United States General Accounting Office

GAO

Report to the Honorable
Willis D. Gradison, Jr., House of
Representatives

January 1989

BORROWER LOAN PREPAYMENTS

OMB Guidelines Need to Be Strengthened

GAO/AFMD-89-19

About Our New Cover...

The new color of our report covers represents the latest step in GAO's efforts to improve the presentation of our reports.

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-229574

January 11, 1989

The Honorable Willis D. Gradison, Jr.
House of Representatives

Dear Mr. Gradison:

In response to your request, we evaluated several aspects of loan prepayment programs the administration carried out during fiscal year 1987 to allow borrowers to pay off their loans at less than the amounts owed. This report addresses the statutory authority for and financial issues related to five of these programs. It also discusses the guidelines the Office of Management and Budget (OMB) provided to agencies for these programs.

Our review showed that, for the programs we reviewed, the agencies had the statutory authority to allow borrowers to pay off their loans at less than unpaid principal balances. We found that loan prepayment costs generally exceeded benefits and that nonmonetary credit reform objectives were better achieved through loan asset sales than through borrower prepayment programs. We also concluded that loan prepayments will not reduce the structural budget deficit. OMB guidelines focused on loan sale issues and did not cover key financial considerations of borrower prepayment programs.

As agreed with your office, we obtained comments from OMB on a draft of our report and have incorporated these comments into the report where appropriate. Unless you announce the contents of the report earlier, we will not distribute it until 30 days after the publication date. At that time, we will send copies to the Director, Office of Management and Budget; the Secretaries of Education, Housing and Urban Development, and Agriculture; the Administrator of the Small Business Administration; and other interested parties. Copies will also be made available to others on request.

This report was prepared under the direction of Jeffrey C. Steinhoff, Associate Director. Other major contributors are listed in appendix V.

Sincerely yours,

Frederick D. Wolf
Director

Executive Summary

Purpose

The President's fiscal year 1987 budget request put forth several credit management reform initiatives that introduced to federal loan portfolio managers two credit management tools—loan asset sales and borrower loan prepayments. In a February 1988 report entitled, Loan Asset Sales: An Assessment of Selected Sales, GAO evaluated the use of loan asset sales as a credit management tool. The present report responds to questions raised by Congressman Willis D. Gradison, Jr., regarding selected fiscal year 1987 loan prepayment programs.

In this review, GAO analyzed the results of five fiscal year 1987 borrower loan prepayment programs by (1) determining the legal authority for the programs, (2) determining program costs and benefits, (3) determining and evaluating the differences in financial results between prepayment programs and collateralized loan sales for two loan portfolios, (4) determining and evaluating the ability of loan prepayment programs to achieve the administration's credit reform objectives, and (5) assessing the adequacy of the Office of Management and Budget's (OMB) prepayment guidelines.

Background

In January 1986, the administration implemented a pilot sale of federal loan assets. In July 1986, OMB issued its loan asset sale guidelines, which set the credit management reform goals for the pilot program and included specific requirements for agencies to meet in conducting loan sales. OMB's guidelines also authorized prepayments if they would yield higher net proceeds than loan sales.

During fiscal year 1987, several federal agencies consummated borrower loan prepayment programs with an aggregate unpaid principal balance of $3.7 billion and yielded $3 billion in net prepayment proceeds. Under two programs, borrowers prepaid their loans at the unpaid principal balances—$1.9 billion. For the remaining programs, borrowers prepaid their loans at less than the unpaid principal balances. Specifically, loans with an aggregate unpaid principal balance of $1.8 billion yielded $1.1 billion in net prepayment proceeds. In these cases, the agencies gave up the federal government's financial right to recover the full amount loaned to borrowers. It is a long-standing legal principle that no U.S. government officer can give up a government financial right unless there is statutory authority to do so or the government receives a compensating benefit. This legal principle was discussed in a July 1987 Comptroller General decision regarding a proposal to modify the terms of Federal Financing Bank (FFB) loans to foreign governments under the

Foreign Military Sales (FMS) program. Congressman Gradison was particularly interested in the applicability of this principle to borrower loan prepayments.

Results in Brief

GAO's review determined that fiscal year 1987 loan prepayment programs had statutory authority to accept prepayments at less than unpaid principal balances. In some cases, prepayment program costs exceeded their financial benefits. Loan prepayments were not as effective as loan asset sales in achieving the government's nonfinancial credit reform goals, such as improving loan documentation. Prepayments did avoid the transaction costs associated with asset sales, but their yields were not totally comparable with those of the loan asset sales because of the nature of the loan portfolios involved. GAO also found that net proceeds from the prepayment programs varied due to a lack of guidance concerning the appropriate interest rates to be used to calculate prepayment amounts. The use of Treasury rates was found to reduce losses associated with prepayment programs. GAO's review pointed to the need for more detailed OMB guidelines in this area and for a requirement that cost-benefit analyses be performed to determine when prepayments or asset sales should be used.

Principal Findings

The Five Loan Prepayments Reviewed Were Within the Law

For the five loan prepayment programs GAO reviewed, agencies had the statutory authority to accept less than the unpaid principal balances when borrowers prepaid their loans. Consequently, compensating benefits were not an issue in these transactions.

Prepayment Program Costs Generally Exceeded Benefits

For the five fiscal year 1987 prepayment programs which GAO reviewed and for which the government accepted less than the unpaid principal balances on the loans, the government generally received less in net prepayment proceeds (benefits) than the present value of future loan principal and interest payments (costs) it would have received if it had held the loans to term and collected the payments. In completing the cost-benefit analysis, GAO adjusted the payments for average portfolio default rates.

Treasury Rates Should Be Used to Determine Loan Baseline Values to the Government

The interest rates used to determine both the baseline value of the loans to the government and the loan prepayment amounts was a key factor causing costs to exceed benefits. This baseline value should be based on Treasury interest rates. If prepayments are made at the baseline value, the government sustains neither a gain nor a loss by accepting the prepayments. GAO estimated that the government lost from $51 million to $80 million in value by allowing prepayments based on commercial rather than Treasury interest rates. In both cases, these present values of future principal and interest payments were determined using the Treasury interest rate. The $51 million estimate adjusted the prepaid loans for average historic loan defaults on the portfolio. The $80 million figure assumed no defaults would have occurred on the prepaid loans.

For specific policy and program goals, Congress may specify or agencies may recommend using an interest rate higher than Treasury's interest rate for comparable securities to determine loan prepayment amounts, which will result in the government's not receiving at least the baseline value of the loans. The difference between the loans' baseline value based on Treasury rates and those amounts actually received represents the cost of the policy or program goals and should be available to management and the Congress for decision-making purposes.

Loan Prepayments Do Not Effectively Achieve Credit Objectives

Collateralized loan asset sales conducted in fiscal year 1987 appear to have achieved the administration's credit management reform objectives better than borrower loan prepayment programs. Specifically, agencies conducting loan prepayment programs primarily worked with their own staffs and were not exposed to private sector credit management policies, practices and techniques. Agencies conducting loan sales, on the other hand, had to work closely with their private sector financial advisers and underwriters. In addition, neither prepayments nor sales can accurately measure credit program subsidies.

Loan Prepayment and Loan Asset Sale Net Proceeds Are Not Comparable

Two of the five loan portfolios were involved in loan asset sales as well as prepayment programs. The two loan sales incurred about $61 million in sale costs—underwriters' fees and reserve expenses—which were no incurred in the borrower prepayment program. These sale costs were considered in determining the net sale proceeds due the government.

The loan sale and prepayment net proceeds, however, are not fully comparable. The sales involved the disposal of a package of loans, whereas the prepayments involved only a limited number of borrowers who elected to prepay their loans. They may not have the same creditworthiness as those whose loans were sold.

OMB's Guidelines Need Strengthening

OMB's loan asset sale guidelines, which were revised in March 1988, focus on the specifics of how to conduct a loan prepayment or sale. The guidelines, however, do not address methodologies for (1) determining the costs and benefits of borrower prepayment and loan sale programs, (2) choosing, on a portfolio-by-portfolio basis, between borrower prepayment and loan sale programs as the most appropriate divestiture method, and (3) determining when a loan portfolio should be held to term rather than divested. Guidance is needed in these areas to ensure that sale or prepayment decisions are made consistently across the government and that individual agency decisions yield the optimum financial and credit management reform benefits for the government.

Recommendations

GAO recommends that the Director, Office of Management and Budget, revise OMB's loan asset sale guidelines to require agencies to complete an appropriate cost-benefit analysis to determine

- what monetary and nonmonetary benefits can be received from loan asset sale and prepayment programs,
- when the government should hold loans to term or dispose of them through asset sales or prepayments, and
- which disposal method—sales or prepayments—should be used if the loans are not held to term.

Agency Comments

OMB generally concurred with the substance of GAO's analysis and stated that it is currently revising Circular A-129 to strengthen the guidelines and satisfy the requirements of GAO's recommendation for agency loan asset sale and prepayment programs. However, OMB disagreed with GAO's long-standing position on using Treasury interest rates to calculate federal credit program subsidies and on certain advantages of loan prepayment programs over loan asset sales. GAO has advocated basing federal credit program subsidy costs on Treasury interest rates because this methodology (1) yields a subsidy cost to the government which can be compared to other programs in the budget and (2) does not introduce budget costs which will never be incurred. (See appendix III for OMB's specific comments.)

Contents

Abbreviations

FFB	Federal Financing Bank
FmHA	Farmers Home Administration
FMS	Foreign Military Sales
GAO	General Accounting Office
HUD	Housing and Urban Development
OMB	Office of Management and Budget
RDIF	Rural Development Insurance Fund
SBA	Small Business Administration

Introduction

In fiscal year 1987, the administration proposed using two credit management tools—loan asset sales and borrower prepayments—to help reform credit management in the government. To date, both of these tools have been used with varying results. Our February 1988 report[1] evaluated the use of loan asset sales as a credit management tool. This report responds to questions by Congressman Willis D. Gradison, Jr., regarding five loan prepayment programs carried out during fiscal year 1987. (See appendix I.) It focuses on the statutory authority for and financial issues related to the five prepayment programs.

Congressman Gradison was particularly interested in the applicability to borrower loan prepayments of the legal principle that a United States government officer cannot give up the government's financial rights without securing an adequate compensating benefit unless specific statutory authority to give up such rights exists. This principle was discussed in a July 1987 Comptroller General decision[2] regarding a proposal to modify Federal Financing Bank (FFB) loans to foreign governments under the Foreign Military Sales (FMS) program.

Background

In January 1986, the administration proposed a pilot sale of federal loan assets to private investors as part of the President's fiscal year 1987 budget request. The goals of the proposed pilot sale were to initiate federal credit management reforms and generate budgetary receipts to help reduce the budget deficit. Congress increased proposed loan sales from the initial $1.8 billion in fiscal year 1987 to $12.6 billion for fiscal year 1988.

Under the fiscal year 1987 pilot loan sale program, the administration offered borrowers the opportunity to prepay their loans if the prepaid amount was estimated to be greater than the estimated net proceeds from selling the loan to private investors. The Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509) also authorized agencies to offer borrowers the opportunity to prepay their loans.

During fiscal year 1987, six federal agencies[3] consummated borrower loan prepayment programs. These programs involved the prepayment of

[1] Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988).

[2] Comp. Gen. Dec. B-226058, July 21, 1987.

[3] Department of Commerce, Department of Education, Department of Agriculture, Department of Housing and Urban Development, Export-Import Bank, and the Small Business Administration.

loans with an aggregate unpaid principal balance of $3.7 billion and yielded $3 billion in net prepayment proceeds. Under prepayment programs conducted by the Department of Commerce and the Export-Import Bank, borrowers prepaid these loans at the unpaid principal balances—$1.9 billion. The borrower prepayment programs consummated by the four remaining agencies allowed borrowers to prepay their loans at less than the unpaid principal balances. Specifically, under these programs, borrowers prepaid loans with an aggregate unpaid principal balance of $1.8 billion, yielding $1.1 billion in net prepayment proceeds. Details are presented in table 1.1.

Table 1.1: Fiscal Year 1987 Borrower Prepayment Programs

Dollars in millions

	Unpaid principal	Prepayment receipts
Commerce		
Economic Development Administration Loans	$12.0	$12.0
Education		
College Housing Loans	704.2	438.2
Academic Facilities Loans	87.6	60.8
Export-Import Bank Loans	1,900.0	1,900.0
Agriculture		
Rural Development Loans[a]	218.9	157.6
Rural Electrification Loans[b]	726.8	427.8
Housing and Urban Development		
Public Facility Loans	9.9	8.4
Small Business Administration		
Disaster Home Loans	4.2	3.4
Total	**$3,663.6**	**$3,008.2**

[a]Contains figures resulting from prepayments consummated in fiscal years 1987 and 1988.

[b]During fiscal year 1987, the Federal Financing Bank allowed borrowers to prepay the unpaid principal balance of $582 million on loans guaranteed by the Department of Agriculture's Rural Electrification Administration.

Source: Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988) and the Congressional Budget Office.

To support the loan asset sale program, the administration articulated its credit management reform goals and discussed how loan asset sales and prepayments would work to achieve these goals in the Office of Management and Budget's (OMB) July 1986 guidelines. We reviewed these guidelines and both testified[4] and reported[5] on our findings and our recommendations for improvement. Also, the House Committee on Small Business[6] June 1988 draft report on prepayments was considered in preparing this report. In response to our recommendations and to agencies' experiences with loan asset sales and borrower prepayment programs consummated during fiscal year 1987, OMB issued revised guidelines in March 1988. (See appendix II.) The revised guidelines reiterated the administration's credit management reform goals established in July 1986:

- Reduce the government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector.
- Provide an incentive for agencies to improve loan origination and documentation.
- Determine the actual subsidy of a federal credit program.
- Increase unified budget receipts in the year of sale.

Overall, the administration's credit management reform guidelines and initiatives focused on bringing private sector credit management techniques into the government and on transferring to the private sector the day-to-day management and administration of federal loan portfolios. The current administration contends that the private sector can carry out these functions more efficiently and effectively than the federal government. They view the generation of budgetary receipts through loan sales as an ancillary goal.

The March 1988 revised loan asset sale guidelines incorporate recommendations we made regarding the original guidelines' provisions for nonrecourse sales. They include five specific requirements regarding borrower prepayment programs:

- Only borrowers who are not individuals and who are current on their loan payments will be offered the opportunity to prepay their loans.

[4]The Government's Loan Asset Sales Pilot Program, statement by Charles A. Bowsher, Comptroller General, before the Subcommittee on Legislation and National Security, House Committee on Government Operations, September 26, 1986.

[5]Loan Asset Sales: OMB Policies Will Result In Program Objectives Not Being Fully Achieved (GAO/AFMD-86-78 and GAO/AFMD-86-79, September 25, 1986).

[6]Recent Prepayments of Federal Loans, Committee on Small Business, House of Representatives, June 1988.

- Net prepayment proceeds shall be deposited into the Treasury general fund.
- Borrower financing of loan prepayments must be done on a taxable basis.
- When borrowers discharge their loans at less than the unpaid principal balance, payment amounts shall be calculated as the present value of future loan principal and interest payments, based on an appropriate composite of Treasury interest rates adjusted for administrative expenses and possible loan losses.
- Prepayment plans and proposed pricing options shall be developed with assistance from a financial advisor and shall be submitted to Treasury and OMB for review prior to any offering.

Objectives, Scope, and Methodology

As agreed with the congressional requester, our objectives were to determine and assess

- the legal requirements and authority for borrower prepayment programs, with particular consideration of the need to obtain compensating benefits;
- prepayment program costs and benefits;
- differences in financial results between loan prepayment programs and collateralized loan sales to private investors;
- the ability of borrower loan prepayment programs to achieve the administration's credit reform objectives; and
- the adequacy of loan prepayment requirements in OMB guidelines.

In meeting our work objectives, we reviewed and evaluated five of the six borrower loan prepayment programs consummated in fiscal year 1987 that involved the prepayment of loans at less than the unpaid principal balances. Specifically, we reviewed loan prepayment programs consummated by the following agencies:

- Department of Agriculture, Farmers Home Administration (FmHA)—Rural Development Loans;
- Department of Education—Academic Facilities Loans and College Housing Loans;
- Department of Housing and Urban Development (HUD)—Public Facility Loans; and
- Small Business Administration (SBA)—Disaster Home Loans.

We did not review the sixth program, the Rural Electrification Administration, because it was not included in the request and because it is the subject of an ongoing review.

We reviewed the statutes authorizing the five prepayment programs selected for review to determine the legal requirements and authority for these programs. We reviewed agency loan files, documented loan principal and interest balances, and documented prepayment program financial results using agency financial records. We discussed prepayment program methodology and financial results with representatives from several leading private sector financial institutions and several major colleges and universities.

Our review was performed between September 1987 and April 1988. As agreed with your office, we obtained official agency comments from the Office of Management and Budget (OMB). We conducted our work in accordance with generally accepted government auditing standards.

Structure of the Report

The succeeding chapters address the legal, financial, and policy issues relating to the loan prepayment programs we reviewed.

- Chapter 2 discusses the statutory authority for loan prepayment programs selected for review.
- Chapter 3 addresses the costs and benefits of selected prepayment programs consummated in fiscal year 1987.
- Chapter 4 compares the use of loan asset sale and borrower prepayment programs as credit management reform tools.
- Chapter 5 addresses the adequacy of OMB's guidelines to agencies for conducting borrower prepayment programs.
- Chapter 6 presents our conclusions and recommendations.

Agencies Acted Within the Law When Consummating Borrower Prepayments

Agencies can only allow borrowers to pay off their loans at less than the unpaid principal balances if (1) they have specific statutory authority to do so or (2) the government receives a compensating benefit. For five prepayment programs we reviewed, agencies had statutory authority to allow borrowers to pay off their loans at less than unpaid principal balances. Consequently, the question of compensating benefits was not a legal issue for these prepayment programs.

Loan Prepayments at Less Than Unpaid Principal Generally Require Compensating Benefits

As established in prior Comptroller General decisions, no agent or officer of the United States may surrender or waive contractual rights to the financial detriment of the United States without an adequate compensating benefit, in the absence of specific statutory authority to do so.[1] In the case of loan prepayments, a compensating benefit is not a legal requirement if the agency is authorized by Congress to allow borrowers to discharge their loans at less than the unpaid principal amount owed the government. This general principle was addressed in a 1987 Comptroller General decision regarding a proposal to modify loan agreements under the government's Foreign Military Sales (FMS) program.[2] From the mid-1970s to the mid-1980s, the United States financed a number of "credit sales" of military equipment to foreign countries under the FMS program. These loans were made by the Federal Financing Bank (FFB) and repayment of these loans was guaranteed by the Defense Security Assistance Agency.

The FFB loans were made at market interest rates prevailing during the mid-1970s to the mid-1980s, which were substantially higher than current market interest rates. Several debtor nations, which now face repaying long-term loans at high interest rates, appealed to the United States Government for relief. The current administration planned to offer debtor nations two options:

- allowing borrowers to prepay the unpaid principal balance of their loans without a prepayment penalty or
- reducing the loans' high interest rates to lower market rates while converting the difference between the two interest rates to a new loan that would be due, with interest, at the maturity of the original loan.

[1] 40 Comp. Gen. 684, 688 (1961); Union National Bank vs. Weaver, 604 F.2d 543, 545 (7th Cir. 1979); and 62 Comp. Gen. 489, 490 (1983).

[2] B-226058, July 21, 1987. (See appendix IV.)

In rendering a decision on the administration's proposal to grant credit relief to debtor nations under the FMS program, the Comptroller General stated that under the terms of the loans in question the United States has a contractual right to receive repayment of the loans on a certain schedule and at a certain interest rate. In addition, promissory notes attached to the loan agreements provided that borrowers would make payments according to a schedule without right of prepayment. In his decision, the Comptroller General stated that the statute under which the loans were made[3] did not permit the President to waive any contractual rights accruing to the United States under the terms of the loans and underlying promissory notes.

In the case of the administration's proposal to modify the FMS loan agreements, the Comptroller General decided that, under both options to restructure the FMS loans, the United States would incur either a financial loss—giving up the right to receive interest payments at a high rate of interest under the loan prepayment option—or a substantial risk of significant financial loss—the potential failure of debtor nations to make the balloon payments of capitalized interest. Thus, the Comptroller General concluded that, in order to modify the FMS loan agreements under either option, the United States government would have to receive an adequate compensating benefit in each case. The Comptroller General further concluded that the administration's restructuring plan for FMS loans would not provide the United States with an adequate compensating benefit and therefore could not be implemented.

In general, borrower loan prepayment programs also involve giving up a financial right of the government. Specifically, agency actions to allow borrowers to prepay their loans at less than the unpaid principal balances are analogous to the administration's plan to restructure FMS loans. In both instances, agencies would be giving up a financial right—that is, the government's contractual right to receive principal and interest payments from borrowers in accordance with the terms of the loan. Consequently, agencies needed specific statutory authority to waive these financial contractual rights or needed to demonstrate that the government received adequate compensating benefits.

[3] Arms Export Control Act, 22 U.S.C. 2751 (1982).

Selected Loan Prepayments Were Authorized by Law

For the five 1987 borrower prepayment programs we reviewed, agencies had the statutory authority to allow borrowers to prepay their loans at less than the unpaid principal amount. This authority derived from the Omnibus Budget Reconciliation Act of 1986 as well as other statutes that authorized the loan programs. Borrowers prepaid their loans at the present value of future loan principal and interest payments based on a variety of interest rates. Table 2.1 summarizes the financial results of these programs. The details of the summary financial results presented in table 2.1 and the methodologies used in determining these results are discussed in detail in chapter 3.

Table 2.1: Loan Prepayments at Less Than Unpaid Principal Balance

Dollars in millions

Agency and program	Unpaid principal	Prepaid amount	Discount amount[a]
Farmers Home Administration			
Rural Development Loans[b]	$218.9	$157.6	$61.3
Education			
Academic Facilities Loans	87.6	60.8	26.8
College Housing Loans	704.2	438.2	266.0
Housing and Urban Development			
Public Facility Loans	9.9	8.4	1.5
Small Business Administration			
Disaster Home Loans	4.2	3.4	.8
Total	**$1,024.8**	**$668.4**	**$356.4**

[a]Interest rate differences account for the total discount amount shown. Borrowers used interest rates higher than those on the prepaid loans to determine the present value of future loan principal and interest payments—the loan prepayment amounts. For example, if a loan had a stated interest rate of 4 percent and the interest rate used to determine the value of the loan was 8 percent, a discount would result.

[b]Contains figures resulting from prepayments consummated in fiscal years 1987 and 1988.

Loan Prepayments Authorized by Omnibus Budget Reconciliation Act of 1986

The Omnibus Budget Reconciliation Act of 1986 authorized the Secretary of Agriculture, under the terms prescribed by the Secretary, to sell loans held by the Farmers Home Administration's Rural Development Insurance Fund (RDIF) to generate net proceeds to the government of not less than $1 billion during fiscal year 1987. The act also amended prior statutory authority that provided the Secretary with the right to sell loans. This authority did not contain any requirements that would prevent FmHA from selling loans to borrowers at the same terms that might apply if the loan was being sold to a third party purchaser. FmHA has authority under these provisions to offer borrowers the opportunity to prepay their loans at a discount. Therefore, FmHA conducted both a loan sale and prepayment program. In the prepayment program, 829 loans with an aggregate unpaid principal balance of about $219 million were prepaid at a discount. FmHA received about $158 million in net prepayment proceeds. The balance of the $1 billion in net proceeds was generated by the loan sale.

Loan Prepayment Discounts Authorized by Other Program Statutes

For the remaining four agency programs we reviewed, prepayments of less than unpaid principal amounts were specifically authorized by the statutes that created the loan programs. The Administrator of the Small Business Administration and the Secretaries of Education and Housing and Urban Development had the legal authority to discount loans when offering them to borrowers for prepayment. Specific authorization is as follows:

- Education allowed borrowers to prepay 1,031 College Housing Loans and 151 Academic Facilities Loans at less than outstanding principal balances. These prepayments were authorized by the Higher Education Amendments of 1986, which allowed the Secretary of Education to modify loan interest rates and payments of any installments of principal and interest, and to grant its borrowers the option of repaying their loans at a discount.
- HUD allowed borrowers to prepay 52 of its Public Facility Loans at less than unpaid principal balances. The Public Facility Loan program was authorized by title II of the Housing Amendments of 1955. Under 42 U.S.C. 3535, the Secretary of HUD has the authority to sell, or exchange at public or private sale or lease, real or personal property; the Secretary may also sell or exchange any securities or obligations upon such terms as he may fix. Thus, HUD had authority to implement this loan prepayment program.
- SBA allowed about 2,700 borrowers to prepay Disaster Home Loans having original loan amounts of $5,000 or less at less than unpaid principal balances. Under section 5 (b)(2) of the Small Business Act of 1950 (15 U.S.C. 634 (b)(2)), the Administrator of SBA has the authority to assign or sell at a public or private sale, or otherwise dispose of for cash or credit upon such terms and conditions and for such consideration as he determines to be reasonable, any debt, contract, claim, personal property or security assigned or held by him in connection with the payment of SBA loans. The Secretary is authorized to collect or compromise all obligations assigned to or held by him and all legal rights accruing to him in connection with the payment of such loans. This provision gives SBA the authority to allow borrowers of Home Disaster Loans to prepay their loans on a discounted basis.

Loan Prepayment Results Varied But Costs Generally Exceeded Benefits

In general, loan prepayments incurred costs that exceeded benefits and did not to any significant extent achieve credit management reform goals the administration set for its loan sale program. For the prepayment programs we reviewed, agencies experienced different net prepayment proceeds because different prepayment methods and interest rates were used. Agencies that determined loan prepayment amounts using Treasury interest rates not adjusted for loan defaults (the loans' baseline value to the government) realized the loans' upper bound[1] baseline value to the government in net prepayment proceeds. Agencies that used market interest rates to determine loan prepayment amounts received between $51 million and $80 million less in net prepayment proceeds than the loans' value to the government. The $80 million does not reflect estimated loan defaults or administrative costs while the $51 million reflects historic default rates on two loan portfolios eligible for prepayment.

The only significant benefit of these programs has been generating budgetary receipts in the year of prepayment. This benefit, however, is only temporary since the receipts will be offset by forgone future loan principal and interest payments. As a result, prepayment programs will not reduce the structural budget deficit in the long term and could actually increase it where the government does not receive its full value for the loans. A cost-benefit analysis should be utilized to decide whether to hold loans to term or to offer them to borrowers for prepayment.

Borrower Prepayment Programs Varied Widely as to Terms

As shown in table 1.1, in fiscal year 1987, six agencies conducted eight borrower loan prepayment programs using a wide variety of terms. Borrowers on two programs paid the unpaid principal balances on their loans; under another two programs borrowers prepaid the present value (based on the current Treasury interest rates) of future loan principal and interest payments; under yet another three programs borrowers prepaid the present value (based on commercial market interest rates) of future loan principal and interest payments; and, finally, borrowers under another program prepaid the present value (based on commercial market interest rates) of future loan principal and interest payments adjusted for a minimum prepayment discount amount.

[1]The valuation of a loan portfolio using interest rates for comparable Treasury securities may need to be adjusted to show the impact of a loan portfolio's average historical default rate. The default rate will affect the upper and lower baseline values of prepaid loans. The upper bound baseline value is the present value of future principal and interest payments not adjusted for average historical loan defaults, and the lower bound baseline value is the present value of future principal and interest payments adjusted for average historical loan defaults.

We focused our review on five of the six prepayment programs where borrowers prepaid less than the unpaid principal balances of their loans. In these programs borrowers prepaid the present value of future loan principal and interest payments. These present values were computed based on Treasury interest rates as well as varied commercial market interest rates. The use of different interest rates resulted in different financial results for each prepayment program.

In evaluating the financial and credit management reform results of borrower prepayment programs, we focused on five key issues:

- differences in net prepayment proceeds if the present values of future loan principal and interest payments are based on Treasury interest rates versus commercial market interest rates,
- costs and benefits of holding loans to term rather than offering them to borrowers for prepayment at less than the unpaid principal balances,
- the impact of loan prepayments on budgetary receipts and outlays in the short and long terms,
- credit management reform objectives achieved through the borrower loan prepayment programs, and
- differences in net proceeds between a prepayment program and a collateralized sale of loans to private investors.

Succeeding sections of this chapter discuss the first three of these issues. Chapter 4 discusses the credit management reforms initiated by loan prepayments and the financial differences between loan prepayments and collateralized loan asset sales to private investors.

Treasury Interest Rates Should Be Used as the Baseline to Determine Loan Value

Of the five loan prepayment programs we reviewed, three used commercial market interest rates to determine the present value of future loan principal and interest payments or the loan prepayment amounts. The two other programs used Treasury interest rates to determine the present value of the loans. Using Treasury interest rates, the loans' present value not adjusted for expected default rates represents the upper bound of the loans' baseline value to the government. Similarly, the present value of the loans, adjusted for average portfolio default rates and using the same Treasury interest rates, represents the lower bound[2] of the loans' baseline value to the government. This estimate leads to a lower bound of the baseline value because the default rates for borrowers who prepay their loans would probably be less than or equal to the

[2]See footnote 1, page 19.

average default rates for the portfolio involved in the prepayment program.

We estimate that the use of commercial market interest rates to value the loans and determine prepayment amounts resulted in the government's receiving about $80 million less than the loans' upper bound baseline value and $51 million less than the loans' lower bound baseline value in net prepayment proceeds.

How to Determine the Value of a Loan

A loan is a financial asset which is designed to produce a stream of interest and principal payments to the lender over a period of years. The value of that stream of payments at any point in time can be determined by discounting the future payment stream by an appropriate interest rate to determine its present value or "discounted present value." For the federal government, the appropriate interest rate to use in determining the present value of a loan—its upper bound baseline value to the government—is the current Treasury borrowing rate for comparable Treasury securities unadjusted for loan defaults. The Treasury rate should be used because the government is a net borrower of funds and this is the rate at which Treasury would borrow money if the prepayment had not taken place. Similarly, a lower bound baseline value could be computed using Treasury rates with adjustment for historic loan defaults.

If the net proceeds of a prepayment are equal to the upper bound baseline value of the loan, the government experiences no financial loss by allowing prepayment. If the rate of return used to determine the prepayment amount is higher than the Treasury rate at the prepayment date, unadjusted for loan defaults, then the government incurs a cost reflecting the difference between the Treasury rate and the discount rate used. By using the higher rate to determine loan prepayment amounts, the government is in effect obtaining funds at a higher rate than necessary.

For example, if a loan with an interest rate of 10 percent is considered for prepayment when the Treasury rate is also 10 percent, then the present value of the loan would be its face value. If the same loan is considered for prepayment when the Treasury rate is 8 percent, the present value of the loan would be greater than its face value. Conversely, if the Treasury rate was 12 percent at the proposed prepayment date, the value of the same loan would be less than its face value.

The Congress may specify or agencies may recommend that a rate higher than Treasury's interest rate be used to determine the prepayment amounts. Such decisions may be based on policy, fiscal, and/or credit reform goals and are a management decision. However, any difference between the present value of the loans and the prepayment amounts should be available to management and recognized as a cost to the government early in the decision-making process.

Use of Commercial Interest Rates Results in Prepayment Net Proceeds Below Upper Bound Baseline Value

The authorizing statutes provided guidance in selecting the appropriate market rate for two of the three programs which used commercial market rates to calculate prepayment amounts. These programs were Education's College Housing and Academic Facilities Loan programs. Table 3.1 presents our comparison between prepayment amounts realized using these commercial market rates of interest and the loans' upper bound baseline value to the government.

Table 3.1: Comparison of Prepayment Amounts Using Market Rates and the Loans' Baseline Value to the Government

Dollars in thousands

Portfolio	Amounts realized[a]	Loans' upper bound baseline value to the government	Unrealize portion c baselin valu
Education			
College Housing Loans	$438,214	$513,051[b]	$(74,8
Academic Facilities Loans	60,845	66,162[b]	(5,31
Small Business Administration			
Disaster Home Loans	3,404	3,597[c]	(19
Total	**$502,463**	**$582,810**	**$(80,34**

[a]Amount received based on market interest rates at 9.01 percent for Education loans and 8.85 percent for SBA loans.

[b]Estimated figure based on available data and Treasury interest rates of a security with a maturity date similar to those loans prepaid. Amounts not adjusted for loan defaults or administrative costs.

[c]Estimated figure based on sample of loans discounted at Treasury interest rates of securities that match the weighted average maturity of the loan portfolio. Amounts not adjusted for loan defaults or administrative costs.

The Farmers Home Administration and the Department of Housing and Urban Development consummated loan prepayment programs using Treasury rates to determine loan payoff amounts based on the remaining life of the loan. In these programs, the government received the loans' upper bound baseline value in net prepayment proceeds. Table 3 compares the loans' upper bound baseline value received as prepaymer net proceeds to estimated prepayment amounts that would have been received had the loans been valued using a market interest rate. Assuming a difference in the interest rate of one percent, FmHA and HUD would have lost about $6.4 million in net prepayment proceeds had they used commercial market interest rates.

Table 3.2: Comparison of Prepayment Amounts at the Loans' Baseline Value to the Government and Estimated Prepayment Amounts if Market Interest Rates Had Been Used

Dollars in thousands

Portfolio	Amounts realized[a]	Amounts estimated if prepaid at the market rate[b]	Forgone receipts if market rates had been used
Farmers Home Administration			
Rural Development Loans	$52,650	$46,871	$5,779
Housing and Urban Development			
Public Facility Loans	8,483[c]	7,873	610
Totals	**$61,133**	**$54,744**	**$6,389**

[a]These amounts are equal to the upper bound baseline value.

[b]Since these loans were prepaid at the Treasury rate, we assumed, for illustration purposes, a market interest rate of 1 percent above Treasury rate of a security with a maturity equal to the weighted average maturity of the loan portfolio for September 1987.

[c]Amount includes about $99,000 granted as discounts by the agency in lieu of administrative savings.

OMB's original loan asset sale guidelines issued in July 1986 did not fully address the issue of borrower loan prepayment programs. The March 1988 revised guidelines, however, require that agencies use a composite Treasury interest rate to determine the present value of future loan principal and interest payments—the loan payoff amount. We agree that the government should use the Treasury interest rate as its baseline rate to determine loan value to the government—adjusting for expected defaults—because it represents a more accurate calculation of the government's capital cost. Since the government raises capital through Treasury borrowing, Treasury interest rates represent the government's opportunity cost for financial transactions.

Although most borrowers' interest rates are above the Treasury interest rate, prepayments of loans valued at this rate may be attractive to some borrowers for several reasons. Borrowers may want to reduce their debts or undertake activities that would be restricted by maintaining the loans. In addition, some borrowers may raise funds at interest rates below the Treasury rate, although OMB guidelines do prohibit tax-free borrowing for the purpose of loan prepayment.

Allowing prepayments based on interest rates above the Treasury rate may leave the government worse off in present value terms than holding the loans to term or selling the entire portfolio. This can occur when the borrowers who prepay their loans have default risks below the average or other default rate used to compute an adjusted interest rate. Use of the Treasury rate to value the loans would eliminate a potential adverse selection problem (under which the worst risks remain in the portfolio and the best risks prepay less than the expected value of their loans to the government) and would ensure that the government is never financially worse off from allowing prepayments. If the Treasury rate is used in place of higher market rates to determine loan prepayments, fewer prepayments would probably be made. Thus, a higher quality of loans would be available for retention or sale than in an approach using higher interest rates.

In commenting on a draft of this report, OMB stated that using current Treasury rates can lead to adverse selection because those parties who borrowed when interest rates were high would be more likely to prepay. We believe that such adverse selection would not occur as long as both future principal and interest are valued using the current Treasury rate. In prepayment programs where only the unpaid principal balance needs to be paid back, however, this adverse selection could occur. In that case, borrowers holding loans with interest rates above current levels would have an incentive to prepay their loans. The government would receive less than the current present value of these loans, prior to adjustment for expected defaults.

Loans' Lower Bound Baseline Value Generally Exceeded Monetary Benefits for Prepayments

For three of the five prepayment programs reviewed, the government received less in borrower prepayments than the present value of the amount of money the government would have received if it had held the loans to term and adjustments were made for average historic defaults. As discussed in our February 19, 1988, report on selected loan asset sales[3], we believe decisions to hold a loan portfolio to term or to offer it to borrowers for prepayment or to investors for sale should be based on a cost-benefit analysis and should be made on a portfolio-by-portfolio basis. The cost-benefit analysis should evaluate estimated net prepayment proceeds in terms of the present value to the government of the loan portfolio if it held the loans to term and collected future loan principal and interest payments.

[3]Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988).

In analyzing the costs and benefits of the prepayment programs in which borrowers paid off their loans at less than the unpaid principal balances, we computed the costs and benefits as follows:

- Costs were computed as the present value—based on comparable Treasury interest rates—of future actual loan principal and interest payments, adjusted for average historic loan loss rates. In short, the costs we computed are the prepaid loans' lower baseline values, as previously discussed. We used average historic loan loss rates in our computations because (1) borrowers did not prepay all loans held by the government and (2) it was impossible to determine whether borrowers who prepaid their loans would have defaulted on their loans at some future time if they had not prepaid them.[4]
- Benefits were the amounts borrowers actually paid the government to prepay their loans. These amounts were the present values of future loan principal and interest payments borrowers would have paid the government. These present values, as previously discussed, were based on Treasury or commercial market interest rates.

Cost and benefits for the different programs varied due to the influence of three key factors: (1) the interest rate on the prepaid loan, (2) the interest rate used to determine the present value of future loan principal and interest payments at the date of loan prepayment, and (3) the portfolio loan loss rate for the prepaid loans. These factors can influence the difference between costs and benefits as follows:

- If the loan interest rate is the same as the interest rate used to determine the present value of future loan principal and interest payments, then the present value will equal the unpaid principal balance on the loans.
- If the loan interest rate is lower than the interest rate used to determine the present value of future loan principal and interest payments—as is usually the case for government loans—then the present value will be less than the unpaid principal balance on the loans. For example, if the loan rate is 4 percent and the Treasury's rate is 8 percent, a loss will result.
- If the government's historic loss rate on the prepaid loans is greater than zero, the amount of future loan principal and interest payments will be reduced, resulting in the present value of these future payments also being reduced.

[4]One could argue that a borrower who prepays a loan should not be considered a default risk. However, economic and/or other factors may cause a borrower to default in the future. Therefore, accepting the prepayment eliminates this risk.

- If the interest rate used to determine the present value of the government's forgone future loan principal and interest payments is lower than the one used to determine the loan prepayment amount, a loss will occur. For example, if the Treasury rate is 8 percent and the rate available to the borrower is 10 percent, the government incurs a loss when the 10 percent rate is used.
- If, on the other hand, the interest rate used to determine the value of the government's forgone future loan principal and interest payments (the government's discount rate) is greater than the interest rate used to determine the prepayment amount, a gain to the federal government will result.

Based on the foregoing, we computed estimated costs and benefits for the five borrower loan prepayment programs consummated in fiscal year 1987 that we reviewed. Table 3.3 covers the loans that were prepaid based on commercial market interest rates, and table 3.4 covers the loans that were prepaid based on comparable Treasury rates of interest.

Table 3.3: Prepayment Amounts Realized at Market Rates and Amounts Estimated If Loans Had Been Held to Term

Dollars in thousands

Portfolio	Market interest rate percent	Amount realized at market rate	Treasury interest rate percent	Loan loss rate percent	Amount estimated if held to full maturity[a]	Net loss
Education						
College Housing Loans	9.01[b]	$438,214	7.5[c]	5	$487,398	$(49,18
Academic Facilities Loans	9.01[b]	60,845	7.5[c]	5	62,854	(2,00
Small Business Administration						
Disaster Home Loans	8.85	3,404	8.5	3.2	3,482	(7
Total		**$502,463**			**$553,734**	**$(51,27**

[a]Amounts net of the portfolio's historical default rate, discounted at the Treasury rate of a security with a similar maturity.

[b]The discount interest rate used is the market BBB corporate bond rate as of March 1987 of a bond whose maturity matches the weighted average maturity of the loan portfolio.

[c]The discount interest rate used was the Treasury rate as of March 1987 of a security whose maturity matches the weighted average maturity of the loan portfolio.

Table 3.4: Prepayment Amounts Realized at Treasury Rates and Amounts Estimated If Loans Had Been Held to Term

Dollars in thousands

Portfolio	Treasury interest rate[a] percent	Amount realized at Treasury rate	Loan loss rate percent	Anount estimated if held to full maturity[b]	Net loss
Farmers Home Administration					
Rural Development Loans	8.875	$52,650	.4	$52,439	$211
Housing and Urban Development					
Public Facility Loans	8.625	8,483[c]	0	8,483	0
Total		**$61,133**		**$60,922**	**$211**

[a]The discount interest rate used was the Treasury rate as of September 1987, which is similar to the weighted average maturity of the portfolio the loans were prepaid from.

[b]Amounts net of the portfolio's loss rate, discounted at the Treasury rate of a security with a similar maturity.

[c]Amount includes about $99,000 granted as discounts by the agency in lieu of administrative savings.

As table 3.3 shows, for three prepayment programs, the government received about $51 million less in prepayments than it would have received had it held and collected the loans. Table 3.4 shows that one program's costs about equaled its benefits, while in another program the government received about $211,000 more in prepayments than it would have received had it held and collected the loans because of the historic default rate.

A cost-benefit analysis would have enabled the agencies to calculate these results before deciding between loan prepayments and holding loans to term. OMB's revised loan asset sale guidelines, however, do not require agencies to complete such analyses before implementing borrower loan prepayments, nor do the guidelines include any discussion of cost-benefit analyses for either loan asset sales or borrower loan prepayment programs. In view of this, we believe decisions to hold a loan portfolio to term or offer it to borrowers for prepayment should be based on cost-benefit analysis and should be made on a portfolio-by-portfolio basis.

Borrower Loan Prepayments Will Not Reduce the Structural Budget Deficit

Net proceeds of loan prepayment programs will not reduce and will likely increase the federal government's long-term structural budget deficit. Prepayments simply shift the present value of loan principal and interest payments that the government would receive in future years to the year of the prepayment. As a result, budget cash receipts are increased in the year in which prepayments are made, reducing the budget deficit for that year only. In future years, however, budgetary cash receipts will be reduced by principal and interest payments which would have been collected if loans had been held to term.

In addition to the issue of whether prepayments reduce the deficit, we noted a conflict between the legal statutes and OMB guidelines, which require the payments to be deposited as miscellaneous receipts. For the eight federal loan programs in which payments were accepted, proceeds are, by law, to be used for program-related purposes. Prepayment proceeds must be deposited in various accounts and revolving funds maintained by Treasury. The statutes governing some of these programs may, however, allow an agency to transfer excess moneys not needed for current operations to miscellaneous receipts of the Treasury. Therefore, the OMB guidelines need to be revised to provide that prepayment proceeds should be deposited as miscellaneous receipts or as otherwise provided by law. Limitations on the use of prepayment proceeds are shown in table 3.5.

Table 3.5: Legal Provisions Governing Use of Loan Prepayment and Sale Proceeds

Loan portfolio	Legal provisions
Education	
College Housing Loans	All program loan payments of principal and interest, as well as appropriations made available to the Secretary, shall be deposited in a checking account with the Treasury. These funds shall be available for Education activities as authorized by the Congress (20 U.S.C. 1132g-1).
Academic Facilities Loans	Principal payments on loans and any other moneys derived from activities such as prepayments shall be deposited in a program revolving loan fund. Education may transfer money in the fund that exceeds the present and prospective needs of the fund into the general fund of the Treasury (20 U.S.C. 1132d-2(b)(2)).
Farmers Home Administration	
Rural Development Loans	All net proceeds must be deposited in and become part of the Rural Development Insurance Fund. Money in the fund not needed for current operation shall be deposited in the Treasury to the credit of the fund (7 U.S.C. 1929a(c) and 7 U.S.C. 1929a(e)).
Housing and Urban Development	
Public Facility Loans	All proceeds shall be deposited in a liquidating programs revolving fund. Excess fund balances not needed for the operation of the fund shall be deposited to the Treasury (42 U.S.C. 5317 and 12 U.S.C. 1701g-5).
Small Business Administration	
Disaster Home Loans	All proceeds must be deposited in Disaster Loan Revolving Fund to be used only for program purposes. SBA may transfer any excess moneys not needed for the fund's operation into the Treasury as miscellaneous receipts (15 U.S.C. 633(c)).

We noted that OMB's revised guidelines regarding borrower prepayment programs state that agencies shall deposit net proceeds obtained from loan prepayments into the Treasury general fund. Thus, the guidelines are not entirely consistent with the statutory limitations on the treatment of such revenues for the eight sales reviewed. In these cases, the statutory requirements must govern, absent any other specific legal authority enacted by Congress. In either case, whether prepayment proceeds are deposited to miscellaneous receipts to the Treasury or to a specific Treasury fund, they are available to reduce outlays and therefore reduce the budgetary deficit for the budget year during which the prepayment proceeds are received.

Chapter 4

Borrower Loan Prepayment Programs Versus Loan Asset Sales as Credit Management Reform Tools

In contrast to loan asset sales, prepayment programs have resulted in only minimal credit management reforms. They have not been able to meet the administration's reform goal of determining federal credit program subsidy costs because prepayments measure benefits to the borrower rather than costs to the government. On the other hand, in some cases prepayment programs may generate larger net cash proceeds than collateralized loan asset sales.

Prepayments Result in Minimal Credit Management Reforms

During fiscal year 1987, three collateralized loan asset sales were consummated. They have resulted in initiating federal credit management reforms—particularly in the areas of loan origination and documentation—in the agencies involved in the sales. In addition, loan sales have required federal credit program managers to learn and understand private sector credit policies, practices, and techniques. These reforms occurred because agencies, by the very nature of loan asset sales, had to become involved with private sector credit management requirements through their financial advisors and loan sale underwriters.

On the other hand, agencies involved only in borrower prepayment programs were not forced to work with private sector organizations. They primarily worked with their own staffs and borrowers and, consequently, were not exposed to private sector credit management policies, practices, and techniques. However, two agencies involved in the prepayment programs we reviewed in detail also conducted loan sales. Therefore, these two agencies had experience in working with the private sector.

In general, borrower prepayment programs have produced only minimal credit management improvements. These improvements varied among agencies completing loan prepayments and generally were not measurable in dollar savings. Specifically, they were reported as follows:

- HUD reported that the prepayment of Public Facility Loans enabled the department to reduce its line of credit with the Federal Financing Bank. The sale also reduced the number of loans that the agency had serviced by the Federal Reserve Bank of Richmond. HUD did not set a dollar savings amount for these improvements.
- SBA gained knowledge in using financial advisors and in conducting loan prepayment programs.

- FmHA noted that the prepayment of Rural Development Loans allowed the agency to avoid future loan delinquencies, defaults, and loan servicing costs. FmHA officials also claimed that the sale helped identify deficiencies in the agency's accounting systems.
- The Department of Education avoided future defaults, delinquencies, and legal costs associated with the loans that were prepaid. The prepayments also lowered Education's servicing costs to the Federal Reserve Bank of Richmond by an estimated $100,000.

Loan Prepayments Cannot Determine Subsidy Costs of Federal Credit Programs

Prepayment programs, as well as loan asset sales, cannot achieve the credit management reform goal of determining the government's federal credit program subsidy costs because the net proceeds from a loan prepayment reflect the interest subsidy to the borrower rather than the subsidy cost to the government. Furthermore, the subsidy can be determined independent of loan sale or prepayment programs.

As we have reported previously,[1] the administration's plan to determine the subsidy cost of a federal credit program by subtracting net loan sale proceeds—or, conceivably, net loan prepayment proceeds by having borrowers compete with investors—from the outstanding principal balance of the loans sold will overstate the government's loan subsidy cost (cash outlays). Net sale proceeds will reflect factors in addition to the creditworthiness of the borrowers (loan risk) and the cost to service the loans. These factors include the following:

- the investor's rate of return on alternative investments, which is generally higher than Treasury's borrowing rates;
- the degree of risk the investor assumes for estimated future loan losses;
- the investor's lack of familiarity with the type of loan the government is offering for sale; and
- the investor's cost to service the loan and consummate the sale, including the cost to obtain credit ratings on loans offered for sale.

In addition to the above factors, subsidy costs determined through the sale, or conceivably the prepayment of existing loans, will also reflect the interest rates prevailing at the time the loans are sold or prepaid rather than those in effect at the time the loans were originally granted. For example, if the interest rates increase significantly between the time the loans are originally made and the time they are sold or prepaid, then subsidies measured by subtracting net sale or prepayment proceeds

[1] Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988).

from the loans' outstanding principal balances will be significantly larger than they would have been had the net sales or prepayment proceeds been based on the original interest rates.

Furthermore, the subsidy cost of credit programs can be determined without disposing of the loans through either a sale or prepayment program. Calculations of the cost should take into account the following elements:

- the difference between (1) the present value of the future principal and interest payments, including consideration for loan fees paid by the borrower, discounted at the comparable[2] interest rate and (2) the amount o money loaned out;
- the present value of future loan program administrative costs, based on the comparable interest rate; and
- the present value of future principal and interest payments, based on the appropriate interest rate on loans that are expected to go into default during the life of the loan program.

In its comments on a draft of this report, OMB stated that it disagrees with our methodology for calculating the subsidy of a federal credit pro gram. OMB pointed out that our methodology, which determines the subsidy cost to the government by considering estimated administrative an default costs as well as the government's cost to borrow funds to make the loans, does not reflect the economic subsidy to the borrower. OMB stated that federal direct loans are frequently made to less creditworth borrowers at terms and conditions much easier than those of private lenders. In addition, OMB commented that the government's loan servicing practices are more lenient than the private sector's. Overall, OMB took the position that the federal loans' more lenient terms and conditions represent cost that should be measured and considered in the budget process.

OMB's approach to determining the subsidies inherent in federal credit programs focuses on measuring the economic subsidies provided to federal borrowers. However, in our February 1988 report on selected loan

[2]The appropriate interest rate is based on the interest rates for Treasury securities with comparabl maturities.

asset sales and our testimonies on proposals for improved credit program budgeting[3], loan asset sale programs[4], and privatization initiatives[5], we have consistently taken the position that the subsidy costs should be the cash costs the government incurs in granting a loan. Specifically, the subsidy costs should include the interest costs incurred to borrow the funds to make the loan (Treasury's cost of funds), less the interest charged borrowers, plus estimated loan administrative and default costs. We have pointed out that the cash subsidy costs are consistent with the way the federal budget is presented. This allows federal credit programs and their subsidy costs to be compared to other programs included in the budget.

Loan Prepayment Yields Are Not Comparable to Loan Asset Sale Proceeds

The loan prepayment programs' primary benefit is generating budgetary cash receipts during the budget year in which prepayments are consummated. In some cases, they may generate larger cash proceeds than collateralized loan asset sales. This would occur because sales involve additional costs (such as trust reserve expenses) which reflect future possible loan defaults, underwriter fees, and administrative costs. These additional costs are deducted from the proceeds of a loan sale, thus reducing net proceeds to the government. In short, on a loan sale, the government may have higher costs related to transactions and the assumption of risk. There is no assumption of risk by a third party on a loan prepayment.

In fiscal year 1987, two agencies conducted both loan asset sales and borrower prepayment programs from the same loan portfolios. The overall yields from sales and prepayment programs could not be compared because (1) the loans included in the sales and prepayments may have varied as to maturities, collateral, and creditworthiness of borrowers and (2) reasonable forecasts of the borrower defaults the government avoided by selling loans and allowing borrowers to prepay could not be made.

In addition, the loan sale costs reduced net proceeds by about $61 million. Since borrower prepayments did not incur such costs, it would appear on the surface that prepayment programs yielded higher net

[3]Proposals for Improved Credit Program Budgeting (GAO/T-AFMD-87-5, March 4, 1987).

[4]The Government's Loan Asset Sales Pilot Program (GAO/T-AFMD-87-6, March 10, 1987).

[5]Federal Government Credit Activities and How They Relate to Loan Sales (GAO/T-AFMD-88-2, November 10, 1987).

proceeds than loan asset sales. However, such a comparison of yields does not take into consideration the impossibility of making reliable predictions about such factors as actual loan defaults. At this time, no one knows (1) how many, if any, of the prepaid loans would have gone into default in the future for reasons such as changing economic conditions or (2) the amount of overcollaterization in the loan sales that may be returned to the government because actual default rates were less than those predicted at the time of sale.

Overall, we do not believe that a meaningful comparison of loan asset sale and loan prepayment yields can be made when a sale or prepayment program is consummated. The final yields of loan asset sales will only be known after all the sold loans are paid off by the borrowers and the loans retained by the government are either paid off or written off.

Agency Comments and Our Evaluation

In its comments on a draft of this report, OMB stated that we concluded that prepayments are preferable to third party sales because they avoid the transaction costs associated with sales. OMB agreed that transaction costs are significantly lower for prepayments than for sales. However, they asserted that lower costs do not automatically make prepayments preferable to third party sales for the following reasons:

- Prepayments diminish the quality of the government's loan portfolio to a greater degree than sales because the most creditworthy borrowers will prepay their loans.
- Sales achieve credit management improvements to a greater degree thar prepayments.
- Prepayments do not measure the subsidy inherent in federal credit programs.

Our report has been revised to clarify that, because of potential asset quality differences, the financial results of loan sales and borrower prepayments are not directly and fully comparable. However, GAO still believes that higher transaction costs related to sales versus prepayments should be considered in deciding which loan disposition method t use. The draft report OMB commented on pointed out that sales achieve credit management improvements to a greater degree than loan prepayments. The draft report also pointed out that neither loan sales nor prepayments of existing loans accurately measure the subsidy cost of federal credit programs.

OMB Guidelines Do Not Adequately Address Loan Prepayment Issues

OMB's March 1988 revised loan asset sale and prepayment guidelines do not cover key financial considerations pertaining to borrower loan prepayment programs since they focus on loan sale issues. Specifically, the guidelines do not address methodologies for (1) determining the costs and benefits of borrower prepayment and loan sale programs so they can be adequately compared, (2) choosing, on a portfolio-by-portfolio basis, borrower prepayment or loan sale programs as the most appropriate divestiture method, and (3) determining when a loan portfolio should be held to term rather than divested or offered for prepayment. OMB's current guidance is a step in the right direction, but more needs to be done to ensure that the government receives the maximum benefits from loan prepayments and sales.

Cost-Benefit Analysis Guidance Needed

OMB's March 1988 loan asset sale guidelines focus on the specifics of how to conduct a prepayment or sale program. These guidelines, however, do not address the issue of determining the costs and benefits of a prepayment or loan sale program. Simply stated, the cost of sale or prepayment is the present value of future loan principal and interest payments the government gives up by either selling a loan or allowing borrowers to prepay their loans. The benefits of a sale or prepayment program are the net proceeds the government receives. Costs and benefits of a prepayment or sale transaction should be a key consideration in deciding whether or not to sell a loan or allow the borrower to prepay it.

The estimated costs and benefits of a proposed loan prepayment or sale program can be readily determined. A loan is a financial asset that consists of a stream of principal and interest payments to the lender over a period of years. The value of that stream of payments can be calculated at any point in time by discounting the future payment stream by an appropriate interest rate to determine its present value. As stated by OMB, the appropriate interest rate for the federal government to use in determining the present value is a composite interest rate consisting of the current market rate yield on Treasury securities of comparable maturities plus an allowance for administrative expenses and possible losses. This rate should be used because it represents the rate at which Treasury would borrow money if the sale or prepayment program had not taken place. In other words, it is the borrowing opportunity cost for the federal government.

If the net proceeds of a loan asset sale or borrower prepayment program are equal to the present value of the loans to the government, no gain or loss is incurred from the sale or prepayment program. For example, in the absence of default and administrative costs, if a loan has an interest rate equal to the current Treasury borrowing rate, the prepayment of the loan's unpaid principal results in no cost to the government.

If the net proceeds are less than the present value of the loans to the government, then the government incurs a net cost on the sale or prepayment program. For example, the prepayment of unpaid principal on loans with interest rates higher than the current Treasury borrowing rate results in a cost to the government. In addition, if loans are prepaid at the present value of future loan principal and interest payments based on an interest rate higher than Treasury's borrowing rate at prepayment date, the government incurs a cost.

Comparing the estimated costs and benefits of a proposed loan sale and/or borrower prepayment program can be an effective basis for agencies to use when deciding on

- the most cost effective method of disposing of federal loan assets (a collateralized loan sale to private investors or a borrower prepayment program) or
- whether to hold a portfolio to term and collect loan principal and interest payments or dispose of the portfolio through a sale or prepayment program.

Broader Guidance Needed for Selecting Sales or Loan Prepayments

OMB's March 1988 guidelines focus on the comparative financial results of loan sales versus borrower prepayments. The guidelines, however, do not relate the comparative financial results of loan sales versus borrower prepayments to the nonmonetary benefits and policy considerations related to these options.

Prior to the administration's credit reform initiatives the government held loans to maturity and collected principal and interest payments. These initiatives, however, now require agencies to use private sector loan portfolio management methods—that is, loan sales and borrower prepayment programs. However, federal portfolio managers in some cases lack experience with these programs. Although OMB's current guidelines have been improved, more guidance and experience are needed to ensure that the government receives the maximum benefits from loan sales and borrower prepayments. Guidelines are particularly needed to help federal portfolio managers to select sales or prepayments as the most appropriate loan disposition method.

Our discussions with representatives of leading private sector financial organizations and our current review illustrate the types of considerations that could be used in making loan sale versus prepayment decisions. The private sector representatives told us that, as a general rule, banks will require loans to be prepaid at the unpaid principal balance. Furthermore, banks will charge borrowers a penalty to prepay their loans early in the life of a loan. Banks will accept a loan prepayment at less than the unpaid principal balance generally in two circumstances:

- a loan work-out situation for a borrower in financial trouble or
- a portfolio cleanup situation in which the bank wants to dispose of loans with a low principal balance or interest rate.

In a loan work-out situation, the bank will generally compare the present value of the restructured loan to the estimated net proceeds the bank expects to receive by exercising its legal rights under the loan agreement in the event of borrower default. In a portfolio cleanup situation, a bank will accept a loan prepayment at less than the unpaid principal balance if

- the current cost of servicing the loan equals or exceeds the interest income generated by the loan or
- the loan prepayment amount equals at least the net present value of future loan principal payments based on the bank's cost of funds—the interest rate the bank incurs to borrow money.

Overall, banks focus on the unpaid principal balance of a loan in making decisions on selling a loan or accepting a prepayment offer from a borrower. In contrast, private sector finance companies and securities dealers, when they buy and sell loans as investments, focus on the economic value of a loan rather than its unpaid principal balance. A loan's economic value is based on the loan maturity, borrower risk, loan interest rate, and market interest rate. Thus a loan is bought and sold based on the present value of its future loan principal and interest payments discounted at the current market interest rate.

Our review showed that in choosing between loan sales and prepayments consideration must be given to not only the broad range of factors analyzed by private sector financial institutions, but also to financial versus nonfinancial costs and benefits. OMB's current guidelines do not address the need to relate monetary benefits of a sale or prepayment transaction with the nonmonetary—credit management reform improvements. For example, the guidelines do not discuss how much in net proceeds should be given up to achieve specific credit management reforms and later on other credit management goals. In the early stages of credit management reform, the primary goal is to expose federal credit program managers to credit management techniques used in the private sector. As the government continues with its program of loan sales, federal credit managers should become fully knowledgeable in private sector credit management techniques. The emphasis will then shift to considering how specific economic and credit management goals will be achieved through sales and prepayments. For example, an agency could streamline loan portfolios by eliminating low principal balance high cost loans. As discussed in chapter 4, loan prepayment programs avoid transaction costs associated with conducting collateralized loan asset sales, but collateralized loan asset sales result in greater nonmonetary credit management reforms than loan prepayments.

Overall, OMB needs to provide more guidance on how to evaluate both financial and nonmonetary costs and benefits in making loan sale versus loan prepayment decisions. Current OMB guidelines leave much of the decision-making up to the individual agencies. Guidance is needed to ensure that these decisions are consistently made on a governmentwide basis and that the individual agency decisions, when taken together, yield the optimum financial and credit management reform benefits and later economic and credit management goals for the government.

Guidance Needed for Decisions to Hold or Dispose of Loans

OMB's March 1988 loan sale guidelines do not include criteria for deciding when loans should be held to maturity, sold, or offered to borrowers for prepayment. These decisions should be based on an appropriate cost-benefit analysis, as discussed previously. Guidance in this area will be needed if the government continues to use loan sales and prepayments as routine credit management tools. The guidance should focus on the monetary gains to be realized and the credit reforms to be achieved.

As discussed in chapter 3, some agencies could have collected more net proceeds from their loans if they had held them until maturity. For example, at Education we found that the agency would not collect about $49 million in present value terms because it had allowed its borrowers to prepay their loans at a market discount rate. As shown in table 3.3, Education received the equivalent of $438 million on its prepayments, but could have received about $487 million if it had chosen to continue collecting the outstanding principal and interest payments over the life of the loans. If the guidance that we are proposing had been available, agencies and OMB, in proposing loan sales and prepayments, would have had to specifically articulate the nonmonetary credit management reform or other goals to be achieved in exchange for the monetary costs to be incurred.

In commenting on a draft of this report, OMB agreed with GAO's conclusion that loan prepayments should be preceded by an in-depth analysis, and to this end OMB is currently revising and plans to reissue Circular A-129, "Managing Federal Credit Programs." Among other things, this circular will explicitly require agencies, as part of their annual budget submission, to complete cost-benefit analyses for proposed loan prepayments and/or sales. (See pages 41 to 42).

Conclusions and Recommendation

Agencies have completed the fiscal year 1987 first round of loan asset sales and borrower prepayments under the administration's credit management reform initiatives. Under this initiative, the administration plans to dispose of $12.6 billion in loans in fiscal year 1988 and realize $8.5 billion. The first round of sales and prepayments was a learning experience for OMB, the agencies, and the private sector financial advisors, underwriters, and investors involved. Overall, costs exceeded benefits for fiscal year 1987.

Conclusions

With respect to borrower loan prepayments, agencies acted within the law when allowing borrowers to prepay their loans at an amount less than the unpaid principal balance. Financial results of prepayment programs varied widely among the portfolios involved. The programs that used the comparable Treasury borrowing rate to determine the prepayment amounts appear to have yielded greater returns than the programs that used higher interest rates based on market considerations. However, we could not determine the extent to which participation in the prepayment program would have declined if Treasury rates (which would have raised borrowers' prepayment costs) were used for all cases.

The loan sale and prepayment data may not be fully comparable since sales involve the disposal of a package of loans, whereas prepayments can involve only a limited number of borrowers who elect to prepay their loans. They may not have had the same creditworthiness as those whose loans were sold. Loan sales appear to have led to more significant long-term credit reform gains—such as improved understanding of private sector credit management techniques—than prepayments. Prepayments, however, may contribute to credit reform by providing an alternative market and measure of the value of loans to the private sector. In general, however, the costs of borrower prepayment programs exceeded benefits.

A key reason for the varied financial results of borrower prepayment programs was that agencies used different interest rates to discount future loan principal and interest payments to determine the amount borrowers would prepay. Agencies used wide discretion in setting interest rates because OMB did not issue guidelines for specific rates to be used until March 1988. OMB's revised guidelines do not address the issues of (1) when agencies should hold loans to term rather than dispose of them and (2) when agencies should use loan prepayment programs versus loan asset sales to achieve credit management reform objectives. Our analysis has shown that the basis for these decisions should be derived from appropriate cost-benefit analyses. OMB's guidelines need to address the cost-benefit analyses issue in order to maximize proceeds from loan prepayment programs and loan asset sales and to optimize credit management reforms.

Recommendation

We recommend that the Director, Office of Management and Budget, revise OMB's loan asset sale guidelines to require agencies to complete appropriate cost-benefit analyses to determine

- what monetary and nonmonetary benefits can be received from loan asset sales and prepayment programs,
- when the government should hold loans to term or dispose of them through asset sales or prepayments, and
- which disposal method—sales or prepayments—should be used if the loans are not held to term.

Agency Comments and Our Evaluation

In its comments on a draft of this report, OMB stated that it agreed with the substance of our report, including the conclusion that the administration had the legal authority to permit borrowers to prepay less than the outstanding principal balance in the cases studied. OMB also stated that it agreed with our conclusion that prepayments need to be evaluated within the context of overall federal credit policy. OMB disagreed with our positions on comparing prepayments to loan asset sales and computing the subsidies of federal credit programs. Details on OMB's disagreements with us and our evaluation are presented at appropriate points in our report.

OMB agreed with our conclusion that prepayments should be preceded by an in-depth cost-benefit analysis. However, rather than modifying its loan asset sale guidelines, OMB is including this guidance in its current revision of Circular A-129, "Managing Federal Credit Programs." According to OMB, the revised circular will strengthen the sales process by requiring agencies to (1) perform reviews of loan portfolios to verify the accuracy of payment history and loan balance, (2) evaluate the credit performance and financial characteristics of each loan portfolio, and (3) make qualitative and quantitative determinations of each loan portfolio's sale value by comparing sales potential to previous loan sales. In addition, Circular A-129 will require that the President's budget request include an analysis for all proposed loan asset sales and prepayment programs submitted to the Congress.

We agree that these changes to Circular A-129, if fully implemented as currently stated, should provide the agencies with the guidance necessary to ensure that the best financial interests of the government are met when disposing of loan portfolios through asset sales or prepayment programs.

Request Letter Dated August 19, 1987, From Representative Willis D. Gradison, Jr.

BILL GRADISON
2d District, Ohio

MARGARET TOTTEN
Administrative Assistant

Committees:
WAYS AND MEANS
BUDGET

2311 Rayburn House Office Building
Washington, DC 20515
Telephone (202) 225-3164

Federal Office Building
550 Main Street
Cincinnati, OH 45202
Telephones (513) 684-2456

Congress of the United States
House of Representatives
Washington, DC 20515

August 19, 1987

Charles A. Bowsher
Comptroller General of
 the United States
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Bowsher:

I note with interest your recent letter report to Rep. Obey (July 21, 1987) in which you conclude that the Administration lacks the statutory authority to restructure Foreign Military Sales (FMS) loans. In a similar vein, I am asking for GAO's opinion about the legality of what appears to be similar activity involving at least four other programs.

Three federal agencies required to sell loans in FY 1987 by the 1986 Reconciliation Act (P.L. 99-509), or scheduled to do so as part of the Administration's pilot program, have allowed borrowers to prepay their loans at a discount from par. The table below shows data on the prepayments received by each agency in FY 1987. In each case, the prepayment period is over, so the data are final.

AGENCY/PROGRAM	FACE VALUE	PREPAID	DISCOUNT
	(in millions of dollars)		
Department of Education:			
College Housing	704.2	438.2	38%
Higher Ed. Facilities	87.6	60.8	31%
Farmers Home Administration:			
Rural Development	383.0*	268.0*	30%
Department of Housing and Urban Development:			
Public Facilities	10.1	8.5	16%

* Approximate.

Later this month a fourth agency, the Small Business Administration, will notify certain disaster loan borrowers of a right to prepay their loans at discount by the end of FY 1987.

GAO has ruled that, absent specific statutory authority, federal agencies cannot surrender or waive contract rights vested in the government, including the right to receive loan repayments on a certain schedule and at a certain interest rate, without a compensating benefit to the United States.

In your July 21st letter to Rep. Obey you relied on this principle in concluding that the Administration's proposed restructuring of FMS debt held by the Federal Financing Bank (FFB) should not be implemented without the enactment of specific statutory authority. The proposal would allow borrowers to prepay FMS loans held by the FFB, despite the fact that the loan contracts specifically proscribe prepayments.

In light of the principle enunciated by GAO, several questions arise regarding the practice of the three agencies that have allowed prepayments of loan assets at a discount from par in FY 1987 (as well as SBA, which intends to do so):

1) Have the agencies lost money on the prepayments by accepting less than the face value or current market value of the loans?

2) If so, how much have they lost?

3) If losses were incurred, did the agency or agencies involved receive compensating benefits?

4) If not, what specific statutory authority allowed the agency or agencies to incur the losses?

These questions are not merely of legal interest. As you know, I have been championing comprehensive credit reform in the Congress. It pains me to see the Administration, which has made an outstanding credit reform proposal, engage in activities which are so clearly counterproductive to the credit reform objectives I share with them.

Unless agencies set minimum amounts for loan prepayments that accurately reflect loan asset values--perhaps by allowing investors to compete with borrowers to "purchase" loan assets intented for sale--the practice of giving borrowers a prepayment option will undermine a principal objective of nonrecourse asset sales: the measurement of loan subsidy costs.

Further, because prepayments at a loss involve additional subsidy costs, under credit reform they would require advance appropriations. Setting a precedent of allowing agencies to permit borrowers to prepay at a loss without taking steps to measure the additional subsidy costs accurately can only make more difficult calculating and requiring subsidy cost appropriations for such transactions in the future.

Given the possible abuses to which prepayments at a discount from par could be subject, and given congressional interest in credit reform and in using asset sales only to measure subsidy costs (and not for deficit reduction), I think it would be quite useful for GAO to conduct an analysis of the FY 1987 loan prepayment programs of the four agencies and to provide Congress with answers to my questions as soon as possible.

Sincerely,

Bill Gradison

BILL GRADISON
Representative in Congress

OMB's Revised Loan Asset Sale and Borrower Prepayment Guidelines Issued March 8, 1988

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

M-88-14

March 8, 1988

MEMORANDUM FOR CABINET OFFICERS AND AGENCY HEADS

FROM: Joseph R. Wright Jr.
Deputy Director, OMB and Chairman, Federal
Credit Policy Working Group, EPC

SUBJECT: Prepayment Guidelines

Attached is a copy of the prepayment guidelines for the FY 1988 loan asset sale pilot program. These prepayment guidelines have been incorporated into the revised loan asset sale guidelines recently sent to you.

In 1987, five agencies conducted prepayment programs. Gross proceeds of $2.5 billion from prepayments accounted for a large portion of the total revenue generated by the entire FY 1987 loan asset sale pilot program. Last year the prepayment option was offered before the successful third party sale of Rural Development Insurance Fund loans, and College Facilities loans. In each instance the prepayment program was an important element of the overall loan asset sale strategy. Additionally, prepayments assist privatization while avoiding some of the costs associated with third party sales such as underwriter fees, and printing costs.

In FY 1988, prepayments will continue to be a big part of the pilot program. Therefore, the guidelines have been revised to define more clearly the technical requirements of the prepayment program.

These guidelines should ensure that agencies enlist the services of a financial advisor. A financial advisor will help an agency to conduct an asset valuation of its portfolio and assist the agency to determine an acceptable prepayment price by providing pricing options in accordance with A-70.

Once again, thank you for the eagerness and enthusiasm you and your staffs exhibited for the FY 1987 sales. I trust these prepayment guidelines will be of assistance.

Attachment

LOAN ASSET SALES AND PREPAYMENT GUIDELINES

March 8, 1988

I. Introduction

The following guidelines for the sale of loan assets and prepayments have been established and approved by the Federal Credit Policy Working Group. The guidelines are designed to insure that agencies will meet the objectives of the loan asset sale program which have been derived from the Administration's stated priority to reform Federal credit. These guidelines are for the purpose of providing policy direction for the FY 1988 pilot program. The guidelines are not intended to take precedence over statutory requirements. These objectives are set forth as follows:

- o reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;
- o provide an incentive for agencies to improve loan origination and documentation;
- o determine the actual subsidy of a Federal credit program; and
- o increase unified budget offsetting collections in the year of sale.

II. Guidelines for Loan Asset Sales

The following guidelines shall be adhered to by each agency in its approach to, and implementation of, all loan asset sales. However, the Federal Credit Policy Working Group realizes that there are or will be occasions for which changes to the guidelines will be necessary. Agencies are encouraged to bring problems to the Working Group for discussion. The guidelines have been amended to reflect modifications already authorized by the Working Group, and will be modified periodically in the future to reflect additional changes.

A. Loan asset sales shall be made without future recourse to the Federal Government. For the purposes of these guidelines, recourse includes any Federal guarantee of principal or interest payments; agreements to repurchase loans or to replace delinquent loans with current loans; warranties as to collateral value; and other agreements entailing continued Federal involvement that could create contingent liability. Recourse does not include: representation and warranty obligations in accordance with Guideline B; changes in internal agency policy or regulations needed to satisfy the agency's legal obligations to borrowers; arrangements made by the purchaser of the loans to provide for credit enhancement measures (such as overcollateralization, reserve funds or insurance) that do not impose contingent liability on the agency or the government; or retention by the Federal Government of a junior security representing a residual interest in the income produced by the loans after the sale. Agencies planning to retain a junior interest for more than 18 months or for an indefinite period must submit to OMB a plan for disposition.

B. If necessary, agencies may include in a loan sale agreement representations and warranties to the purchaser of loan assets concerning matters of fact and law, such as the characteristics of loans, the agency's authority to sell loans, and the legal enforceability of loans and security interests. Agencies may not warrant as to the future credit-worthiness of borrowers. The duration of warranty periods will be based on reasonable time periods for verification and will be determined on a case-by-case basis. The remedy for a breach of warranty may include substitution of an alternative loan not initially included in the sale pool or cash payment by an agency up to the value of the defective loan. Each agency is responsible for ensuring that it has the resources needed to satisfy warranty obligations. Loan sale agreements incorporating warranties shall be signed by an agency official of appropriate rank and shall name the individual agency as the warrantor. The text of warranties should be reviewed by OMB and Treasury.

C. Loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to full Federal income tax. This does not preclude sales of securities representing pooled loans or whole loans to tax-exempt investors for portfolio or trading accounts in the normal course of business, but is meant to preclude purchases by such investors from the proceeds of tax-exempt borrowings made for that purpose. Further, the financing of prepayments of loans shall be on a taxable basis; that is, borrowers should not issue tax-exempt bonds to prepay their outstanding loan balances.

-2-

D. Agencies should seek to contract out the servicing of loan assets prior to sale. If for valid reasons agencies are not able to do so before sale, collection and servicing shall be transferred to the purchaser with the sale of a loan asset.

E. Agencies shall sell loans and prepare to sell loans in the amounts stated in the budget for FY 1988 and FY 1989. Agencies shall sell newly issued loans and seasoned loans from their portfolios after approval of their sale plan.

F. Where appropriate, each agency shall choose, through a competitive process, professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.

G. Loan asset sales may be conducted on a competitive bid or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.

H. In limited circumstances where the borrower is not an individual, agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price; borrowers who are not current on their principal and interest payments shall not be allowed to purchase their loans.

I. Loan asset sales shall be sufficiently large to assure market interest. This is particularly important when developing markets for new types of securitized loans. In such cases, we would expect sales to be over $100 million. Other details, including timing of sales, the composition and size of loan pools, and other marketing issues, shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

J. Agencies may sell loan assets held by the FFB.

K. Agencies should not sell loan assets directly to Government-Sponsored Enterprises or to entities acting on their behalf for their own account.

L. To the extent possible, newly made loans should be sold on a regular basis within six months of when the loan was closed. It is recommended that when newly

-3-

made loans are scheduled for sale, agencies arrange for private servicing from the beginning. All proceeds from the sale of newly made loans will flow into the Treasury General Fund, absent legislation to the contrary.

M. In competitive bid situations agencies should be prepared to analyze bids for minimum price acceptability against an established valuation methodology. It is not likely that there will be good reason to disclose the methodology or price floors to bidders. Any such minimum price valuation methodology should be reviewed by OMB and Treasury.

III. Guidelines for Prepayment at a Discount 1/

A. In limited cases (where the borrower is not an individual and not delinquent on loan payments), agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price. Borrowers may become eligible to purchase their loans only if all past due principal, interest and charges are paid in full prior to discounting the remaining balance.

B. Proceeds from the prepayment of loan assets, net of the agency's reasonable and approved costs of sale, shall be deposited into the Treasury General Fund.

C. The financing of prepayments of loans shall be on a taxable basis; that is the borrowers may not prepay their outstanding loan balances either directly or indirectly through tax-exempt borrowings.

D. The prepayment plan and proposed price must be set very carefully to avoid undue cost to the Government or additional subsidy to the borrower. In general, the price should be calculated by discounting the remaining payments due on the loans by a composite interest rate consisting of the current market yield on Treasury securities of comparable maturities plus an allowance for administrative expenses and possible losses.

1/ Except for REA because of FY 1989 proposed budget reforms.

-4-

E. A financial advisor should be engaged to perform the following tasks and summarize the results in a report to the agency:

- o Conduct a portfolio valuation;
- o Compare pricing options; and
- o Provide a fairness letter.

Based on the financial advisor's report, the agency should develop a prepayment program and schedule. The plan must include an analysis of the pricing option offered. Prepayment plans and proposed pricing should be submitted to OMB and Treasury for review prior to any offering.

-5-

Comments From the Office of Management and Budget

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OCT 18 1988

Mr. Frederick D. Wolf
Director, Accounting and
Financial Management Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Wolf:

Thank you for the opportunity to respond to the draft report entitled "Borrower Loan Prepayments: OMB Guidelines Need To Be Strengthened." We agree with much of the substance of your report including the conclusion that the Administration had the legal authority to permit borrowers to prepay less than the outstanding principal balance in the cases studied. We also agree with your assessment that these prepayments need to be evaluated within the context of overall Federal credit policy and have used this framework in developing a response to your report.

The report identifies a number of areas in which the General Accounting Office (GAO) and the Office of Management and Budget (OMB) concur. However, we have strong objections to the following three conclusions raised in the report, and we will deal with each in turn: (1) prepayments are preferable to sales; (2) the appropriate interest rate for determining the present value of cash flows in estimating the subsidy is the rate on Treasury securities; and (3) the loan asset sales guidelines should be revised to require formal cost benefit analyses.

I. Prepayments are Preferable to Sales

See comment 1.

GAO concludes that prepayments are preferable to third party sales because they avoid the transaction costs associated with public sales. OMB agrees that transaction costs are significantly lower for prepayments than sales. However, we do not agree that lower costs automatically make prepayments preferable to third party sales, for three reasons.

See comment 2.

First, prepayment programs diminish the quality of the portfolio that the Government is left holding substantially more than sales. This "adverse selection" occurs because those borrowers who elect to prepay are likely to be more creditworthy than borrowers in the portfolio as a whole. They are borrowers who have accumulated excess funds or who can borrow in private markets at favorable terms. While some loans are omitted from the sale pool, the loans sold are closer to representative of the portfolios as a whole.

Those who prepay also may have loans on terms and conditions that are not similar to the majority of loans in the portfolio or the loans that would be sold. For example, borrowers with high interest rates may be more likely to prepay. For these reasons, the basis for GAO's conclusion that prepayments are preferable to sales is highly misleading. GAO uses a simple ratio of proceeds to outstanding balances for prepayments compared with sales.

After a prepayment program, the remaining portfolio consists of the higher risk loans with lower interest rates. These loans are the most expensive to service. Furthermore, the value of the portfolio may be so diminished that a third party sale is not feasible.

See comment 3.

Second, GAO's conclusion that prepayments are preferable to sales omits the benefits of credit management improvements that the sales process forces an agency to adopt in order to prepare a portfolio for sale. In fact, pages 9 and 10 of your own report supports our contention:

> "Loan sales appear to have led to more significant long-term credit reform -- such as improved understanding of private sector credit management techniques -- than prepayments."

We recognize that many of the improvements resulting from sales are difficult to quantify, particularly in the near-term, but we will continue to press agencies to adopt as formal procedures the commercial standards used throughout the loan asset sales process. Both the Department of Education and the Farmers Home Administration (FmHA) have upgraded their loan documentation standards and have made improvements in the servicing and systems areas. For example, both the Department of Education and FmHA now have on-line databases that track the credit history of borrowers over the past ten years.

See comment 4.

Third, prepayments unlike sales do not assist in measuring the subsidy inherent in Federal loan programs. This is because only the most creditworthy borrowers can afford to prepay and the price at which they prepay is not market determined. We agree that the sale of seasoned loans does not provide a measure of the subsidy, but the sale of newly made loans does. For this reason, for the 1990 Budget, OMB will focus primarily on sales of new loans.

-2-

Future sales of new loans should provide an accurate, objective measure of the subsidy. When loans are sold shortly after origination, changes in interest rates, economic conditions and borrowers' situations are minimized. In such cases, the difference between the outstanding principal and the proceeds (gross rather than net of sales costs) is the value of the subsidy. (We agree that servicing costs should not be included in the subsidy. We also agree that high information costs due to investor unfamiliarity should not be included. Early sales may thus yield higher than appropriate estimates of the subsidy; we are working hard to improve investor information to eliminate this factor).

II. Treasury Interest Rates Should Be Used to Calculate the Subsidy

See comment 5.

GAO's discussion of subsidy estimation on pages 52-55 is seriously flawed. GAO argues that the subsidy inherent in Federal credit programs can be calculated using the Treasury borrowing rate. We disagree with this approach to subsidy estimation.

GAO's approach of calculating the present value of the repayments of principal and interest on loans minus administrative and estimated default costs discounted by the risk-free Treasury interest rate of comparable maturity, results in a seriously understated estimate. Federal direct loans and loan guarantees are frequently made to less creditworthy borrowers. These loans usually have lower downpayments, higher loan to collateral ratios, and other terms and conditions much easier than those available from private lenders.

For public policy reasons, many loans are restructured or remain delinquent to a greater extent than private loans. As a result, default rates are higher for Federal than for private loans, and taxpayers bear the cost of greater losses as well as the risk that economic conditions could increase the loss well beyond that expected when the loans were made. In addition, the taxpayer bears the opportunity cost of this use of funds.

The more lenient terms and conditions on Federal loans represent real costs in the form of an immediate unrealized capital loss to the Government at the time a subsidized direct loan or loan guarantee is made. These costs must be used when allocating budget resources to a Federal credit program rather than to other forms of Federal assistance. Private competitive market rates of return provide the most expert and objective rate of discount for the expected repayment and income stream.

-3-

III. Require a Cost-Benefit Assessment in the Guidelines

See comment 6.

OMB agrees with GAO's conclusion that prepayments should be preceded by an in-depth analysis. Substantial analysis has occurred prior to each sale, and thus we do not agree that the guidelines need to be revised to accomplish this. The guidelines outline a review procedure that was designed to ensure that all levels of the Executive Branch, as well as financial advisors, bring their expertise and points of view to bear on the proposed sale. Implicitly, the procedures already in place accomplish the aims of the GAO recommendation.

The Federal Credit Policy Working Group meets frequently to review major policy issues raised by the individual sales. In addition to this forum, the Cash and Credit Management Branch of OMB tracks the daily progress of the sales and provides an analytical clearing house for staff views. Prior to any sale, the OMB Associate Director for Management, the Assistant Secretary for Domestic Finance and a ranking policy official of the selling agency sign an approval statement that signals compliance with the guidelines.

OMB is in the process of revising and reissuing Circular A-129, Managing Federal Credit Programs. The revised circular will strengthen the sales process by explicitly requiring agencies, as part of their annual budget submission, to take the following actions that are consistent with your recommendation:

A. Perform a review of loans to verify the accuracy of payment history and loan balances, and to seek parity with private sector standards for documentation and accounting information systems;

B. Evaluate the credit performance of the portfolio by analyzing loan terms, Federal interest rates versus market rates, average outstanding balance, payment history, number of loans, geographic location, delinquency/default rates, and historical trends; and

C. Make qualitative and quantitative determinations of the potential sale value by comparing sales potential to previous loan sales from existing portfolio and/or similar Government portfolios that were sold; and examining current market conditions affecting sales of similar private sector portfolios.

-4-

Thank you for giving us the opportunity to review your draft report entitled Borrower Loan Prepayments: OMB Guidelines need to be Strengthened. If you need further clarification on any of the issues discussed in this letter, please feel free to call me or Gerry Riso.

Sincerely,

Joseph R. Wright, Jr.
Acting Director

-5-

The following are GAO's comments on the Office of Management and Budget's letter dated October 18, 1988.

GAO Comments

1. The draft of the report OMB commented on did not conclude that prepayments are preferable to third party sales. The report, however, has been clarified to point out that the finanical results of prepayments and sales cannot be directly compared. See chapter 4, pages 33 to 34.

2. Report clarified. See chapter 3, pages 23 to 24.

3. As mentioned in comment 1, the draft of the report OMB commented on did not conclude that prepayments are preferable to sales. The report has been revised to clearly point out that sales better achieve credit management improvements. See chapter 4, pages 33 to 34.

4. No report change needed. The report does not discuss the role of newly made loans to measure subsidy costs.

5. GAO has taken the position in several reports and testimonies that the subsidy cost of a federal credit program should be the actual (cash) cost to the government of granting loans and not the economic benefit subsidy to the borrowers as advocated by OMB. See chapter 4, pages 31 to 33.

6. GAO agrees that OMB's proposed revisions to Circular A-129, "Managing Federal Credit Programs" will satisfy our recommendation for cost-benefit analyses. See chapter 6, pages 41 to 42.

Comptroller General's July 21, 1987, Decision on Foreign Military Sale Prepayments

Comptroller General
of the United States
Washington, D.C. 20548

B-226058

DO NOT MAKE AVAILABLE TO PUBLIC READING
FOR 30 DAYS

July 21, 1987

The Honorable David R. Obey
Chairman, Subcommittee on Foreign
Operations
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

This is in response to your letter dated January 7, 1987, requesting that this Office review the legal propriety of the Administration's proposal to restructure certain loans made under the Foreign Military Sales (FMS) program. For the reasons set forth below, we conclude that the Administration's restructuring proposal should not be implemented without specific statutory authority.

We requested comments from the Departments of State, Defense, and the Treasury, and the Office of Management and Budget. The Department of the Treasury coordinated its response with the Department of State in a letter dated February 6, 1987. Defense deferred to Treasury, and State and OMB declined to comment. The Treasury comments are set forth below, as appropriate.

FACTS

From the mid-1970s to the mid-1980s, the United States financed a number of "credit sales" of military equipment to foreign countries under section 23 of the Arms Export Control Act, 22 U.S.C. § 2763 (1982), which provides that the President "is authorized to finance the procurement of defense articles . . . by friendly foreign countries." The loans here in question were financed by the Federal Financing Bank (FFB) under 12 U.S.C. § 2285 (1982). The Defense Security Assistance Agency (DSAA) guaranteed the loans under section 24 of the Arms Export Control Act, 22 U.S.C. § 2764 (1982), which provides that the President

> "may guarantee any individual, corporation, partnership or other judicial entity doing business in the United States . . . against political and credit risks of nonpayment arising out of their financing of credit sales of defense articles . . . ."

When a debtor nation defaults on a DSAA-guaranteed loan, DSAA pays FFB out of a Guaranty Reserve Fund. 22 U.S.C. § 2764(c) (Supp. III 1985).

The fact that the loans were financed by FFB at "market" interest rates in the late 1970s and early 1980s has created problems, both economic and political, for several debtor nations which now face repaying long-term loans at rates much higher than current, relatively low interest rates. According to Treasury's submission:

> "Some of the United States' closest friends and allies have questioned how our security relationships would allow the U.S. to let them face this heavy burden without trying to assist in some way. Several key allies, including Egypt, Israel and El Salvador, have pressed us for some form of FMS loan restructuring. President Mubarak, in particular, has urged that the U.S. act to ease the heavy burden of FMS debt repayment on Egypt's struggling economy. Members of Congress . . . have also expressed concern over the problem."

Accordingly, the Administration intends to offer debtor nations two options:

> "1. Prepayment at Par. Borrowers with the resources to do so or access to international capital markets will be permitted to repay the outstanding principal on high interest loans without penalty. The U.S. Government will not be guaranteeing any borrowed funds which may be needed to prepay these loans.
>
> "2. Partial Capitalization of Interest. The U.S. Government will reduce the original interest rates on the high interest loans to a current market rate and capitalize the difference in payments between the new and the old rates. The capitalized amounts would be repaid with interest at the end of the loans' original maturity. This option will enable FMS recipients to benefit from a temporary reduction in FMS debt servicing. At the same time, the U.S. Government will still recover the full value of each loan within the life of the original loan contract."

Treasury has taken the position that the debt restructuring is proper:

2 B-226058

> "The options as structured do not require new legislation nor budget authority. With regard to the first option, a provision for prepayment of FMS loans at par, in the event of default, is included in the FMS loan contracts . . . . As to the second option, as the full value of the affected USG assets (i.e. the FMS loans) would be recovered within the original maturity of the underlying loan, the restructuring of repayment terms through interest capitalization is permitted. (12 U.S.C. Section 2281, et seq.; 22 U.S.C. Section 2764)."

ANALYSIS

Without a compensating benefit to the United States, agents and officers of the United States have no authority to dispose of the money or property of the United States, to modify existing contracts, or to surrender or waive contract rights that have vested in the government. 40 Comp. Gen. 684, 688 (1961); Union National Bank v. Weaver, 604 F.2d 543, 545 (7th Cir. 1979). This rule clearly is applicable to the loans here in question. The United States has a contractual right to receive repayment of the loans on a certain schedule and at a certain interest rate.

The rule against surrender or waiver of the government's contract rights may be inapplicable when there is specific statutory authority for waiver of the government's interest. 62 Comp. Gen. 489, 490 (1983) (authority to "compromise" loans constitutes specific authority permitting discharge of debt at less than full value). We are aware, however, of no such specific authority applicable to the loans here in question, and Treasury has brought none to our attention.1/

1/ Section 633(a) of the Foreign Assistance Act, 22 U.S.C. § 2393(a) (1982), provides that, with regard to functions authorized under that Act, the President may waive provisions of law "regulating the making, performance, amendment, or modification of contracts." The FMS loans here in question, however, were made under the Arms Export Control Act, which includes no such authority. See 22 U.S.C. § 2751 (note) (1982). The Treasury Department does have certain authority to modify contracts "without regard to other provisions of law," when the modification would "facilitate the national defense." 50 U.S.C. § 1431 (1982), Pub. L. No. 85-804. See Executive Order No. 10789, November 14, 1958. It is not clear whether this statute could be applicable in the instant case. See 22 U.S.C. § 2751 (note) (1982). The legislative history of section 1431 indicates that it was intended to apply in "emergency"

3 B-226058

We conclude that under one of the options in the Administration's restructuring proposal, the United States would certainly incur a financial loss. Under the second option, the financial loss may be only a temporary cash flow impediment but, as will be discussed, infra, there is a substantial possibility that the final payment to the United States may have to be forgiven or rescheduled. These conclusions are substantially consistent with those of the Congressional Budget Office (CBO), presented in testimony before the House Appropriations Committee, Subcommittee on Foreign Operations, on May 6, 1987. See Hearings on Foreign Assistance and Related Programs Appropriations for 1988, Foreign Military Sales Debt Prepayment and Restructuring, May 6, 1987 (stenographic minutes); "Statement of James L. Blum, Assistant Director, Budget Analysis Division, Congressional Budget Office, before the Subcommittee on Foreign Operations, House Committee on Appropriations," May 6, 1987 (hereinafter referred to as "CBO Statement").

Under the "prepayment at par" option, the United States would lose the benefit of receiving high interest payments over the remaining life of the loan. The CBO has estimated that if, in accordance with the Administration's original budget estimates, nine debtor countries prepaid, the net interest loss to the FFB would be approximately $350 million. CBO Statement at 6. Second, because the FFB would still be required to make interest payments on the public debt it incurred to finance the FMS loans, and would not have the benefit of the cash flow from the FMS loans, the FFB would need to borrow additional funds to make the payments.

Treasury has taken the position that the prepayment option is permissible because the relevant loan agreements include a provision whereby, in the event of default by the debtor nation, FFB may,

> "declare immediately due and payable the unpaid principal and accrued interest on the Note and any other note or other indebtedness of the Borrower held by the holder of the Note and such amount shall become immediately due and payable without protest, presentment, notice or other demand of

---

situations. B-212529, May 31, 1984. In any event, Treasury does not rely on this statute in its submission or otherwise indicate that it intends to invoke it and comply with its various restrictions and reporting requirements. Accordingly, we will not discuss further its applicability here.

4 B-226058

> any kind, all of which are hereby expressly waived by the Borrower . . . ."

Treasury, accordingly, proposes to declare a default, whereby the debtor nation would deliberately fail to make a required payment, with the concurrence of FFB, and FFB would then demand immediate prepayment in full in accordance with the loan agreement's default provision. It apparently is Treasury's position that, because the agreement permits the government to demand repayment in full upon default, the government "waives" no rights under the contract when the loan is prepaid in this manner. We do not concur in Treasury's analysis. The debt rescheduling plan does not constitute settlement of debts determined to be uncollectible, which the executive branch does have authority to compromise. See generally 31 U.S.C. § 3711. There is also no persuasive evidence that default is really imminent on any of the loans in question. Treasury is reading the default provision in isolation, without looking at the entire loan agreement. The loan agreement also provides:

> "If the Borrower fails to make payment when and as due of any installment of principal or interest under the Note, the amount payable shall be the overdue installment of principal or interest, plus interest thereon at the rate specified in the Note, from the due date to the date of payment. If the Borrower's failure to pay such installment or any part thereof continues for sixty days, the Borrower shall pay an additional charge of 4% per annum on such installment or part thereof for each day thereafter until payment is made."

Further, the promissory note annexed to the loan agreement provides that the borrower will make payments according to a schedule "without right of prepayment." (Emphasis added.)

Read in the context of the entire loan agreement, it is clear that the default provision is intended to protect the lender (the FFB), not to provide a mechanism to forgive part of the borrower's obligation. Since the agreement provides another remedy for late payments--a remedy which anticipates payments being as much as 60 days late, and which is far more advantageous to FFB--we cannot conclude that the default provision was intended to be used when the borrower was late 10 days in making one payment, but otherwise appeared solvent. Rather, in our opinion, the default provision was intended to allow FFB to declare the entire amount due, in an attempt to salvage at least part of the debt, if it became evident that the borrower was in fact insolvent and would be unable to continue making payments.

5 B-226058

This interpretation of the intent of the default provision is certainly in accord with commercial practice.

With regard to the "capitalization of interest" option, Treasury has taken the position that, because the principal and amortized interest will be scheduled to be repaid in full during the term of the loan, there is no surrender of any right or property by the government. We conclude that, at least in theory, Treasury is correct. The "capitalization of interest" option does provide for recovery by the government of all principal and interest, including interest on the capitalized interest. Nevertheless, Treasury is proposing rescheduling of the debt because the current payments are too high. However, the capitalization of interest option would require a participating debtor nation to pay a very large balloon payment at the end of the term of the loan. A debtor nation realistically might have difficulty in meeting this large balloon payment, and there is a substantial possibility that the loan would have to be forgiven or again rescheduled. See GAO, "Unrealistic Use of Loans to Support Foreign Military Sales," ID-83-5, January 19, 1983; GAO, "Military Loans: Repayment Problems Mount as Debt Increases," NSIAD-86-10, October 30, 1985. If the loans here in question are forgiven or rescheduled again, the government would suffer a loss.

The CBO, using the Administration's budget estimates, calculates these added costs to the government in the case at hand would be approximately $210 million. CBO Statement at 7. Accordingly, although the "recapitalization of interest" option does contemplate, on its face, that the United States will be made whole, there is a substantial risk under that option that the government would in fact suffer a significant loss.

"ADEQUATE COMPENSATION"

We have concluded that under the options available to debtor nations under the Administration's debt restructuring proposal, the United States will incur either a financial loss or a substantial risk of significant financial loss.

As discussed in our earlier analysis, no agent or officer of the United States may surrender or waive vested contract rights to the financial detriment of the United States without an adequate compensating benefit, in the absence of specific statutory authority to surrender or waive such rights. The only compensating benefit suggested by the Treasury is that its proposal will alleviate the financial plight of several friendly nations and thus advance the foreign policy interests of the United States.

6 B-226058

We have no doubt that Treasury's foreign policy concerns are serious and that it might be in the best interests of the United States to relieve the heavy debt burden of our friends and allies. Moreover, our decisions on adequate compensation have never insisted that the benefit be entirely financial. See, for example, 58 Comp. Gen. 7, 9 (1978), in which we decided that the government could waive the right to a special discount for federal employees on accommodations in national parks provided in standard National Park Service concession contracts. We overruled an earlier case (40 Comp. Gen. 234 (1960)), in which the concessioners were seeking to be relieved of the obligation, and we advised the Secretary of the Interior that he could not waive a contract right solely because the concessioners found it to be onerous and Interior wished to accommodate them. In the 1978 case, a study conducted by the House Government Operations Committee, with which the Secretary of the Interior concurred, found that the acceptance of free or reduced rate accommodations by government employees on official business might violate--or appear to violate--federal conflict of interest laws. We sanctioned the waiver because (1) failure to do so might actually call in question the integrity of a government agency; and (2) the agency's oversight committees had made it clear that they considered the continued use of the contract benefit to violate other federal laws. See also B-223329, October 17, 1986 (66 Comp. Gen. ___ (1986)). The Soil Conservation Service, Department of Agriculture, asked for an advance decision from our Office approving the modification of certain fixed-price construction contracts to delete a requirement that the contractors pay premium rates for overtime worked in excess of 8 hours a day. (The requirement had been deleted in a statute enacted after the contracts in question were signed, but the coverage of the statute was prospective only.) The only reason offered for waiving the requirement was the avoidance of contract complaints and objections from the contractors whose costs were higher than they would otherwise be. However, the contract was "fixed price"; in the absence of some compensating benefit to the United States, there was no reason to change the contract. We rejected the argument that "public policy" alone was sufficient to justify the modification of the contract. See also, 35 Comp. Gen. 56, 59 (1955). Modification of Foreign Investment Guarantee contracts to lower insurance rates, based on a desire to facilitate administration of the program and create a feeling of confidence in the business community was too intangible and speculative to constitute adequate compensation for sustaining a financial loss.

In each of these cases, it was clear that the lack of adequate compensation for a financial concession would not prevent such action if there was specific legislative

7 B-226058

authority for the agency to waive a contractual right. We have been unable to find any such statutory authority. On the contrary, we note significant interest and concern with the debt problems of friendly nations and a distinct aversion to the only solution proposed by the Administration to date.

In 1985, the Congress amended the Arms Export Control Act to authorize the President to finance sales at concessional (or less than market) rates of interest. International Security and Development Cooperation Act of 1985, § 102, Pub. L. No. 99-83, 99 Stat. 190, 195 (1985). The statute also extended the period of repayment of loans for certain countries. Id., § 101(b). In explaining the concessionary financing provision, the House Foreign Affairs Committee stated:

> "This new section 23 facilitates the new approach to FMS financing which enables foreign recipients to repay FMS loans on a concessionary interest rate basis. It is the committee's expectation that such concessionary financing will be available for countries facing serious debt-servicing problems as defined by internationally recognized economic criteria. Countries facing such problems are countries that have accumulated significant arrearages in their long-term external debt, have rescheduled debt, have sizeable external debt and debt-service ratios, are drawing on credit facilities of the International Monetary Fund, or have low per capita incomes. The committee expects to be fully consulted regarding terms and countries made eligible for concessionary FMS financing."

H.R. Rep. 39, 99th Cong., 1st Sess. 12 (1985).

The same year, in section 551 of the Foreign Assistance and Related Programs Appropriations Act, 1986, the Congress again addressed the FMS debt problem, as follows:

> "The United States foreign military assistance loan programs, which have had very high interest rates in past years, have contributed to the security of our friends and allies, but also have played a contributing role in adding to the debt burdens of many of our friends and allies;
>
> . . . . .
>
> "The past few years have seen several positive legislative steps taken to alleviate the FMS loan-

8 B-226058

> related debt burdens of our friends and allies by reducing interest rates, stretching out the repayment period of these loans, and by increasing the level of MAP grants and forgiven FMS credits;
>
> "These steps have helped to ease these problems in the short term, but the long-term debt servicing problems of our friends and allies remain;. . . "

The statute then concluded,

> "(5) the President is urged to propose, in the next formal Congressional Presentation for Security Assistance Programs, reforms and refinements in the foreign military assistance programs along these lines for consideration by the appropriate committees of the Congress."

Pub. L. No. 99-190, § 101(i), 99 Stat. 1185, 1314.

The President responded on December 18, 1986 with the two alternate proposals for debt restructuring we have been discussing, _supra_. The proposals were not warmly received, at least by the House Committee on Appropriations. H.R. 1827, making supplemental appropriations for fiscal year 1987, initially contained a provision forbidding the President to implement either proposal until the later of October 1, 1987 or passage of a regular appropriation to the programs for fiscal year 1988. This restriction was dropped by agreement of the full House from the version of H.R. 1827 which became Pub. L. No. 100-71, enacted July 11, 1987. Nevertheless, the House committee report reads as follows:

> "The Committee has substantial concerns about the advisability of the Administration's proposal. It appears to have substantial budgetary ramifications by decreasing future year revenues while at the same time failing to truly assist countries deeply burdened by their military debts. The Committee is deeply concerned that the proposal, if fully implemented, will create a future debt payment crisis far greater than the one which is currently being faced by these countries.
>
> "The moratorium will allow the Committee and the Congress the time to fully study the potential ramification of this proposal."

H.R. Rep. 100-28, 100th Cong., 1st Sess., March 25, 1987.

These legislative provisions indicate that the Congress has been aware of and is planning to act on the debt problems of friendly nations. It is apparent that the committees are not satisfied with the Administration's December 18, 1986 proposals.

For all of the above reasons, we believe that the Administration should not attempt to implement the proposals or any other debt restructuring proposal without clear evidence of congressional approval.

DEPLETION OF THE GUARANTY RESERVE FUND

Subsequent to the receipt of your January letter, a member of your staff orally requested that we review the recent depletion of the Guaranty Reserve Fund to determine if the depletion of that fund violated the Antideficiency Act. 31 U.S.C. § 1341. The Guaranty Reserve Fund constitutes "a single reserve for the payment of claims under guaranties" issued under the "credit sales" program. 22 U.S.C. § 2764(c), (Supp. III 1985).

We received two oral requests from other congressional sources for opinions on the same subject. The last requestor called our attention to the new amendment to section 24(c) of the Arms Export Control Act, enacted on July 11, 1987 as part of Pub. L. No. 100-71, the Supplemental Appropriations Act for fiscal year 1987. Section 24(c) of the AECA, as amended, provides alternative sources of funding to pay claims of the FFB when the Guaranty Reserve Fund is inadequate for that purpose.

The new amendment may possibly change our answer to your question. However, its enactment is so recent that we have not yet had time to study its implications thoroughly. With your permission, we would prefer to respond to this question at a later time.

This letter will be available for release to the public 30 days from today, unless released earlier by you or your staff.

Sincerely yours,

for Harry R. Van Cleve
Comptroller General
of the United States

10 B-226058

Major Contributors to This Report

Accounting and Financial Management Division, Washington, D.C.

Jeffrey C. Steinhoff, Associate Director, (202) 275-9454
Ernst F. Stockel, Group Director
Harold P. Santarelli, Supervisory Accountant
Mark Elam, Accountant
Ravi T. Shetty, Accountant

Office of the General Counsel

Rollee H. Efros, Senior Associate General Counsel
Alan N. Belkin, Senior Attorney

Office of the Chief Economist

Randolph M. Lyon, Economist

Related GAO Products

Federal Assets: Information on Completed and Proposed Sales (GAO/RCED-88-214FS, September 21, 1988).

Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988).

Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988).

Federal Government Credit Activities and How They Relate to Loan Sales (GAO/T -AFMD-88-2, November 10, 1987).

An Assessment of the Government's Loan Assets Sale Program (GAO/T-AFMD-87-7, March 26, 1987).

The Government's Loan Asset Sales Pilot Program (GAO/T-AFMD-87-6, March 10, 1987).

Proposals for Improved Credit Program Budgeting (GAO/T-AFMD-87-5, March 4, 1987).

The Government's Loan Asset Sales Pilot Program, statement by Charles A. Bowsher, Comptroller General, before the Legislation and National Security Subcommittee, House Committee on Government Operations (September 26, 1986).

Loan Asset Sales: OMB Policies Will Result in Program Objectives Not Being Fully Achieved (GAO/AFMD-86-79, September 25, 1986).

☆U.S. G.P.O. 1989-241-164:80362