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REPORT TO THE CONGRESS

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Legislation Recommended To Reduce Losses Of Two Insured Loan Funds Of The Farmers Home Administration

B-114873

Department of Agriculture

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

JULY 20, 1971

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114873

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on legislation recommended to reduce losses of two insured loan funds of the Farmers Home Administration, Department of Agriculture.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget; to the Secretary of Agriculture; and to the Secretary of the Treasury.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

LEGISLATION RECOMMENDED TO REDUCE LOSSES OF TWO INSURED LOAN FUNDS OF THE FARMERS HOME ADMINISTRATION 358
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DIGEST

WHY THE REVIEW WAS MADE

The Farmers Home Administration (FHA) is authorized to make loans from the Agricultural Credit Insurance Fund and the Rural Housing Insurance Fund to individuals and to public and nonprofit associations for various purposes. As required by law, FHA sells the borrowers' loan notes to investors on a guaranteed basis and uses the proceeds to finance additional loans.

Because of the rapid increase in loans (from $202 million in 1964 to $895 million in 1969) and the sizable operating losses ($104 million) incurred in recent years for the two funds, the General Accounting Office (GAO) made a review to determine (1) the reasons for the losses and (2) the ways in which future losses could be kept to a minimum. (See p. 5.)

FINDINGS AND CONCLUSIONS

Reasons for operating losses

Under money-market conditions prevailing in the last few years, the FHA interest rates on loans to borrowers have been significantly less than the rates at which FHA sells the borrowers' loan notes to investors. This difference in interest rates has been the principal cause of the operating losses reported for the two funds in recent years. (See p. 10.)

Financing loan programs through Treasury borrowings rather than through loan note sales

Future annual operating losses of both funds could be minimized if FHA could finance new loans through borrowings from the Treasury rather than through sales of borrowers' loan notes to investors. The sale of borrowers' loan notes, however, is required by legislation establishing the loan programs--the Consolidated Farmers Home Administration Act of 1961 and the Housing Act of 1949.

Tear Sheet

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To determine the additional interest costs which the Government would incur by financing the loan programs through the sale of borrowers' loan notes rather than through borrowings from the Treasury, GAO compared the guaranteed interest rates on a sale of notes totaling $350 million in January 1970 with the interest yields on marketable Treasury obligations of comparable maturity periods. If the notes had been financed through borrowings from the Treasury, the Government could have saved $17.5 million.

FHA plans to market $5.2 billion of borrowers' loan notes in fiscal years 1971 and 1972. The total additional interest costs which the Government will incur by not financing these loans through borrowings from the Treasury will be substantial. (See p.17.)

Another reason for financing FHA's insured loan programs through borrowings from the Treasury is that such programs then would be subjected to the same budget discipline and appropriation processes accorded other Federal activities whose budget requests are shown as cash outlays in the Federal budget. GAO believes that the public interest is best served when Government programs are financed through the appropriations process, because of the periodic congressional scrutiny and the affirmative congressional action inherent in that process. (See p. 23.)

Interest rates charged borrowers

A further reduction in operating losses of the Agricultural Credit Insurance Fund could be made if FHA were authorized to charge interest on loans at rates more closely related to the Government's cost of financing the loans and to the borrowers' abilities to pay. Pertinent legislation requires that the interest rate charged to borrowers on loans made from this fund be 5 percent or less per annum. (See p.16.)

The legislative history of the act establishing the Agricultural Credit Insurance Fund does not indicate the intent of the Congress in establishing the 5-percent interest ceiling. This rate was higher than the interest rates paid to investors who purchased FHA loan notes from 1961 to 1965. Since 1965 the 5-percent rate has been significantly less than the rates which FHA has paid to investors on loan notes. (See p. 18 and graph on p. 19.)

FHA officials said that many borrowers could pay interest on loans made from the Agricultural Credit Insurance Fund at rates in excess of the statutory rate of 5 percent. For example, FHA income statistics on borrowers indicated that, in fiscal year 1970, the income levels for about 50 percent of the borrowers of 5-percent farm-ownership and recreation loans were similar to the income levels of FHA borrowers who paid interest at higher rates for certain types of rural housing loans. (See pp. 20 to 22.)

Until fiscal year 1970 FHA set its interest rates on loans to public bodies for water and sewer systems at the same rates that the Economic Development Administration charged to borrowers of public works loans for development of water and sewer facilities. In 1970, when this Administration increased its interest rate on public works loans to 5-3/4 percent, FHA was prevented by the statutory ceiling on its interest rate of 5 percent from making a similar change. For fiscal year 1971 the Economic Development Administration's interest rate is 6-3/4 percent. (See p. 21.)

Need for improved cost disclosure

FHA's financial statements furnished to the Treasury Department and the budget justifications presented to the Congress relating to the two funds do not show the full costs of administering the loan programs and do not show the interest cost on the Government's investment in the two funds. (See p. 28.)

Further, FHA budget justifications do not show the substantial interest costs on sales of borrowers' loan notes that FHA has committed the Government to pay in future years. For the loan notes of $3.8 billion held by investors at March 31, 1970, FHA estimated that, if the investors held the loans for the full nonredemption periods, the interest paid to investors would be about $443 million in excess of the interest collected from the borrowers. (See p. 31.)

RECOMMENDATIONS OR SUGGESTIONS

GAO's recommendations for minimizing operating losses of the two funds, which would require changes in existing legislation, are discussed under the matters for consideration by the Congress. With regard to financial statements and budget presentations for the two funds, FHA should provide for

--including in its financial statements all costs related to the loan programs and

--disclosing in its annual budget justifications, the commitments of Government resources which the loan sales program has created and the current yields which FHA is required to guarantee investors who purchase such loans. (See p. 33.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

FHA, the Treasury Department, and the Office of Management and Budget agreed or did not disagree with GAO's recommendations. Each of the three

Tear Sheet

agencies made certain observations regarding the method of financing FHA's insured loan programs through the sale of borrowers' loan notes. Comments of each agency are presented starting on page 23 and are followed by GAO's evaluation.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Because of the potential annual interest savings that could be possible through the financing of FHA loan programs through Treasury borrowings, the Congress may wish to amend the legislation which requires FHA to finance its insured loan programs through sales of borrowers' loan notes.

Also, the Congress may wish to remove the 5-percent interest limitation and provide that the interest rates be based on the market yields on outstanding Government obligations of comparable maturities and be adjusted in accordance with the borrowers' abilities to pay.

C o n t e n t s

ABBREVIATIONS

ACIF	Agricultural Credit Insurance Fund
EDA	Economic Development Administration
FHA	Farmers Home Administration
GAO	General Accounting Office
RHIF	Rural Housing Insurance Fund

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

LEGISLATION RECOMMENDED TO REDUCE LOSSES OF TWO INSURED LOAN FUNDS OF THE FARMERS HOME ADMINISTRATION
Department of Agriculture B-114873

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Future annual operating losses of both funds could be minimized if FHA could finance new loans through borrowings from the Treasury rather than through sales of borrowers' loan notes to investors. The sale of borrowers' loan notes, however, is required by legislation establishing the loan programs--the Consolidated Farmers Home Administration Act of 1961 and the Housing Act of 1949.

To determine the additional interest costs which the Government would incur by financing the loan programs through the sale of borrowers' loan notes rather than through borrowings from the Treasury, GAO compared the guaranteed interest rates on a sale of notes totaling $350 million in January 1970 with the interest yields on marketable Treasury obligations of comparable maturity periods. If the notes had been financed through borrowings from the Treasury, the Government could have saved $17.5 million.

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- --including in its financial statements all costs related to the loan programs and
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AGENCY ACTIONS AND UNRESOLVED ISSUES

FHA, the Treasury Department, and the Office of Management and Budget agreed or did not disagree with GAO's recommendations. Each of the three agencies made certain observations regarding the method of financing FHA's insured loan programs through the sale of borrowers' loan notes. Comments of each agency are presented starting on page 23 and are followed by GAO's evaluation.

MATTERS FOR CONSIDERATION BY THE CONGRESS

Because of the potential annual interest savings that could be possible through the financing of FHA loan programs through Treasury borrowings, the Congress may wish to amend the legislation which requires FHA to finance its insured loan programs through sales of borrowers' loan notes.

Also, the Congress may wish to remove the 5-percent interest limitation and provide that the interest rates be based on the market yields on outstanding Government obligations of comparable maturities and be adjusted in accordance with the borrowers' abilities to pay.

CHAPTER 1

INTRODUCTION

The Farmers Home Administration makes what are termed "insured loans" from the Agricultural Credit Insurance Fund (ACIF) and the Rural Housing Insurance Fund (RHIF) to individuals and to public and nonprofit associations in rural areas for various purposes. This review was directed toward determining (1) the reasons for the funds' sizable operating losses in recent years, (2) ways in which future losses could be kept to a minimum, and (3) the adequacy of information presented in financial statements and budget presentations relating to the cost of operating the loan programs.

As required by applicable legislation, FHA sells borrowers' loan notes to investors on a guaranteed basis and uses the proceeds of the sales to finance additional loans through the two funds. Investors may have FHA repurchase the loans after specified nonredemption periods, and FHA may either resell or retain the loan notes. FHA makes the loans, collects principal and interest payments from the borrowers, performs all other loan-servicing functions, and absorbs all losses on the loans.

Under existing legislation FHA has authority to borrow from the Treasury, subject to limitations imposed by the Secretary of Agriculture, to pay obligations of the funds when the proceeds of loan sales and the repayment of loans and interest thereon are insufficient to meet such obligations.

Loans made by FHA from the two funds have increased more than fourfold in 6 years--from about $202 million in 1964 to about $895 million in 1969. At March 31, 1970, investors held about $3.8 billion of borrowers' loan notes. At that date FHA had recorded accumulated net losses totaling about $104 million for the two funds. The accumulated net losses were the result of sizable operating losses in fiscal years 1968-70.

ORGANIZATION OF FHA

Under the direction of an Administrator, FHA's headquarters office in Washington, D.C., is responsible for (1) determining overall policy within the framework of laws enacted by the Congress, (2) issuing operating instructions, (3) controlling budgets, and (4) directing the technical training of field staffs.

FHA maintains 41 State offices and 1,742 county offices which serve the 50 States, the District of Columbia, Puerto Rico, and the Virgin Islands. Each FHA State office is headed by an FHA State Director who is responsible for all program operations within his territorial jurisdiction. The FHA county offices, each under the supervision of a county supervisor, are located to serve all agricultural counties.

FHA's fiscal, business management, and accounting services are carried out centrally by about 500 employees at the Finance Office in St. Louis, Missouri. The Director of the Finance Office--under the guidance of the Assistant Administrator for Management--is responsible for the design, installation, and maintenance of FHA's accounting and data processing system and for related financial and reporting functions. He is responsible also for processing note sales and repurchases.

The Director of the Budget Division, under the Assistant Administrator for Management, is responsible for annual budget presentations within the budgetary contraints determined by the Secretary of Agriculture.

LOANS MADE FROM THE AGRICULTURAL
CREDIT INSURANCE FUND

The Consolidated Farmers Home Administration Act of 1961 (7 U.S.C. 1921) authorizes FHA to make loans to individuals, who are unable to obtain credit elsewhere at reasonable rates and terms, for the acquisition of farmland and buildings, improvement and repair of farm structures, development of recreational facilities, and improvement of farmland through soil and water conserving practices. The act provides that the loans be repaid in 40 years or less and bear interest at the rate of 5 percent or less per annum. The loans may not be made if they increase the borrower's total indebtedness against the farm or other security to more than $100,000 or the normal value of the security property.

The act authorizes FHA also to make loans to public and nonprofit associations for the development or improvement of water, sewer, recreational, and irrigation facilities and for the acquisition and development of grazing land. The loans must be

--made at interest rates of 5 percent or less,

--made only when FHA determines that the associations are unable to obtain credit elsewhere at reasonable rates and terms,

--limited so that the principal loan indebtedness and grant assistance not exceed $4 million for an association, and

--repaid within 40 years.

A summary of the various types of loans made in fiscal year 1970 from ACIF follows.

Loan program	Amount
Farm-ownership	$256,490,900
Recreation--individuals	1,211,180
Soil and water--individuals	4,047,640
Associations	94,249,920
Total	$355,999,640

Proposed legislation introduced in the 92d Congress (H.R. 3141 and S. 1806) would provide FHA with authority to make farm operating loans from ACIF. Operating loans now are financed with Treasury borrowings and are made out of FHA's Direct Loan Account, which would be abolished under the proposed legislation. FHA plans to make $275 million of farm operating loans in fiscal year 1972.

LOANS MADE FROM THE RURAL HOUSING INSURANCE FUND

Title V of the Housing Act of 1949 (42 U.S.C. 1472) authorizes FHA to make loans to rural residents, who are unable to obtain credit elsewhere at reasonable rates and terms, for the construction, improvement, alteration, repair, or replacement of rural housing and for the purchase of the necessary land as a site for such housing. The act provides that the loans be repaid in 33 years or less and that interest rates:

--For borrowers with low or moderate incomes be based on a statutory formula that ties the interest rate to interest yields on marketable Government obligations but, depending on the borrowers' incomes, may be reduced to as low as 1 percent. The interest rate for fiscal year 1971 is 7-1/4 percent.

--For borrowers with above moderate incomes be equal to the charges for mortgages insured by the Federal Housing Administration under section 203 of the National Housing Act (12 U.S.C. 1709). That rate was 8-1/2 percent in September 1970 and by April 1971 was 7 percent.

The 1949 act (42 U.S.C. 1484) also authorizes FHA to make loans to farmers or to public or nonprofit associations for housing and related facilities for domestic farm labor. The act provides that these loans be repaid in 33 years or less and bear interest at a rate of 5 percent or less per annum.

The 1949 act (14 U.S.C. 1485) further authorizes FHA to make loans to individuals or associations for constructing, improving, or purchasing rural rental and cooperative housing for rural residents. The act provides also that these loans be repaid in 50 years or less, with interest rates to vary in the same way as those charged low-to-moderate-income persons receiving rural housing loans.

Following is a summary of the various types of loans made in fiscal year 1970 from RHIF.

Loan program	Amount
Rural housing	$751,013,550
Farm labor housing	1,549,260
Rural rental housing	27,132,790
Total	$779,695,600

CHAPTER 2

FINANCING OF LOANS FROM THE AGRICULTURAL CREDIT INSURANCE AND RURAL HOUSING INSURANCE FUNDS

FHA sells borrowers' loan notes from ACIF and RHIF to investors at interest rates that are higher than the interest rates that the Government would have to pay if additional loans were financed through Treasury borrowings. The differences in these interest rates are large enough to significantly increase the cost to the Government of financing new loans.

In addition, under money-market conditions prevailing in recent years, the FHA interest rates on loans made to borrowers have been significantly less than the interest rates at which FHA sells the borrowers' loan notes to investors. This difference in interest rates has been the principal cause of the operating losses reported for the two funds in recent years.

The following sections discuss the financing of the loan programs conducted through the two funds, reasons for the operating losses in recent years, and ways in which future operating losses could be minimized. Such changes to minimize operating losses would require legislation by the Congress, since the sale of borrowers' loan notes to investors and the maximum interest rates FHA can charge borrowers on loans are provided for in legislation authorizing the loan programs.

SALE OF BORROWERS' LOAN NOTES

Section 309 of the Consolidated Farmers Home Administration Act of 1961 (7 U.S.C. 1929) and section 517 of title V of the Housing Act of 1949 (42 U.S.C. 1487) require FHA to sell the borrowers' loans made from ACIF and RHIF. The proceeds of such sales are used to finance new loans.

FHA sells the borrowers' loan notes to investors on a guaranteed-repayment basis at whatever interest rates are necessary to make the notes attractive to investors, regardless of the rates charged the borrowers. The rates of interest on loans sold to investors vary according to money-market conditions. Since 1965 these rates generally have been higher than the interest rates charged to the borrowers. The following table shows the interest rates charged to borrowers and the interest rates at which borrowers' loan notes were sold to investors as of January 1970 and January 1971.

	January 1970		January 1971	
Type of loan	Interest rates charged FHA borrowers	Interest rates on loans sold to investors (note a)	Interest rates charged FHA borrowers	Interest rates on loans sold to investors (note a)
Farm-ownership	5%		5%	
Soil and water	5		5	
Labor housing	5	8-1/2% 1 to 2 yrs.	5	6% 3 to 4 yrs.
Rural rental housing	1 to 6-1/4	8-5/8 3 to 5 "	1 to 7-1/4	6-1/2 5 to 9 "
" housing--low to moderate incomes	1 to 6-1/4	8-3/4 10 to 25 "	1 to 7-1/4	7 10 to 25 "
Rural housing--above moderate incomes	8-1/2		7-1/2	

[a]Excludes loans sold under block-sale contracts discussed on pages 12 and 13.

Of borrowers' loan notes of $5.1 billion sold from fiscal year 1959 to March 31, 1970, about $4.1 billion were sold through orders received at FHA's Finance Office and county offices. Not all administrative costs associated with the sales of loan notes by the Finance Office and county offices are identified separately in FHA's accounting records, and FHA has not developed estimates of such costs.[1] Sales of the remaining $1 billion were arranged by the FHA headquarters office. Sales by the headquarters office--all of which occurred since 1965--involved the following interest rates and other costs:

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[1]See our comments on page 28 pointing out that FHA, in the design of its accounting system, should provide for the allocation of administrative costs to its various loan programs.

Method	Period of sales	Amount (millions)	Annual interest rates	Other cost--fees
By agent	1966-68	$500	4-3/4% to 6-1/2%	$ 545,000
By competitive bids	1966-69	55	Various	-
To Federal National Mortgage Assn.	1969	100	7-3/4	-
To underwriter syndicate	1970	350	8-7/8 to 8-9/10	1,500,000

The sale of loan notes totaling $350 million in January 1970 was made to an underwriter syndicate made up of 76 primary security dealers throughout the United States. Under the purchase agreement, the syndicate purchased loan notes totaling $200 million to be held for 5 years and loan notes totaling $150 million to be held for 10 years, at a discount which provided the syndicate with a fee of about $1.5 million. The purchase agreement provided for the syndicate to sell the loan notes to investors at annual interest rates of 8-7/8 percent for the 5-year holding period and of 8-9/10 percent for the 10-year holding period.

The purchase agreement provided also that all principal repayments collected on the loans be reinvested in other FHA loan notes, to maintain a fairly constant dollar investment over the fixed 5- and 10-year holding periods. A custodian for the syndicate maintains physical possession of the loan notes which may be disposed of by the investors at will.

According to FHA officials, most sales of loan notes in fiscal years 1971 and 1972 will be marketed through block sales to underwriter syndicates. FHA's budget justifications for fiscal years 1971 and 1972 indicate that sales of loan notes will total about $2.9 billion in fiscal year 1971 and about $2.3 billion in fiscal year 1972. The following table shows the terms and conditions under which FHA has made additional block sales of loan notes since January 1970.

Date of sale	Amount (millions)	Annual interest rate	Specified holding period	Syndicate fees (millions)
Aug. 1970	$300	8-5/8%	15 years	$1.4
Dec. 1970	$300	7	10 years	$1.4

The block-sale method is designed to make FHA loans more attractive to long-term investment sources by (1) eliminating the requirement of physical possession of the notes by the purchasers and (2) maintaining the invested funds at a constant level over the fixed holding periods. The block-sale method meets the criteria established by the Comptroller General for a sale of assets, because the custodian takes physical possession of the loan instruments and the investors may dispose of them at will.

For the loan notes of $3.8 billion held by investors at March 31, 1970, FHA estimated that, if the investors held the loans for the full nonredemption periods, the interest paid to the investors would be $443 million in excess of the interest collected from the borrowers. Of this amount, FHA estimated that about $249 million would be paid to the investors within the next 5 years.

As discussed on page 28, FHA budget justifications to the Congress have not shown the projected interest costs which FHA has committed the Government to pay in future years. The interest to be borne by each fund is as follows:

	ACIF	RHIF	Total
	(millions)		
Market by underwriter syndicate	$ 40.8	$ 55.9	$ 96.7
Held by Federal National Mortgage Association	-	6.9	6.9
Held by other investors	221.7	117.5	339.2
Total	$262.5	$180.3	$442.8

FHA officials have taken the position that sales of borrowers' loan notes provide a method of financing the insured loan programs without significantly affecting reported Federal cash outlays. For budget purposes the sales proceeds are subtracted from the Government's cash outlays for the loans. If borrowings from the Treasury instead of revenues derived from sales of borrower's loan notes were used to finance additional loans, the budget would show the gross cash outlays for the loans. Thus the sale of loan notes permits the loan programs to be financed largely without regard to the Federal debt ceiling or the legal limitation of 4-1/4 percent that the Treasury can pay on long-term marketable obligations.

OPERATING LOSSES

FHA's Statements of Financial Condition for the ACIF and RHIF at March 31, 1970, showed that the funds' combined net accumulated operating losses amounted to about $104 million.[1] FHA's statements of income and expense for the funds showed that, for fiscal years 1960 through 1969 and for the first 9 months of fiscal year 1970, the operating results were as follows.

Year	Net Income or Loss(-) ACIF	RHIF
1960	$ 987,538	$ -
1961	1,036,553	-
1962	1,274,137	-
1963	2,127,292	-
1964	3,352,179	-
1965	4,239,778	-
1966	5,198,665	911,460
1967	-100,105	493,150
1968	-4,789,700	-2,152,008
1969	-54,964,770	-15,123,451
1970	-33,661,503	-20,218,305

The income of the funds consists mainly of interest on loans to borrowers. The expenses include the interest on borrowers' loan notes sold to investors, interest on borrowings from the Treasury, losses on loans, and a portion of the administrative expenses related to making and servicing loans.

Of the combined accumulated net losses of $104 million for the two funds, about $77 million represented interest

[1] These losses do not include significant administrative costs. (See p. 28.)

paid to investors in excess of the interest FHA charged borrowers. The result of selling the borrowers' loan notes to investors at interest rates that are higher than the interest rates charged the borrowers is illustrated as follows. If a borrower's 25-year loan of $20,000, bearing interest at 5 percent, is sold to an investor at an interest rate of 8-1/2 percent, the interest costs--providing the loan note was held for 25 years--would amount to $14,865 in excess of the interest paid by the borrower.

WAYS TO MINIMIZE OPERATING LOSSES

Future annual net operating losses of both funds could be minimized if FHA financed new loans through borrowings from the Treasury rather than through sales of borrowers' loan notes to investors. A further reduction in operating losses of ACIF could be made if FHA were authorized to charge borrowers interest rates which were more closely related to the Government's cost of financing such loans and to the borrowers' abilities to pay.

Cost of financing through Treasury borrowings rather than through loan sales

In hearings in 1962 before the Subcommittee on Conservation and Credit, House Committee on Agriculture, the FHA Administrator claimed that the financing of the FHA loan programs through the sale of borrowers' loan notes to investors was not costing the Government much. This situation was true prior to fiscal year 1965, when the interest rates on loan notes sold to investors were less than the interest rates charged to the borrowers. Since 1965, however, the interest rates on the loan notes sold to investors have been substantially higher than the rates charged to borrowers.

With respect to FHA's block sale of loan notes totaling $350 million, as discussed in detail on page 12, the Secretary of the Treasury, in approving the sale, advised the FHA Administrator that:

> "As you may know, the Treasury has been concerned for some time about the cost to the Government and to the taxpayer of selling assets in the form of direct loans at rates well above what the Government would have to pay were it to borrow in its own name. This problem has been particularly acute in the case of the Farmers Home Administration because of the nature of the paper involved, and because of the size of the program as a whole."

The following comparison of the guaranteed interest rates on this block sale of loan notes with the interest yields on marketable Treasury obligations of comparable maturity periods provides an indication of the additional interest costs to the Government of financing the loan programs through the sale of borrowers' loan notes rather than through borrowings from the Treasury.

Loan holding period	Loan notes sold: Amount (millions)	Loan notes sold: Interest rates (note a)	Interest yields on Treasury obligations (note b)	Difference in interest
5 years	$200	8.675%	8.21%	0.465%
10 "	150	8.7	7.85	.850

[a]The interest rates were reduced two tenths of 1 percent for comparison purposes, because interest on Treasury obligations is paid semiannually and interest on FHA loans is paid annually.

[b]The interest yields were furnished to us by a Treasury official. The yields were based on the market-bid yields for marketable Treasury obligations currently outstanding, which mature in 5 and 10 years.

By applying the above interest differentials to the amounts of the loan notes sold, we estimated that the Government's additional interest costs would amount to about $17.5 million--$4.7 million for the loans in the 5-year holding period and $12.8 million for the loans in the 10-year holding period.

As pointed out on page 12, during fiscal years 1971 and 1972 FHA plans to sell borrowers' loan notes of $5.2 billion, most of which will be sold to underwriter syndicates. Although the terms of future sales of loan notes may vary, interest differentials such as those shown above indicate that, in any event, the additional cost to the Government resulting from this method of financing will be very substantial. Assuming an interest differential of only one half of 1 percent for the planned loan note sales of $5.2 billion, the additional annual interest costs would amount to $26 million.

In making the above comparisons, we recognize that the interest rates on long-term Treasury obligations maturing in excess of 7 years are limited by the law to 4-1/4 percent and that, since 1965, the Treasury has been unable to sell its long-term obligations because of the high market interest rates. We believe, however, that our comparison of the additional interest costs to the Government of financing the loan programs through the sale of borrowers' loan notes totaling $350 million gives a reasonable indication of the substantial savings that could be possible through the financing of the loan programs through borrowings from the Treasury.

Interest rates charged to borrowers

The Consolidated Farmers Home Administration Act of 1961 provides that loans from ACIF be made at interest rates of 5 percent or less per annum. The legislative history of the act does not indicate the intent of the Congress in establishing the 5-percent interest ceiling.

This rate was higher than the interest rate paid to investors who purchased FHA loan notes from 1961 to 1965. Since 1965 the 5-percent rate has been significantly less than the rates which FHA has paid investors on loan notes.

The graph on page 19 shows that, since the midpoint of fiscal year 1966, the interest rates on borrowers' loan notes sold to investors have exceeded the interest rates charged the borrowers. The rates reached a high of 8-3/4 percent in fiscal year 1970.[1]

The difference between the interest rates charged to the borrowers and the interest rates paid to investors is the principal cause of the fund's operating losses in recent years.

In a report to the Congress in November 1966, on the advantages and disadvantages of direct and insured loan programs, the Secretary of the Treasury pointed out that, although subsidies were clearly a legitimate means for

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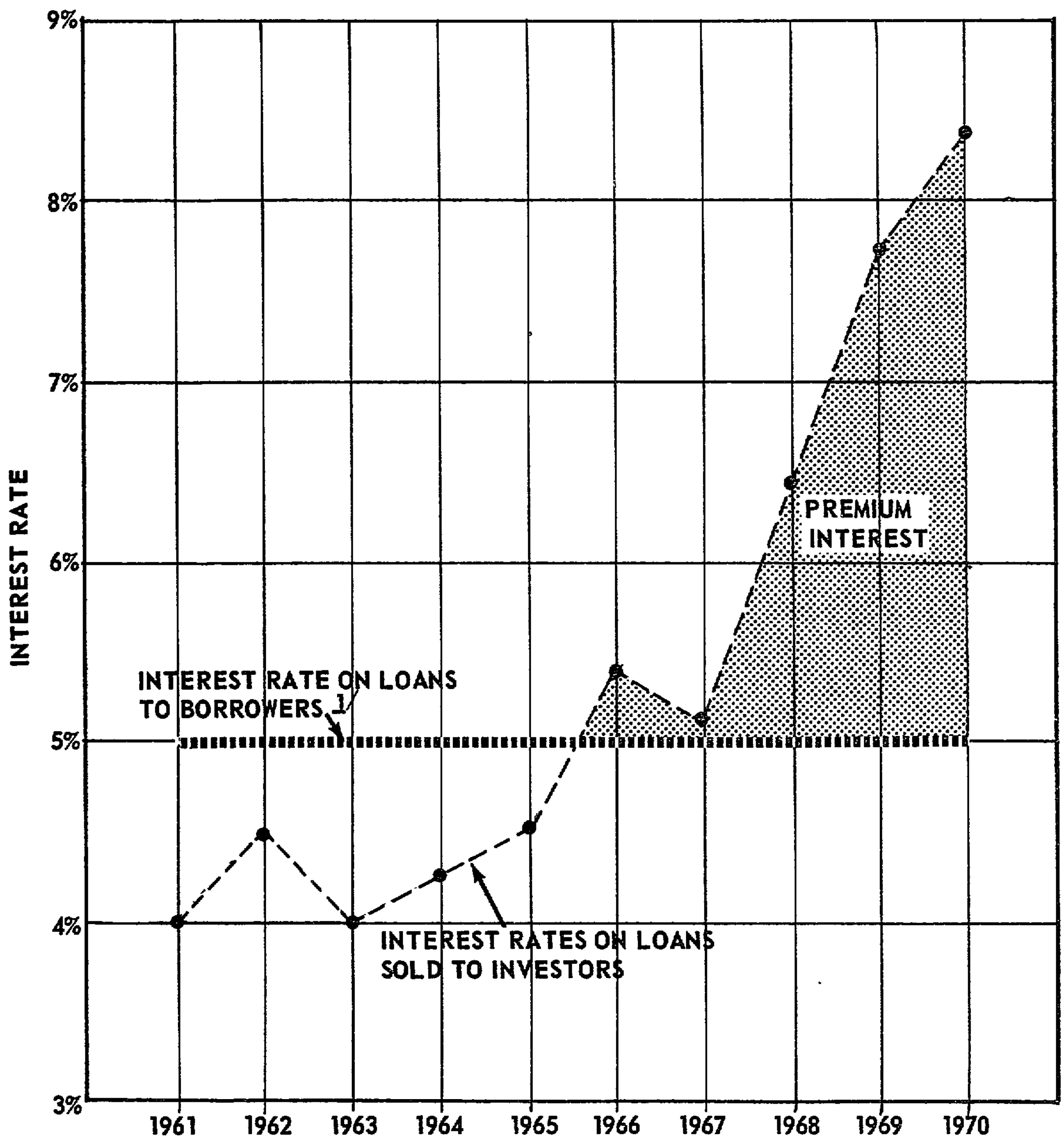
[1]Excludes loans sold under block-sale contracts.

INTEREST RATES ON LOANS TO BORROWERS
AND ON LOANS SOLD TO INVESTORS
FISCAL YEARS 1961 – 1970



1/ SOME BORROWERS CHARGED LESS THAN 5 PERCENT INTEREST achieving program objectives, an interest rate subsidy fixed by statute did not necessarily accomplish the program objectives as efficiently and economically as variable subsidies tailored to the borrowers' needs and abilities to pay.

The principal FHA loan programs affected by the 5-percent interest rate are farm-ownership and recreation loans to individuals and loans to public and nonprofit associations for water, sewer, recreational, and irrigation facilities and for the purchase and development of grazing land. FHA officials responsible for the administration of these loan programs advised us that many of the borrowers could pay interest at rates in excess of the statutory rate of 5 percent.

FHA's income statistics on borrowers of certain types of loans indicated that many of the borrowers could pay interest at higher rates on their loans. For example, the income levels of many borrowers of farm-ownership and recreation loans are similar to the income levels of borrowers of certain types of rural housing loans, who must pay interest at higher rates. The following table shows the interest rates on rural housing, farm-ownership, and recreation loans in fiscal year 1970.

Type of loan	Number of loans	Amount of loans (millions)	Interest rates
Rural housing loans to persons of:			
Above moderate incomes	1,667	$ 21.6	7-1/2 or 8-1/2%[a]
Low to moderate incomes	54,037	601.0	6-1/4[b]
Low to moderate incomes	11,399	128.4	Less than 6-1/4
Total	67,103	$751.0	
Farm-ownership and recreation loans to individuals	11,316	$257.7	5

[a]At January 1971 the rate is 7-1/2 percent.

[b]For fiscal year 1971, the rate is 7-1/4 percent.

The graph on page 22, which was developed from FHA income statistics, shows that, of the 8,910 recipients of farm-ownership and recreation loans during fiscal year 1970,[1] 4,455, or 50 percent, had annual incomes of from $6,000 to over $10,000. This range of income was similar to the income of recipients of rural housing loans who were charged interest at higher rates, as noted above. During fiscal year 1970 FHA income statistics show that, of the 65,034 recipients of rural housing loans,[1] 42,922, or 66 percent, had annual incomes of from $6,000 to over $10,000.

With respect to loans made to associations, FHA records show that the bulk of the insured loan funds are used for the development and improvement of rural water and sewer facilities. For example, of the association loans of $121 million made in fiscal year 1969, $90 million, or 74 percent, was for development of rural water and sewer facilities. Many of these loans had been made to local public bodies which are in geographical areas eligible for assistance from the Economic Development Administration (EDA).

EDA makes loans and grants for public works and development facilities to local public bodies in regions of substantial and persistent unemployment and underemployment to enable them to take effective steps in planning and financing regional economic development. EDA public works loans, which may be used to finance water and sewer systems, are made for a maximum term of 40 years, at interest rates established pursuant to a statutory formula based on the market yields on outstanding Treasury obligations. EDA's interest rate for such loans was 4-3/4 percent for fiscal year 1969, 5-3/4 percent for 1970, and 6-3/4 percent for 1971.

Until fiscal year 1970 FHA set its interest rates on loans to public bodies in EDA-qualified areas at the same rates EDA charged to borrowers of public works loans. In 1970, when EDA increased its interest rate on public works loans to 5-3/4 percent, FHA was prevented from making a similar change by the statutory ceiling on its interest rate of 5 percent.

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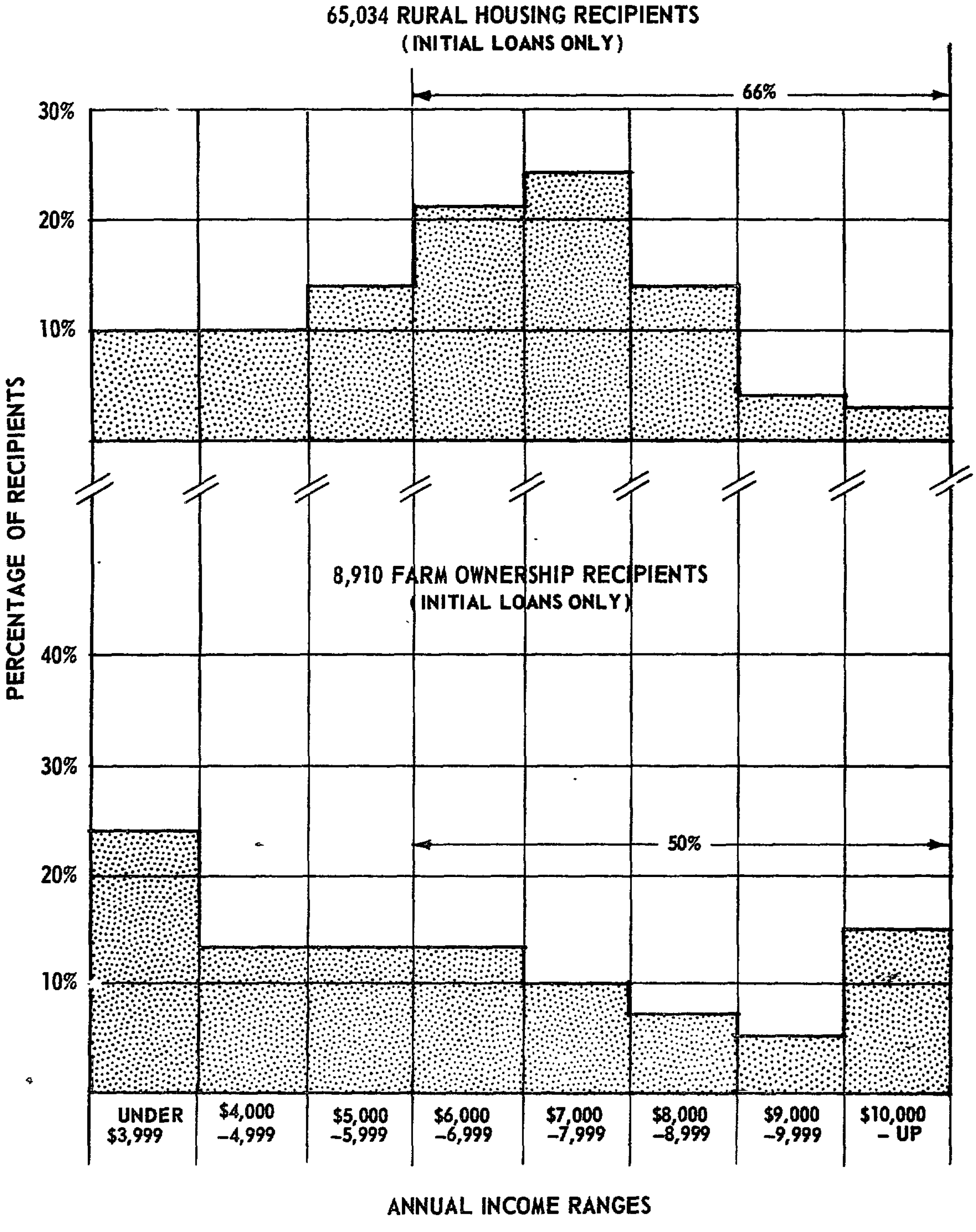
[1]Some recipients received more than one loan.

NET INCOME FOR RURAL HOUSING AND FARM OWNERSHIP RECIPIENTS

JULY 1969 – JUNE 1970



CONCLUSIONS

If FHA could finance its insured loan programs through borrowings from the Treasury, the Government's cost of financing new loans and the operating losses of the two funds could be significantly minimized. The operating losses of ACIF could be minimized further by authorizing FHA to charge borrowers an interest rate more closely related to the Government's cost of financing such loans and to the borrowers' abilities to pay.

Because applicable legislation provides that loans made from the two funds be sold to investors and that the interest on loans made from ACIF not exceed 5 percent, legislative action for either change is required.

In our opinion, an additional reason for financing FHA's insured loan programs through borrowings from the Treasury is because such programs would be subjected to the same budget discipline and appropriation processes accorded other Federal activities whose budget requests are shown as cash outlays in the Federal budget. As pointed out on page 13, under the present method of financing FHA's insured loan programs, the proceeds from sales of borrowers' loan notes for budget purposes are subtracted from the Government's cash outlays for the loans.

We consistently have taken the position that the public interest is best served when Government programs are financed through the appropriation process, because of the periodic congressional scrutiny and affirmative congressional action inherent in that process.

AGENCY COMMENTS AND GAO EVALUATION

FHA, the Treasury Department, and the Office of Management and Budget, in letters dated January 27, 1971; January 5, 1971; and February 19, 1971, respectively (see app. I, II, and III), commenting on a draft of this report, expressed agreement with our view that the statutory interest-rate ceilings on loans made from FHA's ACIF should be eliminated in favor of variable interest rates related to the Government's cost of financing such loans.

The Administrator, FHA, stated that legislative proposals to amend the governing legislation were being cleared for submission to the Congress. The Deputy Director, Office of Management and Budget, stated that his office understood that the Department of Agriculture was currently considering FHA proposals providing for flexible interest rates related to Treasury borrowing costs for FHA loan programs which presently had statutory interest-rate ceilings.

With respect to financing FHA's various insured loan programs through Treasury borrowings, the three agencies, although recognizing that the Treasury could borrow funds at somewhat lower costs than other Federal agencies, made certain observations regarding the method of financing FHA's insured loan programs through sales of borrowers' loan notes. Pertinent comments of each agency and our views thereon follow.

FHA comments

The Administrator, FHA, stated the belief that FHA was realizing benefits, from a program point of view, which offset a slightly higher interest cost and warranted the continuation of FHA's authority to insure and sell borrowers' loan notes. The Administrator stated also that he expected that, as FHA's block sales of borrowers' loan notes became better known in the financial community, the differential between the interest rates at which the Treasury borrows funds and the rates which FHA must pay on borrowers' loan notes sold to investors would be reduced.

We discussed with an FHA official the nature of the benefits FHA derives from its current method of financing insured loan programs. That official pointed out that financing additional loans through sales of borrowers' loan notes provided FHA with greater flexibility in obtaining funds, because such sales were reported as an offset to the cash outlays for FHA loan programs shown in the Federal budget. He stated that, in view of current restrictions on budget outlays, loan funds for the insured loan programs would be more readily available through the sale of borrowers' loan notes than if FHA had to finance the programs through borrowings from the Treasury.

Treasury Department comments

The Under Secretary of the Treasury for Monetary Affairs stated that he had no basic disagreement with our findings but stressed the point that FHA's methods of financing the loan programs were not unique. He stated that, according to the fiscal year 1971 budget, the FHA insured loans accounted for only $2.3 billion of $20.7 billion of Federal credit programs financed outside the Federal budget. The Under Secretary concluded that, in the general context of Federal credit programs, the cost of financing had not been the determining factor in much of the credit program legislation enacted by the Congress in recent years.

Office of Management and Budget comments

The Deputy Director, Office of Management and Budget, stated that the sale of borrowers' loan notes to investors provided a mechanism whereby urban-based lending institutions could assist in financing certain requirements of the rural residents. He stated also that, if direct loans financed through Treasury borrowings were substituted for funds obtained through the sale of loan notes, private lending institutions could no longer avail themselves of this mechanism. The Deputy Director pointed out that, although Treasury financing provided a similar mechanism inasmuch as Treasury securities were purchased by private investors, there was a less direct relationship between these investors and the FHA borrowers.

The Deputy Director said that direct loans financed through borrowings from the Treasury were included in budget totals as cash outlays, whereas FHA's sale of insured loan notes constituted a sale of assets and thus reduced program outlays, as shown in the Federal budget.

GAO evaluation

The comments of the various agencies did not indicate any disagreement with our basic conclusion that the Government's cost of financing new loans and the operating losses of ACIF and RHIF could be significantly minimized if FHA financed its insured loan programs through borrowings from the Treasury rather than through sales of borrowers' loan notes.

With respect to FHA's view that the continuation of authority to insure and sell loan notes is warranted by the greater flexibility in obtaining funds, since sales of loan notes are reported as an offset to Federal outlays in the budget, we previously have stated our view (see p. 23) that the public interest is best served when the financing of Government programs is through direct appropriations, because of the periodic congressional scrutiny and affirmative congressional action afforded by the appropriation process. This would result in the programs' being subjected to the same budget discipline as the vast majority of other Federal programs and would make appraisal and control by the Congress of FHA's insured loan programs easier.

We do not disagree with the comment of the Under Secretary of the Treasury that, generally, the cost of financing has not been the determining factor in much of the credit program legislation enacted by the Congress in recent years. One of the purposes of this report is to reveal to the Congress the additional costs incurred by the Federal Government as a result of FHA's method of financing insured loan programs, so that the Congress may take such action as it deems appropriate.

With respect to the comments of the Deputy Director, Office of Management and Budget, concerning the directness of the relationship between FHA borrowers and investors purchasing the borrowers' loan notes, the investors purchase the notes directly from FHA. FHA makes the loans, collects all principal and interest payments from the borrowers, performs all other loan servicing functions, and absorbs all losses on the loans. In such circumstances there is little or no direct contact between the borrowers and the investors who purchase the borrowers' loan notes, and there is very little difference from the situation where the Treasury sells marketable obligations to investors and uses the proceeds, in part, to finance FHA's insured loan programs.

MATTERS FOR CONSIDERATION BY THE CONGRESS

We recommend that the Congress consider amending the legislation pertaining to the loan programs financed through ACIF and RHIF to require that:

--The loans be financed through borrowings from the Treasury within such amounts as may be specified annually in appropriation acts.

--The interest rates on loans made from ACIF be based on the market yields on outstanding Government obligations of comparable maturities and be adjusted in accordance with the borrowers' abilities to pay.

CHAPTER 3

NEED FOR IMPROVED COST DISCLOSURE

FHA's financial statements furnished to the Treasury Department and the budget justifications presented to the Congress do not show the full costs of administering the loan programs financed through ACIF and RHIF and do not show the interest cost on the Government's investment in the two funds. Moreover, FHA's budget justifications do not show the substantial interest costs on sales of borrowers' loan notes that FHA has committed the Government to pay in future years.

In our report to the Congress "Improvements Needed in Financial Statements of the Emergency Credit Revolving Fund of the Farmers Home Administration" (B-114873, December 30, 1970), we pointed out many areas in FHA's accounting system which were in need of improvement. We recommended that the Administrator assign an adequate staff to the task of designing an accounting system which would meet the needs of FHA managers and the requirements set forth by the Comptroller General. In commenting on a draft of that report, the Acting FHA Administrator advised us that FHA was in general agreement with our recommendation and had hired accounting specialists to implement a financial management system for the agency as promptly as possible.

We believe that, in the design of its accounting system, FHA should provide for the allocation of administrative costs to its various loan programs and for the recognition of interest on the Government's investment in the two insurance funds. We believe also that FHA's annual budget justifications should disclose this information as well as the total interest costs that the Government will have to pay on loan notes sold to investors.

ADMINISTRATIVE COSTS

The administrative costs of FHA include operating the headquarters office, 41 State offices, 1,742 county offices, and the Finance Office. FHA's annual salaries and expenses appropriation provides funds for paying such costs and permits a limited amount of income from the funds to be used for paying such costs.

FHA's financial statements submitted to the Treasury Department pursuant to Treasury Circular No. 966 and its budget justifications for each of these funds do not show all the administrative expenses allocable to these loan programs. The Finance Office prepares an internal consolidated statement of income and expenses which shows FHA's estimate of administrative costs by major loan types, such as rural housing loans, soil and water loans, and farm-ownership loans. This statement, however, does not show the separate costs for direct and insured loans.

We analyzed FHA's statements and estimated the costs allocable to the insured loans on the basis of the number of insured and direct loans made and the number of borrowers' accounts serviced during the last 3 years. Our estimates of the administrative expenses allocable to insured loans totaled $81.7 million, as shown below.

Fiscal year	Program	FHA costs for direct and insured loans	GAO estimates of costs for insured loans
1968	Rural housing	$ 19,324,091	$13,632,565
	Farm-ownership	10,151,721	8,002,193
	Soil and water	4,123,608	2,516,425
1969	Rural housing	22,052,191	16,185,518
	Farm-ownership	13,539,568	11,216,595
	Soil and water	3,851,440	2,226,168
1970[a]	Rural housing	21,515,648	16,809,083
	Farm-ownership	10,744,663	9,009,117
	Soil and water	3,455,659	2,141,781
		$108,758,589	$81,739,445

[a]Through March 31, 1970.

FHA's financial statements for the two insurance funds for fiscal years 1968-70 showed a total of only $3.6 million of administrative expenses for both funds. This amount was the estimated portion of income of the funds that had been used to pay such expenses and did not bear a direct relationship to the administrative costs of making and servicing the loans.

INTEREST ON GOVERNMENT INVESTMENT

ACIF and RHIF were capitalized with a $1 million and a $100 million appropriation, respectively. FHA pays interest at rates ranging from 3-1/4 to 8 percent on funds borrowed from the Treasury for both funds but pays no interest on the appropriated capital. The financial statements and budget justifications for the funds show the interest paid on the borrowings from the Treasury but do not show (1) interest on the Government's investment in the two funds or (2) the difference between the interest paid on certain borrowings from the Treasury and the cost to the Government of borrowing money.

The accounting principles and standards prescribed by the Comptroller General require the disclosure of significant interest costs of the Government's investment when such funds are used in a revenue-producing operation. They require also that, when interest required to be paid by an agency is significantly less than the cost of money to the Treasury, the difference should be shown on the agency's records as an additional interest cost. The prescribed accounting principles and standards provide that interest costs recognized for reporting purposes be determined on the basis of average yields on outstanding marketable obligations of the United States having maturities reasonably comparable to the estimated period for which Federal funds are invested.

The interest that FHA pays the Treasury on borrowings for the two funds is determined by formulas set forth in the legislation establishing the funds. For RHIF the formula provides for payment of interest based on the average rate on Treasury marketable obligations which are neither due nor callable for redemption for 15 years from their date of issue.

Since fiscal year 1968--the first year of borrowings for this fund--the interest rates have ranged from 3-1/4 percent to 3-34/100 percent. We believe that the interest rates derived by this formula do not realistically measure the cost of borrowings from the Treasury for the fund. Consequently, the interest costs shown on the financial statements for this fund are understated by the difference between the interest paid by FHA on borrowings from the Treasury and the Government's cost of borrowing money.

In contrast, the formula for ACIF provides for payment of interest on borrowings from the Treasury based on the current average market yield on Treasury marketable obligations having comparable maturities. Since fiscal year 1968, the interest rates for borrowings for this fund have ranged from 4-88/100 percent to 8 percent. We believe that these rates provide a more realistic measure of the current cost of money to the Government.

We estimated that the cost of loan programs financed through the two funds was understated by about $8 million in fiscal year 1970 as a result of not including as operating costs (1) the interest on the Government's investment in the two funds and (2) the difference between the interest paid on borrowings from the Treasury for RHIF and the Government's costs of borrowing money.

FUTURE INTEREST LIABILITY ON LOAN NOTES SOLD

FHA's sales of borrowers' loan notes present a somewhat unique reporting problem. Because these transactions are considered sales of Government assets rather than borrowings, no direct liability is shown on FHA's statement of financial condition. FHA does show, in a footnote to the financial statements, the contingent liability for borrowers' loan notes held by private investors.

As discussed on page 11, FHA sold notes under conditions ranging from those favorable to the Government--the sale of loan notes to investors at interest rates less than those charged the borrowers--to the present unfavorable condition of having to sell loan notes to investors at interest rates in excess of those charged to the borrowers.

For the loan notes of $3.8 billion held by investors at March 31, 1970, FHA estimated that, if the investors held the loans for the full nonredemption periods, the interest paid to investors would be $443 million in excess of the interest collected from the borrowers. This estimated liability is shown in footnotes to the statements of financial condition for the two funds at March 31, 1970, but is not shown in FHA's budget justifications.

Because these loan sales transactions are unique and commit the Government to pay substantial interest costs, FHA's annual budget justifications to the Congress should disclose the full amount of the liability.

CONCLUSIONS

FHA's financial statements and annual budget justifications do not disclose the full costs of the loan programs financed through the two insurance funds. Disclosure of the full costs of each loan program conducted through both funds would be of assistance in FHA management decisions and congressional evaluations.

RECOMMENDATIONS TO FHA ADMINISTRATOR

To facilitate improved disclosure of the costs of the loan programs financed through ACIF and RHIF, we recommend that the Administrator provide for:

--Including in financial statements all costs related to the loan programs. Specifically, all administrative costs, the interest on the Government's investment in the two loan funds, and the full interest cost of the borrowings for the funds should be disclosed.

--Reporting, in the explanatory notes section of its annual budget justifications, the commitments of Government resources which the loan sales program has created and the current yields which FHA is required to guarantee investors who purchase such loans.

AGENCY COMMENTS

FHA, the Treasury Department, and the Office of Management and Budget agreed with our findings and recommendations concerning the need for improved cost disclosure.

The Administrator, FHA, stated that action was being taken by FHA to modify the design of its financial management system and that the modified system would produce financial statements showing all costs incurred by ACIF and

RHIF. The Administrator stated also that FHA would provide, in the explanatory notes to its budget justifications, a statement showing

--the current interest rates which FHA paid investors who purchased borrowers' loan notes,

--the insured loans outstanding in the hands of investors, and

--the estimated premium interest liability on insured loans in the hands of investors.

CHAPTER 4

SCOPE OF REVIEW

Our review was made at the FHA headquarters office in Washington, D.C., and at the FHA Finance Office in St. Louis.

We reviewed legislation pertaining to FHA's insured loan programs and FHA's policies and procedures under which borrowers' loan notes were sold to investors to finance these programs. We examined FHA documents, reports, records, and files pertaining to the operating results of the insured loan programs; FHA's statistical reports showing borrower income levels; and the Secretary of the Treasury's 1966 report to the Congress on the Feasibility, Advantages, and Disadvantages of Direct Loan Programs Compared to Guaranteed or Insured Loan Programs. We interviewed various FHA officials responsible for matters discussed in this report and obtained from a Treasury official an estimate of the Treasury's cost of borrowing money.

APPENDIXES

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
WASHINGTON, D.C. 20250

OFFICE OF THE ADMINISTRATOR

JAN 27 1971

Mr. Bernard Sacks
Assistant Director
Civil Division
U. S. General Accounting Office
Washington, D. C.

Dear Mr. Sacks:

This is in response to your request for our comments on the draft report entitled, "Financing of Loans Through the Agricultural Credit and Rural Housing Insurance Funds by the Farmers Home Administration."

GAO Comment: Congress may wish to consider changing legislation requiring FHA to finance its insured loan programs through loan sales.

Under GAO proposals to Congress, the report recommends that Farmers Home Administration finance insured loans through Treasury borrowings. The Congress in legislating authority to FHA to bring its credit services into rural areas has given due and deliberate consideration to providing a means whereby the private sector could invest in Farmers Home insured notes (actual promissory notes). The Congress is aware of the system of financing used by the FHA. The offerings made by FHA are coordinated with and subject to the policy overview of the Treasury Department and Office of Management and Budget.

The system for marketing insured notes has been improved and perfected by FHA and under the present marketing program investors may purchase insured notes at the local level through county offices originating the loan transaction,and this is an attractive feature to local investors. Larger investors may purchase insured notes through the Finance Office. In 1969 the agency developed a block sale instrument so that it could efficiently and effectively market a portion of its insured notes through the capital market. The availability of this method of financing the program is one of the components in the Congress' annual deliberation of the budget of the FHA. The authority of the FHA to finance its programs through the sale of insured notes to private investors is a long standing authority, originating with the farmer loan programs and extended by the Congress at different times to other major program authorities of the agency. The block sale contract, perfected by FHA, has received good acceptance in the financial community and the FHA is receiving the benefit of fully competitive interest rates.

We recognize that the FHA cost of money from the sale of its insured notes will be higher than Treasury cost of borrowings. As our block sale contract becomes better known in the financial community, this differential will be reduced.

From a program point of view, we are realizing benefits which offset a slightly higher interest cost and these benefits, in our opinion, warrant the continuation of our authority to insure and sell notes. Farmers Home Administration should borrow its loan funds where it can get them at least cost, providing there are not disadvantages that more than offset the benefit to the public of borrowing at the lowest cost.

The agency is beginning to obtain additional value from the full faith and credit of the U. S. Government, which was documented by the Attorney General's Opinion of December 29, 1969. Also, the agency is cooperating with Treasury to provide 10 and 15-year funds with the aid of the block sale contract.

> GAO Comment: Congress may wish to consider legislation removing the 5 percent interest limitation and provide instead that the rates of interest be based on the market yield on outstanding government obligations of comparable maturities.

Legislative proposals to amend FHA's governing legislation are being cleared for submission to Congress.

> GAO Recommendation: FHA should provide in a design of its financial management system for the reporting in financial statements of all costs related to loan programs.

Concerted action is being taken to modify the design of the FHA financial management system to meet the standards set forth by GAO. This system will provide for financial statements which will reveal all costs incurred by these funds.

> GAO Recommendation: FHA should provide disclosure of the Government's future interest commitments and include the current interest rate in budget justifications.

The following additions are being made to the explanatory notes for the Agriculture Credit Insurance Fund and the Rural Housing Insurance Fund.

a. A statement regarding the current interest rates available to investors.

b. A statement showing insured loans outstanding in the hands of lenders which are contingent liabilities against each fund as of June 30, 1970, 1971, and 1972.

c. A statement reflecting the projected premium interest liability on loans in the hands of investors.

We appreciate your giving us an opportunity to discuss the draft review prior to issuance of a final report and to submit the foregoing comments.

Sincerely,

for JAMES V. SMITH
Administrator

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON 25, D.C.

JAN 5 1971

Dear Mr. Pahl:

This is in reply to your letter to Secretary Kennedy of December 1, 1970 in which you request comments on the proposed GAO report to the Congress on asset sales by the Farmers Home Administration (FHA) and on the possible financing of FHA loans through Treasury borrowings.

FHA presently finances a substantial volume of its loans through direct Treasury borrowings. As shown in table E-3 on page 74 of the Special Analyses of the Budget for fiscal 1971, FHA had a total of \$2,694 million in direct loans outstanding on June 30, 1969, and the Budget estimates were \$2,970 million for June 30, 1970, and \$2,112 million for June 30, 1971.

FHA is authorized to make either direct or insured loans under a number of its programs. However, as indicated in your report, those loans which are made from either the Agricultural Credit Insurance Fund or the Rural Housing Insurance Fund must be sold to private investors. Thus, as you indicate, legislative action would be necessary in order to provide for Treasury financing of all FHA loans.

While there is no question that direct Treasury financing of FHA loans would be less expensive than insured loan financing, this is also true of a number of other Federal credit programs. In fact, the Department of Housing and Urban Development conducts a program of subsidized loans for low income housing in urban areas, which is similar to the FHA program in rural areas; and the HUD program is financed through the Federal National Mortgage Association at higher interest rates than those by the Treasury.

As indicated in table E-6 of the Special Analyses of the 1971 Budget, the net increase in direct loans outstanding in the fiscal year 1971 is estimated at \$1.6 billion, compared to an increase of \$20.7 billion in guaranteed, insured, and Government sponsored agency loans. The FHA loans discussed in your report account for only \$2.3 billion of this \$20.7 billion of Federal credit programs financed outside of the budget and thus outside of the Treasury. While many of these programs require very little subsidy, a number of them involve larger interest rate subsidies and higher market borrowing costs than the FHA loans (See table E-4). Thus I think it important to view the financing of the FHA program in the context of Federal credit programs generally.

It is widely recognized that direct Treasury financing, while cheaper, is not appropriate for all private borrowings assisted by the Federal Government; although in some cases Treasury borrowing may be clearly the most appropriate means of financing.

I note in your draft a reference to a report to the Congress by the Secretary of the Treasury in November 1966 on the advantages and disadvantages of direct and insured loan programs. As you know, that report discussed at some length the circumstances under which various methods of financing Federal credit programs might be appropriate. Several such studies of Federal credit programs have been made in recent years, yet we still seem to be lacking a consensus as to the principles and procedures which should govern these programs. It is clear to me that the cost of the financing has not been the determining factor in much of the credit program legislation enacted by the Congress in recent years.

I certainly would not disagree with your basic points regarding the problems arising from fixed interest rates in Federal credit programs. The Treasury Department's views on this matter have been explicitly stated in many reports to the Congress on credit program legislation. In fact, the flexible interest rate formula tied to Treasury borrowing costs which we recommend, and which is suggested in your report, is explicitly set forth for the guidance of credit program agencies in Bureau of the Budget Circular No. A-70, February 1, 1965. We understand that the Farmers Home Administration is presently considering the adoption of more flexible interest rates in its loan programs.

I would also agree that the financial management, accounting, and reporting of Federal credit programs should explicitly recognize all Government interest costs, including direct subsidies and the implicit costs resulting from the provision of Federal capital. The Treasury has urged in a number of reports to the Congress the adoption of revolving fund financing for credit programs which clearly discloses the interest and other costs to the Government.

In short, I have no basic disagreement with the findings in your report, although we believe that the costs to the Government of the Farmers Home program should be calculated on a present value basis. Yet while our procedures in estimating these costs would be somewhat different from those employed in your draft report, the conclusions would be similar.

The point I would like to stress, however, is that the loan terms and methods of financing employed by the Farmers Home Administration are not unique. There are many other Federal credit programs which also involve fixed interest rates, asset sales, hidden subsidies, and, in some cases, much less efficient methods of financing. There is a clear need for greater understanding of these programs, and I believe that your report is a very useful contribution.

Sincerely yours,

Paul a Volcker

Paul A. Volcker

Mr. Eugene L. Pahl
Assistant Director
Civil Division
United States General
Accounting Office
Washington, D. C. 20548

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

19 FEB 1971

Mr. A. T. Samuelson
Director, Civil Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Samuelson:

This is in response to your request of December 7, 1970, for the views of the Office of Management and Budget concerning the General Accounting Office draft report entitled "Financing of Loans Through the Agricultural Credit and Rural Housing Insurance Funds by the Farmers Home Administration, Department of Agriculture." Due to the workload associated with preparation of the President's 1972 budget, I regret that we were unable to provide comments by your requested date of January 8, 1971.

We have reviewed the draft report and offer the following comments for your consideration:

Finding -- "The interest rates paid private investors by FHA on loans sold from the Agricultural Credit and Rural Housing Insurance Funds are higher than the interest rates the Government would have to pay if additional loans were financed through Treasury borrowings."

Comment -- While we recognize that the Department of Treasury can borrow at somewhat lower cost than other Federal agencies, FHA insured loans provide a mechanism for providing a conduit for urban based lending institutions to assist in financing certain requirements of rural residents. Investment bankers and pension funds purchase FHA insured loans with maturities ranging from three to 25 years. If direct loans were substituted for the present FHA insured loans, private lending institutions could no longer avail themselves of this mechanism for financing housing and sewer and water facilities in rural areas. Of course, Treasury financing through direct Federal loans provide a similar mechanism inasmuch as Treasury securities are also purchased by private investors although there is a less direct relationship between the investor and the borrower. Furthermore, direct loans are included in budget totals as outlays while FHA insured loans constitute a sale of assets and are excluded from budget totals.

Finding -- "... under money market conditions prevailing in the last few years, the interest rates charged borrowers by FHA are significantly less than the interest rates FHA must pay private investors who purchase the loans. This situation has been the principal cause of the sizeable operating losses reported in the two funds in recent years."

Comment -- As a result of considerable discussion between OMB and USDA, we understand that the Secretary's Office is currently considering a FHA set of proposals which would provide for flexible interest rates for those loan programs which presently have statutory interest rate ceilings. The rate structure under consideration would be related to Treasury borrowing costs thereby providing a better correlation between interest rates to borrowers and Treasury borrowing costs. We concur completely with the conclusion contained in the draft report on this matter; namely, that statutory interest rate ceilings should be eliminated, and that variable rates tied to Treasury borrowing costs should be substituted therefor.

Finding -- "FHA's financial statements furnished to the Treasury Department and the budget justifications presented to the Congress relating to the Agricultural Credit and Rural Housing Insurance Funds do not show: (1) FHA's full costs of administering the loan programs financed from the two funds and (2) the interest cost on the Government's investment in the two funds."

Comment -- We agree completely with your recommendation concerning the need for design of an adequate financial management system within FHA for disclosure of the above information. On the matter of budget presentation, we agree with the objective to which your recommendation is directed, but believe that further study by FHA of the most appropriate means for its attainment is required.

We appreciate and thank you for the opportunity to review this report in draft and hope that our comments will be helpful to you.

Sincerely,

Caspar W. Weinberger

Caspar W. Weinberger
Deputy Director

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF AGRICULTURE AND THE FARMERS HOME ADMINISTRATION RESPONSIBLE FOR ADMINISTRATION OF MATTERS DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
DEPARTMENT OF AGRICULTURE		
SECRETARY OF AGRICULTURE:		
Clifford M. Hardin	Jan. 1969	Present
Orville L. Freeman	Jan. 1961	Jan. 1969
FARMERS HOME ADMINISTRATION		
ADMINISTRATOR:		
James V. Smith	Jan. 1969	Present
Howard Bertsch	Apr. 1961	Jan. 1969
ASSISTANT ADMINISTRATOR, MANAGEMENT:		
George C. Knapp	June 1971	Present
Sylvester Pranger	Mar. 1969	June 1971
E. Marshall Newton, Jr.	May 1967	Mar. 1969
Robert C. Leary	May 1961	May 1967

U.S. GAO, Wash., D.C.