
|---|---|---|---|---|
| **Collateral Requirements** | • 75% loan to collateral ratio, minus any lien<br>• Loans exceeding $500,000 must be secured by first mortgage | • 85% loan to collateral ratio<br>• Independent appraisal of real estate<br>• 3rd or 4th mortgage as primary security for assets with limited life | • 91% to 100% loan to collateral ratio<br>• Mortgage or security interest in real estate, building, or personal property of business<br>• Loans exceeding $250,000 need real estate evaluation<br>• Loans exceeding $1 million must have independent appraisal on real estate<br>• Registered with the state<br>• Owned by borrower | • 80% loan to collateral ratio<br>• No livestock or personal items<br>• First lien position or personal real estate guarantee with second position |
| **Collateral Inspections** | Performed based on the loan officer availability | Properties inspected twice a year | Performed if a problem arises | None performed; however, all farms go through state agricultural inspections |
| **Collateral Value Assessment** | Relies on borrowers' reported value or internal evaluations | Internal evaluations and independent appraisals | Internal evaluations and independent appraisals | Independent appraisals |
| **Personal Guarantees or Co-signers** | At the discretion of the Board of Agriculture and Conservation | Required for individuals and shareholders with 25% or more ownership | Required for:<br>• Individuals and shareholders with more than 20% ownership<br>• Shareholders with 5% ownership receiving a regular annual salary | Required for individuals and shareholders with 10% or more ownership |
| **Loan Processing Costs** | $50 application fee and some direct costs | $100 for legal fees and direct appraisal costs | 1% origination fee | $2,000 to $3,000 for legal closing costs |
| **Average Default Rate** | 1.8% | 1% | 1% | 1 of 9 loans in default |
| **Lending Software** | No | No | Yes | Yes |

THE STATE
of ALASKA
GOVERNOR SEAN PARNELL

**Department of Natural Resources**

Office of the Commissioner
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September 11, 2013

Ms. Kris Curtis, Legislative Auditor
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

RECEIVED
SEP 1 2 2013
LEGISLATIVE AUDIT

Dear Ms. Curtis:

The Department of Natural Resources (DNR) received your preliminary report regarding the Agricultural Revolving Loan Fund (ARLF) and appreciates the opportunity to provide comments. The following provides background information regarding how and why the Board of Agriculture & Conservation (BAC) performs their functions. You will also find DNR's comments in relation to the preliminary report's Conclusions, Findings and Recommendations.

In summary, we disagree with the report's fundamental conclusion that current administrative practices will necessarily harm the health of the ARLF. While it is true that the fund's value has decreased significantly since its inception, we believe that the fund has performed well over the last five years. Our records show that the ARLF net balance (fund equity) has seen steady growth over the past 5 years, from a balance of \$21,598,249 on June 30th, 2008, to \$22,864,474 on June 30th, 2012—an increase of \$1,254,187 to the fund or 5.7% growth.

The report identifies a number of areas where improvements can be made to the administration of ARLF, and we agree with most of those recommendations. But we caution that to simply move ARLF to another agency will not by itself cause all the stated shortcomings of the ARLF's administration to be cured. We believe that most of those improvements to ARLF can be made regardless of which agency is responsible for its administration. Further, it is important to note that many findings related to administrative deficiencies occurred well in the past and not within the 5 year period as outlined in the scope of the audit—"*ARLF's administration and decision making processes from FY09 through February 2013.*"

The other fundamental finding in the report is that the Board of Agriculture and Conservation is not the appropriate mechanism to make loan decisions, and to ultimately control the ARLF. This is, in our view, the single biggest issue raised by this report, and will need careful deliberation by Alaska's agricultural industry, the administration, and the legislature. The current structure of the BAC and its management of the ARLF is perhaps unique in Alaska, and maybe the nation, but it was designed so for a purpose—to promote the more rapid development of agriculture as an industry throughout the state. We should exercise caution before making significant changes to this system, especially as we believe that the ARLF has been performing well in recent history.

**Background:**

The purpose of the audit was to evaluate the performance of the ARLF's loan portfolio, identify the duties performed by DNR employees in the administration of the ARLF, identify areas for efficiencies, determine whether DNR should continue to administer ARLF, compare ARLF's program structure to other Alaska and non-Alaska governmental lending programs, and whether inherent conflicts with respect to the board exist. The audit evaluated fund performance over the fund's life, from ARLF's inception in 1953 to present. During this timeframe, fifteen administrations have come in and out of office (20 Directors or Acting Directors), each of which placed different priorities on the importance of agriculture in Alaska.

During the Jay Hammond administration, much focus was placed on agriculture and the Alaska Agricultural Action Council (AAAC) was created by Chapter 75, SLA 1979, First Session, and Eleventh Alaska Legislature. The effective life of the council was from July 1, 1979 to July 1, 1984. Alaska Statute 44.33 was amended to reflect the legislation, which mandated the council report to the legislature before January 15th of each year per AS 44.33.425(a). The report was to contain recommendations for the development of agriculture in the state during the next fiscal year. The council was composed of three state and two private sector members, each appointed by the Governor. The council was chaired by the Special Projects Coordinator in the Office of the Governor, located within but independent of the Department of Commerce and Economic Development (DCED). The AAAC's powers were broad, but in effect, became the agency for new, large-scale agricultural development and innovative technology. The AAAC oversaw the development of the large scale agriculture projects – Pt. MacKenzie, Delta I and Delta II. When projects faced substantial financial difficulties, the agriculture loans were moved from AAAC/DCED to the Division of Agriculture (DoAg), ARLF. ARLF was left with contractual and financial commitments including collection, write-off and general management of those loans.

In 1998, the legislature once again took a renewed interest in the operations and budget of the DoAg and mandated a shift in focus. From 1998-2000, DNR worked with the Legislature to establish the Board of Agriculture and Conservation (BAC) (AS 03.09.010). From the implementation of BAC in 2000 through 2002, DNR assisted the newly appointed BAC to become fully functioning as directed by the Legislature.[1] The responsibility of the BAC is to "*Promote the more rapid development of agriculture as an industry throughout the state by means of long-term low-interest loans* (AS 03.10.010)."

Over the past five years, Alaska has followed the national trend and seen an increased interest in local agriculture. Farmers Markets have blossomed throughout the state, as consumers have an increased interest in knowing where and who produces their food. This interest has been seen in the legislature as well. Several bills relating to agriculture were introduced early in the 2013 legislative session, including HB40, which allows municipalities to exempt qualifying food storage or processing structures to facilitate reduction of operational costs for farmers, and HCR1, which calls on the Governor to establish a state food resource development working group to bring together representatives from state departments to set

[1] DNR Response to Legislation Audit Control #10-30017-03 dated January 8, 2003

policies to build a strong, sustainable and local healthy food system; both were passed and signed by the Governor on June 28, 2013. Late in the 2013 legislative session, HB 207 was also introduced, which merges the responsibilities and functions of two existing boards—the BAC and the Natural Resources Conservation and Development Board (NRCDB)—into a new Board of Agriculture, Conservation and Development and transfers to the Department of Commerce, Community, and Economic Development the authority to approve loans from the ARLF.

**DNR Response to Report Conclusions:**

ARLF's fiscal condition is the result of agricultural policy decisions made over the past years by executive and legislative branches of government. Many lending and management decisions were made in favor of supporting the agricultural industry over maintaining the fund's fiscal health.

DNR agrees that there have been decisions made over the lifetime of the fund that did negatively affect the overall fiscal health of ARLF, and as the report recognizes, some decisions were beyond the control of DNR or even the BAC.

The Board's statutory directive is to promote the more rapid development of agriculture as an industry in Alaska by means of long-term low-interest loans, which is fundamentally different from the directive of other lending institutions. The BAC, consisting of industry representatives and financial experts,[2] understands the importance of a healthy loan fund and its importance to the agriculture community. It is important to note that ARLF continues to revolve with no additional capitalization since 1986, and DNR maintains that over the past few years, ARLF has been managed more effectively. DNR understands and agrees that there may be administrative processes that can be improved but would also like to point out that the ARLF is unique in that it was established for use to promote agriculture as an industry. Therefore, the legislature and the executive branch need to carefully deliberate over the BAC and its management of the ARLF and how moving management of the ARLF will impact the development of agriculture as an industry throughout the state.

ARLF's equity has declined 69 percent over the life of the fund.

DNR agrees that ARLF's equity has declined 69 percent over the life of the fund. As the audit noted, ARLF has been funded with approximately $71 million since its creation in 1953. Certain actions, outside of ARLF's control pulled $41 million from the fund between 1980 and 2007, which contributed to the large equity decline. However, we believe that the fund equity has seen a steady increase in value over the past 5 years and the fund has continued its ability to revolve with no additional capitalization since 1986.

ARLF default rates were similar to other lending programs.

DNR agrees with this conclusion.

[2] The current board membership includes two members with finance backgrounds who provide additional financial assistance in loan decisions. The member having general business or financial experience has an accounting background and the member who is part of a statewide agriculture promotion organization is in the banking industry and also has an accounting background. Both are also active in the farming community.

Deficiencies were found in ARLF administration.

We address the specific points below.

*Loan Evaluation and Approval Processes*

Loan collateral values were not independently verified prior to approving loans.

DNR recognizes that there is some benefit in having collateral verified, and agrees that past loan files did not have adequate documentation and that better file documentation showing an independent verification of collateral values by the loan officer was needed. We have corrected this issue, and we maintain that the current ARLF loan officer has the expertise and tools available to verify loan collateral values.

Current statutes and regulations do not require a third party appraisal unless a borrower is requesting a loan to purchase property. Third party appraisals are generally not required because there are very few appraisers who have expertise in farm equipment or farm property. Collateral values are independently verified by the ARLF loan officer using researched comparables on source materials for farm equipment found both online and in book editions (also used by the Farm Service Agency), borough tax assessments, invoices, and Broker's Opinions of values. In the past, staff expertise has also been used to evaluate collateral.

Personal property was accepted as loan collateral.

The use of personal property is allowed by regulation. The applicant needs to provide on the application, per 11 AAC 39.101 (a)(5), a list of collateral intended to secure the loan.

In conversations with Division of Legislative Audit, it is our understanding that this finding is a result of a single case where an applicant listed a personal computer as collateral. Over the past five years, DNR and the board have worked to better provide the ARLF loan staff with guidelines on collateral. However, DNR recognizes that improvements may be made and that collection of collateral should be enforced.

Corporate and limited liability company borrowers were not consistently required to provide personal guarantees as individual loan co-signers.

The regulations do not require personal guarantees; however, the regulations give the board discretion to require a personal guarantee. See 11 AAC 39.231 (e). The notion of requiring a personal guarantee was discussed at a previous BAC meeting; however, after advisement from the Assistant Attorney General at the Department of Law, it was determined to be in ARLF's best interest to continue allowing the board discretion as to when a personal guarantee is required because not every loan requires a personal guarantee. Some basic parameters for when the BAC would want to require personal guarantees have also been discussed in the past and both DNR and the BAC have discussed the need for regulation updates; however, both also recognize the need to allow the Board some flexibility in its determinations in order to fulfill its mission.

The restructured loan amount increased beyond the amount allowed by regulations.

DNR believes this is in reference to one loan, in which a loan was refinanced in 2009 at a lower interest rate for an amount greater than the loan balance. This is not a typical event and we agree that there is no documentation in the file for why this occurred. DNR recognizes that there may be some improvement in its internal processes and has undergone an effort to provide better documentation in existing and future case files.

However, the BAC is allowed to approve loans if restructuring the loan is expected to increase return to the state (AS 03.10.033 and 11 AAC 39.660 (b)(3)). It is general lending practice by financial institutions to consider the value of the collateral at the time of restructure or refinance, and the BAC follows this practice to the best of its ability.

Additional loans were given to borrowers who experienced substantial financial losses and had difficulty meeting prior loan obligations.

DNR agrees with the conclusion that additional loans were given despite difficulty meeting prior loan obligations, but board minutes reflect that the board found reasonable cause for approving the loan, which is allowed in regulation (11 AAC 39.940). In this one case, existing dairy farmers were in a position to dump milk, and providing a loan to Valley Dairy appeared to be the only viable option.

New loans were given to borrowers without consideration of prior ARLF loan defaults.

DNR disagrees with this conclusion. The BAC does in fact consider prior ARLF history in making their decisions, but often they must also take into account broader issues related to the overall health of the agricultural industry. For example, in 2007, Governor Palin gave the BAC the mandate to assist the struggling dairy industry. The new board, tasked with a difficult job, followed all statutes and regulations and approved loans that may have helped prevent the total collapse of the dairy industry. A Department of Law attorney attended all meetings and provided legal advice to the board.

Short term loans were restructured into new short term loans to inappropriately extend loan terms beyond the statutory time limit.

The BAC relied on the legal advice provided by the Department of Law attorney. The statute authorizing short term loan extensions (AS 03.10.030) appears to allow these extensions. However, after the extensions were authorized, the attorney researched the legislative history and provided the board with a memo discouraging such restructuring in the future except in exceptional circumstances.

*Property Management*

Asset & loan collateral was not regularly inspected.

ARLF's collateral inspection is similar to other state loan programs (e.g., Commercial Fishing Revolving Loan), in that an inspection is performed in the case of default or if another problem arises. Although assets are not inspected regularly due to limited resources, farm visits are performed when staff is in the area and assets and loan collateral are then inspected.

Repossessed property was not properly maintained which resulted in unnecessary and preventable property deterioration.

DNR disagrees with the generality of this statement and is aware of only one property in which this occurred. This incident occurred well outside the timeline of the scope of the audit as the property was sold in 2006.

Business properties lacked sufficient oversight.

DNR disagrees with the generality of this statement. The DoAg continues to actively manage Mt. McKinley Meat & Sausage (MMM&S). DoAg provides a Production Manager at the facility, who reports on inventory, animals processed, and prices set for product on a monthly basis. In addition, DNR's Support Services Division (SSD) also provides monthly financial reports on the ARLF and updates the BAC at each meeting.

Although the Alaska Farm Cooperative (AFC) is an asset of ARLF, neither the BAC nor DNR is responsible for its day-to-day business operations. In 1993, a bankruptcy reorganization plan was submitted and approved in bankruptcy court, which established the lease amount and terms of the lease. Continued operation was a stipulation of the approved plan and subsequent lease, and if operations cease the lease agreement becomes void at the end of the calendar year.

The lease terms for the Umnak slaughter facility are also reviewed by the board every five years.

Lease rates provided little return on investment.

Again, this statement appears to apply to only one situation—the AFC. DNR agrees that the rental of the AFC brings minimal yearly return to the state, but the rental contract was the result of a settlement of state court litigation (Case No. 4FA-91-956 Civil) and a Chapter 11 bankruptcy workout between the debtor and the Department of Law (Case No. 92-00878). The terms of the settlement were submitted to the bankruptcy court for approval and the debtor's bankruptcy reorganization plan was approved on June 16, 1993. The settlement resulted in resolution of the state court action, and enabled the debtor to remain in business so that it could continue to provide goods and services to agricultural businesses in the Fairbanks area.

Real Estate property and cash were given to a contractor with no oversight over contract performance which resulted in a loss to the fund in property and cash.

We believe this is in reference to the historic Matanuska Maid cannery/creamery, whose disposal resulted from an agreement that was worked through the Department of Law. We have limited information on this transaction as it happened prior to the tenure of the current Director of DoAg. It was determined to be in the best interest of the state to transfer the property to a party who would restore and preserve it, due to its historical significance. The cash payment was to mitigate potential contamination issues of the property.

The financial status of one significant ARLF asset was unknown because neither financial nor operating information about the business property asset was requested by DoAg or BAC in the last five years.

DNR believes this statement is in regards to the AFC. There is no reason for either the DoAg or the BAC to request this financial information from the AFC. As stated earlier, a bankruptcy reorganization plan established the lease amount and terms of the lease and so long as AFC remained in operation, the lease agreement stands. The AFC has continued to operate for the past 20 years.

*Loan Management*

The required property insurance for collateral expired and no follow up was performed by DoAg.

DNR agrees that insurance had expired on collateral in **one** file and has corrected the deficiency. DoAg is looking to develop a tickler system to assure appropriate checks are in place in an attempt to keep track of property insurance for collateral.

Loan collateral was sold by a borrower without BAC approval and no follow up was performed by DoAg staff for five years.

The property in question was never sold but was in an Owner Finance Agreement which was relinquished. The loan officer did inform the borrower that he could not sell his property without paying off his loan with ARLF and that it would be a violation of loan terms to enter into a contract for sale or lease with option to purchase at an interest rate and payment amount higher than their ARLF loan. Although there was no follow up throughout the five year period, the borrower continued to make direct payments on their loan and therefore it did not become an issue. However, once the loan officer realized that they were in default of their loan due to a "Contract Sale Agreement" and "Memorandum of Grant of Right to Purchase," the loan officer contacted both the borrower and the buyer to remedy the situation. As a result, the buyer recorded a Quit Claim Deed which released his interest in the property.

ARLF annually loses approximately $118,000 from its Mt. McKinley Meat & Sausage (MMM&S) investment.

DNR agrees with this statement, but believes the continued operation and state subsidy of MMM&S provides benefits to the agricultural industry that must be taken into account. Even with the $118,000 annual subsidy to MMM&S, the ARLF has been able to maintain itself and increase its value over the last several years.

After multiple meetings with industry, DNR and the BAC determined it an important asset of the agriculture industry and continues to subsidize the loss through the ARLF. With only 3 USDA slaughter facilities on the road system in Alaska, MMM&S provides a vital service to livestock producers in south central Alaska and serves industry from Homer, to Kenny Lake to Talkeetna. USDA slaughter facilities provide the necessary USDA stamp to move quality product into commerce and there are only three USDA slaughter facilities on the road system in Alaska. This facility serves: 4-H/FFA students who raise project animals each year that are then sold at local fairs, small scale producers as well as Alaskan residents who raise their own animals for family consumption.

This slaughter facility also serves as a training opportunity for inmates, teaching skills from meat cutting, inventory tracking, to basic job skills. Boxed meats are purchased by this facility and processed to provide additional training opportunities to inmates, meet demand of institutional orders, and help reduce losses. Inmates are provided letters of reference upon release, if they have learned and/or demonstrated positive job skills.

We continue to look for efficiencies to minimize the cost to the ARLF and the BAC, DoAg, DNR and members of the agricultural industry have discussed the future of MMM&S at length on many occasions and how to minimize negative impacts on the agricultural industry. DoAg has initiated three Requests for Proposals (RFP's) in 2000, 2002 and 2006 to facilitate transferring the facility from State ownership to private or Cooperative ownership. Each of these disposal attempts required the new owner(s) to keep the kill floor open and accept all healthy Alaskan livestock for slaughter. Past disposal offerings have included purchase, lease or lease to purchase options. No acceptable offers have been tendered to the BAC with such use conditions. Subsequent to the 2006 RFP offering, the BAC reiterated its open door policy to proposals offered for management and/or purchase of MMM&S.

Personal services for ARLF administration were not fully recorded as ARLF expenditures.

DNR agrees with this conclusion but believes that the Administrative Officer I position only spends 5-10% of their time on ARLF duties and not the 30-40% as reported in Attachment C.

Staff from both the DoAg and the Support Services Division work on a variety of programs within their divisions that experience duty overlap, and DNR does not believe it would be cost effective or efficient to separate out time spent when duties overlap from program to program in this situation. There are other personnel that are not listed in Attachment C who also support ARLF but absorb that as part of their regular duties. For example, there are additional personnel in the Support Services Section of DNR who work on financial statements and revenue and billing accounts' management reconciliation for the entire department, which include ARLF accounts. The time spent on these activities is not tracked separately and it would likely cost more to determine how much time was actually spent on particular activities than the cost of providing that support.

Inefficiencies were identified in ARLF's administration.

> The $50 application fee charged to ARLF borrowers is not sufficient to cover the cost associated with processing and closing loans even though regulations require borrowers pay all costs for processing and closing loans.
>
> DNR agrees that the $50 application fee does not cover the cost of personnel, although borrowers do pay any additional costs associated with closing a loan. The application fee is outlined in regulation and a fee increase would require a regulation change.
>
> ARLF administrators do not use an automated lending system for loan processing, monitoring and reporting. The current loan filing and reporting system is archaic and inefficient. Files

lacked documentation to adequately support the loan application evaluation process. Furthermore, DNR's payment receipting system cannot provide historical default and delinquency data.

DNR does not use an automated lending system for loan processing, monitoring, and reporting and we recognize that some loan files have lacked appropriate documentation in the past. DNR implemented an online application system in 2008 to better facilitate proper documentation. DNR has also implemented new policies, has seen an improvement in files, and continues to look for ways to improve.

DNR's payment receipting system does have the ability to provide historical default and delinquency data, with additional programming. DNR is looking at potential methods for improving and better integrating internal processes.

Duties are not properly segregated in ARLF's payment receipt process.

Due to the size of the division, complete segregation to separate employees of payment receipt and depositing duties within the DoAg is difficult, although policies are in place to provide as much segregation as possible. We are taking this recommendation under advisement.

ARLF administrators have not obtained USDA FSA loan guarantees for ARLF loans to mitigate potential loan losses. In accordance with the federal regulation, ARLF is eligible for USDA FSA loan guarantees.

DNR agrees that that the BAC has not obtained FSA loan guarantees on any ARLF loans to date. ARLF is an approved lender eligible for loan guarantees; however, to the best of our knowledge, attempts to apply for a loan guarantee have been unsuccessful. Although FSA loan guarantees will guarantee up to 90% of eligible loans, this is contingent on federal funds being available and the guarantee is limited and not all borrowers qualify. In addition, short term loans and processors or processing facilities are not eligible for the loan guarantee program. We agree that mitigation of potential loan losses is something that may need to be further explored and we will continue to explore FSA loan guarantee options; however, loan guarantees are not currently required either in statute or regulation.

ARLF regulations contribute to poor performance.

DNR disagrees with this conclusion. The audit concluded in the middle of page 14, that the ARLF's default rates over the past five years were reasonable when compared to other agricultural loan programs. Further, the past 5 years have seen in increase in the fund portfolio.

DNR does agree that the ARLF regulations should be revised to promote industry best practices, but still allow the board the needed flexibility to serve the agriculture industry.

There are inherent conflicts with respect to BAC members approving loans.

DNR agrees with this conclusion but believes the current structure of the board provides benefit to the agriculture industry. The seven member board, comprised of 4 agriculture producers, 1 soil and water conservation district member, 1 business or financial person, and 1 state-wide agriculture promotion seat is laid out in statute (AS 03.10.050(b)). Although the board structure may be somewhat unique, it was designed for the purpose of promoting the more rapid development of agriculture as an industry throughout the state.

Auditors did note that Board members have appropriately recused themselves when a conflict did arise. The Department of Law also has an attorney attend each meeting.

Boards similar to BAC are not commonly utilized for approving loans.

DNR agrees with this conclusion but it is more important to note that two of the six agricultural lenders, against which the ARLF was compared, have similarly structured boards—the Alaska Rural Rehabilitation Corporation (ARRC) and the State of Hawaii agricultural loan program. Although the audit states that the two programs differ from BAC by having a more balanced membership, we believe that board members with agricultural expertise benefit both the agriculture community and the loan programs with their personal knowledge of markets, production, and costs.

Transferring ARLF administration to DCCED's DED may improve efficiency and effectiveness.

DNR believes that improvements to ARLF can be made regardless of which agency is responsible for its administration; however, we again caution that to simply move ARLF to another agency will not by itself fix all the stated shortcomings of the ARLF's administration. DNR is interested in improving efficiency and effectiveness of the ARLF for the benefit of the agriculture community and will use this audit's recommendations.

> DED already administers 13 state loan programs. ARLF would benefit from economies of scale offered by DED which could improve the efficiency of lending and collections. While it is difficult to estimate the actual costs associated with transferring ARLF, the incremental costs of adding ARLF to other DED lending programs would likely be less than the annual administrative costs of approximately $385,000 incurred by DoAg.
>
> DNR understands that a detailed comparison between the two agencies has not been studied. The ARLF has five employees in the component; DCCED's loan programs have 41. It should be noted that the lion's share of the administrative costs incurred by DoAg are operational costs necessary to keep the MMM&S open, which is a vital service to the agriculture industry.
>
> DED uses an automated loan program for loan accounting and servicing that may improve ARLF's operation and efficiency.
>
> DNR agrees that an automated system would benefit loan fund administrators and may be beneficial to some of our borrowers and we do provide application forms that can be filed electronically. This is an area where there is an opportunity for DNR to improve its internal processes to improve ARLF's operation and efficiency.
>
> ARLF would benefit from DED's lending expertise including uniform loan evaluations and processing procedures that may result in less defaults and write-offs as well as potentially decrease the severity of loan losses.
>
> DNR agrees that ARLF may benefit from DED's lending expertise. However, the preliminary report recognizes that "ARLF's default rates for the last five years are reasonable when compared

to other agricultural loan programs" and also identifies a number of areas where improvements can be made in administering ARLF. We believe that many of the improvements to ARLF can be made regardless of which agency is responsible for the administration.

Transferring administration from DoAg may include the following challenges.

DED does not have experience with agriculture. However, agriculture related questions can be directed to DoAg similarly to DED administers its other lending programs. Furthermore, DED loans and collections officers are accustomed to working with specialized loan programs experiencing wide economic fluctuations and secured by atypical collateral.

DNR agrees with this conclusion. However, the BAC has experience that is not replicated in the Division of Agriculture. The BAC is comprised of producers actively involved in Alaskan agriculture and who have direct knowledge of how farms operate and the risks associated with the many variables. While the Division of Agriculture works closely with the agriculture community, staff is not involved in the day-to-day business of production agriculture.

DED currently does not have an office in the Matanuska Valley where 60 percent of the current ARLF borrowers are located. Thus, new loan applicants and existing borrowers would have to become familiar with different personnel, lending practices, and office locations.

DNR agrees with this conclusion.

**DNR Response to Findings and Recommendations:**

**Recommendation No. 1:** The legislature should consider moving ARLF's administration to DCCED's DED.

DNR believes that most of the recommendations to improve ARLF's performance and administration can be realized no matter which agency is responsible for the administration of ARLF. But the fundamental issue here is the unique role of the BAC in providing loan support to the state's agricultural industry. The BAC's directive of promoting and encouraging Alaska's agricultural industry, while maintaining the fund's fiscal health, is challenging.

Decisions to subsidize MMM&S and maintain the lease with AFC may not bring immediate return to the ARLF but provide long term benefit to the state including increased food security, social benefits provided by working farms, and economic benefit to communities in which they are located.

DNR disagrees with the following assertion on page 23 that "*if the deficiencies described in this report persist, ARLF's equity may continue to decline, and the fund's ability to promote agricultural development through long-term low-interest loans may diminish.*" Over the past five years, DNR and the board have worked diligently to implement policies that incorporate best practices and have provided the ARLF loan staff with guidelines on collateral verification. The board structure currently includes two members with finance backgrounds (accountant & banker), who provide additional financial expertise. The remaining five members have specific farm sector involvement and commercial agriculture production experience. The current ARLF loan officer also brings years of private sector loan experience.

All of the above have played a fundamental role in the current health of the ARLF program. During this time frame, the ARLF net balance has seen steady growth, from a balance of $21,598,249 on June 30, 2008, to $22,864,474 on June 30, 2012; showing an increase of $1,254,187 to the fund. In addition, we recognize many of the deficiencies outlined in this report, and have worked, or are working to correct them to further improve ARLF's performance.

**Recommendation No. 2:** ARLF administrators should revise ARLF's regulations to promote industry best practices.

DNR agrees that the ARLF regulations should be revised to promote industry best practices, but still provide the board with the needed flexibility to serve the agriculture industry as mandated in statute. DNR and the BAC have been discussing potential changes to regulations that may help improve management of the ARLF.

**Recommendation No. 3:** ARLF administrators should pursue the disposal of business properties and revise property leasing rates to provide a return on ARLF assets.

DNR agrees with the recommendation to pursue disposal of business properties. But as discussed earlier in this letter, disposal of these properties is easier said than done, and could have severe ramifications on the agriculture industry.

**DNR Comments to Attachments A – E:**

Attachment A

The information provided for FY13 is only through February 18, 2013, as noted in the footnote. As of June 30, 2013, the number of delinquent loans is 2 – (1 short term and 1 Farm development) and the defaulted loan status is 4 (1 short term, 2 chattel, and 1 farm development).

Attachment B

DNR agrees with attachment

Attachment C

DNR understands that the percentage of employee time spent working on ARLF is based on conversations with staff and assessment of duties according to the job description. However, the Division asserts that the Administrative Officer I position only spends 5-10% of time working on ARLF.

Attachment D and E

DNR would like to clarify the information presented in this attachment.

- *Collateral Requirements* under ARLF regulations allow the use of tax assessment statements or appraisals for real estate.
- *Collateral Inspections* are performed in case of default or other significant problem, not only based on loan officer availability.

- *Collateral Value Assessment is* based on internal evaluations, borrower's evaluations, and independent appraisals.
- *Personal Guarantees* are not required per regulation.

DNR would like to reiterate that the Board's statutory directive is to encourage and promote agriculture in Alaska by means of long-term low-interest loans, which is fundamentally different from the directive of other lending institutions. The BAC, whose current membership consists of industry representatives and financial experts, understands the importance of a healthy loan fund and its importance to the agriculture community. We would like to reiterate that ARLF continues to revolve with no additional capitalization since 1986 and DNR maintains that over the past few years, ALRF has been managed more effectively. DNR understands that there may be administrative processes than can be improved but would like to point out that ARLF is unique in that it was established specifically to promote agriculture as an industry.

DNR appreciates the opportunity to respond and looks forward to working on implementation of the improvements suggested in this report.

Sincerely,

Ed Fogels
Deputy Commissioner

CC: Franci Havemeister, Director, Division of Agriculture
Ben VanderWheele, Chair, Board of Agriculture and Conservation

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THE STATE
of ALASKA
GOVERNOR SEAN PARNELL

Department of Commerce, Community, and Economic Development

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September 11, 2013

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LEGISLATIVE AUDIT

Ms. Kris Curtis, CPA, CISA
Legislative Auditor
Alaska State Legislature
Legislative Budget and Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

RE: Preliminary Audit Report, Department of Natural Resources (DNR), Agriculture Revolving Loan Fund (ARLF) Selected Issues, June 24, 2013

Dear Ms. Curtis:

Thank you for the opportunity to respond to the auditor's conclusion and recommendation issued in the preliminary audit report regarding administration of the Agricultural Revolving Loan Fund managed by DNR. Our response to the one recommendation related to the Department of Commerce, Community, and Economic Development (DCCED) is below.

Recommendation No. 1

The Legislature should consider moving ARLF's administration to DCCED's Division of Economic Development (DED).

Although this audit recommendation is directed at the legislature, DCCED appreciates the opportunity to preview the recommendation that may affect the department. DCCED concurs that the DED has existing expertise in lending and loan servicing, and appreciates the audit comments noting the operational efficiency and effectiveness of the DED loan procedures. In addition, administering a larger number of loans has provided economies of scale benefits for the DED programs.

Also as noted in the report, DCCED does not have experience with agricultural loans, does not have an office in Matanuska Valley where 60 percent of the current ARLF borrowers are located, and does not manage businesses.

DCCED remains open to cooperative review of any options proposed by the legislative and executive branches that will benefit the state.

Again, thank you for the opportunity to respond to the preliminary audit report recommendation. If you have any additional questions, please contact me at 907-465-2500.

Regards,

Susan K Bell

Susan K. Bell
Commissioner

cc: Jo Ellen Hanrahan, Director ASD

THE STATE
of ALASKA
GOVERNOR SEAN PARNELL

**Department of Natural Resources**
**Division of Agriculture**

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September 10, 2013

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LEGISLATIVE AUDIT

Kris Curtis, CPA, CISA
Legislative Auditor
Legislative Budget and Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

Dear Ms. Curtis:

RE: Board of Agriculture and Conservation Response to Preliminary Audit Report, DNR, DoAg, ARLF, dated June 24, 2013

The Board of Agriculture and Conservation (Board) is in receipt of the above referenced report and while we appreciate your conclusions and recommendations regarding the ARLF, we respectfully present the following in response.

As referenced in your report (pg. 8) and in Alaska Administrative Code (11 AAC 39.011) the duty of the Board is to "encourage and promote the development of agriculture as an industry throughout the state." Unlike for- profit banks or lending institutions, the Board is driven by the directive to encourage and promote agriculture in Alaska. This creates several anomalies when comparing ARLF history to other agriculture lenders and industry standards.

First, in order to encourage and promote agriculture we rely heavily on the experience and expertise of agriculture producers to evaluate the feasibility of loan applications. The five producers on the ARLF Board contribute a wide breadth of experience to assist applicants with suggestions and tools for success. Inherent in this board composition is the inevitable conflict of interest possibility. Unfortunately, it is often this very conflict in which the board needs the expertise of the excused member the most.

Additionally, although overlooked in the letter, the board also has a board member in the finance seat, as required, and the state wide member of an agriculture organization is filled by a local lender. These two members bring accounting and finance expertise that the Board has not previously experienced.

All the decisions the Board makes are driven by the mission to encourage agriculture. We work diligently to support the individuals who are working to enhance agriculture in Alaska. Further, as established by state law, this Board does not operate solely at its own discretion.

ARLF Equity Decline

Several points in the letter indicate that the ARLF has had reasonable default and delinquency rates over the past 5 years. Nevertheless, the Board must operate under State of Alaska Executive and Legislative prerogatives. The Board cannot be held responsible for decisions made by past administrations and outside normal operating functions such as loans that were approved by the Alaska Agriculture Action Council, funds that were used to cover operating expenses of the division or funds appropriated back to the general fund. Fund equity has indeed declined 69% over the life of the fund but not because of poor loan administration. Although the fund has seen a decline in the past, the last five years have seen a steady growth in the fund.

Deficiencies in administration

The board concurs that many processes regarding loan management were deficient in the past. We have worked diligently to correct many of these issues. We have made needed changes in personnel and improved the application of consistent board policies. We have worked to improve loan collateral deficiencies, moved several loans to the AAG office for collection, tightened repayment schedules, and required better initial financial information on loan applications prior to board review. The auditor has indicated that the loan files for the past two years have improved. Again, the board should not be held responsible for previous actions taken.

Personnel Services not recorded

ARLF accounting is done by DNR accountants – the same ones who do the State's oil and gas accounting.

ARLF board members do not have access to detailed information regarding charges made to the fund and don't receive backup documentation. Although there is no direct billing to ARLF by the Director's office, it seems appropriate that a program housed within a division would require oversight and time from the Director. This is another area beyond the control of board members.

Inefficiencies in ARLF administration

The board will address the four points made in the letter. We are uncertain why these 4 inefficiencies warrant transferring ARLF administration to DCCED.

ARLF regulations

As stated earlier, the board has worked to apply consistent policies to like situations that come before the board. This audit attempts to "examine the fund's performance and administration and compare fund administration to other loan programs and industry best practices." (p. 13) as page 17 & 18 of the letter indicates there are a number of regulations that need clarification and interpretation. The board is trapped between complying with regulations, fulfilling our mission, and establishing appropriate policies.

Recommendation No. 1

While several of the audit findings merit changes in the way the fund operates, the board strongly disagrees with the conclusion that the fund administration should be moved to DCCED's DED. As indicated in the letter, "the deficiencies can be partially attributed to the competing priorities ..." (p.23). Further, we disagree with the conclusion that "ARLF equity will continue to decline and the fund's ability to promote agricultural development through long-term low-interest loans will diminish." The fund has seen steady growth over the last 5 years so this appears to be conjecture on the part of the auditors. The fund's senior accountant, Cristin Cowles-Brunton has stated that the fund is solvent and revolving properly. Taken collectively, the perceived deficiencies alone will not cause losses and reduction of equity to occur.

If the systems noted in the audit are currently available at other state agencies, what is prohibiting the ARLF from utilizing those systems to improve fund performance and assist our loan officer? Transferring lending duties to a department unfamiliar with agricultural lending or processes is not in the best interest of the agricultural industry.

Moving the fund will not insulate it from administrative actions that have had such a negative impact on fund equity. Further, we are uncertain how transferring the fund will reduce expenses to either the fund or the state.

Recommendation No. 2

The board concurs that ARLF regulations should be reviewed and revised. The goal of promoting agriculture and implementing industry best practices are often at odds. The board needs the flexibility to structure loans to meet borrower's needs while still protecting the assets of the fund and the interest of the State.

Recommendation No. 3

The board concurs with the recommendation to dispose of foreclosed assets as long as it is in the best interest of the agricultural industry in Alaska. The entire board would like to see MMM&S operated privately and continues to seek private buyers. However, if such a sale does not result in a USDA certified slaughter facility for south central Alaska, not only is the agricultural industry not being helped neither are area residents, 4-H and FFA members who require slaughter services.

We concur that lease rates should be reviewed to provide an appropriate return.

The Board of Agriculture and Conservation members take their responsibility very seriously and work to promote agriculture by offering low-cost loans to residents engaged in viable agriculture ventures. The fund should be evaluated based on its purpose, not according to industry lending standards and financial return to the State of Alaska. The ARLF provides a critical link in the promotion of agriculture, expansion of self-sufficiency, and food safety for Alaskans.

Sincerely,

Ben VanderWeele

Ben VanderWeele
Chair
Board of Agriculture and Conservation

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# ALASKA STATE LEGISLATURE
## LEGISLATIVE BUDGET AND AUDIT COMMITTEE
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October 4, 2013

Members of the Legislative Budget
and Audit Committee:

We have reviewed the Department of Natural Resources (DNR) and the Board of Agriculture and Conservation (BAC) managements' responses to the audit report. Nothing contained in the responses causes us to revise or reconsider the report conclusions and recommendations. However, there are points raised in DNR's response that we wish to clarify or address.

In DNR's response, DNR states that ARLF's fund equity has "*seen steady growth*" over the past five years, and the growth indicates good fund performance. We disagree. While the fund equity did increase from FY 08 to FY 12, the cause of the increase was a recovery of the fund's investment in the Matanuska Maid Dairy which resulted in an increase in fund equity of approximately $2.2 million in FY 10. Excluding the recovery in FY 10, fund equity decreased over the five-year period.

DNR's response states that regulations do not allow for certain fiscal improvements. We note that DNR is the entity responsible for changing regulations. Again, we emphasize that ARLF regulations should be changed to incorporate industry best practices in a number of areas including the following.

- Regulations do not address the types of personal property that may be accepted as collateral, nor do regulations require verification of collateral values offered by borrowers.

- ARLF regulations do not provide guidance as to whether loans should be made to borrowers with poor credit history. Regulations should provide clear and basic guidance regarding the process of approving or denying loans. Additionally, the loan documents should require an evaluation of a borrower's credit history including past loans with ARLF.

- ARLF regulations do not provide guidance for establishing lease rates and terms which would help ensure a return on investments.

We also emphasize that ARLF does not have statutory authority to own business properties such as the Mount McKinley Meat and Sausage Company and the Alaska Farm Cooperative. Regardless of whether operating the businesses supports the agricultural industry, ARLF lacks statutory authority to own the businesses. Disposal of these business properties should be actively pursued.

In summary, we reaffirm the audit report conclusions and recommendations.

Sincerely,

Kris Curtis, CPA, CISA
Legislative Auditor