RESTRICTED — Not to be released outside the General Accounting Office except on the basis of specific approval by the Office of Congressional Relations.

REPORT BY THE Comptroller General OF THE UNITED STATES

7414

RELEASED

Evaluation Of Agency Comments On Cash And Investment Management Of Defense Nonappropriated Funds

GAO reviewed the management and investment of Defense central nonappropriated funds and recommended that the Congress enact legislation directing that these funds be

--deposited in the Treasury and invested in Treasury securities and

--specifying what the interest policy on such investments would be.

GAO also recommended that Defense tighten present management and financial controls.

Defense disagreed with the recommendations regarding the Treasury, manintaining that (1) nonappropriated fund income would be lost, principally on investments, and (2) financial management would be hampered. GAO has consistently urged that nonappropriated funds be handled through the Treasury and reflected in the Federal budget. Defense and the Treasury, in commenting on the recommendation, did not provide any detailed information which would cause GAO to change its position, and unless they do, the Congress should enact GAO's suggested legislation.

RELEASED

FPCD-78-78
OCTOBER 11, 1978

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 letter is in response to your request of May 31, 1978, for our evaluation of the Departments of Defense's and the Treasury's comments on our report entitled "Cash and Investment Management of Department of Defense Nonappropriated Funds Need To Be Improved" (FPCD-78-15, Jan. 19, 1978). This report had not been formally commented on by Defense and the Treasury, and you were particularly interested in whether any of the agency comments would cause us to change our recommendations. In brief, neither has presented any information to change our position. Defense provided a number of arguments, some of which may have merit, but without details and analysis, it is not possible on balance to determine whether its position is justified.

Our major recommendation, set forth in chapter 2 of the report, was that unless Defense can show that the disadvantages outweigh the advantages, the Congress should enact legislation (1) directing that Defense nonappropriated funds (NAFs) be put in the Treasury and invested in Treasury securities and (2) specifying what the interest policy should be. This recommendation envisioned NAF receipts being deposited to the credit of the Treasury and funds excess to current operating needs being invested in Treasury securities. The recommendation was primarily based on the overriding principle of Federal financial management that all funds, including trust funds, received and disbursed by the Government as a result of its operations, should be deposited with the Treasury and included in the Federal budget.

As noted in the report, we have consistently recommended to the Congress that off-budget activities be included in the Federal budget. We stated that as a general rule, only where the Congress has provided to the contrary are funds received by the Government as a result of its operations (1) not included in the Federal budget, (2) not reported to the Treasury, and (3) not deposited and disbursed in accordance with Federal fiscal and accounting policies and procedures as prescribed by us, the Office of Management and Budget, and the Treasury in accordance with statutes enacted by the Congress.

We also made this recommendation, in part, because we are concerned with financial responsibility and accountability for NAFs, particularly those within the Department of Defense, which has about 98 percent of the Federal personnel-related NAFs. The problems in controlling Defense NAFs that surfaced in the late 1960s were due in part to the lack of systemic controls similar to those normally applied to appropriated funds. Financial management and auditing of the Defense NAF instrumentalities have been greatly improved in recent years. Nevertheless, stewardship of NAFs can and should be improved.

Requiring NAFs to be deposited in the Treasury and invested in Treasury securities, along with attendant control and reporting systems or procedures that must necessarily be introduced, should enhance NAF stewardship.

In commenting on our major recommendation, Defense contended that

--NAFs are not Government funds,

--NAFs are handled in accordance with present policies, and

--no requirement exists to deposit NAFs in the Treasury or to include them in the Federal budget.

Defense stated that the current investment policy fully complies with Treasury Circular No. 176 (regulations governing depositaries and financial agents of the Government) which the Department claimed clearly recognizes and provides for operating NAFs off-budget.

Defense opposed the recommendation on depositing NAFs in the Treasury because the recommendation has no apparent advantage to the Government or Defense. On the contrary, Defense contended that adoption of the recommendation will (1) result in loss of revenue to the nonappropriated fund instrumentalities (NAFIs), (2) adversely impact local (particularly minority) banks, and (3) possibly increase appropriated fund costs of overseas military banking facilities.

Our position that NAFs are Government funds is supported by the fact that the funds are maintained and controlled solely by instrumentalities of the Government. This characterization is consistent with the explanation of NAFs in DOD Manual 1330.191M "Personnel Policy Manual for Nonappropriated Fund Instrumentalities" (Sept. 6, 1974) as follows:

"Nonappropriated Fund Instrumentality (NAFI) is an integral DoD organizational entity which performs an essential Government function. * * * It is established and maintained individually or jointly by the heads of the DoD Components. It maintains custody of and control over its nonappropriated funds. * * * It is not incorporated under the laws of any State or the District of Columbia and it enjoys the legal status of an instrumentality of the United States.

"Nonappropriated Funds (NAFs) are cash and other assets received by NAF Instrumentalities from sources other than monies appropriated by the Congress of the United States. NAFs are Government funds; * * *." (Emphasis added.)

Our position is further supported by the determination of the Federal Deposit Insurance Corporation (FDIC) that NAFs are "public funds" as that term is used in 12 U.S.C. 265, and thus may be insured as such under the authority of 12 U.S.C. 1821. "Public funds," as used in 12 U.S.C. 265 includes "* * * any funds the deposit of which is subject to the control or regulation of the United States or any of its officers, agents, or employees.

We have consistently maintained our position with regard to exerting greater Government control over NAFs since we issued a comprehensive report on NAF activities throughout the Government (B-45101, Aug. 10, 1949) nearly 30 years ago. Citing various statutory provisions which are still in effect today, particularly 31 U.S.C. 484 (which requires the deposit in the Treasury of the gross amount of all moneys received for the use of the United States except as otherwise provided) and 31 U.S.C. 725s (which generally requires deposit in the Treasury of funds received by the Government as trustee), we expressed serious concern over the legality of agencies' practice of not depositing NAFs in the Treasury. We stated that the Congress had not "otherwise provided" for disposition of the subject funds, and clearly the Government held a number of such funds in the capacity of a trustee. Nevertheless, in recognition of the agencies' longstanding practice and the fact that literal compliance with the cited statutes could be impracticable in some cases, we recommended that clarifying legislation be enacted which would outline

--the activities which could be conducted,

--their financing and accounting, and

--the disposition of both appropriated and nonappropriated funds.

We have maintained this position ever since, most recently advancing it in our January 1978 report. In 1962, for example, in response to the request of the then Chairman of the House Committee on Government Operations, we stated:

> "The position of the General Accounting Office with regard to nonappropriated funds remains as stated in reports to the Congress B-45101 and I-17351. It is our opinion that clarifying legislation is necessary to outline the income-producing activities which might be properly carried on, the financing thereof, and the accounting for and disposition and use of the funds involved * * *." (B-148581 dated April 30, 1962.)

Similarly, we have consistently recommended to the Congress that off-budget activities be included 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 Government. In our opinion, this concept clearly should extend to NAF activities, just as many other trust revolving funds, considering the millions of dollars involved and the fact that the funds are maintained and controlled solely by Government instrumentalities. The Congress should be aware of the total magnitude and nature of these activities, and placing NAF activities on the Federal budget can significantly contribute to this end.

Defense stated that its current investment policy for NAFs fully complies with Treasury Circular No. 176, which <u>clearly</u> recognizes and provides for operating such funds off-budget. This Circular, implementing 12 U.S.C. 265, simply provides for the designation of depositaries of public money of the United States and financial agents of the Government, and authorizes the deposit of public money in such depositaries. As stated earlier, the FDIC has determined that NAFs qualify as public funds within the meaning of 12 U.S.C. 265.

Although Defense did not specify why it believed its investment policy complies with the Treasury Circular, it appears that Defense relied on those sections of the Circular which provide that (1) every bank insured by FDIC is "designated as

a depositary and Financial Agent of the Government" and (2) each depositary is authorized "without further action, to accept a deposit of public money in an official account, other than an account in the name of the United States Treasury."

Although NAFs are deposited pursuant to the Treasury Circular, such deposits are not in Treasury accounts in those depositaries, and for this reason, we do not think the degree of control is or can be maintained within the meaning of our recommendation that NAFs be deposited in the Treasury. A proper degree of control could be achieved only by transferring the NAFs to Treasury accounts within authorized depositaries.

With regard to Defense's statement that Treasury Circular No. 176 clearly recognizes and provides for operating NAFs off-budget, we find no such clear authorization. The fact that public funds are deposited in authorized depositaries within the intent of the Circular does not and should not preclude the placement of such funds in the Federal budget for purposes of greater congressional awareness.

The operations of NAFIs should be portrayed in the Federal budget as are similar business-type operations such as the Navy Midshipmen's store, Navy ships' stores, the Veterans Canteen Service, and a number of others. We are not aware of any NAF activity that could not be successfully operated through a revolving trust fund account.

We recognize there will be advantages and disadvantages to depositing NAFs in the Treasury. (A detailed discussion is contained in app. I.) For example, we agree there is a possibility that some revenue may be lost to the NAFIs if the Congress does not authorize the Treasury to pay interest rates on NAFI investments equivalent to what they might otherwise earn in the commercial market. On the other hand, adoption of the recommendation may also increase interest income by making more cash available for investment and reduce operating costs through centralized accounting and banking, including the elimination of compensating balances.

Some business may be withdrawn from local banks, including minority-owned banks. It must be presumed that the NAFIs were paying only for services rendered and most of the banks will continue to be Treasury depositaries. Investments in financial institutions would be decreased, and this would reduce the level of funds with which they may operate. The majority of the investments are in larger institutions, which the military services maintain should be able to attract

other customers. Overseas military banking facility business should not be appreciably reduced since deposits to the Treasury also would be made through them.

Defense provided a number of arguments, some of which may have merit, but without details and analysis, it is not possible to determine whether their position is justified. In view of the general statutory requirement that Government moneys and moneys held by the Government as trustee be deposited in the Treasury (31 U.S.C. 484, 31 U.S.C. 725s), we believe the burden is on Defense, which itself classifies NAFs as Government funds, to clearly show why NAFs should not be deposited in the Treasury and placed on budget. In the absence of convincing evidence to this effect, we must necessarily maintain our previously expressed position.

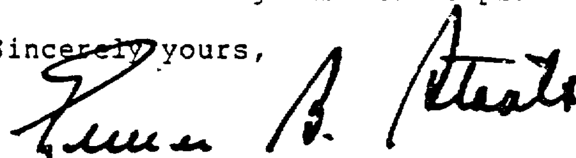
We are pleased that Defense and the military services are responding favorably to our recommendations that

- --the Army and Marine Corps adopt central banking;
- --the Army establish formal objectives, goals, and procedures for cash management and monitor its investment program; and
- --the Army, Navy, and Marine Corps comply with collateral requirements.

The military services have taken exception to a number of our statements regarding their practices and procedures at the time of our review, and these are addressed in appendix II.

We appreciate the opportunity to respond to Defense's and the Treasury's comments on our report. Your Office requested that we make no further distribution of the report prior to a determination of the need for hearings at which the report will be used. We expect that determination to be made within the next 30 days, after which we plan to distribute copies of the report to interested parties if no hearings are contemplated.

Sincerely yours,



Comptroller General
of the United States

DEPOSIT OF DEFENSE NAFs IN THE TREASURY AND INVESTMENT IN TREASURY SECURITIES

TREASURY CAN PROVIDE SERVICES

Defense comments

Defense states it cannot assess the cost or responsiveness of proposed Treasury management of NAFs in the absence of data or analyses. The military departments maintain that the Treasury cannot provide the business-oriented banking services their NAFIs require nor could the Treasury be expected to be responsible in view of a 1975 GAO report 1/ purportedly critical of Treasury management of overseas military banking facilities. The military departments contend specifically that

--the Government does not maintain sufficient disbursing offices and

--the Treasury cannot provide the service/sales-generating NAFIs the line of credit they need, decentralized disbursing, or full commercial-type services.

Evaluation

It would be difficult to determine the additional costs that would be incurred by the Treasury as a result of depositing NAFs in the Treasury. Whether these costs would be greater or less than those now being paid to private institutions by the NAFIs can only be determined by a detailed cost analysis. The Treasury was unable to provide detailed costs necessary to make such an analysis.

The Treasury stated it is capable of performing banking functions for NAFs by establishing a deposit fund account for each of the military departments, and it would expect to be reimbursed for its services. The Treasury is not organized to provide the services the military departments claim are needed by the NAFIs. The Treasury does not provide

---

1/"Overseas Military Banking: How It Is Financed and Managed" (ID-76-29, Dec. 12, 1975).

detailed check reconciliation, cannot provide current account balances daily, nor can it advance public moneys to the NAFIs. The Treasury maintains the military departments must keep detailed accounts of their transactions. Such accounting should be a part of centralized accounting, banking, and investment programs the military departments should have to effectively manage their NAFI operations and investments.

Within the Treasury system, NAFs would continue to deposit receipts in local banks designated as Treasury depositaries. Instead of maintaining funds in the banks (or in central banks) to compensate them for services, the banks would be paid directly by the Treasury. The funds would be transferred immediately through the Federal Reserve System to the credit of the Treasury. The funds could (1) remain idle until disbursed by the disbursing officers on behalf of the NAFIs; (2) be invested in Treasury securities upon advice from NAFIs; or (3) be immediately invested by the Treasury in Treasury securities, and liquidated as needed to cover checks issued to the account of the NAFIs. In the latter instance, funds could be invested more quickly and to a greater extent than now realized by NAFIs.

NAFs could be disbursed efficiently by disbursing officers upon receipt of validated advice from the NAFIs. Generally, in the past, the failure to pay bills on time has resulted from agencies' failure to timely process paperwork. Defense disbursing officers currently issue checks and do not need to wait for paperwork to be processed through Treasury disbursing offices. Furthermore, good cash management does not always dictate quick payment but rather timely payment. That is, pay bills only when due or early enough to realize discounts, but not earlier.

Although the Treasury may not provide, within its existing system, the unique business-oriented services the NAFIs now receive from commercial bankers, it does not appear this would adversely affect those NAFIs. The Treasury already provides banking services through revolving or trust revolving funds for such business-oriented functions as the Navy ships' stores; Navy Midshipmen's store; Air Force Cadet Fund; surcharge collections for Army, Navy, Marine Corps, Air Force, and Coast Guard commissaries; Federal Prison Commissaries; and the Veterans Canteen Service. Commissary store receipts and disbursements through revolving stock funds also are handled by the Treasury.

Defense has over 350 disbursing officers to meet the diverse needs of Defense units throughout the world. NAFIs are usually collocated with these units. Deposits and disbursements for NAFIs should be handled the same as for those units. If necessary, additional disbursing officers could be designated. They could be either military personnel, or U.S. civilian employees paid from either nonappropriated or appropriated funds.

Our report on overseas military banking facilities stated that the Treasury had not provided definitive, standardized program guidelines for the banks, and bank operating losses could be reduced if actual bank earning capacities were used instead of Treasury formulas to determine earning rates on account-holders' deposits. Since the Treasury did not handle or manage the cash or investments, we did not imply any criticism of those functions. Neither did we question the banks' abilities to act as Treasury depositaries.

BENEFITS AND DISBENEFITS OF TRANSFER TO TREASURY

Defense comments

Defense strongly opposes our recommendation that legislation be enacted to require that NAFs be deposited in the Treasury because the recommendation has no apparent advantage to the Government unless the Government were to pay a lesser rate of interest than the prevailing rate for other borrowings. Defense also sees no advantage to itself--only disadvantage. Defense claims that freeing compensating balances is an option not related solely to depositing NAFs in the Treasury. Defense points out the following disadvantages:

--The check float would be lost.

--Reduction in compensating balances in overseas military banking facilities would result in increased appropriated funding of them.

--Local U.S. communities would be affected.

--Minority banks would be adversely affected.

--Prices for goods and services would be increased and/or morale, welfare, and recreation (MWR) programs would be curtailed.

Additionally, the military departments point out that:

--Large amounts of NAFs would be eliminated.

--Appropriations for MWR programs will have to be increased.

--The Government will incur substantial additional costs for fiscal administration.

--Soldiers and their families will foot more of the MWR bill.

--The integrity of retirement programs will be compromised or rendered actuarially unstable, requiring additional cash contributions and reduced effectiveness in attracting and retaining competent personnel.

--Cash discounts may be lost.

--Addition of appropriated fund budgeting and accounting procedures would cost more.

--Under no circumstance would interest earned increase.

--Extrication from retirement pension management would be expensive and complicated.

--The Government would receive complaints of intervention in or assumption of private commercial functions.

--Deposit to and withdrawal from the Treasury is more complex than writing a check.

--Pension fund administration is too complex to tie-in with the Treasury.

--Advanced cash and investment management techniques would be negated.

Evaluation

No cost/benefit analyses has been done to specifically identify the exact costs and benefits that would be realized through deposit and investment of military NAFs in the Treasury. Therefore, it is difficult for us to specifically address each issue with certainty. However, our opinion on the comments follow.

Loss of NAF income

The comments ignore our recommendation that the Congress express its desired interest policy on NAF investments in enacting legislation. As discussed in our report, this was in recognition of the fact that recent Treasury interest rates were lower than Defense was realizing on some NAF investments and retirement programs. The Congress can specify interest policies that would result in a lesser, equal, or greater interest rate than now being realized. For example, an earlier legislated saving program for military personnel overseas specified a 10-percent interest rate.

However, if NAFIs were required to invest in Treasury securities at prevailing market rates as suggested by the Treasury, any loss of interest earnings as a result of the difference between rates may be offset by other improvements in cash management. Neither should it be assumed that Treasury rates will always be lower than average rates of return on NAF portfolios. In some instances, as shown in Navy comments, and in our report, Treasury rates may be higher. Also as later discussed, apparently other Federal employee retirement programs recently have been experiencing similar rates of return on special issue Treasury securities as private commercial retirement programs have primarily on commercial investments. Indications are that these programs are turning more toward Treasury securities.

Funds deposited to Treasury accounts in local depositaries would be quickly transferred through the Federal Reserve System and if so elected by the NAFIs, may be immediately invested by the Treasury. Long-range investment decisions would be made by NAF custodians. Compensating balances would not be maintained in banks, and present NAF balances could be used or invested. Banks would be directly compensated for their services. The Treasury recently has determined that direct compensation is less costly than maintaining a compensating balance, and the funds can be put to better use.

If adequate cash accounting systems are in place and cash is deposited to the Treasury account on a timely basis, even where investment decisions are retained by NAF custodians, more cash should be available for investment than under the present system or systems.

Interest rates negotiated on retirement systems have, in some instances, exceeded prevailing Treasury rates. If the Congress does not see fit to establish a policy that would

result in no loss of investment earnings, then such losses may affect the actuarial stability of the programs as Defense claims. As stated in our report, extrication from retirement program contracts would be troublesome and, unless allowed to lapse, could be costly. On the other hand, we recently completed a review of retirement programs of the Government and have tentatively concluded that there is no justification for treating Federal employees differently in retirement programs. We expect to recommend that one retirement program be established for the benefit of all Federal retirees. Interest rate policies could be set by the Congress that would result in a greater return on investments than prevailing market rates on Treasury securities.

Financial operations could cost more

The Treasury has concluded that the use of compensating balances was not the most economical method for compensating banks for their services and has gone to direct compensation. Since less services would be provided by commercial banks if NAFs were deposited to Treasury accounts, costs to the NAFs would be less. The cost of Treasury operations will increase, but no estimate is available. Treasury would expect to be reimbursed for services provided to NAFs.

The military NAFIs would have to improve cash accounting and management procedures and establish centralized systems. We do not know the costs associated with these improvements but believe better cash management will result. Thus, we recommended in our report that the Army adopt centralized banking and accounting and the Marine Corps adopt centralized banking, investment, and accounting systems. Detailed cash accounts would have to be maintained by the NAFIs for individual activities.

Complexity of Treasury deposit and withdrawal

Because of the vastness of the MWR programs and variety of methods used, we did not attempt to evaluate local receipt deposit and check disbursing systems. Nevertheless, we do not believe that cash discounts should be lost. Defense has over 850 disbursing officers who directly issue checks and permit petty cash funds or appropriated fund disbursement. This same network could be used for disbursing NAFs on behalf of local activities which normally are collocated with other appropriated fund functions. Appropriated funds used directly and indirectly to support MWR programs are disbursed by these officers. Should their number be insufficient or their workload too great, additional disbursing officers could be appointed. NAF fund custodians may be designated disbursing officers inasmuch as they are considered Federal employees. Non-U.S.

citizens may not be so designated. Thus, the NAFIs should be able to obtain cash discounts provided proper paperwork is processed in a timely fashion as dictated by effective cash control and management under any system. Issuing Treasury checks does not have to take appreciably longer than issuing commercial bank checks.

The check float, to the extent it is used by NAFIs, would be lost to them. A lesser cash float, due to more rapid processing of checks, could be realized by the Treasury. We could not determine what the value of that float might be. If it could be realized and identified, charges to NAFIs for Treasury services could be off-set to that extent. If the NAF custodians elect immediate investment, more cash would be invested and, on the average, probably sooner.

Impact on commercial banks

As we stated in our report, withdrawal of compensating balances and investments in commercial banks, including overseas military banking facilities, would reduce the amount of funds with which they might operate. As for minority institutions, our understanding is that funds were not invested in financial institutions unless they were competitive--investments were not made solely on the basis of whether a financial institution was minority owned. Also, minority institutions were being compensated for services they provided. Minority institutions, as with any other bank, should not be compensated for services they do not provide. There is no reason to believe that these institutions cannot serve as Federal depositaries and continue to receive the NAFs, although admittedly on a more temporary basis. Likewise, other commercial banks will be similarly affected. Savings and loan associations would lose the benefit of any Federal fund business.

Appropriated funds are used to pay for operations of overseas military banks. As with commercial banks in the United States, they would lose some operating cash but would continue to process Treasury deposits and be reimbursed for their efforts. To the extent their earnings do not measure up to contract terms, appropriated funds would be used to defray operating costs. Again, they should be compensated only for services they provide.

Since funds held by the Government as a trustee (such as in the case of NAFs) are generally required to be deposited in the Treasury, we see no basis for commercial

financial institutions to maintain a right to the receipt of NAFs or complain of Government assumption of private commercial functions.

Retirement programs

In view of the rates of return experienced by NAF retirement programs in recent years, there is a possibility that those programs may lose interest income if required to invest in Treasury securities. However, this possibility may not be certain if the Congress enacts legislation establishing an interest rate policy that would result in a return on retirement program investments comparable to that now being received.

Recently, we have been gathering data on rates of return on investments by Federal employee retirement programs (excluding NAF employee programs) and private commercial investment programs. On the basis of limited data collected on Federal programs, which invest only in Treasury securities paying average prevailing market rates, the programs in recent years realized as good as or greater returns than returns on investments of the private commercial programs. There is evidence that many of the commercial programs are turning to Treasury securities for better return and increased liquidity. We realize that some NAF retirement programs are guaranteed rates of return under current contracts with retirement program investment managers that are higher than Treasury rates. Nevertheless, some investments in Treasury securities have returned at similar rates.

We do not accept the military departments' contention that retirement program management is too complex to involve the Treasury. The Treasury already is involved in the country's largest retirement program--the Civil Service Commission-managed general schedule employee retirement and disability program--and several others. We know of no reason why it is not possible for NAF retirement program money to be invested in Treasury securities. Other Federal employees have a vested interest in their and their employers' share of contributions, and these are required by law to be invested in Treasury special issues securities.

Additionally, at the request of several members and committees of the Congress, we are studying the need for the many separate Federal employee retirement programs. We have concluded that NAF employees are Federal employees, and our tentative conclusions, reached without benefit of executive and judicial branch comments, are that there is a need for

only a single retirement system covering all Federal employees that would have unique features in unique situations. Acceptance of this conclusion and resultant action by the Congress could bring NAF employee retirement programs into a common retirement program.

Effect on MWR programs

Whether NAFIs would experience a net loss of income as a result of depositing their funds in the Treasury and investing them in Treasury securities is, at best, conjecture in lieu of a detailed cost/benefit analysis that would involve many assumptions. In the event of such loss, Defense points out three alternatives:

--Cut back MWR programs.

--Increase MWR program user fees.

--Increase appropriated fund support.

We addressed these issues to some extent in our report to the Senate Appropriations Subcommittee on Defense on appropriated funding of MWR programs (excluding commissaries) in August of 1977. 1/

We agreed with a Defense study group that the Government should support only the most necessary programs and stated that if maximum benefit is to be received from available funds, they should not be used to duplicate similar facilities off-base. We reported that nearly half the military installations in the continental United States with about 45 percent of the military population were in or adjacent to urban areas, indicating that a substantial number of military personnel has access to private sector facilities.

We pointed out that military resale outlets have substantial potential for generating additional NAFs but should not necessarily have to shoulder the cost of all other MWR programs because fees and dues could be brought more in line with operating costs.

1/"Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58, Aug. 31, 1977).

In response to the Subcommittee's request, we presented two alternatives to the Defense study group's proposed guidelines for providing appropriated fund support which we believed were feasible and consistent with (1) longstanding congressional committee statements that MWR funding ought to be funded primarily with appropriated funds but considered it impractical to do so and (2) our discussion of the need for the Government to support essential aspects of MWR. We proposed:

1. "Appropriated funds should be provided at all locations, but only for the operation of the kinds of public community (type) activities such as libraries, athletic fields, tennis courts, swimming pools, etc., on the same basis as they are provided in the nearest urbanized area as designated by the Bureau of the Census.

2. "Appropriated fund support of MWR should be eliminated at installations in or adjacent to urban areas in the United States when adequate community facilities exist. Away from urban areas, funds should be appropriated for commonly provided community facilities mentioned in item 1 above in the nearest urban area. Such activities could also be supported at places in urban areas upon case-by-case certification by the Office of the Secretary of Defense that available community facilities are in fact inadequate for use by military personnel. Installations in foreign countries should receive a dollar level of support comparable to installations in remote areas of the United States."

Under either alternative, we suggested the Congress should continue appropriated fund support for common base services whose MWR costs are not feasible to identify.

In summary, although we are not endorsing Defense contentions that NAFs will be significantly reduced, cash and investment management improvements may mitigate any possible losses, and there are viable funding alternatives to essential MWR programs.

IMPROVEMENTS IN CURRENT NAF

CASH AND INVESTMENT MANAGEMENT

It is encouraging to note the military services' positive response to our recommendations to improve the management of NAF cash and investments. However, the military services take issue with a number of our statements. These are discussed below:

INVESTMENT INSURANCE AND COLLATERAL

Army

The Army maintains that it has no investments which are uninsured or not protected by collateral. We reported that the Army required collateral for only one investment in the 2 years preceding our work, and written notice of the collateral was not received until after the security had matured. We said the Army relied on Federal insurance to cover its investments, but many were not covered by insurance nor by pledged collateral.

The Army maintains it has relied on FDIC and Federal Savings and Loan Insurance Corporation (FSLIC) insurance. It takes the position that the Army Central Investment Program is insured up to $100,000 per individual fund custodian in each financial institution. Since about 1,000 custodians are in the program, the Army believes it is insured up to $100 million in each financial institution.

We agree with the Army's theory which is based on FDIC and FSLIC rulings that individual fund custodians remain in charge of their funds in the program and thus are entitled to up to $100,000 coverage in each financial institution in which their share of funds is deposited. This of course does not necessarily result in each fund custodian receiving $100,000 coverage in each financial institution in which the Central Investment Program money is invested. Each custodian would be covered only to the extent of his or her respective share in each financial institution and the combined total of insurance coverage the custodian will receive in all financial institutions cannot exceed the amount of the custodian's share in the Central Investment Program. For example, if a custodian has only $10,000 in the Central Investment Program and the Program has investments in 10 financial institutions, the custodian could receive insurance coverage up to $10,000 in each of the 10 institutions, but could not receive more than $10,000 coverage in total for all financial institutions. If a custodian's share exceeds $1 million in this example, collateral would have to be secured to protect that portion of his share.

The need for collateral was discussed with Army investment officials. The investment officer told us he had no record of collateral except with respect to minority financial institutions which the Army required to pledge collateral on investments regardless of insurance coverage. He said that when he purchased a certificate of deposit, he notified the bank of collateral requirements and notified the Army Finance Center of details of the transaction. He assumed the banks pledged collateral and the Finance Center followed up on it.

September 1977 documentation we were provided on minority bank collateral showed that several certificates of deposit were not immediately secured by collateral. A January 1977 letter from the Army Finance Center showed that collateral for two certificates of deposit were not secured and confirmed until the securities had matured. The Army told us that collateral was not sought on certificates of deposit bought in the secondary market through its brokers.

During our closeout conference, Army investment officials agreed with our findings with respect to collateral and said they would correct the situation. The Army's securing collateral for investments in minority banks would have been inconsistent with an awareness that each fund custodian was insured up to $100,000.

As stated, we agree with the Army's current position on insurance coverage for the Army Central Investment Program to the extent its investments meet Federal insurance guidelines. But the Army has other substantial investments of central funds in which installation and command-level fund custodians do not have a share or are not custodians of a share.

As of June 30, 1977, the Army had invested $23.4 million of Army Morale Support Fund money apart from the Central Investment Program. There is only one Fund custodian for this money which comes from (1) dividends paid by the Army and Air Force Exchange Service, (2) residual assets of dissolved NAFIs, (3) interest on securities and student loans, (4) accounting fees, and (5) loan payments. This money is used for (1) payment of dividends to other NAFIs, (2) loans to NAFIS, (3) grants to NAFIs, (4) construction, (5) Fund administrative expenses, and (6) claims on dissolved funds. To the extent that investments of this money exceed $100,000 in a commercial financial institution, they are uninsured. At the time of our review, the Army presented no records of collateral that might have been required for such investments.

The situation is the same with respect to other central funds, such as the Army Club Fund and the Army Central Insurance Fund, which had $12.6 million and $2.3 million invested through the Central Investment Program, respectively.

The situation may be similar also with respect to all or part of $20.2 million invested through the Central Investment Program by the Army and Air Force Civilian Welfare Fund; U.S. Military Academy; Hale Koa Hotel; Pacific Stars and Stripes; U.S. Army, Europe Club Fund; and European Stars and Stripes.

Navy

As stated in our report, the Navy followed a practice of securing collateral after, rather than before, investment purchases. 31 C.F.R. 202.6 states that collateral should be pledged before the purchase. The Navy stated it complies with the requirement by requiring banks to pledge collateral on all bank deposits prior to the commitment of funds. However, the Navy's practices resulted in instances where investments were not covered by collateral for various periods of time.

Marine Corps

Marine Corps headquarters investments were adequately secured with collateral. Our statement in the report and the recommendation were addressed to the decentralized investments, records for which were not readily available. The Marine Corps stated that local auditors ensure that appropriate collateral is required.

Concentration of investments

Our report pointed out that there may be some drawbacks to concentrating investments in one financial institution. Mainly, lump sum withdrawal could have an adverse impact on an institution. We have not attempted, however, to estimate the probability of such a happening nor the possible effect on certain institutions. The Army states that it has reduced its investment in one bank from 48 percent to 27 percent, and that all investments were fully insured by FDIC.

As previously stated, we have not analyzed the matrix of Army investments and their insurance coverage, but we do know that a portion of the investments are not insured or secured by collateral. The Army states its investments are in 21 different financial institutions. It is not clear whether the Army's Central Investment Program or Morale Support Fund

money is in all of those financial institutions. Nevertheless, the maximum coverage any one fund custodian could obtain in any one institution is $100,000 and $9.1 million in total. The Moral Support Fund investments at June 30, 1977, were $23.4 million, so it was underinsured to the extent of $14.3 million. The Army Club Fund had $12.6 million invested through the Central Investment Program, and thus was underinsured by $3.5 million. The Army has not obtained adequate collateral to secure these investments.

Borrowing Funds

DOD Instruction 7000.12 states that funds will not be accumulated merely for investment purposes. It encourages borrowing from other DOD components before going to the commercial market to borrow funds (for programed purposes such as purchasing fixed assets, increasing inventories, and paying liabilities).

The Army admi[illegible] it borrowed funds for reinvestment purposes using its inves[illegible]nts as collateral as a method to enhance yield, and maintains it was not investing for investment's sake. In our opinion this practice constitutes borrowing for investment purposes, which is inconsistent with the policy expressed in DOD Instruction 7000.12 and therefore should be discontinued. Furthermore, funds were not first borrowed from other Defense components.

Limited investment guidelines

The Army's general investment policies for NAFs are set forth in chapter 2, Adjutant General Regulation 230-3, dated August 1, 1975. The regulation specifically states that the custodian of the Army Morale Support Fund will, by formal memorandum, provide periodic guidance to the investment officer. The purpose of such guidance is to (1) outline and update investment strategy and portfolio content and (2) provide any other direction relating to the conduct of the investment program as may be necessary. The regulation does not provide a similar requirement with respect to the Central Investment Program.

As stated in the report, we found limited guidance for the Central Investment Program investment manager. At the time of our review, there were no standing operating procedures or other written guidance relating to security transactions. Neither did the investment manager record security transaction proceedings. Thus, there was no record of competitive quotes from financial institutions that may have been solicited, nor was there written rationale of why one

investment was selected rather than another. There were few records on securing collateral.

We did not criticize the Army for poor investment management, although such result could be realized in the absence of sound investment guidance through appropriate policy, adequate standing operating procedures, and adequate documentation of financial transactions. It is encouraging that the Army is developing more detailed standing operating procedures that will ensure that adequate procedures and safeguards will meet audit and inspection standards.

Rates of return could be increased

Under the Air Force central banking system, receipts are deposited daily with local banks and immediately transferred to the concentration bank. Cash earmarked for investment goes into the Air Force's Central Investment Program fund account where it is invested at approximately 7 percent. Cash for normal daily business operations goes into the checking account, where it earns about 5 percent. The Navy has a similar concentration bank and Central Investment Program, except no interest was being received on its temporarily idle cash in checking accounts. Similarly, Army and Marine Corps activities we visited were banking locally but were not receiving interest on checking accounts.

Also, at the time of our review, local investments by Army and Marine Corps activities in Hawaii were earning about 5.6 percent (weighted average), whereas investments in Army, Navy, and Air Force Central Investment Programs were all earning in excess of 7 percent.

(990515)