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BY THE U.S. GENERAL ACCOUNTING OFFICE

# Report To The Secretary Of Agriculture

# Equitable Interest Rates Are Needed For Farmers Home Administration Loans

In fiscal year 1982, the Farmers Home Administration loaned $4.9 billion to help borrowers buy and operate farms, purchase or improve homes, and construct or expand community facilities. But the interest rates charged on these loans have not been fair and equitable for the agency or its borrowers.

Some borrowers were charged interest rates lower than the Government's cost of money rate, thereby increasing the agency's program cost, while others were charged rates higher than the cost of money rate. Because of the large amount of funds loaned, these under and overcharges will result in millions of dollars in interest subsidies or premiums for the agency's borrowers. For example, during the 10-month period ending March 1982, some 74,000 borrowers received $103 million in interest subsidies while about 20,000 borrowers were overcharged $9 million in interest. As subsidies far exceeded premiums, the agency's program cost on these loans will be increased by $94 million. Interest subsidies and/or premiums were also evident on Farmers Home loans made during the 10-month period ending January 1983.

GAO makes a number of recommendations to the Secretary of Agriculture to prevent unwarranted interest subsidies or excessive interest charges in future loan transactions.

UNITED STATES GENERAL ACCOUNTING OFFICE

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

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

B-211882

The Honorable John R. Block
The Secretary of Agriculture

Dear Mr. Secretary:

We reviewed the Farmers Home Administration's (FmHA) policies, procedures, and practices for setting interest rates on farm, home, and community facility loans. The review was initiated as part of our continuing efforts to determine whether economies could be realized in the administration of Federal programs. The report contains a number of recommendations to provide for equitable interest rates on FmHA loans. Several of these recommendations have the potential for increasing FmHA's interest income, thereby reducing program cost and the appropriations necessary to reimburse FmHA's revolving funds for subsidies and losses.

As you know, 31 U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and 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 Committees on Agriculture and on Banking and Currency; the Senate Committees on Agriculture, Nutrition, and Forestry and on Banking, Housing, and Urban Affairs; the Director, Office of Management and Budget; the Under Secretary for Small Community and Rural Development; the Administrator, FmHA; your Inspector General; interested Members of Congress; and other parties.

Sincerely yours,

for J. Dexter Peach
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE SECRETARY OF
AGRICULTURE

EQUITABLE INTEREST RATES ARE
NEEDED FOR FARMERS HOME
ADMINISTRATION LOANS

## D I G E S T

The Department of Agriculture's Farmers Home Administration (FmHA) needs to improve its policies, procedures, and practices for setting and revising loan program interest rates. Improvements are needed if FmHA is to charge interest rates that are equitable for FmHA and its borrowers and consistent with FmHA's authorizing legislation.

FmHA makes farm ownership and operating loans to farmers (including farmers with limited resources), single-family housing loans, and community facility loans. Except for community facility loans, interest rates are required to be based on the Government's cost of borrowing (the current average market yield on Treasury's marketable obligations). Community facility loans are required to have rates based on municipal bond yields. In fiscal year 1982, these FmHA programs accounted for 137,000 loans totaling about $4.9 billion, or about 60 percent of the total dollars FmHA loaned.

GAO reviewed FmHA's policies, practices, and procedures for setting and revising loan interest rates as a part of its continuing efforts to determine whether better economies could be realized in the administration of Federal programs. (See p. 1.)

### IMPROVEMENTS NEEDED IN RATE REVIEW/DECISIONMAKING PROCESS

Between June 1981 and March 1982, FmHA approved about 94,000 housing and farm loans. GAO estimated that based on a comparison of loan interest rates to the Government's monthly cost of money, these 94,000 borrowers will receive subsidies or pay premiums that will total $112 million (present value fiscal year 1982) over the life of their loans. And because subsidies of $103 million will exceed premiums of $9 million, FmHA's program cost on these loans could be increased by as much as $94 million. (See p. 16.)

This problem has continued beyond the time frame selected for GAO's review. Subsidies and premiums were evident on FmHA loans approved during the 10-month period ending January 1983. (See app. I.)

FmHA has considerable discretionary authority in setting interest rates on housing and farm loans. For example, it can change rates whenever it sees fit, add up to 1 percentage point to current average market yields to arrive at a maximum interest rate for farm ownership and operating loans, and set rates lower than this maximum. But GAO found that FmHA has not developed an adequate rate review/decisionmaking process to provide for the judicious use of this authority. (See p. 7.)

FmHA's guidelines state that changes in interest rates will be considered when the existing loan rates differ from current average market yields (cost of money) by 0.5 percentage points. This cutoff represents the break-even point for changing rates, considering the cost of making rate changes. But GAO found that this cutoff was an estimate and that no actual analysis had been made to substantiate it. (See p. 9.)

FmHA's application of these guidelines has resulted in inconsistencies. For example, in January 1982, FmHA reduced the interest rate for new farm operating loans because the then existing loan interest rate (1) differed from the current average market yield by more than 0.5 percentage points and (2) exceeded the maximum interest rate permitted by law for this program. But GAO found that FmHA's action here was inconsistent with its decision not to increase the interest rate on new home loans in 5 of the 10 months GAO reviewed. In each of these 5 months, FmHA's rate reviews showed that the then existing home loan interest rate was at least 0.875 percentage points below the minimum rate (current average market yield) that could be charged for this program.

GAO also found that although interest rates were subject to change in 21 program months based on FmHA's guidelines, interest rates were not changed in 19 of the 21 program months. Other factors, such as economic conditions, trends in interest rates, and financial conditions in the farm, housing, and rural sectors, were also considered in making rate changes.

For example, FmHA decided not to increase interest rates on farm loans in September, October, and November 1981 because of depressed economic conditions in the farm sector. Depressed conditions have existed in the farm sector roughly since March 1980. But FmHA apparently did not consider this condition in its rate decisions until June or July 1981 because interest rates on farm loans were increased in April and May 1981. Even then, rates were not reduced in July on farm operating loans because FmHA's interest rate projections indicated an upswing in interest rates.

This situation and others GAO found occurred because FmHA has no specific, quantitative criteria to weigh the factors considered in its rate decisionmaking process. (See p. 10.)

Without such criteria, FmHA's rate review/decisionmaking process has resulted in the inequitable treatment of borrowers within the same program. For example, on farm operating loans approved during the 10-month period ending March 1982, some borrowers received subsidies as high as 1.50 percentage points while others received less or none or paid a premium of 1.25 percentage points. These subsidies and/or premiums occurred because FmHA interest rates were not changed each month to reflect the Government's cost of money. (See p. 16.)

GAO believes FmHA could provide for more equitable interest rates on farm and home loans if FmHA would change loan interest rates each month to provide for a rate equal to the Government's monthly cost of money. This action would eliminate the subsidies and premiums GAO found that could not be justified under FmHA's existing rate review/decisionmaking process. (See p. 20.)

Furthermore, monthly rate changes could be implemented without an adverse effect on FmHA workload if FmHA would make some minor procedural changes. (See p. 18.)

NEED FOR A LONGER LOAN MATURITY PERIOD TO SET RATES

FmHA's authorizing legislation provides for using the current average market yields on Treasury securities that have remaining periods to maturity comparable to FmHA loans. But GAO found that the 25-year period FmHA uses to set rates on real estate-type loans was 7 to 13 years less than the average maturity period on these FmHA loans.

FmHA could use a 30-year period, which is the longest period for Treasury borrowings. On 64,000 single-family housing loans approved between June 1981 and March 1982, GAO estimated borrowers would be overcharged $17.1 million (present value fiscal year 1982) in interest over the life of their loans compared to the interest that could have been charged if a 30-year maturity period had been used. FmHA was still using a 25-year period to set rates as of April 1983.

Market conditions during the period GAO reviewed were abnormal in that short-term interest rates were higher than long-term rates. But in normal market conditions when the reverse is true, a 30-year maturity period should produce higher interest rates and additional income for FmHA. (See p. 24.)

USE A REVENUE BOND INDEX TO SET RATES ON COMMUNITY FACILITY LOANS

In setting interest rates on community facility loans, FmHA uses a municipal bond rate based on a general obligation bond index. But GAO believes that the use of a revenue bond index would be more appropriate. GAO found that most municipalities used revenue bonds to finance community facility projects like those FmHA finances. Revenue bonds also have maturity periods more comparable to the maturity period on FmHA loans than do general obligation bonds.

Revenue bonds generally provide for higher yields than do general obligation bonds. Consequently, FmHA's use of a revenue bond index should result in higher interest rates and additional interest income for FmHA. For example, on loans made in the 6-month period ending March 1982, GAO estimated that FmHA could have collected an additional $30.6 million (present value fiscal year 1982) in interest over the life of these loans if FmHA used a revenue bond index to set rates.

FmHA makes some community facility loans at interest rates below the bond market rate to serve low-income persons. The interest subsidies provided on these loans, about $472 million for fiscal year 1982, are funded through the budget process. Consequently, FmHA could use any additional interest income to help pay the cost of these subsidies. (See p. 30.)

## RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

GAO recommends that FmHA revise the interest rates applicable to new farm and home loans every month, setting the new rates at the Government cost of money rate. To facilitate these monthly rate changes, GAO also is recommending several minor changes in FmHA's procedures so as to avoid any adverse impacts on FmHA's workload. Further, if FmHA should continue to need some leeway in setting rates to address other factors, such as depressed conditions in the farm sector, then GAO recommends that FmHA be required to develop specific, quantitative criteria to identify and weigh these factors in setting loan program interest rates. (See p. 22.)

In addition, GAO recommends that FmHA use

--a 30-year period to set interest rates on its real estate-type loans, and

--a revenue bond index to set interest rates on its community facility loans. (See pp. 29 and 37.)

## VIEWS OF RESPONSIBLE AGENCY OFFICIALS AND GAO's EVALUATION

The Department of Agriculture's Under Secretary for Small Community and Rural Development, who is responsible for FmHA's activities, stated that GAO's review covered a time of unusual volatility in interest rates and Treasury's borrowing costs and that this volatility tends to exaggerate the impact of lags in FmHA's procedures for setting interest rates. He expressed concern over the impact monthly rate changes would have on FmHA's workload but his comments did indicate that FmHA planned to quantify the information used in its rate decision process in connection with FmHA's development of a portfolio management system.

GAO agrees with the Under Secretary's comments concerning the volatility in Treasury's costs of borrowing. But in periods of such instability, fairness dictates that rates be revised more frequently to reflect this volatility. Further, while this volatility tends to increase the monetary significance of lags, even in periods of relative stability, a small change in Treasury's borrowing cost can affect FmHA's total interest collections by millions of dollars because of the volume of FmHA loans. Although the Under Secretary was concerned about the adverse impact monthly rate changes would have on FmHA's workload, his comments did not address the minor procedural changes GAO is recommending to avoid these adverse impacts. (See p. 21.)

The Under Secretary did not endorse outright GAO's recommendation that FmHA use a 30-year maturity period to set rates on real estate-type loans. However, he requested that GAO provide FmHA with the results of its computer analysis so that this data could be used together with the agency's analysis to make a decision on this issue. Although GAO believes a sufficient basis now exists for using a 30-year maturity period in setting rates, it provided the requested data to FmHA. (See p. 29.)

As to the appropriate bond index to use to set rates on community facility loans, the Under Secretary stated that GAO's description and analysis of the facts appeared to be generally accurate, but he could not agree with GAO's conclusions that a revenue bond index be used. He said that additional factors should be considered which justify the policies FmHA has followed. These included the Secretary's discretionary authority to set rates lower than the bond market rate, the absence of a clearly established bond market rate and the need to estimate this figure, the objective of the program, and the need to supplement loans (including some made at bond market rates) with grants.

GAO believes a revenue bond index provides a more accurate estimate of bond market rates considering the nature of the projects being financed, the type of bonds (revenue) that communities generally use to finance such projects, and the term of FmHA loans. It believes that a revenue bond index better reflects the rates communities pay for private sector financing, thus fulfilling the program's objective of providing loans at reasonable rates and terms. Furthermore, although grants are used to supplement FmHA loans, most loans made at bond market interest rates do not include grants. (See p. 35.)

# Contents

## ABBREVIATIONS

| | |
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| FmHA | Farmers Home Administration |
| FPAD | FmHA's Financial and Productivity Analysis Division |
| GAO | General Accounting Office |
| HUD | Department of Housing and Urban Development |

# CHAPTER 1

## INTRODUCTION

The Farmers Home Administration (FmHA), which is an agency within the Department of Agriculture, is a credit agency for agriculture and rural development. Through loan programs authorized principally by the Consolidated Farm and Rural Development Act (7 U.S.C. 1921) and title V of the Housing Act of 1949 (42 U.S.C. 1471), it provides credit to those in rural America who are unable to get credit from other sources at reasonable rates and terms. During fiscal year 1982, FmHA made or guaranteed about 186,000 loans totaling almost $8.2 billion. And as of September 30, 1982, it was servicing a loan portfolio consisting of about 1.5 million borrowers having loans totaling about $56 billion.

This report examines FmHA's policies, practices, and procedures for setting and revising loan program interest rates in its farm ownership, farm operating, single family housing, and community facility loan programs. In fiscal year 1982, these programs accounted for 137,000 loans totaling about $4.9 billion, or about 60 percent of the total dollars FmHA loaned.

### FmHA LOAN PROGRAMS AND INTEREST RATE PROVISIONS

Under FmHA's farm ownership program, FmHA makes loans to enable farmers and ranchers to buy, improve, or enlarge family-size farms. Loans may include funds to construct or repair farm homes and service buildings and facilities; improve land; develop water, forestry, and fish farming resources; establish recreation and other nonfarm enterprises to supplement farm income, and refinance debts. Loans can be made for up to $200,000 and are repayable over periods up to 40 years.

FmHA also makes operating loans to enable operators of farms not larger than family farms to acquire needed resources, make improved use of land and labor resources, and make adjustments necessary for successful farming, recreation, and nonfarm enterprises. Funds may be used to pay for equipment, livestock, feed, seed, fertilizer, other farm and home operating needs; refinance debts; provide operating credit for fish farmers; carry out forestry purposes; and develop income producing recreation and other nonfarm enterprises. Loans can be made for up to $100,000 and are repayable usually within 1 to 7 years.

Interest rates on farm ownership and operating loans are set periodically based on the Government's cost of borrowing. Specifically, the law (7 U.S.C. 1927 and 1946) provides that interest rates should be determined by the Secretary of Agriculture but may not exceed the current average market yield on outstanding marketable obligations of the United States (Treasury securities) with remaining periods to maturity comparable to the average maturities of FmHA loans, plus an additional amount, as determined by the Secretary, of up to 1 percent, and as adjusted to the nearest one-eighth of 1 percent.

In addition, FmHA also makes low interest rate loans to enable limited-resource farmers to purchase or operate farms. Limited-resource farmers are owners or tenants of small farms that yield low production and low income and lack the equipment, capital, land, financing, or sound farming practices necessary to succeed in farming. Interest rates on limited-resource farm ownership loans are set at a rate determined by the Secretary but not in excess of one-half of the current average market yield on Treasury securities with remaining periods to maturity comparable to the average maturities on FmHA loans. The Secretary of Agriculture was given discretionary authority to set the rate lower than this but not less than 5 percent. (See 7 U.S.C. 1927.) Interest rates on limited-resource operating loans carry an interest rate 3 percentage points less than FmHA's regular farm operating loans. (See 7 U.S.C. 1946.) The interest rate charged on a limited-resource loan remains in effect for the first 3 years. At the end of 3 years and every 2 years thereafter, the interest rate will be reviewed and increased, commensurate with the borrower's repayment ability, until the rate equals the current rate on farm ownership or operating loans, as appropriate.

During fiscal year 1982, FmHA made about 10,000 farm ownership, including limited-resource, loans totaling $662 million. During the same year, FmHA made almost 45,000 farm operating, including limited-resource, loans totaling $1.25 billion.

FmHA makes housing loans to low-and moderate-income families including senior citizens to build, buy, and repair homes located in rural areas. Loans are repayable over periods up to 33 years. Moderate income borrowers are required to pay the same interest rate applicable to mortgages insured by the Department of Housing and Urban Development (HUD), provided the annual principal and interest payments at this rate plus taxes and insurance do not exceed 20 percent of the borrower's annual adjusted income. For borrowers unable to pay this rate, the Secretary of Agriculture is authorized (42 U.S.C. 1490a) to set the interest rate at a rate not less than the rate determined by the Secretary of the Treasury based on the current average market yield on Treasury securities with remaining periods to maturity comparable to the average maturities of FmHA loans, adjusted to the nearest one-eighth of 1 percent. Although the Secretary of the Treasury sets the minimum rate, the Secretary of Agriculture has discretionary authority to set the interest rate higher than this minimum. Hereafter, when we refer to the interest rate on single-family housing loans, we are referring to the rate set by the Secretary of Agriculture.

For low income housing borrowers, FmHA is authorized to charge as little as 1 percent interest with FmHA paying or absorbing the difference between the subsidized rate and the rate applicable to single-family housing loans. The initial interest rate charged on the loan depends on the borrowers' income and housing cost. However, depending on future changes in the borrowers' income, the interest rate can be increased but not in excess of the FmHA rate in effect when the loan was made. FmHA reviews the income of borrowers at least biennially to determine what, if any, adjustments are needed in interest rates. Although some borrowers may never have their rates increased to the FmHA rate, FmHA is authorized to recapture any subsidies it provides from any appreciation in the value of the borrower's house when the borrower sells, transfers, or vacates the house financed with the FmHA loan.

During fiscal year 1982, FmHA made 80,000 single-family housing loans totaling $2.5 billion to low- and moderate-income families.

FmHA makes community facility loans to public bodies, nonprofit associations, and Indian tribes to finance most notably water and waste disposal systems and other essential community facilities, such as hospitals, clinics, and schools. Loans for water and waste disposal projects serve residents in open country and rural towns with a population of 10,000 or less whereas loans for other essential community facilities aid communities of up to 20,000 in population. The maximum repayment period on these loans is 40 years.

Interest rates on community facility loans are required by law (7 U.S.C. 1927) to be set at a rate not to exceed the current market yield on municipal bonds with maturity periods comparable to the average maturity period on FmHA's loans. However, in areas where the median family income of persons served is below the poverty line, the law authorizes 5 percent interest rate loans to upgrade or construct facilities needed to meet applicable health or sanitary standards.

During fiscal year 1982, FmHA made about 1,200 community facility loans totaling about $500 million.

## FmHA's POLICIES AND PROCEDURES FOR SETTING LOAN INTEREST RATES

FmHA's authorizing legislation does not specify how often interest rates for new loans should be revised, that is weekly, monthly, quarterly, or annually. To determine when and if interest rates should be revised, FmHA's Financial and Productivity Analysis Division (FPAD) monitors the yields on Treasury securities and conducts rate reviews. To monitor yields, it obtains data early each month from the Department of the Treasury as to the current monthly average market yields on Treasury securities. In fact, the Treasury sends FmHA a letter each month to certify the current monthly average market yields. The yields[1] certified by the Treasury cover only those Treasury securities that have remaining maturity periods comparable to the maturity period on FmHA loans. FmHA is responsible for determining the latter and notifying the Treasury so it can provide the appropriate yields in its monthly certification letters. For FmHA's single-family

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[1]Treasury rounds yields to nearest one-eighth of one percent consistent with program requirements.

housing loan program, the Treasury certified rate represents the minimum rate the Secretary of the Treasury is required to establish pursuant to the legal provisions applicable to this program. For the most part, the certified rate for this program is the same as the current monthly average market yield.

Rate reviews consist of comparing the existing FmHA program interest rate to the current monthly average market yield on Treasury securities (the yield certified by the Treasury), current data on daily average market yields on Treasury securities, and as appropriate, data on interest rates charged on similar loans made by commercial banks and institutions within the Farm Credit System (Federal Land Banks and Production Credit Associations) or on home mortgages insured by HUD.

Based on these rate reviews, FPAD will develop proposed rates for each program and solicit comments on its proposals from FmHA's program divisions. After considering these comments, FPAD finalizes its recommendations and forwards them to the Administrator for action.[2] The Administrator can accept, reject, or modify any or all of FPAD's recommendations. When the Administrator approves a change in rates, he notifies FPAD, and in turn the appropriate divisions and field offices of the pending change and the effective date of the new rates.

On community facility loans, interest rates are adjusted at the beginning of each quarter during the fiscal year. The rates for this program are determined by taking a 4-week average of municipal bond yields, using a well known bond index, about a month before the start of the quarter.

## OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our review was to determine whether economies could be realized in FmHA's policies, practices, and procedures for setting and revising loan program interest rates. Our review was limited to FmHA's farm ownership and operating loans, limited-resource farm ownership and operating loans, single-family housing loans, and community facility loans because we noted that potential deficiencies existed in setting interest rates in these programs. These deficiencies were also applicable to FmHA's economic emergency and multifamily housing loan programs. But these programs were dropped from our review because:

--FmHA discontinued making economic emergency loans when the program expired in fiscal year 1982. FmHA was subsequently given discretionary authority to make economic emergency loans in fiscal year 1982 but it had not acted to activate this program at the time of our review.

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[2]These procedures were revised in January 1983. The FmHA Administrator now meets jointly with FPAD and program officials to set the interest rate.

--Virtually all of FmHA's multifamily housing loans are subsidized in such a manner that a change in interest rates would not yield any benefits for FmHA or its borrowers.

We performed our review in accordance with generally accepted government audit standards. However, we relied on FmHA computer generated data without testing its accuracy. This was the best available information on FmHA's programs and activities.

To accomplish our objective, we reviewed FmHA's authorizing legislation and legislative history; FmHA policies, procedures, and practices for setting interest rates; FmHA's rate review files; FmHA's statistical data on its programs; data on the yields on Treasury securities and municipal bonds; and audit reports issued on FmHA by the Department of Agriculture's Office of Inspector General. We interviewed in person or by phone FmHA's financial and program managers, chiefs of community programs at FmHA State offices, and one county supervisor; officials at the Department of Treasury and Federal Reserve Board, an economist in the Department of Agriculture's Economic Research Service; and officials with the Municipal Finance Officers Association, Bond Buyer,[3] Public Securities Association, and American Hospital Association. In addition, we obtained from the FmHA Administrator written responses to questions we had regarding the rationale behind FmHA's rate setting policies and actions.

Our review was conducted between March and August 1982. We selected the 10-month period ended March 31, 1982, for reviewing FmHA's policies and practices for setting interest rates because the FmHA policy we reviewed had only been in effect for this 10-month period at the time we initiated our review. For FmHA's community facility loan program, only the 6-month period ended March 31, 1982, was reviewed because the interest rate provisions applicable to that program had only been in effect since October 1, 1981.

We compared FmHA policy and rate setting guidelines with FmHA rate decisions for consistency and analyzed the time periods required to make rate changes. We also compared FmHA interest rates to the current monthly average market yields on Treasury securities to determine whether borrowers received subsidies or paid premiums.

We extracted data from FmHA's computer system for loans made in fiscal years 1980 and 1981, the two fiscal years preceding the period of our analysis, to test the accuracy of the maturity periods FmHA used to set interest rates. We computed a simple average loan maturity for each program for each fiscal year. Although a weighted average would have been more accurate, the simple averages we computed were very close to the maximum maturity periods authorized by law, which indicated to us that a large number of loans were being made at the maximum maturity period.

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[3]A trade publication that concentrates on municipal bonds.

Further, we believed that the larger the dollar amount of the loan the more likely the maximum maturity period would have been allowed for loan repayment. Consequently, our simple average probably understates what the weighted average would be if computed on the dollars loaned. For real estate type loans, which had maturity periods in excess of 30 years, any such understatements would not affect our review results. When our average differed from the maturity period FmHA used, we reviewed monthly average market yield data on Treasury securities to determine what effect using our average would have had in setting interest rates.

We reviewed data on FmHA community facility loans to determine the types of projects being financed and loan maturity periods. We reviewed data on municipal bond financing to determine what kind of municipal bonds--general obligation or revenue bonds--were typically used by communities to finance similar projects. We evaluated the bond index FmHA used to set rates to determine whether it adequately reflected the types of bonds communities used to finance comparable projects and the loan maturity periods on FmHA financed loans. We also determined whether other more appropriate bond indexes were available and what effect their use would have had in setting interest rates.

When we believed that FmHA should have charged a different rate, we computed the gains or losses FmHA would have realized had it sold its loans at the end of the month in which they were approved to yield a rate equivalent to the rate we believed FmHA should have charged. We used our own computer program to make these computations and the resulting gains and losses, in our opinion, provide a reasonable measure of the present value of the subsidies and premiums that could be expected over the life of the approved loans.

Although the period covered by our review ended in March 1982, our findings are just as applicable today. As of April 1983, FmHA was still following the same basic policies, procedures, and practices as covered by our review. Only a procedural change was made in January 1983 to provide for quicker implementation of new interest rates once the Administrator determines that a change in rates is appropriate. However, the dollar impacts of these deficiencies could have changed because of changes in the volume of loans and the frequency and size of any subsidies and/or premiums.

To show that subsidies and premiums still existed relative to the findings discussed in chapter 2, we compared FmHA interest rates in 5 loan programs, excluding community facility loans, to Treasury's monthly cost of money rates (current average market yields) for the 10-month period ending January 1983. The results of this comparison are shown in Appendix I. However, we did not attempt to determine whether FmHA's rate review criterion or guidelines (see ch. 2) were followed in setting these program interest rates nor did we obtain the FmHA Administrator's rationale for any actions or inactions regarding rates during this period. However, FmHA has yet to develop criteria to identify and weigh those important factors which were being considered in setting program interest rates.

CHAPTER 2

# IMPROVEMENTS ARE NEEDED IN FmHA's RATE REVIEW/DECISIONMAKING PROCESS

FmHA needs to revise interest rates monthly for new farm and home loans, setting the new monthly rates at the current average market yield on Treasury securities. This action is needed to ensure that interest rates are revised in a timely, economical, and equitable manner. Under FmHA's existing rate review/decisionmaking process, we found that:

--FmHA had no documented support for its rate review criterion or guidelines.

--FmHA's rate review criterion and rate setting guidelines were not always followed.

--FmHA had no specific, quantitative criteria to identify and weigh important factors, such as depressed economic conditions, which were also considered in setting interest rates but not covered by the FmHA guidelines.

FmHA's rate review/decisionmaking process has resulted in the inequitable treatment of borrowers participating in the same loan program, providing subsidies to some while others received none or were charged a premium. On 94,000 loans FmHA approved between June 1981 and March 1982, we estimated that FmHA borrowers received subsidies or paid premiums, which will total $113 million (present value fiscal year 1982) over the life of these loans. And because subsidies far exceeded premiums ($103 million compared to $9 million), FmHA's program cost on these loans will be increased.

## ADEQUACY OF RATE REVIEW CRITERION AND FmHA COMPLIANCE

FmHA's rate review criterion[1] states that a rate review should be made every 2 months unless the current monthly average yield on Treasury securities differs by more than 1 percentage point from the preceding month's average monthly market yields. When the latter occurs, the criterion states that a rate review should be made for the current month. However, FmHA was not able to provide us with any documented support, such as a cost-benefit analysis, for this criterion.

According to the FmHA Administrator, the time frame for adjusting rates is a discretionary matter and FmHA chose 2 months as a reasonable time between reviews. He stated that the present policy keeps him informed of changes in the funds market, a

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[1]This criterion is contained in a May 21, 1981, memorandum on interest rates from the then Acting FmHA Administrator.

quarterly or semiannual review would result in operating without timely information on rates and funds markets, and the present system enables FmHA management to reach decisions for changing rates in a cost effective manner. He also explained that the present system was equitable in that it permits rate changes to be made in an efficient manner and permits FmHA to use the program discretion intended by the Congress.

In addition, FmHA had not always prepared rate reviews as required by its rate review criterion. During the 10 month period June 1981 through March 1982, FmHA did not perform rate reviews during 3 of the 10 months because it determined that the difference in monthly average market yields was less than 1 percent in comparison to the preceding month's yields. However, we found that during 1 of the 3 months (December 1981), the monthly average market yields on Treasury securities with respect to farm operating loans, including limited-resource farm operating loans, had decreased 1.375 percent from October to November 1981. Therefore, under FmHA's criterion, a rate review should have been made during early December 1981 for these two programs.

The Acting Director, FPAD, told us that a rate review was not made then because the rates in effect were on target with the current average market yields and the average market yields for all programs were close together. In addition, he showed us a memorandum that was sent to the Administrator advising him of the differences in the monthly average market yields. Athough a rate review was not believed necessary, FmHA's rate review criterion does not provide for any exceptions to cover circumstances such as this one.

At the beginning of December 1981, FmHA's interest rates were 14.5 percent for farm operating loans and 11.5 percent for limited-resource farm operating loans. The current monthly average market yields on comparable Treasury securities for November was 14.25 percent and the current daily average market yield on December 2 was 13.25 percent, which indicated a further downward trend in market yields. Based on this, FmHA could have conceivably lowered interest rates by 0.25 percent on farm operating and limited-resource farm operating loans. Rates for the latter are set at three percent below the rate for farm operating loans. Further, if a lower rate had been put into effect before January 1, 1982, then some 3,850 borrowers who received about $115 million in operating loans during January 1982 could have benefited from this change.

ADEQUACY OF FmHA GUIDELINES
FOR SETTING INTEREST RATES

FmHA's guidelines[2] for changing interest rates state that:

--Usually no change in rates will be made if the existing loan rate differs by less than 0.5 percent from the current monthly average yield.

--The Administrator will consider setting a new rate, keeping in mind both the requirements of the law regarding rates and program needs, if the existing loan rate differs between 0.5 percent and 1 percent from the current average monthly yield.

--The existing loan rate will usually be changed if the existing loan rate differs by more than 1 percent from the current average monthly yield.

FmHA was not able to provide us with any documented basis for any of the figures used in the Administrator's guidelines for revising loan interest rates. According to the Acting Director, FPAD, the 0.5 percent cutoff was the break-even point for changing rates considering the cost of making rate changes. However, the Acting Director also told us that the 0.5 percent cutoff was an estimate based on the judgment of FmHA officials and that no actual analysis has been made of cost to substantiate this figure.

This 0.5 percent cutoff is not new. FmHA used it in a prior policy for determining whether to revise interest rates on farm operating loans. However, its use then was questioned by the Department of Agriculture's Office of Inspector General.

In a June 30, 1978, audit report on "Farmers Home Administration Operating Loan Interest Rates as of June 23, 1978" (Audit Report 402-35-HY), the Inspector General stated that FmHA's policy for revising rates did not provide for a timely response to changes in the current market yield. At that time, FmHA's policy provided for changing rates no more than twice each fiscal year and only when the current monthly average market yield on Treasury securities increased or decreased by 0.5 percent or more. However, the Inspector General was unable to locate any documentation to substantiate FmHA's 0.5 percent cutoff.

In the absence of documentation to support FmHA's 0.5 percent criteria, the Inspector General found that even a 0.125 percent change in market yields, the smallest change possible since interest rates are rounded to the nearest one-eighth of one percent (0.125 percent), warranted a rate adjustment. For example, the Inspector General stated that a 0.125 percent change in rates would affect interest cost by about $209,000 based on the then

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[2]These guidelines were also in the Acting Administrator's memorandum of May 21, 1981. See footnote 1 on p. 8.

average monthly amount of obligations (loans approved) and the life of these loans. In all, the Inspector General determined that 34,971 FmHA borrowers were overcharged about $8.4 million in interest and 10,446 borrowers were undercharged about $1.1 million in interest on loans obligated between January 1976 and June 1977 because rates were not changed monthly to reflect changes in the current monthly average market yield.

The Inspector General recommended that the FmHA Administrator

--perform a benefit/cost analysis to determine what degree of change in market yields would warrant a change in the interest rate, and

--implement rate changes promptly once this increment has been set.

The Acting Director, FPAD, told us that FmHA had not done the recommended benefit/cost analysis. He said that since the Inspector General's report was issued, the legislative requirements for setting interest rates on farm operating loans have been changed.

At the time of the Inspector General's review, the law provided that the interest rate on farm operating loans be determined by the Secretary of the Treasury taking into consideration the current average market yield, adjusted to the nearest one-eighth of one percent, plus not to exceed one percent per annum as determined by the Secretary of Agriculture. In August 1978, the law was changed to allow the Secretary of Agriculture to set the rate at a rate not in excess of the current average market yield, adjusted to the nearest one-eighth of 1 percent, plus an add on of up to 1 percent (see p. 1).

By granting the Secretary of Agriculture the authority to establish the applicable interest rates, this legislative change expanded the Secretary of Agriculture's discretionary authority, thereby increasing rather than lessening the need for FmHA to be able to substantiate its rate review guidelines. Although the Acting Director, FPAD, told us that FmHA considered the Inspector General's recommendations in forming its present policy, he also said (see p. 9) that the 0.5 percent cutoff in the present policy was an estimate based on the judgement of FmHA officials.

## ADEQUACY OF RATE DECISIONS

As will be noted in this section, the FmHA Administrator has not revised rates consistent with FmHA guidelines because important factors such as economic conditions in the farm sector were also considered. However, FmHA has no criteria to weigh important factors in setting program interest rates.

During the 10-month period ended March 1982, FmHA reviewed rates in 7 of the 10 months. For the 5 programs we reviewed, this means there was a maximum of 35 program-months (5 programs times

7 months) in which rates were reviewed. However, in actuality, rates were reviewed in only 31 of the 35 program-months because FmHA's rate review criterion and guidelines for making rate changes did not apply to 2 of the programs during 2 of the 7 months, or for 4 program-months.[3]

Under FmHA's guidelines, program interest rates were subject to change in 21 of the 31 program-months because the program interest rate at the time of the rate reviews differed by 0.5 percent or more from the current monthly average market yield. Moreover, in 12 of the 21 program-months, the difference between the program interest rate and the current monthly average market yield was greater than 1 percent. In this situation, FmHA's guidelines provide that the loan interest rate will usually be changed. Details for each of the five programs are shown in the following table.

| | Number of program-months in which the program interest rate was | | | |
|---|---|---|---|---|
| | Below market yield | | Above market yield | |
| Program | By 0.5 to 1 percent | By more than 1 percent | By 0.5 to 1 percent | By more than 1 percent |
| Farm operating | 2 | 2 | 1 | 1 |
| Farm ownership | 2 | 3 | - | - |
| Limited-resource farm operating | 1 | 2 | - | 1 |
| Limited-resource farm ownership | 1 | - | - | - |
| Single-family housing | 2 | 3 | - | - |
| | 8 | 10 | 1 | 2 |

In 2 of the 21 program months, FmHA decreased the program interest rate because the rate in effect was higher than the maximum rate permitted by law. In this same month (January 1982), the interest rate for a third program (limited-resource farm ownership) was also reduced because the rate in effect for this program was higher than the maximum rate permitted by law. However, this program was not part of the 21 program months because the rate in effect for this program differed from the current monthly average market yield by less than 0.5 percent. Details for the three programs are shown in the following table.

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[3]Two of the rate reviews occurred before October 1, 1981, at which time rates in the limited-resource farm ownership and limited-resource farm operating loan programs were not based on current average market yields, and therefore, not subject to FmHA's criterion and guidelines.

| Program | Interest rate in effect | Maximum rate permitted by law (note a) | Rate exceeds maximum (in percent-age points) |
|---|---|---|---|
| | --------(percent)-------- | | |
| Farm Operating: | | | |
| Regular | 14.50 | [b]14.25 | .25 |
| Limited Resource | 11.50 | [c]11.25 | .25 |
| Farm Ownership | | | |
| Limited Resource | 7.00 | [d]6.625 | .375 |

[a]These were also the new rates approved by FmHA.
[b]Treasury rate plus add on of 1 percent.
[c]Same as regular farm operating minus 3 percent.
[d]One-half of the Treasury rate.

The FmHA Administrator stated that rates were reduced in the regular farm operating program in order to be in compliance with the law. The Acting Director, FPAD, stated that the rates were reduced in the other two programs for the same reason.

But FmHA's action here is inconsistent with its action not to increase program rates on single-family housing loans in 5 months when rate reviews showed that program interest rates were at least 0.875 percent below the legal minimum rate for this program (current average market yield) as set by the Secretary of the Treasury (see p. 2). In explaining why the interest rates for single-family housing loans were not increased to the minimums, the FmHA Administrator stated that although the law prescribes a minimum, the law is silent as to how often the rate should be adjusted and how FmHA is to administratively accomplish the objective of the authorizing legislation.[4] Although the law is silent on these matters, the law is equally silent on these matters with respect to farm operating and limited-resource farm operating and ownership loans. Yet rates in these programs were decreased so as not to exceed the maximum rates prescribed by law.

In 19 of the 21 program-months, the FmHA Administrator decided not to change program interest rates. The Administrator stated that several factors, such as economic conditions, current and projected trends in interest rates, volatility of interest rates, and financial conditions in the farm and rural sectors, are considered to determine what effect an adjustment in rates would have on program needs and whether rate revisions should be made.

## Interest rates not increased due to depressed economic conditions

In September, October, and November 1981, the interest rates for farm ownership and farm operating loans were below the average

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[4]The FmHA Administrator also stated that rates were not increased because of depressed conditions in the housing market. See p. 13 for a further discussion of this.

market yields generally by more than 1 percent, thus indicating that a rate change was in order. But the FmHA Administrator stated that interest rates were not increased then because of the depressed economic conditions in the farm sector. He stated that a report dated March 15, 1982, prepared by the Department of Agriculture's Economic Research Service on the financial conditions in the farm sector, indicated that during the past 2 years net farm income had been at depressed levels and was expected to decline further in 1982.

According to the Economic Research Service report, depressed conditions existed in the farm sector roughly during the period March 1980 to March 1982. Yet we found that

--in April 1981, interest rates were increased in the farm ownership and farm operating programs.

--in May 1981, the interest rate was increased in the farm operating program.

--in July 1981, the interest rate in the farm operating and farm ownership programs was permitted to remain above the average market yield when it could have been reduced.

--in December 1981, the interest rate on farm operating loans was permitted to remain above the average market yield when it could have been reduced. In this case, FmHA decided not to do a rate review although one was required by FmHA's criterion. (See p. 8.)

We questioned why the rates were increased or allowed to stand in these instances during a time of depressed economic conditions. The Acting Director, Financial and Productivity Analysis Division, told us that, although the Economic Research Service report indicated that depressed conditions existed from early 1980, the study was done in retrospect. He said that the factors FmHA uses to evaluate the economic condition of the farm sector such as delinquency rate on loans, economic surveys by Federal Reserve Banks, general Wall Street data, and Economic Research Service data, did not indicate a depressed economic condition until sometime in June or July 1981. However, he also stated that FmHA has not developed any criteria to measure the severity of depressed economic conditions and its relationship to program interest rates.

Also, the FmHA Administrator stated that interest rates on single-family housing loans were not increased in September, October, and November 1981 and February and March 1982 because of the depressed conditions in the housing market, volatility of interest rates, and indications that rates were declining. At the time of these rate reviews, the FmHA interest rate was 0.875 percent or more below the legal minimum rate as set by the Secretary of the Treasury. (See p. 12 for FmHA's explanation for not increasing rates to the minimum.)

The Acting Director, FPAD, stated that FmHA became aware of the depressed housing markets around August and September 1981 based on reviews of various financial publications such as the Wall Street Journal, which showed declines in housing starts. He stated that none of these documents or a record of FmHA's review of them were included in FmHA's rate review files. The Acting Director also stated that FmHA did not have any formal criteria to identify depressed conditions in the housing market or to weigh these conditions in setting interest rates.

Interest rates not changed due to interest rate projections

FmHA also had not increased rates in its single-family housing loan program because of the volatility of interest rates and indications that rates were declining. The FmHA Administrator provided us with the following table to illustrate the decline and volatility of Treasury cost of money rates (monthly average market yields) from May 1981 to April 1982.

| Year/month | Treasury cost of money rate | Change from previous month |
|---|---|---|
| | (in percent) | |
| 1981 | | |
| May | 13.75 | -0- |
| June | 13.125 | -.625 |
| July | 13.5 | +.375 |
| August | 14.125 | +.625 |
| September | 14.75 | +.625 |
| October | 14.75 | - |
| November | 14.0 | -.750 |
| December | 13.25 | -.750 |
| 1982 | | |
| January | 14.125 | +.875 |
| February | 14.375 | +.250 |
| March | 13.625 | -.750 |
| April | 13.5 | -.125 |

The FmHA Administrator stated that, as this table shows, Treasury cost of money rates declined from 14.75 percent in September to 13.25 percent in December, which brought FmHA's interest rate of 13.25 percent on single-family housing loans in line with the Treasury cost of money rate. He also stated that although Treasury cost of money rates increased in January and February 1982 to 14.125 percent and 14.375 percent, respectively, rates declined again in March and April to 13.625 percent and 13.5 percent, respectively.

Although FmHA's data illustrates the decline and volatility of Treasury cost of money rates, all this information was not available to FmHA at the time of the September, October, and November 1981 and the February 1982 rate reviews. Moreover, based on the information that was available to FmHA at the time of these rate reviews, indications were that rates were on an upswing rather than a decline. For example, FmHA's September 1981 rate review showed that the Treasury rate for August had increased 0.625 percent compared to the Treasury rate for July. In addition, the review showed that the Treasury rate on September 1 of 15.09 percent indicated a further upswing in rates in comparison to the Treasury rate for August. FmHA's October 1981 rate review showed that the Treasury rate for September had increased 0.625 percent compared to August, thus confirming the upswing in rates that should have been evident from the September 1981 rate review. Although FmHA's November 1981 rate review showed no change between the October and September Treasury rate, FmHA's review did show that the Treasury rate on November 2 was 15.27 percent compared to the 14.75 percent Treasury rate for October. In our opinion, this information should have indicated that rates would remain up during November with a further increase likely.

Despite the clear indications that rates were increasing, FmHA did not increase the single-family housing loan interest rate. This contrasts sharply with FmHA's decision in May 1981 to increase rates for this program. FmHA's May 1981 rate review showed that the Treasury rate for April (13.125 percent) had increased by 0.375 percent compared to the Treasury rate for March. The review also showed that on May 13 the Treasury rate was 14.17 percent. According to the FmHA Administrator, this information indicated a sharp upswing in interest rates. But, despite the prediction of a sharp upswing, FmHA only increased its interest rate from 13 percent to 13.25 percent to bring its rate more in line with the Treasury average cost of money for April.

FmHA's July 1981 rate review showed that the interest rate for farm operating loans was 0.5 percent above the average market yield and, therefore, was subject to adjustment under FmHA's guidelines. However, the Administrator determined not to decrease the program interest rate because the rate had been increased in May and FmHA's interest rate projections indicated an upswing in the average market yields. At the time of the rate review, the program rate was 14.5 percent and the average market yield was 14 percent. According to the Acting Director, FPAD, FmHA estimated that the average market yield would increase very soon to about 14.5 percent.

Subsequent events showed that, although FmHA was correct in estimating that average market yields would increase, it was not correct in estimating the extent of the increase. The average market yield increased from 14 percent in July to 14.375 percent in August and to 15.25 percent in September. Since the program interest rate remained at 14.50 percent during this same period, FmHA borrowers who obtained loans in July paid an interest premium of 0.5 percent; those who obtained loans in August paid an interest premium of 0.125 percent; and those who obtained loans in September received an interest subsidy of 0.75 percent.

In all, FmHA's rate decisionmaking process has resulted in inconsistencies. Although other important factors were apparently considered in the rate decisionmaking process, FmHA did not have criteria to weigh these factors. Consequently, FmHA's explanations of its actions only serve to highlight the inconsistencies.

## FmHA's INTEREST RATES RESULT IN SUBSIDIES AND PREMIUMS

During the first 10 months that FmHA's May 1981 rate review criterion and rate changing guidelines were in effect, the monthly interest rates in the five programs we reviewed were almost always below or above the monthly average market yield (Treasury cost of funds) and by amounts that varied from month to month within each program. When program rates are below Treasury's cost of funds (average market yield), FmHA borrowers receive an interest subsidy and, when program interest rates are above Treasury's cost of funds, FmHA borrowers pay an interest premium. The table on page 17 shows the interest subsidy or premium by program during each of the 10 months we reviewed.

During the 10 month period reviewed, FmHA made few, if any, changes in its program interest rates. Consequently, borrowers in the same program generally received the same interest rate regardless of the month their loan was approved. For example, the farm ownership and single-family housing loan interest rate was 13.25 percent during each of the 10 months we reviewed. Although this gives the appearance that borrowers were being treated equally, the table on page 17 shows that this was not the case when rates were compared to Treasury's monthly cost of money rates. We asked the FmHA Administrator if there was any special reason why interest rates in the same program were kept at the same level from month to month. But the Administrator stated that rate stability was not a necessary or determining factor in setting or adjusting interest rates.

Interest subsidies increase FmHA's program costs while interest premiums reduce costs. The table on p. 18 shows the dollar amount of the subsidies and premiums on FmHA loans approved during the 10-month period ending March 1982. These subsidies and premiums represent those that could be expected over the life of the loans if all the loans were made at the rate in effect at the time of loan approval[5], no defaults occurred, and no changes were made in a borrower's loan interest rates.[6] Dollar values represent the present value of subsidies or premiums at the time the loans were approved. As the table shows, subsidies exceeded premiums by $94 million. Because FmHA obtains appropriations each year to reimburse it for subsidies and losses, FmHA's annual budget request for these reimbursements will have to be increased over the life of these loans if FmHA is to recover these excessive subsidies.

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[5]FmHA will close loans at the rate in effect at the time of loan approval or loan closing, whichever is less.

[6]Interest rates on limited-resource farm ownership and operating loans are subject to change over the life of the loan. (See p. 2.)

## INTEREST SUBSIDIES AND PREMIUMS ON FmHA LOANS

| Month of loan approval | Farm operating program: Amount of interest subsidy received | Farm operating program: Amount of interest premium paid | Farm ownership program: Amount of interest subsidy received | Farm ownership program: Amount of interest premium paid | Single family housing program: Amount of interest subsidy received | Single family housing program: Amount of interest premium paid | Farm operating limited-resource program (note a): Amount of interest subsidy received | Farm operating limited-resource program (note a): Amount of interest premium paid | Farm ownership limited-resource program (note a): Amount of interest subsidy received | Farm ownership limited-resource program (note a): Amount of interest premium paid |
|---|---|---|---|---|---|---|---|---|---|---|
| | (percent) | | | | | | | | | |
| June 1981 | .125 | | .50 | | .50 | | | | | |
| July 1981 | | .50 | | .125 | | .125 | | | | |
| August 1981 | | .125 | .25 | | .25 | | | | | |
| September 1981 | .75 | | .875 | | .875 | | | | | |
| October 1981 | 1.50 | | 1.50 | | 1.50 | | 1.50 | | .375 | |
| November 1981 | 1.125 | | 1.50 | | 1.50 | | 1.125 | | .375 | |
| December 1981 | | .25 | .75 | | .75 | | | .25 | - 0 - | - 0 - |
| January 1982 | | 1.25 | - 0 - | - 0 - | - 0 - | - 0 - | | 1.25 | | .375 |
| February 1982 | .125 | | .875 | | .875 | | .125 | | .375 | |
| March 1982 | .50 | | 1.125 | | 1.125 | | .50 | | .50 | |

a/Before October 1, 1981, interest rates on limited-resource loans were not based on current average market yields, and therefore, were not subject to FmHA's rate review criterion and guidelines.

| Program | Interest subsidies received by borrowers Number of loans approved | Amount | Interest premiums paid by borrowers Number of loans approved | Amount |
|---|---|---|---|---|
| Farm operating | 17,609 | $ 6,238,000 | 7,277 | $4,528,000 |
| Farm operating limited-resource | 2,085 | 757,000 | 777 | 524,000 |
| Farm ownership | 4,913 | 17,509,000 | 805 | 470,000 |
| Farm ownership limited-resource | 561 | 2,050,000 | 119 | 490,000 |
| Single family housing | 48,429 | 76,912,000 | 11,584 | 3,264,000 |
| Total | 73,597 | $103,466,000 | 20,562 | $9,276,000 |

Although the period covered by our review ended in March 1982, our comparison of FmHA interest rates to Treasury's monthly cost of money rate showed that subsidies and premiums were still evident during the 10-month period ending January 1983. The results of this comparison are shown in Appendix I.

## MONTHLY RATE CHANGES ARE POSSIBLE WITHOUT ADVERSELY AFFECTING FmHA's WORKLOAD

FmHA could revise the interest rates applicable to new loans every month, setting the new rates at the Treasury's cost of money.[7] Such a policy would eliminate the subsidies and premiums we found and enable FmHA or its borrowers to benefit from even the slightest changes in Treasury's cost of money. The FmHA Administrator believes monthly rate changes would adversely affect FmHA's workload. But the Administrator's concerns could be overcome with just minor changes in FmHA's policies and procedures.

The FmHA Administrator believes monthly interest rate changes could create an administrative hardship on FmHA field offices as loan budgets would need to be reworked for all loans in process. However, the Acting Director, FPAD, Directors of the Farm Real Estate and Production Loan Division and the Single-Family Housing Processing Division, and an FmHA county supervisor we talked to,

[7]The rate on limited-resource farm ownership or operating loans could be set at a rate equal to one-half of or 3 percentage points less than, respectively, the cost of money consistent with the legal provisions applicable to these programs. (See p. 2.)

all generally agreed that monthly rate changes could be made without adversely affecting FmHA's workload, if FmHA

--set rates at the Treasury's cost of money,

--established a specific date during the month for new rates to become effective, and

--required its county supervisors to determine the maximum interest rate applicants can pay.

Setting rates at the Treasury's cost of money would eliminate the need for FmHA's rate review/decisionmaking process, thereby enabling FmHA to make more timely rate changes. And by establishing a specific date for these changes, FmHA's field offices could schedule the review and processing of loan applications to avoid an imbalance in workload.

Our review indicated that FmHA could make rate changes by the 5th working day of each month as data on Treasury's cost of money is available from the Treasury by phone before the end of the preceding month. Further, only five working days are needed for FmHA's State Offices to notify its county offices of the new rates and for the Finance Office to change its computer edit checks.

In the FmHA field office, the FmHA county supervisor is responsible for processing and approving farm and home loan applications. By requiring the county supervisors to determine the maximum interest rate an applicant can pay, FmHA would not need to perform a complete reevaluation of an applicant's repayment ability (rework loan budgets) in the event interest rates had increased at the time of loan approval. County supervisors would merely have to check to assure that the new rate was within the maximum rate capability of the applicant. If the new rate exceeded the applicant's repayment ability, the applicant could be considered for a reduced interest rate loan through the limited-resource farm ownership or operating loan programs or an interest subsidy through the single-family housing loan program.

In its report on FmHA farm operating loan interest rates (see p. 9), the Office of Inspector General also indicated that the impact on field offices to effect more frequent rate changes would be minimal, as long as field offices were timely notified of rate changes.

The Administrator also informed us that other Federal lenders do not adjust rates on a fixed schedule. For example, he said the Department of Housing and Urban Development rate (mortgage insurance rate) is adjusted whenever there is a need to adjust the rate to the private mortgage market. He said adjustments are made for one-half or a full percent and not for one-eighth or one-quarter percent and the time between rate adjustments has been as short as 6 weeks and as long as 6 months.

Farm lending institutions, like the Federal Land Banks and Production Credit Associations, which are regulated by the Farm Credit Administration, change their rates whenever their cost of funds (money) changes. As Treasury's cost of money changes daily as well as monthly, monthly changes in FmHA rates would seem to be in order and consistent with the practices of these lending institutions.

Further, the Administrator's statement that HUD's mortgage insurance rates are adjusted in increments of one-half percent or more and at intervals less frequently than monthly is somewhat misleading. The Administrator's statement, although technically correct, ignores the points that lenders charge to increase the effective yield above the HUD stated rate. Points are interest charges that are paid at the time a property (home) is purchased. They are paid by the seller but they also can be passed on to the buyer indirectly in terms of a higher purchase price for the home. Each point equals 1 percent of the mortgage (loan) amount.

## CONCLUSIONS

FmHA does not have an adequate rate review/decisionmaking process to provide for the judicious use of its discretionary authority. As a result, loan program interest rates were not always revised in a timely manner. Relative to the Government's cost of money rate, some borrowers received subsidies while others received none or were charged a premium. Because this occurred in the same loan programs, borrowers were not being treated equitably. Moreover, because subsidies in the period covered by our review far exceeded premiums, FmHA's program cost will be increased by millions of dollars.

FmHA could change the interest rates for new farm and home loans each month commensurate with changes in Treasury's monthly cost of money rates. Because interest rates are rounded to the nearest one-eighth of 1 percent, Treasury's monthly cost of money rate would have to change by at least one-sixteenth of 1 percent (one-half of one-eighth) to actually trigger a change in FmHA's interest rate. Furthermore, appropriate adjustments could still be made to provide for reduced interest rates for limited-resource farmers consistent with the legal provisions applicable to these loans. Rates on limited-resource operating loans could be set at 3 percentage points less than the cost of money rate applicable to farm operating loans. And rates on limited-resource farm ownership loans could be set at a rate equal to one-half of the cost of money rate applicable to regular farm ownership loans.

Monthly changes in rates would result in more frequent changes in interest rates. More importantly, monthly rate changes, if based solely on Treasury's cost of money rate, would help ensure that FmHA and its borrowers were being treated in a fair and equitable manner. FmHA would charge all borrowers in the same program rates equal to the cost of money, except for the reduced rates for limited-resource farmers, thereby providing (1) greater consistency in the rate decisionmaking process and (2) eliminating subsidies and premiums, which can occur, but cannot be adequately justified, under FmHA's existing rate review/decisionmaking process. But to facilitate these monthly rate changes, FmHA will need to make some minor policy and procedural changes to avoid any adverse effects on its workload.

Because depressed conditions have existed and can exist in the farm and/or housing sectors, FmHA could conceivably need some leeway to set rates lower than the Government's cost of money rate. To some extent, this can be accomplished through available subsidies in the single-family housing loan program or with lower interest rate limited-resource loans (see p. 2). If FmHA is to continue to have leeway to set interest rates lower or higher than the cost of money rate, then it will need to develop specific, quantitative criteria to identify and weigh each factor in setting loan interest rates. Without such criteria, no assurance exists that FmHA and its borrowers are being treated fairly and equitably.

## VIEWS OF RESPONSIBLE AGENCY OFFICIALS AND OUR EVALUATION

The Department of Agriculture's Under Secretary for Small Community and Rural Development, who is responsible for FmHA's activities, stated that the period we reviewed (June 1981 to March 1982) covers a time of unusual volatility in interest rates and costs of Treasury borrowing. He added that such volatility tends to exaggerate the impact of lags in FmHA procedures used to set loan interest rates.

We agree that in recent years, including the period covered by our review, interest rates and costs of Treasury borrowing have been volatile. But in periods of such instability, fairness dictates that loan interest rates be revised more frequently to reflect this volatility. While this volatility tends to increase the monetary significance of any lags in changing rates, even in periods of relative stability a change in Treasury's borrowing cost as small as one-eighth of 1 percent (.125 percent) can affect total interest collections by millions of dollars because of the large volume of FmHA loans.

In addition, the Under Secretary stated that to adjust rates for increments as small as one-eighth of 1 percent each month would have a very adverse effect on FmHA field office and Finance Office operations. Specifically, he stated that when rates are changed

--All 2,200 FmHA field offices need to be notified prior to the effective date of the rate change.

--Farm and home plans and family budgets for loan applicants need to be reworked.

--The Finance Office needs to change computer edit checks to include new rates.

In all, the Under Secretary stated that it is impossible to measure all of the intangible effects on a nationwide organization with over 10,000 employees and 2,200 delivery offices of what appears to be a simple change.

Our report discusses the adverse impacts referred to by the Under Secretary and how these impacts could be alleviated with minor changes in FmHA's procedures (see p. 18). However, the Under Secretary's comments did not address the procedural changes we proposed. Furthermore, if the frequency of interest rate changes does in fact have a significant effect on FmHA workload, then this is all the more reason that FmHA should have done a cost/benefit analysis, as recommended by the Inspector General (see p. 10), to determine what degree of change in market yields (Treasury cost of money) would warrant a change in interest rates.

The Under Secretary also stated that FmHA is developing a Request for Proposal to establish a portfolio management system. He stated that this system will (1) include management and economic data to better quantify the data now used to support rate change decisions and (2) enable FmHA to implement the use of additional quantitative criteria in the rate decisionmaking process. Consequently, when this system is complete, he stated that FmHA intends to further quantify the information used in the rate decisionmaking process.

The Under Secretary's comments imply that quantitative criteria may in fact be needed to guide FmHA's rate decisionmaking process. However, according to the Director of FmHA's Financial and Productivity Analysis Division, FmHA's proposed portfolio management system will not enable FmHA to develop criteria to address <u>all</u> of the factors that need to be considered in setting interest rates. (This system is expected to become operational by September 1984 provided that a contract can be awarded before the end of fiscal year 1983.) But the Director explained that he also planned to augment this effort with a sensitivity analysis to develop criteria for any other factors that need to be considered. He also said that this sensitivity analysis would consider the appropriate frequency for making rate changes. Furthermore, he said he planned to give these matters top priority once existing staff vacancies were filled.

FmHA's efforts, if properly implemented, could lead to the development of appropriate criteria to guide the rate review/decisionmaking process. We will monitor FmHA's efforts in following up on any FmHA actions taken on our recommendations.

## RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

We recommend that, to provide for changes in farm and home loan program interest rates in a timely, economical, and equitable manner, the Secretary direct the FmHA Administrator to revise interest rates monthly, setting new rates at the Treasury monthly cost of money rate with appropriate adjustments for limited-resource farm loans. To facilitate this change without adversely affecting FmHA workload, we also recommend that the Secretary direct the FmHA Administrator to

--implement rate changes by the 5th work day of each month and

--require FmHA county supervisors to determine the maximum rate applicants can pay.

The latter actions are needed to provide for the orderly processing of applications and to avoid reprocessing of applications (loan budgets) if rates should be increased before an application can be approved.

Further, we recommend that before extending FmHA authority to consider other factors (such as depressed conditions in the farm sector) in setting interest rates, the Secretary require the FmHA Administrator to develop specific, quantitative criteria to identify and weigh these factors in setting loan program interest rates.

## CHAPTER 3

## FmHA NEEDS TO USE A LONGER MATURITY PERIOD

## TO SET INTEREST RATES ON REAL ESTATE-TYPE LOANS

FmHA needs to use a longer maturity period--one that is more comparable to the maturity period on its loans--if it is to set interest rates on its real estate-type loans in a manner consistent with its authorizing legislation. Interest rates are set based on the average market yield on Treasury securities having maturity periods comparable to the maturity period on FmHA loans. (See p. 1.) FmHA uses a 25-year maturity period to set rates on real estate-type loans. However, we found that the average maturity period on FmHA's real estate loans was well in excess of 30 years.

The longest period the Treasury borrows for is 30 years. Consequently, FmHA could use a 30-year instead of 25-year maturity period to set interest rates. At times, use of a 30 year maturity period could mean a difference in interest rates of at least 0.125 percentage points. For individual borrowers such a small change in rates may not seem substantial. But considering the volume and term of FmHA's real estate type loans, a change in interest rates of 0.125 percentage points can result in millions of dollars in interest over the life of FmHA's loans. In normal market conditions[1] FmHA would benefit from the change because long term rates tend to be higher than short-term rates. But in abnormal market conditions such as those experienced in recent years, FmHA's borrowers would benefit because long-term rates tend to be lower than short-term rates.

### THE MATURITY PERIOD FmHA USES TO SET REAL ESTATE LOAN INTEREST RATES IS TOO SHORT

FmHA uses the average market yields on 5-year and 25-year Treasury securities to set interest rates on operating and real estate-type loans, respectively. According to the FmHA Administrator, the 5- and 25-year maturity periods FmHA uses are estimates developed several years ago by its program and financial managers. He stated that FmHA recognizes the need to verify these estimates against actual data from its accounting system at the Finance Center in St. Louis. But he stated that the resources were not available at the present time to develop the computer software to do this. The Administrator did state that FmHA intended to review the resources needed to develop software to obtain average maturity data on an annual basis after it completes its conversion to a new accounting system. As of May 1983, FmHA expected to complete this conversion by November 1983.

Based on information we retrieved from FmHA's computer at its St. Louis Finance Center, we calculated a simple average loan

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[1]In the past 10 years, normal market conditions existed the majority of the time.

maturity period for each loan program for fiscal years 1980 and 1981. The following table shows by program the average maturity periods we computed:

| Type/loan program | Average maturity period in years: Fiscal year 1980 | Average maturity period in years: Fiscal year 1981 |
|---|---|---|
| Operating: | | |
| Regular farm | 4.72 | 4.97 |
| Limited-resource farm | 5.02 | 5.03 |
| Real estate: | | |
| Regular farm ownership | 38.10 | 36.63 |
| Limited-resource farm ownership | 38.77 | 38.75 |
| Single-family housing | 32.34 | 32.46 |

As the table shows, the use of a 5-year maturity period for operating type loans appears reasonable. However, the use of a 25-year maturity period for real estate loans is 7 to 13 years less than the average maturity periods we computed.

## MATURITY PERIOD'S IMPACT ON INTEREST RATES

Based on the average maturity period of FmHA's real estate loans, FmHA could use a 30-year maturity period to set loan interest rates. The longest maturity period on Treasury securities is 30 years. However, according to the FmHA Administrator, the use of a 25-year maturity period does not materially affect the rate charged to borrowers because there is very little difference between the monthly average yields on securities that have 25 and 30 years to maturity. The Administrator stated that the difference in the 1981 fiscal year average of 13 percent for 25-year maturities and 12.92 percent for 30-year maturities does not result in any significant under- or overcharges to borrowers.

A difference in average fiscal year rates (yields) for 25-year and 30-year maturities is irrelevant, in our opinion, because loans are made throughout the year based on monthly rather than fiscal year average yields. However, the monthly yields on 25- and 30-year maturities do tend to flatten out at this level. For example, during 11 of the 18 months in fiscal years 1981-82 (through March 1982), the yields on 25- and 30-year maturities were identical. But in the remaining 7 months, the yields on 25-year Treasury securities exceeded the yields on 30-year securities by 0.125 and 0.25 percentage points. The following table shows the results of our comparisons of yields on 25-year and 30-year maturities for the 18-month period ending March 1982.

| Month/year | Average market yield on Treasury securities 25-Year | 30-Year | Difference |
|---|---|---|---|
| | - - - - - - - - - | (percent) | - - - - - - - - - |
| Fiscal year 1981: | | | |
| Oct. 1980 | 11.25 | 11.25 | - |
| Nov. 1980 | 11.5 | 11.5 | - |
| Dec. 1980 | 12.25 | 12.25 | - |
| Jan. 1981 | 12.5 | 12.5 | - |
| Feb. 1981 | 12.0 | 12.0 | - |
| Mar. 1981 | 12.625 | 12.625 | - |
| Apr. 1981 | 12.75 | 12.75 | - |
| May 1981 | 13.125 | 13.0 | .125 |
| June 1981 | 13.75 | 13.625 | .125 |
| July 1981 | 13.125 | 13.0 | .125 |
| Aug. 1981 | 13.5 | 13.25 | .25 |
| Sept. 1981 | 14.125 | 13.875 | .25 |
| Fiscal year 1982: | | | |
| Oct. 1981 | 14.75 | 14.625 | .125 |
| Nov. 1981 | 14.75 | 14.625 | .125 |
| Dec. 1981 | 14.0 | 14.0 | - |
| Jan. 1982 | 13.25 | 13.25 | - |
| Feb. 1982 | 14.125 | 14.125 | - |
| Mar. 1982 | 14.375 | 14.375 | - |

During the 7 months when the yields differed on 25- and 30-year maturities, FmHA changed interest rates in two loan programs. These changes produced higher loan interest rates than the rates that could have been charged using a 30-year maturity period. Collectively, these higher rates will produce millions of dollars in additional interest income for FmHA at the expense of its borrowers. Although the difference in yields was only 0.125 percent, even a difference as small as this can affect loan interest by millions of dollars because of the volume and life of FmHA's real estate-type loans. Details follow.

As a result of its May 1981 rate review, FmHA changed the interest rate on its single family housing loans to 13.25 percent. Because the yield on 30-year maturities was 0.125 percentage points less than the yield on 25-year maturities, FmHA could have set its new rate at 13.125 percent. On the 64,000 loans totaling about $1.9 billion that FmHA made between June 1981 and March 1982 at 13.25 percent, we estimate that these borrowers will be overcharged $17.1 million (present value, fiscal year 1982) in interest over the life of their loans compared to the interest they would have been charged had rates been based on a 30-year maturity period. Many of these FmHA borrowers will not actually pay these overcharges because of the program subsidies they receive from FmHA. However, to the extent these overcharges are not paid, FmHA will include them in the subsidy that is subject to recapture from any appreciation in the value of the house. (See p. 2.)

As a result of its September 1981 rate review, FmHA set the interest rate on limited-resource farm ownership loans at 7 percent effective October 1, 1981. By law, the interest rate on limited-resource loans is not to exceed one-half of the average market yield on Treasury securities. As shown in the above table, the rate on 25-year Treasury securities for September 1981 was 14.125 percent, one-half of which is 7.0625 percent. Because rates are rounded to one-eighth of one percent (0.125), FmHA rounded this rate down to 7 percent.[2] Using a 30-year maturity period, FmHA could have set the interest rate at 6.875 percent (one half of 13.875 rounded down to one-eighth of 1 percent).

FmHA's 7 percent interest rate was in effect from October 1981 through January 1982, during which time FmHA made about 390 loans totaling about $32 million. We estimated that over the life of these loans borrowers could be charged an extra $470,000 (present value, fiscal year 1982) in interest in comparison to what they would have been charged if rates had been based on a 30-year maturity period. However, the actual amount of the overcharge will be less than $470,000 because interest rates on limited-resource farm loans are increased periodically commensurate with increases in the borrower's repayment ability. (See p. 2.)

Interest rates on farm ownership loans were not changed at all during the 7-month period in which yields differed on 25-year and 30-year maturities. During this 7 month period, FmHA made about 4,300 farm ownership loans totaling $268 million. If interest rates had been reduced by at least 0.125 percentage points during this 7-month period to reflect the lower yields on 30-year Treasury securities, we estimate that these borrowers could have saved about $2.5 million (present value, fiscal year 1982) in interest over the life of their loans.

FmHA borrowers were overcharged interest because the yields on 25-year maturities were higher than the yields on 30-year maturities, which is the situation that occurs in periods of abnormal market conditions. Abnormal market conditions existed during most of fiscal years 1979-81. However, in periods of normal market conditions, FmHA's use of a 25-year maturity period would tend to result in undercharges in interest because short-term rates are lower than long-term rates. Consequently, if normal rather than abnormal market conditions had existed, FmHA's use of a 30-year maturity period could have increased FmHA's interest income and in turn reduced its subsidies and losses by millions of dollars.

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[2] If FmHA had rounded up to 7.125 percent, the rate would have exceeded one-half of the average market yield.

During fiscal years 1972-81, normal market conditions existed in 77 of 123 months[3] or 63 percent of the time. The following table shows the number of months abnormal and normal market conditions existed during fiscal years 1972-81.

| Fiscal year | Number of months market conditions were: Abnormal (note a) | Normal (note b) |
|---|---|---|
| 1972 | - | 12 |
| 1973 | 1 | 11 |
| 1974 | 9 | 3 |
| 1975 | 3 | 9 |
| 1976 | - | c/ 15 |
| 1977 | - | 12 |
| 1978 | 1 | 11 |
| 1979 | 12 | - |
| 1980 | 8 | 4 |
| 1981 | 12 | - |
| Total | 46 | 77 |

a/Short-term rates were higher than long-term rates.
b/Short-term rates were lower than long-term rates.
c/Includes 3 months for the transitional quarter.

## CONCLUSIONS

FmHA needs to use a 30-year maturity period--which is the longest period that the Treasury borrows for--to set interest rates on real estate-type loans. The 25-year maturity period FmHA now uses to set these interest rates is 7 to 13 years less than the average maturity period on FmHA's real estate-type loans. A 30-year maturity period is closer to the average maturity period; therefore, its use would be more consistent with the requirements of FmHA's authorizing legislation.

In contrast to FmHA's use of a 25-year maturity period, a 30-year maturity period could, depending on market conditions, either increase or decrease interest rates, thereby increasing or decreasing, respectively, FmHA's interest income. Only a small change in interest rates should occur but even small changes can affect FmHA's interest income by millions of dollars because of the volume of FmHA's loans. And if normal market conditions prevail the majority of the time as they have in the past, then FmHA should be the primary beneficiary in using a 30-year rather than 25-year maturity period to set interest rates on real estate loans.

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[3]Includes 3 months for the transitional quarter July 1976 to September 1976.

## OFFICIALS AND OUR EVALUATION

The Department's Under Secretary for Small Community and Rural Development stated that the use of 25-year maturities to set rates was established based on the data FmHA had available. He stated that due to the limited resources available for software development, this maturity had not been recently reviewed. He asked if we could provide FmHA with the results of our computer analysis so that this data could be used together with the agency's analysis in making a decision on the use of a 30-year or 25-year maturity. He also stated that in most months, a 30-year rather than 25-year maturity would result in no or a very slight change (.125 or .25 percent) in the rate charged FmHA borrowers.

We believe our report provides a sufficient basis for use of a 30-year maturity. In contrast to the 25-year maturity period FmHA uses, which is an estimate developed several years ago, our 30-year maturity period is based on an actual analysis of FmHA's loan records. In addition, the simple average maturity periods we computed for real estate type loans were very close to the maximum maturity periods permitted--33 years for housing loans and 40 years for farm ownership loans. This suggests that a very large number of loans were being approved for the maximum periods, which is further reason to use a 30-year maturity. To help FmHA reach a decision on whether to use a 30-year maturity, we have provided FmHA with the requested information. Furthermore, in reaching a decision, we believe FmHA should keep in mind that even a slight change in interest rates (as little as .125 percent) can affect loan interest by millions of dollars (see p. 26) due to the large volume of FmHA loans.

## RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

We recommend that, to better comply with the requirements of FmHA's authorizing legislation, the Secretary should direct the FmHA Administrator to use a 30-year maturity period to set interest rates on farm ownership, including limited-resource farm ownership, and single family housing loans. We also recommend that to ensure continued validity of the maturity period being used to set interest rates, the Secretary should direct the Administrator to periodically determine the actual maturity period of FmHA loans.

# CHAPTER 4

# A MORE APPROPRIATE BOND INDEX IS NEEDED TO SET INTEREST RATES ON COMMUNITY FACILITY LOANS

FmHA needs to use a revenue bond index to set interest rates on community facility loans. FmHA sets interest rates on community facility loans based on bond market rates derived from a bond index consisting of general obligation bonds. However, we found that:

--Revenue bonds have been used more frequently than general obligation bonds to finance community facility projects similar to those financed by FmHA.

--Bonds in a well-recognized revenue bond index have maturity periods more comparable to the maturity period on FmHA loans than do bonds in the index FmHA uses.

Revenue bonds generally carry higher interest rates than general obligation bonds. Consequently, FmHA's use of a revenue bond index would result in higher interest rates. These rates would produce millions of dollars in additional interest income, thereby reducing the cost of FmHA's programs. We estimate that on loans made in the first half of fiscal year 1982, FmHA could have collected an additional $30.6 million (present value fiscal year 1982) in interest income over the life of these loans if a revenue bond index had been used to set interest rates.

## FmHA'S SELECTION OF A BOND INDEX

Municipal debt is typically financed through the sale of two types of bonds, general obligation and revenue bonds. General obligation bonds are backed by the full faith and credit of the community and payable from general property taxes. Revenue bonds, on the other hand, are not backed by the full faith and credit of the community and tend to represent a greater risk than general obligation bonds. These bonds are usually payable from charges for services or rent or special excise tax revenues. Because of the greater risk, revenue bonds usually carry a higher interest rate than general obligation bonds.

Several municipal bond indexes exist but the three most widely used indexes are published weekly by the Bond Buyer, a trade publication that concentrates on municipal bonds. The Bond Buyer has two indexes consisting of general obligation bonds, which are known as the 11-bond index and 20-bond index, and one consisting of revenue bonds. The 11-bond index consists of 20-year bonds issued by 11 entities, generally States. This index provides a rating equal to double "A" bonds. The 20-bond index consists of 20-year bonds issued by 20 entities and provides a rating equal to single "A" bonds. According to John E. Petersen of the Municipal Finance Officers Association, the 20-bond index is the most widely used index. The revenue bond index consists of 30-year bonds issued by 25 entities. Bond market rates in the 11-bond index are generally lower than the other two indexes because of the high rating of the bonds, whereas bond market rates in the revenue bond index are higher than the other two because of the greater risk involved with revenue bonds.

FmHA uses the 11-bond index to determine bond market rates, which in turn are used to set rates on its community facility loans. According to FmHA's Deputy Administrator for Financial and Administrative Operations, FmHA chose the 11-bond index to use in setting interest rates because it minimized the impact of increases in interest rates necessitated by legislative changes. Prior to October 1981, the interest rate on FmHA's community facility loans was set by law at 5 percent. However, the Omnibus Budget Reconciliation Act of 1981, which amended FmHA's authorizing legislation (7 U.S.C. 1927), requires FmHA to set interest rates at a rate not to exceed the current market yield on municipal bonds with maturity periods comparable to the average maturity period on FmHA's community facility loans. Loans at the 5 percent rate remain available to upgrade or construct facilities to meet applicable health or sanitary standards in areas where the median family income of persons served is below the poverty line.

FmHA sets loan interest rates quarterly based on a 4-week average of the week-ending bond market rates appearing in the 11-bond index. The table on page 34 shows the bond market rates FmHA used to set interest rates for each of the first two quarters in fiscal year 1982.

## REVENUE BONDS ARE USED MOSTLY TO FINANCE COMMUNITY FACILITY PROJECTS

Revenue bond financing for community projects has increased steadily since the 1930's and in 1981, revenue bonds were used to finance 70 percent of the long-term municipal debt issued that year. Despite the greater risk and higher interest rates on revenue bonds, they have become increasingly popular because of restrictive debt limitations on general obligation bonds and voter opposition to increased taxes to pay bond debts.

More importantly, it appears that revenue bonds are used to a greater extent in rural areas than in metropolitan areas. For example, according to an economist in the Department of Agriculture's Economic Research Service, revenue bonds accounted for 64 percent of the debt issued by rural governments in 1977 whereas only 46 percent of the debt issued by metropolitan governments was financed by revenue bonds.

Revenue bonds are the predominant means of financing water and sewer, including waste disposal, systems and health care facilities. For example:

--In fiscal years 1979-80, 68 percent of municipal long-term debt obligations for water supply systems was financed from nonguaranteed (revenue) sources.

--In 1977, revenue bonds were used to finance 48 percent of the debt for water and sewer facilities.

--In 1981, revenue bonds accounted for 96 percent of the municipal bond debt incurred for hospitals and health care facilities.

In fiscal year 1981, about 87 percent of FmHA's $1 billion in community facility loans was used to finance those facilities generally financed through revenue bonds--water supply and waste disposal systems and health care facilities.[1] The following table shows the amounts and types of projects FmHA funded during fiscal year 1981.

Community Facility Loans Made by FmHA in Fiscal Year 1981

| Type of projects | Number of loans | Amount of loans (thousands) | Percent of loan funds |
|---|---|---|---|
| Water supply | 1,167 | $ 502,000 | 50 |
| Waste disposal | 534 | 198,000 | 19 |
| Combination water supply and waste disposal | 67 | 50,000 | 5 |
| Health care | 216 | 130,000 | 13 |
| Public service | 250 | 88,000 | 9 |
| Public safety | 388 | 39,000 | 4 |
| Recreation | 8 | 3,000 | (a) |
| Total | 2,630 | $1,010,000 | 100 |

a/Less than one-half of one percent.

Revenue bonds also are the primary means of securing FmHA's community facility loans. In 12 of the 14 States, which accounted for about 50 percent of FmHA's loan funds for water and waste disposal systems in 1981, FmHA's community program chiefs told us that revenue bonds are most often used by local governments as security for their water and waste loans as well as for other revenue-producing projects such as hospitals. Similarly, they said revenue bonds are sold on the commercial market for these kinds of projects in their States. However, they did say that many of the community facilities sponsored by nonprofit organizations that do not have bond issuing authority use other types of collateral such as deed of trust, real property, liens, and promissory notes. In addition, FmHA's Program Management Branch Chief, Community Facilities Division, said that based on his experience with the programs, he would say that revenue bonds are most often used as security or collateral for FmHA loans.

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[1]In fiscal year 1982, 75 percent of FmHA's community facility loans was used to finance just water supply and waste disposal systems.

## REVENUE BOND INDEX CONSISTS OF BONDS WITH MATURITY PERIODS MORE COMPARABLE TO FmHA LOANS

FmHA's community facility loans have maturity periods longer than those of most municipal bonds. Most communities sell long-term municipal bonds that mature in 20 to 30 years to finance long-term capital projects, which require large sums of money in a short period of time. The longer the maturity period, generally the higher the interest cost. In contrast, FmHA's community facility loans can be financed for up to 40 years. And according to an analysis of loan maturities made by FmHA's Water and Waste Disposal Division, 99 percent of FmHA's loans for water and waste disposal systems and over 80 percent of FmHA's loans for other essential community facilities in fiscal years 1979-81 had maturity periods longer than 35 years.

Bonds in the revenue bond index, which have 30 year maturity periods, are more comparable to the maturity period on FmHA loans than the 20-year bonds included in the 11-bond or 20-bond indexes. Therefore, in terms of maturity periods, use of the revenue bond index, in our opinion, would be more consistent with FmHA's authorizing legislation. This legislation requires FmHA to set interest rates at a rate not to exceed the bond market rate on bonds with maturity periods comparable to those on FmHA's loans. (See p. 3.)

## USE OF REVENUE BOND INDEX COULD SIGNIFICANTLY INCREASE FmHA's INTEREST INCOME

Considering the use of revenue bonds to finance community facility projects and the greater comparability of these bonds to FmHA loans, it would be appropriate, in our opinion, to use a revenue bond index, rather than a general obligation bond index, to set FmHA loan interest rates. Because revenue bonds generally carry higher interest rates, the use of a revenue bond index to set rates could result in a significant increase in the interest income FmHA collects on its community facility loans.

The following table compares the bond market rates FmHA used to set interest rates for each of the first two quarters in fiscal year 1982 with comparable rates from Bond Buyer's revenue bond index. It also shows the difference in interest rates that would have resulted if FmHA had used the revenue bond index to set rates. The 4-week average of week-ending rates in the 11-bond index was the FmHA interest rate.

| Week ending | Bond market rate: 11-bond index | Bond market rate: Revenue bond index | Percentage points revenue bond index exceeds 11-bond index |
|---|---|---|---|
| | - - - - (percent) | - - - - | |
| 1st Quarter Fiscal Year 1982: | | | |
| 8/13/81 | 11.54 | 12.55 | 1.01 |
| 8/20/81 | 12.08 | 13.04 | .96 |
| 8/27/81 | 12.58 | 13.89 | 1.31 |
| 9/03/81 | 12.67 | 14.10 | 1.43 |
| 4 week average (note a) | b/12.25 | 13.375 | 1.125 |
| 2nd Quarter Fiscal Year 1982: | | | |
| 11/12/81 | 10.98 | 12.66 | 1.68 |
| 11/19/81 | 11.27 | 13.06 | 1.79 |
| 11/25/81 | 11.56 | 13.26 | 1.70 |
| 12/03/81 | 11.74 | 13.49 | 1.75 |
| 4 week average (note a) | b/11.375 | 13.125 | 1.75 |

a/Rounded to the nearest one-eighth of one percent.
b/FmHA interest rate for quarter.

In the first two quarters of fiscal year 1982, FmHA made 674 loans totaling $247.8 million at interest rates set on the basis of bond market rates derived from the 11-bond index. We estimate that if FmHA had set interest rates based on the revenue bond index, FmHA could have collected an additional $30.6 million (present value fiscal year 1982) in interest income over the life of these loans.

Similar savings could be realized on future loans. According to John E. Petersen of the Municipal Finance Officers Association, Bond Buyer's revenue bond index is usually 100 to 150 basis points (100 basis points equals 1 percent) higher than the 11-bond index FmHA uses. Consequently, a revenue bond index should consistently produce higher interest rates than would a general obligation bond index.

In addition, FmHA expects to continue making many of its future loans at the bond market rate despite new provisions in its program to provide loans at lower interest rates. During the first two quarters of 1982, about 93 percent of such FmHA loans were made at the bond market rate. The remaining loans were made at a fixed rate of 5 percent to serve low income communities. (See p. 3.) By August 1982, only about 81 percent of such loans had been made at the bond market rate. The reduction in loans made at the bond market rate stems from action FmHA took in July 1982. On July 9, 1982, FmHA issued regulations to provide for an additional interest rate half way between 5 percent and the bond market rate. This new intermediate rate applies to projects that do not meet the requirements for the 5 percent rate when the median family income of the service area is not greater than 85 percent of the nonmetropolitan median family income of the State. This action provides a reduced interest rate for additional lower income communities but maintains interest rates at the bond market rate for high income communities that can afford to pay bond market rates. At the time FmHA's regulations were issued, FmHA anticipated that a large percentage of its loans would continue to be made at the bond market rate.

FmHA could use future revenues to help reduce its budget cost for this program. For example, FmHA's budget request for fiscal year 1984 asked for about $478 million to reimburse the Rural Development Insurance Fund for subsidies and losses sustained during fiscal year 1982. And most of these funds, about $472 million, are needed to cover interest subsidies on community facility loans.

## CONCLUSIONS

A revenue bond index is a more appropriate index for FmHA to use to set interest rates on its community facility loans. Revenue bonds are mostly used to finance community facility projects and have maturity periods more comparable to the maturity period on FmHA's loans. Use of a revenue bond index to set FmHA's interest rates would result in higher interest rates. But these higher rates would produce millions of dollars in additional interest income, which could be used to cover the cost of interest subsidies provided through FmHA's 5-percent and intermediate interest rate loans. During fiscal year 1982, interest subsidies on FmHA's outstanding community facility loans totaled about $472 million.

## VIEWS OF RESPONSIBLE AGENCY OFFICIALS AND OUR EVALUATION

The Under Secretary stated that our description and analysis of facts appeared to be generally accurate but he could not agree with our conclusions. He said additional factors should be considered which justify the policies FmHA has followed.

Specifically, the Under Secretary stated that the law requires the interest rate to be set at a rate not to exceed the bond market rate and that rates below or at the bond market rate would comply with the law.

We recognize that FmHA has the authority to set rates lower than the bond market rate and that such a rate would comply with the law. In essence, the Under Secretary's comment implies that even if FmHA used a revenue bond index to determine the bond market rate, FmHA could use its discretionary authority to set the rate lower to match the rate produced currently through use of the 11-bond index. Although this could be done, we believe FmHA would need adequate criteria to justify setting the rate lower than the bond market rate. Chapter 2 discusses the need for such criteria in connection with FmHA's discretionary authority in setting interest rates in its other loan programs.

The Under Secretary stated that the bond market rate is not a clearly established figure and must be estimated. He stated that the 11-bond index used to estimate this figure is regularly published, widely used, and recognized by the municipal bond industry.

Bond Buyer's revenue bond index is also regularly published. Although this index has not been in existence as long as Bond Buyer's general obligation bond indexes and therefore may not be as widely used, we continue to believe that use of a revenue bond index would be more appropriate. Further, according to John E. Petersen of the Municipal Finance Officers Association, Bond Buyer's 20-bond index is the most widely used. Therefore, on the basis of use, we question FmHA's selection of the 11-bond index over Bond Buyer's more popular 20-bond index. Use of the 20-bond index would produce an interest rate somewhat higher than the rate produced using the 11-bond index but lower than the rate produced using the revenue bond index.

The Under Secretary stated that some community facility and water and waste disposal loans are evidenced (supported) by revenue bonds, some by general obligation bonds, and some by notes or other documents. However, he stated that it is FmHA policy to encourage the use of general obligation bonds to the extent practical. We agree that in obtaining security for a loan, general obligation bonds provide less risk than revenue bonds and that their use should be encouraged. However, revenue bonds continue to be the prevalent means used to finance projects similar to those financed by FmHA.

The Under Secretary also stated that it is not a required objective of the program that loans be made at the least cost to the Government. He stated that the main objective is to help provide needed facilities in communities that cannot obtain financing from the private sector at reasonable rates and terms. Therefore, he considered it logical to provide loans at rates similar to the rates available to communities that can obtain favorable private sector loans.

We agree that loans should be provided at rates similar to the rates communities pay for private sector loans. Because many communities use revenue bonds to obtain private sector financing, a revenue bond index should better reflect the rates communities pay for private sector financing.

Finally, the Under Secretary stated that water and waste disposal loans are often supplemented by grants to bring the debt service costs and resulting user rates down to a level the users can afford. He stated that in some cases the loan subsidy savings from increasing the loan interest rate would be offset by an increased need for grant funds.

We recognize that to the extent borrowers receive loans at the bond market rate concurrent with grants, the effect of our proposal would be to increase the need for grant funds to compensate for the higher interest rates. However, the majority of FmHA water and sewer loans were made without a concurrent grant. For example, in fiscal year 1982, FmHA made 928 water and waste disposal loans. However, only 444 grants were awarded during this period.

## RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

We recommend that the Secretary of Agriculture direct the FmHA Administrator to use a revenue bond index to determine bond market rates for the purpose of setting interest rates on community facility loans.

## RESULTS OF GAO'S COMPARISON OF FmHA LOAN INTEREST RATES TO TREASURY'S MONTHLY COST OF MONEY RATES (CURRENT AVERAGE MARKET YIELDS) FOR THE 10-MONTH PERIOD ENDING IN JANUARY 1983

| | Difference between loan interest rates and Treasury's monthly cost of money rates (note a) | | | |
|---|---|---|---|---|
| Year/month | Farm operating (note b) | Farm ownership | Limited-resource farm ownership | Single-family housing |
| | (percentage points) | | | |
| 1982 | | | | |
| April | .375 | (.375) | (.125) | (.375) |
| May | .125 | (.25 ) | (.125) | (.25 ) |
| June | .5 | - | - | .25 |
| July | .25 | (.375) | (.125) | (.125) |
| August | (.25) | (.625) | (.25 ) | (.375) |
| September | .875 | .125 | .125 | .375 |
| October | .75 | .75 | .375 | .875 |
| November | .25 | .125 | .125 | .125 |
| December | 1.0 | .75 | .375 | .75 |
| 1983 | | | | |
| January | - | .125 | - | .125 |

a/Subsidies are shown in parenthesis.

b/These same premiums or subsidies applied to limited-resource farm operating loans, which have an interest rate that is 3 percentage points less than the rate for regular farm operating loans.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

Mr. J. Dexter Peach
Director, Community and Economic
Development Division
General Accounting Office
Washington, D.C. 20548

JUN 28 1983

Dear Mr. Peach:

This replies to the letter of May 20, 1983, from Mr. Lowell Dodge, which transmitted the draft audit report, "Fair and Equitable Interest Rates Are Needed For Farmers Home Administration Loans." The survey period (from June 1981 to March 1982) used in this draft report covers a time of unusual volatility in interest rates and costs of Treasury borrowing. Such volatility tends to exaggerate the impact of lags in the procedures FmHA has been using to set interest rates for its loan programs.

Our comments on the three major recommendations contained in the draft report are as follows:

Recommendation 1: Improvements needed in Rate Review/Decisionmaking Process. GAO recommends that FmHA change rates each month to tie in with the U.S. Treasury cost of funds for similar maturities.

Comments: The authorizing legislation gives the Secretary of Agriculture considerable discretion in the establishment of interest rates for the loan programs based on Treasury cost of funds. For Operating and Farm Ownership loans, the legislation sets a ceiling of Treasury cost of funds plus an add on not to exceed 1 percent. No minimum rate is set in legislation. For Rural Housing Section 502 borrowers a minimum rate is set at Treasury cost of funds, however, no maximum is mentioned. There is no mention of the frequency for changing rates. When the Operating Loan program went to a Treasury cost of funds formula in 1968, rates were set for the fiscal year on the first day of the fiscal year. In the early 1970's, the frequency was changed to semiannual. In 1977, an informal policy of performing rate reviews every month and adjusting rates when rates were out of line was instituted. On May 21, 1981, a formal policy statement on the rate review process was issued, and this has been followed since its issuance. All appropriate data is gathered and reviewed each month. To adjust rates for increments as small as 1/8 of 1 percent each month would have a very adverse effect on FmHA field office and Finance Office operations. When rates are changed, all 2,200 FmHA field offices need to be notified of rate changes prior to the effective date. Farm and home plans and family budgets for loan applicants need to be reworked at the new interest rate. Loans scheduled for closing may need to have the loan closing papers reworked. The Finance Office needs to change computer edit checks to include the new rates. It is impossible to measure all of the intangible effects on a nationwide organization with over 10,000 employees and 2,200 delivery offices of what appears to be a simple change of the originator.

An interest rate review board was established January 17, 1983, to make the decisionmaking process more efficient. FmHA is developing an Request for Proposal (RFP) to establish a portfolio management system. This system will include management and economic data to better quantify the data now used to support rate change decisions. This system will enable the Agency to implement the use of additional quantitative criteria in the rate decision process. At that time the Agency intends to further quantify information used in the rate decision process.

Recommendation 2: Use a 30-year Treasury maturity period rather than a 25-year maturity as the basis for real estate type loans.

Comments: The use of 25-year maturities was established based on the data FmHA had available. Due to the limited resources available for software development, this maturity had not been recently reviewed. GAO states they developed and ran a program to provide current data on the average maturity for each loan program. FmHA would like to receive copies of any supporting computer runs and worksheets GAO has to support the average maturities used in the draft report to be used as part of the analysis the agency would use in making a decision on the use of a 30-year maturity rather than a 25-year maturity. In most months, the use of a 30-year maturity in place of a 25-year maturity would result in no or a very slight change (1/8 or 1/4 percent) in the rate charged FmHA borrowers.

Recommendation 3: Use of the revenue bond index as the basis to establish the rate for community facility loans.

Comments: The description and analysis of facts presented by GAO appears to be generally accurate. However, we do not agree with the conclusion. Additional factors should be considered which justify the policies FmHA has followed.

The Consolidated Farm and Rural Development Act, as amended by the Omnibus Budget Reconciliation Act of 1981, requires that the interest rate on loans for water and waste disposal facilities and essential community facilities be set, "at rates not to exceed the current market yield for outstanding municipal obligations with remaining periods to maturity comparable to the average maturity for such loans." Rates below or at the current market yield for outstanding municipal obligations would comply with the law; rates that exceed the current market yield would not comply.

The current market yield for outstanding municipal obligations is not a clearly established figure. It must be estimated. The Bond Buyer Eleven bond index, used by FmHA to make the necessary estimates, is regularly published and is widely used and recognized by the municipal bond industry.

Some community facility and water and waste disposal loans are evidenced by revenue bonds, some by general obligation bonds, and some by notes or other documents. It is FmHA policy to encourage the use of general obligation bonds to the extent practicable.

It is not a required objective of the programs that loans be made at the least cost to the Government. The main program objective is to help provide needed facilities in communities that cannot obtain financing from the private sector at reasonable rates and terms. It is logical, therefore, to provide loans to eligible applicants at rates similar to the rates available to communities that can obtain favorable private sector loans.

Water and waste disposal loans are often supplemented by grants to bring the debt service costs and resulting user rates down to a level the users can be expected to pay. In some cases, the loan subsidy savings from increasing the loan market interest rate would be offset by an increased need for grant funds.

The report also states that higher interest rates would produce millions of dollars in additional interest income, which could be used to cover the interest subsidies on the intermediate and poverty line interest rate loans. These subsidies are restored to the revolving fund in the annual appropriation act. It would not be feasible to establish an interest rate high enough to cover all subsidies granted. *

For these reasons, we believe the use of the Bond Buyer Eleven bond index, as a guide for establishing the market interest rate on community facility and water and waste disposal loans, is appropriate and should be continued.

Sincerely,

FRANK W. NAYLOR, JR.
Under Secretary
for Small Community
and Rural Development

*GAO COMMENT: It was not our intent to imply that additional interest income would cover <u>all</u> interest subsidies nor do we advocate that the interest rate be set high enough to recover all subsidies.

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