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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D C 20548

CIVIL DIVISION

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Dear Mr. Secretary.

The General Accounting Office has examined into the interest costs incurred on short-term project notes issued by local housing authorities (LHAs) and local public agencies (LPAs) to finance low-rent housing and urban renewal projects under programs administered by the Department of Housing and Urban Development (HUD). Any savings effected through lower interest costs on project notes would reduce the capital costs of LHA and LPA projects and ultimately reduce Federal financing costs incurred through HUD's annual contributions and grants.

Our examination included a review of applicable laws and HUD's administrative policies and procedures, discussions with officials of HUD, the Treasury Department, and the Federal Reserve System; and a review of HUD records at its headquarters office in Washington and at six of its seven regional offices.

LHA and LPA project notes are exempt from Federal taxes and are secured by the full faith and credit of the United States Government. In general, these notes have commanded an extremely ready market and have met with exceptionally favorable investor acceptance. For example, for the 5 months ended July 1969, the total bids on LHA and LPA issues averaged about four times the dollar amount of notes offered to investors.

LHAs and LPAs are generally required by HUD to market their new project notes monthly in separate, consolidated offerings. Each offering is advertised, awarded to the lowest bidder about 2 weeks later, and issued after about 4 additional weeks, in accordance with the sequence of short-term financing dates scheduled by HUD. Part of the proceeds from the sale of the new notes are used to retire maturing notes.

HUD generally requires that, in refinancing project notes, the replacing notes overlap the maturing notes by 3 days New notes are usually issued on a Tuesday, and the notes being retired usually mature on the following Friday.

HUD records relating to project notes totaling over $430 million issued by LHAs during March and June 1968 showed that about 83 percent of

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the proceeds was used to retire notes maturing 3 days later. We estimated that, if this percentage held true for the other LHA note issues, about $1.5 billion of the $1.8 billion note proceeds in fiscal year 1968 was used to retire maturing notes. Using the average interest rate of 3.4048 percent for notes issued during the 6 months ended June 1968, we computed an annual duplicate interest charge of about $430,000 for the overlapping 3-day periods. On the basis of comparable data for LPA issues, we estimated that duplicate interest charges on LPA notes would amount to about $590,000 annually.

The rise in interest rates on project notes during the past year or so has further increased the amount of duplicate interest costs being incurred for the overlap periods. The average interest rate on LPA project notes was about 3.57 percent in the first half of 1968, 4.68 percent in March 1969, and 5 8 in August 1969.

HUD officials discussed with us HUD's reasons for requiring that replacing notes overlap expiring notes by 3 days. The officials explained that under existing procedures, the paying agents for the note purchasers receive no compensation for their services other than free use of the funds during the 3-day periods.

According to HUD records, eight banks that act as their own paying agents purchased about 70 percent of the LHA and LPA project notes issued in fiscal year 1968. In effect, these banks were compensating themselves for the paying agent function by retaining use of the note proceeds during the 3-day periods Other purchasers of LHA and LPA notes who must employ outside paying agents generally turn the purchase funds over to such paying agents, and the paying agents--not the note purchasers--obtain free use of the funds during the 3-day periods as compensation for their services.

HUD's requirements for the 3-day overlaps and the fact that the free use of funds during the 3-day periods serves as compensation for the paying agent function, give rise to certain questions which we were not able to fully explore or resolve during the course of our review and our discussions with HUD officials These questions concern.

1. Whether the value of the free use of funds for the 3-day overlap periods is commensurate with the value of paying agent services.

2. Whether purchasers which act as their own paying agents consider any difference in the respective values of the free use of funds and the paying agent services in determining the amount of their bids and, if so, whether this practice gives them a competitive advantage over potential purchasers who do not act as their own paying agents.

3. Whether overall savings could be achieved through reducing or eliminating the overlap periods and arranging for Federal Reserve Banks to act as paying agents on a cost reimbursable basis.

In addition to the potential savings aspect, we believe that, from a management information standpoint, paying-agent costs should not be commingled with interest costs but should be separately identified and accounted for, so that management will know how much the paying-agent services are costing. Such information could sharpen management's awareness of the need for procedural improvements leading to reductions in paperwork, project note processing requirements, and related costs.

We do not know how much net income is realized by paying agents from the free use of project note proceeds during the overlap periods discussed in this report. Therefore, we do not know to what extent, if any, the interest bids of some purchasers would be affected by the loss of such income. We are not aware of any in-depth study made of this matter by HUD.

To the extent that the use of note proceeds by paying-agent banks which purchase project notes results in income to the banks in excess of the cost of performing the paying agent functions, and the banks take such net income into consideration in formulating lower interest bids on project notes than they otherwise would, HUD's present procedure may give these banks a competitive advantage over other potential bidders who must employ outside paying agents

It should be noted that firms which must employ outside paying agents and do not obtain free use of project note proceeds during the overlapping interest periods have been able to successfully compete for the purchase of project notes. These firms would not have to increase their interest bids to compensate for the elimination of free funds.

Acting on our belief that HUD should explore every opportunity to effectively reduce interest costs on project notes, we suggested to HUD that arrangements be made to use Federal Reserve Banks as paying agents on a cost reimbursable basis.

The Federal Reserve Bank (FRB) of New York advised HUD that it had some doubts whether there was legal authority for it to act as paying agent for project notes in view of the essentially local nature of LHAs and LPAs. From information furnished by HUD, the FRB estimated that its paying-agent service would cost about $350,000 a year. (We adjusted this amount to $410,000 to achieve the same workload basis used in our computation of duplicate interest costs.) The FRB said that HUD's housing and renewal assistance programs presented cost situations difficult to assess and operating problems difficult to resolve, and concluded that a change such as we were suggesting probably would create greater problems than those existing in the present system.

HUD agreed with the FRB and stated its belief that withdrawal of the interest overlap would adversely affect the marketing of project notes and the interest rates bid by note purchasers. Also, HUD stated that it was operating in the most erratic and unstable money market in recent memory and that any change in the paying agent procedure at this time would be especially critical.

We believe that the possibility of using FRBs as paying agents needs further in-depth study.

We recommend that you direct the Office of Audit to obtain meaningful information on the cost and effect of current paying-agent arrangements and possible alternative arrangements. We also recommend that you require the Assistant Secretary for Housing Production and Mortgage Credit to start working toward the time when an appropriate change in paying-agent procedures could be implemented to reduce the costs of the low-rent housing and urban renewal programs.

Please keep us advised of any action taken or contemplated on the matters discussed in this report.

Sincerely yours,

Max Hir

Max Hirschhorn
Associate Director

The Honorable
The Secretary of Housing and
Urban Development