FOREIGN MILITARY SALES (FMS) LOAN FINANCING

by

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During recent months, DISAM has received numerous inquiries concerning the FMS Financing Program. Recent DISAM Newsletters have contained articles regarding FMS loan financing. For example, Dr. Louis J. Samelson discussed FY 82 Security Assistance Legislation in the Spring 1982 issue of the Newsletter, and Mr. Jerome H. Silber (DSAA) discussed Loan Guaranties under The Arms Export Control Act in the Winter 1981-82 issue. The purpose of the present article is to provide a synopsis of FMS loan financing and selected policies and procedures as obtained from various memorandum in the field [such as the Military Assistance and Sales Manual (MASM), Part III, Chapters E and G] and from discussions with the DSAA Financial Reports and Credit Program Division (FR&CPD), Credit Program Branch, and various other organizations.

The FMS Financing Program has grown considerably since its inception. As each year's authorization and appropriation acts are passed by Congress and signed by the President, the FMS Financing Program continues to increase in dollar amount, in number of countries involved, and in complexity. During the 20-year period from FY 1955 to FY 1975, the total value of FMS credit extended was $5.8 billion. In FY 1981 the Administration extended FMS credit in the amount of $3.0 billion and $3.8 billion was approved for issuance in FY 1982. For FY 1983, the President has requested approximately $5.7 billion.

The Arms Export Control Act

Section 1 of the Arms Export Control Act (AECA) states:

> . . . it remains the policy of the United States to encourage regional arms control and disarmament agreements and to discourage arms races. The Congress recognizes, however, that the United States and other free and independent countries continue to have valid requirements for effective and mutually beneficial defense relationships in order to maintain and foster the environment of international peace and security essential to social, economic, and political progress. Because of the growing cost and complexity of defense equipment, it is increasingly difficult and uneconomic for any country, particularly a developing country to fill all of its legitimate defense requirements from its own design and production base.

Section 23 of the AECA states: "The President is authorized to finance procurements of defense articles, defense services, and design and construction services by friendly foreign countries and international organizations . . . ." Loans financed under the authority of Section 23 are commonly called Direct Loans.

Section 24 of the AECA states:

> The President may guarantee any individual, corporation, partnership, or other judiciary entity doing business in the United States (excluding United States Government agencies other than the Federal Financing Bank) against political and credit risks of nonpayment arising out of their financing of credit sales of defense articles, defense services, and design and construction services to friendly countries and international organizations.

Loans financed under authority of Section 24 are commonly called Guaranteed Loans.

Section 31 of the AECA concerns the authorization and ceiling on FMS credits. For example, Section 31 of the AECA, as amended by Public Law 97-113 (International Security and Development Cooperation Act of 1981), indicates that the total amount of credits extended under Section 23 (Direct Credit) is not to exceed $800 million in either FY 1982 or FY 1983. Congress authorized $800 million to be appropriated each FY with the stipulation that not less than $550 million be available to Israel, $200 million to Egypt and $50 million to Sudan. Congress also stated that the total principal amount of loans guaranteed under Section 24 (Guaranteed Credit) should not exceed $3,269,525,000 for FY 1982 and the same level for FY 1983. For FY 1982, Congress has appropriated Israel's and Egypt's authorization but not Sudan's. During recent years, Congress also has identified minimum Guaranteed Credit amounts for a few countries, and has further stipulated that loans to certain countries shall be repaid in not more than 20 years following a grace period of ten years on repayment of principal. Section 31 also requires a minimum Guaranty Reserve of $750 million to cover borrower defaults on repayments of Guaranteed Loans. If the Reserve should fall below $750 million, the President is required to notify Congress and request additional appropriations.

The Congressional Presentation Document

Each fiscal year the President submits to Congress a Congressional Presentation Document (CPD) indicating, among other things, the size of the FMS loan financing program he desires and the countries that are to participate in the program. The CPD identifies by region and by country the proposed Direct Credit and Guaranteed Credit desired for a given fiscal year. For example, the FY 1983 CPD (submitted to Congress in mid-April 1982) identified 41 countries for FMS financing. Of the 41 countries listed, 12 would participate in both Guaranteed and Direct Credit programs, nine would participate in a Direct Credit program only, and 20 countries would participate in the Guaranteed Credit program only.

Policies and Procedures Applicable to all Loans

Basic responsibilities and functions of the agencies involved in the FMS Financing Program are indicated in Chart 1. After the Department of State has approved a loan and notified the Department of the Treasury and the Office of Management and Budget (OMB), the OMB issues an apportionment to the DSAA Financial Reports and Credit Program Division (FR&CPD). The FR&CPD implements and manages both Direct Loans and Guaranteed Loans. For Direct Loans the FR&CPD prepares the loan agreement, obtains signatures, disburses loan funds, bills the borrower, and collects loan payments. For Guaranteed Loans, the FR&CPD issues a Guaranty Agreement to the Federal Financing Bank (FFB), and the FFB prepares the loan agreement, obtains signatures, disburses loan funds, bills the borrower, and collects loan payments.

In response to DD Form 1513 initial deposit requirements, Security Assistance Accounting Center (SAAC) quarterly billing statements and commercial invoices, the borrower requests FR&CPD approval of loan disbursements. The borrower must provide the FR&CPD copies of commercial invoices in order to obtain approval for disbursements to commerical suppliers.

Three authorizations are required from borrowing nations before a loan agreement may be signed and before disbursements may be processed against a loan. The borrower must provide authorization for a designated person to sign the loan agreement, a designated person to sign the Promissory Note, and a designated person(s) to sign requests for disbursements.

Borrowers may use FMS loans to purchase defense items of U.S. origin from either U.S. Military Departments or from U.S. commercial suppliers.

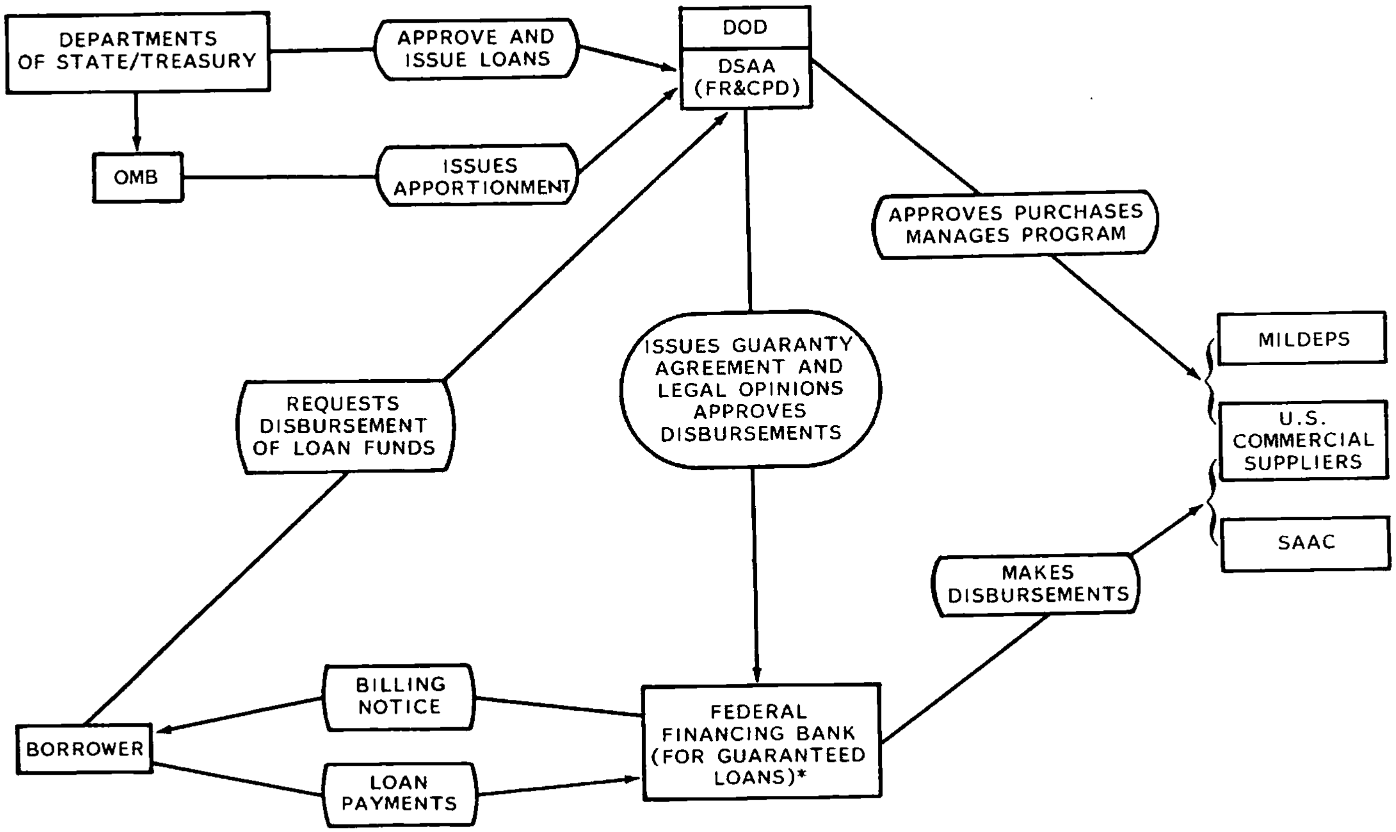
The MASM, Part III, Chapter E, paragraph 6, discusses utilization of FMS loans. Basically, USG policy is that loans issued under the AECA are used to finance only major items, initial spare parts, and training programmed with the introduction of a new or improved capability. Loans are not intended to finance current operating costs. Special circumstances occasionally arise which justify exceptions to this policy; such exceptions require interagency (field activity, Chief of Mission, Department of State, and DoD) coordination and clearance prior to a decision by, or under the authority of, the Under Secretary of State for Security Assistance.

All purchases financed by FMS loans must be approved in advance by DSAA. DSAA "reserves" funds from the loan for subsequent payment to suppliers and for transportation, as necessary.

Borrowers are billed semi-annually for repayment of their FMS loans. Billings are submitted 30-45 days before the due date. Loans are considered in default when overdue payments remain unpaid for ten days or more. All arrearages of 90 days or more are reported to Congress.

Two basic types of financing procedures are used to carry out the total FMS Financing Program. DoD can make Direct Loans funded to 100 percent of the loan payment by budget authority appropriated annually by Congress. The collections from the repayment of these loans are deposited into a Miscellaneous Receipts Account of the U.S. Treasury.

FMS FINANCING PROGRAM
BASIC RESPONSIBILITIES AND FUNCTIONS



*For Direct Loans, DSAA disburses loan funds, bills the borrower and collects loan payments.

CHART 1

Loans extended through the Federal Financing Bank (FFB) which are guaranteed by DSAA against political and financial risks are considered off-budget loan programs. Guaranties may require the obligation of security assistance appropriations (on budget) to maintain an adequate reserve in the Guaranty Reserve Fund. The obligated funds deposited into the guaranty reserve account act as a reserve against claims under guaranty provisions of the loans (generally the payment of rescheduling actions or temporary defaults).

The following paragraphs discuss in greater detail the various programs identified in the AECA, the FY 1982 Authorization Act, the FY 1983 CPD, and the MASM.

AECA, Section 23, Direct Loans

This type of financing utilizes U.S. Government appropriated funds for direct government-to-government loans. Direct Loans require an appropriation of funds equal to the total principal amount being loaned. After the authorization and appropriation acts have been signed into law and released to the Department of State, DSAA is authorized to notify the countries concerned and to coordinate preparation of a loan agreement. The loan agreement format is specified by DSAA and signed by the Director of DSAA and the borrower's representatives.

The Direct Loan agreement delineates conditions under which the loan is offered and accepted and contains four annexes concerning: (1) procedures for the borrower to follow in processing disbursements to commercial suppliers; (2) a sample of a Promissory Note; (3) the principal repayment schedule; and (4) marine transporation waiver procedures. Since FY 1977, Direct Loan agreements require one Promissory Note for the entire amount of the loan agreement. The note is signed when the loan agreement is signed. Individual disbursements of loan funds are requested through use of a form letter. Normally the amount of the loan is divided into an equal number of semi-annual installments, and payments of principal and interest are made directly to DSAA. Because of various USG laws, the loan agreement requires that all defense articles purchased with loan funds, and needing transportation by ocean vessel, must be shipped on vessels of U.S. registry. A waiver may be granted by the Director, DSAA, allowing the borrower to transport as much as 50 percent of the cargo on vessels flying the borrower country's flag. The MASM, Part III, Chapter N, Figure N-2, describes marine transportation waiver procedures. Whenever a waiver is granted, the Department of Commerce, Maritime Administration, in conjunction with DSAA, closely monitors shipments through Freight Forwarders to ensure compliance with the waiver agreement.

Direct Loan Agreements must be signed in the fiscal year in which they are authorized. Funds must be committed within two years of loan signature date (commitment period). In other words, Direct Loan funds must be reserved for approved purchases prior to the expiration of the commitment period. Actual disbursements may continue to be made after the expiration date.

Direct Loans have a fixed interest rate based on the average cost of money to the USG on the last day of the month preceding the month in which the loan agreement is signed. This single interest rate is applied to each loan disbursement throughout the life of the loan. The AECA, Section 37 (Fiscal Provisions Relating to Foreign Military Sales Credits), para (b) advises that amounts received from foreign governments and international organizations as repayments for Section 23 credits, shall be transferred to a Miscellaneous Receipts Account of the U.S. Treasury.

AECA, Section 24 Guaranteed Loans

Guaranteed Loans are issued by the Federal Financing Bank (FFB) (an instrumentality of the USG under the general supervision and direction of the Secretary of the Treasury) after the authorization act and the appropriation act are signed into law and financing program limits are passed to the Department of State, DSAA, and the countries concerned. FFB loans are executed on a loan agreement format specified by the FFB, and are signed by FFB officials and the borrower's representatives.

The basic loan agreement contains the conditions under which the loan is offered and accepted and contains three annexes concerning: (1) the Promissory Note; (2) procedures to be used by the borrower to request advances of funds; and (3) marine transportation waiver procedures. Procedures for the borrower to follow in processing disbursements to commercial suppliers are contained in an exhibit.

As in Direct Loans, one Promissory Note is signed at the time the loan agreement is signed, and a form letter is used by the borrower for withdrawals. The borrower must make principal and interest payments directly to the Federal Reserve Bank of New York for the account of the FFB. The MASM, Part III, Chapter E, paragraphs 8 and 9 contain a comprehensive review of FFB credit procedures.

Guaranteed Loan Agreements must be signed in the fiscal year in which they are authorized. Normally all loan funds must be disbursed within two years after the date of the loan. However, occasionally the borrower has requested and was granted an extension to the two year disbursement period.

Since the FFB loan is guaranteed by a USG agency (DSAA), a Guaranty Fee is assessed. The fee is a one-time payment equal to 1/4 of 1% of the principal amount and must be paid to the Guarantor (DSAA) out of borrower's funds at the time the loan is signed. The Fee is deposited into a Miscellaneous Receipts Account of the U.S. Treasury.

A separate rate of interest is determined for each advance of funds from a FFB loan. The interest charged by the FFB is based on paragraph 6(b), P.L. 93-224, the statutory authority establishing the Bank, which states:

> (b) Any purchase by the Bank shall be upon such terms and conditions as to yield a return at a rate not less than a rate determined by the Secretary of the Treasury taking into consideration (1) the current average yield on outstanding marketable obligations of the United States of comparable maturity, or (2) whenever the

Bank's own obligations outstanding are sufficient, the current average yield on outstanding obligations of the Bank of comparable maturity.

Accordingly, the interest rate charged by the FFB is based on the cost of money to the USG, plus a fractional percentage which is required to cover FFB administrative costs (currently 1/8 of 1 %). The cost of the money to the USG is determined daily through a computer analysis which develops a computed interest rate from the latest yield curves on treasury obligations, projected new issue curves or marketable U.S. Treasury securities, and the specific repayment schedule and terms of the proposed FMS loan.

The sum of the computed interest rate and the fixed percentage for administrative costs becomes the interest rate charged by the FFB to the borrower. This is a fixed rate of interest which is determined, utilizing the method just described, for each advance of funds as of the date of the advance. It is applicable only to the loan or advance being made and for that one day. By law, the FFB cannot reduce the computed interest rate. After all disbursements have been made against a loan, a single weighted average interest rate is established for application on the outstanding principal.

The Guaranty Reserve Fund, administered by DSAA, is used to guarantee FMS loans extended by the FFB and other commercial lending institutions, if applicable. (Since FY 1974, guaranties have been issued only to the FFB). For example, DSAA must pay the FFB upon demand any scheduled repayment of FMS guaranteed loans which is more than ten days overdue. On 16 December 1980, Congress legislated that the Guaranty Reserve Fund shall be maintained at not less than $750 million. The Fund operates as a revolving fund. DSAA makes payments, as necessary, from the fund to the FFB, and collections from the borrower are re-deposited to the fund. Section 37, para (c) of the AECA (Fiscal Provisions Relating to Foreign Military Sales Credits), advises that amounts received from a foreign government after the date of a payment by DSAA to the FFB, with respect to such claim, shall be credited to the reserve fund and shall be available for any purpose for which funds in such reserve are available. Prior to 16 December 1980, Congress appropriated ten percent of the annual FMS guaranteed loan program to the reserve fund. This was apparently more than needed, and subsequently there has been no requirement for an appropriation to maintain the $750 million base. It is expected that "surplus" funds in the reserve are sufficient to meet requirements through FY 1983.

If the borrower becomes delinquent in a payment to the FFB and such payment remains unpaid for 60 days or more, a late charge (often referred to as a "penalty fee") of 4 percent is assessed against the overdue amount. The "penalty Fee" is deposited into a Miscellaneous Receipts Account of the U.S. Treasury. Further, if a country remains in arrears for a period in excess of one year, security assistance may be suspended (Section 517, PL 97-121).

Exceptions to Normal Direct/Guaranteed Credit Loan Policies and Procedures

During recent years, Israel has been authorized $500 million in Direct Credit. In FY 1982, the authorization for Israel was increased to $550 million and Egypt was authorized $200 million. Repayment (of principal and interest) on these loans is waived. Loan agreements, including payment schedules, are drawn up, but each agreement contains an enclosure waiving payment. These loans commonly have been called "Forgiven Credit." The President has requested a total of $950 million for Israel, Egypt, and Sudan for Direct Credit in FY 1983 repayment for which would be waived.

Congress has also granted longer repayment terms for Guaranteed Loans to a few countries. Conventional FFB terms generally require a repayment of FMS loans within 4-8 years, following a 1-2 year grace period. The AECA mandates a maximum of 12 years for Direct Loans but does not specify a maximum repayment period for Guaranteed Loans. The Department of State has used the AECA as a guideline for Guaranteed Loans as well because of the accepted belief that the legislative history reveals Congress' intent in this direction. Repayment terms of 20 years following 10 years of grace on repayment of principal have been extended only upon express statutory direction and then only for very few countries. However, interest must be paid on loan funds disbursed during the grace period and the repayment of principal plus interest is required during the subsequent 20 years. These loans have often been called thirty-year loans.

FY 1982 Military Assistance Program Grants

The FY 1982 Administration request for authorizations of appropriations included $981.8 million for FMS credits to 15 countries and one regional program at reduced interest rates. The loans would be made available in the form of Direct Credit, and the plan was to offer the loans at a "concessional" rate of interest as low as three percent. The countries selected were those facing particularly difficult economic situations and in which the USG has important security and foreign policy interests.

Congress did not go along with the Administration proposal. Actual FY 1982 appropriations approved by Congress for the grant Military Assistance Program (MAP) included $138 million to be employed as MAP grants to selected countries in lieu of the "concessional" direct credits. These MAP funds were made available to supplement Guaranteed Loans. However, articles, services, etc., are being purchased under the FMS program and therefore are not subject to the rules governing MAP accountability.

The Foreign Assistance Act (FAA), Section 503, (A),(3) amendment provided authority to transfer FY 1982 MAP funds for current recipient countries (13 countries and one region) to the FMS Trust Fund and to merge such MAP funds with country FMS funds. The FAA section further provided that merged funds were to be used solely to meet obligations of the recipient country for payment for sales under the AECA. Release of the MAP funds for specific recipients has been initiated by the Department of State through interagency action on a country-by-country basis as accomplished in the FMS Financing Program.

Upon receipt of MAP funds for a specific country, the FR&CPD reviews the country's arrearage status against existing cash sales on a one time basis and, if necessary, applies the MAP funds to liquidate arrearages. If there are no arrearages, and the country has a total annual military assistance financing program of $50 million or more (excluding the value of ESF, IMET and FAA 1961, Section 506(a) - Presidential emergency drawdowns), commitment of funds will comply with the pari passu (proportionate, equal rate) policy. Commitment of funds is managed in such a way that disbursements of grant funds (including Forgiven Loans) will not occur at a rate proportionately faster than the FMS credit Guaranteed Loan portion of the program for any fiscal year.

Procedures are presently being formulated by DSAA as to how the FY 1982 MAP funds will be applied and disbursed for those countries with a total annual military assistance financing program less than $50 million.

DSAA has two years to obligate the MAP funds, but expects to have it all obligated in FY 1982. The amount of funds available to the various recipients vary from $300,000 to $57 million, with the majority in the $1 million to $10 million range.

Direct Loans at "Concessional" Rates of Interest

Many potential security assistance recipients are not financially able to cope with credits on FFB terms, either in part or in full. In fact, situations have arisen where countries have not accepted loans because of high interest rates. In an attempt to recognize the different needs and different economic situations among countries that receive USG financial assistance, the Administration has requested $789 million in the FY 1983 CPD to be provided under Direct Loan "concessional" interest rates. As noted previously, Congress rejected a similar proposal in FY 1982 and substituted the aforementioned MAP grants. If approved for FY 1983, "concessional" interest rates could range as low as three percent. Prevailing economic conditions (ability to pay) in the borrowing countries might be factored to determine the actual rate charged for a specific credit program. It appears the Administration prefers this approach over the outright grants which Congress appropriated in FY 1982.

DSAA, Financial Reports and Credit Program Division, Credit Program Branch

The Financial Reports and Credit Program Division (FR&CPD) provides fiscal accounting and reporting for all DSAA managed security assistance programs. The Credit Program Branch issues Direct Loans and administers the implementation of both Direct and Guaranteed Loans after they are signed. There are three accounting technicians in the Branch responsible for the 40 plus country credit programs. The Credit Program Branch monitors implemented loan data through a computer system and various hard copy reports. Information provided by these reports includes total credit authority, disbursement authority, Promissory Notes outstanding, unexpended funds, interest rate, loan signature date, drawdown expiration date, overdue payments, guaranty fee, principal repaid, interest paid, case disbursements, payment schedule, payment history, and the amounts of interest and principal due on the next due date. Loan data is available on request. However, the Credit Program Branch is unable to make automatic distribution of its reports.

Closed FMS Cases

All excess funds from closed FMS cases, financed by DoD Direct or Guaranteed Loans are reported by SAAC to the DSAA, Financial Reports and

Credit Program Division (FR&CPD). If an FMS case has been financed with both credit and cash, it is assumed that the credit funds were disbursed first and any excess funds would be considered cash available to the purchaser. Since excess credit funds cannot be refunded to the purchaser they may be applied to other FMS cases after approval by the DSAA, FR&CPD.

SUMMARY

In summary, it is readily apparent that the FMS Financing Program is a growing program. Not only are there two basic types of financing procedures (Direct and Guaranteed Loans), but during recent years there has been a number of waivers to existing policy and procedures and various other financing plans have been introduced. DISAM will continually provide current information regarding the progress of legislation and program implementation through future issues of the DISAM Journal. Hopefully, this article has provided insight to the total FMS Financing Program.

ABOUT THE AUTHOR

Mr. Clive D. Luckenbill has been a member of the DISAM faculty since 1977, and specializes in the financial aspects of security assistance management. He holds a Master of Arts degree (Management and Supervision: Logistics Management) from Central Michigan University, and is a retired Air Force Lieutenant Colonel with extensive management and staff experience within the Air Force Logistics Command and the Joint Logistics Commanders.