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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES AND ECONOMIC
DEVELOPMENT DIVISION

B-114873

[Farmers Home Administration's Sale of Certificates of Benificial Ownership to a Security Brokerage Firm]

MAY 21 1976

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The Honorable
The Secretary of Agriculture

Dear Mr. Secretary:

We have reviewed the Farmers Home Administration's (FmHA's) November 1974 sale of $100 million of certificates of beneficial ownership (CBOs) to a security brokerage firm. We made our review pursuant to information brought to our attention alleging that imprudent actions by FmHA in making this sale would cause the Government to incur unnecessary interest costs.

Our review included interviews with headquarters officials of the Department of Agriculture and the Treasury and of the Federal Financing Bank, a wholly owned Federal Government corporation. We reviewed pertinent legislation, regulations, policies, procedures, and records, including a report on the results of an investigation into this matter by your Office of Investigation. FmHA's Administrator requested that investigation after we told his office of the allegation.

According to the record, FmHA's then-Deputy Administrator Comptroller approved the sale on November 4, 1974, knowing that the interest rate paid on CBOs was to be reduced on November 7, 1974. The Comptroller said he approved the sale in the belief that, as long as CBOs were available for sale, he could not refuse a purchase offer under the FmHA regulations then in effect.

An FmHA official calculated that, over the 14-1/2-year term of the CBOs sold to the brokerage firm, FmHA would pay about $3.6 million more in interest costs than it would have had to pay if the sale could have been made at the reduced interest rate effective 3 days after the sale was approved. Also the interest paid will be at least $3.2 million more than it would have been had the CBOs been sold to the Bank.

Representatives of the brokerage firm indicated to the Office of Investigation that the purchase was made to take advantage of FmHA's slow reaction to interest rate changes

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on other Government securities. An additional problem was that FmHA's Finance Office in St. Louis, Missouri, prematurely mailed notices of the November 7 interest rate change to investors on November 1. However, the Office of Investigation could not conclusively state that the brokerage firm or any other investor had advance knowledge of the interest rate change.

FmHA terminated its public sales of CBOs in March 1975 and since then has been selling CBOs exclusively to the Bank. We were told that FmHA planned to continue this arrangement, provided the Bank was able and willing to meet FmHA's funding requirements. A Treasury official told us that there was little likelihood that the Bank would ever be unable or unwilling to purchase CBOs from FmHA.

We concur in the decision to sell CBOs exclusively to the Bank as long as the Bank is able and willing to purchase them. Since this decision is subject to change, however, we are recommending that you direct the FmHA Administrator to prepare written standby procedures to use if FmHA has to reinstitute public sales of CBOs. We are also recommending that, if public sales are reinstituted, FmHA be required to either engage a professional financing manager or obtain assistance from the Department of the Treasury to manage such sales. FmHA generally agreed with our recommendations.

FmHA advised us also that it was exploring the possibility of recovering from the brokerage firm the profit which the brokerage firm realized in taking advantage of FmHA's interest-rate-change procedures.

FmHA PROCEDURES GOVERNING THE SALE OF CBOs

CBOs are negotiable investment security instruments showing ownership in borrowers' loan notes held in trust by FmHA. FmHA started using CBOs in December 1973. Before that it sold borrowers' loan notes to investors on a guaranteed basis. The proceeds from CBO sales, along with the incoming flow of loan repayments, are used to replenish FmHA's revolving funds. Payment of the principal and interest on the trust notes covered by CBOs is fully insured by FmHA.

FmHA has sold CBOs both to the Bank and to the public. The Bank was established by the Federal Financing Bank Act of 1973 (12 U.S.C. 2281(supp. III)) on December 29, 1973. to provide for coordinated and more efficient financing of Federal and federally assisted borrowings from the public. It did not become operational until May 6, 1974. The Bank is subject to the general supervision and direction of the

Secretary of the Treasury, who is also Chairman of the Board of Directors. All other members of the Board of Directors and officers of the Bank are Treasury officials.

The act authorizes the Bank, with the approval of the Secretary of the Treasury, to issue up to $15 billion of its obligations publicly. The Congress may authorize issuance of additional amounts in appropriation acts. Also the Bank is authorized to issue obligations to the Secretary of the Treasury and may require the Secretary to lend it, through the purchase of its obligations, up to $5 billion. The Secretary, at his option, may purchase additional amounts. As of June 30, 1975, Treasury held Bank obligations totaling about $13.5 billion.

FmHA first sold its CBOs to the Bank on July 2, 1974. Although all sales to the Bank have been in amounts of $500 million, FmHA and Treasury officials told us that much smaller sales were permissible.

CBO sales to the public were made daily through FmHA's St. Louis Finance Office. The interest rate paid on such CBOs was the rate in effect on the date the Finance Office received payment. The Finance Office had verbal instructions to obtain headquarters office approval for each CBO sale exceeding $5 million.

As required by FmHA regulations, changes to the interest rates paid on CBOs sold publicly were published in the Federal Register. Generally, the practice was to announce the rate changes in the Federal Register on their effective dates. The Finance Office practice was to notify known FmHA investors of any rate changes through the distribution of a notice to investors entitled "Memorandum to Investors in Government Securities." Although there were no written procedures governing the issuance of these notices, the Finance Office was to time their mailing so that the addressees would not receive them before the effective date of the interest rate change.

SUMMARY OF TRANSACTION

The record shows that on Monday, November 4, 1974, a representative of the brokerage firm telephoned FmHA's then-Deputy Administrator Comptroller twice. The first call was to ask permission to purchase CBOs valued at $25 million; the second call was to ask permission to purchase CBOs valued at $75 million. The Comptroller approved both requests, although he said he was aware of an FmHA decision made on November 1, 1974, to reduce the interest rate paid on the CBOs effective Thursday, November 7, 1974.

The Comptroller explained that he believed that, as long as CBOs were available for sale, he could not refuse a purchase offer under the FmHA regulations then in effect. These regulations stated that CBOs were to be offered for sale from time to time and that such sales were to be made on such terms and conditions as FmHA deemed appropriate.

The Finance Office sold the first $25 million of CBOs to the brokerage firm on November 4, 1974; the second sale, for $75 million, was made on November 6, 1974. Both sales were made when the interest rate being paid by FmHA was 9 percent. The interest rate was reduced to 8.75 percent on November 7, 1974. An FmHA official calculated that over the 14-1/2-year term of these CBOs FmHA would pay about $3.6 million more in interest costs than it would have had to pay if the sale could have been made at the reduced rate of 8.75 percent.

The Comptroller said that Agriculture's Insured Note Marketing Board had approved the following interest rate policy in June 1974.

> "The interest rate on sales of CBO's from St. Louis will have to be competitive to achieve sales goals. We expect that the rate will be comparable to either (1) the rate we pay to the FFB [the Bank] or (2) the rate FFB pays plus a compounding factor needed to compensate the investor for the difference between our annual interest payment and the semi-annual payment offered on other securities."

He said that the rates which would have been paid to the Bank, including the compounding factor, were 8.78 percent on November 4, 1974, and 8.72 percent on November 6, 1974. He also said that, because CBOs were "agency paper," and were considered to be of lesser quality than Treasury securities, the 9-percent rate available on CBOs through November 6, 1974, was not excessively attractive.

For large sales of securities, small changes in the interest rate can result in differences of millions of dollars in interest costs. For example, an FmHA official calculated that, had the two sales in question been made to the Bank at the 8.75-percent and 8.72-percent rates in effect on November 4 and 6, 1974, respectively, FmHA would have saved about $3.8 million in interest costs. The official also calculated that, had the entire $100 million of CBOs been sold to the Bank at the 8.78-percent rate in effect on November 4, 1974, the savings would have been about $3.2 million.

The Comptroller said that a verbal agreement between FmHA and Treasury officials reached in May 1974 provided that the Bank would purchase from $4 to $4.75 billion of CBOs in fiscal year 1975 and that FmHA would raise the balance of its funding needs, estimated at the time to total $5.7 billion, through direct sales of $1 to $1.75 billion of CBOs to the public. The Bank would make an initial purchase of $500 million of CBOs on July 1, 1974, and additional purchases would not exceed $500 million monthly.

According to FmHA's Associate Administrator, the informal agreement did not limit the amount of CBOs the Bank would purchase. He explained that the $4 to $4.75 billion figures were only estimates of the amount of sales to the Bank. Further, he said that the agreement provided that sales of CBOs by the Finance Office would be limited and would be aimed at small investors. The Associate Administrator told us that, although he could not recall a specific figure, individual sales were to be limited to about $3 to $5 million.

The Comptroller's assistant said he was not aware of any restrictions on annual or monthly sales amounts to the Bank, other than the Bank's informal request that FmHA spread its sales to the Bank over the entire year.

A former Treasury official, who at the time of the agreement was the Special Assistant to the Secretary for Debt Management, said that the agreement provided that individual sales would be limited to modest amounts, but he could not recall any specific amounts. He said that, in his opinion, the $100 million sale clearly violated the intent of the agreement that Finance Office sales of CBOs be in modest amounts.

The Comptroller maintained that neither the regulations nor the announced terms and conditions of sales authorized him to limit or disapprove a sale. Further, he said that he was not aware of any agreement that Finance Office sales of CBOs would be limited to small amounts or be aimed at small investors. He said such constraints would have been untenable, because (1) they were not provided for in the regulations and therefore would have been illegal and (2) FmHA could not have achieved its sales goal by limiting sales to small investors. He said historically the largest dollar volume of Finance Office sales has been to investors with large amounts to invest. Also he said that such restrictions could be easily circumvented.

According to the Comptroller, FmHA's in-house practice was that the Finance Office would request headquarters office approval for each sale of more than $5 million so that Treasury officials could be contacted to determine whether FmHA's interest rate was too high and needed to be reduced. He said that, because Treasury officials had been contacted about an interest rate reduction which was being processed at the time of the subject sale, it was not necessary to contact them again.

Representatives of the brokerage firm told the Office of Investigation in January 1975 that the firm had made over $1 million on the resale of the CBOs to its clients. They said that they had been aware for some time of FmHA's slow reaction time to interest rate changes compared with the reaction time of other Government agencies.

The Office of Investigation noted that FmHA reacted slowly to market interest rate changes because its regulations required that rate changes be published in the Federal Register. Adjustments to CBO rates were based on changes in Treasury rates; however, these adjustments were generally made about 4 working days after Treasury rates changed.

The interest rates paid on securities sold by FmHA was the subject of our February 28, 1973, letter to your Assistant Secretary for Rural Development. In that letter we pointed out that after June 1972, when FmHA did not have a full-time financing manager, the differences between the interest rates paid on securities sold by the Finance Office and those paid on other Government securities were greater than normal. We based our observations on interest rate trends from April to November 1972.

In his response dated June 14, 1973, the Assistant Secretary questioned the need for a full-time financing manager, stating that the creation of the Bank would obviate the need for such a position because FmHA would be one of the first agencies to sell its securities to the Bank. The Assistant Secretary said he expected that the interest rates paid on FmHA securities would be equal to those paid on other Government securities, once FmHA began using the Bank.

The Office of Investigation also reported that, although mailing of the notice to investors informing them of the November 7, 1974, interest rate change was to be timed so that investors would receive it on or after the effective date, a Finance Office official said that the notice was mailed to investors on Friday, November 1. The Office of Investigation reported that the brokerage firm and several other investors the Office had interviewed had no records showing when the notice had been received. Accordingly, the Office of Investigation could not conclusively state that the premature mailing had resulted in the brokerage firm's or any other investor's having advance knowledge of the interest rate change. However, the Office of Investigation noted that the Finance Office's CBO sales during that week were larger, by about $57 million, than in any week since it began selling CBOs in March 1974. The Office of Investigation found also that there were no written procedures governing the issuance of the notices to investors.

AGENCY AND DEPARTMENT ACTIONS

In December 1974, prompted by the $100 million sale in November 1974, FmHA and Treasury entered into a verbal agreement which provided that Treasury officials would have to approve all Finance Office sales of CBOs in excess of $2 million. In addition, FmHA changed its regulations to permit it to make interest rate changes without prior notice in the Federal Register and to require headquarters office approval of all sales in excess of $1 million.

On January 31, 1975, the FmHA Administrator suspended all CBO sales through the Finance Office, to allow for an evaluation of FmHA policies and procedures governing such sales. On March 13, 1975, he stopped all such sales.

The Administrator told us that FmHA intended to sell CBOs exclusively to the Bank as long as the Bank was willing and able to purchase them. A Treasury official told us that there was little likelihood that the Bank would ever be unable or unwilling to purchase CBOs from FmHA. The Administrator said that, if it ever became necessary to sell CBOs to anyone other than the Bank, the sales would be made not through the Finance Office but through syndicates of underwriters, the sales outlet FmHA used for large sales of CBOs before the Bank became operational. The Administrator also told us that FmHA was exploring the possibility of recovering from the brokerage firm the profit which the brokerage firm realized in taking advantage of FmHA's interest-rate-change procedures.

In September 1975 Agriculture took formal disciplinary action against the Comptroller, removing him from his position and demoting him two grade levels. The former Comptroller has appealed the disciplinary action to the Civil Service Commission.

COMMENTS OF THE FORMER FmHA DEPUTY
ADMINISTRATOR COMPTROLLER

In commenting on our report, the former Comptroller said that Agriculture's reason for its disciplinary action against him was that he had the authority to disapprove the subject sale and therefore should have done so. He maintained, however, that he had no authority to limit or disapprove a sale.

The former Comptroller told us that, should the Civil Service Commission deny his appeal, he planned to pursue the matter in the courts. In view of the appeal and the possibility of a civil action, we are not expressing an opinion on the question of whether the former Comptroller had the authority to reject the subject sale.

The former Comptroller maintained that there had been a need for funds which could have been met only by the sales of CBOs through the Finance Office because of the restrictions on sales of CBOs to the Bank. He said that FmHA planned to sell $500 million of CBOs in November 1974 and that the Bank therefore would not have purchased the $100 million of CBOs FmHA sold publicly because that amount would have exceeded the agreed-upon limit.

The former Comptroller's understanding of the agreement between FmHA and Treasury regarding sales of CBOs to the Bank differs from that of other FmHA and Treasury officials to whom we talked. According to their interpretations, there were no limits on the amounts of CBOs FmHA could sell to the Bank. Because the agreement was not in writing, however, we were unable to determine which interpretation was correct.

CONCLUSIONS

We concur in the Administrator's decision to sell CBOs exclusively to the Bank as long as the Bank is able and willing to purchase them. Since this decision is subject to change, however, FmHA should prepare standby procedures for marketing CBOs.

RECOMMENDATIONS

We recommend that, to avoid any recurrence of the type of apparent misunderstandings and differing interpretations of responsibilities, agreements, policies, and procedures that were associated with the Finance Office sales of CBOs, you direct the FmHA Administrator to prepare written standby procedures for public sales of CBOs. We recommend also that, if public sales are reinstituted, FmHA be required to either engage a professional financing manager or obtain assistance from the Department of the Treasury to manage such sales.

FmHA COMMENTS AND OUR EVALUATION

In commenting on our report by letter dated April 8, 1976, the FmHA Administrator said that FmHA expected to continue indefinitely its procedure of selling CBOs exclusively to the Bank. This, he said, should preclude any recurrence of the problem of incurring additional interest costs.

The Administrator said also that FmHA would (1) develop instructions for alternative funding through the sale of CBOs to syndicates of underwriters to be used in the unlikely event the Bank was unable to meet FmHA's funding requirements, (2) require written concurrence from the Department of the Treasury for any such sales, and (3) enter into an agreement with Treasury to obtain additional financial expertise when needed.

We believe the proposed actions, if properly implemented, should help preclude the recurrence of the problem of incurring unnecessary interest costs.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. We shall appreciate receiving a copy of your statement to the Committees.

We are sending copies of this report to the Secretary of the Treasury; the Director, Office of Management and Budget; the Chairmen, House and Senate Committees on Appropriations, the Budget, and Government Operations; and other interested congressional committees and Members of Congress. We are also sending copies to your Assistant Secretary for Rural Development; your Administrator, FmHA; and the Directors of your Offices of Audit, Investigation, and Personnel.

Sincerely yours,

Henry Eschwege

Henry Eschwege
Director