United States General Accounting Office

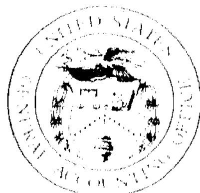
GAO

Report to Congressional Committees

March 1989

RESERVE ACCOUNTING

Rural Telephone Bank's Reserve for Losses Due to Interest Rate Fluctuations



GAO/AFMD-89-15

GAO

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

Accounting and Financial
Management Division

B-159292

March 27, 1989

The Honorable Patrick J. Leahy
Chairman
The Honorable Richard G. Lugar
Ranking Minority Member
Committee on Agriculture, Nutrition
and Forestry
United States Senate

The Honorable E (Kika) de la Garza
Chairman
The Honorable Edward R. Madigan
Ranking Minority Member
Committee on Agriculture
House of Representatives

The Honorable John Conyers, Jr.
Chairman
The Honorable Frank Horton
Ranking Minority Member
Committee on Government
Operations
House of Representatives

In accordance with section 1413(b) of Public Law 100-203, we have studied and are making recommendations concerning the Rural Telephone Bank's (RTB) reserve for losses due to interest rate fluctuations.

Based on our study, we determined the following:

- The reserve for losses due to interest rate fluctuations should be established at a level sufficient to cover future interest rate fluctuations. This level should not exceed $10 million.
- Remaining amounts in the existing reserve of $88.3 million, plus $37.4 million of undesignated profits for fiscal year 1988 should be distributed to RTB's borrowers in the form of class B patronage stock dividends.
- For annual operations, the established reserve level would be reduced by any losses resulting from unfavorable interest rates. A corresponding expense could be recorded to replenish the reserve to its established level or the reserve could be maintained at the reduced level. Any expense incurred would have to be recovered from profits in future years and could result in higher interest rates charged to borrowers.

Rural telephone companies who own RTB class B stock and some members of the Congress have expressed interest in returning cash to RTB borrowers, who are also shareholders, for the interest they paid that resulted in RTB's accumulated profits. Legal restrictions preclude a cash rebate to class B stockholders and also prevent redemption of class B stock until all shares of government-owned class A stock are redeemed, which is to begin as soon as practicable after September 30, 1995. Therefore, if the Congress desires to authorize a cash redemption of class B stock, legislation would be necessary. Principal repayments from outstanding loans and margins from operating profits provide a source of funds for the gradual retirement of class B stock. However, use of those funds for that purpose, assuming no decrease in the level of loan funding, could result in increased borrowing from Treasury, with a resulting rise in interest rates to borrowers.

In commenting on a draft of this report, RTB raised several minor points related to the reserve for losses due to interest rate fluctuations. We have addressed these points in the report. The balance of RTB comments concern the privatization of the bank, as provided for by the Rural Electrification Act of 1936, as amended. This issue is not within the scope of this report.

Objective, Scope, and Methodology

The objective of our study was to satisfy the legislative reporting requirements of section 1413(b) of Public Law 100-203, requiring that we conduct a study with respect to RTB's reserve for losses due to interest rate fluctuations. In conducting our study, we reviewed the legislative requirements of Public Law 100-203 and met with RTB's Assistant Governor and Assistant Treasurer to discuss actions taken by the bank regarding the reserve. We reviewed RTB's operations and the conditions which historically have generated substantial annual operating profits. We also reviewed RTB's treasurer reports and other documents pertinent to our study, including transcripts of hearings and reports of the House Committee on Government Operations, Subcommittee on Government Information, Justice and Agriculture.[1] We performed our work from January through November 1988 at RTB's office located within the Department of Agriculture (USDA). Our work was conducted in accordance with generally accepted government auditing standards.

[1] April 23, 1987, and July 23, 1987, hearings, Rural Telephone Bank: Have Rural Telephone Systems and Ratepayers Been Overcharged? and the Committee's twenty-fourth report, Gouging the Rural Ratepayer: Interest Rate Policies of the Rural Telephone Bank, dated October 7, 1987.

Provisions of Section 1413 of Public Law 100-203

Section 1413(a) of Public Law 100-203,[2] required the Rural Telephone Bank to establish a reserve for losses due to interest rate fluctuations within 30 days from December 22, 1987, the effective date of that law. This reserve is to replace RTB's much broader reserve for contingencies currently included in the equity section of the bank's financial statements. Amounts in the reserve for losses due to interest rate fluctuations may only be used to cover operating losses and only after consideration of any GAO recommendations made under section 1413(b) of the act. Other than a preexisting reserve for loan losses, the law allows no other reserves.

Section 1413(b) of the act requires that GAO complete a study of RTB's operations to determine

- the appropriate level of funding for the reserve for losses due to interest rate fluctuations established by section 1413(a),
- the circumstances under which amounts should be expended from the reserve,
- the circumstances under which amounts should be added to the reserve, and
- the disposition of any excess reserves.

Section 1413(b) of the act also requires us to report our recommendations to the Senate Committee on Agriculture, Nutrition and Forestry, and the House Committees on Agriculture and Government Operations. It also requires us to consider the effects of our recommendations on RTB borrowers, the subscribers of such borrowers, and the United States government.

Section 1413 of the act does not clearly address whether RTB, in response to GAO's recommendations, may use for other than operating losses, any amounts beyond the appropriate level of funding for the new reserve. We are addressing the recommendations in our report to the Congress because we believe the objectives of section 1413 are best met if the Congress provides direction to RTB on its implementation of the actions recommended.

Background

RTB was established in May 1971 as a corporate instrumentality of the United States government to meet the growing capital needs of rural telephone systems and to serve as a source of supplemental financing by

[2]The Omnibus Budget Reconciliation Act of 1987.

providing low-cost, long-term loans. RTB is a wholly owned government corporation until a majority of its stock owned by the United States is redeemed, at which time it becomes privatized and owned by its rural telephone borrowers. RTB operates within the USDA and is subject to the supervision and direction of the Secretary of Agriculture.

To enable RTB to make telephone service widely available to rural users, the Congress declared that the bank should have the capacity to obtain funds for its program at the lowest possible cost. In turn, RTB is required by the Rural Electrification Act of 1936, as amended, to lend money to rural telephone system borrowers at the bank's "cost of money rate." Section 401 of the act requires RTB to conduct its operations to the extent practicable on a self-sustaining basis. Section 403 of the act also provides that RTB may use the facilities or services of the Rural Electrification Administration or any other agency of the Department of Agriculture "without cost to the telephone bank." These provisions suggest that the bank should operate with a view towards breaking even.

Sources of RTB Capital

RTB's capital consists of three classes of stock:

- Class A stock is purchased only by the U.S. government in amounts up to $30 million annually and cannot exceed a total of $600 million. No class A stock is to be purchased after 1991, and retirement of the stock is to begin as soon as practicable after September 30, 1995. When 51 percent of the class A stock has been retired, the bank will cease to be an agency of the United States but will continue as an instrumentality of the United States and as a mixed-ownership government corporation. Class A stock is nonvoting and pays cash dividends at a rate of 2 percent annually.
- Class B stock is held only by recipients of RTB loans. Borrowers are required to invest 5 percent of loan proceeds in class B stock. No cash dividends are payable on class B stock, but if RTB has operating profits, stockholders can be given patronage refunds in the form of additional class B stock.
- Class C stock is available for purchase by eligible borrowers and pays a cash dividend at a rate set by RTB's Board of Directors.

Reserves

RTB's annual profits, after distribution of class A and C cash dividends, are retained as patronage capital contributed by borrowers, who are also stockholders. In accordance with RTB bylaws effective before the enactment of Public Law 100-203, after the close of each fiscal year, not

less than 10 percent of the patronage capital (with the exact amount determined by RTB's Board of Directors) was to be placed in a contingency reserve (which was transferred to the reserve for losses due to interest rate fluctuations, as required by Public Law 100-203). The residual balance was to be distributed to each holder of class B stock as a patronage refund in the form of additional class B stock. The amount of stock to be distributed to each class B stockholder was to be determined by the ratio of loan interest paid by the stockholder to total interest paid during the fiscal year.

From its inception in 1971 through September 30, 1988, RTB has accumulated $223.5 million in profits. As of September 30, 1988, RTB has converted $87.8 million of these profits to class B patronage stock as subscriber refunds and has designated $98.3 million as a reserve for contingencies. The remaining undesignated portion, $37.4 million, represents fiscal year 1988 profits earned, after provision of $9.9 million for class A cash dividends.

Method Used to Set Interest Rates

Prior to December 22, 1987, when the Congress passed Public Law 100-203, RTB calculated the interest rate it charged to borrowers each quarter by taking a weighted average of the estimated cost of all its sources of capital for that year. These sources have included up to $30 million appropriated annually by the Congress for class A stock, proceeds from the sale of class B and class C stock, funds obtained through Treasury borrowing, and annual profits after payment of cash dividends (also referred to as margin or patronage capital). Principal repayments were considered relendable at no cost and were not included in the calculation.

The amount estimated to be lent is based upon congressionally established minimum levels of $177 million for new RTB loans. The calculation assumed that RTB would issue new loans at the minimum loan level. Any shortfall after the proceeds from the sale of class A, B, and C stock, as well as operating profits, would be financed through Treasury borrowing. Table 1 shows RTB's interest rate calculation for the fourth quarter of fiscal year 1986.

Table 1: RTB's Calculation of Cost of Money for Fourth Quarter 1986

Source of funds	Amount	Interest rate (percent)	Cost of funds
Class A stock	$28,530,000[a]	2.000	$570,600
Class B stock	8,852,000	0	0
Class C stock	100,000	8.500	8,500
Margins	22,589,000	8.000[b]	1,807,120
Treasury borrowing	116,974,000[c]	8.985[d]	10,510,114
Total	**$177,045,000**		**$12,896,334**
Weighted average interest rate		7.284	

[a]The $30 million normally appropriated was reduced in accordance with Gramm-Rudman legislation.

[b]An opportunity cost rate assumed by RTB if margins were invested.

[c]The calculation assumed the Treasury borrowing amount as the difference between funds received from stock plus margins and the minimum level of new loans. However, only $53,000 was actually borrowed during fiscal year 1986, due to a reduced level of loans and repayment of principal and interest from prior years' loans.

[d]This figure represents RTB's estimate of the long-term Treasury rate.

The weighted average cost of money calculated in table 1 is $12,896,334 divided by $177,045,000 or 7.284 percent. RTB arbitrarily rounded the 7.284 percent calculation upward to the next quarter percent and set the fourth quarter 1986 interest rate at 7.5 percent.

The interest rate was calculated quarterly and applied to all loan commitments made during that quarter. Interest rates under those commitments were fixed for the life of the loan, regardless of when the loan proceeds were actually advanced. Advances on loan commitments are normally drawn down over a period of several years even though Treasury interest rates fluctuate, thus creating risk for RTB to cover the advances at the preapproved rate.

The Congress passed Public Law 100-203, which changed RTB's procedure for setting interest rates to borrowers to more accurately reflect RTB's cost of money. Effective December 22, 1987, interest rates on new loans are to be established on each advance at the time the loan funds are drawn down. The interest rate on an advance from the time the advance is made until the end of the fiscal year is initially set at the Treasury rate for an obligation of comparable length maturity. For succeeding fiscal years, the interest rate is the cost of money rate calculated within 30 days after the end of each fiscal year. Further, under the new procedure, funds acquired through repayments of principal are now assigned a cost based on the rate of RTB's historical cost of money rate

since inception, which, through September 30, 1988, was 6.44 percent. Setting the interest rate at the end of the fiscal year allows the borrowers' interest rate to be tied more directly to RTB's actual cost of money, as all sources of funding are known at that time.

RTB Risk and Reward From Interest Rate Fluctuation

Prior to the passage of Public Law 100-203, RTB's risk due to interest rate fluctuation was high. This risk occurred because interest rates on loan commitments to borrowers were fixed, while the interest rates paid by RTB to Treasury for loans to cover advances were variable. In a period of rising interest rates, this is particularly risky, as historically only a small portion of funds are drawn down within the first year following loan approval. Drawdowns could take up to 6 years or longer if the loan commitment is extended by mutual agreement.[3] As of September 30, 1988, RTB's unadvanced commitments for previously approved fixed-rate loans totaled $625 million, out of $688 million in total loan commitments. These outstanding fixed-rate commitments present a risk to the bank if interest rates rise sharply. However, if interest rates drop, RTB will benefit from additional profits which arise from the favorable interest rate spread.

Public Law 100-203 eliminated fixed-rate loan commitments for advances under loan commitments made after October 1, 1987. Instead, interest rates will be set under a statutory formula that more closely matches interest charged on loan drawdowns with RTB's cost of money, thus substantially reducing both risk and reward due to interest rate fluctuations.

However, with $625 million in unadvanced fixed-rate loan commitments outstanding, RTB still faces some near-term risk if there is a substantially large increase in Treasury interest rates. Table 2 presents a worst case scenario for fiscal year 1989 operating results, under which we assumed that all fixed-rate loan commitments had been advanced as of the beginning of the year. As shown in table 2, Treasury interest rates would have to rise above 19 percent in order for RTB to incur a loss.

[3]Loan commitments of 3 years with a 3-year option have been RTB's normal practice, although we have been unable to find any published regulation that sets any specified period.

Table 2: Risk of Loss During Fiscal Year 1989 at Various Treasury Rates

Treasury interest rate (percent)	Gain (loss) on loans
16[a]	$22,470,878
17	16,364,801
18	10,258,701
19	4,152,601
20	(1,953,499)

[a]The highest interest rate ever reached on 30-year Treasury bonds was 14.68 percent in October 1981.

Although it is normal for the amount of advances to increase during a period of high interest rates, RTB's lending experience indicates that it is unlikely that the amount of annual drawdowns would approach anything close to the $625 million in fixed-rate unadvanced loan commitments existing on September 30, 1988. In perspective, RTB had $422 million in unadvanced loan commitments in 1980, when interest rates on 30-year Treasury Bonds exceeded 12 percent. Despite this high interest rate, drawdowns on unadvanced loan commitments at lower interest rates increased only $69 million over the previous year. When interest rates ranged from 12 to over 14 percent in the high-interest years of 1981 and 1982, advances decreased to 1979 levels, and annual net income from loans during the 1980 to 1982 period dropped about $2 million.

Additionally, RTB's risk due to interest rate fluctuation will substantially decrease over the next 6 years as commitments for fixed-rate loans expire. Table 3 shows an example of what might be expected regarding unadvanced fixed-rate loan commitments for fiscal years 1989 to 1994 using certain assumptions. In compiling the table, we assumed that loan commitments would not be extended, used a high interest rate of 16 percent, and assumed that all unadvanced fixed-rate loan commitments are drawn down at the beginning of the fiscal year. For example, in 1990, the maximum amount of unadvanced fixed-rate loans would be $541.2 million. If these advances were made at the beginning of the fiscal year and were financed through Treasury borrowing at a 16-percent interest rate, RTB would have an operating gain of $25.9 million for the year.

The table also shows the break-even interest rate, that is, the Treasury interest rate above which RTB would experience a net interest loss on its loan portfolio if all unadvanced loans were drawn down. For example, in 1990 RTB would experience a net loss on loans if the Treasury interest

rate were to exceed 20.8 percent and all unadvanced loans were drawn down.

Table 3: Unadvanced Fixed-Rate Loan Commitments for Fiscal Years 1989-1994

Fiscal year	Maximum outstanding loan commitments[a]	Gain assuming a 16-percent interest rate	Break-even interest rate percent
1989	$625,146,342	$20,145,086	19.2
1990	541,228,144	25,892,523	20.8
1991	477,626,236	30,185,652	22.3
1992	384,695,783	36,458,458	25.5
1993	298,940,460	42,246,941	30.1
1994	147,511,160	52,468,419	51.6

[a]Includes $129,130,985 of 6-year commitments expired in 1988 or earlier but not extended or rescinded. These expired commitments are available for drawdown until both RTB and the borrower agree to a rescission.

Establishing and Maintaining the Reserve for Losses Due to Interest Rate Fluctuations

Because of the low risk of large losses, a $10 million reserve for losses due to interest rate fluctuations appears more than reasonable. As seen in table 3, without extensions of loan commitments, interest rates would have to exceed 19.2 percent in 1989 with substantial interest rates thereafter for a loss to occur. With RTB realizing a $37.4 million profit after $9.9 million in class A dividends for fiscal year 1988, and with Treasury interest rates at approximately 9 percent, it is difficult to see any near-term losses from interest rate fluctuations that could not be covered by a $10 million reserve. To deplete a $10 million reserve would require a long-term Treasury rate of 20.8 percent in 1989 and increasingly higher rates thereafter. Moreover, reserve levels should be periodically evaluated by RTB to determine if further reductions can occur as the risk of loss diminishes.

Once an appropriate level of funding is established for the reserve for losses due to interest rate fluctuations, standard accounting practices should be followed when expending from or adding amounts to the reserve. Any losses incurred would be charged to and, therefore, reduce the reserve. The reserve could then be adjusted to the established level through an increase to the reserve and a related expense charged to that year's operations, or, the reserve could be left at the reduced level. Any expense incurred would have to be recovered from profits in future years and could result in higher interest rates charged to borrowers.

Disposition of Excess Reserves

Section 1413 of Public Law 100-203 provides that the total amounts transferred from the reserve for contingencies to the new reserve for losses due to interest rate fluctuations may be used only to cover RTB's operating losses, after taking into consideration GAO's recommendations concerning, among other things, the disposition of any excess reserves. We are recommending that a portion of the amounts in the new reserve be used for patronage refunds.

As previously noted, a $10 million reserve for losses due to interest rate fluctuations appears more than reasonable. After the level of reserve for losses due to interest rate fluctuations has been established, any residual amounts from the reserve for contingencies could then be transferred to RTB's borrowers by issuing patronage refunds in the form of class B stock.

In its comments on a draft of this report, RTB stated that our study should address which years' earnings should be retained in the reserve. We have not specified which years' earnings should be retained in the reserve, as we leave that decision to RTB management. As of September 30, 1988, the reserve for contingencies contained $98.3 million in accumulated profits since the 1971 inception of RTB plus $37.4 million in undesignated profits earned in fiscal year 1988 for a total of $135.7 million. Retaining $10 million for the reserve for losses due to interest rate fluctuations would leave $125.7 million to be distributed for class B patronage refunds. An equitable calculation would be a weighted average of $944.3 million (interest paid by borrowers from inception of the bank through September 30, 1988) to $125.7 million (amount expected to be distributed as class B patronage refunds) for a rate of 12.64 percent. However, an argument could be made to calculate the reserve from the first $10 million of income earned prior to September 30, 1988, to recognize a period of building up the reserve, which penalizes the earlier borrowers of the bank. Finally, the calculation could use the most current period from September 30, 1988, backwards until $10 million was earned, shifting the funding of the reserve to the most recent borrowers and rewarding past borrowers for their contributions.

Redemption of Class B Stock for Cash

Some interest has been expressed by rural telephone company stockholders and some members of the Congress in returning cash amounts representing interest which borrowers paid that resulted in RTB's accumulated profits. Statutory and other legal restrictions currently preclude cash payments to class B stockholders. Section 406(g) of the Rural

Electrification Act, 7 U.S.C. 946(g), provides that RTB profits, after payment of dividends on class A and C stock, shall be set aside for patronage refunds on class B stock, and section 406(d) of the act, 7 U.S.C. 946(d), allows payment of such refunds only in class B stock of RTB. Providing cash to class B stockholders through a stock redemption before all class A stock is redeemed would be inconsistent with the act and RTB's bylaws, which appear to establish a contractual, vested right of prior redemption for the class A stock. Specifically, section 2.2(b) of RTB's bylaws provides that class B stock may be redeemed and retired only after all shares of the government-owned class A stock have been redeemed and retired.

Section 406(c) of the Rural Electrification Act provides that class A stock shall be redeemed and retired by RTB as soon as practicable after September 30, 1995, but only to the extent that RTB determines that such retirement will not impair its operations. Section 406(c) provides that the minimum amount of class A stock that must be retired annually at that time must equal the amount of class B stock sold during the year. Assuming a congressionally established minimum lending level of $177 million, the 5-percent stock purchase requirement of section 406(d) would generate about $8.9 million annually. At that minimum rate, it would take about 68 years to retire the total $600 million of class A stock expected to be issued. Over the years, RTB has elected to reinvest its accumulated profits in program loans rather than establish a sinking fund to retire outstanding stock which would have necessitated additional borrowing from Treasury to sustain the same level of loans.

In addition to the legal barriers RTB faces in returning its accumulated profits to its borrowers in the form of cash, there is uncertainty whether RTB's operations can generate the cash needed to refund those profits without increasing interest rates to borrowers. Any cash payout will affect the calculated interest rates RTB must charge its customers in order to break even. Also, depending on how much stock would be redeemed annually for cash, RTB may have to increase its Treasury borrowing to sustain current lending levels or reduce its level of lending. Current Treasury rates are higher than the historic cost of money rate assigned to RTB's accumulated profit margins, which thus far have been recycled and used as a source of funds for additional loans. As a result, the average cost of RTB's funds available for loans would increase and have to be passed along in the form of higher interest rates to borrowers.

Conclusions

RTB's reserve for contingencies was originally established to offset operating and other losses and deficits. The transfer of the amounts in the reserve for contingencies to a reserve for losses due to interest rate fluctuations has, by law, narrowed its purpose and reduced the corresponding level necessary for the reserve. Considering the minimal risk RTB faces because of interest rate fluctuations, a reserve for losses of no more than $10 million is appropriate to provide for any future charges. Once the level of the reserve has been established, standard accounting practices should be followed to maintain the reserve at that level or at an even lower level as the risk of interest losses decreases. Excess reserves should be converted to class B patronage stock in amounts proportionate to interest payments made by those borrowers for the period the profits were accumulated. Whether the excess reserves should be refunded in cash through the retirement of class B stock before the planned retirement of class A stock is a matter of congressional policy and would require legislation.

Should the Congress decide to mandate such a cash refund, it should provide RTB's Board of Directors with sufficient flexibility in returning the accumulated profits so that RTB's future operations are not impaired.

Recommendations

We recommend that the Congress direct the Governor of the Rural Telephone Bank to

- initially establish the reserve for losses due to interest rate fluctuations at an amount not to exceed $10 million;
- distribute amounts over the initially established $10 million level as class B patronage stock dividends to RTB's borrowers, in proportion to the interest each borrower paid over the period when the excess was accumulated;
- charge the reserve for any losses due to interest rate fluctuations; and
- replenish the reserve, as needed, to the established level or a lower level, as the risk of interest losses decreases.

Agency Comments and Our Evaluation

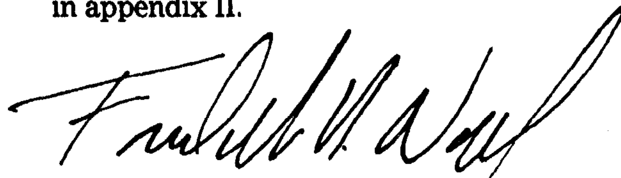
In its comments on a draft of this report, RTB focused primarily on the issue of the bank's privatization. The specific focus of our report, as directed by section 1413(b) of Public Law 100-203, was to make recommendations concerning RTB's reserve for losses due to interest rate fluctuations. Overall, the financial effect of our recommendations is to convert excess RTB contingency reserves to class B stock. This conversion would leave RTB's total equity position unchanged, unless class B

stock is redeemed for cash, a measure which would require legislative change. We agree that the privatization issue is important. RTB management is beginning to take steps to develop a detailed implementation plan. RTB would be best served if it developed this plan with input from the Congress and the rural telephone companies RTB serves.

RTB also expressed concern over its ability to generate future earnings. We believe that in the normal course of business, RTB should not incur an operating loss that would adversely affect its operations because of the following: (1) RTB now lends out at its cost of money rate in accordance with Public Law 100-203, (2) it can charge the Treasury rate until the end of the fiscal year in which the advance is made, and (3) significant income is expected from past loans. Even if an operating loss occurred, it would not be so rapid that appropriate management actions could not be taken. Further details on RTB's comments and our evaluation are presented in appendix I.

We are sending copies of this report to the Governor of the Rural Telephone Bank, the Director of the Office of Management and Budget, the Secretary of the Treasury, and other interested parties. Copies will also be made available to others upon request.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits. Other major contributors are listed in appendix II.



Frederick D. Wolf
Assistant Comptroller General

Comments From the Department of Agriculture

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

United States Department of Agriculture | Rural Electrification Administration | Office of the Administrator | Washington, D.C. 20250

DEC [illegible]

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

Dear Mr. Wolf:

We have reviewed your draft report entitled, Reserve Accounting: Rural Telephone Bank's Reserve for Losses Due to Interest Rate Fluctuations (GAO/AFMD-89-15).

We do not believe the draft General Accounting Office (GAO) report has given adequate consideration to several very important points.

See comment 1.

First, the GAO study does not consider all scenarios that could result in an operating loss for the Rural Telephone Bank (RTB). Specifically, it does not analyze the impact of future changes in the RTB's capital structure required under Sections 406 and 410 of the Rural Electrification Act of 1936, as amended (RE Act). The study also omits any discussion of the RTB's future ability to pay dividends after the conversion of class B stock into class C stock upon total loan repayment. There is also no mention of the RTB's long-term ability to recover its administrative expenses through the interest rates applied to loan advances. Throughout the study, the analysis seems to rely on the RTB's existing earnings level without adequate consideration of the fact that the existing RTB interest rate formula was designed to generate little or essentially no earnings. The study should address the method of replenishing the reserve after the RTB's earnings have declined.

See comment 2.

See comment 3.

See comment 1.

Second, the GAO study needs more discussion on the impact of its recommendations on the U.S. Government. The study discusses the impact of retiring class B stock on the interest rate borrowers would have to pay but does not reflect any consideration of the effects of such retirements on the statutory objectives of the RTB and on the interests of the U.S. Government. Specifically, the study fails to consider the impacts of retirements of class B stock on the statutory objective of the RTB to become a privately owned and privately financed corporation. This objective is to be accomplished in part through the retirement of class A stock as soon as practicable after September 30, 1995, but not to the extent it impairs the operation of the RTB.

See comment 1.

We would also suggest that the study calculate the total cost to the U.S. Government if the RTB retires the class A stock at the minimum level over a 68-year period.

See comment 4.

Third, the GAO study makes the statement that "These factors imply that the bank should operate with a view towards breaking even." This statement does not follow from the RE Act nor from the requirement set forth in Section 401 that the RTB should conduct its operations to the extent practicable on a self-sustaining basis. It also does not follow in light of eventual changes in the RTB's capital structure required under Sections 406 and 410 of the RE Act.

Mr. Frederick D. Wolf 2

See comment 5.

Finally, it follows from your recommendations that the study should address which year's earnings should be retained in the reserve. It also follows that you should discuss whether the reserves should contain the RTB's most current margins.

We appreciate the opportunity to submit comments for inclusion in your final report.

Sincerely,

JACK VAN MARK
Acting Administrator

The following are GAO's comments on the Department of Agriculture's letter dated December 10, 1988.

GAO Comments

1. No change made to the report. These points were not within the scope of our study, as they are related to the issue of privatization.

2. Regarding dividend payments, there is no requirement to pay dividends on class B stock, and class C stock dividends are as determined by RTB's Board of Directors. The conversion of class B stock into class C stock only occurs upon payment of all outstanding loans by borrowers, which historically has not happened in any significant amount.

3. Administrative expenses have been kept low to nonexistent by the bank's enabling legislation and will undoubtedly increase upon privatization, which will require a higher interest rate to cover. Although the existing interest formula does not consider administrative expenses, RTB is allowed to charge the Treasury rate on new loans until the end of the fiscal year in which the advance is made.

4. While we agree with RTB that the Rural Electrification Act of 1936, as amended, does not expressly require RTB to conduct operations so as to break even, our position is not inconsistent with the act. We believe the act's provisions, when taken as a whole, reflect an expectation that RTB would charge the lowest possible rates to borrowers and, in so doing, operate with a view towards breaking even. The report was revised by citing those statutory provisions which instruct RTB to limit costs and rates.

5. Report revised to address this comment.

Major Contributors to This Report

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

Robert W. Gramling, Director, Corporate Financial Audits
(202) 275-9406
Roger R. Stoltz, Assistant Director
Shirley L. Abel, Audit Manager
Terry G. Baskin, Accountant-in-Charge

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