United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Rural Development and Rural Electrification, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate

April 1990

LOAN ASSET SALES

An Evaluation of FmHA's 1987 Sales

141338

RESTRICTED——Not to be released outside the General Accounting Office unless specifically approved by the Office of Congressional Relations.

5482A RELEASED

GAO/AFMD-90-42

GAO

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

Accounting and Financial
Management Division

B-235161

April 6, 1990

The Honorable Howell Heflin
Chairman, Subcommittee on Rural Development
and Rural Electrification
Committee on Agriculture, Nutrition, and Forestry
United States Senate

Dear Mr. Chairman:

In your letter of June 27, 1988, you asked us to conduct a review of two pilot loan asset sales completed by the Department of Agriculture's Farmers Home Administration (FmHA). These sales were authorized by the Omnibus Budget Reconciliation Act of 1986, Public Law 99-509, which directed FmHA to sell enough loans in fiscal year 1987 from its Rural Housing Insurance Fund and its Rural Development Insurance Fund to realize not less than $2.7 billion in net sale proceeds. To meet these targets, FmHA sold loans with an aggregate unpaid principal balance of more than $4.9 billion and realized over $2.8 billion in net sale proceeds. The responsibility for servicing these loans was also transferred to the loan purchaser, as authorized by the act.

This report focuses on whether FmHA (1) conducted these loan asset sales in a professional manner—that is in a manner similar to that of private sector organizations, (2) received the maximum net proceeds practicable for the loan assets sold, and (3) protected the rights of the borrowers whose loans were sold.

This report also discusses two commonly held misunderstandings regarding loan asset sales. First, that the net proceeds from FmHA loan asset sales are not as large as those from recourse sales. Second, that the sale of FmHA loans will reduce the budget deficit in both the short and long term.

Results in Brief

We concluded that FmHA conducted its pilot loan asset sales in a professional manner by competitively obtaining the services of some of the leading U.S. investment bankers as financial advisors and underwriters to assist in managing the sales. Further, we found that the FmHA loan sale financing structures followed those established by private sector financial markets and used by financial institutions to conduct similar sales for major private sector entities. Overall, the FmHA pilot sales adhered to OMB's loan sale guidelines. In short, the private sector financial markets treated FmHA the same way they would handle any other private sector entity seeking to sell pools of loans.

The financing structures and marketing strategies used by financial advisors and underwriters handling the sales, along with FmHA's use of credit enhancements were designed to ensure maximum net sales proceeds. However, the government paid upfront transaction fees of about 3 percent of the amount realized.

Our review also showed that the legal rights of the FmHA borrowers were protected in the loan sale agreements and that the loan servicing rights of the community program borrowers were honored by the commercial loan servicer during the first year following the sale.

Background on Loan Asset Sales

The Farmers Home Administration (FmHA), an agency with the Department of Agriculture, is one of the nation's leading lenders of rural development and housing loans. FmHA makes direct loans to farmers and rural communities who are unable to obtain credit from commercial lenders at a reasonable rate through its Rural Housing Insurance Fund and Rural Development Insurance Fund.[1]

In fiscal year 1986, the Reagan administration proposed the pilot sale of federal loan assets as a part of an overall program to improve federal credit management. The chief objectives of these pilot sales were to improve federal loan origination and documentation, reduce the cost of federal credit programs by transferring loan servicing to the private sector, and increase budget receipts in the year of sale. A loan asset sale program was included in the Omnibus Budget and Reconciliation Act of 1986 which directed the Secretary of Agriculture to sell enough loans from the Rural Housing Insurance Fund and the Rural Development Insurance Fund to realize not less than $2.7 billion in net proceeds by the end of fiscal year 1987, $1.7 billion and $1 billion respectively, and which authorized the Secretary to transfer loan servicing responsibility to the loan purchaser. Prior to the sale, FmHA's unpaid principal balance due on loans outstanding from these two funds was $29.3 billion and $8.0 billion, respectively.

[1]The loans from these funds are more commonly referred to as rural housing loans and community program loans, respectively.

In September 1987, the Secretary of Agriculture sold to private investors rural housing and community program loans with an aggregate unpaid principal balance of $4.9 billion. FmHA transferred loan servicing for the community program loans to a private servicer in September 1987. However, because of its complex rural housing loan servicing procedures, FmHA agreed to continue to service these loans for a maximum period of 2 years following the sale. Servicing of these loans was transferred to the private sector loan servicer in August 1989.

Objectives, Scope, and Methodology

Our work focused on determining whether FmHA

- conducted the sales in a professional manner,
- received the maximum net proceeds practicable for the value of the loan assets sold, and
- protected the rights of the rural communities and homeowners during the sale of their loans and after servicing had been transferred to the private sector.

Our review was performed primarily at FmHA, which conducted the sales with the assistance of several private sector financial institutions. We also held discussions with the private sector financial advisors and sale underwriters that assisted FmHA.

To determine whether FmHA conducted the pilot sales in a professional manner, we compared FmHA financing/sale structures to those generally used by the secondary credit markets to sell pools of loans offered for sale by private sector entities. We focused on assuring ourselves that the FmHA loan sales were handled by FmHA's financial advisors and underwriters in the same manner in which they handled similar sales by the private sector.

To determine whether FmHA received the maximum net sale proceeds practicable, we analyzed the FmHA financing structures and marketing strategies used by its financial advisors and underwriters participating in the sale, and we analyzed the costs incurred by FmHA in conducting these sales. In addition, we reviewed the loan sale documentation files available at FmHA and the proposals received from the other financial institutions interested in helping FmHA conduct the sales, and we interviewed agency officials responsible for conducting the sales.

Finally, to determine whether the rights of FmHA borrowers were fully protected under these sales, we sent questionnaires to a random sample of 380 of the 3,897 community program borrowers whose loan(s) were sold in September 1987 and still were being serviced by the private servicer at the time of our review. Our sample provided for a 95 percent level of confidence, with a maximum sampling error of plus or minus 5 percent. Rural housing program borrowers were not included in our questionnaire universe because servicing of these loans had not transferred to the private servicer at the time the questionnaires were mailed. FmHA agreed to continue servicing these loans for 2 years after the date of sale. Appendix I contains a copy of the questionnaire and provides summary information on selected responses received.

Our audit was performed between August 1988 and November 1989, in accordance with generally accepted government auditing standards. As requested by your office, we did not obtain official agency comments on this report. We did, however, discuss the matters in this report with FmHA officials during the course of our review and have incorporated their views where appropriate.

FmHA Conducted Loan Sales in a Professional Manner

FmHA conducted the sale of its rural housing and community program loans in a professional manner. We defined "professional manner," as those sale structures and approaches used by the private sector financial institutions to sell similar securities for private sector entities. In addition, the fees charged FmHA by its sale underwriters were comparable to fees charged to other private entities conducting similar sales. FmHA competitively obtained the management services of private sector financial institutions to serve as financial advisors and loan sale underwriters for its loan sales. These financial institutions assisted FmHA in conducting the pilot sales in a manner similar to that used when they conduct securitized asset sales for major private sector entities. The FmHA sales were conducted using a structured sales approach and credit enhancements to secure an AAA rating for the financial interest sold. The AAA rating is the highest credit rating granted to private sector securities and, consequently, would help to ensure the marketability of the securities.

For both the rural housing and community program loan sales, FmHA competitively selected a sales management team drawn from major U.S.

financial institutions to assist in managing the loan sales.[2] These management teams were composed of a financial advisor and a group of seven to eight underwriters. They assisted FmHA in structuring the sale and provided professional advice and consultation to FmHA during the entire sales process.

FmHA competitively selected the investment firms of Kidder, Peabody and Company, and Manufacturers Hanover Trust Company to serve as financial advisors for its rural housing and community program loan sales, respectively. In addition, FmHA competitively selected a group of technically qualified underwriters to participate in each loan sale. Each underwriting group was headed by a lead underwriter.

Shearson Lehman Brothers, Inc. was selected as the lead underwriter for the community program loan sale and Salomon Brothers, Inc. for the rural housing sale. These underwriting groups negotiated the placement of the financial interests in the loan pools with private investors—a practice which is common for securitized asset sales with the financial magnitude of FmHA's loan asset sales.

The securitized loan sale structures recommended and used by FmHA's sale management teams were similar to those structures used in the securitized sale of corporate assets and by the Federal National Mortgage Association to conduct similar mortgage backed security sales. For example, FmHA's sales management team formed a special purpose private corporation to take title to the community program loans and to issue bonds to private investors as financial interests in the loan pools. Similarly, the FmHA loan sales management team for the rural housing loans formed a rural housing trust which issued mortgaged backed securities similar to those used by the Federal National Mortgage Association that represented equity interests in the loans held by the trust. Appendix III provides more detailed information on the loan sale financing structures used by FmHA and the types of trusts created.

In keeping with generally accepted financing practices within the existing secondary credit markets,[3] FmHA's rural housing and community program loan sales involved the pooling of loans and the sale of securities—financial interests in the pooled loans—to private investors. These

[2]Appendix II contains a detailed listing of the major financial institutions participating on these management teams.

[3]The secondary credit markets serve as a medium through which the financial community trade mortgage and nonmortgage loans and related securities.

sales include the features described below and are commonly termed structured sales, as opposed to the simple auction of individual loans like the sale of Treasury securities. Further, the FmHA sales were classified as structured sales because the sales structure generally included

- creating a new security, such as a bond or participation certificate, using the future principal and interest payments from the pooled loans as collateral;
- arranging for a third-party commercial organization to collect and account for loan principal and interest payments from borrowers—that is, servicing the pooled loans; and
- providing some form of credit enhancement for the new security—that is, compensating purchasers at the time of sale for estimated future loan losses.

The foregoing structured sales techniques, including credit enhancements, are those currently being used in the private sector financial market to provide private sector entities, state and local government agencies, as well as FmHA, with the means of selling pools of loans to maximize net sale proceeds.

The rural housing and community program loan sales used two forms of credit enhancements—overcollateralization and credit insurance. These credit enhancements were used to ensure that the bonds and mortgaged backed securities sold to private investors received a AAA credit rating—the highest credit rating given securities in the private sector markets.[4] The AAA credit rating was desired to help ensure that FmHA received the maximum net sale proceeds practicable from the sale.

By overcollateralization, we mean that FmHA transferred to the trusts a pool of loans whose aggregate unpaid principal balance was greater than the face value of the securities sold. The overcollateralization amount is determined by the rating agencies—Standard and Poors and Moody's Investors Service—and is based on the collateral quality which considers such things as the historic loan collection, delinquency, and loss rates.

Credit insurance obtained from an independent private insurance company guarantees all or a portion of the investor's income stream

[4]OMB's loan asset sale guidelines precluded loan sales with future recourse to the government; that is, sales with some type of government guarantee protecting the purchaser against future loan losses. OMB's guidelines did permit, however, purchasers to provide credit enhancements such as overcollateralization and credit insurance.

expected from the receipt of future principal and interest payments due on the securities sold. FmHA used credit insurance to complement the overcollateralization on the rural housing sale to form a total credit enhancement package that would ensure a AAA credit rating for the financial securities sold to private investors. This policy guarantees the holders of senior financial interests in the trust 100 percent of their scheduled principal and interest payments in the event the trust is unable to make these payments. Credit insurance was not used on the community program sale because the sale received a AAA rating based solely on the degree of overcollateralization provided by FmHA.

These forms of credit enhancements are common practice in the private sector financial markets. For example, these forms of credit enhancements are used by private sector entities for the securitized sale of pooled automobile loans. As a matter of fact, many private corporations guarantee the payment of principal and interest on some securitized sales.

Cost of FmHA Pilot Sales

The Cost of Conducting Credit Enhanced Sales Is Reflected in Net Sale Proceeds

Loan asset sales under the pilot program were conducted on a credit enhanced basis. OMB's loan sale guidelines prohibit any federal guarantee of principal and interest payments or repurchase agreement—future recourse—which the government has used in past sales. However, agencies were permitted to conduct loan sales on a credit enhanced[5] basis using the credit enhancements discussed in the previous section. These enhancements provide prospective investors limited protection against future losses. The net proceeds realized from the FmHA sales, an average of 58 percent of the unpaid principal balance of the loans sold, primarily reflect the up-front costs associated with credit enhanced sales. These costs include the interest rate discount amount[6] given investors who

[5]Credit enhanced sales, as defined for the purpose of this report, do not include those sales which provide a federal guarantee or repurchase agreement. The financial community does consider these types of recourse provisions to be credit enhancements.

[6]The interest rate discount amount is the reduction in sale proceeds that results when the coupon rate of the financial interests sold is lower than the interest rate of comparable securities at the time of sale.

purchased financial interests in the rural housing and community program trusts as well as the cost of credit enhancements required by the rating agencies to obtain the highest credit rating for the financial interests sold. These net proceeds also reflect about $91 million in sales transaction costs, or about 3 percent of net sale proceeds, paid by FmHA at the time of sale.

Net Proceeds

The FmHA net sale proceeds are equal to or above those realized by other federal agencies consummating loan sales under the pilot program on a credit enhanced basis. FmHA conducted its pilot sale in accordance with OMB's loan asset guidelines and employed generally accepted financing structures to maximize its sale proceeds from these pilot sales. Nothing came to our attention during the course of this review to indicate that FmHA could have restructured these sales to allow it to substantially increase the net sale proceeds realized from these sales.

FmHA realized over $2.8 billion in total net proceeds from the securitized sale of its rural housing and community program loans with an aggregate unpaid principal of over $4.9 billion. This amount exceeded the revenue target of $2.7 billion set in the Omnibus Budget Reconciliation Act of 1986 by $106 million. These net proceeds represent about 58 percent of the total aggregate unpaid principal balance of the loans sold. The remainder of the government's unpaid principal balance went essentially towards three types of costs incurred by FmHA in conducting these sales. These costs include interest rate discounts, credit enhancements, and sales transaction costs. Table 1 shows the net proceeds realized from both FmHA sales and the related expenses of the sale.

Table 1: Analysis of Proceeds From FmHA Loan Asset Sales

Dollars in millions

	Community program sale	Rural housing sale	Total
Unpaid principal balance of loans sold	$1,934.4	$2,969.0	**$4,903.4**
Face value of financial interests not sold	0	(594.0)[a]	**(594.0)**
Face value of financial interests sold	**1,934.4**	**2,375.0**	**4,309.4**
Interest rate discounts	(614.0)	(313.2)	**(927.2)**
Present value of financial interests sold	**1,320.4**	**2,061.8**	**3,382.2**
Cost of credit enhancements on financial interests sold	(186.3)	(282.6)[b]	**(468.9)**
Gross sale proceeds	**1,134.1**	**1,779.2**	**2,913.3**
Transaction costs	(56.9)	(34.5)	**(91.4)**
Net sale proceeds	**$1,077.2**	**$1,744.7**	**$2,821.9**

[a]FmHA holds subordinate securities in the rural housing trust for this amount.

[b]This includes $61.5 million for the cost of credit insurance used in the rural housing sale.

As shown in table 1, a significant factor in determining the government's net sale proceeds was the interest rate discounts which represents $927 million or 19 percent of the unpaid principal balance. These discounts were necessary to compensate investors for the difference in the interest rate on the securities offered by FmHA and the market interest rate available to investors at the time the loans were sold. For example, the FmHA community program trust securities were offered to investors at a coupon rate of 4.5 percent in a market environment where 30-year Treasury obligations were yielding 9 to 10 percent. As a result, these financial interests had to be discounted to compensate investors for this disparity in interest rates. The 4.5 percent rate was close to the level charged to borrowers under the FmHA program.

Another factor that impacted FmHA's net sale proceeds was the cost of credit enhancements—overcollateralization and credit insurance. The credit enhancements for both sales totalled $468.9 million. Overcollateralization on the community program sale resulted in a reduction of $186.3 million in sale proceeds, while the rural housing sale proceeds were reduced by $282.6 million due to overcollateralization and insurance costs. As mentioned above, these costs were necessary to obtain the highest quality rating for the financial interests sold, which helped to maximize net sale proceeds.

The amount of overcollateralization provided by FmHA was the amount required by the security rating agencies to compensate investors if actual loan losses exceed anticipated losses at the time the sale was consummated. If actual losses are less than anticipated, the government will receive back any unused overcollateralization and other remaining interest in the trust when the trust is terminated—that is, when all obligations of the trust have been paid. This amount is called the government's residual interest.[7] At the time of sale, the estimated value of FmHA's residual interest in these trusts was valued at over $234.6 million—$33.6 million in the community program trust and $201 million in the rural housing trust. The latter amount includes $180 million which represents the fair market value, at date of sale, of the $594 million in subordinate securities held by FmHA in the rural housing trust. The $234.6 million represents the estimated value of additional cash flows FmHA should receive from the two loan sales we reviewed.

The remainder of the government's unpaid principal balance, $91 million or 2 percent, represents the fee FmHA paid for conducting these credit enhanced sales. This amount represents costs that the government would not have incurred if it had held the loans to maturity. Table 2 provides a breakout of these various transaction costs.

Table 2: FmHA Sales Transaction Costs

Dollars in millions

	Community program sale	Rural housing sale	Total
Financial advisors fees	$1.0	$1.1	**$2.1**
Underwriting fees	15.3	17.9	**33.2**
Issuance costs	5.5	5.5	**11.0**
Reserve/special accounts[a]	35.1	10.0	**45.1**
Total	**$56.9**	**$34.5**	**$91.4**

[a]These accounts include reserve funds for such trust expenses as principal and interest payments, loan servicing fees, and estimated future income tax liabilities.

Yields From FmHA Sales Fall Within Range of Other Credit Enhanced Sales

The net sale proceeds realized from FmHA's sale of its rural housing and community program loans fall within the range of that obtained from other federal agencies conducting credit enhanced sales under the pilot program. As previously mentioned, FmHA's net sale proceeds to-date on

[7]Residual interest is the estimated equity value of all excess funds remaining in the trust after all trust obligations have been satisfied. This amount is comprised of such things as excess overcollateralization and servicing fees, and excess interest earned on reserve funds. These pilot sales were among the first government loan asset sales to use overcollateralization and commercial credit insurance as credit enhancement techniques. In the past, government sales have generally been consummated on a full recourse basis.

these pilot sales have averaged 58 percent of the government's unpaid principal balance. These amounts are similar to the results achieved by other federal agencies which consummated pilot sales during the same time frames and under similar market conditions. For example, the net sale proceeds realized by other federal agencies selling financial interests through a similar type financing structure, using overcollateralization and insurance as credit enhancements, ranged between 54 and 56 percent of the aggregate unpaid principal balances of the sold loans, as shown in the following table.

Table 3: Comparison of FmHA Sale Proceeds to Other Credit Enhanced Sales

Dollars in millions

Federal loan sales	Unpaid principal sold	Net sales proceeds	Percent realized
FmHA loan sales			
Community program	$1,927	$1,078	56
Rural housing	2,969	1,746	59
Department of Commerce	28	15	54
Department of Education	761	412	54
Department of Veterans Affairs	309	172	56
Total	**$5,994**	**$3,423**	

As these sales were among the first sales to be conducted under OMB's loan sale guidelines, no precedent existed for conducting these sales or for determining what would be a reasonable rate of net sale proceeds. While these net proceeds may not be comparable because of the differences in the quality of the loans and interest rate of the underlying loan pools, they do provide one measure of the success or failure of the FmHA sales. The above comparison shows that the yields on the FmHA sales were equal to or above those obtained through other pilot sales.

Rights of FmHA Borrowers Were Fully Protected During Sale

FmHA took steps to protect the legal rights of the rural housing and community program borrowers whose loans were sold in the 1987 pilot sales in the sale agreements. Specifically, the agreements between FmHA and the trusts included provisions to continue all the significant rights available to these borrowers under FmHA regulations. Further, our study of a sample of FmHA community program[8] borrowers confirmed that the original legal provisions of these loans had not changed and that they had

[8]Rural Housing program borrowers were not included in our sample because FmHA was servicing these loans at the time of our review.

not been adversely affected by the sale. Several borrowers did, however, voice concern over certain additional accounting and financial reporting requirements which were placed upon them by the new loan servicer and which FmHA had not previously exercised.

As FmHA proceeded with the sale of its community program and rural housing loans, one of its primary objectives was to fully protect borrowers' rights. Registration statements filed with the Securities and Exchange Commission and the legal documents associated with these sales all stipulate that the notes and bonds would not be altered, thus protecting all the borrowers' legal rights.

Specifically, these documents provide for the protection of such rights as the following:

- Loan reamortization—that is, the extension of a loan's repayment period to the maximum.
- Loan assumption—that is, the transfer of loan repayment responsibility from one borrower to another.
- Payment moratorium—that is, the deferral of principal and interest payments for a qualified borrower in whole or in part for a period of 2 years.
- Interest credit—that is, the subsidy of the interest payments for qualified borrowers.

A sample of 380 community program borrowers, whose loans are now being serviced by the General Electric Capital Corporation, confirmed that these borrowers' legal and loan servicing rights had been protected during the first year following the sale. For instance, when asked what impact the new private servicer has had on loan servicing, 82 percent of the 311 respondents stated that no change had been made with regard to the original provisions of their loans. Further, we found that only five borrowers, or 2 percent of the respondents, had requested any type of special servicing from the new servicer involving rights previously available under FmHA servicing procedures. These borrowers sought the private servicer's approval to sell or lease assets used to secure the loan. Approval was granted in three of the five cases. Further, the majority of the community program borrowers, about 80 percent, rated the overall performance of the new servicer as being adequate or better.

However, over 16 percent of the respondents did express concern over the additional accounting and reporting requirements placed upon them by the new loan servicer, but these complaints primarily involved reporting requirements which FmHA was not enforcing. For example, these borrowers complained about requests for increases in insurance coverage and for annual audited financial statements. According to FmHA officials, the private servicer is within its legal rights to request this information. Specifically, to protect the government's interest, FmHA regulations require borrowers to show proof of insurance each year and also authorized FmHA to require borrowers to provide annual financial audits. FmHA officials stated that FmHA has been lax in enforcing these regulations in the past and that corrective actions were under way to ensure that these regulations would be enforced in the future.

Proceeds From Credit Enhanced Sales Are Not Comparable to Recourse Sales

The concept of selling federal loan assets to private investors is not new. Historically, FmHA has sold securities—participation certificates—to the public which were backed by a specific pool of loans. The net proceeds reported from these recourse sales have averaged over 99 percent of the aggregate unpaid principal balance in the loans sold. The FmHA loan asset sales discussed in this report, however, were not conducted on the same basis as prior sales of federal loan assets and the difference in sale basis resulted in the FmHA sales yielding an average of 58 percent. Consequently, the reported net sale results from these sales are not comparable because the recourse net sale proceeds do not reflect the interest rate discount, recourse costs, and sale costs actually incurred by the government in conducting these sales. These costs are paid separately by the government over the life of the trust and are not reflected in net sale proceeds. In the two pilot sales discussed in this report, FmHA incurred interest rate discounts, credit enhancements (which are analogous to recourse costs), and sale costs. These costs were paid in total at the date of sale and were explicitly disclosed as a deduction from sale proceeds. Consequently, the 99 and 58 percent net sale proceed percentages should not be compared because they are computed on different bases.

The interest rate discount paid by FmHA to compensate investors for the difference between the coupon rate of the financial interests sold and the market interest rate was not reflected in the recourse sales because in those sales, FmHA subsidized the coupon rate offered on the securities. FmHA paid the holders of these recourse securities the difference between the interest due on the securities sold and the interest collected from the pooled loans because the interest rate of the underlying collateral loans was less than the coupon rate promised on the financial interests sold. As a result, the securities in these recourse sales were not significantly discounted at the time of sale because FmHA subsidized the coupon rate of these securities, offering them at an interest rate comparable to the market interest rate of similar securities. FmHA paid this difference—the interest credit subsidy—over the life of the securities sold from its appropriated funds and did not deduct it from the net sale proceeds reported at the time of sale.

These net proceeds also do not reflect losses experienced by FmHA as a result of loan defaults, delinquencies, and/or prepayments to the pooled loans. This cost is paid up front in a credit enhanced sale and is limited to the amount of overcollateralization and credit insurance paid at the time of sale. In past recourse sales, losses due to loan defaults, delinquencies, and prepayments were borne solely by FmHA over the life of the financial interests sold and were not shared with private investors. Lastly, the proceeds from recourse sales do not reflect all the transaction costs which occur in credit enhanced sales. Specifically, FmHA incurred no financial advisor fees or trust operating expenses in these recourse sales. In addition, the underwriting commissions for the recourse sales were passed on to the investor and not paid by the federal government.

Sale of FmHA Loans Will Not Reduce Federal Deficit

A misunderstanding regarding loan sales is the view held by the current and past administrations that loan sales are a means of reducing the budget deficit. As we have stated in previous reports and testimonies,[9] and as our current analysis indicates, loan sales will not reduce the structural budget deficit. Such sales simply shift the present value of loan principal and interest payments, which the federal government expected to receive in future years, to the year of sale. Consequently, budget cash receipts are increased in the year of sale—thereby reducing the budget deficit for that year. However, in the future years that span the payback periods of the sold loans, budgetary cash receipts are similarly reduced.

For the two FmHA loan sales we reviewed, financial interests with a face value of $4.3 billion were sold to investors. These securities, which were backed by FmHA loans, had an estimated present value of $3.4 billion because, at the time the securities were sold, market interest rates were higher than the interest rates carried by the loans. The market value of these securities was further adjusted downward by $.5 billion to pay for

[9] An Assessment of the Government's Loan Asset Sale Program (GAO/T-AFMD-87-7, March 26, 1987) and Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, February 19, 1988).

credit enhancements—overcollateralization and credit insurance—required to protect investors against future loan losses. The resulting $2.9 billion represents, on a present value basis, the net loan principal and interest payments FmHA would have expected to receive if it had held the loans to term rather than sold them. Thus, FmHA gave up receiving $2.9 billion.

In conducting the loan sales, FmHA was charged about $.1 billion in sale costs which were deducted to yield net sale proceeds of $2.8 billion to FmHA in the year of sale. Consequently, government budgetary receipts were increased in the year of sale by $2.8 billion and the government could avoid $2.8 billion in borrowing to meet its cash needs. In the budgetary years following the sale, the government will have to borrow $2.9 billion (in present value terms), in addition to other borrowing to meet cash needs, because it gave up the right to receive these funds. Consequently, over the long term, the structural budget deficit is not reduced because of loan asset sales.

Observations

The FmHA loan sales were conducted in a professional manner in an effort to maximize the sale proceeds to the government. The government incurred about $91 million in sales transaction costs that it would not otherwise have incurred had it held the loans to maturity. The reduction in net sale proceeds caused by the interest rate discounts given investors and the costs of credit enhancements represent unavoidable costs FmHA incurred in conducting these credit enhanced sales. The rights of the borrowers whose loans were sold were fully protected during the loan sale transactions.

The sale of federal loans is not a sound approach to reducing this country's structural deficit. Such sales simply accelerate the government's rights to receive future revenues to the year of sale. The transaction costs associated with these sales are the price the government pays for accelerating these cash receipts. If the net proceeds from these sales equal the government's present value in the loans less anticipated loan defaults and delinquencies, the government incurs neither a gain nor loss. If the net sale proceeds are less than the government's present value, then the government incurs a loss, as in the FmHA sales. Further, since these sales do not create additional future cash receipts above those which the government would have received if it had held the loans, the projected future annual deficit will increase because revenues anticipated from loan payments will decrease in later years.

As agreed with your office, we did not obtain agency comments. Unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of this report. At that time we will send copies of the report to the, Director of the Office of Management and Budget, the Secretary of Agriculture, and other interested parties. We will also make copies available to others upon request.

Please contact me at (202) 275-9454 if you or your staff have any questions regarding the contents of this report. Major contributors to this report are listed in appendix IV.

Sincerely yours,

Jeffrey C. Steinhoff
Director, Financial Management
Systems and Audit Oversight

Contents

Abbreviations

FmHA	Farmers Home Administration
OMB	Office of Management and Budget

Survey to Evaluate Servicing of Community Program Loans

United States General Accounting Office

Survey to Evaluate Servicing of Community Program Loans

INSTRUCTIONS

The United States General Accounting Office (GAO) is an independent congressional agency which assists the Congress in overseeing the operation of the federal government. Recently, the Congress asked us to review the Department of Agriculture's sale of community program loans to private investors. The purpose of this survey is to determine how well these private companies are servicing community program loans like yours.

In September 1987, the Secretary of Agriculture sold about 6,000 community program loans to private investors. As a result, the responsibility for servicing these loans transferred from the Farmers Home Administration (FmHA) to the General Electric Capital Corporation (GECC), formerly the General Electric Credit Corporation.

Through this survey, we are asking for information on your organization's servicing experiences with GECC. By servicing we mean billing, collections, and handling of any other loan-related activities. We want to know the effect, if any, the change from a government agency to a private company has had on your organization.

We would have liked to talk to all those affected by this sale, but that would have been too time-consuming and costly. Therefore, we took a random sample of about 380 borrowers to represent a cross section of all the community program borrowers. Since our sample is small, it is important that every borrower selected answers our survey questions.

This survey should take no longer than 30 minutes to complete. It should be completed by the staff member in your organization who is most knowledgeable about GECC's servicing of your account.

The respondent to this survey should provide answers to each applicable question and, if necessary, seek the help of co-workers or associates in answering these questions. If GECC is servicing more than one of your organization's loans, base your organization's answers on all loans to which the question applies. For overall satisfaction questions, base your organization's answer on its combined experience with all loans.

What your organization has to say as a community program borrower is important to this study. Your name or organization will not be identified in our report; all responses will be kept confidential. Remember, we cannot make an accurate evaluation of this area without your assistance and participation.

Please return your completed questionnaire in the self-addressed envelope within 15 days. The return address is:

U.S. General Accounting Office
Mr. Ernst Stockel, AFMD
Room 6007
441 G Street, NW
Washington, DC 20548

If you have any questions, please contact **Ronald Parker at (202) 634-5217 or Ernst Stockel at (202) 695-7111.**

RESPONDENT INFORMATION (Please Print)
(Primary person completing the survey)

Name: ______________________________

Title: ______________________________

Months in position: _____ Phone #: ____________

Please correct any errors in the following information:

1. Has the General Electric Capital Corporation (GECC) serviced your organization's account since October 1987 (i.e., billing, collection, and other loan-related activities)? *(Check one)*

   (13)

   1. ☐ Yes (CONTINUE) 311
   2. ☐ No (**STOP - Return questionnaire in self-addressed envelope**) 9

2. When were you first notified that the Farmers Home Administration (FmHA) would no longer be servicing your organization's account? *(Fill in the blank)*

   ____
   (Month / Year) (14-19)

3. Who notified your organization of this change? *(Check all that apply)*

   (20-23)

   1. ☐ FmHA 262
   2. ☐ GECC 95
   3. ☐ Other, specify:________________ 6

      ____
   4. ☐ No basis to judge 13

      No Answer 4

4. Was your organization given enough notice before you had to make your first scheduled payment to GECC? *(Check one)*

   (24)

   1. ☐ Yes 282
   2. ☐ No (EXPLAIN BELOW) 18
   3. ☐ No basis to judge 10

      No answer 1

      If no, explain :________________

      ____

      ____

      ____

      ____

5. Since the initial transfer of your account, has GECC made any of the following changes in the provisions of any of your loans? *(Check all that apply)*

   (25-31)

   1. ☐ Increased payment amount 4
   2. ☐ Changed final payment due date 0
   3. ☐ Decreased days allowed before late fee is charged 0
   4. ☐ Increased late payment fee 1
   5. ☐ Other, specify:________________ 25

      ____
   6. ☐ No provisions for any loan have changed 255
   7. ☐ No basis to judge 10

      No answer 16

      If any of the above items (#1 through #5) have been checked, please explain:

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

      ____

6. Has GECC added any unusual expenses to your organization's account without prior notice (excluding late payment fees)? *(Check one)*

(32)

1. ☐ Yes (EXPLAIN BELOW) 23
2. ☐ No 280
3. ☐ No basis to judge 8

If yes, explain:

7. Since the transfer of your account, has your organization asked GECC to perform any of the following services? *(Check all that apply)*

(33-39)

1. ☐ Reamortize any loan (rearrange any of the original terms) 0
2. ☐ Approve the sale or exchange of all or a part of the assets securing any loan 4
3. ☐ Approve the lease of all or a part of the property securing any loan 1
4. ☐ Subordinate its lien securing any loan (place payment of another debt ahead of GECC in event of default) 0
5. ☐ Approve the transfer of responsibility for any loan to a third party 0
6. ☐ None of the above services have been requested (GO TO QUESTION 13) 294
7. ☐ No basis to judge (GO TO QUESTION 13) 6

No answer 6

8. For how many of your organization's loans did you ask for the following services? *(Please specify the number of loans for each service requested in Question 7)*

(40-49)

Service requested from GECC	Number of Loans	
1. Reamortize any loan (rearrange any of the original terms)		
2. Approve the sale or exchange of all or a part of the assets securing any loan		4
3. Approve the lease of all or a part of the property securing any loan		1
4. Subordinate its lien securing any loan (place payment of another debt ahead of GECC in event of default)		
5. Approve the transfer of responsibility for any loan to a third party		

Not applicable 306

9. Did GECC approve **all** of the services you asked for in Question 7? *(Check one)*

(50)

1. ☐ Yes (GO TO QUESTION 13) 3
2. ☐ No 2
3. ☐ No basis to judge (GO TO QUESTION 13)

Not applicable 306

10. For how many of your organization's **loans did** GECC deny the service you asked for? *(Please specify the number of loans for each service denied by GECC)* (51-60)

Service denied by GECC	Number of Loans
1. Reamortize any loan (rearrange any of the original terms)	
2. Approve the sale or exchange of all or a part of the assets securing any loan	1
3. Approve the lease of all or a part of the property securing any loan	
4. Subordinate its lien securing any loan (place payment of another debt ahead of GECC in event of default)	
5. Approve the transfer of responsibility for any loan to a third party	

Not applicable 309
No answer 1

11. Did GECC adequately explain **all the denials** specified in Question 10? *(Check one)* (61)

1. ☐ Yes (GO TO QUESTION 13)
2. ☐ No
3. ☐ No basis to judge (GO TO QUESTION 13)

Not applicable 310
No answer 1

12. For each denied request for services, please indicate: (1) the service denied, (2) GECC's reason for denial, (3) why you believe the reason was inadequate, and (4) what effect, if any, the denial had on your organization. 2(13-32)

Service denied (1)	Reason for denial (2)	Why reason inadequate (3)	Effect, if any (4)

13. Has your organization asked GECC to perform any other services not mentioned in this questionnaire? *(Check one)*

(33)

1. ☐ Yes (EXPLAIN BELOW) 25
2. ☐ No (GO TO QUESTION 15) 284
3. ☐ No basis to judge (GO TO QUESTION 15) 0

No answer 2

If yes, approximately how many requests have you made?

____

If yes, explain the nature of your requests:

____
____
____
____
____
____
____
____

14. Overall, how satisfied were you with GECC's handling of the other services mentioned in Question 13? *(Check one)*

(34)

1. ☐ Satisfied all of the time 4
2. ☐ Satisfied most of the time 9
3. ☐ Satisfied half of the time 2
4. ☐ Dissatisfied most of the time 3
5. ☐ Dissatisfied all of the time 7
6. ☐ No basis to judge 2

Not applicable 284

15. Overall, how would you rate GECC's servicing of your account? *(Check one)*

(35)

1. ☐ Very adequate 97
2. ☐ Generally adequate 132
3. ☐ Marginally adequate 33
4. ☐ Generally inadequate 16
5. ☐ Very inadequate 10
6. ☐ No basis to judge 13

No answer 10

16. **Overall, how would you rate the quality of service you are receiving from GECC as compared to that provided by FmHA?** *(Check one)* (36)

1. ☐	GECC substantially better than FmHA	6
2. ☐	GECC moderately better than FmHA	12
3. ☐	GECC about the same as FmHA	176
4. ☐	GECC moderately worse than FmHA	54
5. ☐	GECC substantially worse than FmHA	25
6. ☐	No basis to judge	29
	No answer	9

Please explain your response:

17. If you have any additional comments, please express your views below and on the blank cover pages, if necessary. **Thank you for your assistance.** (37)

(Mar. 1989, AFMD, JFL)

List of Major Participants in the Rural Housing and Community Program Loan Sales

Rural Housing Program

Financial Advisor	Kidder, Peabody, & Co.
Lead Underwriter	Salomon Brothers, Inc.
Co-Lead Underwriters	E. F. Hutton & Co., Inc. Shearson Lehman Brothers, Inc. Goldman, Sachs & Co.
Co-Managing Underwriters	The First Boston Corp. Merrill Lynch Capital Markets Bear, Stearns & Co., Inc. Manufacturers Hanover Ltd.
Master Servicer	Manufacturers Hanover Agent Bank Services Corp.

Community Program

Financial Advisor	Manufacturers Hanover Trust Co.
Lead Underwriter	Shearson Lehman Brothers, Inc.
Co-Lead Underwriters	Salomon Brothers, Inc. Morgan Stanley, & Co.
Co-Managing Underwriters	Goldman, Sachs & Co. Kidder, Peabody, & Co. Bear, Stearns & Co., Inc. Merrill Lynch Capital Markets
Master Servicer	General Electric Capital Corp.

Selected Information on the Rural Housing and Community Program Financing Structures

Rural Housing Program

Name of Issuing Entity	Rural Housing Trust 1987-1
Type of Trust	Real Estate Mortgage Investment Conduit (REMIC)[1]
Type of Security Issued	Pass-through certificate[2]
Par Value of Securities Sold	$2.375 billion
Classes of Securities Issued	Class A (Senior)—80 percent Class B (Subordinate)—20 percent
Credit Rating of Securities	Class A—AAA Class B—Not rated
Credit Enhancements Used	Overcollateralization—80/20 ratio[3] Credit Insurance—$61.5 million—cost of insurance policy with American Loan Guarantee Association

[1] A REMIC is a special purpose non-taxable entity authorized by the Tax Reform Act of 1986 which holds a fixed pool of real estate mortgages and which issues securities to its investors representing their financial interest in the pool of mortgages.

[2] A pass-through certificate is a debt instrument which is secured by a pool of loans. The issuer of these securities passes principal and interest payments made on the loan pool to investors on a regular basis. These certificates, also known as participation certificates, are often issued by quasi-governmental agencies such as the Federal National Mortgage Association.

[3] Ratio of senior/subordinate securities.

Community Program

Name of Issuing Entity	Community Program Loan Trust 1987 A
Type of Trust	Business Trust[4]
Type of Security Issued	CMO type bond[5]
Par Value of Securities Sold	$1.934 billion
Classes of Securities Issued	Class A (Senior)—93 percent Class B (Subordinate)—7 percent
Credit Rating of Securities	Class A—AAA Class B—A minus
Credit Enhancements Used	Overcollateralization—93/7 ratio[6] Credit insurance not used

[4]A business trust is a trust which is taxable as a corporation and wherein legal title to its business assets are vested with the trustees who hold and manage them for the benefit of trust beneficiaries.

[5]A collateralized mortgage obligation(CMO) is a type of mortgage-backed corporate bond which has a multiclass(multitranche) priority structure. In such issues, each class of bonds is ranked in order by which it can be redeemed.

[6]Ratio of senior/subordinate securities.

Major Contributors to This Report

Accounting and Financial Management Division, Washington D.C.

Ernst F. Stockel, Assistant Director, Financial Management Systems and Audit Oversight, (202) 697-0816
Ronald E. Parker, Accountant-in-Charge
Denise Ho, Accountant
Christina L. Quattrociocchi, Accountant
James F. Loschiavo, Evaluator

Office of the General Counsel

Gary L. Kepplinger, Associate General Counsel
Alan N. Belkin, Senior Attorney

Related GAO Products

Borrower Loan Prepayments: OMB Guidelines Need to be Strengthened (GAO/AFMD-89-19, January 11, 1989).

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

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

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

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

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

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

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

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100