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United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

B-284547

February 10, 2000

The Honorable John R. Kasich
Chairman, Committee on the Budget
House of Representatives

Subject: Rural Utilities Service: Loan Origination Policies and Procedures
for Generation and Transmission Loans

Dear Mr. Chairman:

This letter summarizes the information provided during today's briefing to your office. You asked us to provide information on the Rural Utilities Service's (RUS) loan origination policies and procedures for making generation and transmission (G&T) loans. Specifically, you asked us to determine (1) what RUS' loan origination policies and procedures are for making G&T loans and whether these policies and procedures are effectively designed to mitigate future loan losses to the government and (2) whether these loan origination policies and procedures for G&T loans have been changed since fiscal year 1994 to prevent problems with the existing loan portfolio from occurring in the future. The enclosed briefing slides highlight the results of our work and the information we provided during the briefing.

RUS provides direct loans or loan guarantees primarily to rural electric cooperatives that market power on a wholesale and retail basis. Most RUS borrowers are either G&Ts or distribution cooperatives.

In the 1970s and 1980s, RUS provided financing for several G&Ts that had invested in the construction of large nuclear-generating and coal-fired generating power plants. Several of these plants were completed late and over budget. In addition, expected increase in demand for electric power did not materialize. As a result, several of these G&Ts became financially troubled and could not meet their debt-servicing requirements. In turn, the federal government incurred several billion dollars in loan losses.

In recent years, RUS has not made large-scale loans. Rather, RUS-approved loans have been for relatively small projects such as low risk transmission projects and improvements or replacements at existing generating facilities. These loans were made to existing borrowers who generally were financially healthy.

RESULTS IN BRIEF

RUS' loan origination policies and procedures for G&T loans are in RUS regulation 7 CFR 1710 *General and Pre-Loan Policies and Procedures Common to Insured and Guaranteed Electric Loans*. This regulation requires RUS to obtain, among other things, basic information for loan approval such as the borrower's ability to secure and repay the loan, borrower's financial ratios and projections, service area information, construction work plans,¹ and a statement on pending litigation. RUS summarizes its assessment of the borrower's loan application and recommends the loan for approval to RUS' loan committee(s).² Once recommended by the loan committee(s), the loan request is forwarded to the Assistant Administrator, Division Director, or Administrator for approval.³ Once approved, the approving official certifies that the security for the loan is adequate.

While RUS' loan origination policies outlined in 7 CFR 1710 are reasonably designed to mitigate future loan losses to the government and are generally consistent with banking industry standards, RUS lacks implementing procedures in certain key areas to carry out its policies for determining whether to make G&T loans. Specifically, RUS does not have implementing procedures on how to assess and approve the borrower's construction work plans and financial forecasts⁴ which must be prepared by the borrower to support the loan application. Guidance on how to document the loan assessment and recommendation that a loan be approved is also lacking. RUS stated that while it has not established written loan origination procedures for G&Ts in these areas, staff involved in the loan origination process are provided internal training on how to assess and evaluate loan applications. In addition, RUS stated that its staff are instructed to refer to RUS' loan origination guidance for distribution borrower loans where applicable. However, the internal training does not consist of a written curriculum, but rather, senior level staff provide on-the-job training to new staff responsible for various loan origination functions. Because RUS lacks implementing procedures to carry out its G&T loan origination policies in certain key areas, misinterpretation and/or inconsistent implementation of the loan origination policies could occur.

RUS' loan origination policies and procedures did not change significantly from fiscal year 1994 through 1999. However, RUS stated that since fiscal year 1994, it has made one change to its loan origination policies and procedures to mitigate future loan losses to the

¹The construction work plan (CWP) documents the borrower's short-term needs for plant additions, improvements, replacements, and retirements. The CWP includes investment cost estimates and supporting engineering and cost studies to demonstrate the need for each proposed facility.

²RUS has two loan committees. Loan applications are always reviewed by the first committee. Loan applications may go to the second loan committee depending on the amount of the loan and/or other risk factors.

³The Administrator must approve a G&T loan that is reviewed by the second loan committee. All other loans may be approved by the Assistant Administrator or Division Director.

⁴The financial forecast demonstrates the effects additional generation and transmission facilities will have on the borrower's sales, costs, revenues, and on the cost of power to the member distribution systems.

government.⁵ During fiscal year 1997, RUS began using trust indentures instead of mortgages to secure certain G&T loans. Under the trust indenture, an independent third party is appointed as trustee to provide oversight and monitoring of the borrower's financial transactions that could affect the security of RUS financed assets, such as securing additional debt and/or selling or disposing of assets. RUS said that the trust indenture, which is used primarily for financially and managerially strong borrowers, reduces the amount of RUS required oversight for these borrowers. As a result, RUS stated that it can devote more of its scarce resources to monitoring weaker borrowers. While RUS expressed the belief that this step mitigates future loan losses to the government, we do not consider the use of a trust indenture to be a significant change because both the trust indenture and a mortgage collateralize the underlying assets for RUS G&T loans. Also, the trust indenture features, such as requiring the borrower to (1) maintain an investment grade rating and (2) be managerially strong, can be incorporated in a mortgage. The only significant difference between a trust indenture and a mortgage is that the primary oversight and monitoring of the borrower's financial transactions are performed by an independent third party instead of RUS.

RECOMMENDATION

In order to ensure consistent implementation of G&T loan origination policies, we recommend that the Secretary of Agriculture direct the Acting Administrator of the Rural Utilities Service to develop and document written procedures for

- the assessment and approval of a borrower's construction work plans and financial forecasts, which must be prepared by the borrower to support the loan application, and
- the overall assessment and recommendation for loan approval.

AGENCY COMMENTS

We obtained oral comments on a draft of our briefing slides from RUS officials. They agreed with our recommendation. Their comments have been incorporated where appropriate.

SCOPE AND METHODOLOGY

In order to identify RUS' loan origination policies and procedures and determine whether they are effectively designed to mitigate future loan losses, we reviewed RUS regulation

⁵RUS stated that during the 1980s, it made numerous changes to its loan origination policies and procedures. For example, RUS stated that during that time, it established two loan committees whereby direct loans and loan guarantees are reviewed by at least one loan committee, depending on the size of the loan and/or other risk characteristics. However, RUS stated that it has only been codifying changes to its loan origination policies and procedures since fiscal year 1987. RUS stated that it does not have a complete set of changes made to its loan origination policies and procedures prior to codification.

7 CFR 1710 applicable for fiscal years 1994 through 1999.⁶ We also compared RUS' loan origination policies and procedures to the Federal Reserve's *Commercial Bank Examination Manual*, which discusses policies and procedures for a commercial bank's application and loan approval process and to the American Institute of Certified Public Accountant's (AICPA) industry audit guide entitled *Audits of Banks*, which discusses written guidance on credit file documentation. In addition, we selected one loan from each of the 6 fiscal years in order to confirm our understanding of the policies and procedures that were in place for fiscal years 1994 through 1999.

In order to determine whether RUS' loan origination policies and procedures had changed since fiscal year 1994 to prevent problems with the existing loan portfolio from occurring in the future, we interviewed RUS officials and reviewed RUS' regulation. We did not verify the accuracy of the underlying data RUS used to assess the loan applications, nor did we reperform any of RUS' procedures to approve these loans.

We conducted our work from December 1999 through early February 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this letter to the Honorable John M. Spratt, Jr., the Ranking Minority Member of your Committee; the Honorable Daniel Glickman, the Secretary of Agriculture; Christopher A. McLean, the Acting Administrator of the Rural Utilities Service; the Honorable Jacob J. Lew, the Director of the Office of Management and Budget; and other interested parties. Copies will also be made available to others upon request.

If you have any questions about this letter or the briefing, please contact me at (202) 512-9508 or McCoy Williams, Assistant Director, at (202) 512-6906. Key contributors to this assignment were Art Brouk and Carla Lewis.

Sincerely yours, .



Linda M. Calbom
Director, Resources, Community,
and Economic Development, Accounting
and Financial Management Issues

Enclosure

(913885)

⁶Our previous report *Rural Utilities Service: Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively* (GAO/RCED-98-42, January 21, 1998), assessed other types of opportunities for making RUS' electricity loan program more effective and less costly.

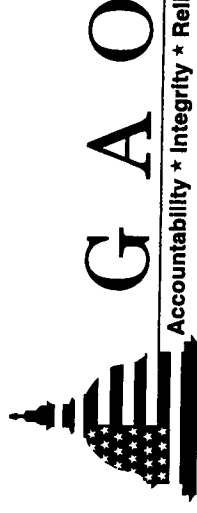
GAO

Accounting and Information
Management Division

**Rural Utilities Service: Loan
Origination Policies and Procedures
for Generation and Transmission
Loans**

Briefing to the House Committee on the
Budget

February 10, 2000



GAO Objectives

- The Committee asked us to provide information on Rural Utilities Service's (RUS) loan origination policies and procedures for making generation and transmission (G&T) loans. Specifically, it asked us to determine
 - What RUS' loan origination policies and procedures are for making G&T loans and whether these policies and procedures are effectively designed to mitigate future loan losses to the government?

GAO Objectives

- Have these loan origination policies and procedures for G&T loans been changed since fiscal year 1994 to prevent problems with the existing loan portfolio from occurring in the future?

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GAO Scope and Methodology

- In order to identify RUS' loan origination policies and procedures and determine whether they are effectively designed to mitigate future loan losses, we
 - reviewed RUS regulation 7 CFR 1710 *General and Pre-Loan Policies and Procedures Common to Insured and Guaranteed Electric Loans* applicable for fiscal years 1994 through 1999,¹

¹Our previous report *Rural Utilities Service: Opportunities to Operate Electricity and Telecommunications Loan Programs More Effectively* (GAO/RCED-98-42, January 21, 1998), assessed other types of opportunities for making RUS' electricity program more effective and less costly.

GAO Scope and Methodology

- compared RUS' loan origination policies and procedures to the Federal Reserve's *Commercial Bank Examination Manual*², and to the AICPA's industry audit guide entitled *Audits of Banks*³, and

²The *Commercial Bank Examination Manual* discusses policies and procedures for a commercial bank's application and loan approval process.

³The American Institute of Certified Public Accountants' (AICPA) *Audits of Banks* industry guide discusses written guidance on credit file documentation.

GAO Scope and Methodology

- selected one loan from each of the 6 fiscal years reviewed in order to confirm our understanding of the policies and procedures that were in place for fiscal years 1994 through 1999.
- In order to determine whether RUS' loan origination policies and procedures had changed since fiscal year 1994, we

GAO Scope and Methodology

- interviewed RUS officials and reviewed RUS' regulation to determine if changes have been made to prevent problems with the existing loan portfolio from occurring in the future.
- We did not verify the accuracy of the underlying data RUS used to assess loan applications, nor did we reperform any of RUS' procedures to approve these loans.

GAO Scope and Methodology

- We obtained and incorporated agency comments as appropriate.
- We conducted our work in accordance with generally accepted government auditing standards from December 1999 through early February 2000.

GAO Background

- RUS provides direct loans or loan guarantees primarily to rural electric cooperatives that market power on a wholesale and retail basis.
- Most RUS borrowers are either G&Ts or distribution cooperatives.

Background

- In the 1970s and 1980s, RUS provided financing for several G&Ts that had invested in the construction of large nuclear-generating and coal-fired generating power plants.
- Several of these plants were completed late and over budget. In addition, expected increase in demand for electric power did not materialize.

GAO Background

- As a result, several of these G&Ts became financially troubled and could not meet their debt-servicing requirements.
- In turn, the federal government incurred several billion dollars in loan losses.

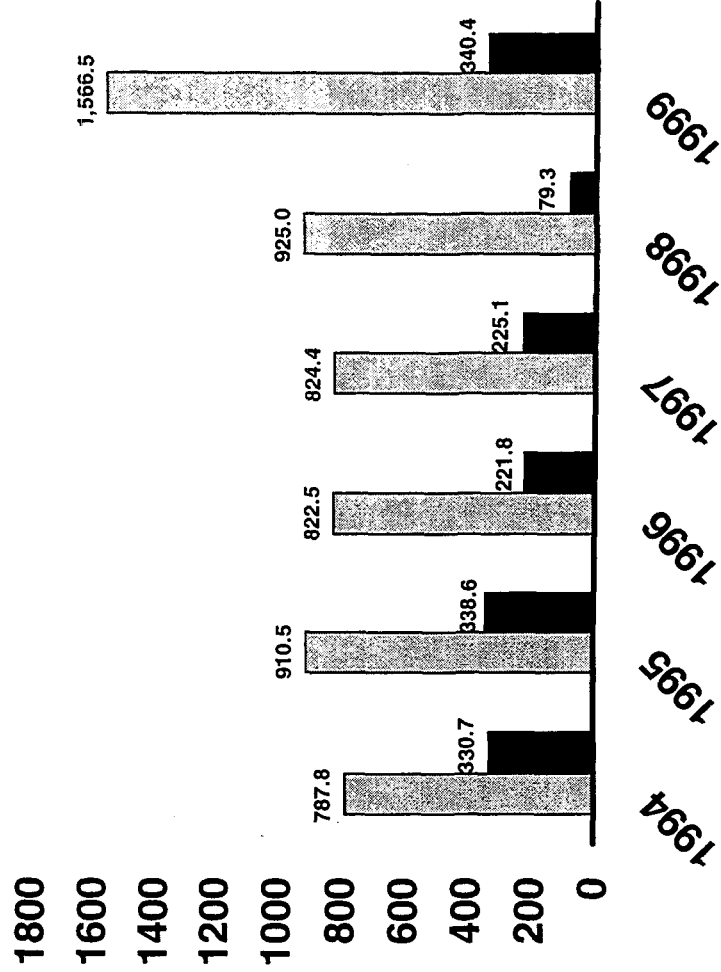
Background

- In recent years, RUS has not made large-scale loans. Rather, RUS-approved loans have been for relatively small projects (e.g., low risk transmission projects and improvements or replacements at existing generating facilities).
- These RUS loans were made to existing borrowers who generally were financially healthy.

- For fiscal years 1994 through 1999, the dollar value of RUS loans approved for G&Ts represented, on average, about 26 percent of the total dollar value of RUS electric loans approved. The remaining 74 percent were approved for distribution cooperatives.

GAO Background

Figure 1: Comparison of the dollar value of G&T loans approved to the dollar value of total electric loans approved (in millions)



□ Total dollar value of electric loans approved
■ Total dollar value of G&T loans

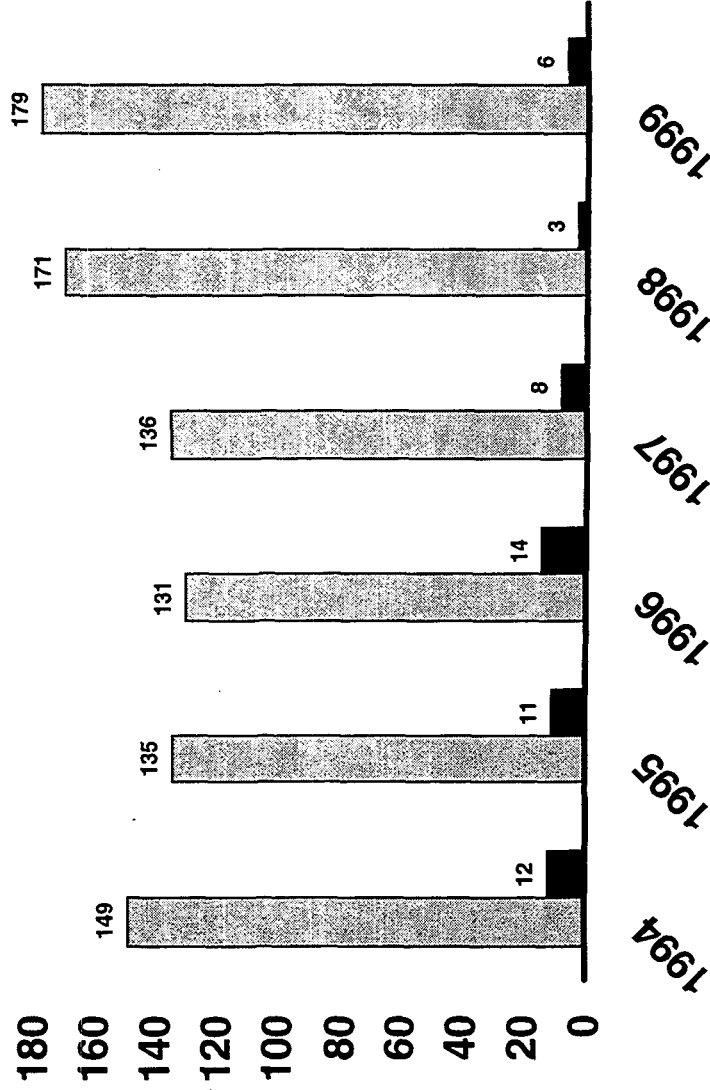
Source: RUS.

GAO Background

- For fiscal years 1994 through 1999 the number of RUS loans approved for G&Ts represented, on average, about 6 percent of the total number of electric loans approved.

GAO Background

Figure 2: Comparison of G&T loans approved to total electric loans approved
(in numbers)



□ Total electric loans approved
■ Total G&T loans

Source: RUS.

GAO RUS' Loan Origination Policies and Procedures

- RUS' loan origination policies and procedures for G&T loans are in RUS regulation 7 CFR 1710.
- This regulation requires basic information for loan approval in the following six areas.
 - Area coverage - determining the electric service area and whether the service will be made available to the widest practical number of rural users.

GAO RUS' Loan Origination Policies and Procedures

- Feasibility - determining the borrower's ability to repay the loan. RUS assesses, among other things, the borrower's long-range financial forecast, times interest earned ratio (TIER)⁴ and debt service coverage (DSC)⁵ ratio, power requirement projections, and capitalization projections.

⁴TIER - a ratio used to measure the borrower's ability to repay its long-term debt.

⁵DSC - a ratio used to measure the borrower's ability to generate sufficient funds to cover the annual debt service payments on its long-term indebtedness.

GAO RUS' Loan Origination Policies and Procedures

- Security - determining whether the borrower can provide RUS with a first lien on all of the borrower's real and personal property, including intangible personal property and any property acquired after the date of the loan.

GAO RUS' Loan Origination Policies and Procedures

- Interim Financing - determining if requested loan replaces the borrower's interim financing, and if so, was the interim financing used for purposes approved by RUS and does it meet all the requirements of 7 CFR 1710.

GAO RUS' Loan Origination Policies and Procedures

- Facilities for nonrural areas - determining whether service provided by the facilities to nonrural areas are incidental to service provided to rural areas.
- Facilities included in rate base - determining whether borrower provided evidence that the state regulatory authority will not exclude proposed facilities from borrower's rate base, in states having jurisdiction.

GAO RUS' Loan Origination Policies and Procedures

- In addition, 7 CFR 1710 identifies other loan application documents, such as construction work plans,⁶ financial reports and a statement on pending litigation, that the borrower must submit to RUS so that it can assess the loan application.

⁶The construction work plan (CWP) documents the borrower's short-term needs for plant additions, improvements, replacements, and retirements. The CWP includes investment cost estimates and supporting engineering and cost studies to demonstrate the need for each proposed facility.

GAO RUS' Loan Origination Policies and Procedures

- RUS summarizes its assessment of the borrower's loan application and recommends the loan for approval to RUS' loan committee(s).⁷

⁷RUS has two loan committees. Loan applications are always reviewed by the first committee. Loan applications may go to the second loan committee depending on the amount of the loan and/or other risk factors.

GAO RUS' Loan Origination Policies and Procedures

- Once recommended by the loan committee(s), the loan request is forwarded to the Assistant Administrator, Division Director, or Administrator for approval.⁸
- Once approved, the approving official certifies that the security for the loan is adequate.

⁸The Administrator must approve a G&T loan that is reviewed by the second loan committee. All other loans may be approved by the Assistant Administrator or Division Director.

GAO Effectiveness of Policies and Procedures

- RUS' loan origination policies outlined in 7 CFR 1710 are reasonably designed to mitigate future loan losses to the government.
- These policies are generally consistent with banking industry standards to ensure that sufficient borrower information (both financial and collateral related) is required and analyzed in support of the loan approval.

GAO Effectiveness of Policies and Procedures

- However, RUS lacks implementing procedures in certain key areas to carry out its policies for G&T loan originations. Specifically,
 - how to assess and approve the borrower's construction work plans and financial forecasts⁹ which must be prepared by the borrower to support the loan application, and
 - how to document RUS' assessment and recommendation that the loan be approved.

⁹The financial forecast demonstrates the effects additional generation and transmission facilities will have on the borrower's sales, costs, revenues, and on the cost of power to the member distribution systems.

GAO Effectiveness of Policies and Procedures

- RUS stated that while it has not established written loan origination procedures for G&Ts in these areas, staff involved in the loan origination process are provided internal training on how to assess and evaluate the loan applications. In addition, RUS stated that its staff are instructed to refer to RUS' loan origination guidance for distribution borrower loans where applicable.

GAO Effectiveness of Policies and Procedures

- However, the internal training does not consist of a written curriculum, but rather, senior level staff provide on-the-job training to new staff responsible for various loan origination functions.

GAO Effectiveness of Policies and Procedures

- Because RUS lacks implementing procedures to carry out its G&T loan origination policies in certain key areas, misinterpretation and/or inconsistent implementation of the loan origination policies could occur.

GAO Changes to RUS' Policies and Procedures

- RUS' loan origination policies and procedures did not change significantly from fiscal year 1994 through 1999.
- RUS stated that since 1994, it has made one change to its loan origination policies and procedures to mitigate future losses to the government.¹⁰

¹⁰RUS stated that during the 1980s, it made numerous changes to its loan origination policies and procedures. For example, RUS stated that during that time, it established two loan committees whereby direct loans and loan guarantees are reviewed by at least one loan committee, depending on the size of the loan and/or other risk characteristics. However, RUS stated that it has only been codifying changes to its loan origination policies and procedures since fiscal year 1987. RUS stated that it does not have a complete set of changes made to its loan origination policies and procedures prior to codification.

GAO Changes to RUS' Policies and Procedures

- During fiscal year 1997, RUS began using trust indentures instead of mortgages to secure certain G&T loans.
- Under the trust indenture, an independent third party is appointed as trustee to provide oversight and monitoring of the borrower's financial transactions that could affect the security of RUS financed assets (e.g., securing additional debt and/or selling or disposing of assets).

GAO Changes to RUS' Policies and Procedures

- The trustee represents all secured creditors under the indenture and has a fiduciary responsibility to act in the best financial interests of these creditors.
- RUS stated that the trust indenture requires the borrower to maintain an investment grade rating, whereas RUS does not require such a rating when a mortgage is used.

GAO Changes to RUS' Policies and Procedures

- RUS said that the trust indenture, which is used primarily for financially and managerially strong borrowers, reduces the amount of RUS required oversight for these borrowers. As a result, RUS stated that it can devote more of its scarce resources to monitoring weaker borrowers.

GAO Changes to RUS' Policies and Procedures

- While RUS expressed the belief that this step mitigates future loan losses to the government, we do not consider the use of a trust indenture to be a significant change because
 - both the trust indenture and a mortgage collateralize the underlying assets for RUS G&T loans, and

GAO Changes to RUS' Policies and Procedures

- features included in a trust indenture such as requiring the borrower to (1) maintain an investment grade rating and (2) be managerially strong can also be incorporated in a mortgage.

GAO Changes to RUS' Policies and Procedures

- The only significant difference between the trust indenture and mortgage is that the primary oversight and monitoring of the borrower's financial transactions are performed by an independent third party instead of RUS.

GAO Recommendation

- We recommend that RUS develop written procedures to ensure consistent implementation of its G&T loan origination policies. In particular, procedures need to be developed and documented related to the
 - assessment and approval of a borrower's construction work plans and financial forecasts, which must be prepared by the borrower to support the loan application, and

GAO Recommendation

- overall assessment and recommendation for loan approval.