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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Director Office Of Management And Budget

Federal Credit Policy On Guaranteed Loans Should Be Clarified And Enforced

Office of Management and Budget (OMB) Circular No. A-70 was issued to help provide effective and economical Federal credit assistance programs by prescribing, for example, that certain fees be charged, that private lenders share financial risk on guaranteed obligations, that excessive interest rates be controlled, and that guarantees of tax-exempt obligations be avoided. However, Federal agencies often do not comply with these principles because the circular does not communicate clearly and OMB has not enforced compliance. The resulting costs and inequities are serious, but OMB has postponed corrective action for years.

GAO is recommending that OMB reissue the circular and enforce the principles adopted. If such action is to be postponed further, GAO recommends that interim guidance be provided in memorandum form. Such actions would be consistent with the administration's other efforts to improve management control of Federal credit.

119850

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/RCED-83-22
NOVEMBER 4, 1982

023844

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES,
COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-203240

The Honorable David A. Stockman
Director, Office of Management and Budget

Dear Mr. Stockman:

This report addresses the causes and effects of noncompliance with the executive branch credit policy contained in OMB Circular No. A-70. We believe that this problem is a serious one and that corrective action should not be postponed further. Our review was made to help address recent concerns over the control of Federal credit.

Recommendations to you are on page 25. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the above committees; the House and Senate Banking Committees; the Senate Budget Committee; other interested committees; the Secretaries of Agriculture, Commerce, Energy, Transportation, and the Treasury; the Administrator, Small Business Administration; and the Chairman of the Board of Governors, Federal Reserve System.

Sincerely yours,

J. Dexter Peach
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE DIRECTOR,
OFFICE OF MANAGEMENT
AND BUDGET

FEDERAL CREDIT POLICY ON
GUARANTEED LOANS SHOULD
BE CLARIFIED AND ENFORCED

D I G E S T

Office of Management and Budget (OMB) Circular No. A-70, issued in 1965, was intended to help provide that the most effective and economical policy principles were used to design and administer Federal credit assistance programs. That important objective is not being met because the circular does not communicate clearly and because OMB has not emphasized compliance with its principles. The consequences are serious.

Failure to charge guarantee fees or require lenders to share financial risk or prohibit guarantees of tax-exempt obligations increases the Federal cost to operate loan guarantee programs by millions of dollars. Noncompliance with the circular's principles also allows some borrowers or lenders to receive more favorable loan terms than their counterparts in other programs and diminishes private participation--the source of financing for many guaranteed loans. OMB has acknowledged the problem for years but has postponed corrective action because other matters have received higher priority. Agency officials GAO interviewed did not indicate that they planned to take immediate steps to bring their programs into compliance with the circular's principles. The usual indication was to take a "wait-and-see" posture, while agreeing with the need for more centralized guidance.

While OMB's resources are not unlimited, GAO believes that actions to improve compliance should not be postponed further. GAO therefore recommends (see p. 25) that the circular be reissued in a form that clearly communicates executive branch policy on the four principles discussed in this report, amending it to include additional policy guidance as soon as practicable; and that OMB enforce compliance with the principles adopted. If such action is to be postponed further, GAO recommends, as an interim step, that OMB send a memorandum to the heads of executive agencies providing policy guidance on the four principles.

In recent years, interest in improving management of Federal credit assistance has intensified. In view of this concern, GAO reviewed the effectiveness of OMB's management of Circular No. A-70 by measuring program compliance with four basic principles adopted by the circular: (1) that recipients of credit assistance should pay a fee for such assistance, (2) that private lenders should share part of the risk on loans receiving guarantees, (3) that agencies should prohibit excessive interest rates on guaranteed loans, and (4) that guarantees should not be extended to tax-exempt obligations. GAO measured compliance with these principles in 11 guarantee programs, the most prevalent form of credit assistance. (See app. II.)

NONCOMPLIANCE WITH A-70 PRINCIPLES IS A SERIOUS PROBLEM

Noncompliance with the circular's principles has serious consequences. In GAO's review, 2 of 11 programs had foregone millions of dollars in guarantee fees. For example, GAO calculated that the Economic Development Administration and the Small Business Administration have given up over $4 million in 4 years by not charging a guarantee fee in two programs. (See pp. 16 and 19.) Eight of the 11 programs did not charge fees high enough to recover all program costs. Two of the 11 programs increased the Government's financial risk by millions by not requiring lenders to bear any risk on guaranteed loans, and two programs increased Federal tax losses by guaranteeing tax-exempt obligations.

The inconsistencies created by noncompliance with the circular's principles also created inequities because some lenders or borrowers receive the same Federal assistance as applicants in other programs, but on more favorable terms. For example, because the Farmers Home Administration allowed guarantees of tax-exempt obligations, one of its borrowers received a below-market interest rate of 11.74 percent at a time when the prime rate was 19 percent. (See app. V.) At the same time, a similar Small Business Administration program prohibiting such guarantees was allowing its lenders to charge up to 21.75 percent.

GAO found that inconsistencies between agencies, and even within different programs administered by the same agency, lowered the participation rate of the banking community and created a generally negative atmosphere around Federal loan guarantees. According to members of the banking community, more uniformity would result in more private sector participation and possibly lower interest rates because of the potential for lowering overhead costs.

OMB ACKNOWLEDGES NONCOMPLIANCE WITH THE CIRCULAR'S PRINCIPLES, BUT POSTPONES CORRECTIVE ACTION

As a result of OMB's lack of emphasis on A-70 and its principles, agency officials were generally not aware of it, and nearly all who were did not use it. However, these officials said that such centralized guidance would be helpful to them and that they could follow the A-70 principles, but OMB would have to provide more leadership. OMB officials acknowledged noncompliance with A-70 principles but said that corrective action must be postponed further.

In 1962, the Committee on Federal Credit Programs found that, because credit assistance programs were not governed by formal policy guidelines, effective and economical financial principles were not consistently being used to design and administer such programs. OMB Circular A-70 was issued in 1965 to alleviate this problem, adopting as executive branch policy the principles recommended by the committee.

However, instead of stating those principles explicitly in Circular A-70, OMB incorporated them by reference to the committee's report. That report is out of print and thus not readily accessible to the agencies that need it to fully understand the circular's principles. (See p. 16.)

In addition, the circular does not directly state that agencies are required to follow the report's principles. It states only that agencies proposing credit assistance legislation--which is often done in conjunction with program reauthorizations--are required to prepare a memorandum to OMB discussing implementation of the principles. According to OMB's Acting Assistant Director for Budget Review, however, the circular requires that agencies follow the report's principles, whether legislation is being proposed or not. Because the circular does not communicate clearly, agencies question its applicability (see p. 14) and do not actively use it.

In 1974, OMB proposed revising the circular, acknowledging that the circular needed to state its principles more clearly and explicitly and that the circular's principles were not always consistently or vigorously applied. However, the proposed revision was never formalized because of opposition to the principle prohibiting guarantees of tax-exempt obligations. (See p. 9.)

OMB has been planning to review the circular's principles and reissue it. However, priority has been given to other work. A recent effort to perform a general credit policy review has not, to date, addressed the improvements needed in A-70.

Eight years after the 1974 revision was proposed, OMB has no specific oversight procedures (see p. 8) and OMB officials readily acknowledge that agencies still do not follow the circular's principles. According to OMB's Acting Assistant Director for Budget Review, OMB has not sufficiently emphasized compliance with the principles to bring about consistent enforcement.

OMB COMMENTS AND GAO's EVALUATION

OMB said (see app. IX) that it shares GAO's concern for the benefits which could be provided by an improved Circular A-70 and agreed that the circular needs to be revised and reissued. However, OMB reaffirmed its decision to postpone corrective action, stating that the report fails to recognize the time and complexity involved in updating and reissuing the circular and the importance of the other aspects of executive branch credit policy competing for OMB's resources. According to OMB, the proposal in GAO's draft report regarding distributing the 1974 draft revision of the circular as interim guidance would not help because it does not discuss the proper role of the Federal Financing Bank. It also said that the report does not give adequate treatment to its record in overseeing the management of loan guarantee programs.

OMB has acted to improve the overall management of loan guarantee programs, as this report recognizes throughout, but the question at hand is how soon Circular A-70 can be revised. Developing a comprehensive credit policy circular is a complex and time-consuming task, and there are many important credit issues competing for OMB's limited resources. However, GAO continues to believe that guidance addressing the four basic principles discussed in this report could be provided quickly and would remedy the serious inequities and excess costs GAO observed. Policy decisions have been made on guaranteeing tax-exempt obligations and requiring lender coinsurance, and the remaining two principles are now being analyzed in preparation for the fall Director's review scheduled for October and November 1982. Thus, it should be possible to revise and reissue the circular, limiting it to the four principles, soon after the fall review. The circular can then be amended to include other principles as soon as policy decisions are reached.

In addition, most guarantee programs are not financed through the Federal Financing Bank, and those that are can still adhere to the four A-70 principles discussed in this report. Thus, a revised Circular A-70 which does not address the proper role of the bank would still provide important benefits.

If OMB priorities preclude allocating the limited resources necessary for such action, policy guidance can be provided to executive agencies in the form of a memorandum from the Director, OMB. GAO agrees that using the 1974 draft revision of the circular would not serve as appropriate interim guidance because, although paragraph 5.d. of that document does address the use of the Federal Financing Bank, the 1974 draft discusses many principles--some of which may be inappropriate to today's financial environment.

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ABBREVIATIONS

CFCP	Committee on Federal Credit Programs
DOE	Department of Energy
EDA	Economic Development Administration
FmHA	Farmers Home Administration
GAO	General Accounting Office
MarAd	Maritime Administration
NOAA	National Oceanic and Atmospheric Administration
OMB	Office of Management and Budget
SBA	Small Business Administration

CHAPTER 1

INTRODUCTION

In our society, the allocation of credit for private purposes is generally a function of the free market system. At times, however, this system may develop "credit gaps." For a variety of reasons, particular activities, some groups of borrowers, or specific geographic areas may be denied access to credit on reasonably competitive terms, even though they would be able to repay loans extended on such terms. To promote the social or economic well-being of the Nation, the Federal Government sometimes acts to supplement the free market system to reduce or eliminate these credit gaps. This action often takes the form of Federal credit assistance.

The Federal Government uses four basic forms of credit assistance: loan guarantees, direct loans, loans by privately owned Government-sponsored enterprises, and access to tax-exempt credit. Guaranteed loans are privately financed, but the Government guarantees the private lender against all or part of any potential loss occasioned by a default on the loan. Direct loans are made to borrowers by Federal agencies using public funds. Government-sponsored enterprises are privately owned but federally chartered, and they carry out federally chartered programs. These financial intermediaries, like the Federal National Mortgage Association, for example, carry out loan programs either through direct lending or through the purchase of loans originated by the private groups they were established to assist. Tax-exempt credit refers to the exemption from Federal income tax of the interest income to investors in obligations issued by State and local governments.

The use of Federal credit assistance has proliferated in recent years, with loan guarantee programs becoming especially prevalent. In 1952, $24.4 billion in loan guarantees was outstanding; by 1980 this figure had grown tenfold. From 1971 to 1980 alone, the outstanding amount more than doubled from $125.1 billion to $259.8 billion. In 1980, guaranteed loans accounted for 9.3 percent of the $348 billion advanced in U.S. credit markets.

Loan guarantee assistance has become an increasingly important policy tool for achieving the Nation's social and economic objectives. However, significant costs are associated with its use. The Government incurs costs in administering the many loan guarantee programs and in repaying lender losses involved in loan defaults. According to the Congressional Budget Office (CBO), 1/ loan guarantees also impose costs on the economy by, among other things, increasing interest rates. This occurs, according to CBO, because the guarantees lower the price of credit

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1/Testimony by the Director, CBO, at hearings on Federal credit programs and policies held by the Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Affairs, on April 29, 1981.

for federally favored borrowers, thus increasing the demand for credit without increasing its supply.

FEDERAL ACTIONS TO IMPROVE MANAGEMENT OF CREDIT ASSISTANCE

The management of Federal credit assistance involves many interrelated processes. For example, the total amount of credit assistance to be provided in any given year needs to be decided upon. Effective standards and procedures are needed to ensure the appropriate selection of recipients, servicing of accounts, and collection of debts owed the Government. In addition, to serve the public interest well, use of the various forms of credit assistance should be governed by sound basic financial principles. In recent years, the rapid growth of loan guarantees and other forms of Federal credit assistance, coupled with concerns about their inflationary impact on the economy, have intensified interest in improving management of such assistance.

Loan guarantee programs do not receive the normal policy review associated with the congressional budget process because they are "off budget." Title IV of the Congressional Budget Act of 1974 (31 U.S.C. 1302) excludes loan guarantees from the targets and ceilings on budget authority and outlays that can be considered in the budget resolutions. This is done because Federal outlays for loan guarantees are made not at the time of loan commitment but only in the event of default.

Since fiscal year 1981, however, the Government has emphasized budgetary control of the quantity of credit activity by introducing the Federal credit control system. This system provides a "credit budget" measuring the overall amount of credit activity. Proposals for limitations on this activity are developed by the executive branch in conjunction with its budget review process and presented to the Congress in the Budget Appendix. The Congress then reviews and acts on the proposals in appropriations bills. While this system has been implemented only on an informal, piecemeal basis, it provides a valuable basis for budgetary review that was previously absent.

Other problems have also been identified. A series of our reports (see app. VIII) beginning in 1978 highlighted the necessity of improving the Government's management of its debt collection processes. In August 1979, the Debt Collection Project was created within the Office of Management and Budget (OMB) to address the Government's problems in this area. The Project completed a report 1/ in January 1981, and some of the recommendations are being implemented while others are under study.

1/The Debt Collection Project, Report on Strengthening Federal Credit Management, January 1981, U.S. Government Printing Office.

In 1963, the Committee on Federal Credit Programs reported 1/ that credit assistance programs were not governed by formal guidelines on the appropriate financial principles to use in designing and administering such programs. As a result, the programs were not consistently using the most effective and economical principles in providing such assistance. OMB Circular No. A-70 was issued in 1965 to alleviate this problem, adopting as executive branch policy the credit principles recommended by the committee.

According to OMB, the circular's principles are to be followed when legislation authorizing credit assistance programs does not mandate the use of different principles. Since the Congress often leaves such decisions to the agencies, the circular's principles have wide applicability.

OBJECTIVE, SCOPE, AND METHODOLOGY

In view of recent concerns with providing improved management of credit assistance, this report evaluates OMB's management of Circular No. A-70 to determine whether credit assistance programs could be managed more economically and efficiently. To determine the effectiveness of OMB's management of the circular, we measured the level of agency compliance with principles adopted by the circular, the effects of any noncompliance with those principles, and OMB's efforts to prevent any noncompliance. While Circular A-70 contains a number of principles, we studied compliance with four of these principles regarding the charging of guarantee fees, lender risk sharing, excessive interest rates, and the guarantee of tax-exempt obligations. We selected these four principles because we believe them to be among the most fundamental adopted by the circular. A detailed discussion of these principles is included in chapter 2.

Although there are four basic forms of credit assistance, we concentrated our study on loan guarantee programs because loan guarantees are the most prevalent form of Federal credit assistance. Our study measured compliance with the circular's principles in 11 guarantee programs administered by three departments and one agency. The agencies involved were responsible for administering 34 of the 65 loan guarantee programs listed in the 1982 "Catalog of Federal Loan Guarantee Programs," published by the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs. This catalog attempted to list all guarantee programs, but an unknown number may have been omitted because of information-gathering problems. The catalog also listed 65 insured loan programs which may be classified as guarantee programs. However, we omitted insured programs from our review because Government liability for them is different than for guarantees. The number of programs sampled was not large enough to provide

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1/ Report of the Committee on Federal Credit Programs to the President of the United States, February 11, 1963, U.S. Government Printing Office (out of print).

statistical certainty that our findings in these programs are reflective of conditions in all programs. However, in our professional judgment, our findings in the 11 programs do reflect general conditions.

The 11 programs studied were comprised of 3 existing programs and the 8 1/ new programs enacted by the Congress in 1980. These programs are described in appendix II. The three existing programs, one each in the Departments of Agriculture and Commerce and one in the Small Business Administration (SBA), provided us with a historical perspective of OMB management of Circular A-70. These three programs were enacted in 1958, 1965, and 1972. To provide a measure of the use of the circular's principles in recently enacted programs, we also reviewed the eight new guarantee programs enacted by the Congress in 1980. These programs were identified in Special Analysis F of the 1982 Budget of the United States.

To understand the effects of any noncompliance with the circular's principles, we conducted a comparative analysis of program legislation and regulations and discussed the use of the principles with agency officials. We followed this analysis with 11 case studies of loans guaranteed by the three existing programs. Case studies could not be performed in the new programs because many had not yet guaranteed loans. We selected 10 case studies in New Hampshire, New York, Texas, and Vermont on the basis of such criteria as relative size, location, time of guarantee, use, and type of business. We chose these selection criteria to ensure that the projects studied would be roughly comparable, thus providing a baseline to clearly isolate the effects of any noncompliance with the circular's principles. We discussed our selection criteria with agency officials, who generally agreed that our criteria were reasonable. One additional case study in Colorado was selected, in conjunction with the Farmers Home Administration (FmHA), as a good example of a recent form of the guarantee of tax-exempt obligations, which is contrary to Circular A-70 policy. Summary data, as well as specific examples from these case studies, appears throughout this report.

To understand OMB's management of compliance with the circular's principles, we reviewed numerous reports and discussed the management of the circular with officials from OMB, the Treasury Department, the 11 programs reviewed, CBO, the Robert Morris Associates, the Public Securities Association, and other members of the banking industry. Our review was performed in accordance with generally accepted government audit standards.

1/One additional program, authorizing guarantees by the Synthetic Fuels Corporation under Public Law 96-294, was also enacted. However, this program is not subject to OMB Circular A-70 and was therefore excluded from this report.

CHAPTER 2

OMB ACKNOWLEDGES NONCOMPLIANCE WITH THE CIRCULAR'S PRINCIPLES, BUT POSTPONES CORRECTIVE ACTION

OMB Circular No. A-70 represents executive branch credit policy on the most effective and economical principles to use in designing and administering credit assistance programs. OMB has known and acknowledged for years that the circular does not clearly communicate that policy and that agencies are not complying with its principles. The circular incorporates the principles of an out-of-print 1963 report by reference, rather than stating them explicitly in the circular itself. Further, the circular does not directly state that agencies are required to follow the report's principles. Instead, it asks agencies to respond to a series of questions regarding how the principles are implemented.

An explicit and assertive revision to the circular was proposed in 1974, but because of opposition to the principle on guarantees of tax-exempt obligations (see pp. 7 and 8), the proposal was never formalized. In recent years a reissuance of the circular has been postponed because priority has been given to the credit budget and debt collection projects. While compliance with the circular's principles is not formally overseen, OMB officials responsible for administering A-70 stated that they know agencies are not following its principles, but OMB has not sufficiently emphasized compliance with those principles to result in consistent enforcement.

OMB CIRCULAR NO. A-70 COMMUNICATES BASIC EXECUTIVE BRANCH CREDIT PRINCIPLES POORLY

In response to the need for credit principle guidelines, the Committee on Federal Credit Programs (CFCP) recommended in 1962 that all new credit assistance programs be designed in accordance with principles set forth in its report and that existing programs be gradually changed to comply with them. President Kennedy agreed and in February 1963 transmitted the committee's report to all departments and agencies administering credit assistance programs. In his transmittal memorandum, the President suggested that agency heads be guided by the principles in the CFCP report in administering their present programs, and especially in proposing any new or expanded credit authority. He requested the Director of the Bureau of the Budget (now the Office of Management and Budget) "to take the lead in assuring an effective and equitable application of those guidelines." OMB responded by issuing OMB Circular No. A-70 in February 1965, which adopted the CFCP recommendations as executive branch credit policy. The circular has not been revised since it was issued and continues to state the policy of the executive branch.

The CFCP report discusses many credit principles. Among them are principles regarding (1) charging a fee to reimburse the Government for its costs to provide credit assistance, (2) the sharing of financial risk between the Government and private lenders, (3) agency control over interest rates, and (4) guarantees of tax-exempt obligations.

Executive branch credit principles

In providing any Government service, the question arises whether to charge a fee for that service and, if so, how much to charge. The circular adopts the principle that loan guarantees should be accompanied by fees and premiums that provide for full recovery of the costs of administering the program and the probable costs of loan defaults and losses. 1/ In line with this principle, some programs charge a one-time fee of 1 percent of the guaranteed amount of the loan. While the policy guidance allows either lenders or borrowers to pay the fee, it does not provide guidance on how the fee may be paid--out of loan proceeds which may be guaranteed, from interest payments, or from separate resources of the borrower or lender.

Another fundamental policy question is how much financial risk the Government is willing to assume to induce lenders to participate in guarantee programs--90 percent of the risk, 50 percent, 10 percent? The principle adopted in Circular A-70 is to require lenders to bear some risk, or coinsure, on each guaranteed loan. For example, some programs will guarantee only up to 90 percent of the loan amount, with the private lender required to bear the risk on the remaining 10 percent, which is not guaranteed. According to the CFCP report, coinsurance should be required in order to provide lenders with an incentive to carry out their responsibilities for selecting and servicing loans with normal care and vigilance; were all financial risk assumed by the Government, lenders would have little economic incentive to use prudence in selecting and servicing guaranteed loans. This policy also reduces budgetary costs by helping provide a reasonable assurance of loan repayment and lowering Government liability on individual loans.

According to the 1963 CFCP report, the most important single determinant of the extent of private participation in loan guarantee programs is the level of interest permitted on the loans. In

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1/If read literally, the CFCP report and Circular A-70 require only that any subsidies provided lenders or borrowers by not charging a guarantee fee, or not charging fees high enough to recover all costs, should be disclosed. However, according to the OMB economist responsible for daily administration of the circular, the policy is that fees that recover all costs will be charged. It might also be noted that the Independent Offices Appropriation Act of 1952 (31 U.S.C. 483a) and OMB Circular No. A-25, both of which predate Circular A-70, state the same policy.

this regard, the circular requires that agencies prohibit the guarantee of loans with excessive interest rates, taking into account interest rates prevailing in the private market and the risks assumed by the Government. By assuming the risk on 90 percent of the loan, for example, loan guarantees substantially reduce lender risk. They also have other special characteristics (see app. IV) which can make them more profitable to lenders than conventional loans. Thus, the Government does not want to be exploited by lenders by allowing interest rates which are so high as to not recognize the substantial benefits of Federal loan guarantees.

Another important policy question, particularly in light of recent high interest rates, is whether guarantees should be extended to tax-exempt obligations. Historically, interest rates on tax-exempt obligations, according to a 1981 study by CBO ("Small Issue Industrial Revenue Bonds," Apr. 1981), have been 30 percent below interest rates on taxable obligations. The combination of the lower interest rate associated with tax-exempt obligations and the reduced financial risk and other special benefits provided by Federal guarantees is extremely attractive to borrowers and investors--but expensive for the Federal Government.

The capacity of States and localities to issue tax-exempt obligations, first granted in 1913 when the Federal income tax was adopted, was used for many years to borrow for public purposes such as school construction. However, since the 1960's, small issue industrial revenue bonds (IRB's) have increasingly been used by States and localities to extend such low interest rate financing to various private industry purposes (such as real estate development, manufacturing facilities, country clubs, ski lodges, and automobile dealerships) to help create and preserve jobs. According to the CBO study cited above, from 1975 to 1980, sales of IRB's increased from $1.3 billion to a record high of more than $8 billion. Federal revenue losses associated with IRB's were expected to amount to $1.4 billion in 1982. In effect, the Federal Government gives up its revenue to subsidize the borrowing costs of private industry.

The CFCP report recommended that direct or indirect Federal guarantees of tax-exempt obligations be prohibited. OMB Circular A-70 formally declared the CFCP recommendation to be executive branch policy in 1965. According to the OMB economist responsible for daily administration of the circular, such guarantees are prohibited because, among other things, (1) tax-exempt obligations are financially inefficient for the Federal Government (according to this official, each $2 in interest savings for the borrowers costs an average of $3 to $3.50 in Federal tax losses) and (2) the superior combination of tax exemption and Federal guarantee would compete with Treasury obligations, and their increasing volume would increase the interest costs of carrying the public debt.

Direct or indirect Federal guarantees of tax-exempt obligations can occur in a variety of ways. In addition to being directly guaranteed, such obligations can be indirectly guaranteed by subordinating direct Federal loans or federally guaranteed loans to other project funding raised by an IRB or other type of tax-exempt obligation. If a default occurs, the bondholders would have first mortgage on any funds generated by the sale of collateral, and the Federal claim would be secondary or subordinate. If proceeds from the sale of collateral would not be sufficient to repay both the bondholders and the Government, the Government may purchase the bondholders' first mortgage to protect its interest. In this situation, the bondholders are in effect guaranteed against loss by the Federal Government.

An IRB can also be indirectly guaranteed by a secondary market purchase of a guaranteed loan by the trustee of the bond. In this situation the bond and a guaranteed loan to a private business are set up separately, but simultaneously, with virtually identical terms. The proceeds of the bond sale are then used by the trustee to purchase the guaranteed loan from the private lender. The principal and interest payments from the guaranteed loan, with terms identical to those of the IRB, are then used to pay the bondholders. However, the revenue to pay those bondholders is now guaranteed. In effect, the Government has guaranteed the IRB.

The circular communicates poorly and is not specifically overseen

OMB Circular A-70 does not state directly in the circular itself the credit principles it adopts. Instead, it incorporates the recommendations of the CFCP report by reference. Thus, it is necessary to have a copy of the 1963 CFCP report to understand the full impact of the principles involved. However, the report is out of print and thus not readily accessible to the agencies that need it to fully understand the circular's principles.

In addition, the circular as written does not directly state that agencies are required to follow the CFCP principles. It states that agencies proposing

> "* * * legislation either to establish a new credit program, or to expand or renew the authority of, or provide broader powers for existing credit programs, * * * are to prepare a memorandum evaluating the proposed legislation in terms of the relevant recommendations of the Report of the Committee on Federal Credit Programs."

The specific questions to be covered in such a memorandum are listed in an attachment to the circular. According to OMB's Acting Assistant Director for Budget Review, however, the circular requires that agencies follow the report's principles in administering their existing programs, whether legislation is being proposed or not. In this regard, we found that OMB actively enforced a circular principle on at least one occasion. (See p. 21.)

OMB has no specific oversight procedures to ensure compliance with the circular's principles. While the memorandum procedure could provide a valuable oversight mechanism, OMB has not implemented the procedure. It is not clear why. According to OMB's Acting Assistant Director for Budget Review, OMB does not specifically oversee all credit programs, but they are "generally looked at" every 3 years or less during the reauthorization process.

OMB HAS POSTPONED CLARIFICATION AND ENFORCEMENT OF THE POLICY

OMB has acknowledged for some time that the circular does not clearly communicate executive branch credit policy and that agencies do not follow the CFCP principles. While the circular does not have the force and effect of law, OMB has administrative options available for enforcement. However, because OMB's emphasis on enforcing the principles is not strong, the problem continues.

In 1969, President Nixon established the Committee to Reappraise Federal Credit Programs. This group found that the A-70/CFCP principles were valid but were not being as consistently applied as they should have been. Five years later, OMB published a proposed revision of the circular. In the issuing statement accompanying the proposed revision, OMB Director Roy Ash also observed that the principles were not always consistently or vigorously applied and that the circular did not clearly communicate executive branch policy.

The proposed revision provided an explicit and assertive statement of the policy, but the proposal was never formalized. According to the OMB officials previously cited, the proposal failed because of opposition to the principle prohibiting the guarantee of tax-exempt obligations. According to the 1974 proposed revision, State and local officials viewed the tax-exempt prohibition as a new policy because many were unaware of the existing Circular A-70 policy. These officials also believed that the principle would be applied more broadly than OMB intended. The circular still has not been formally reissued, despite its shortcomings.

According to the OMB economist responsible for daily administration of the circular, OMB has been planning to review the circular's policies and reissue it, but in the last 3 years priority has been given to work on the credit budget and debt collection projects. According to this official, the Budget Review Division has more expertise in budgeting than in management; thus, its organizational perspective is a budgetary one. The Division has limited resources, and when priorities are set, budgetary problems often get the resources. In January 1982, however, during our review, the Working Group on Credit Policy began active efforts to perform a general credit policy review. According to the OMB financial economist participating in the review, the working group is staffed and led by OMB and is one of a number of working groups under the aegis of the Cabinet Council on Economic Affairs. According to this official, the working group's efforts are not specifically directed to the circular. However, the Council has reaffirmed the A-70 policy on guarantees of tax-exempt obligations, and the working group is analyzing the principles regarding guarantee fees and appropriate interest rates in preparation for OMB's fall policy review. According to OMB, the administration is considering both administrative and legislative options for ensuring that common practices on fees and interest rates are followed in all credit programs.

OMB's Acting Assistant Director for Budget Review and Treasury's Assistant Director of the Office of Government Finance readily acknowledge that noncompliance with the circular's principles is widespread, although they were not clear as to its specific extent. According to the OMB official, when OMB becomes aware of a specific program which is not following the circular's principles, it tries to change that program, but emphasis is not always strong enough on the principles to overshadow other considerations and enforce compliance with them. According to OMB (see app. IX), until its work on the credit budget and in rethinking the role of the Federal Financing Bank (see p. 19) is complete, Circular A-70 will have to take second priority.

The following chapter provides our conclusions regarding the seriousness of noncompliance with the A-70 principles and our recommendations to resolve the problem.

CHAPTER 3

NONCOMPLIANCE WITH THE CIRCULAR'S PRINCIPLES IS A SERIOUS PROBLEM WHOSE RESOLUTION SHOULD NOT BE POSTPONED FURTHER

Because OMB has not emphasized compliance with Circular A-70, loan guarantee programs often do not comply with its principles. Noncompliance with these principles has serious consequences. For example, 2 of the 11 programs reviewed have foregone over $4 million in guarantee fees in 4 years, and 8 of the 11 programs did not charge fees high enough to recover all program costs. Likewise, 2 of the 11 programs increased Government financial risk by not requiring lenders to bear any risk on Government-guaranteed loans, and 2 programs had increased Federal tax losses by guaranteeing tax-exempt obligations. Such inconsistencies also created inequities, because some lenders or borrowers received the same Federal assistance as their counterparts in other programs, but on more favorable terms. In addition, these inconsistencies diminished private participation--often the source of program financing.

Program officials who developed and administered the 11 loan guarantee programs we reviewed were generally not aware of the circular, and nearly all of those who were did not use it. However, these program officials said that such guidance would be helpful to them and that they could follow it, but OMB would have to provide more leadership. OMB has already postponed action on the circular for many years, and the agency's Acting Assistant Director for Budget Review told us that the circular would have to take second priority until work on the credit budget was completed.

TAX REVENUES FOREGONE AS A-70 EXERTS LITTLE INFLUENCE IN THE DEPARTMENT OF AGRICULTURE

In the Department of Agriculture, Circular A-70 exerts little influence on the development and administration of programs. In four of the five Department programs we reviewed (see app. II), all of which were administered by the Farmers Home Administration, program officials who designed or administered the programs were not aware of the circular--but they generally agreed that such guidance would have been helpful and that they could have followed it if they had known about it. As a result, there were serious instances of noncompliance with the circular's principles. In all five programs, the agency decided to charge guarantee fees but did not design the fees to recover all program costs. These programs also allowed costly indirect guarantees of tax-exempt obligations, contrary to the principle adopted by Circular A-70. Although FmHA published a proposed rule on February 19, 1982, to prohibit such indirect guarantees, the rule had not been finalized as of July 1982.

In most cases (55 percent) the agency was free to comply with the four A-70 principles we reviewed because the loan program's authorizing legislation did not mandate the use of any particular principle. However, in all five programs, the authorizing legislation did require agency control of maximum interest rates, and in four of the five programs the legislation required lenders to share (or coinsure) at least 10 percent of the financial risk on each loan guarantee. This was required by limiting the agency guarantee to no more than 90 percent of the loan amount. In the fifth program, FmHA could have guaranteed 100 percent of the loan amount without violating the authorizing statute but decided on its own to limit the guarantee to 90 percent.

According to FmHA officials who designed or administered the five programs, while all five charged guarantee fees, none of the fees were designed to recover all costs to operate the programs. The four new programs followed the principles employed in the previously existing Business and Industrial Loan (B&I) Program. The B&I Program charges lenders a one-time fee of 1 percent of the guaranteed amount, which lenders may pass through to borrowers. In our four case studies of B&I guarantees, this fee brought $51,660 in revenue. According to the Director of the B&I Program, however, such fees do not recover all program costs because the agency accounting system does not account for all program costs. Thus, the fees cannot be actuarily calculated to cover them. For example, interest paid to the Treasury on funds borrowed to pay defaults on guaranteed loans is allocated to a group of programs at FmHA, rather than specifically to the B&I Program. For this reason we could not calculate the difference between the income derived through guarantee fees and the total expenses of the programs. According to this official, instead of calculating expected program costs for the B&I Program and charging a commensurate guarantee fee, FmHA simply adopted the fee being charged by SBA.

We also noted that B&I Program borrowers are allowed to pay the fee by including the amount of that expense as part of the loan amount. Because a percentage of the loan amount is guaranteed, this agency is guaranteeing its own fees. Most banks we contacted, however, would not allow such costs as part of the loan. They believed that "soft costs" like guarantee fees, feasibility studies, and others which do not increase the project's value, should be paid from a borrower's own funds and not out of the loan. The circular provides no guidance on the types of expenses which may be included in the loan amount and guaranteed.

According to the OMB economist responsible for daily administration of Circular A-70, many programs do not charge guarantee fees; those that do, like the FmHA programs, often do not recover all program costs. This OMB official believed that there is guidance on estimating Government overhead costs but that estimating the programs' probable losses is difficult because eligibility, terms, and conditions change so often. This official was not aware of any specific effort by OMB to assist agencies in estimating total program costs. He also believed that the control of soft costs is a problem but that detailed guidance should be provided in a separate circular.

The regulations for the B&I Program prohibit the direct guarantee of tax-exempt obligations, but not their indirect guarantee through the secondary market mechanism described on page 8. As a result, according to the Director of FmHA's B&I Program, this situation occurred an estimated 100 times from 1979 to 1981, and its use is increasing, apparently due to the rising cost of financing private loans. According to information provided us by FmHA, the guarantee of tax-exempt obligations has also occurred in other FmHA programs. In 1980 and 1981 in the States of Alabama, Oklahoma, and Louisiana, tax-exempt obligations were guaranteed by FmHA on 205 projects involving some $19 million.

As noted earlier, such guarantees are financially inefficient. For example, if we assume that the investors in these $19 million in tax-exempt obligations were in the 40-percent tax bracket and the tax-exempt obligations bore an average interest rate of 11.74 percent, then the Treasury gave up $1,274,520 in tax revenues to finance $955,700 in interest savings for the users of the $19 million, or $1.33 in foregone tax revenues for every $1 in interest savings. (See app. VII for details of our calculation.) To gain a better understanding of this financing mechanism, we studied one project guaranteed under FmHA's B&I Program. This project is discussed in appendix V.

In developing the original regulations for the B&I Program, the Department tried to incorporate the circular's principle on tax-exempt obligations, according to Agriculture's Deputy Assistant General Counsel for Community Development. However, according to this official, it was not clear as to what constituted an indirect guarantee of tax-exempt obligations. Therefore, the agency, according to a June 22, 1981, letter to us from FmHA's then Acting Administrator, made its own decision to prohibit the direct guarantee of tax-exempt obligations because of the double subsidy associated with such combinations. However, indirect guarantees were not prohibited. FmHA thus had no legal basis to prevent guarantees of tax-exempt obligations through the secondary market mechanism.

By 1979, the private sector began to use the secondary market mechanism in earnest to obtain FmHA guarantees of tax-exempt obligations. As a result, FmHA wrote to OMB in June 1980 to obtain guidance on the tax-exempt principle. On December 5, 1980, OMB responded that the secondary market mechanism was not consistent with the 1965 principle prohibiting indirect guarantees of tax-exempt obligations. FmHA subsequently published its proposed rule to prohibit such guarantees. The OMB economist responsible for Circular A-70 told us that OMB did not prevent FmHA from guaranteeing tax-exempt obligations before 1980 because OMB was not aware of the guarantees due to a lack of program-by-program oversight.

According to the Department's Deputy Assistant General Counsel for Community Development, the Department has known about the circular for some time, and its principles have been discussed in relation to various programs. However, the policy set forth in the 1963 report and 1974 draft circular is not well defined, or well known, and is not enforced by OMB. In addition, the Department believes that the policy is simply that agencies submitting credit assistance legislation are to answer the questions set forth in the circular's memorandum--not that agencies are required to follow the principles set forth in the 1963 report. However, according to OMB's Acting Assistant Director for Budget Review, agencies should follow the principles in the CFCP report whether legislation is being proposed or not. As a result of the circular's problems, according to the Deputy Assistant General Counsel, it "would not exert a big influence in the development of the Department's programs."

THE DEPARTMENT OF ENERGY USES A-70 AS BACKGROUND ONLY

Two of the programs reviewed were administered by the Department of Energy (DOE). DOE uses the circular only as a background document and little more. In the two programs reviewed (see app. II), DOE required guarantee fees. However, in one program DOE did not require all recipients to pay such a fee. Also, one program director expected to recoup all costs through the fee, while the other did not believe such costs could be accurately estimated. Both programs prohibited financing projects by guaranteeing tax-exempt obligations, but one program provided a subsidy to States and localities giving up such financing--while the other provided no such subsidy. The authorizing legislation for both programs mandated requirements for lender coinsurance and agency control over interest rates.

DOE's Municipal Waste Biomass Energy Program does not require a guarantee fee in all cases. The program would have charged private businesses a negotiable 1-percent fee, but it would allow cities in some cases to forego the fee. According to the program director, this was allowed because cities were "penalized" in that under the legislation the guarantee could not cover tax-exempt obligations. However, the program legislation authorized a subsidy, equal to the difference between tax-exempt and taxable interest rates (historically about 30 percent), for the States and localities so "penalized."

The program director stated that although OMB Circular A-95 was discussed extensively during development of the program, he was not aware of Circular A-70. According to this official, if he had known about the circular, a guarantee fee could have been charged in all cases without hurting the program.

While this official was not aware of Circular A-70 and its principles, DOE's Deputy Assistant General Counsel for Financial Incentives was. According to the Deputy Assistant General Counsel, who designed the General Biomass Energy Development Program, DOE is aware of the circular and its principles but uses it as a background document and little more. For this reason, some officials in DOE are aware of it, while others are not. This official told us that agencies generally do not follow the circular and its principles and that OMB provides little assistance in the area of credit principles. OMB, according to this official as well as OMB staff, focuses more on budget principles because of its budgetary perspective, rather than providing the guidance needed on credit principles. Credit policy is, therefore, very open in Government because there is no centralized source of advice on good credit policy. Agencies are often statutorily free to follow the executive branch principles, according to this official, but they are left to their own devices to make credit policy decisions.

MILLIONS FOREGONE AS DEPARTMENT OF COMMERCE OFFICIALS WERE NOT AWARE OF A-70

Three of the programs we reviewed were administerd by agencies under the Department of Commerce. 1/ Officials in these programs were generally not aware of Circular A-70. However, according to one agency official, OMB could be powerful in emphasizing policy principles such as those adopted by A-70, but when consulted on financial policy questions, all too often OMB could not say "here is the policy." As a result of OMB's lack of emphasis on A-70 principles, these programs exhibited important instances of noncompliance. One existing program administered by the Economic Development Administration (EDA) gave up $3.2 million by not charging a guarantee fee. The two new programs, one administered by the Maritime Administration (MarAd) and the other by the National Oceanic and Atmospheric Administration (NOAA), did not require lenders to share the financial risk on loans receiving guarantees. In addition, while all three programs currently prohibit the guarantee of tax-exempt obligations, none of these programs originally prohibited indirect guarantees.

EDA's Regular Business Development Program, authorized in 1965, charged an annual guarantee fee of 0.5 percent of the outstanding guaranteed amount of the loan until January 6, 1977. On that date EDA decided to drop the fee because it was a burden on the borrower. According to the EDA financial analyst who initiated the policy change, when EDA stopped charging its fee it was not aware of Circular A-70; it has not been required by OMB to reinstate the fee in the ensuing 5 years. According to the OMB economist responsible for daily administration of Circular A-70, OMB did not stop the EDA policy change because it was unaware of it.

1/The Maritime Administration, which administers the Ocean Thermal Energy Conversion Program authorized by Public Law 96-320 on August 3, 1980, was transferred from the Department of Commerce to the Department of Transportation on August 6, 1981. However, since the program was designed while still under the Commerce Department, we have grouped this program under that Department.

In three of our four EDA case studies, guarantee fees were foregone in accordance with EDA policy. In one case, however, the bank was confused over the 1977 EDA policy change and raised the interest rate on a 15-year, $222,700 loan by 0.5 percentage points to cover the cost of an anticipated guarantee fee. When we informed the bank that EDA no longer charged the fee, the executive director stated that the interest rate would not be reduced because it was already too low. According to our calculations, if EDA had charged a one-time, 1-percent guarantee fee from 1978 to 1981, program income would have been increased by $3.2 million.

The Ocean Thermal Energy Conversion (OTEC) Program administered by MarAd, like NOAA's new Fishing Vessels and Fishery Facilities Program, is required by law to charge a guarantee fee. The fees in these programs, according to program chiefs, will recover all program costs, although no loans had been guaranteed as of July 1982.

While EDA's program is required by law to limit its guarantee to 90 percent of the loan amount, thus requiring lenders to coinsure the remaining unguaranteed portion of the loan, the MarAd and NOAA programs discussed above did not require lender coinsurance. In MarAd's OTEC Program, the borrower puts up 12.5 percent of the project cost in equity, and the remaining 87.5 percent is financed by the sale of a 100-percent guaranteed security which is sold to investors. According to the Director of the Office of Ship Financing Guarantees, MarAd uses A-70 in designing and administering its loan guarantee programs. However, in accordance with the statute and congressional intent, the ship financing program (of which OTEC is a part) has not required lenders to bear any risk since 1956. Prior to that time, lenders bore a 10-percent credit risk. However, this arrangement did not work, according to this official, and guarantees under the program have since covered 100 percent of lender risk.

The financing for NOAA's Fishing Vessels and Fisheries Program is structured much the same as the MarAd program, but the Chief of NOAA's Financial Services Division stated that he was not aware of Circular A-70 when he was developing the program. Although his office became aware of the circular after the program was developed, he had difficulty in obtaining a copy of the 1963 report, which is essential to understand the full impact of A-70. According to this official, many of the A-70 principles are common sense when the program is run on a businesslike basis. Policymakers, however, hold different views as to the relative priorities of social goals versus financial goals. Some programs, according to the Chief, will do anything on the basis of achieving program objectives, such as saving jobs, while they "lose their shirt to do it." This official stated that lender coinsurance could have been required in this program but it would probably be less effective because the unique nature of the maritime environment, where the loan collateral may be thousands of miles away at sea, makes lenders nervous about being exposed to risk.

According to the OMB economist responsible for daily administration of Circular A-70, the Public Securities Association, and other members of the banking community, it is not necessary for the Government to guarantee 100 percent of a loan to obtain private participation because there is little difference between loans guaranteed at 100 percent and loans guaranteed at 90 percent. In this connection, 19 of 25 bankers in the States of Colorado, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Texas, and Vermont with whom we spoke told us that they would generally continue to participate in loan guarantee programs even if coinsurance requirements were increased above the 10-percent level--although they would probably impose more stringent qualifying criteria on borrowers. According to the chairman of the guaranteed loan committee of the Public Securities Association (a national association of securities dealers), his association is "diametrically opposed" to 100-percent guarantees because they eliminate the incentive for lenders who originate these loans to exercise normal care and vigilance in selecting and servicing them.

While all three programs now prohibit the direct and indirect guarantee of tax-exempt obligations, none of them prohibited indirect guarantees originally. In all three programs, the regulations were changed only after private businesses proposed such financing and the agencies involved took the initiative to seek out guidance on the principle.

For example, EDA guarantees of tax-exempt obligations are indirectly prohibited by the statute governing the Regular Business Development Program, which requires loans eligible for guarantee assistance to be made to private borrowers by private lending institutions. Since tax-exempt obligations are not issued by private lending institutions, an EDA guarantee of such an obligation is prohibited. This requirement does not extend to direct loans, however. Although it is not clear how frequently EDA has used its direct loan authority to guarantee tax-exempt obligations, one recent example is a hotel project in Arkansas initially approved in 1979. In this project, EDA provided a $1,750,000 direct loan which was subordinated to $4,250,000 in tax-exempt obligations also used to finance the project. According to a June 30, 1981, letter in response to our inquiry, EDA's then Acting Assistant Secretary for Economic Development stated that:

> "In the event of the borrower's default and foreclosure on the loan, EDA presumably would be forced to buy-out the first mortgagee to protect the Government's interest. Under such circumstances, the second lien position on the EDA loan would effectively result in an indirect guarantee of a tax-exempt obligation."

In December 1980, shortly after approving the Arkansas hotel project, Commerce's General Counsel wrote to us requesting the Comptroller General's opinion on the propriety of various financing arrangements involving tax-exempt obligations--including the subordination arrangement used in the Arkansas project. According to the General Counsel's letter, EDA understood that it had been Federal policy since 1963 not to guarantee tax-exempt obligations, but because of the "private borrower--private lender" requirement, EDA had "never reached" the A-70 principle. While EDA withdrew its request on April 13, 1981, and allowed the Arkansas project to continue development, the agency published new guidelines on April 1, 1981, which brought its program into compliance with the A-70 principle on tax-exempt guarantees.

EDA's Deputy Assistant Secretary for Development Finance told us that EDA had guaranteed tax-exempt obligations because her predecessors were unfamiliar with Circular A-70. According to her, the agency used it extensively in 1978 and 1979 when it was developing the proposed National Public Works and Economic Development Act. However, according to this official, EDA was not previously aware of the circular's policies. This official told us that EDA had tried to discuss certain policy questions with OMB, but OMB was not especially responsive. This official believed that OMB could be powerful in emphasizing the A-70 principles, "but all too often they could not say: here is the policy."

FEES NOT CHARGED AS SMALL BUSINESS ADMINISTRATION OFFICIALS WERE ALSO NOT AWARE OF A-70

The remaining two programs we reviewed were administered by the Small Business Administration. Program officials at SBA, as in the other agencies reviewed, were generally not aware of the circular. The new Development Company Debentures (503) Program was designed to supplement the existing Local Development Company (502) Program. However, the two programs have important differences with regard to compliance with the A-70 principles. While the 502 Program charges a guarantee fee, the 503 Program charges no fee. Interest rates under the 502 Program may substantially exceed those under the 503 Program. The direct and indirect guarantee of tax-exempt obligations is prohibited in the 502 Program. However, indirect guarantees of such obligations are specifically provided for under the 503 Program regulations--although implementation of the tax-exempt provision was being administratively delayed by SBA as of July 1982. Lender coinsurance was required by SBA in both programs.

SBA's 502 Program, authorized in 1958, charges a one-time guarantee fee of 1 percent of the guaranteed amount of the loan. According to the Director of SBA's Office of Business Loans, the fee does not make the program self-sustaining. SBA's 503 Program charges no guarantee fee. According to the SBA financial analyst referred to us as being the most knowledgeable about the program's development, the program was originally designed to charge a fee of 0.125 to 0.25 percent. According to this official, this fee would not have made the program self-sustaining. The fee, however, was dropped to help out borrowers because the new program added many additional costs. According to this official, he was not aware of Circular A-70 when the program was being developed, but if he had known about it, the program could have been designed to be consistent with the circular's principles. As of the end of June 1982, the 503 Program had approved nearly $84 million in guarantees. If the program had charged a one-time fee of 1 percent on this amount, income from the fee would have amounted to $840,000.

The procedures governing both programs require SBA to control maximum interest rates. In the 502 Program, SBA does this by imposing a formal administrative ceiling. This ceiling allows interest rates on some loans to go as high as 2.75 1/ percentage points over the prime rate. The prime rate is a published interest rate used as an indication of the rate major New York banks charge their best corporate customers for short-term loans. According to the SBA financial analyst we interviewed, SBA's loan guarantees usually receive interest rates 1 to 2 percentage points above prime. Our two SBA case studies were within this range.

SBA's definition of excessive interest rates, as defined by the ceiling discussed above, differs significantly from most of the other programs discussed in this report. In these other programs, the lender and borrower negotiate the interest rates on the loans, as they do in the 502 Program, but maximum interest rates are controlled informally, without a formal published ceiling. In these programs, many officials considered prime as an informal ceiling defining excessive interest rates. For example, while FmHA has no formal ceiling on interest rates in its B&I Program, in 1980 it published informal guidelines stating that interest rates on B&I guarantees should be less than prime. At the same time, similar SBA loans could receive interest rates as high as 2.75 percentage points above prime. SBA's 2.75-percentage-point ceiling also went into effect in 1980.

While the 502 ceiling is 2.75 percentage points above prime and other programs consider prime as an informal ceiling, recipients of guarantee assistance under SBA's 503 Program receive interest rates substantially below prime. This program provides interest rates at the Treasury rate, which is generally lower than the prime rate, because the program is financed through the Federal Financing Bank (FFB). 2/ The FFB, because it finances

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1/On July 29, 1981, SBA published a Notice of Intent to lower its ceiling to prime because of uncertainty as to what the prime rate represents (see p. 34). As of July 1982, the proposal had not been finalized.

2/The FFB is a Government-sponsored corporation supervised and directed by the Secretary of the Treasury. It was established in 1973 to improve Federal debt management of credit assistance programs, which were flooding private credit markets seeking financing. The bank takes the place of private lenders in the case of guaranteed loans, providing the funds necessary to finance the loans by borrowing from the Treasury. OMB Circular A-70 does not discuss the appropriate use of the FFB, since the circular was issued in 1965 and has not been revised.

loans guaranteed by the agencies through Treasury borrowing, provides financing at the Treasury rate plus one-eighth of a percentage point for administrative expenses. According to the SBA financial analyst heavily involved in the development of the program, the FFB rate is about 2 percentage points below prime. Thus, borrowers in this program, which provides guaranteed loans to the same borrowers for the same purpose as the 502 Program, are receiving rates 3 to 4 percentage points below those received by borrowers in the 502 Program.

Federally guaranteed loans have special characteristics which can make them more profitable to lenders than conventional loans. Guaranteed loans substantially reduce lender risk; lenders can make guaranteed loans up to 10 times larger than conventional loans, with the amount at risk the same; and secondary market sales of guaranteed loans can also double a bank's return on its investment (see app. IV). Program officials expressed a great deal of uncertainty as to the value of these special characteristics in determining an excessive interest rate on guaranteed loans, versus rates prevailing in private markets on conventional loans. OMB Circular A-70, even if these officials had been aware of it, provides little help in judging excessive interest rates.

According to the OMB economist responsible for administering Circular A-70, OMB guidelines are not as clear as they need to be. This is because, in trying to establish a policy on maximum interest rates for guaranteed loans, the Government faces two conflicting objectives but has no good analytical basis to quantify the special characteristics of those loans and thus resolve the conflict. On the one hand, the Government wants to avoid artificially dictating interest rates on guarantees to the private sector. If the rates are too low, lenders may cease to participate in guaranteed loan programs. On the other hand, the Government does not wish to be exploited by lenders by setting rates which are so high as to not recognize the substantial risk assumption by the Federal Government. The "spongy" executive branch guidelines, according to this official, are a result of these problems.

Within agency limits on interest rates, individual variations in risk, for example, may justify variations in the interest rates on individual loans. However, different overall definitions of excessive interest rates can significantly alter the interest costs to borrowers under the various programs. For example, in our case studies, all of which were begun before the issuance of FmHA's informal guidelines, interest rates were generally 1 to 2 percentage points over prime. However, EDA approved one loan at an interest rate 0.25 percentage points above the maximum rate allowed by the SBA administrative ceiling, and FmHA also approved one loan at 2.5 percentage points above SBA's definition of excessive interest. The FmHA loan was made at 3 percentage points over prime during the time SBA's ceiling was set at 0.5 percentage points over prime. Although the FmHA Assistant Administrator for Business and Industry considered the rate to be exhorbitant, FmHA efforts to persuade the bank to lower the rate were unsuccessful. If FmHA had held the interest rate on this loan to SBA's definition of excessive interest, the FmHA borrower would have saved $37,500 in first-year interest costs. While the programs reviewed exhibited significant differences in their overall definitions of excessive interest rates, we could not determine whether or not some of them were allowing excessive interest rates because of the vague executive branch guidance.

SBA's 502 Program prohibits guarantees of tax-exempt obligations. According to the director of SBA's Office of Business Loans, he was not aware of Circular A-70 prior to our review and did not use it in administering the program. This official, after we had discussed the circular's policy with him, expressed the belief that the procedure prohibiting the guarantee of tax-exempt obligations was written to provide compliance with the circular when it was issued in 1965. In SBA's new 503 Program, however, the final program regulations specifically allowed the indirect guarantee of tax-exempt obligations through the subordination mechanism described earlier. The Congress provided discretion on the principle in the enabling legislation. However, the author of the program, the Chairman of the Subcommittee on General Oversight and Minority Enterprise, House Committee on Small Business, specifically intended for the program to allow for such guarantees. The chairman believes the A-70 policy is too restrictive (see app. VI). To make clear his intent, the chairman requested that language explicitly allowing guarantees through the subordination mechanism be inserted in the conference report on the legislation.

Although the Treasury Department recommended that the legislation be vetoed, the bill was signed into law. Subsequently, SBA included the tax-exempt provision in its proposed rules for the program and requested public comment on the provision. According to SBA, OMB did not comment on the proposed regulations. The final regulations, issued by SBA on September 30, 1980, therefore authorized the guarantee of tax-exempt obligations.

According to the SBA Administrator, in a meeting after SBA had issued its final regulations, OMB said it was conducting a new study on the question that would be completed by the end of fiscal year 1981. SBA agreed that it would administratively delay implementation of the tax-exempt provision pending completion of the OMB study. As of July 1982, SBA was continuing to delay implementation of the provision.

NONCOMPLIANCE WITH A-70 PRINCIPLES IS COSTLY, INEQUITABLE, AND LIMITS PRIVATE PARTICIPATION

OMB's failure to emphasize compliance with the A-70 credit principles has serious consequences. Government costs are increased by millions of dollars because some programs do not charge guarantee fees, do not require lenders to share financial risk, and do not prohibit guarantees of tax-exempt obligations. Noncompliance with the circular's principles also creates inequities because some lenders or borrowers receive the same Federal assistance as their counterparts in other programs, but on more favorable terms. Finally, the inconsistency created by noncompliance with the circular's principles also diminishes private participation--the lifeblood of the programs.

While it is difficult to accurately estimate the total costs because our sample did not include all guarantee programs, noncompliance with the circular's principles is costly. For example, we estimated the cost of EDA's and SBA's failure to charge guarantee fees at over $4 million. This estimate covered only two programs. Noncompliance with the principle requiring lenders to share part of the financial risk on guaranteed loans adds additional millions in increased Government exposure to financial risk. Further, we estimated that Federal guarantees of tax-exempt obligations cost $1.33 in foregone tax revenues for every $1 in interest savings provided to users of such obligations.

The inequities created by noncompliance with the circular's principles are aptly illustrated by the principle prohibiting guarantees of tax-exempt obligations. For example, because FmHA allowed indirect guarantees of tax-exempt obligations, one of its borrowers received a loan with an interest rate of 11.74 percent (see app. V) at a time when the prime rate was 19 percent. At the same time, loan guarantees from SBA's 502 Program, which prohibits such guarantees, were receiving interest rates of 1 to 2 percentage points above prime. Because of OMB's lack of emphasis on compliance with the circular's principles, this borrower saved between $463,000 and $413,000 in first-year interest costs alone over the interest rates being paid by his counterparts in other programs.

Noncompliance with the circular's principles also diminishes private participation. According to representatives of the Public Securities Association, the Robert Morris Associates, and other members of the banking community, inconsistencies between agencies, and even within different programs administered by the same agency, lower the participation rate of the banking community and create a generally negative atmosphere around Federal loan guarantees. Because of the lack of policy standardization, banks have to hire special personnel to become experts in the programs and to keep up with the constant changes. Small banks often cannot afford the extra cost. Loan officers do not want to get involved with loan guarantees and have no incentive to learn all the differences. According to these officials, more uniformity would result in more private sector participation and possibly lower interest rates because of the potential for lowering overhead costs.

OMB's Acting Assistant Director for Budget Review, as well as Treasury's Assistant Director of the Office of Government Finance, agreed that noncompliance with the circular's policies is costly and inequitable.

CONCLUSIONS

OMB Circular No. A-70 was intended to ensure that executive branch agencies used the most effective and economical policy principles in designing and administering credit assistance programs. That important objective is not being met, and the consequences are serious.

The circular communicates poorly, and OMB has not emphasized or formally overseen compliance with its principles. As a result, the circular has fallen into obscurity and its principles have fallen into disuse. Agency officials are generally not aware of it, and nearly all of those who are do not use it to develop or administer loan guarantee programs. Since OMB has not exercised centralized management control, these agencies are making credit policy decisions on their own, and those decisions are often contrary to the principles adopted by the circular.

Noncompliance with those principles has serious consequences. Government costs to operate the programs are increased by millions of dollars because some programs do not charge guarantee fees, do not require lenders to share financial risk, and do not prohibit guarantees of tax-exempt obligations. Such inconsistencies also create inequities because some lenders or borrowers receive the same Federal assistance as their counterparts in other programs, but on more favorable terms. The inconsistencies created by noncompliance with the circular's principles also diminish private participation--the lifeblood of program financing.

OMB officials acknowledge that the circular does not communicate clearly, that agencies are not following its principles, and that noncompliance with those principles is costly and inequitable. However, corrective action has been postponed for years. The 1974 proposed revision to the circular would have provided a clearer communication of the policy, but the proposal was never formalized because of opposition to the principle regarding tax-exempt obligations. In the years since, OMB has been planning to review the circular's principles and reissue it, but priority has been given to other matters. The recent efforts of the Working Group on Credit Policy to review certain principles adopted by the circular are important, and this report provides detailed discussions of many issues which should be of assistance to the working group. However, its efforts will not specifically address the problems causing noncompliance with the circular--the lack of clear communication, oversight, and enforcement. According to OMB's Acting Assistant Director for Budget Review, action on the circular itself will have to take second priority until work on the credit budget is completed.

At the same time, program officials we interviewed did not indicate that they planned to take immediate steps to bring their programs into compliance with the circular's principles. The usual indication was to take a "wait-and-see" posture, while agreeing with the need for more centralized guidance. Because the circular contains certain ambiguities and because it has languished for 17 years without vigorous enforcement, this reaction is understandable.

We recognize that OMB's resources are limited. However, because of the costs and inequities involved in noncompliance with the circular's principles, we do not believe that actions to improve compliance should be postponed further. We believe that a formal review and reissuance of the circular should be done immediately. However, if the circular is to continue to receive second priority until work on the credit budget is complete, interim actions should be taken to clearly communicate the executive branch's credit policy. Such actions would be consistent with the administration's other efforts to improve management control of Federal credit.

OMB COMMENTS AND OUR EVALUATION

In commenting on a draft of our report (see app. IX), OMB agreed that establishing consistent credit principles is an important part of the overall process of gaining control over Federal credit activity. It also agreed that Circular A-70 should be revised and reissued. However, OMB reaffirmed its decision to postpone corrective action, stating that the report fails to recognize the time and complexity involved in updating and reissuing the circular, as well as the importance of the other aspects of Federal credit policy competing for OMB's limited resources. Our draft report also contained a proposal that if Circular A-70 cannot be revised and reissued quickly, the 1974 draft revision to the circular should be distributed as interim guidance. According to OMB, however, that recommendation would not be very helpful because it does not recognize that the 1974 draft was written for a world in which there was no Federal Financing Bank. In fact, OMB's letter said that any revision or substitute for A-70 which ignores the bank would not be very helpful because of the bank's enormous impact on Federal credit programs. OMB's letter also said that the report does not give adequate treatment to OMB's record of activity in overseeing the management of loan guarantee programs.

OMB has acted to improve the overall management of loan guarantee programs, as this report recognizes throughout. However, the specific question at hand is how soon Circular A-70 can be revised and reissued in light of OMB's limited resources. We are well aware of the complexity and importance of the various aspects of Federal credit policy competing for resources with Circular A-70. However, we see no need to specifically address them in this report because since 1975, we have issued over 170 reports relevant to the issues of debt collection, the credit budget, the Federal Financing Bank, and the management of credit assistance (see app. VIII). We recognize too, that developing a comprehensive circular addressing all credit principles important to the design and administration of credit assistance programs is a complex and time-consuming task.

However, we continue to believe that guidance addressing the four principles discussed in this report would be extremely beneficial and can be provided quickly. These four principles are basic to the design and administration of loan guarantee programs, and the absence of centralized guidance on them is causing serious inequities and excess costs. As discussed in OMB's comments to us policy decisions have already been made on the principles regarding the guarantee of tax-exempt obligations and coinsurance requirements, and the principles regarding fees and interest rates are now being analyzed in preparation for this year's fall Director's review. Thus, soon after the fall review scheduled for October and November 1982, it should be possible to revise and reissue the circular, limiting it to the four principles discussed in this report. The circular can then be amended to include other principles as soon as policy decisions are reached.

We agree that the Federal Financing Bank has had a budgetary impact on Federal credit programs because loan guarantees purchased by the bank are converted to off-budget direct loans. However, according to our analysis of the 1982 Catalog of Federal Loan Guarantee Programs, 1/ 75 percent of the guarantee programs listed are not financed through the bank. In addition, despite the bank's policy against purchasing the coinsured portion of guaranteed loans, guarantee programs financed through the bank can still adhere to the four A-70 principles discussed in this report. For example, SBA's 503 program (discussed on pp. 18 through 21) is financed through the Federal Financing Bank, yet it adheres to three of the four A-70 principles discussed, and was originally designed to also charge a guarantee fee. Thus, a circular which does not address the proper role of the bank would still provide important benefits.

Should OMB's priorities preclude allocating the limited resources necessary to revise and reissue the circular, policy guidance on the four principles can be provided to executive agencies and establishments in the form of a memorandum from the Director, OMB. We agree, and have modified our draft proposal accordingly, that using the 1974 draft revision of the circular would not serve as appropriate interim guidance because, although paragraph 5.d. of that document does address the use of the Federal Financing Bank, the 1974 draft revision discusses many principles--some of which may be inappropriate to today's financial environment.

RECOMMENDATIONS TO THE DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

We recommend that OMB reissue the circular to

--state directly the executive branch policies on charging guarantee fees, requiring lender coinsurance, controlling

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1/Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, United States House of Representatives, January 1982.

interest rates, and guaranteeing tax-exempt obligations, and amend it to include additional policy guidance as soon as practicable;

--state assertively that agencies developing credit assistance legislation and agencies administering existing programs--where existing statutes permit--are required to follow the principles contained in the circular; and

--provide sufficient emphasis on the circular to provide effective oversight and enforcement.

Should such reissuance be determined to be impractical at this time, we recommend that as an interim step, OMB send a memorandum to the heads of executive agencies and establishments providing policy guidance on the four principles discussed in this report.

EXCERPTS FROM OMB CIRCULAR A-70

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

February 1, 1965 CIRCULAR NO. A-70

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Legislation on Federal credit programs

1. Purpose. In transmitting the Report of the Committee on Federal Credit Programs on February 11, 1963, President Kennedy requested all departments and agencies administering such programs to be "guided by the principles outlined in the Report in administering their present programs, and especially in proposing any new or expanded credit authority." The Director of the Bureau of the Budget was asked "to take the lead in assuring an effective and equitable application of these guidelines." President Johnson has indicated his agreement with the principles of the report and his continued interest in their application. This Circular establishes the policies and procedures to be followed in proposing legislation to extend, revise or create Federal credit programs, and supersedes the informal policies and procedures previously used in carrying out the President's request.

2. Definitions. The following definitions apply herein:

a. Agency: Any executive department or independent commission, board, bureau, office, agency, wholly owned or mixed-ownership Government corporation as defined in the Government Corporation Control Act, or other establishment of the Government, including any regulatory commission or board, and also the municipal government of the District of Columbia, but not including agencies of the legislative or judicial branches of the Government.

b. Credit programs: Direct loans and participations; secondary market operations; insurance and guarantees of private loans, and sales credit of more than 45 days duration provided by any agency as defined above.

3. Evaluation of proposed legislation

a. Whenever any agency proposes legislation either to establish a new credit program, or to expand or renew the authority of, or provide broader powers for existing credit programs, the agency will prepare a memorandum evaluating the proposed legislation in terms of the relevant recommendations of the Report of the Committee on Federal Credit Programs. The specific questions to be covered in such a memorandum are enumerated in Attachment A.

ATTACHMENT A
Circular No. A-70

INSTRUCTIONS ON PREPARATION OF MEMORANDUM
EVALUATING CONSISTENCY OF PROPOSED LEGISLATION WITH
REPORT OF THE COMMITTEE ON FEDERAL CREDIT PROGRAMS

Each agency proposing new legislative authority affecting credit programs will submit a memorandum responding to all of the following questions relevant or applicable to the proposed authority. Each question is cross-referenced to the appropriate pages in the Report of the Committee on Federal Credit Programs and should be answered in terms of the discussion contained in the Report.

3. Insured and guaranteed loans (pp. 16-21)

a. If insured or guaranteed loans are proposed, to what extent and how are private lenders required to share the risk (coinsurance)?

b. Does the proposal prohibit or preclude guarantee of tax-exempt obligations directly or indirectly?

c. Does the insuring or guaranteeing agency have authority to limit maximum interest rates charged? If a statutory formula is provided, how is reasonable flexibility assured?

6. Financing of credit programs (pp. 26-33)

a. On proposed loan guarantee and insurance programs, how do insurance premiums or guarantee fees compare with probable losses and administrative expenses?

SUMMARY OF THE PROGRAMS REVIEWED

EDA's REGULAR BUSINESS DEVELOPMENT PROGRAM

EDA's Regular Business Development Program is authorized by section 202 of the Public Works and Economic Development Act of 1965, as amended (42 U.S.C. 3142). According to the act, the objective of this program is to provide credit assistance to "* * * areas and regions of substantial and persistent unemployment and underemployment to * * * enhance the domestic prosperity by the establishment of stable and diversified local economies * * *." EDA measures progress toward this objective primarily in terms of saving and creating jobs in these distressed areas.

During fiscal years 1978-80, the program obligated some $438.6 million in credit assistance--54 percent in the form of guarantees and the remainder in direct loan assistance. In 1980, about half of this assistance was used to acquire or improve such fixed assets as buildings and machinery. The remaining half was for such working capital purposes as debt refinancing or general use in the operation of the company. In the 2 preceeding years, however, the use of such assistance was not as balanced. Approximately one-third of the assistance was used for fixed-asset purposes in 1978, while about two-thirds was used for that purpose in 1979.

During the same 3-year period, 60 percent of EDA's loans were medium sized ($500,001 to $2,500,000). Small loans ($500,000 or less) accounted for 23 percent of the assistance, and the remaining 17 percent was in the form of large loans over $2,500,000.

FmHA's BUSINESS AND INDUSTRIAL LOAN PROGRAM

FmHA's Business and Industrial Loan Program is authorized by section 310B of the Consolidated Farm and Rural Development Act, as amended (7 U.S.C. 1932). The objective of the B&I Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural areas. FmHA also emphasizes saving existing jobs and/or creating new jobs and limits its assistance to nonurbanizing areas and rural cities--giving priority to those with populations under 25,000. This program often assists the same counties as the EDA program, guaranteeing loans in 47 percent of the same 175 counties that EDA assisted during fiscal years 1978-80.

During fiscal years 1978-80, the B&I Program obligated approximately $2.7 billion in loan guarantees. The program has authority to issue direct loans, but the use of this form of credit assistance has been limited. The assistance provided by this program was generally used for fixed-asset purposes, with about two-thirds of the assistance consistently used for those purposes during the 3-year period. During this same period, 56 percent of the program's loans were small ones. Of the remaining assistance, 38 percent went for medium-sized loans and only 6 percent for large loans.

SBA's LOCAL DEVELOPMENT COMPANY PROGRAM

SBA's Local Development Company Program is authorized by section 502 of the Small Business Investment Act of 1958, as amended (15 U.S.C. 696). According to the act, the objective of the "502" Program is to "* * * improve and stimulate the national economy in general and the small-business segment thereof in particular * * *." SBA does not emphasize job creation/saving as a measure of its benefits as much as EDA and FmHA do. SBA also assists some of the same counties as EDA, providing assistance in 31 percent of the counties that EDA made loans to during fiscal years 1978-80.

While the EDA and FmHA programs provide guarantees to private banks, the SBA program works somewhat differently. The 502 Program provides loan guarantees to local development companies (LDC's) rather than to private banks. The LDC is required to be State chartered and principally composed of and controlled by local citizens. It functions as a conduit through which SBA assistance is passed to individual small businesses. While SBA views the LDC as the recipient of the assistance, we have viewed it as the lender, with the ultimate recipient being the small business. This view was taken throughout this report to simplify comparison with other programs.

During fiscal years 1978-80, this program obligated about $200 million in credit assistance, 38 percent of which was for guarantee assistance. The remaining 62 percent was in the form of direct assistance. Virtually all assistance was for fixed-asset purposes because this program prohibits its assistance from being used for general working capital. Debt refinancing is, however, allowed, and SBA "companion" loans under another program are available for working capital purposes. All of this program's loans during the 3-year period we covered were small because there was a statutory limit of $500,000 on the size of its loans.

DOE's AND FmHA's GENERAL BIOMASS ENERGY DEVELOPMENT PROGRAM

This program was authorized by the Biomass Energy and Alcohol Fuels Act of 1980 (42 U.S.C. 8801 note). According to the act, the objective of the program is to reduce the Nation's dependence on imported petroleum and natural gas by increasing national production and use of biomass energy. The term "biomass" refers to any organic matter which is available on a renewable basis, including such things as agricultural crops, wastes, and residues; wood and wood wastes and residues; animal wastes; municipal wastes; and aquatic plants. To help finance projects which would produce energy from biomass materials, the act authorized the use of a variety of credit assistance tools: loan guarantees, insured loans, price guarantees, and purchase agreements.

This program was designed to be jointly administered by the Departments of Agriculture and Energy. DOE was given responsibility for helping to finance large projects (15,000,000 gallons or more annual production capacity), and FmHA (under the Department of Agriculture) was to handle the smaller projects (less than 15,000,000 gallons). While FmHA's portion of the program is inoperable, DOE's Alcohol Fuels Program was authorized $271 million in 1981. However, as of July 1982, no loan guarantees had been approved.

DOE's MUNICIPAL WASTE BIOMASS ENERGY PROGRAM

This program was also authorized by the Biomass Energy and Alcohol Fuels Act of 1980. The program was to help lessen the Nation's energy dependence by providing assistance for the construction of projects which produce energy from municipal waste. The term "municipal waste" refers to the sewage, sludge, and industrial or commercial waste of cities or localities. This act also provided a variety of credit assistance tools: loan guarantees, direct loans, and price support loans and price guarantees. This program was appropriated funds and a small amount was used, but its funds were also rescinded and the program was inoperable as of July 1982.

MARAD's OTEC PROGRAM

The Ocean Thermal Energy Conversion Act of 1980 (42 U.S.C. 9101 note) authorized this program to assist in the construction and operation of vessels or facilities which produce energy from the temperature differences in ocean water. The act authorized loan guarantee assistance for such projects by amending the 1936 Merchant Marine Act (46 U.S.C. 1271), bringing such projects under the authority for the existing ship financing guarantee program. The OTEC Program was allocated $1.6 billion in 1981. However, according to the Chief of MarAd's Division of Domestic Financing Guarantees, as of July 1982, no loans had been guaranteed.

FmHA's AGRICULTURAL SUBTERMINAL FACILITIES PROGRAM

This program was authorized by the Agricultural Subterminal Facilities Act of 1980 (7. U.S.C. 3701 note). According to the act, the movement and storage of bulk agricultural commodities (such as fertilizer and fuel) have been seriously impeded by shortages of transient storage facilities, adequate rail rolling stock, and the deterioration of many railroad track beds and rural highways. The act provided the Department of Agriculture with authority to make loan guarantees and insured loans to assist in the construction or improvement of such agricultural subterminal facilities.

According to FmHA officials, the program did not require new regulations and was just incorporated into the existing regulations for FmHA's B&I Program. The program, according to these same officials, has received no funding.

FmHA's RENEWABLE
RESOURCE ENERGY LOANS

This program was authorized by Section 1 of Public Law 96-438, "An Act To Amend the Consolidated Farm and Rural Development Act" (7 U.S.C. 1923, 1932, 1942, and 42 U.S.C. 5901 note). This program, according to FmHA officials, amended FmHA's B&I Program and several other programs to make the acquisition, installation, and modification of nonfossil energy systems (such as solar energy systems) in family farms and ranches eligible for loan guarantee assistance. According to the act, this was done to assist farmers and ranchers in reducing their dependence on nonrenewable energy resources. According to FmHA's Acting Director of the Farm Real Estate and Production Division, this program does not receive funding separate from the programs it was added to, and no specific records are kept of the number of renewable resource energy loans made. This official, however, estimated that 40 to 50 such loans had been made since the program's inception.

FmHA's RURAL EMERGENCY
LOAN PROGRAM

This program was also authorized by Public Law 96-438 (section 3). This program was to provide loan guarantees or insured loans to certain rural organizations, farmers, or ranchers which have been substantially affected by a natural disaster (such as a flood). According to FmHA's Director of the Emergency Loan Division, this program also basically follows the B&I regulations. This program was also suspended in 1980, according to this official.

NOAA's FISHING VESSELS
AND FISHERIES PROGRAM

This program was authorized by the American Fisheries Promotion Act (16 U.S.C. 1801 note), enacted by the Congress in December 1980. The act amended the 1936 Merchant Marine Act to broaden the scope of the existing Fishing Vessel Obligation Guarantee Program, adding shoreside fishery facilities as an eligible activity for loan guarantees. The administration has proposed a ceiling on the program of $50 million for 1982, but no loans had been guaranteed as of July 1982.

SBA's DEVELOPMENT COMPANY
DEBENTURES (503) PROGRAM

This program was authorized in July 1980 by section 113 of Public Law 96-302 (15 U.S.C. 697), "An Act To provide authorizations for the Small Business Administration, and for other purposes." The 503 Program was designed to supplement SBA's existing

502 Program. The 503 Program, like the 502 Program discussed earlier, works somewhat differently than the other programs reviewed. In the other programs, banks or other private sources of funds generally receive the guarantee directly from the guarantor agency. However, in SBA's 502 Program, a local development company receives the guarantee, although the loan funds may be obtained from local banks. The LDC acts as a financial intermediary between these banks and the small business ultimately receiving the loan funds. The 503 Program, however, modifies this financing arrangement. In this program, SBA provides 100-percent guarantees of debentures issued by the LDC; but instead of the funding coming from private sources of capital, the debenture is sold to the Federal Financing Bank which provides the funding for the debenture. The FFB borrows the money from the Treasury to fund the debenture purchase, in effect providing a direct loan. The LDC then loans the funds to the small business. This financing mechanism generally provides 40 percent of the project cost. Another 50 percent of the cost is provided by a local bank in the form of a separate, unguaranteed loan. The remaining 10 percent is provided by the LDC as an equity injection. From its inception in 1980 to June 30, 1982, this program approved guarantees of $84 million in LDC debentures.

SUMMARY OF GAO's ANALYSIS

OF THE 11 PROGRAMS REVIEWED

	A-70 Principles (as of May 1982)							
Program	Guarantee fee charged?	Authority? 1/	Coinsurance required?	Authority?	Control interest rates?	Authority?	Direct and indirect OTE 2/ prohibited?	Authority?
1. General Biomass Energy Development								
DOE	Yes	D	Yes	M	No formal ceiling	M	Yes	D
FmHA	Yes		Yes		No formal ceiling		No 3/	
2. Municipal Waste Biomass Energy (DOE)	Yes 4/	D	Yes	M	No formal ceiling	M	Yes	M 5/
3. Ocean Thermal Energy Conversion (MarAd)	Yes	M	No	D	No formal ceiling	M	Yes	M 5/
4. Agricultural Subterminal Facilities (FmHA)	Yes	D	Yes	M	No formal ceiling	M	No 3/	D
5. Renewable Resource Energy Loans (FmHA)	Yes	D	Yes	M	No formal ceiling	M	No 3/	D
6. Rural Emergency Loans (FmHA)	Yes	D	Yes	D	No formal ceiling	M	No 3/	D
7. Fishing Vessels and Fishery Facilities (NOAA)	Yes	M	No	D	No formal ceiling	M	Yes	D
8. Development Company Debentures "503" (SBA)	No	D	Yes	M	FFB rate	M	Yes	D
9. Business and Industrial Loans (FmHA)	Yes	D	Yes	M	No formal ceiling	M	No 3/	D
10. Local Development Company "502" Loans (SBA)	Yes	D	Yes	D 6/	Formal ceiling equal to prime + 2.75 percentage points	D 6/	Yes	D
11. Regular Business Development (EDA)	No	D	Yes	M	No formal ceiling	D	Yes	D

1/Policies mandated by enacting legislation or by basic program statute are denoted by an "M." In reviewing program statutes, we considered the term "shall" (for example, "agency shall charge a guarantee fee") as mandating the use of a principle. The letter "D" denotes that the principle is optional at the agency's discretion. In reviewing the program statutes we considered no reference to the principle, or use of the term "may" (for example, the Administration may charge a guarantee fee") as providing agency discretion.

2/Guarantees of tax-exempt obligations.

3/On February 19, 1982, FmHA published a proposed rule to change its regulations to prohibit the indirect guarantee of tax-exempt obligations. As of July 19, 1982, this rule had not been finalized.

4/A fee was to be charged under some circumstances, but not in others (see p. 14).

5/In both programs, the legislation specifically prohibited direct guarantee of tax-exempt obligations. However, the legislation did not clearly prohibit the various forms of indirect guarantees.

6/Until August 31, 1981, the legislation governing SBA's 502 program required both lender coinsurance and the control of maximum interest rates. However, on that date the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35) removed both requirements (see 15 U.S.C. 696), leaving those decisions to SBA's administrative discretion.

SPECIAL CHARACTERISTICS OF GUARANTEED LOANS

Federally guaranteed loans are different from conventional loans. Both types of loans are financed by funds from private lenders. However, lenders receiving Federal guarantees are protected against much of the financial risk associated with loan default. This guarantee is backed by the "full faith and credit" of the U.S. Government. According to a 1979 congressional staff study, 1/ such full faith and credit backing limits the liability of the United States only to the ceilings, if any, on Treasury borrowing authority. According to various agency officials and bankers, while the guarantee lowers the risk on loans, its true value is that it induces bankers to make loans they ordinarily would not make because of their higher risk. It also allows loans with longer maturities and/or other liberalized terms, such as lower equity or collateral requirements.

Because of the lowered risk associated with the Federal guarantee of these otherwise high-risk loans, the appropriate interest rate is sometimes seen as the prime rate or less. However, uncertainty has developed as to what the prime rate actually represents. Until recently, the prime rate was accepted as the lowest short-term rate banks charged their best corporate customers. However, in April 1981, the House Committee on Banking, Finance and Urban Affairs published a staff report 2/ which stated that the prime rate "* * * has become a murky, ill-defined term that rarely reflects the lowest rates available to corporate customers." According to this report, 60.7 percent of the commercial loans granted by large banks in New York during May of 1980 were below the publicly announced prime rate. The average discount from the prime rate was 4.26 percentage points. The committee concluded, among other things, that "Federal agencies * * * should not peg their interest rates to the announced prime rate." They "* * * should use their own resources to determine the real benchmark rates existing in the economy."

According to the Directors of the Domestic Lending and Policy Divisions of the Robert Morris Associates (a national association of senior bank lending officers), the prime rate is indicative of interest rates provided top quality local borrowers. These businesses have little or no bank competition for their business but get a lower interest rate because of their financial stability. Businesses receiving below-prime rates are generally large multinational corporations that are exceptional because of their overall

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1/"A Guidelines Handbook on Federal Loan Guarantee Programs," February 1979, Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Affairs.

2/"An Analysis of Prime Rate Lending Practice at the Ten Largest United States Banks," April 1981.

credit standing and their ability to generate a profitable banking relationship in general. Banks compete for the business of these borrowers, and the competition lowers their interest rates. According to these officials, loan guarantees provide high-risk businesses with a standing about equal to prime in terms of risks.

However, other special characteristics also affect the interest rate. For example, banking law imposes a limitation on the size of any individual loan a bank may make. However, under 12 U.S.C. 84, exception 10, the guaranteed portion of guaranteed loans does not count against this lending limit. Only the coinsured portion is counted against it. Because of this exception, lenders can make guaranteed loans up to 10 times larger than conventional loans, with the amount at risk the same.

Secondary market sales sometimes provide the funds for these large loans. In these sales, the originating lender sells the guaranteed portion of the loan to a second investor, retaining the coinsured portion of the loan and servicing the guaranteed portion of the loan for a fee. Such sales increase a bank's liquidity because guaranteed loans are relatively easy to sell and convert to cash when needed. These sales also may double a bank's return on its investment. An example from an American Bankers Association publication 1/ will illustrate.

A bank makes a $100,000 loan at 10.5 percent interest, which is 90 percent guaranteed. The bank sells the guaranteed portion of the loan ($90,000) to a secondary market investor and receives $90,000 in return. The bank continues to service the entire loan and charges the investor a 1.25-percent servicing fee on the portion of the loan which was sold. The bank retains the $10,000 portion which is not guaranteed and may reinvest the $90,000 received from the sale. Instead of earning an 11.75 percent ($11,750) return on the $100,000 investment, the bank earns a return of 21.75 percent in the first year (see table below).

While Circular A-70 does not address the question, the SBA and FmHA programs we studied allowed private secondary market sales, but the EDA program did not. According to agency officials we spoke to, private secondary market sales may reduce program costs by acting as an incentive to lower interest rates and may provide an incentive for private sector participation. EDA's Deputy Assistant Secretary for Development Finance stated that if secondary market sales of EDA loan guarantees were allowed, they would attract more investment to areas that need it. This would occur because commercial lenders are reluctant to tie up their funds in long-term loans, while a secondary market would allow investors like pension funds and insurance companies to take the investments.

1/Banker's Guide to Federally Guaranteed Loan Programs, 1980, page 127.

Table 1

	Bank income first year
$100,000 loan at 10.5 percent, 90 percent guaranteed, and a 1.25-percent servicing fee	
90 percent guaranteed portion sold in secondary market, and $10,000 retained at 10.5 percent interest ($10,000 X 10.5 percent)	$1,050
1.25 percent servicing fee on $90,000 sold	1,125
Total income	$2,175

Yield before expenses = 21.75 percent ($2,175/$10,000)

According to the Director of FmHA's B&I Program, however, lenders may include features in the loans which make it easier to foreclose on them, as an inducement to secondary market investors. These investors would be more interested in the investment aspects of a loan than in a protracted period of working with the borrower to resolve financial difficulties. In addition, the incentive to lower interest rates which the secondary market provides may be somewhat moderated by a lender's desire to price the loan at a point high enough for easy salability.

Although the benefits discussed above make guaranteed loans potentially more profitable than conventional loans, additional factors offset these benefits. According to officials from the Robert Morris Associates and other representatives of the banking industry, guaranteed loans have higher administrative costs. Paperwork costs are higher, servicing requirements are often higher because of their higher risk, and banks wishing to be continuously involved in guaranteed loans must hire special employees just to keep up with the many inconsistencies, technical details, and constant regulation changes. In addition, businesses receiving guaranteed loans are generally higher risks. Thus, the general banking relationship is not as profitable as with banks' normal customers because checking and other accounts are not as large or as stable and the future growth of the business may be questionable. According to these officials, no one has quantified these costs. They stated that because of these drawbacks, guaranteed loans have a generally negative aura which offsets their financial benefits and results in a higher interest rate.

GAO CASE STUDY OF AN FmHA GUARANTEE

OF A TAX-EXEMPT OBLIGATION

On February 26, 1982, FmHA guaranteed a loan under its B&I program that was expressly designed to result in the FmHA guarantee of a tax-exempt obligation. As discussed in the body of this report, direct or indirect guarantees of such obligations are contrary to executive branch policy. To illustrate one method of obtaining such guarantees, which can be quite complex and innovative, we have provided the details of our case study of one such FmHA-guaranteed project. Because this case study discusses sensitive and confidential business and credit information, we have not identified the persons and organizations involved.

The project, which was expected to produce about 200 jobs, was for construction and operation of an $8.7 million mushroom farm in a socially and economically depressed area in southern Colorado. While project financing came from several sources, including $1.7 million in private equity, an EDA direct loan for $1.3 million, and an Urban Development Action Grant from the Department of Housing and Urban Development for $682,000, most of the funding came from a $5 million tax-exempt bond issue floated by the county. The bonds were sold to an investment banking firm, which subsequently sold them to purchasers ranging from institutional investors to "mom and pop" investors--with much of the issue going to the latter type of investors. A trustee was appointed to handle the funds received from the bond sale and to ultimately pay the bondholders.

In order to obtain the FmHA guarantee, and thus receive a triple A rating for the bonds and the low interest rate (11.74 percent when the prime rate was 19 percent) desired for the project, a $5,000,000 private loan was set up at the same time as the bond issue. The loan terms (interest rate, maturity, etc.) were designed to coincide with those of the bonds. The private lender then obtained FmHA agreement to guarantee 90 percent of the loan in February 1982. Construction costs were financed by a private loan, repaid with the proceeds of the guaranteed loan. On February 26, 1982, when the guaranteed loan was finalized, the bond trustee used the funds received from the sale of the bonds to purchase the guaranteed portion of the loan in the secondary market. At that point the bondholders had $4,500,000 of the bond issue which FmHA guaranteed 100 percent against default. The loan payments by the mushroom farm flow from the farm to the private lender who will service the loan, from this lender to the bond trustee, and from the trustee to the bondholders.

All transactions necessary to insure the FmHA guarantee of the bonds were contractually agreed to in May 1981. The preliminary public statement announcing the intent to issue the bonds, dated March 9, 1981, described the mechanism by which the bonds would be guaranteed on its front page. According to our discussions with the county officials, bankers, and FmHA officials involved, they all understood the FmHA regulation prohibiting the guarantee of tax-exempt obligations. The bond underwriter for the bank that made the guaranteed loan told us that the private loan and secondary market purchase by the trustee of the tax-exempt bonds was a "legal way of using the existing [FmHA loan guarantee] mechanism to finance the project."

According to the vice president of the investment banking firm's Public Finance Department and representatives of the three banks ultimately involved in the project, there was no feasible alternative to Government-assisted financing. Originally, the project was to have been financed by a taxable corporate bond issued by the mushroom farm, with one corporate buyer. However, the corporate buyer pulled out of the project early. According to the banking officials cited above, a taxable corporate bond as originally envisioned was not feasible because the collateral was too unusual and the project was not economically feasible. The mushroom farm building, which was to be the collateral, had only single-purpose value in that area. If it had been located in Denver, however, it might have been useful as a warehouse.

The project was not economically feasible because it is a high-technology business in an area which is socially and economically depressed. Consequently, a corporate bond would have been unratable, with a high interest rate. The high interest rate would have placed a strain on the business' cash flow, causing it to be even more unstable. Government involvement was therefore needed, and FmHA was called on because those involved had heard of another project which was financed by an FmHA guarantee of tax-exempt obligations. According to the chairman and other members of the County Board of Commissioners, if FmHA or some other governmental entity had not helped, the project would still have been built--but closer to Denver and not in their county. As a result the county's tax base would have been lower and additional Government transfer payments would have been required. In other words, according to one commissioner, "pay me now, or pay me later." In discussing concerns about the high cost of guarantees of tax-exempt obligations, these officials stated that tougher qualifying criteria would help. A different mechanism for stimulating depressed economies would also be helpful, according to these officials.

LETTER TO OMB DISCUSSING CONGRESSIONAL DISAGREEMENT WITH POLICY ON TAX-EXEMPT OBLIGATIONS

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December 17, 1980

Honorable James T. McIntyre, Jr.
Director, Office of Management and Budget
Old Executive Office Building
Washington, D.C. 20503

Dear Mr. McIntyre:

* * * * *

SBA has adopted the policy that "no Federal funds should be used to assist a project financed by proceeds from the sale of tax-exempt bonds." EDA has concluded that subordinating its direct or guaranteed loans to tax-exempt obligations "amounts, in practical effect, to an indirect guarantee of such obligations, and would violate the policy in OMB Circular A-70." And FmHA is operating under a proposed rule that precludes "the guarantee of any loan(s) when any planned source of funding for a project will be raised through the issuance of tax-free bonds."

These agency policies, and the OMB policy that underlies them, are not in the best interest of the public. True, they inhibit the use of tax-exempt bonds, perhaps saving some tax revenue or making it a little easier to raise capital in securities markets. However, they also reduce the cost-effectiveness of Federal business development programs. Many worthwhile business development projects do not generate sufficient income to cover their debt service at high market interest rates. At present, these projects are either left unfunded; are funded entirely with low-interest direct loans, quickly exhausting the limited direct loan funds available to these agencies; or are funded entirely with guaranteed loans at market interest rates, generating substantial losses for these agencies. However, if direct or guaranteed loans could be used to fill "gaps" behind tax-exempt bonds, many of these same projects could be accomplished with small amounts of program funding and without substantial losses.

SBA, EDA and FmHA at one time had very permissive policies on agency participation in projects financed with tax-exempt bonds, but under pressure from OMB and the Treasury Department, have adopted very restrictive policies. What these agencies should have are moderate policies that, insofar as possible, further the legitimate objectives of all parties concerned.

My Position

As chairman of the House subcommittee with jurisdiction over the implementation of Federal legislation affecting small businesses, including business loan programs, I plan to take the following position on the issue of whether, and in what ways, business development agencies should be allowed to participate in projects financed with tax-exempt bonds.

(1) I believe that what is needed to curb the growing use of tax-exempt bonds in projects of dubious public purpose is a more restrictive Federal tax policy, not a more restrictive Federal credit policy. A highly restrictive credit policy simply renders infeasible those few projects which require direct Federal participation as a guarantor of tax-exempt bonds or as a source of project funds, projects which tend to be among the most justifiable from a Federal standpoint, having been reviewed by a Federal agency for consistency with Federal eligibility criteria and objectives.

(2) I believe that insofar as Federal credit policy is used to limit the growth of tax-exempt financing, the objective is not to preclude direct or indirect guarantees of tax-exempt bonds, as OMB Circular A-70 suggests, but to preclude Federal participation in projects that either do not require tax-exempt financing to be economically feasible or do not warrant a tax exemption from a cost-benefit standpoint.

When a Federal agency induces additional business investment by participating in a project that could not be financed conventionally, it is generating additional taxable income for the business itself, its stockholders, and its employees. It is also creating jobs and serving other public purposes. The additional taxable income may more than offset any tax loss associated with a tax-exempt bond used in the same project, and the jobs and other public benefits may more than justify any net loss of taxable income. What role the Federal agency plays in accomplishing a project, whether that of guarantor or source of funds, is less significant than what benefits are derived from its participation.

(3) I believe that if the existing policy prohibiting Federal guarantees of tax-exempt bonds is maintained, a more functional definition of a Federal guarantee must be devised. The only argument against Federal guarantees of tax-exempt bonds unique to that particular form of Federal participation in projects is that a guarantee may create a security that is superior to the U.S. Government's own securities by combining the low-risk character of a Federally-back security with the tax-exempt status of a state or locally-issued security.

Using this distinction as a working definition of a Federal guarantee, some forms of agency participation in projects financed with tax-exempt bonds have been mistakenly labeled guarantees of tax-exempt bonds. The most notable one is the subordination of direct or guaranteed loans to tax-exempt bonds.

OMB considers a tax-exempt bond to be "indirectly" guaranteed by a subordinated loan because a Federal agency might have to pay off the bondholder in the event of default in order to protect its collateral position. Yet, the Federal government has no legal obligation to pay off the bondholder in such case and, as a practical matter, does not do so much of the time. SBA and EDA will, depending on the amount of indebtedness ahead of them, the value of collateral, the amount of agency exposure, and the cost of maintaining the collateral, either buy out a first-mortgage holder, sell their mortgage to a third party subject to the existing first mortgage, or let the first-mortgage holder foreclose and accept a loss in liquidation. These agencies provide the first-mortgage holder with no more assurance of repayment than any other subordinated lender since they have no obligation to buy him out in the event of default.

Table 1 shows that the yields on tax-exempt bonds issued in connection with EDA projects are much higher than the average yields on tax-exempt AAA-rated state and local bonds issued on the same date, and are usually even higher than the average yields on taxable U.S. Government securities of comparable maturity issued on the same date. This would not be the case if EDA were actually guaranteeing tax-exempt bonds when it subordinates its loans to them.

Even when the Federal Government does guarantee a tax-exempt bond, as FmHA does when it guarantees a loan purchased with the proceeds of a tax-exempt bond, it does not create a security that is directly competitive with the U.S. Government's own securities. The Federal guarantee extends only to outstanding principal, not scheduled interest payments. Investors who want a guaranteed stream of income from their investments will buy U.S. Government securities or AAA-rated state and local bonds, not tax-exempt bonds used to purchase FmHA-guaranteed loans subject to default.

Table 2 shows that the yields on tax-exempt bonds issued in connection with FmHA projects are substantially higher than the average yields on AAA-rated state and local bonds issued on the same date. This would not be the case of FmHA were creating the equivalent of a tax-exempt U.S. Government security.

OMB staff, in their 1974 revised draft of Circular A-70, defined an indirect guarantee as "a guarantee of 20 percent or more of underlying loan portfolios." Their own definition of an indirect guarantee covers only those cases in which an agency, by guaranteeing loans made or purchased with the proceeds of a tax-exempt bond issue, assumes an obligation to pay off the tax-exempt bond in case of default. The Administration's prohibition against direct and indirect guarantees of tax-exempt bonds, if maintained, should be similarly limited to cases in which such an obligation is assumed by an agency either directly or indirectly.

* * * * *

I would like to see all business development agencies adopt the same policy on tax-exempt financing so as to eliminate the incentive for businesses to shop around for better terms. * * * Whatever happens, I am determined to resolve the issue of whether, and in what ways, SBA can participate in projects financed with tax-exempt bonds as early in the next session of Congress as possible.

Sincerely,

John J. LaFalce

JOHN J. LaFALCE
CHAIRMAN

JJL:rev

cc: A. Vernon Weaver
SBA, Administrator

EXAMPLE OF FEDERAL TAX REVENUE FOREGONE VERSUS INTEREST SAVINGS TO USERS OF TAX-EXEMPT OBLIGATIONS

I. **Assumptions**

A. Amount of tax-exempt obligations = $19,000,000
B. Average interest rate assumed 1/ on tax-exempt obligations = 11.74 percent
C. Assumed 2/ interest rate on similar taxable obligations = 16.77 percent
D. Assumed 3/ investor tax bracket = 40 percent
E. Assume that investors would have purchased similar taxable obligations if the opportunity to invest in tax-exempt obligations had not arisen.

II. Federal tax revenue foregone (first year only) as a result of investment in tax-exempt obligations:

Interest income to investors in taxable obligations ($19,000,000 X 0.1677) X the tax rate which would have applied if the investor had purchased taxable obligations (0.40) = $1,274,520 in Federal tax revenue foregone because of investment in tax-exempt obligations.

III. Interest savings to users of tax-exempt obligations:

Difference between the taxable interest rate (0.1677) and the rate on the tax-exempt obligations (0.1174) X amount of obligations ($19,000,000) = $955,700 in first year savings to the users of the tax-exempt obligations.

IV. Ratio of tax revenue foregone to user interest savings: "II" ($1,274,520) divided by "III" ($955,700) = $1.33 in foregone tax revenue for every $1 in user interest savings.

1/For purposes of our calculation, we assumed that the interest rate on the tax-exempt obligations was the same as that charged on our FmHA case study discussed in appendix V.

2/According to CBO's 1981 study "Small Issue Industrial Revenue Bonds," the spread between tax-exempt and taxable interest rates has historically averaged 30 percent. Therefore, the tax-exempt interest rate assumed (0.1174) divided by 0.70 equals 16.77 percent.

3/According to the 1981 CBO study discussed above, the average marginal tax bracket of all holders of tax-exempt obligations is 40 percent.

SAMPLING OF GAO REPORTS AND TESTIMONY

ON FEDERAL CREDIT POLICY

Since 1975, we have performed well over 200 analyses relevant to the many aspects of Federal credit policy. In addition to the more than 170 reports on such issues as debt collection, the credit budget, the Federal Financing Bank, and the general management of credit assistance, we have provided legal opinions and decisions, comments on proposed legislation, and testimony before congressional committees. The following list is a sampling of our reports and testimony which address various aspects of Federal credit policy from a broad policy perspective.

1. "Revitalizing Distressed Areas Through Enterprise Zones: Many Uncertainties Exist," CED-82-78, July 15,1982.

2. "Industrial Policy: Japan's Flexible Approach," ID-82-32, June 23, 1982.

3. "The Congress Should Control Federal Credit Programs To Promote Economic Stabilization," PAD-82-22, October 12, 1981.

4. "Aggressive Action Needed To Strengthen Debt Collection," HRD-81-5, February 13, 1981.

5. "Federal Budget Totals Are Understated Because of Current Budget Practices," PAD-81-22, December 31, 1980.

6. "Legislative Change Needed To Improve Budget Treatment of Certificates of Beneficial Ownership," PAD-80-32, April 9, 1980.

7. "Improving Management Controls at the Federal Financing Bank," GGD-80-42, February 28, 1980.

8. "Spending Authority Recordings in Certain Revolving Funds Impair Congressional Budgetary Control," PAD-80-29, July 2, 1980.

9. "Improved Controls To Increase Collections, To Restore Accounting System Integrity, and To Guard Against Future Problems Needed," FGMSD-80-46, June 4, 1980.

10. "Unresolved Issues Impede Federal Debt Collection Efforts--A Status Report," CD-80-1, January 15, 1980.

11. "Additional Changes Needed in Servicing and Accounting Activities To Reduce the Delinquency Rate and To Promptly Collect Funds From Mortgagors Due the Government," FGMSD-79-41, August 16, 1979.

12. "A Methodology for Estimating Costs and Subsidies From Federal Credit Assistance Programs," PAD-79-5, July 17, 1979.

13. "Federal Systems Not Designed To Collect Data on All Foreign Investments in U.S. Depository Institutions," GGD-79-42, June 19, 1979.

14. "The Government Can Be More Productive in Collecting Its Debts by Following Commercial Practices," FGMSD-78-59, February 23, 1979.

15. GAO observations on an OMB staff paper entitled, "Achieving Better Control Over Federal Credit Programs," PAD-79-46, December 28, 1978.

16. "The Government Needs To Do a Better Job of Collecting Amounts Owed by the Public," FGMSD-78-61, October 20, 1978.

17. "Federal Agencies Can and Should Do More To Combat Fraud in Government Programs," GGD-78-62, September 19, 1978.

18. "Federal Credit Programs: An Approach to Program Design and Analysis," PAD-78-31, May 31, 1978.

19. "Statement of the Contingent Liability of the U.S. Government," PAD-78-47, February 23, 1978.

20. "Revolving Funds: Full Disclosure Needed for Better Congressional Control," PAD-77-25, August 30, 1977.

21. "Government Agency Transactions With the Federal Financing Bank Should Be Included on the Budget," PAD-77-70, August 3, 1977.

TESTIMONY

22. Testimony on the Federal Role in Fostering Private Sector Productivity before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, January 27, 1982.

23. Testimony before the Special Subcommittee on Control of Federal Credit of the Committee on the Budget, United States Senate, June 23, 1980.

24. Testimony on the Federal Budget Process before the Budget Process Task Force of the Committee on the Budget, United States House of Representatives, December 11, 1979.

25. Testimony on the Federal Financing Bank and Control of Federal Credit Assistance Programs before the Subcommittee on Oversight of the Committee on Ways and Means, United States House of Representatives, September 20, 1977.

26. Testimony on the Federal Financing Bank and Control of Federal Credit Assistance Programs before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, July 19, 1977.

27. Testimony on the Control of Loan Guarantee Programs before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, March 29, 1977.

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

SEP 1 1982

Mr. William R. Anderson
Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to the draft GAO report entitled Federal Credit Policy on Guaranteed Loans Should Be Communicated Clearly and Enforced. It fulfills your formal request dated July 30, 1982 for review and comment on the draft.

This report asserts that the Office of Management and Budget (OMB) is not using its Circular A-70 on Federal credit programs to insure that Federal loan guarantee programs meet sound credit policy and financial standards. It recommends that the circular should be revised so that its principles are more easily grasped.

The draft report may be too narrow in its scope. It focuses on one aspect of executive branch credit program policy to the exclusion of all others and assigns that one absolute priority. OMB staff disagreed with this approach in their discussions with the authors of the draft report and explained why.

Specifically, OMB staff acknowledged, as the report notes in several places, that Circular A-70 in its present form is not a strong management tool. The revision and reissue of the circular has been and is an item on the credit policy agenda for OMB. We agree that the establishment of consistent financial standards for programs is an important part of the overall process of gaining control over Federal credit activity, and that Circular A-70 could be a useful vehicle for enhancing oversight of those standards. We will be working to improve the use of the circular as soon as time and our staff resources permit.

OMB's Federal credit policy agenda must be viewed broadly, in terms of the full variety of available actions and the limitations on staff resources. OMB must set priorities. As the report states, the major thrust of OMB's efforts in Federal credit policy over the past three years has been to develop the credit budget, with its accompanying set of annual limitations in appropriation bills, and to work toward congressional acceptance of that budget. We believe this to be by far the most pressing need in the field of Federal credit program policy because it deals with the most serious problem facing us in this area: the rapid growth of Federal credit activities and the negative economic consequences of that growth. The Administration has undertaken to reassess the appropriate Federal role in providing credit assistance. The credit budget is a framework for agreeing on that role at both aggregate and individual program levels. Beginning with fiscal year 1982, the Administration has been using the credit budget as the basis for achieving a major reversal of growth trends, and we have been greatly encouraged that the First Budget Resolution for fiscal year 1983 contains credit limitations. It is the first budget resolution to do so. We are persuaded by these successes that our emphasis has not been misplaced.

Development and refinement of the credit budget requires a large amount of staff time, and will continue to require it until we have more experience using it and can maintain it with less effort. The revision of Circular A-70, which will also require a large commitment of staff time, will not be possible until then. The draft report states this aspect of OMB's position on Circular A-70 clearly and fairly.

Another point should be made, one that does not receive adequate treatment in the draft report. The issue underlying the use of A-70 is not only the circular. The circular is a policy tool rather than an end in itself. The fundamental policy concern is whether OMB is adequately overseeing the management of loan guarantee programs. On this issue, OMB's record, especially during this Administration, is one of which we are proud. OMB monitors Federal credit programs thoroughly as a routine part of its duties, and raises special issues to a higher policy level as necessary.

-- Through the legislative clearance process, financial standards are reviewed for every program requiring reauthorization. This means that the legislation of most credit programs receives a review that includes financial management criteria every three years or less.

-- The basic responsibility for maintaining standards lies with the program divisions of OMB. These divisions regularly review the operations and management of credit programs; this review is thorough, though it may not explicitly refer to the Circular A-70. For example, OMB has recently directed the Maritime Administration to review its policy toward lender coinsurance in its merchant vessel guarantee program with the aim of requiring lenders to bear some risk on future loans.

-- Through the Cabinet Council on Economic Affairs Working Group on Federal Credit Policy a number of management issues are being addressed at a high policy level. During 1981 and 1982 the CCEA stated unequivocally that the Administration's policy was not to allow guarantees of tax exempt securities, and directed agencies to end the practice wherever clear legislative intent allowed. One example of corrective action taken due to this CCEA directive is the USDA proposed rule prohibiting the Farmers Home Administration from guaranteeing a tax exempt issue. This rule should be published in final form shortly.

-- The fall and spring Director's Review processes are forums for OMB consideration of and action on crosscutting credit issues. Fees to cover costs and appropriate interest rates, two principles raised in the draft report, are now being analyzed in preparation for this year's fall review. The Administration is considering both administrative and legislative options for insuring that common practices or fees and interest rates are followed in all credit programs.

I wish to reiterate that we share the concern expressed in this report that a revised and reissued Circular A-70 could be helpful in achieving the important objective of improving credit program management. However, doing so is not the simple action that the draft report assumes. The report recommends that, if Circular No. A-70 cannot be revised and reissued now, copies of the 1974 proposed revision be provided to agencies administering credit assistance programs and that the agencies be notified that they are expected to comply with its principles. This recommendation misses completely the fact that both the existing Circular No. A-70 and the 1974 proposed revision were written for a world that no longer exists, a world in which there was no Federal Financing Bank. The impact of the Federal Financing on Federal credit programs has been enormous. Any revision of or substitute for the existing A-70 that ignores it will not be very helpful.

To summarize, we intend to revise and reissue the circular as soon as possible. Until then, however, given resource limitations, we reaffirm our decision to allocate the bulk of our available credit staff resources to the credit budget and to rethinking the role of the Federal Financing Bank. We assure you that we continue to monitor credit program management as a routine, ongoing part of our oversight and legislative clearance activities, in every part of OMB responsible for credit programs.

If I can be of any further assistance, please let me know.

Sincerely,

Joseph R. Wright, Jr.
Deputy Director

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