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Report to Jerome A. Miles, Controller, Department of Energy; by D. L. Scantlebury, Director, Financial and General Management Studies Div.

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The letter of credit system is used for paying contractors who are eligible to be financed by advance Government payments. According to Department of Energy (DOE) officials, use of this system over the past 10 years has saved the Government substantial interest costs because it eliminated the need to pay contractors billions of dollars in advances. Contractors surveyed, who were paid under the checks-paid letter of credit system, had excess Federal funds in their bank accounts. One factor contributing to this situation was the difficulty experienced by commercial banks in operating checks-paid letter of credit accounts consistent with Treasury policy. DOE does not have the specific procedures necessary to ensure that Federal funds disbursed under the system are not excessive. The Controller of DOE should: meet with the Treasury Department and consult with the Social Security Administration to refine the checks-paid letters of credit policy and develop specific procedures which will minimize Federal funds in contractor bank accounts, require contractors to negotiate with commercial banks to assure that the bank requiring the least compensation is chosen and that the amount of compensation is not more than that required by the bank to cover its stated charges, periodically monitor the balances of Federal funds in contractor checks-paid letter of credit bank accounts, and use bank-supplied account analyses to help accomplish these recommendations. (HTW)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

B-39995

AUGUST 3, 1978

Mr. Jerome A. Miles
Controller
Department of Energy

Dear Mr. Miles:

This report is to advise you of the results of our survey of the Energy Research and Development Administration's 1/ use of the checks-paid letter of credit system to pay its contractors. Letters of credit is a technique used for paying contractors who are eligible to be financed by advance Government payments. The intent of the letter of credit program, as developed by the Department of the Treasury, is to time the payment of Government funds to coincide with contractors' requirements for cash.

The Department of Energy has used letters of credit for about 10 years, and Energy officials told us that over the years they have saved Treasury substantial interest costs on the public debt because the letter of credit system eliminated the need to pay contractors billions of dollars in advances well before the contractors needed the money. 2/

1/The functions of the Energy Research and Development Administration were transferred on October 1, 1977, to the Department of Energy. Many of the statements and actions attributed to the Department of Energy in this report were actually stated and performed by the Energy Research and Development Administration For simplicity, however, the Department of Energy is referred to throughout the report.

2/Paying the contractors before they need the money, to the extent that Treasury borrows funds to finance premature disbursements, causes Treasury to incur additional interest costs.

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Because of the potential the system has for improving cash management in the Federal Government, we surveyed the checks-paid letter of credit system to find out how it works and the potential for other Government entities adopting the system. During the course of the survey we noted some deficiencies which, if corrected by the Department of Energy, would further improve the system's effectiveness and reduce excess Government cash balances in contractor accounts by at least $1.8 million. Details of these findings follow.

HOW THE CHECKS-PAID LETTER OF CREDIT SYSTEM IS SUPPOSED TO WORK

Under the letter of credit program the Treasury, on behalf of another Federal agency, establishes a letter of credit at a Federal Reserve Bank in favor of a contractor and the contractor's bank. The contractor's bank honors all checks presented for payment against the contractor's special checking account established for letter of credit transactions. Letter of credit procedures authorize the bank to request and receive daily reimbursement from Treasury's account at the Federal Reserve Bank for the amount of checks the commercial bank paid on the account that day.

Commercial banks are entitled to compensation for handling the activity in contractor accounts. Since Government procurement regulations do not allow contractors to receive reimbursement for bank service charges, the banks are compensated in numerous ways, but generally either by (1) the use of funds resulting from a cash balance in the contractor's checking account (similar to the minimum balance required by many banks to provide free personal checking to individuals) or (2) a noninterest-bearing time deposit. The banks do not pay interest on these Government funds; they use the money earned on these funds as compensation.

The amount of Government funds is to be no larger than that necessary to allow a bank to earn a sum closely approximating what it would ordinarily charge for servicing the account. Services include processing deposits, honoring checks, issuing statements, etc. Bank charges for services include cost and an element of profit, and vary from bank to bank. When a bank is compensated by a noninterest-bearing time deposit, the average daily balance of Federal funds in the checks-paid letter of credit account should be zero; when compensated by an agreed-upon minimum balance, the average daily balance should be equal to the agreed-upon balance.

A bank-management tool called "account analysis" can be used as an aid in determining whether the

--amount of Federal funds used as compensation by a bank is excessive,

--bank requiring the least amount of compensation for servicing the checks-paid letter of credit account is selected, and

--average daily balance maintained at the bank exceeds agreed-upon amounts.

Most large banks prepare monthly account analyses for their major accounts, and will generally make them available to customers upon request. Account analyses are used by bankers to determine if customers are maintaining sufficiently high average cash balances in their checking accounts to allow the bank to earn enough money to at least cover its charges for servicing the accounts. If cash balances are below that level, the bank may require additional compensation from its customers. If cash balances are above that level, the bank is receiving more compensation than necessary to cover its stated charges.

The Department of Energy has used the letter of credit system extensively for making advance payments. During the 15-month period ending September 30, 1976, Energy paid about $4 billion of its total $6 billion in payments by letters of credit. At May 1, 1977, there were 158 open letters of credit--totaling about $21 billion--which will cover payments to be made over a long period of time. Of these 158 letters of credit, 51--totaling about $16.7 billion--were under checks-paid letter of credit procedures.

EXCESS FEDERAL FUNDS IN CONTRACTOR CHECKING ACCOUNTS

We used account analyses provided by commercial banks to determine the minimum amounts of Federal cash needed by the banks as compensation for handling the banking activity of three of Energy's largest contractors for a 3-month period. These contractors, who had five letters of credit totaling $4.6 billion, were paid under the checks-paid letter of credit system. We determined that the contractors had about $1.8 million in excess Federal funds in their bank accounts which, to the extent they increased Treasury borrowing, cost

Treasury about $120,000 annually in interest expense. If the same conditions exist for the remaining 46 letters of credit, the unnecessary interest expense incurred is probably substantially higher. Energy officials told us, however, that these conditions do not exist for most of the 46 letters of credit, and that steps are underway to take corrective action.

One of the contractors whose banking activity we reviewed maintained checks-paid letter of credit accounts at two banks in the same city. No agreement had been reached with either bank as to the minimum amount of interest-free Federal cash balances to be maintained. However, based on data from their account analyses, both banks had excessive balances. If these balances were reduced to amounts which would produce earnings to the banks equal to their stated charges for service, about $960,000 could have been returned to Treasury's account at the Federal Reserve Bank.

In addition, one of the banks charges a much higher rate for services than the other bank. We believe that if the contractor had successfully negotiated with the more expensive bank, that bank's charges would have been reduced to meet the competition provided by the other bank. If negotiation did not produce this result, the contractor should have used the bank which used the lower charges in its account analysis. This would have permitted an additional $680,000 to be returned to Treasury, with commensurate interest savings.

Another contractor had negotiated a minimum balance of $600,000 with its commercial bank. By reviewing the bank's account analysis, however, we noted that this amount was $71,000 higher than necessary to adequately compensate the bank for services. Furthermore, we found that the average balance maintained was $731,000, or $131,000 more than the agreed-upon minimum balance. Thus, approximately $202,000 of excess Federal cash was in the bank account.

The final contractor negotiated a new minimum balance with its commercial bank each month, based on the activity of the prior month. At the time of our survey, the negotiated minimum balance was $415,000, but the bank was actually maintaining an average Federal cash balance of $731,000. According to the charges shown on the bank's account analysis, the $731,000 actually maintained was less than adequate to fully compensate the bank for its services. We believe this situation warrants the contractor's entering into negotiations (1) with the present bank, to determine a more realistic minimum balance and (2) with other banks in the area, to determine if charges for services and the amount of Federal cash maintained to provide compensation for handling account activity can be reduced.

NEED FOR IMPROVED POLICY, PROCEDURES, AND PROGRAM MANAGEMENT

The excess balances of Federal funds in contractor bank accounts were caused by

--an incorrect assumption in Treasury and Energy policy and procedures for determining the timing and amount of commercial bank reimbursements from Federal Reserve Banks;

--an absence of specific Energy procedures for establishing and approving agreements made between contractors and their commercial banks, especially regarding the negotiation of compensating cash balances; and

--inadequate Energy monitoring of its checks-paid letter of credit program.

These inadequacies resulted in the commercial banks' requesting and receiving premature and/or excessive reimbursement from Treasury's accounts at Federal Reserve Banks.

Treasury written policy implies that commercial banks will receive same-day reimbursement from the Federal Reserve equaling the sum of checks clearing the bank accounts that day. Treasury officials advised that this was, in fact, the intent of Treasury's policy. However, commercial banks have problems operating checks-paid letter of credit accounts consistent with this policy. The banks must request reimbursement from the Federal Reserve by early afternoon--probably no later than 3 p.m.--to give the Federal Reserve time to process the transaction on the same day. Commercial banks, however, generally continue to process checks they have accepted for payment against the account until a much later hour, perhaps 9 p.m. or later. Thus, the same-day reimbursement policy advocated by Treasury is not working. Because of this, and because of a lack of clear implementing guidance from the Department of Energy, banks are requesting and receiving reimbursement from the Federal Reserve in differing ways.

The contractor that had accounts at two banks was initiating reimbursement requests from the Federal Reserve on behalf of the two commercial banks, based partially on the amount of checks the contractor issued each day. Thus, the commercial banks were receiving Federal funds prematurely, since several days pass from the time these checks are mailed, received by creditors, and cycle back to the contractors' banks for payment. As a result, the banks had large amounts of excess Federal cash on hand.

At the bank which negotiated a $600,000 minimum balance with the contractor, the amount of checks expected to clear the contractor's account each day was estimated, and the bank requested reimbursement from the Federal Reserve for the estimated amount. This amount usually exceeded the total of the actual checks clearing against the account, thereby causing an excess balance of Federal funds in the account.

The fourth bank we surveyed was basing its reimbursement request on the amount of checks paid on the account the previous day. As noted earlier, the $731,000 actually maintained did not cover the bank's charges for services.

Energy officials told us that they instruct contractors to negotiate minimum balances or time deposits with commercial banks, and establish a checks-paid letter of credit account at the bank which will perform the necessary services for the least cost. These agreements are to be reviewed and approved by field office officials.

No specific Department of Energy written procedures, however, either require that cash balances be negotiated, or detail the actions necessary to accomplish the negotiations. Furthermore, no written procedures specified how banks should be compensated for handling checks-paid letter of credit accounts, or how such accounts should be monitored. Treasury regulations make Federal agencies responsible for reviewing the reasonableness of cash balances on hand in contractors' bank accounts and for monitoring the drawdowns of Federal funds to ensure against excessive and/or premature withdrawals by banks. Agencies are also required to establish procedures for performing reviews, at least quarterly, of each contractor's use of funds advanced by letters of credit.

We found that reports and data available to Energy personnel are not adequate to assist them in determining if balances of Federal funds negotiated between contractors and their banks are reasonable, if in fact negotiations took place. Furthermore, reports submitted by Energy's field offices concerning commercial bank account activity and balances did not provide enough information for personnel to determine if, or to what extent, actual balances of Federal funds in contractor bank accounts were excessive.

CONCLUSIONS

There is excess Federal cash in contractor bank accounts. Several factors have contributed to this condition. One factor is the difficulty commercial banks have experienced in operating checks-paid letter of credit accounts consistent with Treasury policy. This situation has allowed commercial banks flexibility when seeking reimbursement from the Federal Reserve, generally to the detriment of the Government. Energy and Treasury officials should meet and develop workable policies and specific procedures regarding the timing and amount of commercial bank reimbursements from the Federal Reserve. 1/

The Department of Energy does not have the specific procedures necessary to ensure that the Federal funds disbursed under the checks-paid letter of credit system are not excessive. Any excess funds maintained to provide compensation for banks servicing checks-paid letter of credit accounts might result in Treasury's incurring additional interest costs. Accordingly, the Department of Energy should establish procedures and take necessary actions to (1) ensure the minimum use of Federal funds necessary to compensate commercial banks and (2) monitor, identify, and eliminate excess balances of Federal funds in checks-paid letter of credit accounts.

Monthly reviews of bank account analyses would enable Energy to effectively monitor balances of Federal funds in contractor accounts. Bank-supplied account analyses provide the information which can help in performing comprehensive reviews of contractor checking account activity with minimum effort.

RECOMMENDATIONS

We recommend that you take the actions necessary to:

--Meet with the Treasury Department and consult with the Social Security Administration to refine the checks-paid letters of credit policy and develop

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1/The only other agency to make widespread use of checks-paid letters of credit is the Department of Health, Education, and Welfare's Social Security Administration. It should be consulted on any changes to the checks-paid system.

specific procedures which will minimize Federal funds in contractor bank accounts.

--Require contractors to negotiate with commercial banks to assure that (1) the bank requiring the least compensation is chosen and (2) the amount of compensation is not more than that required by the bank to cover its stated charges for handling the account's activity.

--Periodically monitor the balances of Federal funds in contractor checks-paid letter of credit bank accounts, to assure that excess balances of Federal funds are identified and withdrawn.

--Use bank-supplied account analyses as an aid in accomplishing the above recommendations.

The contents of this report were discussed with officials representing the Departments of Energy and the Treasury, contractors, and their banks. Their comments were considered in the final preparation of this report. Energy officials informed us that specific written procedures will be developed as part of Energy's efforts to improve its cash management practices.

We would appreciate your comments on our recommendations and are available to discuss this report with you or your representatives if you so desire.

Since the President recently directed that a comprehensive review be made of Federal cash management policies and practices, we are sending copies of this report to the President's reorganization staff involved in a review of Federal cash management. Furthermore, we are sending copies to the Secretaries of the Departments of Energy, the Treasury, and Health, Education, and Welfare; and the Director, Office of Management and Budget.

Sincerely yours,

D. L. Scantlebury

D. L. Scantlebury
Director