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

B-114873

APRIL 9, 1980

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The Honorable Robert N. Giaimo
Chairman, Committee on the
Budget
House of Representatives HSE00800

Dear Mr. Chairman:

Subject: Legislative Change Needed To Improve Budget Treatment of Certificates of Beneficial Ownership (PAD-80-32) HSE00801

We have completed a report to the Budget Process Task Force, House Committee on the Budget, entitled "Federal Budget Outlay Estimates: A Growing Problem" (PAD-79-20, February 9, 1979). As part of that analysis, we performed a series of case studies, one of which involved Department of Agriculture programs in the Farmers Home Administration (FmHA). This letter addresses an issue noted during our study which, while not included in our report, is nevertheless significant and warrants your attention.

AGC00358

FmHA administers three public enterprise revolving funds which are largely financed through the sale of interest bearing Certificates of Beneficial Ownership (CBOs). The three funds are: Rural Housing Insurance Fund, Agricultural Credit Insurance Fund, and Rural Development Insurance Fund.

We have found that a number of undesirable consequences result from the legal requirement that FmHA record the sale of Certificates of Beneficial Ownership as a sale of assets in the budget. The reporting procedure that FmHA is required to use (1) does not conform to established reporting principles, (2) results in an understatement of FmHA and Federal outlays, and (3) creates inconsistency in the budget.

AGC00168

The following procedure is used by FmHA to finance operations through the sale of CBOs. FmHA makes loans to farmers or other rural borrowers. Then FmHA gathers the loans into a pool and sells shares of interest in the pool to the Federal Financing Bank (FFB) in the form of Certificates of Beneficial Ownership. The Federal Financing Bank is an off-budget institution which functions as a financial go-between, purchasing the debt and guaranteed obligations of other Federal agencies and substituting its own borrowing for that of the agencies. FFB borrows from the U.S. Treasury.

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The current authorizing statute for FmHA, 7 USC 1932 (d)(6), requires that the sale of certificates be treated by Farmers Home Administration as a sale of assets. This is shown in the following excerpt (underscoring added).

> (6) No provision of law shall prohibit issuance by the Secretary of certificates evidencing beneficial ownership in a block of notes insured or guaranteed under this chapter or Title V of the Housing Act of 1949 [42 USC 1471 et seq.]; any sale by the Secretary of such certificates shall be treated as a sale of assets for the purposes of the Budget and Accounting Act of 1921.

As a result of this provision, proceeds from the sale of CBOs are recorded as an offsetting collection, which is deducted from outlays and reduces the requirement for budget authority at the account level. The disadvantages of this reporting procedure are described below.

PROCEDURE DOES NOT COMPLY WITH ESTABLISHED REPORTING PRINCIPLES

DLG01268

Treating the sale of CBOs as an asset sale runs counter to reporting principles established by the 1967 President's Commission on Budget Concepts. At the time of the President's Commission, the sale of Participation Certificates, which are essentially the same as CBOs, was treated as an asset sale. The Commission was critical of this practice and recommended that "Participation Certificates should be treated as a means of financing, not as an offset to expenditures which operates to reduce a budget deficit."

The Commission made this recommendation because it found substantial agreement among economists, investors, security analysts, and students of the budget that Participation Certificates are a means of financing very similar to direct borrowing by Treasury. The central point was that Participation Certificates should not be considered an asset sale. The Commission was concerned because it discovered that treatment of Participation Certificates as an asset sale had reduced outlays of Federal loan programs shown in the budget by several billion dollars and "anyone looking at recent budget presentations could have been left with an erroneous impression as to the extent of increase in direct loans outstanding."

We concur with the Commission's conclusion and have extended it in recommendations that Certificates of Beneficial

The Commission concluded that CBOs

Ownership and Certificates of Beneficial Interest should ~~likewise~~ be treated as a debt instrument. We hold this position regarding Certificates of Beneficial Ownership because it is our opinion that the issuance of these certificates is a borrowing activity rather than a sale of loan assets. The certificates are only nominally tied to the underlying pool of the agency's direct loans. The agency (in this case FmHA) retains title to the loans and also continues to administer and service the loans. In addition, the agency is obligated to repay all principal and interest on the certificates to the Federal Financing Bank, regardless of any defaults in the loan pool.

The central question is whether the sale of Certificates of Beneficial Ownership constitutes an actual sale of the underlying loan assets. A similar question was raised in reference to the Export-Import Bank's sale of Certificates of Beneficial Interest. In "Audit of the Export-Import Bank--Fiscal Year 1968" (May 29, 1969), the Comptroller General set out two tests to provide guidance in determining if a loan is actually sold:

1. The buyer actually takes possession of a loan instrument executed by the original borrower.

2. The buyer is free to dispose of this instrument without restrictions by the U. S. Government.

With regard to the sale of CBOs to the Federal Financing Bank, the loans which underlie FmHA certificates clearly do not satisfy these tests, and therefore, the sale of these certificates ought to be considered a financing or borrowing transaction.

FmHA AND FEDERAL SPENDING IS UNDERSTATED

Recording the sale of certificates as an offsetting collection results in an understatement of outlays, not only in the FmHA accounts, but also in the aggregate Federal outlay figure. At the FmHA account level, the amount borrowed from the Federal Financing Bank through the sale of Certificates of Beneficial Ownership is subtracted from total obligations to yield "net" outlays. Offsetting for certificate sales removes from the total outlay figure those outlays which are made with funds borrowed from the FFB. Since the FmHA revolving funds using CBOs make direct loans for rural development, <u>the effect of reducing outlays in this way is to understate the actual amount of Federal resources devoted to rural development</u>.

For the three Farmers Home Administration accounts using CBOs, total obligations for FY 1979 were $17.7 billion. Yet total outlays for these funds were only $1.4 billion, primarily because of offsetting for the sale of certificates. If the law required FmHA to record certificate sales as borrowing, total outlays for the three funds would have been reported as $11.7 billion. 1/ Table 1 shows the impact on FmHA and Federal budget totals of treating sales of CBOs as asset sales.

Table 1

Effect on Budget Totals of Treating CBO Sales as a Sale of Assets vs Borrowing

	CBOs treated as asset sale	CBOs treated as borrowing 1/	Amount of difference
	(in billions)		
FmHA: FY 1979			
Obligations	$ 17.7	$17.7	0
Outlays	1.4	11.7	$10.3
Federal Totals: FY 1979			
Outlays	494.0	504.3	10.3
Deficit	28.0	38.3	10.3

The unclear representation of outlays is perpetuated when outlay figures of FmHA accounts are combined with outlay figures from all other on-budget agencies to produce the aggregate Government outlay figure. As pointed out in our report "Government Agency Transactions with the Federal Financing Bank Should Be Included On The Budget" (PAD-77-70), the problem stems from the Federal Financing Bank's budget status.

1/All hypothetical cases in this report assume a transition period during which FmHA continues to purchase outstanding CBOs as the certificates reach maturity, rather than conducting a one time redemption and complete conversion of outstanding CBOs to borrowing. Purchase of outstanding certificates by FmHA amounted to $1.9 billion of FY 1979 obligations.

If the Bank were on-budget, the reduction of outlays resulting from FmHA certificate sales would be counterbalanced by the increase in FFB outlays used to purchase the certificates. The Bank, however, is an off-budget agency. Therefore, the reduction of outlays resulting from FmHA's sale of certificates is not counterbalanced in the budget, even though the funds used to buy CBOs ultimately come from Treasury borrowing. The result is that aggregate Federal outlays are understated by the dollar amount of certificates sold to FFB.

As previously mentioned, because the law required FmHA to treat certificate sales as a sale of assets, FY 1979 Federal outlays were understated by $10.3 billion. Had FmHA reported the sale of certificates as borrowing, FY 1979 total Federal outlays would have been reported as $504.3 billion rather than $494 billion and the Federal deficit would have been reported as $38.3 billion rather than $28 billion.

The current reporting procedure creates another problem because it enables FmHA to control the level of offsetting collections. FmHA exercises control through discretionary decisions to defer or accelerate the sale of CBOs. This FmHA control over offsetting collections, combined with the fact that an increase in offsetting collections reduces the reported level of outlays, has important ramifications.

There is documentation that FmHA decisions to sell certificates may be made with the specific intent to reduce reported outlays in order to achieve budget targets. A report prepared by the Financial Support Division of Farmers Home Administration, June 1977, entitled "Financing FmHA Programs," states the following (emphasis added):

> "The decision for selling CBOs to the FFB is governed by four factors.
>
> 1. The cash needs of the three revolving funds (ACIF, RDIF, and RHIF).
>
> 2. <u>The status of actual outlays against the outlay target in the Budget (or as modified by the Department and OMB). Outlay goal may be modified by OMB or the Department any time during the fiscal year</u>.
>
> 3. The ACIF has a legal limit of $500 million in new loans that can be held in the fund * * *. When this limit is reached loans have

to be sold in order to continue the program of this fund. 1/

4. Availability of notes to be sold in each revolving fund.

<u>There may be times when FmHA does not need cash, but will have to sell to meet outlay goals, or open up the $500 million limit in the ACIF</u>."

By deciding to sell more Certificates of Beneficial Ownership and thereby increasing the amount of offsetting collections, FmHA can control reported outlays. There is a limit in that FmHA cannot sell certificates in an amount greater than the amount of outstanding loans. This discretion to adjust reported outlays would be eliminated if the sale of CBOs was recorded as borrowing.

From an accounting standpoint, the effect of treating certificates as borrowing would be to increase the recorded level of assets and liabilities in the financial statements of the three revolving funds. Assets would increase by the amount of loans underlying outstanding certificates, reflecting Farmers Home Administration ownership of these loans. Liabilities would increase by the amount of CBOs outstanding, reflecting treatment of certificates as a form of debt. The full amount of interest collected on loans would be recorded as income to the three FmHA funds, rather than being reduced by the amount of interest applicable to the certificates held by the Federal Financing Bank. The full amount of interest paid to the FFB on certificates would be recorded as an

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1/Before 1978, FmHA was required by law to limit the amount of outstanding loans it held at any one time in the Agriculture Credit Insurance Fund to $500 million. Treatment of CBOs as a sale of assets enabled FmHA to use an accounting device to exceed this loan ceiling. When CBOs were sold, the recorded level of loan assets was reduced on paper by the dollar amount of the CBOs, even though FmHA continued to hold the loans. Whenever FmHA expected to exceed the loan limit it could simply sell more CBOs to reduce the amount of recorded assets and thereby circumvent the ceiling. In 1978 the $500 million limit was removed by Public Law 95-334; however, any future limits which Congress might choose to impose on the amount of loans outstanding would be ineffective as long as CBOs are treated as an asset sale.

expense to the funds. Currently interest expense is recorded as a fund expense only in the amount of the additional interest subsidy payable to the FFB.

INCONSISTENCY IS PRODUCED IN THE BUDGET

Government agencies other than FmHA record debt transactions, including the sale of instruments like CBOs, as agency borrowing rather than offsets to budget authority and outlays. The requirement in 7 USC 1932 that FmHA record certificate sales as an asset sale thus creates inconsistency in the budget. The current policy of the Export-Import (EX-IM) Bank is to record the sale of Certificates of Beneficial Ownership (EX-IM calls them Certificates of Beneficial Interest) as a debt transaction. While EX-IM Bank at one time did treat certificate sales as a sale of assets, in 1976 their policy was changed, at our recommendation, to treat such transactions as borrowing. HEW's Higher Education Facilities Loan and Insurance Fund is another example of an account that has recorded the sale of certificates as agency borrowing. (The Department of Health, Education and Welfare discontinued the use of this form of financing in 1970.) It is the current policy of the Office of Management and Budget that all sales of certificates should be recorded as borrowing unless the law specifically requires that they be treated as an asset sale. In Special Analysis F of the U.S. Budget, OMB states:

> "In some cases, the Federal agency sells securities called participation certificates or certificates of beneficial ownership that are backed by loans that the agency continues to hold and service. These are by definition borrowing unless otherwise provided for by law."

Budget estimates of offsetting collections from CBOs

Accuracy in budget estimating is a related problem which is influenced by the treatment of CBOs as an asset. Table 2 shows that in past years the difference between estimated offsetting collections and actual FmHA offsetting collections from certificate sales has been significant. For example, in FY 1979 the actual level of offsetting collections exceeded the budget year estimate by $3.1 billion.

Of the many FmHA activities which are counted as offsetting collections, the sale of certificates is one of the most unpredictable. If CBOs were treated as borrowing, their sale would have no effect on projections of future offsetting collections. Because the remaining categories of offsetting collections are more predictable, the accuracy of the estimate for offsetting collections would likely improve.

Table 2

Variance in Estimates for Offsetting Collections--FmHA Enterprise Revolving Funds (in billions $)

	Budget Year 1st Estimate	Current Year 2nd Estimate	Actual	Amount Variance: 1st Estimate-Actual	Amount Variance: 2nd Estimate-Actual
FY 1979	$7.2	$7.8	$10.3	$-3.1	$-2.5
FY 1978	4.7	6.6	9.2	-4.5	-2.6
FY 1977	5.9	6.3	5.0	+ .9	+1.3
FY 1976	3.4	4.4	3.8	-0.4	+0.6

CONCLUSION

The President's Commission on Budget Concepts stated that the budget should provide information "* * * for an informed assessment by citizens of Government's stewardship of the public's money and resources." The Commission further stated that the budget should provide aggregate figures that provide an accurate measurement of the scope of overall Government financial activities.

FmHA's current method of reporting the sale of Certificates of Beneficial Ownership does not adequately fulfill these objectives. The requirement in 7 USC 1932 (d)(6) that CBO sales be treated as asset sales fails to result in a complete and accurate presentation of the Government's financial activity. More straightforward and consistent reporting would be achieved if certificate sales were recorded as agency borrowing.

RECOMMENDATIONS

We recommend that the Congress amend section 310B(d)(6) of the Consolidated Farm and Rural Development Act, 7 USC 1932 (d)(6), to eliminate the requirement that Certificates of Beneficial Ownership be treated as asset sales and that OMB's current policy of recording such transactions as borrowing then be applied.

* * *

Before sending this letter to your Committee, we provided officials in the Office of Management and Budget and the Farmers Home Administration an opportunity to comment on our findings. The Office of Management and Budget expressed its strong agreement with the report. Its written comments are provided in enclosure I. In our meeting with the Farmers Home Administration, FmHA officials expressed general disagreement with our recommendation and stated that they would prefer to make specific criticisms in writing. It was agreed that 30 days would be provided for written comment. Since a response was not received within 30 days, we are sending this letter without Department of Agriculture comments. We are sending identical letters to the individuals listed in enclosure II. Copies are being sent to other interested parties.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

Enclosures

 Enclosure I

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

FEB 11 1980

Mr. Harry S. Havens
Director, Program Analysis Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Havens:

This responds to your request for our views on your draft report concerning the sale of Certificates of Beneficial Ownership by the Farmers Home Administration (FmHA). We think you have done a good job of laying out the issues and we support your conclusions. The treatment of CBO's as assets does:

— conflict with established accounting principles

— result in understating outlays

— create inconsistencies in the budget

I believe it is the second point that has limited legislative action to correct the situation. As more and more programs have been laid on FmHA and as authorized program levels have increased, total FmHA lending has risen steeply. We now project gross CBO sales to the FFB at around $12 billion in FY 1981. Thus, the sums involved have become so large that neither the Congress nor the Executive Branch is eager to assume the responsibility for a big increase in outlays simply because of a definitional change.

This is not to say that we do not support you in your recommendation. Quite the contrary. We do, however, expect the Congress to make the first move. The statute in question was enacted by the Congress on their own initiative, and had not been supported by the Administration.

Sincerely,

Jim McIntyre

James T. McIntyre, Jr.
Director

Identical letters sent to:

The Honorable Norman Y. Mineta
Chairman, Budget Process Task Force
Committee on the Budget
House of Representatives

The Honorable Henry S. Reuss
Chairman, Committee on Banking,
Finance, and Urban Affairs
House of Representatives

The Honorable Thomas L. Ashley
Chairman, Subcommittee on Housing
and Community Development
Committee on Banking, Finance and Urban Affairs
House of Representatives

The Honorable Thomas S. Foley
Chairman, Committee on Agriculture
House of Representatives

The Honorable Ed Jones
Chairman, Subcommittee on Conservation
and Credit
Committee on Agriculture
House of Representatives

The Honorable Edmund S. Muskie
Chairman, Committee on the Budget
United States Senate

The Honorable William Proxmire
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Harrison A. Williams
Chairman, Subcommittee on Housing and
Urban Affairs
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Herman E. Talmadge
Chairman, Committee on Agriculture, Nutrition
and Forestry
United States Senate

The Honorable Pat J. Leahy
Chairman, Subcommittee on Rural Development
Committee on Agriculture, Nutrition
and Forestry
United States Senate