

May 2004

# DEBT CEILING

## Analysis of Actions Taken during the 2003 Debt Issuance Suspension Period



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-04-526](#), a report to congressional committees

## Why GAO Did This Study

GAO is required to review the steps taken by the Department of the Treasury (Treasury) to avoid exceeding the debt ceiling during the 2003 debt issuance suspension period. The committee also directed GAO to determine whether all major accounts that were used for debt ceiling relief have been properly credited or reimbursed. Accordingly, GAO determined whether Treasury followed its normal investment and redemption policies and procedures for the major federal government accounts with investment authority, analyzed the financial aspects of actions Treasury took during this period, and analyzed the impact of policies and procedures Treasury used to manage the debt during the period.

## What GAO Recommends

GAO recommends that the Secretary of the Treasury (1) seek statutory authority to restore Civil Service fund losses associated with the October 2002 early redemption of Federal Financing Bank (FFB) obligations and (2) direct the Under Secretary for Domestic Finance to document necessary policies and procedures for exchange transactions between FFB and a federal government account with investment authority and seek any statutory authority necessary to implement the policies and procedures. Treasury agreed with our recommendations and has already taken certain steps to document the policies and procedures.

[www.gao.gov/cgi-bin/getrpt?GAO-04-526](http://www.gao.gov/cgi-bin/getrpt?GAO-04-526).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gary T. Engel at (202) 512-3406 or [engelg@gao.gov](mailto:engelg@gao.gov).

## DEBT CEILING

# Analysis of Actions Taken during the 2003 Debt Issuance Suspension Period

## What GAO Found

On February 20, 2003, Treasury determined that a debt issuance suspension period was in effect. A debt issuance suspension period is any period for which the Secretary of the Treasury has determined that obligations of the United States may not be issued without exceeding the debt ceiling. During this period, which lasted until May 27, 2003, the Secretary took actions related to the Government Securities Investment Fund of the Federal Employees' Retirement System (the G-Fund), the Civil Service Retirement and Disability Fund (the Civil Service fund), and the Exchange Stabilization Fund (ESF) to avoid exceeding the debt ceiling. Also, during fiscal year 2003, the Secretary initiated several actions involving the Civil Service Fund, FFB, and the Treasury general fund that related to Treasury's efforts to manage the amount of debt subject to the debt ceiling. The Secretary took other actions to avoid exceeding the debt ceiling, such as suspending the sales of State and Local Government Series Treasury obligations and recalling non-interest-bearing deposits held by commercial banks as compensation for banking services provided to Treasury.

The actions taken, which were consistent with legal authorities provided to the Secretary and related to the G-Fund, the Civil Service fund, and ESF, initially resulted in interest losses to the G-Fund and ESF and principal and interest losses to the Civil Service fund. When the debt ceiling was increased to \$7.4 trillion on May 27, 2003, the Secretary fully invested the G-Fund's investments and on May 28, 2003, fully restored the interest losses, as required by law. On June 30, 2003, the Secretary fully compensated the Civil Service fund for principal and interest losses, as required by law. The losses related to ESF could not be restored without special legislation. As a result, related ESF losses of \$3.6 million were not restored.

The actions initiated by Treasury in fiscal year 2003 that involved the early redemption of FFB debt obligations held by the Civil Service fund and exchanges of obligations among the Civil Service fund, FFB, and the Treasury general fund resulted in all three parties realizing gains or incurring losses. In some cases, GAO has been able to quantify the gains or losses that occurred as a result of these transactions. For example, according to FFB estimates, the Civil Service fund lost more than \$1 billion in interest because of FFB's redemption of FFB obligations held by the Civil Service fund before their maturity date and unforeseen interest rate changes. In other cases, however, information needed to understand the potential consequences of these actions will not be available for a number of years. The Secretary currently lacks the statutory authority to restore such losses and has not developed documented policies and procedures that can be used to minimize such losses in future actions that may be taken by Treasury that involve FFB and an account with investment authority such as the Civil Service fund.

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# Contents

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## Letter

Background	1
Results in Brief	2
Objectives, Scope, and Methodology	9
Chronology of Events	13
Normal Investment and Redemption Policies Used on Major Federal Government Accounts with Investment Authority	16
Actions Related to the G-Fund	18
Actions Related to ESF	21
Actions Related to the Civil Service Fund	22
Effects of Exchange of Debt Obligations between the Civil Service Fund, FFB, and Treasury	23
Documented Policies and Procedures Needed for Civil Service and FFB Exchange Transactions	25
Conclusions	30
Recommendations for Executive Action	30
Agency Comments and Our Evaluation	31

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## Appendixes

<b>Appendix I: Gains and Losses on Federal Accounts with Investment Authority</b>	34
Gains and Losses Associated with Normal Investment and Redemption Activity	34
Gains and Losses Associated with Unusual Events	37
<b>Appendix II: Limitations of the Present Value Analysis Approach to Determining Economic Gains and Losses</b>	39
<b>Appendix III: Gains and Losses Associated with Transactions between the Civil Service Fund, FFB, and the Treasury General Fund</b>	42
Civil Service Fund Interest Losses Associated with the October 18, 2002, FFB Early Redemption	42
Civil Service Fund Gains and Losses Associated with the 2003 Exchange Transaction	45
FFB and Treasury General Fund Gains and Losses Associated with the 2003 Exchange Transaction	47
<b>Appendix IV: Transactions between FFB and the Civil Service Fund</b>	52
1985 Debt Ceiling Crisis	52
1995/1996 Debt Ceiling Crisis	52
2003 Debt Issuance Suspension Period	53

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<b>Appendix V: Comments from the Department of the Treasury</b>	<b>54</b>
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<b>Related GAO Products</b>	<b>57</b>
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<b>Tables</b>	Table 1: Chronology of Events	17
	Table 2: Balance of Obligations Held by the Selected 25 Major Federal Government Accounts with Investment Authority as of January 31, 2003	19
	Table 3: Gains, Losses, and Changes in Portfolio Balances Related to Exchanges between the Civil Service Fund and FFB	28
	Table 4: Example of the Impact on a \$1 Million 6 Percent Obligation Using Different Present Value Discount Factors and Maturity Dates	39
	Table 5: Example of Effects of Changing Interest Rates on Present Value Analyses	40
	Table 6: Maturity Dates and Interest Rates Associated with FFB 9(a) Debt Obligations Redeemed before Maturity on October 18, 2002	43
	Table 7: Comparison of Expected Interest Earnings on October 18, 2002, Redemption Using Different Rates	44
	Table 8: How the March 5, 2003, Transactions between the Civil Service Fund, FFB, and the Treasury General Fund Generated a Gain for FFB	48
	Table 9: Example of How Differing Interest Rates Affect Gains and Losses Recognized by FFB and the Treasury General Fund on the Exchange of Par Value Specials for FFB Obligations	49

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<b>Figures</b>	Figure 1: Debt Subject to the Debt Ceiling, 1984-2003	4
	Figure 2: Debt Exchange Process Used for Fiscal Year 2003 Debt Ceiling Relief	45

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

May 20, 2004

The Honorable Richard Shelby  
Chairman  
The Honorable Patty Murray  
Ranking Minority Member  
Subcommittee on Transportation/  
Treasury and General Government  
Committee on Appropriations  
United States Senate

The Honorable Ernest J. Istook, Jr.  
Chairman  
The Honorable John W. Olver  
Ranking Minority Member  
Subcommittee on Transportation and Treasury,  
and Independent Agencies  
Committee on Appropriations  
House of Representatives

Historically, the Congress and the President have enacted laws to establish a limit on the amount of public debt that can be outstanding (debt ceiling).<sup>1</sup> On various occasions over the years, normal government financing has been disrupted because the Department of the Treasury (Treasury) had borrowed up to, or near, the debt ceiling and legislation to increase the debt ceiling had not been enacted. On February 20, 2003, Treasury determined that a debt issuance suspension period was in effect. A debt issuance suspension period is any period for which the Secretary of the Treasury has determined that obligations of the United States may not be issued without exceeding the debt ceiling.<sup>2</sup> This debt issuance suspension period lasted until May 27, 2003, when the Congress and the President raised the debt ceiling to the current \$7.4 trillion. During the 2003 debt issuance suspension period, Treasury took several actions to raise funds to meet federal obligations without exceeding the debt ceiling.

<sup>1</sup>The public debt limit is established by 31 U.S.C. § 3101 (2000) as amended by Pub. L. No. 107-199, § 1, 116 Stat. 734 (2002) and Pub. L. No. 108-24, 117 Stat. 710 (2003).

<sup>2</sup>5 U.S.C. §§ 8348(j)(5)(B), 8438(g)(6)(B) (2000).

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We are required to review the steps taken by Treasury to avoid exceeding the debt ceiling and to determine whether all major accounts that were used for debt ceiling relief have been properly credited or reimbursed.<sup>3</sup> Accordingly, we (1) developed a chronology of significant events, (2) determined whether Treasury followed its normal investment and redemption policies and procedures for the major federal government accounts with investment authority,<sup>4</sup> (3) analyzed the financial aspects of actions Treasury took during the debt issuance suspension period and assessed the legal basis of these actions, and (4) analyzed the impact of the policies and procedures Treasury used to manage the debt during the debt issuance suspension period. This report presents the results of our review of the actions taken and the policies and procedures Treasury implemented during the 2003 debt issuance suspension period.

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## Background

The federal government began with a debt of about \$75 million in 1790. In February 1941, the Congress and the President enacted a law that set an overall limit of \$65 billion on Treasury debt obligations that could be outstanding at any one time.<sup>5</sup> The law was amended to raise the debt ceiling several times between February 1941 and June 1946. The ceiling established in June 1946, \$275 billion, remained in effect until August 1954. At that time, the first temporary debt ceiling was enacted, which added \$6 billion to the \$275 billion permanent ceiling.

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<sup>3</sup>See the Report of the Conference Committee, H.R. Rep. No. 108-401, at 915 (2003), that accompanied the Consolidated Appropriations Act, 2004, Pub. L. No. 108-199, January 23, 2004, which incorporated the request for our review appearing in H.R. Rep. No. 108-243, at 145 (2003).

<sup>4</sup>Most of these accounts are commonly referred to as trust funds.

<sup>5</sup>The public debt limit established by 31 U.S.C. § 3101 applies to the total of the face amount of obligations issued under chapter 31 of title 31, United States Code, and the face amount of obligations whose principal and interest are guaranteed by the U.S. government that are outstanding at any one time.

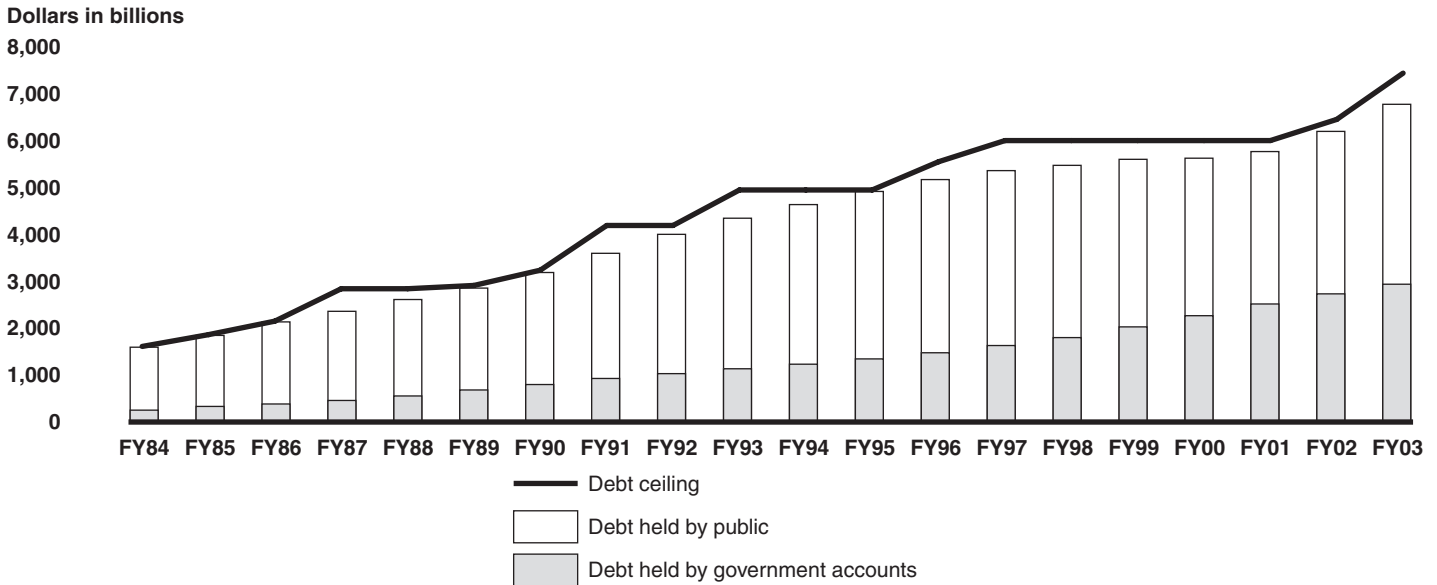
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The Congress and the President have enacted numerous temporary and permanent increases in the debt ceiling. As shown in figure 1, the amount of outstanding debt subject to the debt ceiling<sup>6</sup> has increased from \$1.6 trillion on September 30, 1984, to \$6.7 trillion on September 30, 2003.

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<sup>6</sup>Not all of the obligations issued by federal government agencies are subject to the debt ceiling because either they are not issued under chapter 31 of title 31, United States Code, or their principal and interest are not guaranteed by the U.S. government. See, for example, obligations that may be issued by the Tennessee Valley Authority (TVA) under authority of section 15d(a) of the TVA Act of 1933, 16 U.S.C. 831n-4(a) (2000), and obligations that may be issued by the United States Postal Service (USPS) under the authority of 39 U.S.C. 2005(a) (2000). See *Transaction between the Federal Financing Bank and the Department of the Treasury*, 20 Op. Off. Legal Counsel 64 at 75 (1996).

**Figure 1: Debt Subject to the Debt Ceiling, 1984-2003**



Source: Bureau of the Public Debt, Treasury.

Note: At no point did the amount of outstanding debt exceed the debt ceiling at the end of the above-noted fiscal years. However, at the end of fiscal years 1984, 1985, and 1986, the difference between the amount of debt subject to the debt ceiling and the debt ceiling was about \$25 million—the smallest amount for the period shown in the figure. The 3 years with the next-smallest differences were 1995 (about \$15 billion), 1990 (about \$34 billion), and 1989 (about \$40 billion).

The total amount of debt subject to the debt ceiling as of January 31, 2003, the month before Treasury entered into the 2003 debt issuance suspension period, was about \$6.4 trillion. About 44 percent, or \$2.8 trillion, was held by federal government accounts with investment authority, such as the Social Security trust funds,<sup>7</sup> the Civil Service Retirement and Disability

<sup>7</sup>The Social Security trust funds consist of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund.



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Trust Fund (Civil Service fund), the Exchange Stabilization Fund (ESF), and the Government Securities Investment Fund of the Federal Employees' Retirement System (G-Fund). The remaining \$3.6 trillion represents marketable and nonmarketable obligations held by the public.

The Secretary of the Treasury has several responsibilities related to the federal government's financial management operations, including paying the government's obligations and investing receipts of federal government accounts with investment authority not needed for current benefits and expenses. To meet these responsibilities, the Secretary of the Treasury is authorized by law to issue the necessary obligations<sup>8</sup> to federal government accounts with investment authority for investment purposes and to borrow the necessary funds from the public to pay government obligations.

Under normal circumstances, the debt ceiling is not an impediment to carrying out these responsibilities. Treasury is notified by the appropriate agency (such as the Office of Personnel Management for the Civil Service fund) of the amount that should be invested (or reinvested), and Treasury makes the investment. In some cases, the agency may also specify the obligation that Treasury should purchase. The Treasury obligations issued to federal government accounts with investment authority count against the debt ceiling. If these accounts' receipts are not invested, the amount of debt subject to the debt ceiling does not increase.

We have previously reported on aspects of Treasury's actions during the 2002 debt issuance suspension period and the 1995/1996 and other debt ceiling crises<sup>9</sup> (see Related GAO Products).

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<sup>8</sup>The majority of obligations held by federal government accounts with investment authority are Government Account Series (GAS) securities (commonly referred to as Treasury securities). GAS securities consist of par value securities and market-based securities, with terms ranging from on demand to 30 years. Par value securities are issued and redeemed at par (100 percent of the face value), regardless of current market conditions. Market-based securities, however, can be issued at a premium or discount and are redeemed at par value on the maturity date or at market value if redeemed before the maturity date.

<sup>9</sup>For example, see U.S. General Accounting Office, *Debt Ceiling: Analysis of Actions During the 2002 Debt Issuance Suspension Periods*, [GAO-03-134](#) (Washington, D.C.: Dec. 13, 2002); *Debt Ceiling: Analysis of Actions during the 1995/1996 Crisis*, [GAO/AIMD-96-130](#) (Washington, D.C.: Aug. 30, 1996); *Civil Service Fund: Improved Controls Needed Over Investments*, [GAO/AFMD-87-17](#) (Washington, D.C.: May 7, 1987); and *Treasury's Management of Social Security Trust Funds During the Debt Ceiling Crises*, [GAO/HRD-86-45](#) (Washington, D.C.: Dec. 5, 1985).

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## Statutory Authorities Specifically Enacted to Help Treasury Avoid Exceeding the Debt Ceiling

When Treasury is unable to borrow because the debt ceiling has been reached, the Secretary of the Treasury is unable to fully discharge his financial management responsibilities using normal methods. In 1985, the federal government experienced a debt ceiling crisis from September 3 through December 11. During that period, Treasury took several actions that were similar to those discussed later in this report. For example, Treasury redeemed Treasury obligations held by the Civil Service fund earlier than normal in order to borrow sufficient cash from the public to meet the fund's benefit payments and did not invest some of the fund's receipts. In 1986 and 1987, after Treasury's experiences during prior debt ceiling crises, the Congress enacted several authorities authorizing the Secretary of the Treasury to use the Civil Service fund and the G-Fund<sup>10</sup> to help Treasury manage its financial operations during a debt ceiling crisis. Those authorities, which Treasury used during the 2003 debt issuance suspension period, addressed (1) redemption of Civil Service fund obligations, (2) suspension of Civil Service fund investments, and (3) suspension of G-Fund investments.

1. *Redemption of obligations held by the Civil Service fund.* Subsection 8348(k) of title 5, United States Code, authorizes the Secretary of the Treasury to redeem obligations or other invested assets of the Civil Service fund before maturity to prevent the amount of public debt from exceeding the debt ceiling.<sup>11</sup> The Secretary of the Treasury must determine that a debt issuance suspension period exists in order to redeem Civil Service fund obligations early. The statute authorizing the debt issuance suspension period and its legislative history are silent as to how the Secretary of the Treasury should determine the length of a debt issuance suspension period.
2. *Suspension of Civil Service fund investments.* Subsection 8348(j) of title 5, United States Code, authorizes the Secretary of the Treasury to suspend additional investment of amounts in the Civil Service fund if the investment cannot be made without causing the amount of public

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<sup>10</sup>The G-Fund consists of nonmarketable Treasury obligations held in trust by the federal government as custodian on behalf of individual federal employee participants.

<sup>11</sup>The amount of outstanding obligations that can be redeemed using this authority is limited to the "amount of funds not exceeding the amount equal to the total amount of the payments authorized to be made from the fund" during the debt issuance suspension period. 5 U.S.C. § 8348(k)(2) (2000).

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debt to exceed the debt ceiling.<sup>12</sup> Subsection (j) also authorizes the Secretary of the Treasury to make the Civil Service fund whole after the debt issuance suspension period has ended.

3. *Suspension of G-Fund investments.* Subsection 8438(g) of title 5, United States Code, authorizes the Secretary of the Treasury to suspend the issuance of additional amounts of obligations of the United States to the G-Fund if issuance cannot occur without causing the amount of public debt to exceed the debt ceiling. Subsection (g) also authorizes the Secretary of the Treasury to make the G-Fund whole after the debt issuance suspension period has ended.

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**Other Authorities Relied on  
by Treasury to Avoid  
Exceeding the Debt Ceiling**

During the 2003 debt issuance suspension period, Treasury relied upon authorities in addition to those mentioned above to help manage the amount of debt subject to the debt ceiling. Treasury has also relied on these other authorities during prior periods when it needed to take special actions to avoid exceeding the debt ceiling.

**Suspension of ESF Investments**

Section 5302 of title 31, United States Code, authorizes the Secretary of the Treasury to determine when and if excess funds for ESF will be invested. During previous debt ceiling difficulties, Treasury used this authority to suspend reinvestment of maturing ESF investments to ensure that the debt ceiling was not exceeded.

**FFB 9(a) Obligations Exchanged  
with the Civil Service Fund**

In addition to obligations issued under subsection 8348(d) of title 5, United States Code, other obligations are lawful investments by the Civil Service fund. For example, subsection 8348(e) of title 5, United States Code, authorizes the Secretary of the Treasury to invest surplus Civil Service funds in other interest-bearing obligations of the United States or obligations guaranteed as to both principal and interest by the United States, if the Secretary of the Treasury determines that the purchases are in the public interest. Further, obligations issued by other agencies, such as

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<sup>12</sup>The authority to suspend investments is an exception to the requirement in 5 U.S.C. § 8348(c) (2000) that the Secretary immediately invest the portion of the fund that is not immediately required for payments in interest-bearing obligations of the United States.

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the Tennessee Valley Authority,<sup>13</sup> the United States Postal Service,<sup>14</sup> and the Federal Financing Bank (FFB),<sup>15</sup> are lawful investments for all fiduciary, trust, and public funds whose investments are under the control of the United States, and such obligations are suitable investments for the Civil Service Fund.<sup>16</sup> Treasury relied on such authorities during the 1985 and 1995/1996 debt ceiling crises to exchange obligations issued (commonly referred to as FFB 9(a) obligations) or held by FFB<sup>17</sup> that were not subject to the debt ceiling for Treasury obligations held by the Civil Service fund that were subject to the debt ceiling.

#### Other Special Authorities

In addition to the authorities previously discussed, Treasury has on occasion received special authorities that pertained to specific situations.<sup>18</sup> These special authorities are discussed in our report on the 1995/1996 debt ceiling crisis.<sup>19</sup>

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#### Impact of Gains and Losses on Accounts with Investment Authority

Gains and losses associated with federal government accounts with investment authority and Treasury's general fund can occur for a variety of

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<sup>13</sup>Section 15d(d) of the TVA Act of 1933, 16 U.S.C. § 831n-4(d) (2000).

<sup>14</sup>39 U.S.C. § 2005(d)(3) (2000).

<sup>15</sup>Section 9(d) of the Federal Financing Bank Act of 1973, 12 U.S.C. § 2288(d) (2000). The act's purposes include assuring coordination of federal and federally assisted borrowing programs with the overall economic, fiscal, and debt management policies of the government and reducing the cost of federal and federally assisted borrowing from the public. 12 U.S.C. § 2281.

<sup>16</sup>See *Transaction between the Federal Financing Bank and the Department of the Treasury*, 20 Op. Off. Legal Counsel 64 at 67-70 (1996), concluding that USPS and TVA obligations are suitable investments of the Civil Service fund.

<sup>17</sup>Such obligations include TVA and USPS obligations.

<sup>18</sup>See, for example, Pub. L. No. 104-103, 110 Stat. 55 (1996) (authorizing the Secretary of the Treasury to issue obligations equal to the amount of March 1996 Social Security payments and exempting the obligations from counting against the ceiling) and Pub. L. No. 104-115, 110 Stat. 825 (1996) (exempting certain trust fund obligations issued during a limited period and in a limited amount from being subject to the debt ceiling).

<sup>19</sup>[GAO/AIMD-96-130](#).

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reasons.<sup>20</sup> For example, (1) the type of obligation held may be more susceptible to changes in interest rates and (2) the procedures used to make adjustments can have significant consequences for an account's earnings. Whether these gains and losses affect an account's recipients depends on whether the fund balance is used to determine recipients' benefits. One example where the fund balance has a direct impact on participants is the G-Fund. Specifically, G-Fund earnings are directly related to the amount that G-Fund participants will receive when they redeem their investments. On the other hand, the fund balance in the Civil Service fund does not affect the ultimate payments that retirees and their surviving dependents will receive because the payments will be made from the Treasury general fund even if the Civil Service fund's assets are fully liquidated. Appendix I provides additional information on how gains and losses may occur in accounts with investment authority.

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## Results in Brief

In February 2003, Treasury entered into a debt issuance suspension period because certain receipts of federal government accounts with investment authority could not be invested without exceeding the \$6.4 trillion debt ceiling in effect at the time. This debt issuance suspension period began on February 20, 2003, and lasted until May 27, 2003. It involved Treasury's departure from normal investment and redemption procedures for the G-Fund, ESF, and the Civil Service fund, including exchanging FFB debt obligations for Treasury obligations held by the Civil Service fund. Treasury also took other actions to avoid exceeding the debt ceiling, such as suspending sales of State and Local Government Series (SLGS) Treasury obligations<sup>21</sup> and recalling non-interest-bearing deposits held by commercial banks as compensation for banking services provided to Treasury.

We found that during the 2003 debt issuance suspension period, Treasury used its normal investment and redemption policies and procedures to handle receipts and maturing investments and to redeem Treasury

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<sup>20</sup>Treasury and the Congress have a long-standing position of obtaining the necessary authority to restore interest that was not credited to an account with investment authority because of unusual events. GAO, the Congress, Treasury, and the agency commonly refer to this forgone interest as a "loss" to the fund.

<sup>21</sup>The SLGS obligations program was established in 1972, following federal legislation enacted in 1969 restricting state and local governments from earning arbitrage profits by investing bond proceeds in higher-yielding investments.

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obligations for all but 1 of the 25 major federal government accounts with investment authority that we reviewed. These 25 accounts constituted about 77 percent, or about \$2.1 trillion, of the \$2.8 trillion in Treasury obligations held by federal government accounts with investment authority on January 31, 2003. The departure from normal investment policy and procedures involving one Highway Trust Fund transaction occurred when Treasury erroneously redeemed certain Highway Trust Fund obligations and held the redeemed funds until they were needed to pay fund expenses rather than reinvesting them when the error was detected. We determined that the Highway Trust Fund did not incur any losses due to this error and that the debt ceiling would not have been exceeded even if (1) the error had never been made or (2) Treasury had reinvested the funds when the error was detected.

Consistent with available legal authorities, Treasury departed from its normal investment and redemption procedures for 3 other major federal government accounts with investment authority—the G-Fund, ESF, and the Civil Service fund—that accounted for about \$640 billion of Treasury obligations outstanding on January 31, 2003. During the 2003 debt issuance suspension period, Treasury took the following actions related to the 3 accounts:

- Treasury did not reinvest some of the maturing obligations held by the G-Fund, causing a loss to the G-Fund of about \$362.5 million in interest. On May 27, 2003, when the debt ceiling was raised, the Secretary of the Treasury fully invested the G-Fund's available funds and on May 28, 2003, fully restored the lost interest on the G-Fund's uninvested funds in accordance with subsection 8438(g) of title 5, United States Code. Consequently, the G-Fund was fully compensated for its interest losses.
- Treasury did not reinvest some of the maturing obligations held by ESF. As a result, ESF incurred interest losses of about \$3.6 million. Treasury does not have statutory authority to restore these interest losses.
- Treasury redeemed about \$32.4 billion of Treasury obligations held by the Civil Service fund before they were needed to pay Civil Service fund benefits and expenses and suspended investment of about \$2.5 billion in certain Civil Service fund receipts. On May 27, 2003, when the debt ceiling was raised, Treasury invested about \$30.8 billion of uninvested receipts of the Civil Service fund. These receipts were associated with (1) collections made by the Civil Service fund that had not been invested and (2) funds associated with the early redemptions that had not been

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used for Civil Service fund benefit payments and expenses. As a result of these transactions, the Civil Service fund lost about \$100.8 million. On June 30, 2003, Treasury fully restored this loss on the Civil Service fund's uninvested funds in accordance with subsection 8348(j) of title 5, United States Code.

In addition to the actions described above, Treasury initiated the following actions involving the Civil Service fund, FFB, and the Treasury general fund during fiscal year 2003:

- On October 18, 2002, FFB exercised its right to redeem about \$15 billion of FFB 9(a) obligations held by the Civil Service fund prior to their maturity.
- On March 5, 2003, FFB issued an FFB 9(a) obligation of about \$15 billion to the Civil Service fund in exchange for about \$15 billion in Treasury obligations held by the Civil Service fund. FFB used these Treasury obligations to purchase FFB 9(b) debt obligations held by Treasury. Consequently, Treasury canceled the FFB 9(b) debt obligations that FFB had purchased as well as the Treasury obligations originally issued to the Civil Service fund. These transactions made about \$15 billion of additional borrowing authority available under the debt ceiling because FFB 9(a) obligations are not subject to the debt ceiling.
- On June 30, 2003, FFB redeemed the FFB 9(a) obligation issued to the Civil Service fund and borrowed the necessary funds from Treasury using FFB 9(b) obligations. FFB redemption proceeds were reinvested in the Civil Service fund in accordance with Treasury's normal investment policies and procedures.

Gains or losses on the exchange of obligations between the Civil Service fund and FFB can result when (1) the exchange occurs or (2) the underlying assumptions used to determine the exchange price are not realized. Although we found that the exchange transactions that we reviewed were fair to both parties on the date of the exchange, quantifying the long-term effects of these transactions on the parties involved is difficult and complex because the exchanges were structured to last many years. In some cases, we were able to quantify the gains or losses that have occurred or can be expected to occur that relate to the fiscal year 2003 exchange transactions. In other cases, however, the information needed to understand the potential consequences of these actions will not be available for a number of years. Regardless of whether they sustain any

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additional gains or losses over the long term, the Civil Service fund, FFB, and the Treasury general fund incurred increased risks of gains and losses that they would not have incurred if these transactions had not occurred.

More important, risks, such as unforeseen interest rate changes, related to the transactions between FFB and the Civil Service fund are not typically incurred by these organizations during their normal operations. History has shown, however, that the risks may be substantial. For example, according to FFB estimates, the Civil Service fund lost interest of over \$1 billion on a \$15 billion transaction in October 2002 when FFB decided to redeem early its 9(a) obligations that were issued to the Civil Service fund.<sup>22</sup> These obligations related to Treasury's efforts to manage the debt during the 1985 debt ceiling crisis, and the losses occurred because of (1) the unexpected early redemption by FFB and (2) unforeseen interest rate changes. Although the Secretary of the Treasury has statutory authority to restore losses resulting from not investing Civil Service fund receipts or from early redemption of Treasury obligations held by the Civil Service fund during a debt issuance suspension period, the Secretary of the Treasury does not have statutory authority to restore the types of losses that can result from exchange transactions between FFB and a federal government account with investment authority. Accordingly, Treasury needs statutory authority to restore the losses associated with the October 2002 early redemption of FFB 9(a) obligations.

As we noted in our report on the fiscal year 2002 debt issuance suspension periods,<sup>23</sup> documented policies and procedures would allow Treasury to better determine the potential impacts associated with the policies and procedures it implements to manage the amount of debt subject to the debt ceiling. Although Treasury adopted our recommendation and developed policies and procedures for managing investment and redemption activities of the Civil Service fund and the G-Fund during a debt issuance suspension period, such policies and procedures do not address how exchange transactions between the Civil Service fund and FFB should be handled. It

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<sup>22</sup>In its analysis relating to the early redemption of FFB 9(a) obligations, FFB noted that the beneficiaries of the Civil Service fund are subject to a defined benefit plan and that under current law, their benefits will be honored and paid regardless of the return on the Civil Service fund's investments. See "Federal Financing Bank Borrowings from the Civil Service Retirement and Disability Fund," Memorandum for Peter Fisher, President, FFB, from Paula Farrell, Secretary, FFB (Aug. 16, 2002).

<sup>23</sup>[GAO-03-134](#).



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is the process of documenting the policies and procedures that (1) allows Treasury management to ascertain the effects of these policies and procedures and whether those effects introduce any additional risks to the parties involved, (2) allows Treasury to understand whether it may need additional statutory authority to ensure that all funds are adequately protected, and (3) reduces the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future.

We are recommending that the Secretary of the Treasury (1) seek the statutory authority to restore the losses associated with FFB's early redemption of FFB 9(a) obligations, with restoration computed in a manner that maintains equity between the Civil Service fund and Treasury, and (2) direct the Under Secretary for Domestic Finance to document the necessary policies and procedures that should be used for exchange transactions between FFB and a federal government account with investment authority during a debt issuance suspension period and seek any statutory authority necessary to implement the policies and procedures.

Treasury agreed with our recommendations and stated that (1) it will seek statutory authority to restore losses incurred by federal government accounts with investment authority and by FFB as a result of actions taken for the purpose of fiscal management during a "debt limit impasse" and (2) it will document appropriate policies and procedures that should be used for exchange transactions between FFB and a federal government account with investment authority to ensure the long-term fairness to all parties. Treasury also noted that it has already taken certain steps in documenting the policies and procedures that should be used in future exchange transactions.

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## Objectives, Scope, and Methodology

Our objectives were to

- develop a chronology of significant events related to the 2003 debt issuance suspension period,
- evaluate the actions taken during the 2003 debt issuance suspension period in relation to the normal policies and procedures Treasury uses for investments and redemptions for major federal government accounts with investment authority,

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- analyze the financial aspects of Treasury's actions taken during the 2003 debt issuance suspension period and assess the legal basis of these actions, and
  - analyze the impact of the policies and procedures Treasury used to manage the debt during the 2003 debt issuance suspension period.

To develop a chronology of the significant events related to the 2003 debt issuance suspension period, we obtained and reviewed applicable documents. We also discussed Treasury's actions during the debt issuance suspension period with senior Treasury officials.

To evaluate the actions taken during the 2003 debt issuance suspension period in relation to the normal policies and procedures Treasury uses for certain federal government accounts with investment authority, we obtained an overview of the policies and procedures used and reviewed selected investment and redemption activity to determine whether those transactions were processed in accordance with Treasury's normal policies and procedures. Over 200 different federal government accounts with investment authority hold Treasury obligations, and Treasury officials stated that normal investment and redemption policies and procedures were used for all but 3 of these accounts.

From the federal government accounts with investment authority for which Treasury used its normal investment and redemption policies and procedures, we selected for review accounts with (1) investments in Treasury obligations that exceeded \$10 billion on January 31, 2003 (17 accounts), or (2) recurring investment or redemption transactions of \$1 billion or more from February through May 2003 (8 accounts). For 18 of these 25 accounts, we reviewed selected investment and redemption transactions from February through May 2003. For the remaining 7 accounts, which are managed by the Bureau of the Public Debt, we reviewed all investment and redemption transactions from February through May 2003 except those related to 1 account. For this account, we reviewed all investment and redemption transactions that exceeded \$250 million.<sup>24</sup>

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<sup>24</sup>Because of the large amount of documentation related to the transactions, we reviewed only those transactions that exceeded \$250 million, which we determined would be more susceptible to manipulation affecting the debt ceiling than transactions below that amount.

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The 25 selected federal government accounts with investment authority accounted for about 77 percent, or about \$2.1 trillion, of the \$2.8 trillion in Treasury obligations held by federal government accounts with investment authority on January 31, 2003.<sup>25</sup> For all 25 selected accounts in our review, we confirmed with personnel from the respective agencies the total amount of investment and redemption activity reported by Treasury from February 1, 2003, through May 31, 2003.<sup>26</sup> In any case where normal investment and redemption policies and procedures were not followed, we obtained documentation and other information to help us understand the basis for and impact of the alternative policies and procedures that were used.

To analyze the financial aspects of Treasury's actions that departed from normal investment and redemption policies and procedures, we (1) reviewed the methodologies Treasury developed to minimize the impact of such departures on the G-Fund, ESF, and the Civil Service fund; (2) quantified the impact of the departures; (3) assessed whether any principal and interest losses were fully restored; and (4) assessed whether any losses were incurred that could not be restored under Treasury's current statutory authority.

To assess the legal basis for Treasury's departures from its normal policies and procedures, we identified the applicable legal authorities and determined how Treasury applied them during the 2003 debt issuance suspension period. Our evaluation included authorities related to issuing and redeeming Treasury obligations during a debt issuance suspension period and restoring losses after such a period has ended.

To analyze the impact of the policies and procedures used by Treasury to manage the debt during a debt issuance suspension period, we reviewed the actions taken and the Treasury policies and procedures used during the 2003 debt issuance suspension period. To determine the stated policies and procedures used that related to the Civil Service fund and FFB exchange

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<sup>25</sup>The 3 funds for which Treasury did not follow its normal investment and redemption policies and procedures were also reviewed and had obligation balances totaling \$640 billion on January 31, 2003. Therefore, the 28 funds reviewed totaled about \$2.776 trillion, or about 99 percent of the \$2.815 trillion obligations held by the funds on January 31, 2003.

<sup>26</sup>We used the full-month periods of February 1, 2003, through May 31, 2003, which include the activity during the 2003 debt issuance suspension period (February 20, 2003, to May 27, 2003), because accounting records and reports are generally maintained on a monthly basis.

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transactions, we discussed with Treasury officials the actions taken during this period and examined the support for these actions. We also compiled and analyzed source documents relating to previous debt issuance suspension periods, including executive branch legal opinions, memorandums, and correspondence.

We performed our work from February 2003 through March 2004, in accordance with U.S. generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of the Treasury or his designee. The written response from Treasury's Under Secretary for Domestic Finance is reprinted in appendix V.

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## Chronology of Events

In June 2002, the debt ceiling was raised to \$6.4 trillion. In December 2002, Treasury concluded that this amount might be reached in the latter half of February 2003. Table 1 shows the significant actions the Congress and the executive branch took from June 28, 2002, through June 30, 2003, that relate to the debt ceiling.

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**Table 1: Chronology of Events**

<b>Date</b>	<b>Action</b>
June 28, 2002	The Congress and the President enacted Pub. L. No. 107-199, which raised the debt ceiling to \$6.4 trillion.
October 18, 2002	FFB repaid about \$15 billion of 9(a) obligations it had issued to the Civil Service fund as a result of the 1985 debt ceiling crisis.
December 24, 2002	Treasury notified the Congress that debt subject to the limit might reach the debt ceiling in the latter half of February 2003.
February 19, 2003	The Secretary of the Treasury announced his intent to suspend G-Fund investments beginning on February 20, 2003. Treasury suspended the sales of SLGS Treasury obligations. On May 23, 2003, Treasury announced that the sale of SLGS Treasury obligations would resume on May 27, 2003.
March 5, 2003	FFB exchanged a \$15 billion 9(a) obligation for U.S. Treasury obligations held by the Civil Service fund.
March 25 and 28, 2003	Treasury called back about \$8 billion of Treasury deposits held by commercial banks as compensating balances. According to Treasury officials, these funds were returned to the banks on April 28, 2003.
March 31, 2003	The Secretary of the Treasury began suspending ESF investments.
April 1 and 3, 2003	Treasury called back about \$23.1 billion of Treasury deposits held by commercial banks as compensating balances. According to Treasury officials, these funds were returned to the banks on April 22, 2003.
April 4, 2003	The Secretary of the Treasury declared a debt issuance suspension period beginning no later than April 11, 2003, and lasting until July 11, 2003, which allowed Treasury to redeem Treasury obligations held by the Civil Service fund earlier than normal and to suspend investments of Civil Service fund receipts.
May 1, 2, and 6, 2003	Treasury called back about \$43.4 billion of Treasury deposits held by commercial banks as compensating balances. According to Treasury officials, these funds were returned to the banks on June 16, 2003.
May 15, 2003	Treasury postponed announcement of its weekly 13-week and 26-week bill auctions to avoid exceeding the debt ceiling.
May 19, 2003	The Secretary of the Treasury extended the previously declared debt issuance suspension period until December 19, 2003, which allowed Treasury to redeem additional Treasury obligations held by the Civil Service fund earlier than normal and to continue to suspend investments of Civil Service fund receipts.
May 22, 2003	Treasury postponed announcement of its weekly 13-week and 26-week bill auctions and its monthly 2-year note to avoid exceeding the debt ceiling.
May 27-28, 2003	On May 27, 2003, the Congress and the President enacted Pub. L. No. 108-24, which raised the debt ceiling to \$7.4 trillion and ended the debt issuance suspension period. Treasury invested all uninvested funds of the G-Fund, ESF, and the Civil Service fund on May 27, 2003, and on May 28, 2003, restored the losses incurred by the G-Fund.
June 30, 2003	Treasury fully restored the principal and interest losses incurred by the Civil Service fund that related to (1) the failure to promptly invest Civil Service fund receipts and (2) redeeming obligations before they were needed to pay fund benefits and expenses. FFB also redeemed the \$15 billion 9(a) obligation it issued to the Civil Service fund on March 5, 2003.

Sources: Treasury and GAO.

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## Normal Investment and Redemption Policies Used on Major Federal Government Accounts with Investment Authority

Federal government accounts with investment authority that are authorized to invest their receipts, such as the Civil Service fund,<sup>27</sup> the G-Fund,<sup>28</sup> the Social Security funds,<sup>29</sup> and the Federal Employee Health Benefits Fund,<sup>30</sup> are generally authorized or required to invest them in nonmarketable Treasury obligations. Under normal conditions, Treasury is notified by the appropriate agency of the amount that should be invested or reinvested on its behalf, and Treasury then makes the investment. In some cases, the actual obligation that Treasury should purchase is also specified. When a federal government account with investment authority needs to pay benefits and expenses, Treasury is normally notified of the amount and the date that the disbursement is to be made. Depending on the account, Treasury may also be notified to redeem specific obligations. Based on this information, Treasury redeems an account's obligations.

Our analysis of the 25 major federal government accounts with investment authority for which Treasury stated it had followed its normal investment and redemption policies and procedures during the 2003 debt issuance suspension period showed that for all but 1 account—the Highway Trust Fund—Treasury used its normal investment and redemption policies and procedures to handle receipts and maturing investments and to redeem Treasury obligations. Table 2 lists the federal government accounts with investment authority included in our analysis.

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<sup>27</sup>5 U.S.C. § 8348(d) (2000).

<sup>28</sup>5 U.S.C. § 8438(e) (2000).

<sup>29</sup>Section 201(d) of the Social Security Act, 42 U.S.C. § 401(d) (2000).

<sup>30</sup>5 U.S.C. § 8909(c) (2000).

**Table 2: Balance of Obligations Held by the Selected 25 Major Federal Government Accounts with Investment Authority as of January 31, 2003**

Dollars in billions

Federal government accounts with investment authority	Obligations held as of January 31, 2003
Federal Old Age and Survivors Insurance Trust Fund <sup>a</sup>	\$1,231
Federal Hospital Insurance Trust Fund	238
Department of Defense Military Retirement Fund	178
Federal Disability Insurance Trust Fund <sup>a</sup>	162
Unemployment Trust Fund	57
Federal Supplemental Medical Insurance Trust Fund	34
Bank Insurance Fund	31
Employee Life Insurance Fund	26
Nuclear Waste Disposal Fund	24
Federal Housing Administration—Liquidating Account	23
Highway Trust Fund	19
Department of Defense Medicare Retirement Fund	16
Airport and Airway Trust Fund	13
Pension Benefit Guaranty Corporation	13
Foreign Service Retirement and Disability Fund	12
National Service Life Insurance Fund	11
Savings Association Insurance Fund	11
Railroad Retirement Account	9
Employees' Health Benefits Fund	8
Guarantees of Mortgage-Backed Securities, Government National Mortgage Association	7
National Credit Union Share Insurance Fund	5
Federal Savings and Loan Insurance Fund	3
Railroad Retirement Social Security Equivalent Benefit Account	2
Abandoned Mines Reclamation Fund	2
Postal Service Fund	1
<b>Total</b>	<b>\$2,136</b>

Source: Treasury.

<sup>a</sup>These are Social Security trust funds.

On February 27, 2003, Treasury redeemed about \$343 million of Highway Trust Fund obligations in error. In March 2003, during its normal reconciliation processes, Treasury identified this error. Although normally

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such errors are corrected by investing the funds redeemed in error on the date the error is detected, Treasury did not do so. Rather, it decided to hold the excess funds in an uninvested funds account until they were needed to pay Highway Trust Fund expenses. The funds were used to pay the fund's expenses through March 24, 2003. According to Treasury officials, the primary reasons for not making the necessary reinvestment transaction on the date the error was detected and validated were that (1) the Highway Trust Fund does not earn interest on its investments<sup>31</sup> and (2) the time necessary to identify the error and fully understand its impact meant that very little time actually elapsed when the funds could have been invested. Therefore, the Highway Trust Fund was not harmed by Treasury's decision to not invest the funds. However, Treasury officials subsequently agreed that the over-redemption should have been reinvested on the day the error was detected and adequate information was available to understand the amount that should have been invested, regardless of whether the Highway Trust Fund earns interest on its investments.<sup>32</sup> Holding the excess funds in an uninvested funds account reduced the amount of debt subject to the debt ceiling by no more than \$343 million for 26 days during the 2003 debt issuance suspension period.

To determine whether Treasury would have exceeded the debt ceiling if it had not committed this error or had reinvested the over-redeemed amount of funds when the error was discovered, we reviewed the invested balances in the G-Fund during this period. As noted elsewhere in this report, Treasury used the G-Fund during the 2003 debt issuance suspension period to ensure that the investment activities associated with federal government accounts with investment authority, such as the Highway Trust Fund, do not cause Treasury to exceed the debt ceiling. Based on our review, we found that the debt ceiling would not have been exceeded even if Treasury had not made the original error or had invested these funds when the error was detected, since other policies and procedures would have ensured a corresponding reduction in the amount of funds invested on behalf of the G-Fund. For example, on February 27, 2003, the computation Treasury used

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<sup>31</sup>Subsection 9503(f)(2) of title 26, United States Code, provides that after September 30, 1998, Highway Trust Fund assets would be invested in non-interest-bearing U.S. obligations. Thus, the Highway Trust Fund does not earn interest on its investments. As such, failure to invest excess fund receipts did not have an economic effect on the fund.

<sup>32</sup>Treasury policies and procedures call for the correcting entry to reflect the actual date that the transaction should have been recorded. For example, in this case, if the Treasury policies and procedures had been followed, the over-redemption detected and validated in March 2003 would have been invested on the appropriate date.



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to determine the amount that should be invested in the G-Fund showed that Treasury could invest about \$22.9 billion of G-Fund receipts. If the Highway Trust Fund error had not been made, this computation would have shown that Treasury could have invested about \$22.6 billion in the G-Fund, or about \$0.3 billion less than what was actually invested. Therefore, the amount of debt subject to the debt ceiling would have remained unchanged from its reported \$6.4 trillion level.

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## Actions Related to the G-Fund

Subsection 8438(g)(1) of title 5, United States Code, authorizes the Secretary of the Treasury to suspend the issuance of additional amounts of obligations of the United States to the G-Fund if the issuance cannot be made without causing the amount of public debt to exceed the debt ceiling. Each day from February 20, 2003, to May 27, 2003, Treasury determined the amount of funds that the G-Fund would be allowed to invest in Treasury obligations and, when necessary, suspended some investments and reinvestments of the G-Fund receipts and maturing obligations that would have caused the debt ceiling to be exceeded.

On February 20, 2003, when the Secretary of the Treasury determined that a debt issuance suspension period had begun, the G-Fund held about \$48.3 billion of Treasury obligations that would mature that day. To ensure that it did not exceed the debt ceiling, Treasury did not reinvest about \$8.5 billion of these obligations on that date.

The amount of the G-Fund's receipts that Treasury invested changed daily, depending on the amount of the federal government's outstanding debt. Although Treasury can accurately predict the outcome of some events that affect the outstanding debt, it cannot precisely determine the outcome of others until they occur. For example, the amount of obligations that Treasury will issue to the public from an auction can be determined some days in advance because Treasury can control the amount that will be issued. On the other hand, the amount of savings bonds that will be issued and redeemed and the amount of obligations that will be issued to, or redeemed by, various federal government accounts with investment authority are difficult to precisely predict. Because of these difficulties, Treasury needed a way to ensure that the normal investment and redemption activities associated with Treasury obligations did not cause the debt ceiling to be exceeded and also to maintain normal investment and redemption policies for the majority of these accounts. To do these things, each day during the debt issuance suspension period, Treasury

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- calculated the amount of debt subject to the debt ceiling, excluding the receipts that the G-Fund would normally invest;
  - determined the amount of G-Fund receipts that could safely be invested without exceeding the debt ceiling and invested this amount in Treasury obligations; and
  - suspended investment, when necessary, of the G-Fund's remaining receipts.

For example, on February 27, 2003, the amount of debt subject to the debt ceiling, excluding the G-Fund's requested investment of about \$49 billion, was about \$6,377 billion or about \$23 billion below the debt ceiling. Accordingly, Treasury invested about \$23 billion in the G-Fund. The remaining \$26 billion was uninvested. In accordance with law, interest on the uninvested funds was paid once the debt issuance suspension period ended.

During the 2003 debt issuance suspension period, the G-Fund lost about \$362.5 million in interest because its excess funds were not fully invested. Subsection 8438(g)(3) of title 5, United States Code, requires the Secretary of the Treasury to make the G-Fund whole by restoring any losses once the debt issuance suspension period has ended. On May 27, 2003, when the debt ceiling was raised, Treasury fully invested the G-Fund's receipts and on May 28, 2003, fully restored the lost interest on the G-Fund's uninvested funds. Consequently, the G-Fund was fully compensated for its interest losses during the 2003 debt issuance suspension period. We verified that after this interest payment, the G-Fund's obligation holdings were, in effect, the same as they would have been had the debt issuance suspension period not occurred.

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## Actions Related to ESF

On several occasions from March 31, 2003, through May 23, 2003, Treasury did not reinvest some of the maturing obligations held by ESF. Because ESF's obligations are considered part of the federal government's outstanding debt subject to the debt ceiling, that debt is reduced when the Secretary of the Treasury does not reinvest ESF's maturing obligations. Since ESF was not fully invested, it incurred interest losses of \$3.6 million during the 2003 debt issuance suspension period. The Secretary of the Treasury is not authorized by law to restore these losses.

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The purpose of ESF is to help provide a stable system of monetary exchange rates. The law establishing ESF authorizes the Secretary of the Treasury to invest ESF's balances not needed for program purposes in obligations of the federal government. This law also gives the Secretary of the Treasury the sole discretion for determining when, and if, the excess funds will be invested. During previous debt ceiling crises, Treasury exercised the option of not reinvesting ESF's maturing Treasury obligations, which helped the federal government to stay within the debt ceiling and enabled Treasury to subsequently raise additional cash.

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## Actions Related to the Civil Service Fund

During the 2003 debt issuance suspension period, the Secretary of the Treasury redeemed certain Treasury obligations held by the Civil Service fund earlier than normal and suspended the investment of certain Civil Service fund receipts. In addition, as discussed later, the Civil Service fund exchanged Treasury obligations it held for a \$15 billion FFB 9(a) obligation.

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## Obligations Held by the Civil Service Fund Redeemed Earlier Than Normal

Subsection 8348(k)(1) of title 5, United States Code, authorizes the Secretary of the Treasury to redeem obligations or other invested assets of the Civil Service fund before maturity to prevent the amount of public debt from exceeding the debt ceiling. The statute does not require that early redemptions be made only for the purpose of making Civil Service fund payments. Further, the statute permits early redemptions even if the Civil Service fund has adequate cash balances to cover such payments.

Before redeeming Civil Service fund obligations earlier than normal, the Secretary of the Treasury must determine that a debt issuance suspension period exists. The statute authorizing the debt issuance suspension period and its legislative history are silent as to how to determine the length of a debt issuance suspension period. On April 4, 2003, the Secretary of the Treasury declared that a debt issuance suspension period, as it relates to the Civil Service fund, would begin no later than April 11, 2003, and would last until July 11, 2003. On May 19, 2003, the Secretary of the Treasury extended this period until December 19, 2003.

On April 8, 2003, and May 20, 2003, Treasury redeemed about \$12.2 billion and \$20.2 billion, respectively, of the Civil Service fund's Treasury obligations using its authority under subsection 8348(k)(1) of title 5, United States Code. The \$32.4 billion redemption amount was determined based on (1) the length of the initial debt issuance suspension period (April 8

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through July 11, 2003) and the related extension (through December 19, 2003) and (2) the estimated monthly Civil Service fund benefit payments that would occur during that time.<sup>33</sup> These were appropriate factors to use in determining the amount of Treasury obligations to redeem early.

Treasury redeemed about \$12.2 billion early to cover the obligations associated with the May, June, and July 2003 estimated benefit payments on April 8, 2003. As such, when May's benefit payments were due, Treasury redeemed only the \$60 million difference between the amount that had been redeemed early for the month of May and the actual amount of benefit payments to be made.

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### Investment of Civil Service Fund Receipts Suspended

Subsection 8348(j)(1) of title 5, United States Code, authorizes the Secretary of the Treasury to suspend additional investment of amounts in the Civil Service fund if the investment cannot be made without causing the amount of public debt to exceed the debt ceiling. From April 8, 2003, through May 26, 2003, the Civil Service fund had about \$2.5 billion in receipts that were not invested. On May 27, 2003, after the debt ceiling was raised, these receipts were invested.

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### Civil Service Fund Losses Associated with Early Redemptions and Suspended Investments Restored

When the Secretary of the Treasury redeems obligations earlier than normal or refrains from promptly investing Civil Service fund receipts because of debt ceiling limitations, the Secretary is required by subsection 8348(j)(3) of title 5, United States Code, to immediately restore, to the maximum extent practicable, the Civil Service fund's obligation holdings to the proper balances when a debt issuance suspension period ends and to restore lost interest on the next normal interest payment date. Consequently, Treasury took the following actions once the debt issuance suspension period had ended:

- Treasury invested about \$30.8 billion of uninvested receipts on May 27, 2003. These receipts were associated with (1) collections made by the Civil Service fund that had not been invested and (2) funds associated

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<sup>33</sup>According to Treasury officials, they use the amount of expected benefit payments that will be issued on the first business day of a month in this calculation. For any other benefit payments and expenses incurred by the Civil Service fund during the month, obligations are redeemed on that payment date.

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with the early redemptions that had not been used for benefit payments and expenses.

- Treasury paid the Civil Service fund on June 30, 2003, about \$100.8 million as compensation for principal and interest losses incurred because of the actions it had taken. This was the first semiannual interest payment date since the debt issuance suspension period ended. June 30, 2003, was the proper restoration date according to the statute authorizing the restoration.

We verified that after these transactions the Civil Service fund's obligation holdings were, in effect, the same as they would have been had the debt issuance suspension period not occurred.

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## Effects of Exchange of Debt Obligations between the Civil Service Fund, FFB, and Treasury

During fiscal year 2003, Treasury initiated the following actions involving the Civil Service fund, FFB, and the Treasury general fund related to its efforts to (1) address FFB cash flow issues resulting from previously issued FFB 9(a) obligations to the Civil Service fund and (2) manage the amount of debt subject to the debt ceiling:

- On October 18, 2002, FFB redeemed prior to maturity \$15 billion in FFB 9(a) obligations held by the Civil Service fund. The \$15 billion in FFB 9(a) obligations do not count against the debt ceiling.<sup>34</sup> These FFB 9(a) obligations were the result of a series of transactions stemming from a Treasury-directed exchange of Treasury obligations held by the Civil Service fund for FFB 9(a) obligations to assist Treasury in managing the debt during the 1985 debt ceiling crisis. This early redemption resulted

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<sup>34</sup>Comptroller General Opinion to the Honorable John LaFalce, Chairman, Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Affairs, B-138524 (Oct. 30, 1985), and *The Federal Financing Bank and Debt Ceiling: Hearing before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs*, 99th Cong. 28-34 (1986) (Statement of Harry Havens, Assistant Comptroller General, U.S. General Accounting Office).

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in a loss of over \$1 billion on October 18, 2002, to the Civil Service fund because of lost interest.<sup>35</sup>

- On March 5, 2003, FFB issued an FFB 9(a) obligation of about \$15 billion to the Civil Service fund in exchange for about \$15 billion in Treasury obligations that had been held by the Civil Service fund. FFB used the Treasury obligations to purchase FFB 9(b) obligations held by the Secretary of the Treasury.<sup>36</sup> As a result, the FFB 9(b) debt obligations were canceled and the Treasury obligations that were no longer outstanding were canceled.<sup>37</sup> Consequently, Treasury was provided about \$15 billion in additional borrowing authority under the debt ceiling.
- On June 30, 2003, FFB redeemed early the 9(a) obligation it had issued to the Civil Service fund on March 5. Treasury reinvested the FFB redemption proceeds in accordance with its normal investment policies and procedures.

Our review found that on March 5, 2003, and June 30, 2003, the Civil Service fund received fair value based on a present value analysis<sup>38</sup> for the obligations it surrendered. However, whether the Civil Service fund will have any long-term gains or losses associated with these transactions will not be known for some time.

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<sup>35</sup>In its analysis relating to the early redemption of FFB 9(a) obligations, FFB noted that the beneficiaries of the Civil Service fund are subject to a defined benefit plan and that under current law, their benefits will be honored and paid regardless of the return on the Civil Service fund's investments. See "Federal Financing Bank Borrowings from the Civil Service Retirement and Disability Fund," Memorandum for Peter Fisher, President, FFB, from Paula Farrell, Secretary, FFB (Aug. 16, 2002).

<sup>36</sup>Section 9(b) of the Federal Financing Bank Act of 1973, 12 U.S.C. § 2288(b) (2000), authorizes FFB to issue obligations to the Secretary of the Treasury, and the Secretary is authorized at his discretion to purchase such obligations.

<sup>37</sup>For a detailed discussion of the legal support for these transactions, see Memorandum for Secretary Snow from David D. Aufhauser, "Authority of the Secretary of the Treasury and the Federal Financing Bank to Enter into a Series of Transactions That Are Intended to Reduce the Amount of Outstanding Debt That Is Subject to the Debit Limit Statute" (Mar. 4, 2003).

<sup>38</sup>Present value is the discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present value represents a series of future cash flows expressed in today's dollars.

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Gains or losses on the exchange of obligations between the Civil Service fund and FFB can result when (1) the exchange occurs or (2) the underlying assumptions used to determine the exchange price are not realized. We have found that the initial transactions between FFB and the Civil Service fund relating to a given period in which Treasury was experiencing debt ceiling difficulties<sup>39</sup> were fair to both parties on the date of the exchange. However, quantifying the long-term effects of these transactions on the parties involved is difficult and complex because the exchanges were structured to last many years. The longer the period in the analysis used to evaluate the fairness of a given transaction, such as a present value analysis, the greater the probability that the underlying assumptions used to determine the original exchange price will not accurately reflect the future years' events. This risk is also incurred when the obligations relating to an exchange remain outstanding for a long time. When the assumptions used to determine the initial exchange prices are not realized (e.g., the obligation is redeemed sooner than expected), gains and losses can result from interest rate changes and reinvestment of the repayment in obligations that do not have comparable maturities. For further discussion on the limitations of using a present value methodology to determine gains and losses, see appendix II.

In some cases, we have been able to quantify the gains or losses that have occurred or can be expected to occur that relate to the fiscal year 2003 transactions. However, in other cases, the information needed to understand the potential consequences of the actions taken on March 5 and June 30, 2003, will not be available for a number of years, and we are unable to determine the potential impacts at this time. Table 3 summarizes the gains and losses associated with the fiscal year 2003 transactions between the Civil Service fund, FFB, and the Treasury general fund that we have been able to quantify and those that cannot be determined at this time.

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<sup>39</sup>The Civil Service fund and FFB have exchanged obligations on several occasions, including during the 2003 debt issuance suspension period.

**Table 3: Gains, Losses, and Changes in Portfolio Balances Related to Exchanges between the Civil Service Fund and FFB**

	Effect on Civil Service fund	Effect on FFB	Effect on Treasury general fund
<b>Result of FFB's October 18, 2002, early redemption of FFB 9(a) obligations held by the Civil Service fund</b>			
Gains/losses on transaction date (Oct. 18, 2002)	The Civil Service fund lost interest with a present value of over \$1 billion on the date of the exchange because FFB redeemed funds early and they were invested in Treasury obligations at a significantly lower interest rate than the rates on the FFB 9(a) debt obligations.	Gain unknown.	Not applicable.
Additional gains/losses through June 30, 2005	The Civil Service fund will lose about \$33.4 million in nominal interest because Treasury invested FFB's repayment to the Civil Service fund on October 18, 2002, in accordance with its normal investment policies and procedures rather than using the present value assumptions used to calculate the over \$1 billion of interest.	Not applicable.	Not applicable.
<b>Net result of the March 5, 2003, exchange of Treasury obligations held by the Civil Service fund for FFB 9(a) obligation and FFB's June 30, 2003, early redemption of the obligation</b>			
Net gains/losses on transaction dates (Mar. 5, 2003, and June 30, 2003) and changes in portfolio balances	The Civil Service fund's portfolio balance increased by \$1.153 billion. This increase occurred because the present value of the FFB 9(a) obligation redeemed on June 30, 2003, was greater than the face amount of the Treasury obligations exchanged on March 5, 2003. The majority of this increase was necessitated by Treasury having to invest the June 30, 2003, redemption in obligations with a lower interest rate than the Treasury obligations used in the exchange on March 5, 2003. Further, as discussed in app. III, falling interest rates made the FFB 9(a) obligation more valuable on June 30, 2003, than if the Civil Service fund had maintained the Treasury obligations exchanged on March 5, 2003, in its portfolio. This increase was about \$139.5 million and resulted in a gain to the Civil Service fund. This gain was included in the \$1.153 billion increase in Treasury obligations.	<ul style="list-style-type: none"> <li>• FFB incurred a \$633 million net loss caused by the difference between (1) the additional \$1.153 billion payment from FFB to the Civil Service fund to ensure that the Civil Service fund's future interest earnings would be comparable to its expected interest earnings if the June 30, 2003, FFB repayment was invested in obligations with maturities that were consistent with the present value assumptions and (2) the \$520 million gain on FFB's sale of the Civil Service fund obligations to Treasury.</li> <li>• FFB's loan balance to Treasury increased by about \$1.1 billion because of additional short-term borrowing from Treasury, which was repaid on April 1, 2004.</li> </ul>	The Treasury general fund incurred a \$520 million loss on the purchase from FFB of the Civil Service fund Treasury obligations because Treasury purchased them at more than their par value.



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(Continued From Previous Page)

	Effect on Civil Service fund	Effect on FFB	Effect on Treasury general fund
Gains and losses after June 30, 2003, and changes in portfolio balances	Unknown.	FFB has an expected gain of \$1.153 billion. This expected gain results from the fact that FFB's interest costs associated with its June 30, 2003, borrowings from Treasury that were used to redeem the FFB 9(a) obligation issued to the Civil Service fund are significantly lower than its expected interest income from its loan portfolio.	None.

Sources: Treasury and GAO.

As discussed in the preceding narrative and shown in table 3, it is difficult to quantify all the losses and gains associated with the transactions between FFB and the Civil Service fund. A more detailed explanation of these gains and losses, as well as the reasons why not all of the effects of these transactions can be quantified at this time, is provided in appendix III. Regardless of whether they sustain any additional gains or losses over the long term, the Civil Service fund, FFB, and the Treasury general fund incurred increased risks of gains and losses that they would not have incurred if these transactions had not occurred. More important, the risks related to the transactions between FFB and the Civil Service fund are not typically incurred by these organizations during their normal operations.

It is important to remember that the risks associated with these exchange transactions are not undertaken for programmatic reasons. Rather, they are made at the direction of the Secretary of the Treasury to help manage the federal government's operations when debt ceiling difficulties occur. FFB and Treasury have flexibilities that allow them to structure transactions that reduce or even eliminate the losses that FFB can incur. However, similar flexibilities are not available to the Civil Service fund. Furthermore, although the Secretary of the Treasury has statutory authority to restore losses resulting from not investing Civil Service fund receipts or from early redemption of Treasury obligations held by the Civil Service fund during a debt issuance suspension period, the Secretary does not have the statutory authority to restore the types of losses, discussed above, that result from exchange transactions. Appendix IV discusses transactions between the Civil Service fund and FFB that related to previous debt management difficulties.

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## Documented Policies and Procedures Needed for Civil Service and FFB Exchange Transactions

As we noted in our December 2002 report, documented policies and procedures would allow Treasury to better determine the potential impacts associated with the policies and procedures it implements to manage the amount of debt subject to the debt ceiling. Although Treasury adopted our recommendation and developed policies and procedures for managing investment and redemption activities of the Civil Service fund and the G-Fund during a debt issuance suspension period, such policies and procedures do not address how exchange transactions between the Civil Service fund and FFB should be handled. While we recognize that Treasury needs a great deal of flexibility to structure transactions that fit specific events, we believe that guidelines related to exchange transactions between the Civil Service fund and FFB can be developed that minimize the risk to both parties.

It is the process of documenting the policies and procedures that allows Treasury management to ascertain the effects of these policies and procedures and whether those effects introduce any additional risks to the parties involved. In addition, documenting the policies and procedures allows Treasury to understand whether it may need additional statutory authority to ensure that all funds are adequately protected. Furthermore, if effectively implemented, documentation of the policies and procedures reduces the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future. These points were discussed in our December 2002 report to Treasury.<sup>40</sup> During our review of the actions taken during the 2003 debt issuance suspension period that were affected by those policies and procedures, we found that none of the problems or potential problems that we discovered in the 2002 debt issuance suspension period had occurred.

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## Conclusions

The Secretary of the Treasury can take many actions to manage federal government operations during a debt issuance suspension period. In some cases, these actions pose no long-term financial risk to affected parties because of the statutory authorities currently available to the Secretary of the Treasury. As noted earlier, Treasury used these authorities to restore, in total, \$463 million in losses incurred by the G-Fund and Civil Service fund. However, other actions expose the affected parties to financial risks that are not normally incurred as part of their programmatic operations.

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<sup>40</sup>[GAO-03-134](#).

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Whether the risks associated with specific actions result in actual losses or gains may not be known until many years after the action has been taken. History has shown, however, that the risks may be substantial. For example, according to FFB estimates, on October 18, 2002, the Civil Service fund lost interest of over \$1 billion on a \$15 billion transaction entered into in 1985 because of the unexpected early redemption of 9(a) obligations issued by FFB and unforeseen interest rate changes. Treasury lacks the statutory authority to restore such losses and has not developed the documented policies and procedures that can be used to minimize such losses in future exchanges between FFB and federal government accounts with investment authority, such as the Civil Service fund.

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## Recommendations for Executive Action

We recommend that the Secretary of the Treasury perform the following two actions:

- Seek the statutory authority to restore the losses associated with the October 2002 early redemption of FFB 9(a) obligations. The amount of the restoration should be computed in a manner that maintains equity between the Civil Service fund and Treasury.
- Direct the Under Secretary for Domestic Finance to document the necessary policies and procedures that should be used for exchange transactions between FFB and a federal government account with investment authority during a debt issuance suspension period and seek any statutory authority necessary to implement the policies and procedures.

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## Agency Comments and Our Evaluation

In written comments on a draft of this report, Treasury agreed with our recommendations and stated that (1) it will seek statutory authority to restore losses incurred by federal government accounts with investment authority and by FFB as a result of actions taken for the purpose of fiscal management during a “debt limit impasse” and (2) it will document appropriate policies and procedures that should be used for exchange transactions between FFB and a federal government account with investment authority to ensure long-term fairness to all parties. Treasury has stated that the authority it will seek includes the restoration of the losses associated with the October 2002 early redemption of FFB 9(a) obligations as we recommended. Until Treasury develops its specific legislative proposal and the policies and procedures it will use relating to

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transactions between FFB and federal government accounts with investment authority, we cannot determine the scope of the statutory authority it may seek. Treasury also noted that it has already taken certain steps in documenting the policies and procedures that should be used in future exchange transactions.

Treasury stated that it plans to use FFB's independent auditor to "ensure that the terms and structure [of exchange transactions] clearly achieve the intended accounting result and long-term financial fairness to all parties, prior to transaction approval and execution." Treasury and its independent auditor will need to ensure that this arrangement does not result in a problem with auditor independence under U.S. generally accepted government auditing standards.<sup>41</sup> The independence standard requires that auditors should avoid situations that could lead reasonable third parties with knowledge of the relevant facts and circumstances to conclude that the auditor is not able to maintain independence in conducting its financial statement audit. For example, audit organizations should not perform management functions or make management decisions for entities that they also audit.

Specific technical comments provided orally by Treasury were incorporated in this report as appropriate.

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We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Appropriations; the Senate Committee on Governmental Affairs; the Senate Committee on the Budget; the Senate Committee on Finance; the Subcommittee on Financial Management, the Budget, and International Security, Senate Committee on Governmental Affairs; the House Committee on Appropriations; the House Committee on Government Reform; the House Committee on the Budget; the House Committee on Ways and Means; the Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform; and the Subcommittee on Civil Service and Agency Organization, House Committee on Government Reform. We are also sending copies of this report to the Secretary of the Treasury, the Under Secretary for Domestic Finance of the Department of the Treasury, the Inspector General of the Department of the Treasury, the Director of the

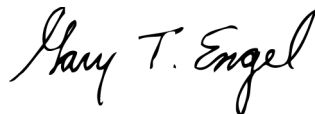
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<sup>41</sup>U.S. General Accounting Office, *Government Auditing Standards: 2003 Revision*, [GAO-03-673G](#) (Washington, D.C.: June 2003).

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Office of Management and Budget, and other agency officials. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you need further assistance or if you or your staff have any questions concerning this report, please contact Chris Martin, Senior Level Technologist, at (202) 512-9481 or Louise DiBenedetto, Assistant Director, at (202) 512-6921. Other key contributors to this report were Wendy M. Albert, Arkelga L. Braxton, and Richard T. Cambosos.



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# Gains and Losses on Federal Accounts with Investment Authority

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Gains and losses can be broken down into two main categories: (1) gains and losses associated with normal investment and redemption activity and (2) gains and losses associated with unusual events, such as a debt issuance suspension period. Treasury's long-standing position is that gains and losses associated with normal investment and redemption activity are borne by the applicable federal government account and that no special action should be taken to adjust an account's investment portfolio for these gains and losses. On the other hand, when the loss is incurred because of unusual events and account participants have a vested interest in the fund, Treasury has, in many cases, received the necessary authority to restore such losses.

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## Gains and Losses Associated with Normal Investment and Redemption Activity

Federal government accounts with investment authority generally invest in interest-bearing nonmarketable Treasury obligations. The investment and redemption activities related to these obligations can cause gains and losses from, for example, changing interest rates and certain errors that are found and corrected. Treasury has a long-standing position that gains and losses associated with normal investment and redemption activities are a cost of doing business. Therefore, Treasury makes no attempt to adjust an account's investment portfolio for such activities.

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## Gains and Losses Associated with Security Valuation

As noted earlier, one of Treasury's basic management policies for federal government accounts with the authority to invest is to maintain equity between these accounts and the general fund—the fund used to pay most government obligations. To do so, Treasury issues two basic types of nonmarketable obligations—market-based and par value specials. Most market-based obligations are mirror images of existing Treasury obligations that are traded on the open market and are purchased or sold at open market prices.<sup>1</sup> Par value specials, on the other hand, are issued and redeemed at par.

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<sup>1</sup>For example, if the price of a 2-year note maturing on July 1, 2005, is 101, the account would either pay or receive a \$1 premium for each \$100 of face value, depending on whether the account was purchasing or selling the security. On the other hand, if the price is 99, the account would either pay or receive a \$1 discount from the \$100 face value. The purpose of premiums and discounts is to adjust the market price of securities with various terms and conditions (e.g., interest rates, maturity dates, and interest payment dates) to ensure that comparable securities will provide similar yields or returns to an investor.

The interest rates for par value specials are specified in the enabling statute or by administrative action. For example, for the G-Fund, Civil Service fund, and Social Security funds, the par value rate is based on the average rate for comparable marketable obligations, as defined by Treasury, with 4 or more years to maturity. This rate is established monthly, and all investments for a given month must bear the same rate. When a federal government account with investment authority needs to redeem obligations to pay benefits and expenses, Treasury redeems these obligations and pays the fund the par value plus any accrued interest. Although only certain accounts are allowed to invest in par value specials, the majority of the \$2.8 trillion of account investments on January 31, 2003, were invested in par value specials. Equity between accounts investing in par value specials and the Treasury general fund is not maintained because (1) the interest rate is determined only monthly and (2) the term of the investment is not relevant, as shown in the following examples:

- The interest rate used to invest an account's receipts is determined only monthly. If market interest rates fall during the month, the Treasury general fund pays the account more interest than market conditions dictate; if market interest rates rise during the month, the investment account receives less interest than market conditions dictate.
- Many federal government accounts with investment authority holding par value specials hold these obligations for a number of years. Accordingly, the interest rates can vary significantly. For example, the Civil Service fund has obligations that carry interest rates ranging from 3.5 percent to 8.75 percent in its portfolio that matures on June 30, 2005. Even the rates for the portfolio that matures on June 30, 2014, range from 3.5 percent to 6.5 percent. However, when the obligations are needed to pay benefits, they are redeemed at par regardless of current market rates. In times of high interest rates, redeeming a low-interest-rate obligation at par benefits the account redeeming the par value special. On the other hand, during periods of low interest rates, redeeming obligations at par benefits Treasury's general fund.
- The interest rate paid on Treasury obligations with 4 or more years to maturity is based on a statutory formula developed in the 1920s to ensure equal semiannual interest payments for obligations held for exactly 1 year. However, as we noted in our 1987 report on the Civil Service fund, when investments are held for less than a year, Treasury's method does not ensure that the account is neither overcompensated nor undercompensated. In the major accounts with investment

authority, such as the Civil Service and Social Security funds, a large number of investments in par value specials are subsequently redeemed, sometimes just days later, for benefit payments and expenses, rather than held to their maturity. Activity associated with current-year investments that were subsequently redeemed in the current investment year for program benefits and expenses can be significant.<sup>2</sup> Such activity totaled well over \$100 billion dollars between January 31, 2003, and June 30, 2003, for the Civil Service and Social Security funds. In addition, as noted elsewhere, the G-Fund, whose investments receive the par value rate, redeems and reinvests its entire portfolio each business day.<sup>3</sup>

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## Gains and Losses Associated with Adjustments

Treasury makes many adjustments to the accounting records to reflect accounting events. Reasons for adjustments may include (1) information received late from an account caused by agreed-upon processing delays such as those associated with the Social Security funds and (2) certain errors made by either Treasury or the account. We found in a 1987 review that the procedures for making adjustments to accounts holding par value specials, which are still being used, do not ensure that the results of adjustments are equitable.<sup>4</sup> For example, during our 1987 review we noted that one error that Treasury made and corrected cost the Civil Service fund almost \$400,000 in lost interest earnings. Specifically, according to Treasury records, the Office of Personnel Management (OPM) instructed Treasury to redeem about \$400 million of obligations on behalf of the Civil Service fund on July 5, 1984. However, Treasury did not make this redemption until OPM notified Treasury of the error in August. Treasury then redeemed the lowest-interest-bearing obligations available at that time, which had rates of 8.75 and 9.75 percent. The interest earnings for this redemption were computed through July 5 (the original requested redemption date). Had the redemption taken place on July 5, the obligations bearing interest rates of 7.5 and 7.625 percent would have been used because the portfolio held

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<sup>2</sup>For example, on June 3, 2003, Treasury, using its normal investment and redemption policies and procedures, redeemed about \$6 billion that had been invested on June 2, 2003, for a Social Security account.

<sup>3</sup>The difference between the market-based rate for obligations that mature the next business day and the G-Fund's par value rate can be significant. For example, on March 31, 2004, the market-based rate for investments that matured the next business day was 1 percent, while the rate used for G-Fund investments was 4 percent.

<sup>4</sup>GAO/AFMD-87-17.



lower-rate obligations at that time. As a result, the Civil Service fund lost about \$400,000 of interest earnings. Treasury agreed with our methodology for computing the effects of this error and with the amount of the loss.

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## Gains and Losses Associated with Unusual Events

Treasury and the Congress have a long-standing position of obtaining the necessary authority to restore interest that was not credited to an account with investment authority because of unusual events. GAO, the Congress, Treasury, and agencies associated with the accounts commonly refer to this forgone interest as a loss to the fund. Several examples follow.

- In OPM's comments on our report on the actions taken during the 1985 debt ceiling crisis, it stated that the Civil Service fund "should be 'made whole' when available funds are not properly invested. This is especially important for situations [such as] . . . when the [Civil Service fund] lost interest as the result of debt ceiling limitations."
- Section 6002 of the Omnibus Budget Reconciliation Act of 1986<sup>5</sup> added subsections (j), (k), and (l) to section 8348 of title 5, United States Code, (l) to authorize the Secretary to suspend investment of amounts in the Civil Service fund in government obligations and to redeem prior to maturity government obligations held by the Civil Service fund when necessary to avoid exceeding the debt ceiling and (2) to authorize the Secretary to make the fund whole after the debt issuance suspension period. The joint explanatory statement of the committee of conference accompanying the Omnibus Budget Reconciliation Act of 1986 states that the amendment requires the Secretary "to make the Fund whole for any earnings lost as a result of the suspension or disinvestment by a combination of special cash payment actions."<sup>6</sup>
- Treasury's July 30, 2003, letter to the Congress concerning the 2003 debt issuance suspension period stated that Treasury has paid interest "totaling \$100,822,854.44, representing the amount that would have been earned, but for the debt issuance suspension period." Treasury also noted that this "represents the interest lost" by the Civil Service fund.

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<sup>5</sup>Pub. L. No. 99-509, 100 Stat. 1874, 1931 (1986).

<sup>6</sup>H.R. Conf. Rep. No. 99-1012, at 256 (1986).

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**Appendix I  
Gains and Losses on Federal Accounts with  
Investment Authority**

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It is also a long-standing practice for the Congress and the President to provide the necessary authority to restore losses caused by unusual events. For example, during the 1985 debt ceiling crisis, Treasury was granted the authority to restore the majority of interest losses associated with its actions to avoid exceeding the debt ceiling. Furthermore, as recommended in our report on the 1985 debt ceiling crisis, Treasury received the authority in 1986 and 1987 to fully restore the losses associated with certain actions it takes in regard to the Civil Service fund and G-Fund during debt ceiling difficulties.

# Limitations of the Present Value Analysis Approach to Determining Economic Gains and Losses

A present value analysis is used to provide a basis for understanding the value of an obligation using current market conditions when that obligation is being purchased, sold, or exchanged before maturity. The present value<sup>1</sup> of an obligation depends on (1) the coupon rate, (2) the length of time the obligation is outstanding, and (3) the current market rate (commonly referred to as the discount factor). Table 4 shows a simple example of the present values of three \$1 million obligations bearing a coupon rate of 6 percent with three different maturities and using three different discount factors.

**Table 4: Example of the Impact on a \$1 Million 6 Percent Obligation Using Different Present Value Discount Factors and Maturity Dates**

Years to maturity	Discount factor for a 6 percent coupon rate obligation		
	5 percent	6 percent	7 percent
5	\$1,043,295	\$1,000,000	\$958,998
10	1,077,217	1,000,000	929,764
25	1,140,939	1,000,000	883,864

Source: GAO analysis.

Note: In this example, interest is paid annually, the principal balance is held until maturity, and the present values are computed on an interest payment date.

As shown in table 4, when the discount factor differs from the coupon rate, the present value of an obligation will differ from the face value—the longer the time interval, the greater the increase or decrease in value.

As noted in our discussion on the effects of exchanges of obligations between the Civil Service fund, the Federal Financing Bank (FFB), and the Department of the Treasury (Treasury), Treasury used a present value analysis to help ensure that the exchange of Treasury obligations held by the Civil Service Retirement and Disability Fund (Civil Service fund) for obligations issued by FFB was fair to both parties. The present value approach was also used to determine the amount of losses incurred by the Civil Service fund when FFB repaid its obligations before they were scheduled to mature. A key assumption in making a present value calculation is that the underlying assumptions on interest rates and cash

<sup>1</sup>Present value is the discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present value represents a series of future cash flows expressed in today's dollars.

**Appendix II**  
**Limitations of the Present Value Analysis**  
**Approach to Determining Economic Gains**  
**and Losses**

flows will not change. For example, if a present value calculation shows that an obligation's cash flows are worth \$1 billion today assuming that the \$1 billion can be invested in a 4 percent obligation that matures on June 30, Year 2, then it is critical that the investment be made in an obligation that bears an interest rate of 4 percent and that the obligation matures on June 30, Year 2. Otherwise, a gain or loss can occur if interest rates change, as shown in table 5.

**Table 5: Example of Effects of Changing Interest Rates on Present Value Analyses**

<b>Event</b>	<b>Present value assumption</b>	<b>Actual</b>	<b>Effect on federal government account with investment authority</b>
January 5, Year 1	\$1 billion will be invested in an obligation maturing on June 30, Year 2, at 4 percent.	\$1 billion is invested in an obligation maturing on June 30, Year 1, at 4 percent.	There is no adverse effect on the account.
June 30, Year 1, scenario I	Not applicable.	\$1 billion obligation at 4 percent purchased on January 5, Year 1, matures and is reinvested in an obligation maturing on June 30, Year 2, at 3.5 percent.	The account will lose about \$5 million because of lower interest rate.
June 30, Year 1, scenario II	Not applicable.	\$1 billion obligation at 4 percent purchased on January 5, Year 1, matures and is reinvested in an obligation maturing on June 30, Year 2, at 4.5 percent.	The account will gain about \$5 million because of higher interest rate.

Source: GAO.

Although the initial exchange was fair, as shown in table 5, since the actual terms of the obligations issued were not the same as those used in the present value assumption, the account is subject to risks associated with interest rate changes.

Another limitation associated with a present value analysis is that it does not consider reinvestment risk.<sup>2</sup> For example, in the case of the March 5, 2003, exchange between FFB and the Civil Service fund, the Treasury obligations exchanged matured from June 30, 2004, through June 30, 2011. However, the FFB 9(a) obligation received had a different cash flow. Therefore, if the principal and interest payments associated with the FFB

<sup>2</sup>Reinvestment risk is the risk that proceeds received in the future will have to be reinvested at a lower potential interest rate in the case of a government account with the authority to invest or that the proceeds will be reinvested at a higher rate in the case of the Treasury general fund.

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**Appendix II**  
**Limitations of the Present Value Analysis**  
**Approach to Determining Economic Gains**  
**and Losses**

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9(a) obligation could not be invested at the same discount factor used in the present value analysis, then a gain or loss would result. If the cash flows can be invested at a higher interest rate, then a gain will occur. Conversely, if the cash flows are reinvested at a lower rate, then a loss will occur.

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# Gains and Losses Associated with Transactions between the Civil Service Fund, FFB, and the Treasury General Fund

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## Civil Service Fund Interest Losses Associated with the October 18, 2002, FFB Early Redemption

During the 1985 debt ceiling crisis, Treasury for the first time invested excess receipts of the Civil Service fund in FFB 9(a) obligations.<sup>1</sup> Because FFB 9(a) obligations are not subject to the debt ceiling, this action allowed Treasury to borrow more cash from the public. At the time of the purchase, these FFB 9(a) obligations carried the same terms and conditions as the Treasury obligations held by the Civil Service fund.<sup>2</sup> As such, as long as FFB did not redeem the debt obligations prior to maturity or the obligations were not otherwise redeemed before needed to pay Civil Service fund expenses in accordance with its normal redemption policies and procedures, the exchange transaction would result in no adverse consequences for the Civil Service fund. However, on October 18, 2002, FFB exercised its right to redeem its obligations before maturity, which resulted in over \$1 billion in interest losses to the Civil Service fund.<sup>3</sup>

According to FFB calculations, the present value interest loss to the Civil Service fund was over \$1 billion when FFB redeemed its obligations.<sup>4</sup> FFB appropriately calculated this loss using a present value methodology that assumed that the Civil Service fund could invest the \$15 billion proceeds from the early redemption of the FFB 9(a) obligations at 3.875 percent—the October 2002 investment rate for Civil Service fund investments—and the funds could be invested with the same maturities as the redeemed FFB 9(a) obligations. Table 6 shows a comparison of the maturity dates and interest rates associated with the FFB 9(a) obligations that were redeemed early.

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<sup>1</sup>The cash that Treasury lends to FFB under a 9(b) obligation is derived from Treasury borrowing under chapter 31 of title 31, United States Code. Thus, the agency obligation financed by FFB is counted against the public debt ceiling in this manner.

<sup>2</sup>U.S. General Accounting Office, *Civil Service Fund: Improved Controls Needed over Investments*, GAO/AFMD-87-17 (Washington, D.C.: May 7, 1987).

<sup>3</sup>According to FFB, this early redemption was necessary because its maturing loans would not provide sufficient funds to enable FFB to repay the entire principal amounts due to the Civil Service fund when these obligations matured. FFB also noted that its loan portfolio had been shrinking, making it more difficult for FFB to pay interest on its 9(a) obligations to the Civil Service fund. See “Federal Financing Bank Borrowings from the Civil Service Retirement and Disability Fund,” Memorandum for Peter Fisher, President, FFB, from Paula Farrell, Secretary, FFB (Aug. 16, 2002).

<sup>4</sup>According to an FFB official, FFB did not calculate the comparable benefit to it by making this repayment.

**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

**Table 6: Maturity Dates and Interest Rates Associated with FFB 9(a) Debt Obligations Redeemed before Maturity on October 18, 2002**

Dollars in billions

<b>Maturity date</b>	<b>Principal amount</b>	<b>Interest rate on FFB 9(a) debt obligations</b>	<b>October 2002 investment rate</b>
June 30, 2003	5	9.25%	3.875%
June 30, 2004	5	8.75%	3.875%
June 30, 2005	5	8.75%	3.875%

Source: Treasury.

FFB's present value analysis assumed that the redemption proceeds would be invested at 3.875 percent using the same maturity dates that were applicable to the original FFB 9(a) obligations. The redemption proceeds were actually invested in a 3.875 percent obligation that matured on June 30, 2003, since Treasury's normal policies and procedures require that current-year receipts be invested in obligations that mature on June 30 of the current investment year.

On June 30, 2003, \$10 billion of the October 18, 2002, investment was, in effect, reinvested in obligations bearing an interest rate of 3.5 percent—the rate applicable to Civil Service fund investments for June 2003. Accordingly, Treasury invested \$10 billion with \$5 billion maturing on June 30, 2004, and \$5 billion on June 30, 2005, at an interest rate of 3.5 percent. The remaining \$5 billion that was received on October 18, 2002, was used to pay current-year fund benefits and expenses and therefore was not available for reinvestment on June 30, 2003. Although FFB redemption proceeds were invested with the same maturity dates as the original FFB 9(a) obligations, they will be invested for a time at 3.5 percent rather than the 3.875 percent assumed in the present value analysis. Therefore, in addition to the over \$1 billion interest loss incurred on October 18, 2002, discussed above, the Civil Service fund will incur about \$33.4 million of additional interest losses (commonly referred to as a nominal interest loss) in these future years because of the lower-than-assumed interest rate on the reinvested amounts.

Table 7 compares the expected interest earnings associated with the October 18, 2002, FFB 9(a) redemption prior to maturity using the present value assumptions and the expected interest earnings that would be received if the obligations were held to maturity.

**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

**Table 7: Comparison of Expected Interest Earnings on October 18, 2002, Redemption Using Different Rates**

<b>Period</b>	<b>Principal balance outstanding</b>	<b>Nominal interest if invested at assumed 3.875 percent</b>	<b>Nominal interest at actual investment rate of 3.5 percent</b>	<b>Nominal interest gain or loss</b>
October 18, 2002, through June 30, 2003	\$15 billion	\$406 million	Not applicable since funds were invested at 3.875%	\$22.9 million gain <sup>a</sup>
June 30, 2003, through June 30, 2004	\$10 billion	\$387.5 million	\$350 million	\$37.5 million loss
June 30, 2004, through June 30, 2005	\$5 billion	\$193.75 million	\$175 million	\$18.8 million loss
<b>Total net nominal interest loss</b>				<b>\$33.4 million loss</b>

Source: GAO.

<sup>a</sup>Since Treasury invested the \$15 billion in 3.875 percent obligations, these obligations became available for redemption to pay the Civil Service fund's benefits and expenses using Treasury's normal investment and redemption policies and procedures. However, if Treasury had invested the FFB repayment in accordance with the present value analysis, \$10 billion of the FFB repayment would not have been available for use by the Civil Service fund during the investment year ending on June 30, 2003. Accordingly, Treasury would have redeemed higher-interest-rate obligations in order to pay the Civil Service fund's benefit payments and expenses during this period. Although an exact estimate of this interest rate differential is difficult to quantify, the amount of benefit to the Civil Service fund by not redeeming these higher-rate obligations could be as much as \$22.9 million.

In our report on the 1985 debt ceiling crisis,<sup>5</sup> we noted that Treasury officials stated that a basic trust fund management policy is to ensure equity between the various trust funds and the Treasury general fund—the fund used to pay most government obligations—and that none of the funds unduly benefit from Treasury's management. Although the losses discussed in this section resulted from a transaction between FFB and the Civil Service fund, the transaction between these two funds was not initially undertaken for programmatic reasons; rather, it was undertaken by the Secretary of the Treasury to help manage debt during the 1985 debt ceiling crisis, and the early redemption in 2002 was undertaken to help manage FFB's cash flow problems.

<sup>5</sup>GAO/AFMD-87-17.

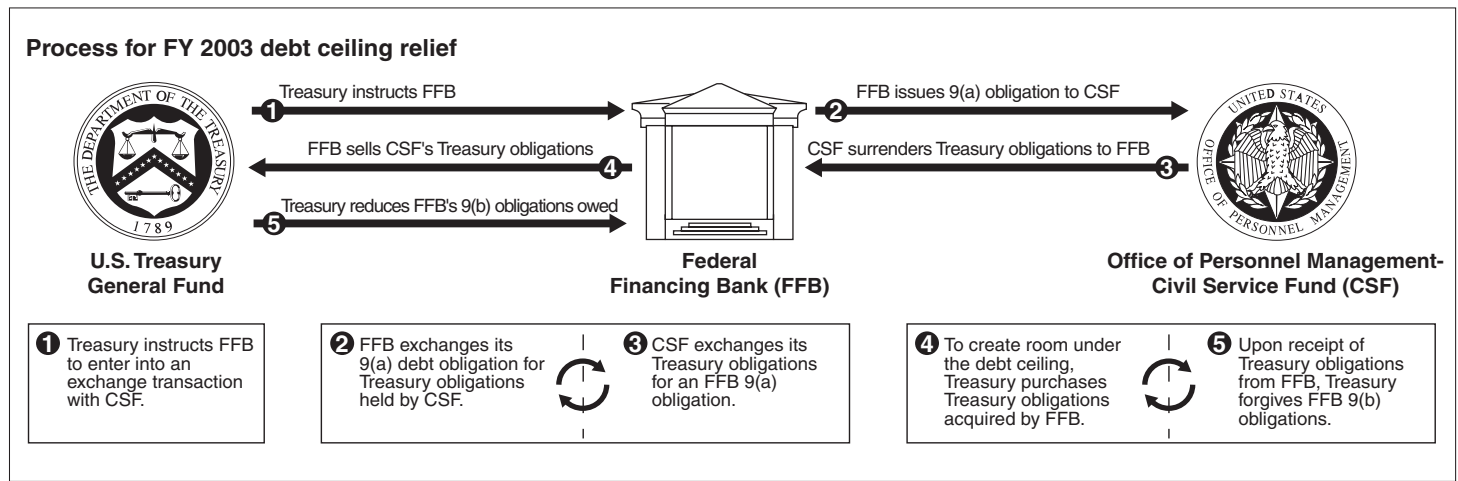


**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

**Civil Service Fund  
Gains and Losses  
Associated with the  
2003 Exchange  
Transaction**

On March 5, 2003, Treasury exchanged certain Treasury obligations held by the Civil Service fund for an FFB 9(a) obligation of about \$15 billion issued by FFB to the Civil Service fund. The purpose of this transaction, similar to the purpose of the transaction that occurred during the 1985 debt ceiling crisis discussed above, was to make about \$15 billion of additional borrowing authority available under the debt ceiling. Figure 2 shows the process for debt ceiling relief during fiscal year 2003.

**Figure 2: Debt Exchange Process Used for Fiscal Year 2003 Debt Ceiling Relief**



Source: GAO.

However, unlike the terms and conditions of the 1985 exchange transaction, the terms and conditions of the FFB 9(a) obligation issued to the Civil Service fund during the 2003 debt issuance suspension period were different from those of the Treasury obligations surrendered. Specifically, the terms of the FFB 9(a) obligation held by the Civil Service fund stated that if FFB redeemed its obligation before maturity, the redemption price would be based on current market rates rather than par value, which was the basis used in the 1985 exchange. Therefore, to ensure that the value of the exchange was fair to both parties on the date of the exchange, Treasury used a present value analysis to compare the value of future cash flows expected from the Treasury obligations being exchanged by the Civil Service fund with the value of future cash flows expected from the FFB 9(a) obligation. On June 30, 2003, FFB redeemed its March 5, 2003, 9(a) obligation before the December 2035 maturity date. As discussed

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**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

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below, these transactions introduced risks to the Civil Service fund that it would not have incurred had this exchange not taken place.

The transactions between the Civil Service fund and FFB fairly compensated the Civil Service fund, based on a present value analysis, on the date of the exchanges. The net result of the March 5, 2003, and June 30, 2003, transactions between the Civil Service fund and FFB was that the Civil Service fund had about \$1.153 billion more in Treasury obligations than it did before the March 5, 2003, transaction. This increase in Treasury obligations held by the Civil Service fund occurred because the prevailing market interest rates at the time of the exchanges were lower than the rates of the Treasury obligations exchanged with FFB. However, the Civil Service fund had a gain of only about \$139.5 million<sup>6</sup> because it had to invest the proceeds from the obligation FFB redeemed on June 30, 2003, at a lower interest rate. In other words, the Civil Service fund had more principal to invest but was unable to invest that principal at a rate as high as the rate of the Treasury obligations it had surrendered. Therefore, the Civil Service fund needed more principal to generate approximately the same returns as the obligations it had originally surrendered during the transaction on March 5, 2003. The long-term economic effect of the June 30, 2003, transaction on the Civil Service fund depends on the terms of the obligations in which the proceeds are invested.

In this case, one way to have helped ensure that the Civil Service fund would not have cash flow gains or losses associated with investment of the proceeds from the FFB redemption would have been to invest the proceeds using a methodology that ensured that the fund had cash flows similar to those from the original Treasury obligations used for the exchange on March 5, 2003. This methodology is commonly referred to as a “cash flow” approach. However, the cash flow approach can also result in gains and

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<sup>6</sup>This gain was computed by taking the present value on June 30, 2003, of the Treasury obligations that were exchanged with FFB on March 5, 2003, and comparing this hypothetical value to the present value of the FFB 9(a) obligation that was redeemed on June 30, 2003. A gain occurred because the interest rate had changed since the March 5, 2003, exchange. Specifically, as noted earlier, the March 5, 2003, interest rate used to determine the exchange value was 3.875 percent, but on June 30, 2003, the interest was 3.5 percent. Since the FFB obligation had a longer term than the Treasury obligations, the reduction in interest rates had a greater effect on the FFB 9(a) obligation, that is, the FFB 9(a) obligation became more valuable. See app. II for a discussion on how changing interest rates and terms affect a present value analysis.

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**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

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losses, since it does not consider the reinvestment risks<sup>7</sup> that may be present. Appendix II discusses how the cash flow methodology ensures that a cash flow gain or loss does not occur and how reinvestment risks are not considered in this methodology.

Treasury's approach for investing the June 30, 2003, FFB redemption proceeds was to apply its normal investment policies and procedures. In this case, Treasury, in effect, (1) replaced the dollar value of the obligations used for the March 5, 2003, exchange with 3.5 percent Treasury obligations and (2) divided the remaining proceeds equally over a 15-year period. While this approach differs from the cash flow approach and may result in future gains and losses, the key point is that Treasury has not yet developed documented policies and procedures for managing such transactions. The process of documenting the policies and procedures that should be used for such transactions allows Treasury's management to understand the impacts of various alternatives and whether they introduce any additional risks to the parties involved. It also helps Treasury evaluate whether it may need additional statutory authority to ensure that all accounts are adequately protected. Further, if effectively implemented, documentation of policies and procedures reduces the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future.

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**FFB and Treasury  
General Fund Gains  
and Losses Associated  
with the 2003  
Exchange Transaction**

FFB and the Treasury general fund had gains and losses associated with the March 5, 2003, and the June 30, 2003, transactions. As shown in table 3, the net result for FFB of these two transactions was a \$633 million loss on June 30, 2003. FFB expects to earn about \$1.153 billion in future years to offset this loss. The Treasury general fund also lost \$520 million, which is not expected to be recovered. Several key decisions and actions related to the March 5, 2003, and June 30, 2003, transactions are discussed below.

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<sup>7</sup>Reinvestment risk is the risk that proceeds received in the future will have to be reinvested at a lower potential interest rate in the case of a government account with the authority to invest or that the proceeds will be reinvested at a higher rate in the case of the Treasury general fund.

**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

**Treasury Accepted Par  
Value Specials at Their  
Present Value**

On March 5, 2003, Treasury purchased from FFB the Treasury obligations (par value specials) that FFB had acquired from the Civil Service fund. Treasury agreed to pay FFB about \$520 million more than the par value of these obligations. As payment for this purchase, Treasury sold back to FFB 9(b) obligations issued by FFB that Treasury held. In effect, Treasury canceled about \$15.7 billion of the FFB 9(b) obligations it held with about \$15.2 billion of Treasury par value specials that FFB had received from the Civil Service fund. Therefore, FFB had a gain and the Treasury general fund had a corresponding loss on the exchange. Table 8 shows how this transaction generated a gain for FFB.

**Table 8: How the March 5, 2003, Transactions between the Civil Service Fund, FFB, and the Treasury General Fund Generated a Gain for FFB**

Description	Amount
Value of the canceled FFB 9(b) obligations held by Treasury (face value of about \$15.473 billion and accrued interest of about \$230 million)	\$15.703 billion
Redemption value of Treasury obligations received from the Civil Service fund in exchange for FFB 9(a) obligation (about \$15.045 billion of principal and about \$138 million of accrued interest)	\$15.183 billion
Debt canceled in excess of redemption value of Treasury obligations exchanged (gain to FFB and loss to Treasury general fund)	\$520 million

Source: Treasury.

The March 5, 2003, exchange was in contrast to FFB's October 18, 2002, early redemption of its 9(a) obligations held by the Civil Service fund. On October 18, 2002, Treasury decided that the FFB 9(a) obligations being redeemed prior to maturity that were related to Treasury's effort to manage the 1985 debt ceiling would be redeemed at par value and that the Civil Service fund would incur the loss. Treasury's redemption of par value specials in excess of their par value is also in contrast to its normal policies and procedures, which allow agencies holding the par value specials only to redeem them from Treasury at face value to pay for the fund's benefits and expenses. If Treasury had accepted the par value specials at par rather than at current market rates, then the total losses to FFB would have been about \$1.153 billion rather than the \$633 million total net loss resulting

**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

from the March 5, 2003, and June 30, 2003, transactions.<sup>8</sup> The \$1.153 billion is also the amount of the gain FFB expects to make in future periods.

The key difference between the March 5, 2003, exchange and the normal exchanges between Treasury and federal government accounts with investment authority related to their investments in par value specials is that for the March 5, 2003, exchange between Treasury and FFB, a present value analysis was used to calculate the amount of debt that should be removed from Treasury’s books—the same analysis that Treasury used to ensure that the exchange between FFB and the Civil Service fund was fair. Whether FFB or the Treasury general fund incurs a gain or loss when par value specials are used to cancel FFB 9(b) obligations depends greatly on the value of the Treasury obligations held by the Civil Service fund that are selected for the exchange. For example, if the interest rates on the Treasury obligations held by the Civil Service fund had been 3.875 percent rather than 5.25 percent, Treasury would have exchanged par value specials with a value of about \$16.2 billion held by the Civil Service fund with FFB, and FFB would have provided these to Treasury to cancel the \$15.7 billion of FFB 9(b) obligations. In this case, Treasury would have recognized a gain rather than the loss that was recorded because 5.25 percent par value specials were used in the exchange. Table 9 provides a simplified example of how this works.

**Table 9: Example of How Differing Interest Rates Affect Gains and Losses Recognized by FFB and the Treasury General Fund on the Exchange of Par Value Specials for FFB Obligations**

<b>Interest rate associated with Civil Service fund’s par value specials</b>	<b>Principal and accrued interest of Civil Service fund obligations required for exchange</b>	<b>Book value of Treasury loans to FFB</b>	<b>Gain or loss to FFB</b>	<b>Gain or loss to Treasury</b>
3.875 percent	\$16.2 billion	\$15.7 billion	\$500 million loss	\$500 million gain
5.25 percent	\$15.2 billion	\$15.7 billion	\$500 million gain	\$500 million loss

Source: GAO.

<sup>8</sup>The amount of the June 30, 2003, short-term loan from Treasury used to finance this loss that is discussed in the next section was about \$1.1 billion.

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FFB Issued Additional 9(b)  
Obligations on June 30,  
2003, to Redeem FFB 9(a)  
Obligation

As discussed earlier, when FFB decided on June 30, 2003, to redeem prior to maturity the 9(a) obligation it had issued to the Civil Service fund, another present value analysis was performed. As a result of this analysis, FFB had to borrow about \$16.6 billion from Treasury using 9(b) obligations to redeem the \$15 billion FFB 9(a) obligation it had issued to the Civil Service fund. FFB needed these additional funds because the FFB 9(a) obligation was based on an interest rate yield of 5.25 percent and the interest rate used in the present value analysis was 3.5 percent (the June 2003 Civil Service fund investment rate). According to FFB officials, the following approach was used to structure this \$16.6 billion loan from Treasury:

- FFB borrowed \$15.4 billion using principal repayments that mirrored principal payments used in the original FFB 9(a) obligation to the Civil Service fund, which, in turn, mirrored the underlying FFB loans made to its borrowers. For example, if FFB held a loan that called for a \$10 million principal payment on December 31, 2005, then FFB would have borrowed \$10 million from Treasury with a December 31, 2005, repayment date. In effect, after these transactions, FFB's loan repayments for its 9(b) obligations to Treasury mirrored the underlying loan principal repayments that FFB expected to receive from its loan portfolio.
- FFB borrowed about \$1.1 billion using a short-term obligation.

The \$1.1 billion corresponds to FFB's net loss of \$633 million and the Treasury general fund's loss of \$520 million, which were realized on the March 5, 2003, and June 30, 2003, transactions. According to FFB's 2003 financial statements, FFB expects to recover its loss in future years.<sup>9</sup>

FFB repaid the short-term \$1.1 billion 9(b) obligation on April 1, 2004, since FFB had adequate cash flows from its loans to make these payments. According to FFB officials, these increased cash flows resulted from (1) the reduced interest costs associated with the October 18, 2002, early redemption of FFB 9(a) obligations issued to the Civil Service fund noted earlier in this report and (2) the reduced interest costs associated with the June 30, 2003, FFB 9(b) obligations that were used to redeem the FFB 9(a)

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<sup>9</sup>U.S. Department of the Treasury, Office of Inspector General, *Audit of the Federal Financing Bank's Fiscal Years 2003 and 2002 Financial Statements*, OIG-04-013 (Washington, D.C.: Dec. 9, 2003).

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**Appendix III  
Gains and Losses Associated with  
Transactions between the Civil Service Fund,  
FFB, and the Treasury General Fund**

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obligation issued to the Civil Service fund on March 5, 2003. Therefore, once the short-term 9(b) obligation is redeemed, the future principal payments associated with FFB's loan portfolio will, for all practical purposes, mirror the principal payments that will be made to Treasury. However, the interest earnings on FFB's loan portfolio will be far greater than the interest payments that will be due to Treasury on FFB 9(b) obligations issued to Treasury. This interest rate differential will then translate into increased earnings for FFB that can be expected to offset the losses associated with the 2003 exchange transactions with the Civil Service fund.

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# Transactions between FFB and the Civil Service Fund

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During the 1985 debt ceiling crisis, Treasury for the first time invested excess Civil Service fund receipts of the Civil Service fund in FFB 9(a) obligations. Treasury has also exchanged Treasury obligations held by the Civil Service fund for obligations held or issued by FFB when Treasury experienced debt ceiling difficulties during the 1995/1996 debt ceiling crisis and the 2003 debt issuance suspension period. These exchanges and their effects on the Civil Service fund are discussed below.

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## 1985 Debt Ceiling Crisis

During the 1985 debt ceiling crisis, Treasury for the first time exchanged about \$15 billion of Treasury obligations held by the Civil Service fund for obligations issued by FFB. The purpose of this transaction was to make \$15 billion of additional borrowing authority available under the statutory debt ceiling. At the time the transaction was made, these FFB obligations were mirror images of the Treasury par value specials held by the Civil Service fund. As long as the FFB obligations were held to maturity or redeemed in accordance with the normal redemption policies of the Civil Service fund, this transaction would result in no adverse financial consequences for the Civil Service fund. As noted earlier in this report, it was not until October 2002 that the Civil Service fund portfolio was affected by this transaction.

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## 1995/1996 Debt Ceiling Crisis

During the 1995/1996 debt ceiling crisis, Treasury exchanged about \$8.6 billion of Treasury obligations held by the Civil Service fund for federal agency obligations held by FFB. The purpose of this transaction was to make an additional \$8.6 billion of borrowing authority available under the statutory debt ceiling. Since the federal agency obligations held by FFB differed from the terms and conditions of the obligations held by the Civil Service fund, the task of determining a fair exchange price was more complicated than in 1985. Because the effects of these differences in terms and conditions can be significant, a generally accepted methodology was used that considered such factors as (1) the current market rates for outstanding Treasury obligations at the time of the exchange, (2) the probability of changing interest rates, (3) the probability of the federal agency paying off the debt early, and (4) the premium the market would provide to an obligation that could be redeemed at par regardless of market interest rates. Treasury then obtained the opinion of an independent third party to determine whether its valuations were accurate.



In 1997, portions of the obligations received in this transaction were repaid early. Since the original analysis included a factor for the risk associated with the federal agency redeeming its obligations early, the Civil Service fund did not suffer any adverse consequences.

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## **2003 Debt Issuance Suspension Period**

During the 2003 debt issuance suspension period, Treasury once again exchanged Treasury obligations held by the Civil Service fund for a \$15 billion FFB 9(a) obligation. However, unlike the 1985 exchange, the terms and conditions associated with the FFB 9(a) obligation was not identical to the terms and conditions of the Treasury obligations held by the Civil Service fund. Therefore, to ensure that the transaction was fair to both parties, Treasury performed a present value analysis of the cash flows associated with the FFB obligation and the cash flows associated with the Treasury obligations held by the Civil Service fund. Furthermore, it was agreed that if FFB redeemed this obligation before maturity, the price paid would be based on current market rates. An agreement between FFB, Treasury, and Treasury on behalf of the Civil Service fund allowed the Secretary of the Treasury on behalf of the Civil Service fund to redeem the FFB 9(a) obligation at par. As noted earlier, in June 2003 FFB redeemed this obligation and the Civil Service fund had a \$139.5 million gain.

# Comments from the Department of the Treasury



UNDER SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

April 30, 2004

Mr. Gary T. Engel  
Director  
Financial Management and Assurance  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. Engel,

Thank you for the opportunity to comment on the draft report entitled **Debt Ceiling: Analysis of Actions Taken During The 2003 Debt Issuance Suspension Period (GAO-04-526)**. We appreciate the high level of professionalism exhibited by GAO staff in conducting this exhaustive analysis of a very complex matter.

As your draft report indicates, when Treasury borrowing in 2003 reached the federal debt ceiling and legislation to increase the debt ceiling had not been enacted, the Secretary of the Treasury took a series of actions involving the Civil Service Retirement and Disability Fund ("Civil Service fund"), the Government Securities Investment Fund ("G Fund") of the Federal Employees' Retirement System, the Exchange Stabilization Fund, and the Federal Financing Bank ("FFB"). We are pleased that you concluded that all of Treasury's actions were "*consistent with legal authorities provided to the Secretary*," and that the investment losses of the Civil Service fund and the G Fund resulting from the Secretary's determination that a "debt issuance suspension period" existed were fully restored as required by law.

Responses to Recommendations:

Following are our responses to the recommendations for executive action made in the draft report.

*"GAO recommends that the Secretary of the Treasury...*

*"(1) seek the statutory authority to restore the losses associated with the October 2002 early redemption of Federal Financing Bank (FFB) obligations, computed in a manner to maintain equity between the Civil Service fund and Treasury."*

Treasury will seek statutory authority to restore losses incurred by federal government accounts with investment authority and by FFB as a result of actions taken for the purpose of fiscal management during a debt limit impasse. We look forward to working with Congress to enact legislation providing the Secretary with such authority.

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**Appendix V**  
**Comments from the Department of the**  
**Treasury**

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As you know, it was a difficult decision for Treasury to execute the 2002 early redemption of FFB obligations held by the Civil Service fund. In 2002, FFB was facing imminent cash flow stress attributable to the long-term consequences of the exchange transactions that Treasury, FFB, and the Civil Service fund entered into during a debt limit impasse in 1985. As a result of the structure of those transactions, 18 years later, FFB had a limited set of choices: (a) do nothing, and risk a liquidity crisis for FFB; or (b) exercise the par call option which was included as a term of the original transactions.

Exercising the call option presented, in our view, fully calculable costs (i.e., reinvestment risk) to the Civil Service fund compared to the alternative. As a result, the Treasury executed a course of action that was considered the least harmful of a short list of less than palatable options.

*“GAO recommends that the Secretary of the Treasury...*

*“(2) direct the Under Secretary of Domestic Finance to document the necessary policies and procedures that should be used for exchange transactions between FFB and a federal government account with investment authority and seek any statutory authority necessary to implement the policies and procedures.”*

Treasury agrees that it will document appropriate policies and procedures to be used for exchange transactions between FFB and a federal government account with investment authority to ensure the long-term fairness to all parties to such complex market based transactions. However, we are gratified that you recognized in your report that *“Treasury needs a great deal of flexibility to structure transactions that fit specific events.”* On its own initiative, Treasury has already taken notable steps in the direction of documenting policies and procedures for exchange transactions. For example, during the debt issuance suspension period of 2003, the Treasury Under Secretary for Domestic Finance, who is, ex officio, also the President of FFB, approved core guidelines for future exchange transactions.

As you noted in your analysis, the 2003 exchange transaction was executed within the time frame of the 2003 debt issuance suspension period and reversed shortly thereafter. We appreciate GAO’s acknowledging, *“The transactions between the Civil Service fund and FFB fairly compensated the Civil Service fund, based on a present value analysis, on the date of the exchanges.”* As noted in your analysis, the Civil Service fund received a substantial increase in the amount of Treasury securities that the fund holds as investments, and FFB’s financing base was restructured, allowing it to recover losses over time.

FFB has taken additional steps to ensure the long-term fairness to all parties of exchange transactions. Not the least of these is the requirement that all exchange transactions be reviewed by FFB’s independent auditor to ensure the terms and structure clearly achieve the intended accounting result and long-term financial fairness to all parties, prior to transaction approval and execution. The Inspector General for Treasury, who oversees

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**Appendix V**  
**Comments from the Department of the**  
**Treasury**

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the audits of FFB, has been asked to include such reviews in the scope of its audit contracts.

Conclusion:

Congress granted the Secretary of the Treasury statutory authority to manage the government's financial operations in order to avoid exceeding the debt ceiling during a debt issuance suspension period. During the most recent episode, lasting from February 20 through May 27, 2003, Treasury took – as in previous administrations – a number of actions to stay under the debt ceiling. All of the actions taken then, as in previous occurrences, were authorized by law. However, not all of the authorized actions that the Secretary takes to protect the full faith and credit of the United States are without cost. As long as there continues to be the possibility for a debt limit impasse in the future, Treasury will need to retain maximum flexibility in order to safeguard the credit standing of the U.S. in the world markets and execute its duty to the nation.

Sincerely,



Brian C. Roseboro  
Under Secretary for Domestic Finance

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# Related GAO Products

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We have previously reported on aspects of Treasury's actions during the 2002 debt issuance suspension period and earlier debt ceiling crises in the following reports:

*Debt Ceiling: Analysis of Actions During the 2002 Debt Issuance Suspension Periods.* [GAO-03-134](#). Washington, D.C.: December 13, 2002.

*Debt Ceiling: Analysis of Actions during the 1995/1996 Crisis.* [GAO/AIMD-96-130](#). Washington, D.C.: August 30, 1996.

*Information on Debt Ceiling Limitations and Increases.* [GAO/AIMD-96-49R](#). Washington, D.C.: February 23, 1996.

*Debt Ceiling Limitations and Treasury Actions.* [GAO/AIMD-96-38R](#). Washington, D.C.: January 26, 1996.

*Social Security Trust Funds.* [GAO/AIMD-96-30R](#). Washington, D.C.: December 12, 1995.

*Debt Ceiling Options.* [GAO/AIMD-96-20R](#). Washington, D.C.: December 7, 1995.

*Civil Service Fund: Improved Controls Needed Over Investments.* [GAO/AFMD-87-17](#). Washington, D.C.: May 7, 1987.

*Treasury's Management of Social Security Trust Funds during the Debt Ceiling Crises.* [GAO/HRD-86-45](#). Washington, D.C.: December 5, 1985.

*A New Approach to the Public Debt Legislation Should Be Considered.* FGMSD-79-58. Washington, D.C.: September 7, 1979.

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