



United States Department of Agriculture

Rural Utilities Service Financial Management of Section 313A Guarantees for Bonds and Notes



Audit Report 09601-0001-11

June 2020

OFFICE OF INSPECTOR GENERAL

Rural Utilities Service Financial Management of Section 313A Guarantees for Bonds and Notes

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OIG evaluated RUS' monitoring and oversight of the Section 313A Program.

OBJECTIVE

Our objective was to determine whether RUS properly monitors and provides adequate oversight of the Section 313A Program.

REVIEWED

We reviewed the laws, regulations, and monitoring processes in place from February 2019 through March 2020 associated with the Section 313A Program. We also interviewed key personnel to understand their roles and responsibilities, as well as selected a non-statistical sample of monitoring reports to review.

RECOMMENDS

We are not making any recommendations.

WHAT OIG FOUND

The U.S. Department of Agriculture (USDA) Rural Utilities Service (RUS) administers and monitors the Section 313A Program. This program allows USDA to guarantee payments on bonds or notes issued by a cooperative or other lender organized on a not-for-profit basis, if the proceeds of the bonds or notes are used to make utility infrastructure loans. Under the Section 313A Program, only two financial institutions are currently eligible to receive guarantees: the National Rural Utilities Cooperative Finance Corporation (CFC) and CoBank. The collateral backing the Government's debt are unencumbered loans made by CFC and CoBank, which are subject to certain quality standards. At the time of our review, the Section 313A Program had obligations of \$8.3 billion.

We determined that RUS properly monitored and provided adequate oversight of the Section 313A Program. Accordingly, we are not making any recommendations in this report, and no further action or response to us is required.



United States Department of Agriculture
Office of Inspector General
Washington, D.C. 20250



DATE: June 23, 2020

AUDIT
NUMBER: 09601-0001-11

TO: Chad Rupe
Administrator
Rural Utilities Service

ATTN: Gary Bojes
Acting Chief Risk Officer
Rural Development

FROM: Gil H. Harden
Assistant Inspector General for Audit

SUBJECT: Rural Utilities Service Financial Management of Section 313A Guarantees for
Bonds and Notes

This report presents the results of the subject review. We are not making any recommendations in this report. No further action by your staff is required.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions. This report contains publicly available information and will be posted in its entirety to our website (<http://www.usda.gov/oig>) in the near future.

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Background and Objective

Background

The Office of Management and Budget's (OMB) passback language requested that we conduct an audit of the Section 313A Guarantees for Bonds and Notes Program's monitoring processes to ensure proper oversight.¹ The program is administered and monitored by the Rural Utilities Service (RUS), one of three major program agencies operating under the U.S. Department of Agriculture (USDA) Rural Development mission area.² RUS was established by public law enacted on October 13, 1994.³ RUS provides infrastructure improvements to rural communities, including electric power and telecommunications services. These services help expand economic opportunities and improve the quality of life for rural residents.

The 2002 Farm Bill authorized the Section 313A Program in Section 313A of the Rural Electrification Act of 1936, as amended in 7 U.S.C. § 940c-1, *Guarantees for Bonds and Notes Issued for Utility Infrastructure Loans*.⁴ The program allows USDA to guarantee payments on bonds or notes issued by a cooperative or other lender organized on a not-for-profit basis, if the proceeds of the bonds or notes are used to make utility infrastructure loans. It also allows USDA to refinance bonds or notes issued to a borrower that has received, or is eligible to receive, a loan under this chapter, if the bonds or notes were issued for utility infrastructure loans. The Section 313A Program is implemented by regulations in 7 Code of Federal Regulations (C.F.R.) § 1720, which includes regulations governing lender reporting requirements.

Under the Section 313A Program, only two financial institutions are currently eligible to receive guarantees: the National Rural Utilities Cooperative Finance Corporation (CFC) and CoBank. The collateral backing the Government's debt are unencumbered loans made by CFC and CoBank, which are subject to certain quality standards. The total loan portfolio for the Section 313A Program consists of CFC's \$7.8 billion in outstanding obligations and CoBank's \$500 million in outstanding obligations.

CFC's principal purpose is to provide its members with financing to supplement the loan programs administered by RUS. CFC is a member-owned cooperative incorporated in the District of Columbia in April 1969 as a Section 501(c)(4) tax exempt organization. Leading up to CFC's formation in 1969, there was a growing need for capital for electric cooperatives to build new electric facilities due to growth in rural America. The cooperatives formed CFC so an additional source of financing would be available to supplement other loan programs and to mitigate the uncertainty of Government funding. As a cooperative, CFC is owned by and exclusively serves its members, which consist of not-for-profit entities/subsidiaries or affiliates of not-for-profit entities. As a member-owned cooperative, CFC's objective is not to maximize

¹ The passback is OMB's formal communication to Federal agencies regarding their budget and also may include, among other things, program policy changes and personnel ceilings.

² Rural Housing Service and Rural Business-Cooperative Service are the other two major program agencies.

³ Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, Pub. L. No. 103-354, 108 Stat. 3178.

⁴ Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134-540 (2002 Farm Bill). This Act includes 7 U.S.C. § 940c-1, "Guarantees for bonds and notes issued for electrification or telephone purposes."

profit, but rather to offer members cost-based financial products and services. CFC operates from its corporate headquarters in Dulles, Virginia.⁵ CFC is guided by 23 board members who represent 10 geographically defined districts, an at-large financial expert from a member electric system, and two representatives of the cooperative network's national trade association. Comprised exclusively of electric cooperative directors, trustees, and executives, the board sets overall policy, establishes programs, and develops strategies for CFC.⁶

CoBank is a national cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing, and other financial services to agribusinesses and rural power, water, and communications providers in all 50 States.⁷ CoBank is Federally chartered under the Farm Credit Act.⁸ The bank is a mission-based lender with the authority to make loans and provide related financial services to eligible borrowers in the agribusiness and rural infrastructure industries, and to certain related entities, as defined by the Farm Credit Act. CoBank is not authorized to accept deposits to fund its operations. Instead, it raises funds primarily by issuing debt securities through the system's agent, the Federal Farm Credit Banks Funding Corporation. The bank is cooperatively owned by its customers. Its customers consist of: agricultural cooperatives; other food and agribusiness companies; rural power, communications, and water cooperatives and companies; rural community facilities; Agricultural Credit Associations, which are regulated; farmer-owned financial institutions and members of the Federal Farm Credit Banks Funding Corporation; and other businesses that serve agriculture and rural communities. CoBank provides a broad range of loans and other financial services through three operating segments: Agribusiness; Farm Credit Banking; and Rural Infrastructure. Its headquarters is located outside Denver, Colorado, and it serves customers from regional banking centers across the country.⁹

In accordance with OMB Circular A-129 and as a result of the Agricultural Act of 2014, in 2015, RUS formed the Intensity Team to perform additional monitoring to include reviewing collateral and financial reports on a quarterly and annual basis.^{10, 11} The Intensity Team works jointly to review the Section 313A Program. It is comprised of personnel from several Rural Development disciplines, including RUS employees, Rural Development's Office of the Chief Financial Officer, and the Office of the Chief Risk Officer, as well as a representative from USDA's Office of the General Counsel. Each quarter, and prior to approving any loan advances, the Intensity Team reviews the list of collateral to ensure the notes meet the requirements set forth in the bond and pledge agreements. In addition, they conduct onsite bank collateral reviews to confirm that the collateral list matches the notes in the vault.

⁵ CFC, *Form 10-K 2018*, <https://www.nrucfc.coop/content/nrucfc/en/investor-relations/financial-reporting.html> (last visited May 5, 2020).

⁶ CFC, *Annual Report 2019*, <https://www.nrucfc.coop/content/nrucfc/en/investor-relations/financial-reporting.html> (last visited May 5, 2020).

⁷ CoBank, *About Us* (May 6, 2020), <https://www.cobank.com/corporate/about>.

⁸ Farm Credit Act of 1971, Pub. L. No. 92-181, 85 Stat. 583. This Act is subject to supervision, examination, and report of condition by an independent Federal agency, the Farm Credit Administration.

⁹ CoBank, *Annual Report 2019*, <https://www.cobank.com/corporate/financial> (last visited May 6, 2020).

¹⁰ OMB, *Policies for Federal Credit Programs and Non-Tax Receivables, Appendix C Management and Oversight Structures*, Circular A-129, Appendix C (January 2013).

¹¹ Agricultural Act of 2014, Pub. L. No. 113-79, 128 Stat. 649 (2014 Farm Bill).

Objective

Determine whether RUS properly monitors and provides adequate oversight of the Section 313A Program.

Section 1: Determination that Rural Utilities Service Properly Monitors and Provides Adequate Oversight of the Section 313A Program

As requested by OMB, the Office of Inspector General (OIG) reviewed RUS' monitoring and oversight processes for the Section 313A Program. We reviewed the laws, regulations, and monitoring processes in place from February 2019 through March 2020 and determined RUS properly monitored and provided adequate oversight of the Section 313A Program. At the time of our review, the Section 313A Program had obligations of \$8.3 billion.

The Intensity Team performs oversight of the Section 313A Program, as detailed in bond guarantee and pledge agreements with the borrowers.^{12, 13, 14} These agreements outline the borrower's security and collateral requirements in order to ensure RUS is properly protected from potential losses. The monitoring procedures include: site visits to the borrower's headquarters; annual meetings to discuss the borrower's financial condition for the most recent fiscal year; copies of existing indentures for the borrower's Collateral Trust Bonds; and observation of the borrower's internal audit site visits to the collateral agent's office.

The Intensity Team monitors pledged collateral quarterly, annually, or every time there are changes in the pledged collateral. This collateral represents loans that CFC or CoBank make to borrowers, which are then used as collateral for guarantees issued by RUS. The pledged collateral represents loans from CFC or CoBank's entire portfolio of loans, not just those made as part of the Section 313A Program. Monitoring helps ensure that these notes and bonds are not classified by the borrower as non-performing, impaired, unsecured and/or short-term, or are not restructured loans.¹⁵ The pledged collateral is required to be valued at 100 percent of RUS' total exposure; however, the target is pledged collateral near 110 percent in case a borrower loan is not performing.¹⁶ Further, no borrower is permitted to represent more than 5 percent of the total collateral in a lender's portfolio, to limit the concentration risk of any single borrower as well as the overall impact to the portfolio of collateral.

¹² A guarantee agreement is the written agreement between the Secretary and the guaranteed lender that sets forth the terms and conditions of the guarantee. A guaranteed bond is any bond, note, debenture, or other debt obligation issued by a guaranteed lender on a fixed or variable rate basis and approved by the Secretary for a guarantee under the regulations.

¹³ Based on guidance outlined in Section 313A of the Rural Electrification Act of 1936, Pub. L. No. 74-605, 49 Stat. 1363, as amended (the RE Act) and the regulations promulgated thereunder, as set forth in 7 C.F.R. § 1720.

¹⁴ As delineated in the definition section of the pledge agreement, the pledge agreement means the agreement as originally executed and as it may from time to time be supplemented, restated, or amended.

¹⁵ A loan is non-performing when payments of interest and/or principal are past due by 90 days or more, or payments are less than 90 days past due, but there are other good reasons—such as a debtor filing for bankruptcy—to doubt that payments will be made in full. Alternatively, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. A note or bond is unsecured when it is not secured by collateral greater than or equal to the outstanding amount of debt owed by the debtor to the borrower. Finally, a restructured loan is a new loan that replaces the outstanding balance on an older loan, generally over a longer period of time with a lower installment amount in order to accommodate a borrower in financial difficulty, and thus avoid default.

¹⁶ *Sixth Amended, Restated and Consolidated Pledge Agreement*, Section 2.03 (b) (Feb. 13, 2020).

Bond guarantee and pledge agreements provide the framework for the Intensity Team's quarterly and annual monitoring procedures, which ensure RUS adequately monitors the Section 313A Program. To perform quarterly reviews, the team obtains and reviews: financial statements filed quarterly with Form 10-Q with the U.S. Securities and Exchange Commission (SEC); the most recent credit assessment and rating of the borrower issued by a rating agency; and other information as is reasonably requested by the Secretary.^{17, 18}

The annual review includes the elements of the quarterly review, as well as review of:

- Any audited financial statements, as filed annually with Form 10-K with the SEC;
- An annual certificate of pledged collateral for the fiscal year;
- A receipt from the collateral agent for the pledged collateral held at the end of the fiscal year; and
- A projection of the borrower's balance sheet, income statement, and statement of cash flows projected out five years, pro forma assuming the full principal amount of the bond is advanced.

In addition to the financial and collateral reviews, the Intensity Team performs a Condition of Records Review in accordance with RUS staff instruction, which is part of the loan application process.¹⁹ The Condition of Records Review includes a summary of the Intensity Team's review of the quarterly and annual financial review and credit ratings. The Loan Fund and Accounting Review is another review conducted at the borrowers' headquarters by the Intensity Team every other year.²⁰ The Loan Fund and Accounting Review includes a summary of the scope of the review to include: testing compliance with the Rural Electrification Act; testing compliance with 7 C.F.R. 1720; testing compliance with covenants of the bond guarantee agreements; and testing compliance with covenants of the pledge agreements.

We determined RUS properly monitored and provided adequate oversight of the Section 313A Program. Further, we determined that the Intensity Team's approach to using the bond guarantee and pledge agreements as written policies and procedures was reasonable and that the additional reviews, as noted above, provide another level of oversight to the 313A Program. Accordingly, we are not making any recommendations in this report, and no further action or response to us is required.

¹⁷ The Federal Financing Bank also performs a review, which is submitted to RUS as well.

¹⁸ 7 C.F.R. § 1720.12(a)(1-6).

¹⁹ Staff Instruction 1710-1, *Processing Electric Loans to Distribution Borrowers* (May 8, 2002).

²⁰ Staff Instruction 1700-6, *Loan Fund and Accounting Review* (June 17, 1998). RUS provides periodic training for these reviews and is currently in the process of updating this guidance, with an estimated completion date of September 30, 2020.

Scope and Methodology

We conducted an audit of RUS' monitoring of Section 313A Guarantees for Bonds and Notes, and reviewed documentation from RUS' National office in Washington, D.C. Our audit covered a sampling of oversight activities performed from February 2019 through March 2020 for the \$8.3 billion in obligations at the time of our review. We performed fieldwork between February and April 2020.

To accomplish our objectives, we:

- Reviewed applicable laws and regulations related to the Section 313A Program;
- Interviewed key personnel to gain an understanding of their roles and responsibilities relating to the monitoring of the program;
- Selected and reviewed a non-statistical sample of monitoring reports, including both financial and collateral reviews;
- Ascertained the adequacy and effectiveness of RUS' oversight of the Section 313A Program; and
- Discussed the results of our fieldwork with relevant Department and agency officials.

As mentioned above, our audit covered a sample of reviews from February 2019 through March 2020. We non-statistically selected two quarter-ends, as well as the most recent fiscal year-end available, to review both the financial and collateral reviews. In total, we reviewed six financial reports—three for each entity—and five collateral reports: one for CoBank and four for CFC, as it represents the vast majority of the advanced amount. We evaluated RUS' monitoring to ensure that RUS complied with oversight guidelines as set forth in the bond and pledge agreements and C.F.R. guidance. This oversight included a review of entity financial statements, credit assessments by rating agencies, and whether the pledged collateral met appropriate thresholds. Additionally, we reviewed CFC's most recent Condition of Records Review and Loan Fund Accounting Review. We ensured RUS' monitoring met the standards outlined in C.F.R. guidance and Departmental instructions, as well as the bond and pledge agreements. For the 13 monitoring reports we reviewed, no issues were noted, and we determined RUS properly monitored and provided adequate oversight of the Section 313A Program.

During the course of the audit, we obtained and reviewed information from the Rural Development Commercial Loan Servicing System. Aside from using this system to obtain the universe and support for the collateral reports, we did not solely rely on or verify information in any agency information system. We also make no representation regarding the adequacy of any agency computer system, or the information generated from it, because evaluating the effectiveness of information systems or information technology controls was not one of the audit's objectives.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusion based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusion based on our audit objective.

Abbreviations

CFC	National Rural Utilities Cooperative Finance Corporation
C.F.R.	Code of Federal Regulations
OIG	Office of Inspector General
OMB	Office of Management and Budget
RUS	Rural Utilities Service
SEC	U.S. Securities and Exchange Commission
USDA	U.S. Department of Agriculture

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