

GAO

Report to the Congress

**FEDERAL
FINANCING BANK**

**The Government
Incurred a Cost of
\$2 Billion on Loan
Prepayments**





United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

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To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our review of loan prepayments at the Federal Financing Bank in response to the review requirements mandated by the Omnibus Budget Reconciliation Act of 1987.

For the loan prepayments that we reviewed, the Bank incurred an economic cost of about \$2 billion because legislation authorized specific Bank borrowers to prepay their loans at less than the current Treasury market value. We believe that the Bank's current policy of valuing loans at their current Treasury market value balances the economic costs and benefits of loan prepayments because it provides the borrowers with the flexibility of repaying the loans but does not create costs for the Bank.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Secretary of the Federal Financing Bank. We will also send copies of this report to interested parties at their request.

This report was prepared under the direction of Jeffrey C. Steinhoff, Director, Financial Management Systems Issues. Major contributors are listed in appendix IX.

A handwritten signature in black ink that reads 'Charles A. Bowsher'.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

The Treasury's Federal Financing Bank makes loans to federal agencies, private sector organizations, and foreign governments under several federal programs. As of June 30, 1988, the unpaid principal balances on the Bank's loans and agency securities purchased by the Bank totaled almost \$150 billion.

While most of the Bank's borrowers make periodic principal and interest payments as called for in their loan agreements and pay off their loans over the loans' original lives, some borrowers elect to pay off their loans early—that is, to prepay their loans. The Omnibus Budget Reconciliation Act of 1987, which directed this study, required that GAO

- determine all benefits that Bank lending provides and the procedures and conditions for prepaying current Bank loans,
- determine Bank borrowers' costs and benefits when they prepay their loans, and
- identify prepayment conditions and alternative financing measures the Bank should use to balance costs and benefits.

Background

The Federal Financing Bank was established in 1973 to finance government loan programs, coordinate federal borrowings, and reduce the costs of federal borrowings. The Bank obtains funds to make loans by borrowing from Treasury. Each loan made by Treasury matches the terms and conditions, except for the interest rate, of the corresponding loans made by the Bank. For example, loans from Treasury must have the same principal amounts, maturity dates, payment schedules, and prepayment provisions as loans made by the Bank.

To determine what interest rates to charge the Bank, Treasury uses a yield curve showing the relationship between the interest rates on Treasury securities issued to the public and the maturities of the securities. Each point on the curve represents the approximate interest rate that Treasury would pay on a newly issued Treasury security with a maturity corresponding to that point. Therefore, the interest rate that Treasury charges the Bank is the yield from the curve for the loan's payment schedule and maturity—termed the interest rate on comparable Treasury securities.

The Bank charges its borrowers the interest rate it incurs on the Treasury loan, plus a fee of one-eighth of 1 percent to cover administrative costs and to establish a reasonable reserve for contingencies.

Results in Brief

Since its inception, the Bank has provided borrowers with funds to carry out federal programs. The Bank has helped borrowers by offering low interest rates and by giving them the flexibility of prepaying their loans.

In general, the current prepayment policy not only provides borrowers with flexibility but also protects the government from incurring costs. Under that policy, the Bank accepts prepayment of loans at their current Treasury market value. A loan's current Treasury market value is the present value, based on interest rates for Treasury securities with comparable maturities, of future loan principal and interest payments that the Bank forfeits by accepting prepayment.

When loans are prepaid at their current Treasury market value, the Bank experiences neither an economic cost nor a gain. Because legislation directed the Bank to make an exception to its basic policy and to accept prepayment from certain borrowers at less than the current Treasury market value, however, the Bank experienced a \$2 billion cost on loan prepayments consummated through December 1988.

The Bank remains obligated to Treasury for the \$2 billion cost. There are two alternatives to finance these costs: (1) have the Bank use the funds generated by the administrative fees the Bank charges its borrowers, which is likely to require an increase in the current one-eighth of 1 percent fee or (2) have the Congress provide appropriations to the programing agencies or to the Bank for costs associated with each prepayment transaction when it authorizes prepayments at other than the current Treasury market value.

Principal Findings

Benefits of Bank's Lending and Prepayment Policy

The interest rates that the Bank charges its borrowers have been consistently lower than those available in the private sector. In 1987, Aa-rated corporate 15-30 year bonds yielded an average interest rate of 9.68 percent, compared with an average rate of 8.58 percent on 30-year Treasury bonds. After the Bank added its administrative fee to Treasury's interest rates, its borrowers obtained loans at an average rate of 8.71 percent that year. While some borrowers, such as government agencies, might be able to finance loans at rates below the Aa rate, other

borrowers might obtain private loans only at rates above the Aa interest rate in the absence of federal guarantees.

In 1975, the Bank established its policy of accepting loan prepayments at the loans' current Treasury market value because it realized that

- the prepayment prohibition in some loan agreements did not provide borrowers with the flexibility they needed and
- prepayment premiums based on interest rates specified in loan agreements, rather than on Treasury's current borrowing interest rate, could result in an economic gain or cost to the government if there is a material difference between loan interest rates and current Treasury market interest rates when the loans are prepaid.

Loan Prepayment Costs

Between October 1985 and December 1988, loans with book values totaling \$13.3 billion were prepaid. Of this total, loans with book values totaling about \$8.5 billion were prepaid at their book value as directed by legislation. Since these loans' current Treasury market values, as defined by the Bank, totaled about \$10.5 billion, the Bank experienced an economic cost of approximately \$2 billion. (See chapter 3.)

Because of the general decline in interest rates since their levels in the early 1980s, some Bank borrowers were left holding loans with interest rates substantially higher than the current commercial rates. Borrowers that had obtained high-interest rate loans in 1980 and 1981, therefore, wanted to prepay their loans. However, some wanted to prepay at the loans' book value (the unpaid principal balance plus accrued interest).

After the Bank maintained that prepayments must be made at the loans' current Treasury market value (which was higher than the book value), the borrowers appealed to policymakers for relief. In response, legislation was passed that allowed certain borrowers to prepay their loans at book value.

Alternatives to Balance Prepayment Costs and Benefits

The Bank's current policy of valuing loans at their current Treasury market value balances the Bank's prepayment costs with economic benefits to the borrower without penalizing other borrowers by charging higher administrative fees. But GAO recognizes that program and policy priorities, in addition to financial considerations, also affect loan prepayment decisions. The cost of the program or policy objective achieved by allowing borrowers to prepay their loans at other than the current

Treasury market value is the difference between loan book and current Treasury market values.

When borrowers prepay their loans at other than the current Treasury market value, there are primarily two alternatives that could be used to finance and account for the government's economic costs. The Bank could use the funds generated by the administrative fees it charges its borrowers, which is likely to require an increase in the magnitude of these fees, or the Congress could provide the programing agency or the Bank with an appropriation to cover the prepayment costs. The latter alternative would provide full financial disclosure of prepayment activities without penalizing other Bank borrowers. (See chapter 4.)

Matters for Congressional Consideration

In considering legislative proposals to allow selected Bank borrowers to prepay their loans at book value rather than at the current Treasury market value, as called for in Bank policy, the Congress should consider providing the programing agencies or the Bank with appropriations to cover the costs of authorizing loan prepayments at book value.

Agency Comments

In commenting on a draft of this report, the Department of the Treasury and the Office of Management and Budget (OMB) concurred with GAO's analysis and its conclusion that the Bank incurred a cost of \$2 billion when program borrowers prepaid their Bank loans at less than the current Treasury market value. Treasury supported making appropriations available to program agencies to cover prepayment costs the Bank incurs when agency program borrowers prepay Bank loans. OMB commented that appropriations for the costs incurred should be made available to either the appropriate program agency, the Bank, or a central loan accounting account in Treasury. The agencies' written comments are contained in appendixes VII and VIII.

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Abbreviations

DOD	Department of Defense
DSAA	Defense Security Assistance Agency
FMS	Foreign Military Sales
GAO	General Accounting Office
OMB	Office of Management and Budget
REA	Rural Electrification Administration
SBA	Small Business Administration
TVA	Tennessee Valley Authority

Introduction

The Federal Financing Bank was created by the Federal Financing Bank Act of 1973. The Bank was established to (1) efficiently finance federal loan and loan guarantee programs in ways that least disrupt private financial markets, (2) coordinate federal borrowing programs with the government's overall fiscal policy, and (3) reduce the costs of federal and federally assisted borrowing from the public.

Historically, in carrying out its statutory mandate, the Bank has provided financial assistance to or on behalf of federal agencies by (1) making direct loans to federal agencies to allow them to fund their programs, (2) purchasing loan assets from federal agencies, and (3) making direct loans to nonfederal borrowers (including foreign governments) which were secured by federal agency guarantees against risk of default by borrowers on loan principal and interest payments. Prior to enactment of the Balanced Budget and Emergency Deficit Control Act of 1985, Public Law 99-177 (commonly known as Gramm-Rudman-Hollings), the Bank was off-budget as a matter of law. None of the Bank's operations providing financial assistance to or on behalf of federal agencies was included in the budget authority, outlay, and receipt totals in the federal budget before fiscal year 1986.¹

The enactment of Gramm-Rudman-Hollings brought the Bank on budget by requiring all of the Bank's financing activities to or on behalf of federal agencies to be reflected in the budget authority, outlay, and receipt totals of the particular agency involved. Beginning in fiscal year 1986, for budget presentation purposes, the Office of Management and Budget (OMB) retroactively converted the various forms of financial assistance the Bank provided to or on behalf of federal agencies to direct loans from the agency to the borrowers. Therefore, when the Bank makes a loan to a nonfederal enterprise that is guaranteed by a government agency, the loan is treated for budgetary purposes as an outlay by the guaranteeing agency at the time the loan is made. The Bank, however, continues to maintain its accounting records and prepares its financial reports based on its pre-1986 off-budget status. For ease of presentation of the issues surrounding the prepayment of loans made by the Bank, our report is based on the methodologies used by the Bank to maintain its accounting records and prepare its financial reports.

¹ However, when an agency that had received a direct loan from the Bank used the loan proceeds to fund its programs, the agency's expenditure of the loan proceeds was counted as an outlay of the borrowing agency.

As of June 30, 1988, the Bank reported a loan portfolio of unpaid principal totaling almost \$150 billion. These assets included 120 direct loans to 4 federal entities with unpaid principal balances totaling about \$34 billion; 355 issues of agency securities with unpaid principal valued at about \$64 billion; and 9,467 loans to nonfederal organizations with unpaid principal balances totaling about \$52 billion. Under the terms of Gramm-Rudman-Hollings, the Bank's assets must be presented, for budget presentation purposes, as agency loans to the public and are recorded as outlays of the borrowing agencies. (Appendix I presents the Bank's loan portfolio.)

According to Bank officials, the borrowers, in most cases, make periodic principal and interest payments as called for in the loan agreements and pay off their loans over the loans' original lives. In some recent cases, however, borrowers have elected to pay off their loans early—that is, to prepay their loans. As discussed in chapter 3, the Omnibus Budget Reconciliation Acts of 1986 and 1987 and the Foreign Operations, Export Financing, and Related Programs Appropriations Act of 1988 allowed certain borrowers to prepay their loans guaranteed by federal agencies, and directed the Bank to make an exception to its basic policy and to accept the loan prepayments at the loans' book value—the unpaid principal balance plus any accrued interest. This cleared the borrowers' and agencies' books without clearing the books of the Bank.

Treasury's Loans to the Bank

The Federal Financing Bank Act of 1973 authorized the Bank to finance its activities by issuing its own securities publicly and to have outstanding, at any point in time, up to \$15 billion in these securities. The act also gave the Bank unlimited authority to borrow additional funds directly from Treasury, subject to the Secretary of the Treasury's approval. According to the Bank's manager, since July 1974, the Bank has raised most of its funds by borrowing from Treasury.

The Bank borrows funds from Treasury under a master note agreement. (See appendix II for a copy of this agreement.) The agreement states that each advance of funds (loans) by Treasury to the Bank must match the terms and conditions, except for the interest rate, of corresponding loans made by the Bank. Accordingly, the loans from Treasury must have the same principal amounts, maturity dates, principal and interest payment schedules, and prepayment provisions as the corresponding loans made by the Bank. For example, if the Bank makes a 10-year loan to a borrower for \$10 million, it must borrow \$10 million for 10 years from Treasury. Accordingly, the Bank's assets—loans receivable and

purchased agency securities—should equal its loans payable to Treasury. In short, the Bank should have what is termed a matched book.²

Objectives, Scope, and Methodology

The Omnibus Budget Reconciliation Act of 1987 directed that GAO

- determine all benefits provided by Federal Financing Bank lending and the procedures and conditions for prepaying current Bank loans,
- determine Bank borrowers' costs and benefits when they prepay their loans, and
- identify alternative prepayment conditions and procedures—termed financing measures in this report—the Bank should use to balance costs and benefits.

Our review focused on the prepayment of loans by private sector borrowers and foreign governments that are guaranteed by federal agencies under whose programs the loans were made. We did not address the prepayment of loans made directly by the Bank to federal agencies to finance their program activities because the imposition or waiver of prepayment premiums would be a transaction between federal agencies and consequently would have no effect on the financial condition of the federal government as a whole. Imposition of a prepayment premium, however, could affect the computation of costs for deriving the administration fee to be charged borrowers, and thereby indirectly affect the levels of federal collections from the public.

We met with Treasury and Bank officials to obtain their views on loan prepayment policies. To determine the contractual provisions on loan prepayments, we reviewed the promissory notes and loan agreements between the Bank and its borrowers and Treasury. We also spoke with representatives of private sector banks and obtained their views on prepayment conditions, costs associated with prepayments, and procedures for covering such costs. We reviewed the results of loan prepayments made to the Bank between October 1985 and December 1988, and determined their costs and benefits to the Bank.

²Under 12 U.S.C. 2288(a), the debt structure of the Bank shall be commensurate with its asset structure so far as is feasible.

We made our review between June and December 1988 at Treasury's Federal Financing Bank and Financial Management Service in Washington, D.C. We did our work in accordance with generally accepted government auditing standards. We also obtained comments from the Department of the Treasury and the Office of Management and Budget.

The succeeding chapters address (1) the benefits of the Bank's loans and the current prepayment policy, (2) the impact of interest rates on loan prepayments, and (3) alternatives for financing prepayment costs.

Benefits of the Bank's Loans and Current Prepayment Policy

Before the Federal Financing Bank was established, Treasury and several other federal agencies, such as the Farmers Home Administration, were authorized to borrow from the public or to make loan asset sales with recourse—loans sold with guarantees—to obtain funds to support federal direct loan and loan guarantee programs.¹ Because agency securities and loan assets were sold in lots of small dollar amounts and lacked the firm secondary markets enjoyed by Treasury securities, they were considered less liquid than Treasury securities. These differences, along with the private securities and financial markets' unfamiliarity with individual agency programs and securities, meant that agencies had to pay higher interest rates than Treasury paid on its comparable securities, even though both issues were issued a guarantee by the full faith and credit of the U.S. government. In addition, individual agencies incurred administrative costs for staffing and underwriting expenses.

To eliminate these problems, the Congress created the Bank in 1973. Since its inception, the Bank has fulfilled its mission of providing funds to help carry out federal programs—particularly federal credit programs. Since beginning operations, the Bank has provided loans to federal agencies at interest rates close to the Treasury rate and to private sector borrowers at interest rates below the private sector rates for loans having comparable risk.

In addition to providing low-interest-rate loans, the Bank has given borrowers the flexibility they need to prepay their loans. To help reduce future interest costs, borrowers may want to prepay high interest rate loans when interest rates fall. Recognizing that all borrowers needed the flexibility to prepay their loans, the Bank, in 1975, adopted a general policy of accepting prepayment of loans at their current Treasury market value—even those loans whose agreements prohibit prepayment. A loan's current Treasury market value, computed as defined by the Bank, is the present value, based on interest rates for Treasury debt of comparable maturities, of future loan principal and interest payments that the Bank forfeits by accepting prepayment. Therefore, the Bank's basic prepayment policy not only provides borrowers with flexibility but also protects the government from economic costs by tying loan prepayments to interest rates in effect at the prepayment date.

¹In guaranteed loan programs, the Bank lends the funds it borrows from Treasury to a nonfederal enterprise. A government agency with interest in the enterprise's activities guarantees the loans. Under sections 201 and 214 of Gramm-Rudman-Hollings, Bank loans that are guaranteed by a federal agency are treated for budgetary purposes as an outlay of the guaranteeing agency.

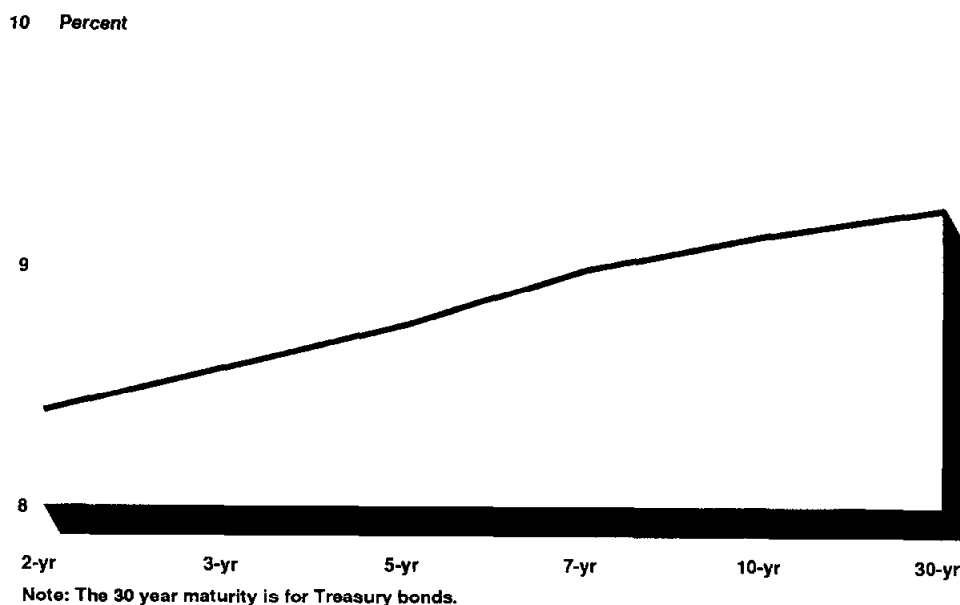
Determining Bank Interest Rates

The interest rates the Bank charges its borrowers, as discussed in chapter 1, are determined on a loan-by-loan basis and depend on the rates it receives on its loans from Treasury. The Bank charges a borrower the interest rate it incurs on the Treasury loan, plus a fee of one-eighth of 1 percent to cover administrative costs and to establish a reasonable reserve for contingencies. The payments from the administrative fee are accumulated in the Bank's administrative reserve fund. The administrative expenses of the Bank have averaged about \$1.5 million per year, while, on average, the fund has collected about \$180 million per year in fees. Traditionally, the Bank has not returned these fees to borrowers but has transferred the excess to the Treasury.

How Treasury's Yield Curve Works

To determine what interest rates to charge the Bank, Treasury uses a yield curve showing effective interest rates, or yields, based on actively traded Treasury securities (bills, notes, and bonds) issued to the public. The yields are determined by the prices of actively traded securities on securities markets after their initial issuance. (See sample yield curve in figure 2.1.)

Figure 2.1: Treasury's Yield Curve for July 29, 1988



Source: Based on figures extracted from the Federal Reserve Statistical Release, August 2, 1988.

A Treasury note or bond comprises three key components: face value (the principal amount borrowed), loan term, and coupon interest rate (the rate of simple interest that will be paid on the face value). On a matured \$10,000, 2-year, 10-percent Treasury note, the government will have paid the holder of the note \$12,000 (face amount of \$10,000 plus 10-percent simple interest for 2 years). If market yields are higher than 10 percent, investors will pay less than \$10,000 for the note. By paying less than the face value, investors would, in effect, increase the interest earned, or the yield, on the notes. Appendix III shows how to calculate the yield, assuming annual interest payments, if an investor pays \$9,500 for a \$10,000 face value note.

The Treasury yield curve shows the relationship between the maturities on Treasury securities and the various yields of the securities. Each point on the curve represents the approximate interest rate, or yield, that Treasury would pay on a newly issued Treasury security with a maturity corresponding to that point on the curve, regardless of the face value of the Treasury security. The Treasury yield curve is updated each business day based on closing quotes of actively traded Treasury securities supplied by the New York Federal Reserve Bank. Whenever Treasury makes a loan to the Bank, the interest rate will be equal to the yield from the yield curve for securities with similar loan payment streams and maturities. For the purposes of this report, the interest rates from the yield curve are termed the interest rates on Treasury debt with comparable maturities.

Relationship Between Treasury's Loans to the Bank and Treasury Securities

The terms and conditions on Treasury's borrowing from security investors bear no direct relationship to the loan terms and conditions of Treasury loans to the Bank or other borrowers. Treasury uses the funds from selling its securities with varying maturity dates to provide the Bank with funds to make its loans with varying maturity dates and to finance various other activities. The maturity dates of the loans do not affect Treasury's decisions with respect to its decisions on the maturity dates of its borrowings.

At quarterly meetings with Federal Reserve officials and a formally chartered advisory committee comprised of government security dealers, Treasury presents its planned offering schedule for the succeeding 3 months and its latest estimate of cash needs in the near term. The government security dealers provide a perspective on what they believe to be the best mix of market financing to minimize market disruption and to achieve the lowest interest costs. Treasury does not announce

amounts to be sold in specific offerings until approximately 1 week before each auction of bills, notes, and bonds.

Thus, in the federal government's current borrowing environment, funds for Treasury's loans to the Bank could be obtained from both short- and long-term securities. Treasury's yield curve for actively traded securities is an acceptable measure available for establishing interest rates on Treasury's loans to the Bank, because it accurately reflects the cost to the government of funds borrowed for this period of time. The yield curve also reflects the yields that Treasury would expect to pay in order to issue a new security for any given maturity.

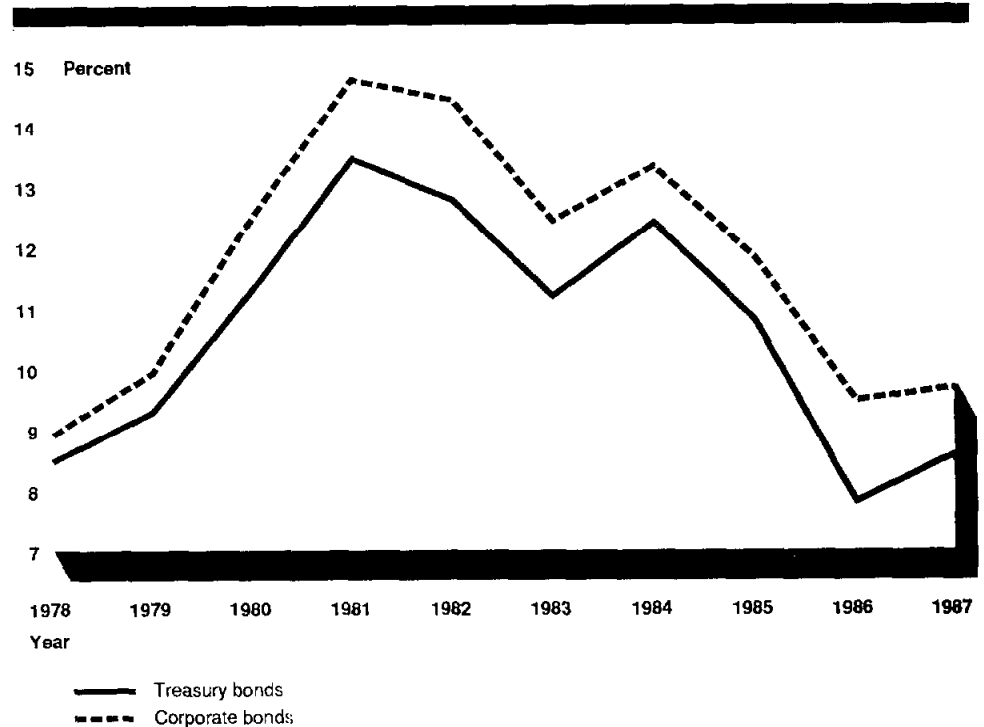
Bank Interest Rates Lower Than Those in the Private Sector

The interest rate the Bank charges a borrower is one-eighth of 1 percent above Treasury's interest rate for securities with comparable payment streams and maturities. Because Treasury's interest rate is consistently lower than that for comparable private sector securities, the Bank's customers receive the benefit of obtaining funds at lower interest rates.

For example, the yearly interest rate yields for a 30-year Treasury bond during 1980-83 averaged 12.17 percent. Adding the Bank's administrative fee brings its interest rates on 30-year loans to an average of 12.29 percent during this period. For the same period, Aa corporate bonds yielded an average of 13.52 percent. Further, Treasury interest rates in 1986 and 1987 averaged 7.80 percent and 8.58 percent, respectively, while the corresponding Bank interest rates would have been 7.93 and 8.71 percent. Corresponding Aa bond rates averaged 9.47 percent and 9.68 percent.² Figure 2.2 illustrates the relationship between Treasury and corporate interest rates for 30-year securities during 1978 through 1987.

²The 30-year securities are compared since according to Bank officials they most closely resemble the maturity of Bank loans that were prepaid in fiscal years 1987 and 1988 under the Rural Electrification Administration's loan program. The Aa corporate bond rate was used since it would be the approximate borrowing rate for rural electric cooperatives if they had borrowed from private sector institutions rather than from the Bank

Figure 2.2: Annual Average Interest Rates on 30-Year Treasury Bonds and Aa Corporate Bonds



Corporate bond rates are for securities rated Aa.

Sources: Based on data extracted from *Treasury Bulletin*, Spring Issue, June 1988, and *Moody's Industrial Manual*, Volume 1, 1988.

Bank Accepts Loan Prepayments at Current Treasury Market Value

As we have previously stated, the Bank's policy has been to accept loan prepayments³ at the loans' current Treasury market value in the absence of prepayment provisions in the loan agreements. All Bank loan agreements under the Department of Defense (DOD) foreign military sales (FMS) program, for example, prohibit loan prepayments. Also, some of the Bank's older Rural Electrification Administration (REA) loan agreements require a prepayment premium based on the loan's interest rate. (See appendix IV for a discussion of such premiums.)

³Under Gramm-Rudman-Hollings, for budget presentation purposes, OMB requires all repayments, including prepayments of loans to the public financed by the Bank, to be shown as involving borrower payments to the agency (including payments directly to the Bank with the Bank acting as an agent for the agency), agency payments to the Bank, and Bank payments to the Treasury. As a result of the legislation permitting prepayments at book value, the private lenders' obligations to the agencies and agencies' obligations to the Bank to repay loans at current Treasury market rate were forgiven without a concurrent forgiveness of the Bank's obligations to Treasury.

The Bank instituted its current prepayment policy because it realized that

- borrowers needed the flexibility to prepay their loans and the prepayment prohibition in some loan agreements was impractical and
- loan prepayment premiums based on loan interest rates, rather than on Treasury's current interest rate, could result in an economic gain or cost to the government.

According to Treasury and Bank officials, whether a loan can be prepaid is determined on a loan-by-loan basis unless the Bank is required by statute to allow prepayment. Ordinarily, a proposed prepayment will not be allowed unless Treasury agrees to (1) the borrower's loan prepayment to the Bank and (2) the prepayment of Treasury's mirror-image loan to the Bank at the prepayment amount the Bank received from its borrower based on the loan's current Treasury market value.

Government Experiences Neither an Economic Gain Nor a Cost on Current Treasury Market Value Prepayments

A loan's current Treasury market value¹, as defined by the Bank, is determined by calculating the net present value of the future stream of principal and interest payments the government gives-up by the Bank accepting the prepayment of a loan. When determining the current Treasury market value, the Bank uses the current interest rate for a Treasury security with a comparable maturity.² This rate is appropriate because it is the rate the government would pay to borrow funds to replace the future principal and interest payments it gives up by allowing the loan prepayment.

When a loan is prepaid at its current Treasury market value, the Bank experiences neither an economic gain nor a cost on the prepayment. In short, the Bank and the federal government are financially no worse off by allowing the borrower to prepay its loan than if the Bank held the loan to its original term and no loan default occurs.

For example, the Bank would be entitled to receive 120 payments of \$161,335 for a \$10 million, 30-year, 5-percent loan with quarterly payments. If the loan were granted on January 1, 1974, and if the borrower

¹This value represents the loan's present value determined at Treasury's current market yields for securities with comparable maturities. For the purpose of this report, current Treasury market values do not reflect potential future defaults or forgiveness of the loans.

²In a loan prepayment, the comparable Treasury security is determined by the remaining life of the loan at prepayment. For example, for a 30-year loan prepaid in the 16th year, the comparable maturity Treasury security would be a 15-year Treasury bond.

prepaid the loan on July 2, 1989, the Bank would forfeit payments over the remaining 14-1/2 years of the original loan term. If Treasury's interest rate for 15-year Treasury bonds on July 2, 1989, were 6 percent, the market value of the future quarterly loan principal and interest payments would be \$6,220,356. Stated another way, on July 2, 1989, the Bank would have to borrow from Treasury \$6,220,356 at 6 percent to replace the foregone 58 quarterly payments of \$161,335. If the Bank received that amount as prepayment, the government would realize neither an economic gain nor a cost.

While loan prepayments at the current Treasury market value protect the government from economic costs, they do affect the timing of Treasury's financial needs. In setting its quarterly projections of the government's cash requirements, Treasury considers all anticipated revenues, such as employer deposits of federal income and Federal Insurance Contribution Act tax withholdings, federal excise taxes, and repayments of government loans. Treasury's immediate expected cash needs and its need for public borrowing decrease when it accepts prepayments because it generally collects the present value of all future loan principal and interest payments at the prepayment date. However, in periods following a prepayment transaction, because Treasury gives up its right to collect planned future principal and interest payments, its cash needs will increase, which in turn increases its borrowing from the public.

Private Sector Prepayment Provisions Are Also Tied to Market Interest Rates

Private sector financial institutions also recognize that borrowers need the flexibility to pay off loans early and that loan prepayment provisions must be structured to recover all loan costs. These costs include loan origination and servicing (administrative) costs, loan risk (estimated default) costs, and costs of obtaining funds to make the loans—the largest cost incurred by any lender under normal operations. Specific loan prepayment provisions vary by lender, type of loan, borrower, and amount borrowed.

The cost of obtaining funds cannot be directly managed or controlled by lenders; it is determined by general economic conditions and by interest rates demanded by investors. During periods of stable interest rates, lenders can predict fairly accurately their cost of funds over a loan's life and, consequently, can recover the costs of loan prepayments through prepayment premiums or the loan's interest rate. The banking industry does not follow a uniform loan prepayment policy. However, based on our discussions with bank industry officials, we found that loan prepayment provisions have historically fallen into two categories:

(1) For fixed-interest-rate loans (other than mortgages), loan agreements may (a) prohibit prepayment during the loan's early life to allow the lender to recover loan origination costs out of loan interest payments or (b) assess a loan prepayment premium or penalty to compensate the lender, at some level, for foregone future loan interest payments, based on the loan's interest rate. Under this type of loan, the borrower pays the unpaid principal balance and the prepayment penalty.

(2) Fixed-rate mortgage loans generally do not include prepayment provisions but can be prepaid at their unpaid principal balance plus accrued interest (book value). However, to cover overall prepayment costs projected for their mortgage loans, lenders increase the interest rates on these loans or increase the points charged to borrowers.¹⁵

During the period of volatile interest rates that began in the late-1970s and ended in the mid-1980s, private sector lenders realized that fixed-interest-rate loans—particularly mortgage loans—could not adequately cover their constantly fluctuating cost of funds and that adequate provisions to cover the costs of loan prepayments could not be built into the fixed interest rates. To overcome these problems, lenders introduced variable-interest-rate loans. The interest rates on these loans varied according to interest rate indexes that reflected changes in market interest rates and that more accurately reflected the lenders' fluctuating cost of funds. Both commercial and mortgage lenders are moving towards variable-interest-rate loans. For example, about 40 percent of all recently issued long-term home mortgage loans are variable-rate loans.

Private sector lenders' movement to variable-interest-rate loans protects them by allowing loan interest rates to rise and fall with their cost of funds. By enabling the lenders to maintain, over time, a fairly constant spread between their cost of funds and the interest rates they charge borrowers, variable-interest-rate loans obviate the need for prepayment premiums when borrowers pay off their loans early. Private lenders allow borrowers to prepay their variable interest rate loans at book value. Similarly, the Bank no longer enforces loan prepayment premiums based on loan interest rates but has moved to a policy that ties loan prepayment amounts to the present value of the loan's future stream of principal and interest payments based on the Bank's cost of funds at the prepayment date; that is, Treasury's interest rates for securities with comparable maturities.

¹⁵Representatives of the Mortgage Bankers Association of America told us that the average single-family residential mortgage is paid off in the seventh year of its original contract maturity.

Impact of Interest Rates on Loan Prepayment Costs

According to Bank officials, during the period of relatively stable or rising average annual interest rates that ended in the late 1970s, most borrowers chose to pay off their loans according to the payment schedule in original loan agreements. It was not until the recent decline in interest rates that the issue of loan prepayments was brought to the forefront. Borrowers were left holding loans with interest rates substantially higher than the current commercial rates even though the loans had been made at the lowest possible interest rates at the time of disbursement. Thus, the key benefit to Bank borrowers—loans at interest rates below commercially available rates—was negated.

From 1985 to 1988, several of the Bank's borrowers wanted to refinance, or prepay, the high-interest-rate loans they had secured during 1980 and 1981. While some of these borrowers prepaid their loans at the loans' current Treasury market value, as required by bank policy, others were permitted by legislation to prepay their loans at the book value. As a result, the government gave up its financial right to collect about \$2 billion.

Desire to Prepay Loans Induced by Falling Interest Rates

Interest rates were relatively stable for more than half a century. The annual average interest rates on 30-year Aa corporate bonds, although fluctuating somewhat, gradually increased from 5.86 percent in 1919 to 9.94 percent in 1979. In the early 1980s, interest rates soared to high levels and then dropped to prepeak levels. The rate on 30-year corporate bonds peaked at 14.75 percent in 1981 and then dropped to 12.42 percent in 1983.

When interest rates are falling, borrowers benefit by prepaying high-interest-rate loans if they do not have to pay a penalty. For example, on a 30-year loan with a \$10 million face value at 14 percent, 120 quarterly principal and interest payments of \$355,732 are needed to pay off the loan. If the loan is prepaid after the 60th payment, the outstanding principal balance will be \$8,873,632. If the borrower refinances this principal at 10-percent interest over the remaining 60 periods, the resulting quarterly payments will be \$287,092—a savings of \$68,640 per payment, or about \$4.1 million over the remaining loan term.

Recognizing the benefit of prepaying, several of the Bank's borrowers that had obtained long-term, high-interest-rate loans during the early 1980s approached the Bank to prepay their loans. These borrowers wanted to prepay at the book value (unpaid principal balance plus accrued interest), not the higher current Treasury market value as

required by Bank policy. Because the government has a financial right to all scheduled principal and interest payments on Bank loans, the Bank maintained that prepayments must be made at the loans' current Treasury market value. It is a long-standing legal principle that no officer of the U.S. Government may give up a financial right of the government without the statutory authority to do so or without receiving an adequate compensating benefit.¹ As discussed in chapter 2, loan prepayments consummated at the current Treasury market value give the Bank the loans' full economic value at the prepayment date, which is adequate compensation for giving up the future loan payments.

After the Bank refused to accept prepayments at the book value, the borrowers turned to the Congress for relief. In response, the Congress passed the following three acts:

(1) The Omnibus Budget Reconciliation Acts of 1986 and 1987 directed the Bank to accept prepayments from borrowers under the REA loan program at the loans' book values rather than the current Treasury market values.

(2) The Foreign Operations, Export Financing, and Related Programs Appropriations Act of 1988 (Public Law 100-202) overrode the loan prepayment prohibitions in certain loan agreements between the Bank and foreign governments under DOD's foreign military sales program. The act authorized the Bank to accept prepayment of these loans at their book values.²

¹Comptroller General Decision (B 226058), July 21, 1987, to the Chairman, Subcommittee on Foreign Operations, House Committee on Appropriations.

²The loans authorized for prepayment (1) were outstanding as of December 22, 1987, (2) had principal amounts due and payable after September 30, 1989, and (3) carried an interest rate of 10 percent or more.

Recent Loan Prepayment Costs Under Legislated Exceptions to Bank's Policy

During fiscal years 1985-88, several bank borrowers that had obtained long-term, high-interest-rate loans under credit programs run by 10 federal agencies prepaid their loans. These loans had a total book value (unpaid principal balance plus accrued interest) of \$13.27 billion at the prepayment dates. As shown in table 3.1, the prepayments were made on two bases: (1) the current Treasury market value, as required by Bank policy, and (2) the book value, as directed by legislation.

(1) Loans with book values totaling \$4.74 billion were prepaid at their current Treasury market value based on Treasury interest rates for securities with comparable maturities at the prepayment date. The net proceeds of these prepayments totaled about \$5.1 billion, or about \$360 million above the book value.

(2) Loans with book values totaling \$8.53 billion were prepaid at their book value. Since the current Treasury market value of these loans was \$10.5 billion, the Bank experienced an economic cost of \$2 billion. This \$2 billion represents the costs for prepayments made as of December 31, 1988. For the balance of fiscal year 1989 and part of fiscal year 1990, the administration is expecting additional prepayments which could generate additional costs.

Chapter 3
Impact of Interest Rates on Loan
Prepayment Costs

Table 3.1: Financial Results of Loan Prepayments Between October 1, 1985 and December 31, 1988

Dollars in thousands

Agency	Loan book value	Loan current Treasury market value	Prepayment amount received	Economic cost to the government
Loans prepaid at market value				
Agriculture				
REA	\$2,078,991	\$2,111,597	\$2,111,597	\$0
Farmers Home Administration	1,004,243	1,163,409	1,163,409	0
Export-Import Bank	670,000	791,047	791,047	0
Health and Human Services	9,684	9,504	9,504	0
Housing and Urban Development	40,199	42,792	42,792	0
National Aeronautics and Space Administration	65,338	67,185	67,185	0
Small Business Administration	169,353	186,350	186,350	0
Tennessee Valley Authority	607,365	621,772	621,772	0
Transportation	91,291	104,198	104,198	0
Total	\$4,736,464	\$5,097,854	\$5,097,854	\$0
Loans prepaid at book value				
Agriculture				
REA in fiscal year 1987	\$597,164	\$762,769	\$597,164	\$165,605
REA in fiscal year 1988	2,032,510	2,505,329	2,032,510	472,819
DOD foreign military sales				
fiscal year 1988	2,524,230	3,337,869	2,524,230	813,639
fiscal year 1989 (1st qtr.)	3,380,079	3,911,981	3,380,079	531,902
Total	\$8,533,983	\$10,517,948	\$8,533,983	\$1,983,965
Total	\$13,270,447	\$15,615,802	\$13,631,837	\$1,983,965

Note: Data do not include prepaid Defense Security Assistance Agency guaranteed Bank loans that were in default because guaranty provisions required the Bank to collect any installment of principal or interest due from the agency. These 19 loans from 3 countries had a book value of about \$853 million.

Even though these loans have been paid off, the government does not avoid potential future costs of default by these borrowers. The government could incur these costs because it guarantees repayment of the loans the Bank's borrowers obtain from private lenders to provide them with the funds to prepay their Bank loans. For example, under the REA prepayment program, REA guarantees full repayment of the private sector loans secured by rural electric cooperatives to obtain the funds to prepay their Bank loans. In addition, the legislation that authorizes the refinancing of FMS loans allows the Defense Security Assistance Agency

(DSAA) to guarantee 90 percent of the private loans secured by foreign countries to prepay their Bank loans.³

Foreign countries will raise the funds needed to prepay their FMS Bank loans by selling bonds in private securities markets in the United States. Because interest rates have declined since the Bank originally granted the FMS loans, the bonds sold will likely carry a lower interest rate than that on the Bank's loans to these countries. The proceeds of these bond sales will be used to prepay the FMS loans. The U.S. Government, through DSAA, guarantees investors the repayment of 90 percent of the unpaid face value of the bonds in the event of default by the foreign country. More information on the refinancing and prepayment of Bank loans issued under the DOD/FMS program is provided in our recent report on this issue.⁴

³See appendix V for Bank loans issued on behalf of the DSAA as of June 30, 1988.

⁴Security Assistance: Foreign Military Sales Debt Refinancing (GAO/NSIAD-89-175, to be issued.)

Alternatives for Financing Prepayment Costs

By following its prepayment policy on about \$4.7 billion in loans, the Bank received the loans' market value and, as a result, the government was no worse off financially than if it had held the loans to term. But because the Bank also accepted, under specific legislative requirements, the prepayment of about \$8.5 billion in loans at the book value rather than the current Treasury market value, without the programing agencies being held liable for the difference, the Bank incurred a cost of about \$2 billion since it received about \$2 billion less than the current Treasury market value of the prepaid loans. The Bank, however, remains legally obligated to Treasury for the \$2 billion difference between the market value of the prepaid loans and the prepayment amounts the Bank received. This chapter discusses two alternatives available to the Bank to finance and fully disclose this cost. Appendix VI provides a more detailed discussion of the legal requirements for the Bank to record and report loan prepayment costs.

Bank Is Obligated to Treasury for Prepayment Costs

The acts requiring the Bank to accept REA and FMS loan prepayments at book value rather than at the current Treasury market value did not change the prepayment terms of the Bank's loan agreements with its borrowers and, consequently, the terms of the Bank's master note agreement with Treasury. Therefore, although the legislation specifically prohibited the Bank from collecting the loans' full current Treasury market value from either the borrowers or the guaranteeing agencies, in our opinion, it did not prohibit Treasury from collecting from the Bank the full current Treasury market value of the prepaid loans. Consequently, the Bank remains obligated to Treasury for the \$2 billion difference between the current Treasury market value of the prepaid loans and the prepayment amounts the Bank collected. (See table 3.1.) The \$2 billion difference relates to REA and FMS loan prepayments made by December 31, 1988. Further FMS loan prepayments are authorized during the balance of fiscal year 1989 and part of fiscal year 1990 if foreign countries apply to repay these eligible loans. If additional countries exercise their options to prepay their loans, the government will incur additional costs.

Additional Bank loan prepayments are authorized for REA program borrowers for fiscal year 1989. Again, if the Bank's borrowers exercise their loan prepayment options, without penalty as authorized, the government will incur additional costs.

The Bank's current policy of allowing prepayments at current Treasury market value balances the costs and benefits of a loan prepayment transaction. Specifically, if the Bank receives a loan's current Treasury

market value at the prepayment date, it incurs neither a gain nor a cost on the transaction. At the same time, its borrower gets the flexibility of paying off its loan early to achieve other program goals. On the other hand, prepayments at book value have a cost to the government. For example, the cost of the recently authorized prepayments has been \$2 billion to date. This \$2 billion represents the cost of the policymakers' decision to achieve certain program and policy objectives for the REA and FMS programs. These program and policy objectives can include reducing financing costs incurred by the Bank's borrowers to provide them with the funds to support other program operations. Recording these costs in the Bank's accounting records, financial reports, and budget requests will, in our view, provide the Congress with better financial disclosure of the Bank's loan prepayment activities and the full costs of the program or policy objectives.

Alternatives for Financing Prepayment Costs

In our view, the two primary alternatives for financing and accounting for costs that occur when the loan's current Treasury market value is not collected are (1) using the Bank's reserve fund or (2) obtaining an appropriation from the Congress.

Use of the Reserve Fund Would Inappropriately Spread Costs to Other Borrowers

One alternative is to use the Bank's reserve fund to cover prepayment costs. This alternative would likely require the Bank to raise the administrative fee it charges its borrowers.

In a similar situation in 1977, the U.S. Postal Service obtained congressional approval to prepay Bank loans at the book value of \$925 million rather than at the current Treasury market value. When the Postal Service prepaid the Bank \$925 million, the Bank prepaid the Treasury loan it had obtained to fund the Postal Service loans. However, since the Bank's prepayment of \$943 million to Treasury was based on the current Treasury market value, in accordance with the master agreement between the Bank and Treasury, the Bank incurred an economic cost of \$18 million. The cost was covered by excess administrative fees in the Bank's reserve fund.

Because the Bank's fee of one-eighth of 1 percent generates excess administrative fees of about \$180 million annually, the Bank might have to raise its fee substantially to cover the \$2 billion cost discussed in this report. However, we do not favor raising the administrative fee because

it would, in effect, pass the cost of a legislatively provided special benefit for a few select borrowers on to all other Bank borrowers. In addition, using administrative fees to finance prepayment costs would not provide full disclosure in the budget of the Bank's loan prepayments. But, if the fee is not increased and future accumulation of administrative fees is similar to prior years', it will take the Bank over 11 years to finance the \$2 billion in costs that have occurred as of December 1988.

Use of Appropriations Would Disclose Costs of Prepayments

The second alternative is for the Congress to appropriate funds preferably to the programing agencies whose loans to the public are being prepaid, or, alternatively, to the Bank, to cover prepayment costs. This alternative would fully disclose in the budget the costs of the program or policy objectives achieved by policymakers' decisions to permit prepayments at book value. Further, specific appropriations to cover actual and expected prepayment costs would also negate the need to raise the Bank's administrative fee and, therefore, would not penalize all Bank borrowers.

The Bank is already recording and disclosing prepayment costs in its financial statements. Specifically, the Bank's financial statements for fiscal year 1987 show that REA prepayment costs of about \$165 million resulted in an operating deficit for the Bank. Preliminary statements for 1988 show an even larger operating deficit of about \$1.286 billion from REA and FMS loan prepayments. These costs, combined with a \$532 million prepayment cost for the first quarter of fiscal year 1989, total about \$2 billion, as discussed in chapter 3.

To compensate the Bank for loan prepayment costs it is recording and reporting, the Congress should provide appropriations to cover these costs to the programing agencies whose loans to the public are being prepaid. The programing agencies, in turn, would make payment to the Bank for prepayment costs when it is directed by policymakers to accept prepayment at less than the current Treasury market value on loans issued on behalf of the agencies. Having the agencies transfer these appropriations to the Bank will permit the Bank to prepay its Treasury loan at the current Treasury market value and should provide for full disclosure of all loan prepayment costs in the programing agencies' financial records. Alternatively, the Congress could make appropriations for prepayment costs directly to the Bank. However, making such appropriations to the programing agencies is preferable because the cost would be associated in the budget with the program whose participants receive the benefit.

Appropriating funds to cover loan prepayment costs is consistent with the proposal in the President's fiscal year 1990 budget to establish a central loan accounting account in Treasury. Appropriations to that account would be available to fund future costs arising under the loan asset sale pilot program. Under the President's proposal, appropriations to cover expected costs of loan asset sales and program agency prepayments would be made to Treasury's central account. According to OMB officials, \$160 million in appropriations are being requested to cover the prepayment costs for an estimated \$500 million in Bank loan prepayments to be made by REA program borrowers for fiscal year 1990. However, appropriations are not being requested for authorized REA and FMS loan prepayment costs for the prepayment of Bank loans made by program borrowers in recent prior years.

Conclusions

In accepting REA and FMS loan prepayments at book rather than at current Treasury market values, the Bank incurred a cost of \$2 billion. This cost represents the difference between the aggregate book values of the loans prepaid to the Bank and the aggregate current Treasury market values of the loans owed by the Bank to the Treasury for loan prepayments made by December 31, 1988. The government anticipates further loan prepayments during the balance of fiscal year 1989. If these prepayments occur, the government will experience further costs.

We recognize that financial considerations are only one factor in making loan prepayment decisions and that program and policy objectives—the benefits of loan prepayments—are also a part of the decision-making process. The difference between a loan's book and current Treasury market value, however, is the economic cost of the program or policy objectives to be achieved by allowing borrowers to prepay their loans at less than the current Treasury market value. The key benefit to the federal government of allowing loans to be prepaid at book value is to enable the Bank's borrowers to reduce their current loan obligations to provide them with the funds to achieve other program goals. Decisionmakers, in our opinion, should be made fully aware of the economic cost of achieving these benefits when considering proposals to authorize loan prepayments at other than the current Treasury market value.

In making loan prepayment decisions, the Congress needs information that provides the fullest financial disclosure of the Bank's prepayment activities. The appropriation alternative discussed above provides this disclosure.

Matters for Congressional Consideration

In considering legislative proposals to allow selected Bank borrowers to prepay their loans at book value rather than at current Treasury market value, as called for in Bank policy, the Congress should consider providing the programing agencies or the Bank with appropriations to cover the costs of authorizing loan prepayments at book value.

Agency Comments

In commenting on a draft of this report, Treasury and OMB stated that they agreed with the substance of our report, including the conclusion that the Bank incurred a cost of \$2 billion when program borrowers prepaid their Bank loans at less than the current Treasury market value. Treasury supported making appropriations available to program agencies to cover prepayment costs incurred by the Bank when its loans are prepaid by agency program borrowers. OMB commented that appropriations for the costs incurred should be made available to either the appropriate program agency, the Bank, or a central loan accounting account in Treasury as proposed in the President's 1990 budget. The agencies' written comments are contained in appendixes VII and VIII.

Bank's Loan Portfolio as of June 30, 1988

Dollars in millions

Borrower	Number of loans	Face amount borrowed	Unpaid principal
Direct loans held by the Bank			
Export-Import Bank	56	\$19,502.5	\$11,226.2
National Credit Union Administration	4	96.5	96.5
Tennessee Valley Authority (TVA)	53	16,950.0	16,950.0
U.S. Postal Service	7	6,530.0	5,592.2
Total	120	\$43,079.0	\$33,864.9
Agency assets purchased by the Bank			
Agriculture—Farmers Home Administration	293	\$59,674.0	\$59,674.0
Agriculture—REA	17	4,071.2	4,071.2
Health and Human Services—Health Maintenance Organization	35	174.0	84.0
Health and Human Services—Medical Facilities	9	170.2	102.2
Small Business Administration (SBA)	1	193.0	16.4
Total	355	\$64,282.4	\$63,947.8
Bank lending guaranteed by agencies			
Agriculture—REA	3,975	\$22,081.5	\$19,204.1
DOD—Department of the Navy	18	1,788.3	1,758.9
DOD—Defense Security Assistance Agency	179	21,257.8	18,539.2
Education—Student Loan Marketing Association	15	5,000.0	4,940.0
Energy—Geothermal	1	50.0	50.0
General Services Administration	4	427.9	387.5
Housing and Urban Development Community Development Block Grants	356	413.6	329.7

(continued)

Appendix I
Bank's Loan Portfolio as of June 30, 1988

Borrower	Number of loans	Face amount borrowed	Unpaid principal
Housing and Urban Development—Public Housing Notes	47	\$2,288.3	\$2,037.0
Interior—Guam Power Authority	1	36.0	32.6
Interior—Virgin Islands	2	31.0	26.7
National Aeronautics and Space Administration	4	1,405.1	949.4
SBA—Small Business Investment Company	150	920.7	678.5
SBA—State and Local Development Company	4,689	947.3	884.0
TVA—Seven States Energy Corporation	3	1,976.9	1,976.9
Transportation—Section 511 Railroad Loans	22	90.7	48.5
Transportation—Washington Metropolitan Area Transit Authority	1	177.0	177.0
Total	9,467	\$58,892.1	\$52,020.0
Total	9,942	\$166,253.5	\$149,832.7

Note: This information, which was obtained from Treasury's Financial Management Service, was the most complete and readily available information during our review. On loans whose face amount borrowed equals the unpaid principal balance, borrowers generally pay the Bank accrued interest over the loan term and pay off the principal amount at the loan maturity date.

Master Promissory Note Between the Bank and Treasury

Note No. FFB-11

PROMISSORY NOTE

For value received, the Federal Financing Bank promises to pay the Secretary of the Treasury (herein referred to as the Bank and Secretary, respectively), such sums as may be advanced hereunder. Such advances from the Secretary will match the terms and conditions of corresponding loans made by the Bank and shall bear interest payable at the respective rate determined at the time of each advance by the Secretary of the Treasury pursuant to Section 9(b) of the Federal Financing Bank Act of 1973 (12 U.S.C. 2288 (b)). Both principal and interest shall be paid to the Treasury of the United States in such funds as are then legal tender for the payment of debts due to the United States.

Advances on this note shall be made from time to time by the Secretary upon written request of the Bank.

To the extent not inconsistent with applicable law, this note, so long as the Secretary is the holder hereof, shall be subject to modification by such amendments, extensions and renewals as may be agreed upon from time to time by the Secretary and the Bank.

This note is issued, executed and delivered on behalf of the Bank under and pursuant to Section 9(b) of the Federal Financing Bank Act of 1973.

IN WITNESS WHEREOF, the undersigned, as an authorized official of the Bank, has executed this note at Washington, D. C., by signing it as of the date hereof.

THE FEDERAL FINANCING BANK

By

[Handwritten Signature]
Vice President and Treasurer

DATE June 5, 1975

Calculation of Yield on 2-Year Treasury Note, Assuming Annual Interest Payments, When an Investor Desires an Interest Rate of Return Higher Than the Coupon Interest Rate

$$\text{Bid Price} = \frac{\text{1st Year's Interest}}{1 + \text{Desired Annual Yield}} + \frac{\text{Face Amount} + \text{2nd Year's Interest}}{(1 + \text{Desired Annual Yield})^2}$$

Coupon Interest Rate: 10 percent
 Note Face Amount: \$10,000
 Annual Interest: \$1,000
 Bid Price: \$9,500
 Discount Amount: \$500
 r: Desired Annual Yield

The formula used to determine (r) the yield is:

$$9500 = \frac{1000}{1+r} + \frac{11000}{(1+r)^2}$$

add right side of equation over $(1+r)^2$

$$9500 = \frac{1000(1+r) + 11000}{(1+r)^2}$$

or

$$9500 = \frac{1000 + 1000r + 11000}{(1+r)^2}$$

multiply both sides of the equation by $(1+r)^2$

$$9500(1+r)^2 = 12000 + 1000r$$

expand the square

$$9500(1 + 2r + r^2) = 12000 + 1000r$$

multiply and combine terms

$$9500r^2 + 18000r - 2500 = 0$$

using the quadratic formula

$$r = \frac{-b \pm \sqrt{b^2 - 4ac}}{2a}$$

yields

$$r = \frac{-18000 \pm \sqrt{18000^2 - (4)(9500)(-2500)}}{19000}$$

or

$$r = 12.99\%$$

Note: For this illustration of how to calculate the yield on a Treasury security when the investor pays less than face value, we are assuming annual interest payments to present simplified calculations. In actuality, Treasury pays interest payments semiannually.

Prepayment Premiums Based on REA Loan Agreements

The Bank's older REA loan agreements often preclude the prepayment of a loan within the first 12 years of the loan's term. After the first 12 years, the loan may be prepaid at the book value (unpaid principal balance plus accrued interest), plus a prepayment premium based on the loan's interest rate. The prepayment premium is computed based on two factors.

- **Factor A:** 100 percent of 1-year's interest on the loan's outstanding principal balance at the prepayment date.
- **Factor B:** the ratio of (1) the number of originally scheduled loan payments from the prepayment date to the end of the original term to (2) the number of scheduled loan payments from the 13th year of the original term to its end.

The prepayment premium is determined by multiplying 1 year's interest cost calculated under factor A by the ratio calculated under factor B. For example, let us assume that a \$10 million, 30-year, 5-percent loan originally granted on January 1, 1974, was prepaid on July 2, 1989, after the second quarter of the 16th year of the original loan term. The originally scheduled loan principal and interest payments were made quarterly.¹ The prepayment premium would be computed as follows:

- **Factor A:** 100 percent of 1 year's interest at 5 percent on an unpaid principal balance of \$6,627,563 is \$331,378.
- **Factor B:** (1) the number of originally scheduled quarterly loan principal and interest payments after the loan prepayment date is 58 (14 years multiplied by 4 plus 2 for the last 2 quarters in the 16th year) and (2) the number of scheduled principal and interest payments from the 13th year to the end of the original loan term is 72 (18 years multiplied by 4).

By multiplying the factor A interest of \$331,378 by the factor B ratio of 58/72, or 0.805555, a prepayment premium of \$266,944 is computed.

Premiums were designed to compensate the Bank for future interest it gives up by accepting loan payoff before a loan reaches full maturity. However, basing the prepayment premium on the loan's interest rate ties the premium to the Bank's cost of funds when the loan was made

¹Because the loan is prepaid immediately after a quarterly loan principal and interest payment is made, only the unpaid principal balance is due. No accrued interest is due at the prepayment date.

Appendix IV
 Prepayment Premiums Based on REA
 Loan Agreements

rather than to the cost of funds when the loan is prepaid. If the government is to receive a return of the loan's current value, the loan prepayment amount should be based on the current Treasury interest rate prevailing at the prepayment date. This amount reflects the present value of foregone future loan principal and interest payments. In addition, the use of one year's interest times the ratio may not closely approximate the actual present value difference between the loan and the prepayment.

If prepayment amounts and premiums are based on the loan's original interest rate and if interest rates change substantially between the time the loan is granted and the time it is prepaid, the prepayment amounts and premiums can result in an economic gain or cost to the government. If the prevailing Treasury interest rates at the loan prepayment date are higher than the loan's original interest rate, a prepayment premium based on the loan's interest rate would give the Bank a prepayment amount greater than the loan's current Treasury market value and the Bank would realize a gain.

For the previous example, the prepayment amount for a \$10 million, 30-year, 5-percent loan with quarterly payments would be \$6,894,507 if the loan were prepaid immediately after the 62nd quarterly principal and interest payment. The prepayment amount of \$6,894,507 comprises the loan's unpaid principal of \$6,627,563 and a prepayment premium of \$266,944, based on the loan's 5-percent interest rate. Table IV.I compares the total loan prepayment amount of \$6,894,507 with loan market values based on several assumed Treasury interest rates.

Table IV.I: Comparison of Prepayment Amount Based on Loan Interest Rate With Loan Current Treasury Market Values

Treasury interest rate (percent)	Loan market value based on current Treasury rate	Loan prepayment amount based on loan interest rate	Gain or (cost) realized by Bank
4	\$7,074,318	\$6,894,507	\$(179,811)
5	6,627,563	6,894,507	266,944
6	6,220,356	6,894,507	674,151
10	4,912,393	6,894,507	1,982,114

Bank Loans Issued on Behalf of the Defense Security Assistance Agency as of June 30, 1988

Country	Number of loans	Loan unpaid principal
The Republic of Botswana	2	\$6,496,273
Bolivia	1	6,000,000
The Democratic Socialist Republic of Sri Lanka	1	2,000,000
Republic of Zaire	4	20,065,283
The United Republic of Cameroon	2	5,600,296
Columbia	3	24,736,916
Dominican Republic	6	17,158,823
Ecuador	4	13,279,666
Arab Republic of Egypt	8	5,087,000,000
El Salvador	7	97,200,000
The Gabonese Republic	2	2,404,710
Greece	8	1,264,244,863
Haiti	2	598,401
Honduras	6	38,564,185
The Republic of Indonesia	7	192,490,587
Israel	16	8,600,000,000
Jamaica	2	2,520,015
The Hashemite Kingdom of Jordan	7	290,346,890
Kenya	7	80,467,057
Republic of Korea	5	581,000,000
Lebanon	4	100,040,189
Republic of Liberia	2	12,999,170
Morocco	7	135,850,518
The Sultanate of Oman	1	30,000,000
Malaysia	2	6,498,500
Republic of Niger	2	1,970,624
Peru	3	15,203,670
Republic of Pakistan	5	560,000,000
Panama	3	14,902,268
Portugal	3	139,775,044
Philippines	3	59,960,761
Senegal	1	8,000,000
The Somali Democratic Republic	4	59,960,508
The Kingdom of Spain	7	1,240,838,164
The Democratic Republic of the Sudan	4	110,000,000
The Royal Thai Government	6	306,102,050
Tunisia	10	297,963,007
The Republic of Turkey	12	1,825,561,752
Total	179	\$21,257,800,190

Memorandum on Proper Accounting Treatment and Financial Disclosure of Loan Prepayments Accepted by the Federal Financing Bank at Less Than Market Value

GAO

United States
General Accounting Office

Memorandum

DATE: March 14, 1989

TO: Director, AFMD - Frederick D. Wolf

THRU: General Counsel, OGC - James Hinchey

FROM: Associate General Counsel, OGC/AFMD - Gary L. Kepplinger

SUBJECT: Proper Accounting Treatment and Financial Disclosure of Loan Prepayments Accepted by Federal Financial Bank at less than Market Value (B-233879)

This memorandum responds to your request for our legal opinion concerning the accounting treatment of losses incurred by the United States in connection with loan prepayments to the Federal Financing Bank (FFB) at less than market value. Our discussion of this issue specifically focuses on loan prepayments to FFB during fiscal year 1987 from three rural electric cooperatives that had previously received FFB loans guaranteed by the Rural Electrification Administration (REA). However, our analysis regarding the proper legal and accounting treatment of these prepayments and the associated losses would apply as well to the prepayment of other FFB loans in subsequent fiscal years unless the specific legislation involved requires otherwise.

The question you have raised involves a combination of legal and policy considerations that makes it difficult for our Office to provide a definitive answer from a purely legal perspective. Nonetheless, we conclude that when FFB accepted the prepayments at less than market value of loans funded by the Department of the Treasury (Treasury), it suffered a loss that should be disclosed in the FFB's annual financial statement. This loss arises because FFB remains obligated to make prepayments to Treasury in accordance with the terms of the master note agreement between FFB and Treasury. The master note agreement incorporates the



Operations Improvement

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provisions in FFB's loan agreements with its borrowers providing for prepayment based on the market value of the loan at the time of prepayment. While the legislation establishing the loan prepayment program prohibits FFB from collecting any amount in excess of the outstanding balance of loans that are prepaid, the legislation does not prohibit Treasury from collecting such amounts from FFB. Accordingly, FFB remains obligated to the Treasury for the difference between the market value of the loans that were prepaid and the amounts FFB collected from borrowers on those prepaid loans.^{1/}

As a matter of policy, we concur in your division's view that FFB should obtain appropriations to cover the losses it suffers in legislatively mandated prepayment programs. However, while the Office of Management and Budget has advised us that legislation will be proposed that would allow FFB to obtain appropriated funds to finance such losses, until such legislation is enacted, FFB might have to satisfy its obligation to Treasury using the only mechanism it has for obtaining revenues, the add-on fees it charges borrowers, even if this requires FFB to raise these fees. A detailed analysis explaining the basis for our position is attached.

Attachment

^{1/} In addition to the REA guaranteed loans that borrowers prepaid at less than market value during the 1987 fiscal year, FFB also accepted prepayment at book value (or par) for other REA guaranteed loans in fiscal year 1988 and for foreign military sales loans in fiscal years 1988 and 1989. The total amount of such legislatively mandated prepayment losses that FFB suffered in fiscal years 1987, 1988, and in the first quarter of fiscal year 1989 (through December 31, 1988), is approximately \$2 billion.

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Accounting Treatment of Losses Resulting from
Prepayment to FFB at Less than Market Value

Background

The Federal Financing Bank Act of 1973, Pub. L. No. 93-224, 87 Stat. 937, 12 U.S.C. § 2281-2296, established the FFB as a corporate body and instrumentality of the United States for the primary purpose of centralizing "the marketing of Federal and federally assisted borrowing activities." H. Rep. No. 229, 93d Cong. 1st Sess. 2 (1973). Specifically, 12 U.S.C. 2285(a), authorizes the FFB:

"to purchase and sell on terms and conditions determined by the Bank, any obligation which is issued, sold, or guaranteed by a Federal agency."

FFB relies on the authority contained in this provision to make loans guaranteed by federal agencies, such as the REA guaranteed loans at issue here.^{1/} The FFB obtains the funds it needs to make such guaranteed loans and carry out its other activities by borrowing from the Department of the Treasury (Treasury).^{2/} 12 U.S.C. § 2288(b).

^{1/} When FFB makes a guaranteed loan, FFB purchases the borrower's note backed by the agency's guarantee to repay the loan plus interest in accordance with the terms of the note if the borrower defaults. Although 12 U.S.C. § 2285 authorizes FFB to purchase obligations that are only partially guaranteed by a federal agency, FFB as a matter of policy only purchases fully guaranteed obligations. See letter dated August 23, 1977, from the President, FFB, to the Chairman, Senate Committee on Governmental Affairs. Under sections 201(a) and 214 of the Balanced Budget and Emergency Deficit Control Act of 1985, 2 U.S.C. §§ 622(6) and 655(b), FFB loans guaranteed by a federal agency such as REA are treated for budgetary purposes as an outlay of the guaranteeing agency.

^{2/} While FFB functions, in effect, as a "window" of the Treasury, subject to the direction and supervision of the Secretary of the Treasury, 31 U.S.C. § 305, FFB exists as a separate corporate entity legally distinct from the Department of the Treasury. For example, in B-138524, October 30, 1985, we recognized that if FFB borrows from the
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B-233879

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REA guaranteed the loans in question in accordance with 7 U.S.C. § 936, which authorizes the Administrator of REA to fully guarantee loans to eligible borrowers from legally organized lending agencies, including the FFB. This provision specifies that once the Administrator approves a guarantee, the FFB is required, upon the request of the borrower, to make the loan and must do so at a rate of interest that does not exceed "the rate of interest applicable to other similar loans then being made or purchased by the Bank."

In accordance with FFB's current loan prepayment policy, the loan agreements FFB uses in making REA guaranteed loans contain a provision which allows a borrower to prepay a loan based on the current market value of the loan considering comparable Treasury borrowing rates at the time of prepayment. The master note agreement between FFB and Treasury, under which FFB obtains the funds it uses to make these loans, provide that advances of funds from the Treasury to FFB "will match the terms and conditions of corresponding loans made by the Bank ***." Thus, FFB's loan agreement with Treasury incorporates by reference the loan provisions requiring borrowers who prepay a loan to pay market value^{3/} to FFB.

^{2/}(...continued)

public pursuant to 12 U.S.C. § 2288(a), its borrowings, unlike Treasury borrowings, are not subject to the statutory limit on the public debt. However, even though 12 U.S.C. 2288 authorizes FFB to borrow either from the public or the Treasury, FFB in 1978 adopted the policy of borrowing exclusively from the Treasury. See GAO Report, Audit of Financial Statements of the Federal Financing Bank-Fiscal Years 1975 and 1976, at 4, GGD-77-36, April 27, 1977. This remains FFB's policy, although on rare occasions it has borrowed from the public.

^{3/} In this discussion we have avoided the use of such terms as "prepayment premium" or "prepayment penalty" which often are used to refer to the amount by which the market value of a loan exceeds the book value (the book value of a loan equals the outstanding balance of the loan plus accrued interest). The purpose of requiring borrowers to pay market value instead of book value when they prepay a loan is not to penalize them or charge a "premium" for prepaying;
(continued...)

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Section 101 of the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874, 1875, October 21, 1986, (codified at 7 U.S.C. 936a), provides that borrowers of FFB loans guaranteed by REA under 7 U.S.C. 936 may prepay their loans by paying "the outstanding principal balance due on the loan", if certain conditions are met.^{4/} In addition, 7 U.S.C. 936a(b) provides that:

"No sums in addition to the payment of the outstanding principal balance due on the loan may be charged as the result of such prepayment against the borrower, the Fund [REA revolving fund], or the Rural Electrification Administration."

Thus, this provision enables eligible borrowers to prepay their FFB loans without paying market value provided for in their loan agreements with FFB. During fiscal year 1987, three rural electric cooperatives prepaid their FFB loans under the authority contained in 7 U.S.C. § 936a. If the legislation had not prohibited FFB from collecting the difference between book and market value, the three borrowers would have been required to pay FFB an additional \$165 million under the terms of their loan agreements.

^{3/}(...continued)

rather the market value of a loan represents the amount of money the Treasury would have to borrow, as of the date of prepayment, to compensate it for the scheduled loan principal and interest payments lost as a result of a prepayment.

^{4/} Congress has enacted legislation containing similar provisions authorizing eligible borrowers who received REA guaranteed loan from FFB to prepay their loans without paying market value on at least three other occasions as well. See the Urgent Supplemental Appropriations Act, 1986, 99-349, 100 Stat. 713, July 11, 1986; the Supplemental Appropriations Act, 1986, Pub. L. No. 100-71, 101 Stat. 391, 429, July 11, 1987; and the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-20, December 22, 1987.

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Accounting for the Loss

The issue we have been asked to address concerns the accounting treatment of the \$165 million difference between book and market value that FFB did not collect because of 7 U.S.C. § 936a(b). We agree with your assessment that, regardless of how this situation is treated from an accounting standpoint, the federal government has incurred a \$165 million reduction in revenues representing the difference between the market and book value of the prepaid loans.^{5/} See B-226058, July 21, 1987.

Essentially, there are primarily two alternative methods of accounting for the economic loss suffered by the government here.^{6/} Under one view, FFB has no liability to the Treasury for the \$165 million in question because FFB's master loan agreement with Treasury mirrors the terms of the loan agreements between FFB and the borrowers. Therefore, when Congress enacted legislation modifying, in effect, the terms of FFB's loan agreements with the borrowers by

^{5/} Essentially, this loss arises because FFB bases the interest rate it charges its borrowers on the interest rate the Treasury charges FFB plus a 1/8 of 1 percent "add-on" fee. Treasury charges FFB the interest rate the Treasury pays on outstanding marketable obligations of comparable maturities. The Treasury's legal obligation to continue to pay interest on the money it borrows at the rate and for the full term originally agreed upon is not altered when Congress authorizes FFB borrowers to prepay their loans at book rather than market value.

^{6/} Your submission sets forth "three main options" that might be used to account for and report the loan prepayment losses suffered by the United States. However, in our view, the second and third options listed do not represent different methods of accounting for and reporting these losses. Under both options, FFB would be reporting these losses in its annual financial statement. The difference between the two options is the source of the funds FFB would use to satisfy its obligation to Treasury in accordance with the terms of its master note agreement--either from its administrative expense reserve fund, which would probably require FFB to increase its current 1/8 of 1 percent administrative fee, or through an appropriation from Congress.

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deleting the market value requirement for prepayments, Congress at the same time modified the master note agreement between FFB and Treasury. Under this theory, FFB would owe no more to Treasury on account of these loans than it received from the borrowers and, accordingly, would not have a loss (the \$165 million in the uncollected differential between book and market value) to disclose in its fiscal year 1987 financial statement.

Under the alternative theory, FFB remains obligated to the Treasury in accordance with the original terms of the master note agreement. This theory rests on the conclusion that when Congress enacted 7 U.S.C. § 936a precluding FFB from charging borrowers the difference between book and market value, Congress did not change the terms of the FFB agreement with each borrower. Therefore, the terms of FFB's associated master note agreement with Treasury, under which FFB obtained the funds to make these loans, remains unchanged as well. While the legislation expressly prohibits FFB from collecting the fair market value provided for in its loan agreements with its borrowers, the legislation contains no language prohibiting Treasury from collecting such amounts from FFB. Under this theory, FFB suffered a \$165 million loss, representing the difference between what it received from borrowers that prepaid their loans and what it owes to Treasury, which amount should be recorded as a loss on FFB's fiscal year 1987 financial statement. Unless Congress appropriates funds to cover this loss, FFB could satisfy its debt to the Treasury using reserves generated from the administrative add-on fees it charges its borrowers. 12 U.S.C. § 2285(c).

Analysis

While not entirely free from doubt, we conclude that FFB remains liable to the Treasury for the \$165 million in the uncollected difference between book and market value and accordingly should recognize, i.e., fully disclose, the loss in its annual financial statement. In our opinion, loss recognition and reporting reflects the most appropriate method of accounting for the consequences of these transactions, from both a policy and legal perspective.

As you know, it has been the general policy of the General Accounting Office in carrying out its audit activities to favor the fullest possible disclosure of all relevant data and information relating to the subject matter of the audit. Thus, in a "close case", we think the accounting treatment

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of a transaction that ensures the most complete disclosure of what actually occurred would be preferable. In this case, the United States suffered a \$165 million reduction in revenues as a result of the statutory prohibition that prevented FFB from recovering the market value of the three loans prepaid during fiscal year 1987. Accordingly, since the true costs of the prepayment program authorized by Congress will be more fully disclosed if the FFB is required to record the \$165 million difference between book and market value as a loss on its fiscal year 1987 financial statement, we think that approach is clearly preferable from a policy standpoint.

Our legal analysis leads us to conclude that FFB suffered a loss here. As explained in your submission, the view espoused by some officials in the Treasury Department that FFB should not record the \$165 million uncollected differential as a loss rests primarily on two propositions. First, since FFB has not paid or been billed by Treasury for the \$165 million in question, "Treasury accepted from FFB the loan prepayment amounts FFB received from its borrowers in satisfaction of Treasury's related loans issued to FFB," thus, in effect, waiving any claim Treasury might otherwise have had against FFB for the \$165 million in uncollected prepayments. Second, since Congress enacted legislation which directs FFB to accept loan prepayments at book value, rather than market value, FFB should not be held liable for the difference. We do not agree with either argument.

With respect to the "waiver" argument, the Treasury has never, to our knowledge, expressed a definite and unambiguous intention to accept what it has received from FFB on account of these prepayments as payment in full for FFB's underlying obligation to the Treasury. In fact, the Appendix to the Budget for Fiscal Year 1989, specifically states that as a result of the prepayment program mandated by Public Law 99-509, "FFB suffered an associated loss of \$165 million". See Appendix, I-S12. Moreover, in response to our request to the Secretary of the Treasury requesting Treasury's position on this question, the Deputy Assistant Secretary (Federal Finance) advised us in a letter dated January 23, 1989, (copy enclosed) that "appropriate accounting treatment requires that these losses be

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recognized within the FFB".^{7/} The request by Treasury's Inspector General for us to resolve what "has become a major point of disagreement" in its audit of FFB's financial statement for fiscal year 1987 further indicates that a waiver has not taken place.^{8/}

With respect to the contention that FFB is not responsible for any loss because the legislation directs it to accept prepayments at book value, our examination of the statutory language and its legislative history reveals no support for that proposition. While the language in 7 U.S.C. § 936a(b) prohibits FFB from collecting any amount in excess of the "outstanding principal balance" when a loan is prepaid, it does not purport to amend or modify the loan agreements between FFB and its borrowers and, certainly, does not do so with respect to the associated master loan agreement between FFB and Treasury. In this respect, we agree with the view expressed by the Treasury Department's Deputy Assistant Secretary (Federal Finance) as follows:

"Moreover, these Congressional actions do not purport to provide the FFB with any rights to prepay its Treasury borrowings in ways other than

^{7/} As your submission points out, there is an ongoing dispute within the Treasury Department between Treasury's Fiscal Assistant Secretary, who favors the view that FFB did not suffer any loss and has no disclosure obligation, and Treasury's Assistant Secretary of Domestic Finance (the Department that administers the FFB), who takes the opposing view. The January 23, 1989 letter of the Deputy Assistant Secretary (Federal Finance) advises that his "Office is responsible for determining the effects of prepayments upon the FFB and the Treasury."

^{8/} As a factual matter, Treasury has not demonstrated any intention to relinquish whatever claim it might have against FFB for the uncollected difference in prepayments. In this regard, we are not convinced that the Treasury would have the authority to waive FFB's debt if, in fact, it had intended to do so. Cf. B-226718.2, August 19, 1987. The master note agreement between FFB and Treasury is not particularly helpful in this respect. It authorizes FFB and the Secretary of Treasury to enter into "such amendments" thereto as both parties may agree but only "to the extent not inconsistent with applicable law".

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under the terms of the agreement existing between the FFB and the Treasury. The unaltered contractual agreement between the FFB and the Treasury describes the value to the Treasury of the loans which the Treasury has made to the FFB. It is this contractual value which the FFB must pay to the Treasury in order to prepay these Treasury loans to the FFB."

Thus, since the master note agreement between FFB and Treasury incorporated by reference the provisions in FFB's loan agreements with its borrowers providing for loans to be prepaid based on their market value at the time of prepayment, FFB remains obligated to make prepayment to the Treasury on that basis.

Our reading of subsection(a) of 7 U.S.C. § 936a finds support in subsection (b) of the same section. As noted earlier, 7 U.S.C. 936(a) specifically precludes the REA revolving fund and REA, as well as the borrower, from any responsibility to pay the prepayment at market value as provided for in the loan agreement between FFB and the borrower. 7 U.S.C. § 936a(b), when contrasted with subsection (a), suggests that Congress expected the FFB to absorb the full impact of any loan prepayments that were made. In this regard, subsection 936a(b) reads as follows:

"(1) A borrower will not qualify for prepayment under this section if, in the opinion of the Secretary of the Treasury, to prepay in such borrower's case would adversely affect the operation of the Federal Financing Bank.^{9/}

^{9/} For a discussion of the origin of the provision allowing the Secretary of the Treasury to refuse to accept any prepayment of an REA guaranteed loan that he determined "would adversely affect the operation of the Federal Financing Bank," see the legislative history of the Urgent Supplemental Appropriation Act 1986, Pub. L. No. 99-346, 100 Stat. 713, which provided for a prepayment program virtually identical to the one at issue here. Specifically the "adverse affect" language included in Public Law 99-346 was adopted on the floor of the Senate and House of Representatives after the President threatened to veto the Urgent Supplemental Appropriation Act unless Congress amended the proposed Urgent Supplemental to limit the

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"(2) Paragraph (1) shall be effective in fiscal year 1987 only for any loan the prepayment of the principal amount of which will cause the cumulative amount of net proceeds from all such prepayments made during such year to exceed \$2,017, 500,000." (Emphasis added.) 7 U.S.C. § 936a(c).

Thus, with the limited exception for fiscal year 1987, provided in paragraph (2) quoted above, the Secretary of the Treasury can prohibit borrowers from prepaying their loans at book value if the Secretary determines that prepayment by those borrowers would adversely affect the operation of the FFB.

It is difficult for us to understand how FFB's acceptance of loan prepayments at less than market value could have any adverse effect on FFB's operations, unless Congress expected FFB to absorb the impact of any losses resulting from such prepayments. In other words, if, under the statute, any losses FFB suffered as a result of the prepayments flowed through to the Treasury, its acceptance of a prepayment at book value, rather than market value, would never have an adverse effect on its operations and the language permitting FFB to refuse to accept further prepayment would have no meaning.^{10/}

Thus, we interpret the "adverse affect" language as providing the Secretary of Treasury with the opportunity to stop or, at least, suspend FFB's acceptance of further prepayments if the magnitude of the losses suffered by FFB, because of the difference between the value of the prepayments FFB receives from borrowers and the amount it

^{9/}(...continued)
unrestricted prepayment program. See 132 Cong. Rec. S8574-8603 (daily ed. June 26, 1986); and 132 Cong. Rec. H4106-4132 (daily ed. June 24, 1986).

^{10/} In such circumstances, where the loss is passed through to the Treasury, the Treasury suffers the adverse consequences resulting from the acceptance of prepayments at book value rather than market value. However, the statute refers to adverse affects suffered by FFB, not the Treasury.

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owes to Treasury, threatens to have a negative impact on FFB's solvency and financial integrity.^{11/}

Furthermore, we think our conclusion regarding the proper accounting treatment of losses resulting from FFB's acceptance of prepayments at book value is consistent with FFB's enabling legislation and its past operational practices. When Congress established FFB, it authorized FFB "to charge fees for its commitments and other services adequate to cover all expenses and to provide for the accumulation of reasonable contingency reserves."¹² U.S.C. § 2285(c) (emphasis added). Implicitly, this provision recognizes that FFB's lending and borrowing activities could cause losses, in some circumstances, that would require FFB to have such "contingency reserves."

Relying on this authority, FFB currently charges its borrowers a fee of 1/8 of 1 percent.^{12/} Borrowers receiving FFB loans pay interest at a rate that is 1/8 of 1 percent higher than the interest rate on the loans Treasury makes to the FFB to finance FFB's loan to the borrowers. As pointed out in the AFMD submission, these fees are credited to a "reserve fund" that is used to pay FFB's administrative and operating expenses. On a quarterly basis, amounts in the reserve fund that exceed \$1 million are paid into the Treasury General Fund as miscellaneous receipts.

The moneys in this reserve fund have on at least one prior occasion been used to cover losses sustained by FFB in a situation similar to the one we are considering here. In 1977, the Postal Service obtained congressional approval to prepay \$925 million in unpaid principal on FFB loans at par (book value) rather than at market value. However, when FFB prepaid the underlying loan it had obtained from Treasury to fund the Postal Service loans it did so based on the full market value of the loan in accordance with terms of the master agreement between Treasury and the FFB. As a

^{11/} See 132 Cong. Rec. S8602 (daily ed. June 26, 1986).

^{12/} When FFB began its operations in May 1974, it established a fee of 3/8 of 1 percent. In December 1974, FFB reduced the fee to 1/4 of 1 percent and in June 1975, it lowered its fee to its current level of 1/8 of 1 percent. See GGD-77-36 at 8 (1977).

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result, FFB incurred a loss of more than \$18 million that FFB paid to Treasury out of its reserve fund.

The President, FFB, explained FFB's position regarding the add-on fees to the Postal Service prepayment to the Chairmen of the Senate Committee on Governmental Affairs and to the House Committee on Government Operations as follows:^{13/}

"In sum, the Bank is subject to certain contingencies which if they occur should be treated as operating losses, and we believe a fund should be maintained by the Bank against which those losses can be charged. We think that the Bank should continue to charge a sufficient fee on all loans when made to cover these contingencies, the risk to the Treasury in funding Bank loans with market borrowings, and the administrative expenses of the Bank." Letters from the President, FFB, to the Chairmen, Senate Comm. on Governmental Affairs and House Comm. on Government Operations, dated August 23, 1977.

The manner in which FFB and Treasury handled the Postal Service prepayment situation supports our conclusion that when FFB accepts prepayments of loans at less than market value, as authorized or mandated by Congress, FFB suffers a loss representing the difference between the amount it receives from borrowers and the amount it agrees to repay Treasury when it borrows the funds to make the loans.

As a practical matter, FFB presumably could more easily absorb the \$18 million loss suffered as a result of the prepayment of the Postal Service loans than the \$165 million loss suffered as a result of the REA prepayment program or the much larger losses it has suffered or might suffer in the future in other prepayment programs mandated by Congress. From a legal and accounting standpoint, however,

^{13/} Interestingly, FFB sent this letter to both of these congressional committees to advise them of the actions it had taken in connection with recommendations made in GAO's report on FFB's financial statements for fiscal years 1975 and 1976. GAO's primary recommendation was that FFB discontinue the add-on charges until studies confirm that the Treasury will, over the long run, incur a shortfall, because of borrowing and loan rate differentials. GGD-77-36 at 13, (1977).

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the magnitude of the losses suffered by FFB should not have any impact on the manner in which such losses are viewed or treated. Of course, the magnitude of the losses, presumably, will have an impact on FFB's ability to absorb them, and on the method FFB uses to obtain the funds to reimburse the Treasury.

Paying for the Loss

Your memorandum suggests that FFB has two alternatives to obtain the \$165 million it owes the Treasury: (1) FFB could use its reserve fund to cover the loss (as it did in 1977) which, in all likelihood, would require an increase in the current 1/8 of 1 percent "add-on" fee charged borrowers; or (2) FFB could obtain an appropriation from Congress to repay the Treasury.^{14/}

AFMD favors the "appropriations" solution for several reasons. First, the other alternative, which would rely on the funds generated from the fees FFB charges its borrowers, would contradict GAO's position as set forth in the GAO report on FFB's financial statements for fiscal years 1975 and 1976 in which we recommended that FFB "discontinue charging a fee." See GGD-77-36 at 13. Considering the magnitude of the losses suffered by FFB in the REA prepayment program and in other prepayment programs,^{15/} FFB, in all likelihood, would have to increase

^{14/} The latter alternative is consistent with a proposal in the 1990 budget to establish a "central loan accounting account" in Treasury that would be available to fund any deficiencies that result from the prepayment of FFB loans below market value. See Appendix to the Budget for Fiscal Year 1990, I-S11.

^{15/} In addition to the prepayment of REA-guaranteed loans, Congress has authorized the prepayment at "par" of foreign military sales loans during fiscal years 1988 through 1991. See Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1988, Pub. L. No. 100-202, 101 Stat 1329-131, 1329-148 (1987); and Appendix to the Budget For Fiscal Year 1990, I-S11. As of December 31, 1988, FFB has suffered losses in the foreign military sales prepayment program of approximately \$1.3 billion.

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its 1/8 of 1 percent add-on fee to generate adequate reserves to cover the losses. Use of the add-on fee, in effect, passes the cost of a legislatively provided benefit for a few select borrowers to all other FFB borrowers. Second, the appropriations alternative is consistent with the position GAO has taken in the past concerning the measurement and reporting of government subsidy costs on government credit programs generally. See Testimony of Frederick D. Wolf, Director, AFMD, before the Senate Budget Committee, GAO/T-AFMD-87-5(1987).

FFB explains its position regarding this issue to us in its letter of January 23, 1989, as follows:

"As a result of the extent of the losses to FFB resulting from the Congressionally authorized par prepayments, the FFB is forced to consider a reassessment of the magnitude of the add-on which it will charge its borrowers on future loans. Ordinarily, the FFB would be reluctant to consider an increase in the add-on because such an increase would spread to all FFB borrowers the costs of a non-appropriated benefit provided by Congress to a few select borrowers. Since the largest FFB borrowers are government agencies such as the Farmers Home Administration and the Export-Import Bank, the program costs of these agencies would be increased if the add-on is increased. Nevertheless, the FFB must generate sufficient future earnings to cover the losses resulting from this type of prepayment." Letter from Deputy Assistant Secretary (Federal Finance), William J. Bremner, dated January 23, 1989.

FFB's position concerning this issue is understandable. Since FFB remains "liable" on its obligations to the Treasury for the losses sustained as a result of the congressionally mandated prepayment programs, FFB faces a dilemma. Unless and until another funding source becomes available, presumably, FFB must satisfy its obligation to the Treasury using the only mechanism it has for obtaining revenues--the add-on fees it charges its borrowers--even if this requires FFB to increase those fees.

As a matter of policy, we also prefer the appropriations alternative over the other approach. In our view, it is neither desirable nor fair to expect FFB's other borrowers to cover the cost of a special benefit Congress has bestowed

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on a few borrowers. Such an arrangement would, in effect, transfer appropriated funds or budget authority provided for specific programmatic purposes to other agencies that borrow from, or guarantee loans made by, FFB into an entirely different program for which they were not intended. However, if Congress provides appropriations to FFB to cover anticipated losses resulting from this kind of legislatively mandated prepayment program, such losses would be fully disclosed and included in the overall budget and appropriation process, without adversely impacting on other FFB borrowers.

While the appropriations solution requires legislative action, the Office of Management and Budget has advised us in a letter dated February 17, 1989 (copy enclosed), that legislation will be proposed to establish a central loan accounting account that would use appropriated funds to finance losses resulting from the sale or prepayment of FFB loans below market value. See, also, Appendix to the Budget for Fiscal Year 1990, I-S11. If such legislation is enacted, this problem will be resolved.

Comments From the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON

June 12, 1989

Dear Mr. Wolf:

This is in response to your request for the Treasury Department's comments on the GAO draft report, Federal Financing Bank -- The Government Incurred a Cost of \$2 Billion on Loan Prepayments.

We would like to take this opportunity to commend you and your staff for the incisive analysis contained in the draft report. Also, we strongly support your conclusion that loan prepayment programs should not be undertaken unless appropriations are made available to cover the costs incurred. As noted in the report, making appropriations to the program agencies would associate the cost in the budget of the program whose participants receive the benefit.

We appreciate the opportunity to review the draft report.

Sincerely,

William J. Bremner
Deputy Assistant Secretary
(Federal Finance)

Mr. Frederick D. Wolf
Assistant Comptroller General
Accounting and Financial
Management Division
U.S. General Accounting Office
Washington, D.C. 20548

Enclosure

Comments From the Office of Management and Budget



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

June 22, 1989

Mr. Frederick D. Wolf
Assistant Comptroller General
United States General
Accounting Office
Washington, D.C. 20548

Dear Mr. Wolf:

This letter responds to your request for the Office of Management and Budget's comments on the GAO draft report, Federal Financing Bank -- The Government Incurred a Cost of \$2 Billion on Loan Prepayments.

We have already transmitted some informal comments to your staff, which we will not repeat in this response. However, we wish to take this opportunity to agree with the report's findings that prepayments at book value resulted in un-appropriated subsidies to borrowers who repaid their borrowings at less than the contract value of the loan. We also agree that requiring the Federal Financing Bank to accept payment at less than the loan's contract value loan resulted in substantial losses to the Bank, for which Congress has not made provision. We further agree that Congress should properly account for such mandated subsidies by providing an appropriation for the costs of the subsidy (the amount of the loss realized by the FFB) to either the appropriate program agency, the Bank, or a Central Loan Accounting Account in Treasury as proposed in the President's 1990 Budget.

We appreciate the opportunity to review and provide comments on the draft report.

Sincerely,

Kenneth F. Ryder, Jr.
Deputy Associate Director for
Housing, Treasury, and Finance

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Related GAO Products

Borrower Loan Prepayments: OMB Guidelines Need to Be Strengthened
(GAO/AFMD-89-19, January 11, 1989).

Security Assistance: Update of Programs and Related Activities (GAO/
NSIAD-89-78FS, December 28, 1988).

Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, Feb-
ruary 19, 1988).

Federal Financing Bank: Estimated Effects on the Maturity Composition
of the Federal Debt (GAO/GGD-86-43, March 21, 1986).

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