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REPORT BY THE

# Comptroller General

OF THE UNITED STATES

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## Legislation Needed To Establish Specific Loan Guarantee Limits For The Economic Development Administration

The Economic Development Administration's business loan guarantee program has operated for many years without specific statutory monetary limitations. The fiscal year 1979 Appropriations Act, however, limits the amount of obligations for business loans and guarantees to \$75 million. Since the program's creation in a 1965 act, the agency has guaranteed over \$197 million in loans of which \$131 million remains to be paid as of March 31, 1978.

Four of the unpaid loans totaling \$75 million were made to one company which is experiencing financial difficulties, and sufficient reserves are not available in the event of a default by that company.

GAO recommends that the Congress strengthen its control by limiting the total amount of all loans as well as the amount of individual guarantees (larger loans would require congressional authorization).

GAO further recommends that the Department of Commerce annually reassess the reserve needs for potential loan guarantee losses and adjust the reserve accordingly.



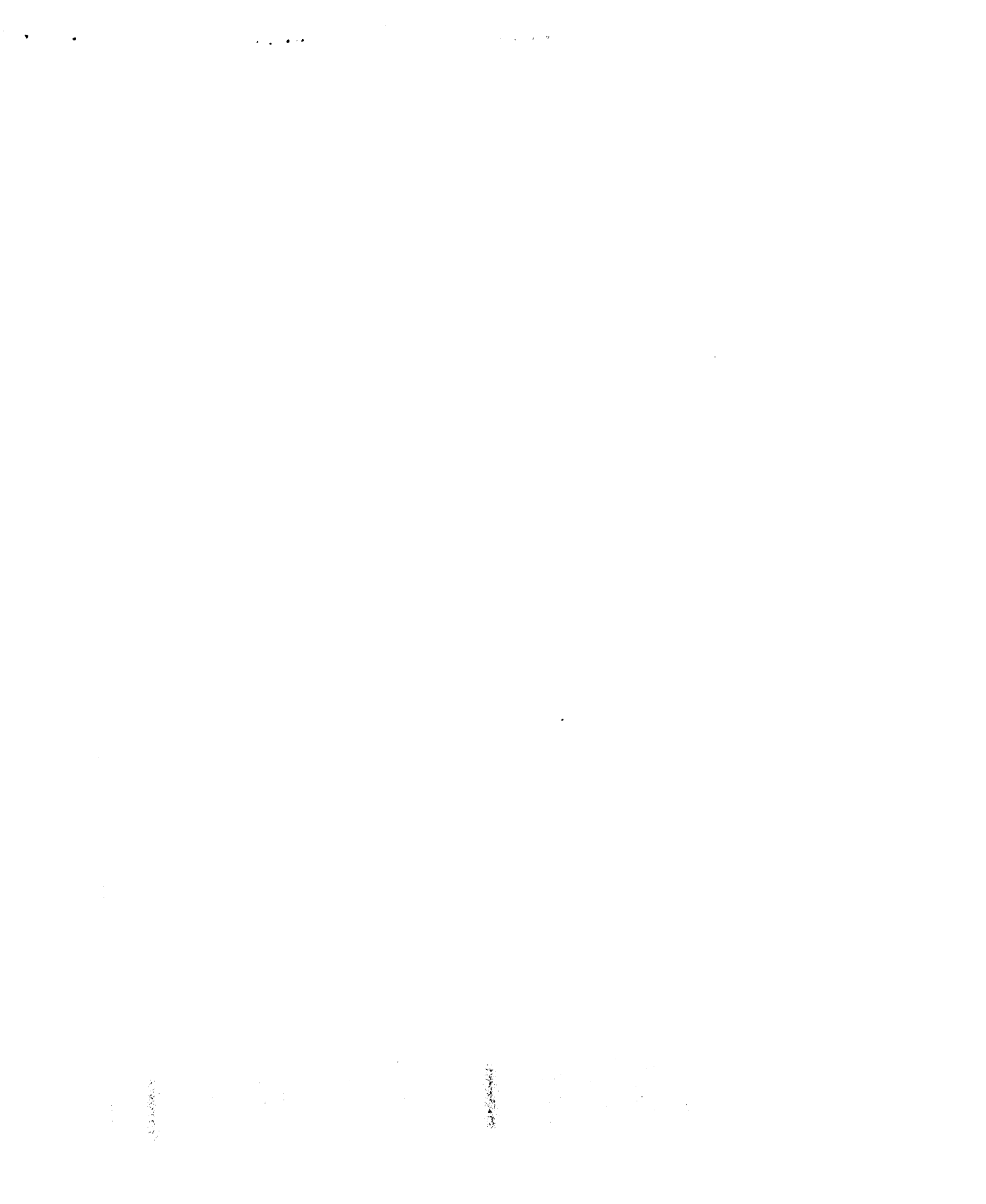
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*report*

FGMSD-78-62  
JANUARY 5, 1979





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

B-133170

The Honorable James C. Cleveland  
Subcommittee on Investigations and Review  
Committee on Public Works and  
Transportation  
House of Representatives

Dear Mr. Cleveland:

As requested in your July 21, 1977, letter, this report discusses our findings on loan guarantee limitations. We reported on the Department of Commerce's commitment to Seatrain Corporation in an earlier report to you. (FGMSD 78-63, Nov. 16, 1978.)

The recommendation for additional congressional control over the Economic Development Administration's loan guarantees affects appropriation matters as well as legislative oversight. Accordingly, in addition to the periodic briefings we have provided your office, we have discussed our recommendations with the House and Senate Appropriations Committees' staffs.

The matters discussed in the report were also discussed with officials of the Economic Development Administration and the Maritime Administration, and their comments have been considered in this report.

We are sending copies of this report to the House and Senate Appropriations' Subcommittees on State, Justice, Commerce, and Judiciary.

Sincerely yours,

  
Acting Comptroller General  
of the United States



REPORT BY THE  
COMPTROLLER GENERAL  
OF THE UNITED STATES

LEGISLATION NEEDED TO ESTABLISH  
SPECIFIC LOAN GUARANTEE LIMITS  
FOR THE ECONOMIC DEVELOPMENT  
ADMINISTRATION

D I G E S T

Congressional control over the Economic Development Administration's growing business loan guarantee program needs to be strengthened. Since June 30, 1971, the average loan guarantee has increased from about \$400,000 to about \$2.3 million. The growth is partly due to the agency's guarantee of six loans totaling \$113 million since 1969. (See p. 3.)

Several congressional committees are concerned about the Government's losses on loan guarantees and have held hearings on the lack of control over loan guarantee programs, such as the one covered by this report. Some Government agencies' guarantee programs have specific dollar ceilings. By enacting such limits for the Economic Development Administration, the Congress could maintain better control of the guarantee program. (See pp. 4-6.)

The large growth of the agency's guarantee program could affect both the loss rate and reserve requirement. If one of its guaranteed loans in the \$20- to \$40-million range defaulted, the program's 10-year loss, \$13 million, could double. (See p. 7.)

Because of the risk associated with large loan guarantees, the Economic Development Administration does not have a reserve commensurate with the potential risk. As of March 31, 1978, it had \$18.3 million in reserve while the unpaid balance of guaranteed loans totaled \$131.1 million. However, sufficient unreserved funds are presently available in its Revolving Fund if needed.

The Economic Development Administration's 1965 enabling legislation created a Revolving Fund

to be used for financing the business loan and guarantee program. Since then, all business loan interest and principal repayments have been deposited in the Fund, which has a balance of \$203 million as of March 31, 1978. The annual appropriations, through fiscal year 1973, contained a section preventing the Economic Development Administration's use of the Fund. In fiscal year 1974, this restriction was deleted and the Fund was available to pay for defaults. Now, however, the fiscal year 1979 Appropriation Act limits the amount of obligations for direct loans and guarantees to \$75 million. Separate limits for both loans and loan guarantees would further strengthen the effectiveness of congressional control and clarify congressional intent.

GAO recommends that the Congress establish

--control over EDA's loan guarantee program by setting a permanent ceiling in the enabling legislation and/or by setting an annual ceiling in the appropriation act on the total amount of loans.

--dollar limits on loan guarantees to an individual borrower (larger loans would require congressional authorizations).  
(See p. 8.)

GAO further recommends that the Secretary of Commerce direct the Head of the Economic Development Administration to annually reassess the reserve needs for potential loan guarantee losses and adjust the reserve accordingly. (See p. 8.)

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ABBREVIATIONS

EDA	Economic Development Administration
GAO	General Accounting Office





## CHAPTER 1

### INTRODUCTION

A July 21, 1977, letter from the Ranking Minority Member of the Subcommittee on Investigations and Review, House Committee on Public Works and Transportation, requested that we investigate the desirability and feasibility of including limitations on loan guarantees in the Economic Development Administration's (EDA's) authorizing or appropriating legislation. As of March 31, 1978, EDA had over \$352 million receivable on 481 loans and a contingent liability of over \$131 million for 52 loan guarantees.

### BUSINESS LOAN AND GUARANTEE PROGRAM

The Public Works and Economic Development Act of 1965 (42 U.S.C. 3121, as amended), administered by EDA, is designed to reduce unemployment in economically distressed areas throughout the United States. Section 202 of the act authorizes financial assistance for businesses willing to establish or expand operations in the Nation's economically distressed areas. Financial assistance may be given for the purchase or development of land and facilities for industrial or commercial use. The assistance can be for

- working capital loans or loan guarantees,
- fixed-asset loans or loan guarantees, and
- buildings and equipment lease payment guarantees.

Guaranteed loans are loans for which the Federal Government guarantees, in whole or part, the repayment of principal and/or interest for the borrower. The guarantees are subject to the following restrictions in the authorizing legislation:

- The guaranteed loan cannot exceed 65 percent of the total cost of land, buildings, machinery, and equipment of the company.
- EDA cannot guarantee more than 90 percent of the amount of the unpaid principal of a loan.
- Financial assistance must be unavailable from other sources without an EDA guarantee.
- Repayment must be reasonably assured.

EDA, which succeeded the Area Redevelopment Administration, is headed by the Assistant Secretary for Economic Development, Department of Commerce. It comprises a headquarters staff in Washington, D.C., and six regional offices in Philadelphia, Atlanta, Chicago, Austin, Denver, and Seattle.

#### SCOPE OF REVIEW

We reviewed pertinent loan records and EDA's legislative history, EDA and Maritime Administration financial and administrative records, and the administrative procedures for making and honoring loan guarantees. We interviewed EDA officials and representatives from private financial institutions.

## CHAPTER 2

### ADDITIONAL CONTROLS ARE NEEDED OVER

#### EDA LOAN GUARANTEES

EDA's loan guarantee program, created in 1965, operated without specific statutory limits until the 1979 Appropriation Act limited the amounts of obligations for direct loans and guarantees from the Economic Development Revolving Fund to \$75 million. The cost of both the program and the individual guarantees has increased since EDA began in 1965. Over 88 percent of the amount of loan guarantees authorized has been made since fiscal year 1972, and an average guarantee has increased from \$400,000 to \$2.3 million. Congressional committees (see p. 5) have held hearings to consider steps needed to gain control of the Federal Government's rapidly growing loan guarantee programs. Some Government agencies have dollar limitations specifically controlling their loan guarantee programs, but EDA does not. We believe its loan guarantee program control should be further strengthened by establishing specific statutory limitations.

#### GROWTH OF EDA'S GUARANTEE PROGRAM

From its beginning in 1965 through fiscal year 1977, EDA has authorized \$185.3 million in guarantees; the major portion of the guarantees (\$163.8 million) was authorized after fiscal year 1971. The following schedule depicts the growth of the guarantee program.

<u>Fiscal year</u>	<u>Authorized guarantees</u>	
	<u>No.</u>	<u>Amount</u>
		(000 omitted)
1966	6	\$ 3,690
1967	17	6,142
1968	18	3,248
1969	7	6,849
1970	4	1,380
1971	1	225
1972	22	19,420
1973	6	23,890
1974	3	900
1975	13	67,606
TQ-1976	28	44,241
1977	<u>3</u>	<u>7,754</u>
Total	<u>128</u>	<u>\$185,345</u>

One reason for the growth of the guarantee program is the increase in the amount of individual guarantees in recent years. During the first 6 years of the program, the average guarantee was about \$404,000, with only four guarantees larger than \$1 million. Since then, the average guarantee has increased to about \$2.3 million, and as of June 30, 1977, 20 guarantees were outstanding for more than \$1 million. Four of these guarantees exceeded \$10 million--the highest being \$36 million. The following schedule illustrates the growth in the size of guarantees and the significant increase in the Government's liability.

<u>Authorized amount</u>	<u>Number of guarantees</u>	
	<u>July 1, 1965</u> to <u>June 30, 1971</u>	<u>July 1, 1971</u> to <u>June 30, 1977</u>
\$0 - \$200,000	30	11
\$200,001 - \$400,000	11	19
\$400,001 - \$600,000	5	12
\$600,001 - \$800,000	3	6
\$800,001 - \$1,000,000	-	8
\$1,000,001 - \$10,000,000	4	16
\$10,000,001 - \$20,000,000	-	1
\$20,000,001 - \$40,000,000	-	<u>3</u>
Total	<u>53</u>	<u>76</u>

Another reason for the increase of the guaranteed amounts was a commitment to help create jobs by aiding two shipbuilding companies. Since 1969 six loans to these companies totaling \$113 million have been guaranteed (60 percent of the amount of all guarantees authorized since fiscal year 1966). One of the companies, organized in 1969 to build large oil tankers, has received \$83 million in guaranteed loans.

CONGRESSIONAL CONTROLS NEEDED  
OVER LOAN GUARANTEE PROGRAMS

Loan guarantee programs operated by several agencies do not contain statutory ceilings on the amounts that can be guaranteed. As a result, their programs operate without congressionally established limitations. Until recently EDA was one of these agencies. Through the use of guaranteed loans, the Federal Government has incurred very large contingent liabilities, and several congressional committees are concerned about their lack of control over the total amount of these contingent liabilities.

The Congress makes funds available for agency spending through appropriation legislation. An appropriation act makes funds available for specific Federal programs, normally for one year. The funds are obligated when goods or services are ordered, and the amount of appropriations available for obligation is reduced accordingly. However, when an agency guarantees a loan it incurs only a contingent liability that is not considered an obligation of funds and is not counted against the agency's appropriation.

Several congressional committees are concerned about Federal loan guarantee programs. In November 1976 three House Committees--the Subcommittee on Economic Stabilization of the Committee on Banking, Currency, and Housing; the Subcommittee on Oversight of the Committee on Ways and Means; and the Tax Expenditure Task Force of the Committee on the Budget--held joint hearings on loan guarantees and congressional control over them. In January 1977 the Subcommittee on Economic Stabilization obtained information on pending loan and loan guarantee legislation as a basis for reviewing and improving existing legislation. In March 1977 the Subcommittee on Economic Stabilization held hearings on loan guarantees and the extent of their contribution to the contingent liabilities of the Federal Government.

The Subcommittee was concerned with the increase in the amount of loan guarantees and the types of loans guaranteed or insured by the Federal Government. The hearings considered what steps, such as dollar ceilings on individual programs, were necessary to improve or increase congressional control over existing loan guarantee programs. The Committees were concerned that the Congress, in enacting legislation for new programs, include adequate limitations on guarantees.

Several Government agencies' guarantee programs are limited by ceilings in either their authorizing or appropriating language. For example, the 1977 Appropriation Act for the Energy Research and Development Administration, contains a \$200 million limitation on the amount that can be guaranteed or committed under that agency's Loan Guarantee and Interest Assistance Program. Another example is the 1977 Appropriation Act for the Farmers Home Administration, Rural Housing Insurance Fund, which provides for a \$500 million limitation on unsubsidized interest guaranteed loans.

During the course of our review we briefed staff members of the House and Senate Appropriations Subcommittees on State, Justice, Commerce, and Judiciary, on the need to establish loan guarantee limits. To improve congressional

control, the Department of Commerce's fiscal year 1979 appropriation act contains a restriction which states that total obligations for new business loans and guarantees under the "Economic Development Revolving Fund" shall not exceed \$75 million. The restriction suggests that congressional intent was to place a limit on the amount of guarantees that EDA can make. In making these loans however, EDA should only record the amounts of direct business loans as obligations because a loan guarantee is only a contingent liability and therefore does not meet the criteria for an obligation under the principles of 31 U.S.C. 200. (See p. 7.) To help clarify congressional intent, consideration should be given to the establishment of separate limits on loans and loan guarantees.

RESERVED FUNDS IN THE REVOLVING  
FUND MAY NOT BE SUFFICIENT TO  
COVER A LARGE DEFAULT

Although EDA does not have enough reserve funds to meet its obligation in the event that a large default occurs, sufficient unreserved funds are presently available in a revolving fund if needed. As of March 31, 1978, contingent liability for guarantees is \$131.1 million, although the reserve is only \$18.3 million.

The Revolving Fund was created in EDA's 1965 enabling legislation (42 U.S.C. 3143) to finance its business loan and guarantee programs. As provided by the statute, all business loan interest and principal repayments have been deposited in the Fund, which has a balance of \$203 million as of March 31, 1978. The statutory provisions establishing the Revolving Fund also require that all monies appropriated for EDA's business loan and guarantee programs be deposited therein. However, each of EDA's annual appropriations through fiscal year 1973 contained a provision, which in effect, prevented EDA's use of the Revolving Fund.

The restrictive provision was not included in EDA's appropriation acts for fiscal years 1974 through 1977. In light of the statutory language and the absence of any restrictive provision in the 1974-77 appropriation acts, all amounts appropriated for the business loan and guarantee programs during that period should have been deposited in the Revolving Fund to be used in funding those programs. Accordingly, all remaining undisbursed funds from those years should now be in the Revolving Fund.

Apparently, because EDA was, in effect, precluded from using the Revolving Fund through the 1973 fiscal year, EDA

established a procedure whereby, once a year, its loan officers would estimate the risk of loss and then for each guarantee made during the year obligate a portion of its annual appropriations. The obligation rate was computed annually and has varied between 10 and 25 percent. Once obligated, the funds then became available to pay for defaults on any guaranteed loans. Although we understand the motive--to provide for an adequate reserve for defaulted EDA guaranteed loans when the Revolving Fund was not available--no legal authority exists under 31 U.S.C. 200 for recording contingent liabilities, such as loan guarantees, as obligations. (A valid obligation is only recorded when a default occurs, which would not normally occur until at least several years after a loan guarantee has been made.) Therefore, all monies obligated for loan guarantees during those years that were not needed to pay for defaults occurring during the particular fiscal year should have been deobligated at the end of the fiscal year and would no longer have been available to cover defaulted loans. However, since all of the \$18.3 million currently in the reserve was obligated between 1974 and 1977, the only action needed is to transfer that amount to the Revolving Fund; and EDA officials have advised us that this action will be taken.

As of March 31, 1978, the contingent liability for guarantees was \$131.1 million, although the established reserve is only \$18.3 million. Since 1966, of the \$66 million in guaranteed loans that have been repaid, EDA has had to pay \$13 million due to defaulted loans. With the substantial growth of EDA's guarantees, the current reserve appears to be inadequate. If a company with a large guaranteed loan defaulted, EDA would not have enough reserves to keep its commitment.

Although the recent availability of the Revolving Fund would provide sufficient funds in the event of a large default as of March 31, 1978, the availability of the money in the Revolving Fund in the future cannot be assured unless it is reserved. In the past, when EDA had a relatively large number of small loans, historical experience provided a reasonably accurate basis for estimating default rates. However, with the change to a small number of large guarantees, we believe that predicting the extent of defaults would be very difficult.

During any year in which funds in the Revolving Fund were not available, the reserve established for that year

would have to be sufficient to cover a large default. In that event, EDA might not be able to honor its guarantee immediately and would have to request a supplemental appropriation in order to meet its obligation as guarantor. We believe that EDA should maintain sufficient reserves in the Revolving Fund to cover a large default.



## CHAPTER 3

### CONCLUSIONS AND RECOMMENDATIONS

#### Conclusions

Since 1965 the size of EDA's guarantee program and individual guarantees has greatly increased. Approximately 60 percent of its entire guarantee program has been to aid two companies in the shipbuilding industry. The reserve set aside to pay loan defaults is only \$18.3 million. If two companies with larger loans, or one of the shipbuilding companies defaulted, EDA may not have enough reserved to meet its commitment.

Congressional control of EDA's loan guarantee program needs to be strengthened. EDA's loan guarantee program has one obligation limit for both business loans and loan guarantees and it appears that the Congress intended to use such a limit to control loan guarantees. Pursuant to Federal statute, however, guarantees are not recorded as obligations when they are made. We believe that congressional control over direct loans and guarantees could be strengthened by treating each category separately--obligation authority could be limited for direct loans, but a limit on loan guarantees could best be achieved by placing a total dollar limit on the amount of loan guarantees that could be authorized in a fiscal year. We also believe the amounts of individual guarantees should be limited, and that adequate reserves should be established.

#### RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress establish:

- Control over EDA's loan guarantee program by setting a permanent ceiling in the enabling legislation and/or by setting an annual ceiling in the appropriation act on the total amount of loans.
- A limit on financial assistance to an individual borrower for loan guarantees either by including restrictive language in EDA's annual appropriation act or by amending its enabling legislation. The provisions could be such that guarantees in excess of the limit could be made with the approval of either the appropriations or legislative committees or both.

#### RECOMMENDATION TO THE SECRETARY OF COMMERCE

We recommend that the Secretary of Commerce direct the Head of the Economic Development Administration to annually reassess the reserve needs for potential loan guarantee losses and adjust the reserve accordingly.



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