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Report to Rep. Jack Brooks, Chairman, House Committee on Government Operations; Legislation and National Security Subcommittee; by Elmer B. Staats, Comptroller General.

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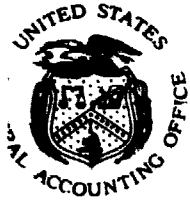
Congressional Relevance: House Committee on Government Operations; Legislation and National Security Subcommittee. Rep. Jack Brooks.

The Department of Defense (DOD) supplements the cost of morale, welfare, and recreation (MWR) programs with nonappropriated funds. These programs generate approximately \$5 billion in receipts each year which are managed by central offices in each military department. As of June 30, 1977, central funds had investments totaling approximately \$813 million. Findings/Conclusions: Several options were considered for involving the Treasury in holding and investing the cash, the most logical option being to transfer banking functions to the Treasury and limit investments to Treasury obligations. This practice would be consistent with Federal fiscal and accounting policies and would have the most safeguards, but it would reduce interest income and investment flexibility. Management of MWR activities did not maximize the effectiveness of cash and investment functions, thus reducing interest earnings. While many central activities used some centralized banking, the Army and Marine Corps did not. In central banking, receipts from many activities are pooled into one or a few banks, enabling central management to invest larger amounts of funds. Deficiencies noted in investment management practices were: defense collateral requirements were not being followed in all cases; the Army, Navy, and Navy Resale System Office had large percentages of their central investments concentrated in single banks or geographic areas; the Army borrowed approximately \$14 million to invest at a higher rate of interest than allowed by DOD instructions; the Army lacked specific investment objectives and policies; and the Marine Corps lacked central control over revenues. Recommendations: The Secretary of Defense should: direct the Army to adopt a centralized banking and accounting system to establish formalized objectives, goals, and procedures for cash flow management and to monitor its investment program;

direct the Army, Navy, and Marine Corps to comply with DOD requirements for collateral; and direct the Marine Corps to adopt a centralized banking and accounting system and consider incorporating these functions with the Navy's. (HTW)

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REPORT OF THE COMPTROLLER GENERAL OF THE UNITED STATES

Cash And Investment Management Of Department Of Defense Nonappropriated Funds Need To Be Improved

Department of Defense morale, welfare, and recreation activities generate about \$5 billion in nonappropriated funds annually. At June 30, 1977, they had invested \$813 million, much of it in non-Government obligations. These funds were accounted for entirely outside the jurisdiction of the Treasury Department, responsible for accounting and reporting for most Federal Government funds. If these funds are deposited in the Treasury and investments limited to Treasury obligations, greater safeguards would be applied, risk of loss reduced, and the Treasury would have information required for its management of cash resources and the public debt.

The Defense Department needs to improve immediately its nonappropriated fund cash and investment management. The Army should adopt central banking, require proper collateral for its investments, refrain from borrowing money to reinvest, and establish investment objectives. The Marine Corps should have central banking and investing and could share the Navy's systems. The Navy also should require proper collateral for its investments.



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

B-148581

The Honorable Jack Brooks, Chairman
Subcommittee on Legislation and
National Security
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report is in response to your April 26, 1977, request that we conduct an indepth review of the management of military central nonappropriated funds with particular attention to the investment practices and depository relationships of the funds. You also asked that we consider whether the best interests of the Government would be served if these funds were held by the Treasury and invested in Treasury securities.

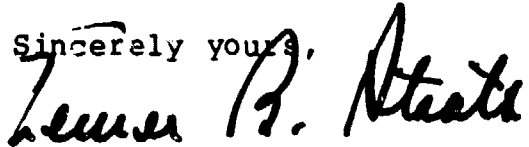
As you requested we did not obtain written comments from the Departments of Defense or the Treasury or discuss our findings and recommendations with them.

This report contains a recommendation to the Secretary of Defense. As you know section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

As arranged with your office, we plan no further distribution of this report until it is released. At that time we will send copies to the Department of Defense and

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other interested parties and make copies available to others upon request. We will soon be in touch with your office to arrange for its release and to set in motion the requirements of section 236.

Sincerely yours,


Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE SUBCOMMITTEE
ON LEGISLATION AND
NATIONAL SECURITY
COMMITTEE ON GOVERNMENT
OPERATIONS
HOUSE OF REPRESENTATIVES

CASH AND INVESTMENT MANAGEMENT
OF DEPARTMENT OF DEFENSE
NONAPPROPRIATED FUNDS
NEED TO BE IMPROVED

D I G E S T

Department of Defense nonappropriated fund programs generate approximately \$5 billion in receipts each year by providing morale, welfare, and recreation services to military personnel and their dependents. Central nonappropriated fund offices in each military department perform varying degrees of cash and investment management of funds. As of June 30, 1977, central funds had investments totaling approximately \$813 million. These were in certificates of account and deposit, insurance companies, savings accounts, and Treasury obligations.

At the request of the Chairman, House Government Operations Subcommittee on Legislation and National Security, GAO (1) considered whether the best interests of the Government would be served if central nonappropriated funds were held by the Treasury and invested in Treasury securities and (2) evaluated central cash and investment management by the military services.

GAO identified four possible ways of involving the Treasury in holding and investing the cash: (1) transfer banking functions to the Treasury with no nonappropriated fund investments, (2) transfer banking functions to the Treasury and limit investments to Treasury obligations, (3) transfer banking functions to the Treasury with investment authority retained by the morale, welfare, and recreation activities, and (4) no transfer of banking functions with investments limited to Treasury obligations.

Implementing any of these options is possible because the Treasury can establish the necessary mechanism to handle the services' cash. (See p. 6.)

Transferring banking functions to the Treasury and limiting investments to Treasury obligations (option 2 above) appears to be the most logical option. It is consistent with Federal fiscal and accounting policies and procedures and would provide greater cash management safeguards and less risk on investment. However, it would also reduce interest income and investment flexibility of the morale, welfare, and recreation activities. (See p. 8.)

Unless Defense can show that these disadvantages would outweigh the advantages of option 2, the Congress should enact legislation directing that these funds be put in the Treasury and specifying what the interest policy on such funds will be. Congressional action would be required in view of Defense's longstanding position that morale, welfare, and recreation activities should manage their own funds. (See p. 11.)

The morale, welfare, and recreation activities were not maximizing the effectiveness of their central cash and investment management functions, thereby reducing the interest earnings supporting their programs. While many central activities employed a form of centralized banking, the Army and Marine Corps did not. Central banking enhances both cash and investment management. In central banking, receipts from many activities are pooled into one or a few banks, enabling central management to invest larger amounts of funds. (See p. 12.)

For morale, welfare, and recreation activities, improved performance and investment earnings translate into a reduced need for further appropriated fund contribution and an increased ability to provide improved quality and expansion of services. GAO noted a need for improved investment management practices by various central nonappropriated fund activities.

- Defense collateral requirements were not being followed in all cases, thus increasing the risk associated with these investments.
- The Army, Navy, and Navy Resale System Office had large percentages of their central investments concentrated in single banks or geographic areas.
- The Army borrowed approximately \$14 million to invest at a higher rate of interest although Defense instructions prohibit this type of activity.
- The Army lacked specific investment objectives, policies, procedures, and documentation of investment decisions.
- The Marine Corps lacked a comprehensive central investment program, which resulted in a lack of central control over revenues and reduced interest income. (See p. 18.)

Transfer of banking functions to the Treasury depends on congressional action and would have to be carried out over a long period of time. However, the Department of Defense needs to improve immediately its cash and investment practices. Therefore, GAO is recommending that the Secretary of Defense direct:

- The Army to adopt a centralized banking and accounting system similar to the Air Force's.
- The Army to establish formalized objectives, goals, and procedures for cash flow management and to monitor its investment program.
- The Army, Navy, and Marine Corps to comply immediately with Defense requirements for collateral.
- The Marine Corps to adopt a centralized banking and accounting system and consider incorporating these functions with the Navy's. (See p. 19.)

As requested by the Chairman, GAO did not obtain written comments from the Departments of Defense or the Treasury nor discuss its findings and recommendations with them.

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ABBREVIATIONS

DOD	Department of Defense
GAO	General Accounting Office
MWR	Morale, welfare, and recreation

CHAPTER 1

INTRODUCTION

We reviewed the management of the military services' central nonappropriated funds in response to an April 26, 1977, request from the Chairman of the Subcommittee on Legislation and National Security, House Committee on Government Operations. We were asked to note particularly the investment practices and depository relationships of these funds. The Chairman also wanted our opinion on whether the Government's interest would be better served if these funds were required to be held by the Treasury Department and invested in Treasury securities. The review centered on the receipt, disbursement, and investment of cash and the feasibility and value of transferring cash functions to the Treasury.

BACKGROUND

Department of Defense (DOD) policy is to provide morale, welfare, and recreation (MWR) facilities from appropriated funds 1/ and to supplement the cost of establishing and operating the programs with nonappropriated funds. These programs are established to insure the mental and physical well-being of military personnel and their dependents. DOD estimates that about 12,700 activities (other than commissaries) carry out the programs, employing about 206,000 people and realizing about \$5 billion yearly in sales.

Revenue producing activities such as exchanges, consolidated package stores, and gas stations sell goods and services and, except for in-kind support, 2/ operate with nonappropriated funds. Profits from these activities are

1/Our previous report, "Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58), Aug. 31, 1977, indicates that the Government spends over \$600 million each year to subsidize these activities (other than commissaries).

2/In-kind support includes the free use of buildings, utilities, and services at installations. Costs are paid by appropriated funds.

distributed under prescribed formulas to headquarters, command, and installation support activities to provide other MWR programs (such as bowling alleys, gymnasiums, tennis courts, golf courses, marinas, and horseback riding). Most of these activities charge fees and produce nonappropriated funds for their own support. Clubs, messes, and other membership associations also generate operating revenue from charges for goods and services. Their goal is to break even or make a small profit for capital improvements. A description of categories of MWR activities is included as appendix II.

Central nonappropriated funds

Nonappropriated funds are cash and other assets received by MWR activities from sources other than congressional appropriations. They are Government funds not recorded in the books of the Treasurer of the United States and are used for the benefit of military personnel, their dependents, and authorized civilians who generate them.

Headquarters activities in the military services centrally manage most of the funds. Cash not needed immediately for program use is invested by the headquarters activities. The amount invested at June 30, 1977, was \$813 million. A list of amounts invested by military service is included as appendix III.

Command and base activities retain or receive a percent of profits from revenue-producing activities or receive loans, grants, and dividends from headquarters for operating, constructing, or renovating facilities for MWR. The command and installation activities may invest their reserves and temporarily excess cash locally or centrally through the headquarters activities. Because cash and investments were combined at installation level, we were unable to determine the exact amount invested locally. A conservative estimate based on activities' reports was \$50 million at June 30, 1977.

Resale and revenue-producing activities make daily deposits in commercial banks, usually the commercial banking facility on the installation. The money is then transferred to the headquarters activities, which have agreements or contracts with several commercial banks to perform banking services for them.

SCOPE OF REVIEW

We reviewed policies, procedures, and practices followed by the military services to administer central nonappropriated fund programs relating to MWR. As requested, we reviewed the management of these funds, paying particular attention to the investment practices and depository relationships. We performed our work at Army, Navy, Marine Corps, and Air Force headquarters, the Navy Resale System Office, and the Army and Air Force Exchange Service.

As requested, we also performed work at the military services' headquarters and the Treasury Department to see whether the Government's interest would be better served if these funds were required to be held by the Treasury and invested in Treasury securities. We also performed work at commands and installations in Europe and Hawaii to determine their role in receiving money from and sending money to the headquarters central funds.

We analyzed fund financial statements, accounting records, contracts and agreements with banks, and audit reports as they related to cash and investment activities. We also held discussions with responsible officials at military headquarters, commands, and installations and at the Treasury.

CHAPTER 2

SHOULD THE TREASURY HOLD

MILITARY CENTRAL NONAPPROPRIATED FUNDS?

Whether the Treasury should hold military central non-appropriated funds, whether it should have interest-free use of the funds, or whether the funds should be invested only in Treasury obligations are policy questions that should be answered by the Congress. We have identified benefits and disadvantages to the Government, the Treasury, and military MWR activities. We believe the Congress should specifically provide that the central nonappropriated funds be deposited in the Treasury as described in option 2 (p. 8).

POSSIBLE USES OF THE TREASURY

We identified four possible ways of involving the Treasury in holding and investing cash generated by DOD's MWR activities: (1) transfer banking functions with no investments (interest-free use of cash), (2) transfer banking functions and limit investments to Treasury obligations, (3) transfer banking functions with investment authority retained by the MWR activities, and (4) no transfer of banking functions with investments limited to Treasury obligations.

MWR activities (excluding commissaries) generate over \$5 billion in revenue annually. This cash is used in normal business operations or is accumulated for designated purposes and invested in certificates of deposit, certificates of account, Treasury obligations, repurchase agreements, and other instruments. Central funds amounting to about \$813 million were invested as of June 30, 1977. A major portion of the \$813 million was nonappropriated fund employee and employer contributions for employee retirement benefit plans. These are usually forwarded to contractors managing the policies and plans.

Central fund activities contract for banking services with a few major banks. The hundreds of MWR activities throughout the world deposit cash receipts at approved local banks, which transfer the cash to accounts in the contracted banks. MWR activities write checks on the contracted banks for their cash disbursements. This process is referred to as central banking, and the accounts are called concentration accounts.

Cash in concentration accounts consists of minimum balance requirements agreed to with the banks in addition to that required for current business transactions. For example, the Navy Resale System Office has agreements with three concentration account banks to handle its receipts and disbursements. On an average day these accounts have a gross balance of about \$17 million. Slightly less than half this amount represents funds that were credited to the account but uncollected by the bank. The remaining balance is referred to as the collected or available balance. Each bank requires the Navy Resale System Office to maintain a minimum available balance in the account to offset bank charges for servicing the account. The remaining available balance is invested in short-term certificates of deposit by the Office's investment manager.

The central funds had about \$31 million at June 30, 1977, in concentration accounts as minimum balances. These concentration accounts are collection points for deposits made at several hundred local banks and transferred periodically, usually daily. In addition to the minimum balances at the central level, local activities have to maintain minimum balances at their banks to offset bank service charges.

Option 1--transfer banking functions with no investments

Under this option all banking activity performed by commercial banks would be transferred to the Treasury. The Treasury would serve as a concentration bank and would assess service charges. No interest would be paid by the Treasury on these deposits, and MWR activities would not invest in either Treasury or commercial securities.

The Treasury would benefit from having several hundred million dollars of nonappropriated funds presently in the commercial sector. The precise amount would depend on how many of these funds were included in this proposal. It would be a detriment to DOD's MWR activities, however, since they would lose interest income which partly funds the various MWR programs.

All funds would be transferred to the Treasury and held until needed. Sources of such funds include sales revenues, proceeds from maturing securities held at the time of implementing this concept, compensating balances

now required by commercial concentration banks, and loan repayments by MWR activities. For the retirement programs, a decision would have to be made whether to allow reinvestments or require transfer of the money to the Treasury. If these investments were maintained, the amount of money available for Treasury use and the attendant benefit to the Government would be substantially reduced.

Transfer is possible

Nonappropriated fund banking functions can be transferred to the Treasury subject to some modifications to DOD and Treasury organization and operations.

The banking mechanism exists for local MWR activities to continue to deposit funds in local banks, which in turn would transfer the funds through the Federal Reserve System to the Treasury. Treasury officials did not envision maintaining separate accounts for each of the thousands of MWR activities, but rather one deposit fund with subaccounts for each service. Each service would administer the detailed accounts by activity and centrally monitor individual transactions. At the present time neither the Army nor Marine Corps is set up to administer detailed accounts since they do not have central banking programs.

The Treasury also could obtain the capability to perform the check payment and reconciliation services for MWR activities. It has taken the position that it should be reimbursed for costs incurred for these services. The Treasury also suggested that if it were to take over these banking functions, provision be made for legislation comparable to that provided for the administration of Social Security trust funds. Under the Social Security legislation, the agency determines the administration cost the general fund in the Treasury should pay and the part the agency should pay. The agency then certifies the amounts and authorizes and directs the Treasury to transfer the amounts.

Treasury benefits: interest-free use of funds

If the minimum balances for central fund bank accounts plus receipts from liquidation of all investments were transferred to the Treasury, it would have interest-free use of about \$845 million. Otherwise it would have to borrow from the public at a cost of about \$51 million a year assuming a 6-percent interest rate. In addition,

the Treasury would have interest-free use of additional millions of dollars--that part of the \$5 billion in sales receipts and other revenues in excess of current liabilities and on deposit in the Treasury.

MWR activities would reap some financial benefits in that large minimum balances in concentration banks now maintained by MWR activities would be free for other uses. This would be partially offset, however, by Treasury service charges. This advantage would be far outweighed by the loss of interest income on investments accumulated by MWR activities for employee retirement plans, self-insurance, severance pay, and other programs. This loss would have to be made up through other means such as improving operations, increasing fees to membership activities, increasing prices at exchanges and clubs, or receiving additional appropriated funds.

In several instances, DOD's MWR activities have contractual agreements with commercial banks for centralized banking services and insurance companies for employee retirement programs. Immediately transferring banking functions to the Treasury and canceling investments would require breaking contractual agreements, which could result in penalties or losses. An alternative, whenever possible, would be to phase in transfers to the Treasury as the contracts terminate.

Effect on minority banks

Transfer of commercial banking functions and divestiture of commercial investments, including those in minority banks, could adversely affect minority banks. At June 30, 1977, Federal funds on deposit in minority banks totaled \$99.8 million, of which \$22.4 million (22 percent) was DOD nonappropriated funds.

Transfer problems

If this option were to be implemented, we believe it should be carried out over a relatively long term. Current investments should be allowed to mature before depositing the proceeds in the Treasury, and contracts should be allowed to end before transferring banking services. Also, Army and Marine Corps decentralized operations would have to be centralized to deal with the Treasury, since the Treasury does not intend to deal directly with each MWR activity.

Option 2--transfer banking functions and limit investments to Treasury obligations

Under this option the Treasury would replace commercial banks as the central depository for nonappropriated funds. MWR activities would be able to invest in Treasury obligations and obtain interest income that could be applied toward funding MWR programs. However, the activities would not receive the higher interest they are now receiving on certificates of deposit and certificates of account. The primary benefit to the MWR activities may be the freeing up of the approximately \$31 million in central fund compensating balances now in commercial banks with no interest. This money would be a one-time saving that could be applied to the MWR programs, but MWR activities would bear the cost of Treasury services.

Treasury benefits under this option would not be as significant as under option 1. Although the Treasury would continue to use the nonappropriated funds deposited and invested, the benefits would be offset by interest payments to the MWR activities. As under option 1, a determination must be made whether to transfer all funds to the Treasury or to leave part, such as the retirement funds, invested in commercial sources.

Investment functions would remain with MWR activities even though investments would be restricted to Treasury obligations. Investment officers would continue to determine such factors as cash needs, amounts available for investment, type of security, and desired maturity date. Treasury officials said they did not want to assume DOD investment functions because they would not be in a position to know how much to invest.

Use of the Treasury as the central bank or depository would require all MWR activities to be centralized at the service headquarters level. At that level the military service could deal with the Treasury and maintain detailed summary records of cash and investments for its subordinate activities.

We believe, however, that this option is preferable because it reduces the risk of loss and provides greater safeguards if the funds are deposited with the Treasury and invested in Treasury obligations. Moreover, an overriding principle of Federal financial management is that all funds, including trust funds, received and disbursed by the Government as a result of its operations

shall be included in the Federal budget. We have consistently recommended to the Congress the inclusion of off-budget activities in the Federal budget. This concept was emphasized by the President's Commission on Budget Concepts in its October 10, 1967, report and has been accepted as an underlying concept of a sound financial plan for the Federal Government. This gives the Treasury information required for its management of cash resources and the public debt.

As a general rule only where the Congress has specifically provided to the contrary are funds received by the Government as a result of its operations not included in the Federal budget, not reported to the Treasury, and not deposited and disbursed in accordance with Federal fiscal and accounting policies and procedures as prescribed by the Office of Management and Budget, the Treasury, and GAO. In view of DOD's longstanding position that MWR activities should manage their own funds, however, clarifying legislation should be enacted, directing that these funds be put in the Treasury and specifying what the interest policy on such funds will be.

Option 3--transfer banking functions
with investment authority
retained by MWR activities

Under this option the Treasury would replace commercial concentration banks. MWR activities, however, would retain investment management authority to invest in securities approved by DOD. The primary benefit would be eliminating several million dollars in compensating balances now required by the commercial concentration banks. But, the cost of Treasury banking would be borne by the MWR activities.

In any event the Treasury would get only limited short-term benefits on nonappropriated funds deposited while awaiting disbursement or investment. No apparent significant benefits would accrue to the Government by implementing this option.

Option 4--no transfer of banking functions
with investments limited
to Treasury obligations

Under this option MWR activities would continue to use commercial banks, but would be restricted to investing only

in Treasury obligations. Little advantage would accrue to the Government since the Treasury would obtain the use of several hundred million dollars, but would have to pay interest on it as it would to any investor. MWR activities in this instance simply replace private buyers of Treasury securities.

Restricting MWR activities investments to Treasury securities could adversely affect their rate of return on investment if Treasury yields should fall below commercial rates.

CONCLUSIONS

Transferring banking functions to the Treasury and limiting investments to Treasury obligations (option 2) appears to be the most logical option and is consistent with Federal fiscal and accounting policies and procedures. Transfer is possible since the Treasury can put the necessary mechanism in place to handle nonappropriated funds. In view of DOD's longstanding position that MWR activities should control their own funds, however, clarifying legislation should be enacted, directing that these funds be put in the Treasury and specifying what the interest policy on such funds will be. Also, the Army and Marine Corps would have to centralize accounting. Any proposed transfer would have to be carried out over a long period of time to avoid disruptions, honor existing contracts, and give the Treasury and DOD time to resolve the problems.

The Treasury under option 1 would benefit from interest-free use of (1) the \$813 million invested by MWR activities (largely in certificates of deposit and account) and (2) operating funds between receipt and disbursement. Also, MWR activities would not need to maintain large compensating balances at commercial banks and could use these funds for MWR activities. They would incur Treasury service charges, however. The \$813 million in investments consists largely of trust funds for retirement programs and severance pay and reserves for self-insurance, construction, and renovation purposes. This interest-free use of funds, however, would deprive MWR trust funds and activities of returns on their investments.

To maintain sound retirement programs and provide adequately for contingencies, the MWR activities would have to replace the loss of interest income through some means or

reduce programs. If funds were invested in Treasury obligations as in options 2 and 4, however, the Treasury would not benefit from the use of most of the \$813 million and MWR activities would still lose income and investment flexibility.

RECOMMENDATION

Unless Defense can show that these disadvantages would outweigh the advantages of option 2, the Congress should enact legislation directing that these funds be put in the Treasury and specifying what the interest policy on such funds will be. Congressional action would be required in view of Defense's longstanding position that morale, welfare, and recreation activities should manage their own funds.

CHAPTER 3

CASH AND INVESTMENT MANAGEMENT

SHOULD BE IMPROVED

The military services have an immediate need to improve their cash and investment management. These improvements should not be delayed until congressional action on transfer of banking functions and interest rates on nonappropriated fund investments is taken. Cost reductions, better management, and greater efficiencies can be achieved through centralized banking, investment, accounting, and other management improvements.

DOD nonappropriated fund policy, although providing guidance for cash and investment management, allows the military services latitude in implementing cash management procedures. As a result, each service manages cash differently. The Air Force and Navy manage cash centrally through headquarters, whereas the Army and Marine Corps activities manage cash at the installation and command levels. Unlike the other services, the Army has no specific investment objectives, policies, or procedures. The Army and Navy concentrate large investments in a few banks and geographic areas, and they did not require proper collateral on their investments. The Army, contrary to DOD instructions, commercially borrowed money and reinvested it at more desirable rates. The Marine Corps lacked a central investment program and could benefit by sharing the Navy's central banking system.

THE ARMY AND MARINE CORPS SHOULD ADOPT THE CENTRAL BANKING CONCEPT

The objective of a central or consolidated banking program is to produce information that will allow program managers to control account balances and make timely investments of cash resources. The headquarters activities managing the central nonappropriated funds generally enter into agreements with a few large banks to obtain cash management services. The MWR activities scattered throughout the world generally deposit cash daily at approved local banks which transfer the money to the central account at the contracted bank. Disbursements are made by writing checks on the central bank.

Central banking permits writing checks on one account with one minimum balance requirement. It also eliminates passing cash through several activities and accounts before coming available for investment. The Army, as an example of decentralized banking, requires about 20 days each month to collect money from local activities for employee contributions for retirement and life and medical insurance. If central banking were used, these funds should be available for investment a few days after being withheld from employee pays.

The Navy, Air Force, Army and Air Force Exchange Service, and Navy Resale System Office use various forms of central banking. Decentralized banking is used by the Army and Marine Corps. The Air Force has an arrangement which pays interest to each membership or revenue-producing activity in the central banking program. Central banking, in conjunction with better contracts with commercial banks, could result in improved control and increased income to the activities. For example, Army, Navy, and Marine Corps MWR activities in Hawaii could increase their rates of return on investments by approximately 2 percent if they operated under the Air Force concept.

Air Force MWR activities do not have individual accounts in regular banks, but rather use the Air Force Central Welfare Fund account in the local bank. Activities make deposits through these accounts and electronically report them to the Welfare Fund. Deposits not required to compensate local banks for services rendered are subsequently transferred to the concentration bank by electronic notification and depository transfer checks.

Another central system is used by the Navy Resale System Office. It maintains three concentration bank accounts through which all Navy exchange sales receipts are deposited, disbursements made, and investments transacted. Domestic retail activities deposit daily receipts in local banks. Many activities prepare a transfer check in the deposit amount and mail it to the concentration bank, a process which results in delays of 2 to 15 days and which in turn delays investments of the funds. Depository practices of the other domestic exchanges provide for immediate credit to the account of the Navy Resale System Office.

The Army and Marine Corps, in contrast, continue to use the decentralized (or individual) bank account concept. Funds idle under this concept could be available for use by

a central fund manager. Under the Army concept for clubs, in the Central Investment Program, money is deposited in the local bank and an installation accounting unit does the accounting. If money is determined to be in excess of current needs, the accounting unit is notified by the fund custodian to draw a check on the local bank and mail it to Army headquarters. Headquarters then deposits the check in its bank account. When sufficient funds have been accumulated, the investment officer in headquarters arranges to buy a security. Two to 3 weeks can pass from the date of initial deposit at the local level to the date of investment.

Army officials said they wanted decentralized banking to support the military banking facility program, and they did not know whether central banking was any better. They recently initiated plans to study central banking. Marine Corps officials believe local commanders know unit needs best and should control local funds.

Central banking has its cost, most commonly paid by maintaining compensating balances that earn no interest. Conversely, the cost of decentralized banking is the combined loss of interest at each installation from not investing cash, delays in investing cash, or investing in low-yield securities. Savings from central banking can more than offset its costs. Timely investment of excess operating funds at the best available rate is the most effective way to keep the nonearning balance in the operating accounts to a minimum.

IMPROVED PERFORMANCE IN INVESTMENT MANAGEMENT IS NEEDED

DOD policy permits MWR activities to invest cash being reserved for contingency purposes or used in normal business operations. Investments are limited to low-risk, short-term securities sold by the Treasury, commercial banks, credit unions, or savings and loan associations or insured by Federal Government agencies. DOD's goal is to obtain maximum return on and protection of its investments.

An activity's investment manager may operate through one or more third parties (brokers or money managers) or make investments directly. Because money markets are often volatile, timing and knowledge of the market are important in investing wisely. Procedures and controls are also necessary to assure sound investments and to avoid preferential investments.

The services' central fund activities differ to some extent in how they manage investments. In some cases we found that collateral requirements were not met, large investments were concentrated in a few banks or geographic areas, funds were inappropriately borrowed to invest at a higher rate of interest, and limited investment guidance existed. Further, all services except the Marine Corps have a central investment program. We believe procedural changes are necessary to obtain maximum return and reduce the risk on the services' investments.

Requirements for collateral not met

DOD Instruction 7000.12 states that investments in bank savings accounts, time deposits, and certificates of deposit are limited to the extent that they are insured by the Federal Deposit Insurance Corporation or by pledge of collateral to the Treasury when they are not insured. ^{1/} In many cases the investing activities made investments that were not insured by the Federal Deposit Insurance Corporation or protected by pledged collateral, thereby increasing the risk of loss.

In violation of DOD policy, the Navy follows a practice of securing collateral after, rather than before, the investment purchase. Further, a number of Navy investments (certificates of deposit) were not protected by the Federal Deposit Insurance Corporation insurance or pledged collateral.

The Army required collateral for only one investment in the past 2 years, but written notice of the collateral was not received until after the security had matured. The Army relied on Federal Deposit Insurance Corporation insurance to cover its investments. Many of its investments, however, were not covered by this insurance or by pledged collateral. Failure to require collateral could result in loss of funds or lengthy delays in collection if a bank closes.

We could not readily determine whether the Marine Corps required appropriate collateral because its investments are highly decentralized and little information exists on them at Marine Corps headquarters.

^{1/}DOD policy also provides that certificates of account at savings and loan associations be insured by the Federal Savings and Loan Insurance Corporation.

Investments concentrated in few banks

The Army and Navy had large percentages of their central investments concentrated in single banks or geographic areas. At June 30, 1977, the Army had 48 percent of its investments in one bank, and the Navy had 42 percent of its certificates of deposit (35 percent of its investments) in one bank. The Navy Resale System Office had nearly all investments in New York City banks, indicating that banks outside the area may not have been contacted for interest quotations. Concentrating large amounts of investments in single banks could have an adverse effect on a bank in the event of quick lump-sum withdrawal by the military investor. Also, concentrating investments in one geographic area prohibits availability of competitive rates outside the area.

Army borrowed funds to increase investment yield

The Army commercially borrowed \$10.8 million as of June 30, 1977, and increased the amount to \$14.8 million by August 1977 to finance purchases of certificates of deposit maturing over a longer period and earning more than the cost of the borrowed funds. DOD instruction allows the investment of only excess funds and precludes this type of activity. When we discussed this practice with Army officials, they said they were taking steps to pay back the borrowed funds and would not borrow again.

Army investment guidelines are limited

The Army does not have specific investment objectives, policies, or procedures. Their absence permits poor investment management and subjects Army officials to charges of failure to exercise their trustee responsibility. An Army internal audit report noted similar deficiencies nearly 4 years ago. Specific policies and objectives should be issued addressing such areas as investment composition, limitations or prohibitions regarding investment type or technique, conflicts of interest, expected return, portfolio review program, limitations on portfolio turnover, and limitations on the percentage of funds that may be invested in a particular security or group of securities.

In addition to not having specific objectives and policies, the Army has no record of what it does to assure

compliance with general regulations. We could therefore not determine what the relationship of the investment officer to patronized brokers and bankers was, how one investment was selected over others, why funds were borrowed to reinvest, or why investment decisions were made.

Marine Corps needs a central investment program

The Marine Corps is considerably more decentralized than the other services. MWR activities at each installation are relatively independent of those at other installations and Marine Corps headquarters. Recreation funds and consolidated club systems invest revenue that is not considered necessary for immediate needs in local accounts. No central investment program for these activities currently exists; however, the Marine Corps exchange system offers its exchanges a voluntary central investment program.

To illustrate the need for a central investment program, Marine Corps MWR activities in Hawaii had approximately \$2.6 million in local investments at an average return of 5.6 percent at June 30, 1977. Other Pacific clubs had local investments drawing interests as low as 3.5 percent. If a central investment program were available, we estimate these activities could earn up to 7.5 percent (based on the Air Force current central investment program rate of return), or an additional \$114,000 a year interest income.

Marine Corps could benefit by sharing Navy banking system

The Marine Corps does not have a central banking system but could benefit by sharing the Navy system. Marine Corps headquarters, however, centrally invests assessments it collects from recreation and mess activities until they are redistributed to MWR activities. Based on the best available information, the Marine Corps could earn \$300,000 more each year under a central banking system.

The Navy can provide central banking, investment, and accounting services to the Marine Corps recreation and mess funds. The Navy also noted that its central accounting unit already prepares some reports for the Marine Corps, and the Comptroller's office provides investment collateral services. The Marine Corps is currently studying automated accounting, but using the Navy system would eliminate duplicate systems.

The Marine Corps officials stated that the Commandant believes all nonappropriated fund operations should be the responsibility of the installation commanders and is opposed to centralization. Since centralized banking involves money management and not program management, we believe the Marine Corps could still function on a decentralized basis without reducing control. Centralizing would relieve staff of administrative duties, however, such as preparing financial statements, investing, and reconciling bank statements. Each commander would still determine how the funds are to be used. We believe the Marine Corps also should take advantage of the Navy banking system and should not duplicate it.

CONCLUSIONS

The Army and Marine Corps can improve their cash and investment management by adopting a central banking concept similar to that used by the Air Force or Navy. Adopting centralized banking should result in a greater return on investment through more timely and efficient cash flow. The Marine Corps could realize a greater return on its investments by establishing a central investment program. Also, the Marine Corps should seriously consider consolidating its cash and investment functions with existing Navy central operations.

By not requiring full collateral for their investments the military services are not meeting their responsibility to properly protect investments of nonappropriated funds belonging to the central funds and to MWR activities and their employees. This was perhaps the most serious shortcoming in investment management and should be corrected immediately. To improve its operations specifically relating to investing in one bank, borrowing funds, and failing to require collateral for investments, the Army should establish specific objectives, goals, and procedures for cash flow management and monitor its investment program more closely to insure that prescribed procedures are followed.

These improvements should result in cost reductions, better management, and greater efficiencies. Therefore, action should be taken promptly, and the services should not wait until action is taken to transfer banking functions to the Treasury and restrict investments to Treasury obligations.

RECOMMENDATION

We recommend that the Secretary of Defense direct

- The Army to adopt a centralized banking and accounting system similar to the Air Force's.
- The Army to establish formalized objectives, goals, and procedues for cash flow management and to monitor its investment program.
- The Army, Navy, and Marine Corps to comply immediately with requirements for collateral set forth in DOD directives.
- The Marine Corps to adopt a centralized banking, investment, and accounting system and consider incorporating these functions with the Navy's.

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NINETY-FIFTH CONGRESS

Congress of the United States

House of Representatives

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

RAYBURN HOUSE OFFICE BUILDING, ROOM B-373

WASHINGTON, D.C. 20515

225-9147

April 26, 1977

Honorable Elmer B. Staats
Comptroller General of the United States
General Accounting Office
441 "G" Street, N.W.
Washington, D. C. 20548

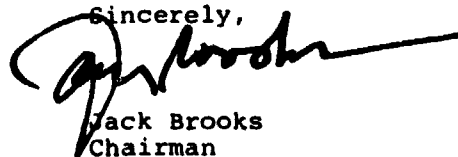
Dear Mr. Staats:

The revenues from nonappropriated fund activities of the military services are held in various central funds. These funds which now total several hundred million dollars are managed by the individual services.

Please have the General Accounting Office conduct an indepth review of the management of these funds with particular attention paid to the investment practices and depository relationships of the funds. Included with this review should be a GAO opinion on whether or not the Government's interest would be better served if these funds were required to be held by the Treasury Department and invested in Treasury securities. Please provide this opinion as soon as GAO can give it rather than waiting for the review to be completed.

Please do not discuss your findings or recommendations with any of the departments involved.

Sincerely,


Jack Brooks
Chairman

DEPARTMENT OF DEFENSEPROPOSED CATEGORIES OF MWR ACTIVITIES

<u>Category</u>	<u>MWR activity</u>
I	Exchanges.
II	Other resale and revenue-sharing activities--civilian employee restaurants and cafeterias, alcoholic packaged beverage stores, Stars and Stripes newspapers, and resale audio clubs.
III	Military general welfare and recreation, divided into the following subgroups.
	<p>IIIA--fund custodians at headquarters, major commands, and installation and unit levels providing support to other MWR activities.</p> <p>IIIB--operating activities subdivided into three groups according to their revenue-generating potential. Following are examples.</p> <p> IIIB-1--Libraries, intramural sports, recreation centers/rooms, and free admission movies at isolated posts and aboard ship. These have little potential for generating revenue and are expected to be primarily appropriated-funded.</p> <p> IIIB-2--Arts and crafts, entertainment, outdoor recreation, swimming pools, youth activities, sports above intramural level, child care centers, stables, marinas, and boating. These are considered to have some potential to earn nonappropriated fund revenues.</p> <p> IIIB-3--Bowling, golf, movies (paid admission), tour, travel information, and ticket service, skating rinks, pro shops, amusement machines, snack bars, skeet and trap ranges, Armed Forces</p>

CategoryMWR activity (cont.)

recreation centers, cabins, and cottages. Operation of these activities is expected to be primarily nonappropriated-funded.

- IV** Civilian employee general welfare and recreation funds.
- V** Open messes.
- VI** Membership associations other than open messes such as flying clubs, yachting clubs, motorcycle clubs, etc.
- VII** Common support services rendered to nonappropriated fund instrumentalities. Pertains to consolidated offices which give support such as accounting, procurement, and personnel to several MWR activities. Does not include normal staff management functions whose costs are chargeable to the benefiting category.
- VIII** Supplemental mission services. These are funds that are adjuncts to mission-oriented services, such as billeting, museums, and chaplains. Only the costs of collecting, accounting for, and disbursing nonappropriated funds are to be reported, not the cost of the entire function.

SCHEDULE OF FUNDS INVESTED CENTRALLYBY THE MILITARY SERVICESJUNE 30, 1977

<u>Service</u>	(millions)
Army	\$101.8
Navy	109.4
Air Force	129.8
Marine Corps	16.5
Marine Corps Exchange	19.0
Army and Air Force Exchange Service	58.7
Navy Resale System Office	<u>30.3</u>
Total	<u>465.5</u>
Total retirement funds invested for the services	<u>347.7</u>
Total all funds	<u>\$813.2</u>

(963067)