FMS Financing and the Guaranty Reserve Fund: A Report

Prepared by

Office of the Comptroller
Defense Security Assistance Agency

[The following is a report furnished to Congress by the Administration on 15 November 1985. The report responds to a statutory requirement (Sec. 106, P.L. 99-84) for information covering the history of the U.S. Foreign Military Sales Financing Program, the status of the Guaranty Reserve Fund (GRF), and recommendations for replinishment of the GRF. The entire report, less the statistical annex, is reprinted herein.]

This report has been prepared in response to the requirement in Section 106 of the International Security and Development Cooperation Act of 1985. The purpose of the report is to provide information on the history of the FMS financing program together with a status report on the Guaranty Reserve Fund (GRF) and specific recommendations for its replenishment. The report traces the legislative background of the FMS financing program, the economic developments that have had an impact on the program over the 30 years since its inception, the workings of the Guaranty Reserve Fund and various replenishment options.

History of FMS Financing. Immediately after World War II the United States began providing peacetime military assistance to friends and allies to achieve both military and political objectives. While there has been no change in the basic objectives of the program, its nature and scope have changed over time in response to changes in worldwide political and economic conditions. Currently there are two programs available to assist friends and allies in purchasing U.S. defense equipment and services. These are the Foreign Military Sales (FMS) Credit program and the Military Assistance Program (MAP). Over the years, each of these programs has undergone considerable change.

The Mutual Defense Assistance Act of 1949 authorized the creation of the Military Assistance Program to improve the defense of NATO allies and other friendly countries. The MAP program at that time was viewed primarily as a complement to the economic aid program that was created under the Marshall Plan. Although MAP defense equipment and services were intended to be provided on either a loan or grant basis, in fact, until about 1970 most were furnished on a grant basis.

The first FMS loan was extended in 1955 and from that year until 1965 the program was essentially a direct loan program. Direct loans financed with MAP funds were made to various countries with the loan agreements being administered by the Export-Import Bank. FMS loans extended during this period provided for repayment terms of up to ten years at varying interest rates. An amendment to the Mutual Security Act of 1954 further provided that repayments within three years would be credited to the current applicable MAP appropriation and used for additional loans without further Congressional action. This in effect created an FMS Credit revolving fund.

Upon enactment of the Foreign Assistance Act of 1961, the three-year repayment limitation was removed and all FMS credit repayments were credited to the revolving fund.

With the passage of the Foreign Assistance Act of 1964 the scope of the FMS Credit program was extended to include the issuance of loan guaranties. Over the next two or three years, guaranties were issued by the Department of Defense to cover loans issued by the Export-Import Bank, private financial institutions, and U.S. suppliers for direct commercial sales. The authority to issue guaranties for Export-Import Bank loans was terminated by Congress as of June 30, 1968, and the revolving fund was slated for liquidation at the same time.

The direct and guaranty loan programs were continued after 1968 under the Foreign Military Sales Act later renamed the Arms Export Control Act. Direct loans were made on a government-to-government basis without the revolving fund feature. Guaranty loans continued to be made through private financial institutions and suppliers who made direct commercial sales. The borrowing country negotiated the terms of guaranty loans with the lender; however, as a matter of policy the U.S. Government did not sanction floating rate loans. In those instances where concessional interest rates were appropriate, direct loans were used.

In 1973, the Congress established the Federal Financing Bank (FFB) in order to centralize control of the debt issuances of government agencies. One of the main objectives of the establishment of the FFB was to reduce the disparity between the yields of loans of government agencies and those issued by the U.S. Treasury. At the same time, the Defense Security Assistance Agency (DSAA) discontinued the practice of directly guaranteeing loans with private institutions, electing instead to work exclusively through the FFB on the guaranty loan program.

From the inception of the guaranty loan program in 1964 until 1980, funds used to guarantee loans were maintained in a segregated reserve within the MAP account (and after 1968, in the Foreign Military Sales Credit appropriation account). The reserve subaccount was capitalized by obligation of a portion of the annual appropriaton equivalent to 25% of the principal amount of the guaranties issued during the current fiscal year. These obligations allowed the reserve account balance to rise in proportion to the outstanding guaranty liability.

In those instances where guaranty loan payments were missed, DSAA, as guarantor, would disburse funds from the reserve subaccount to satisfy guaranty claims and was subrogated to the rights of the lender to collect the corresponding missed payments from the borrower. When a missed payment was eventually received from the borrower, the principal and the interest were returned to the Treasury.

Legislation provided for DSAA to return to Miscellaneous Receipts of the Treasury all reserve account balances in excess of reserve requirements; this condition occurred as loan payments were received. Prior to FY81, approximately $316 million was returned from the reserve account to the Treasury.

Because missed payments were so rare in the early years of the guaranty program, the Congress reduced the 25% reserve requirement to 10% on 1 July 1974. Congress eliminated the annual appropriation requirement entirely in FY 1981 when it authorized the revolving Guaranty Reserve Fund (GRF) on 16 December 1980.

With the formal establishment of the Guaranty Reserve Fund, the fund was left to rise or fall, depending on the frequency and/or timing of missed payments and loan reschedulings. Under the GRF procedures, when a borrower remits a missed payment, the funds are credited to the GRF, rather than to miscellaneous receipts of the Treasury as before. The fund was capitalized at $1.1 billion which represented the cash balance of the reserve account at the time the GRF was authorized.

When Congress eliminated annual appropriations to replenish the reserve, it established the requirement for the President to report on his plans to replenish the fund if reserves fell below

$750 million. On 24 January 1984, the President submitted the requested report and, in his 1985 budget, requested $274 million to restore the reserve to $750 million. Congress appropriated $109 million, thereby implicitly reducing the reserve balance to $500 million.

Economic Factors Affecting FMS Financing. The FMS Credit program has evolved over a thirty-year period during which world economic conditions have varied dramatically. From the mid-fifties, when military credits were first authorized by the Congress, until the early 1970's, the world witnessed rapid economic growth. During this period of expansion, world production tripled as the U.S. and other industrial nations provided markets for many third world countries. Foreign exchange earned by the less developed nations directly fueled economic development and provided an incentive for taking on large amounts of debt. At the same time, strong growth in the world's industrial nations generated resources for new foreign assistance programs. As the apparent economic strength of the recipients of this aid improved, pressure arose to provide foreign assistance in the form of credits as opposed to grants. In fact, in the middle 1970s, Congress directed the executive branch to eliminate grant military assistance in favor of loans extended at cost-of-money to the government.

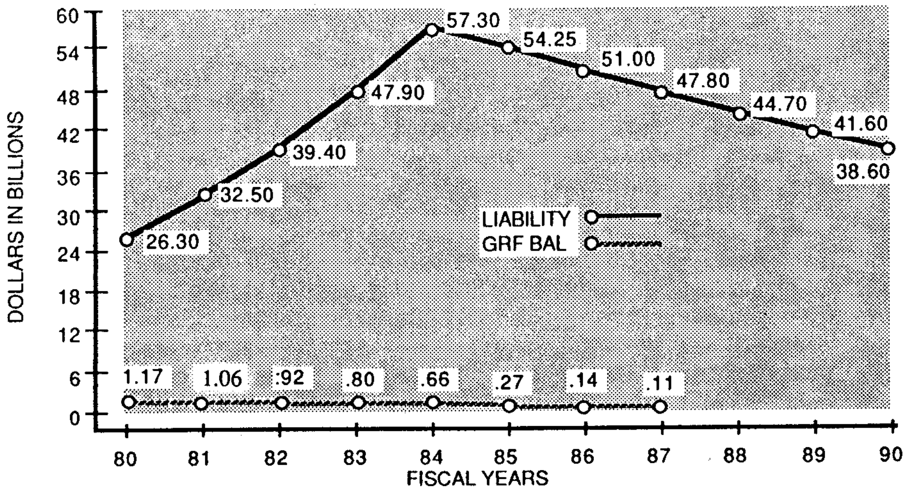
But as a result of the oil shocks of 1974 and 1979, among other factors, the 1970's saw world growth slow noticeably. This general decline in economic conditions, affecting both developed and developing nations, led to a severe global recession between 1980 and 1982. Debtor nations encountered slack demand for commodity exports and low prices for what they could sell abroad. The resulting cash shortage aggravated the growing external debt problem many countries were facing. Much of the external debt acquired during this period can be traced to easy access to large loans that were used to finance ambitious development programs and expensive oil imports. Extremely high real interest rates during the late 1970s/early 1980s period also contributed to the mounting international debt crisis.

As economic conditions deteriorated in the late 1970's, many debtor nations were unable to make loan repayments, including those for FMS loans. The first major FMS delinquencies did not occur until 1978 when nine countries fell into arrears on loan repayments and two countries had to reschedule. As arrearages and reschedulings increased, the role of guarantor and the adequacy of a guaranty fund capitalized at the appropriate level became even more important.

Status of the Guaranty Reserve Fund. At the time of the first serious payment shortfalls in 1978, a satisfactory process was in place to insure that adequate funds were available to meet the Defense Security Assistance Agency's guaranty obligations. Annual appropriations had insured that funds were available in amounts that bore a reasonable relationship to the guarantor's outstanding contingent liability for loan repayments. Through the 1970's, the fund disbursement rate did not provide cause for alarm. However, by FY 1981 the situation began to change quickly. The fund disbursement rate accelerated as major reschedulings occurred and as several large debtors began consistently to pay late. This situation, coupled with the discontinuance of the annual infusion (appropriation) of funds, served to draw down the Guaranty Reserve Fund's cash balance at a rapid rate. Between 1980 and 1985, the fund paid out $2.14 billion to the Federal Financing Bank for late and rescheduled payments. With collections of only $1.19 billion over this same time period, the fund balance was reduced by $954 million or 85% of the original capitalized level before taking into account the $109 million replenishment appropriation in FY 1985.

On the following page are three charts that illustrate (1) the relationship between the Government's contingent liability on guaranty loans and the Guaranty Reserve Fund balance; (2) disbursements from the fund for late and rescheduled payments, and (3) recoveries into the fund for late and rescheduled payments.

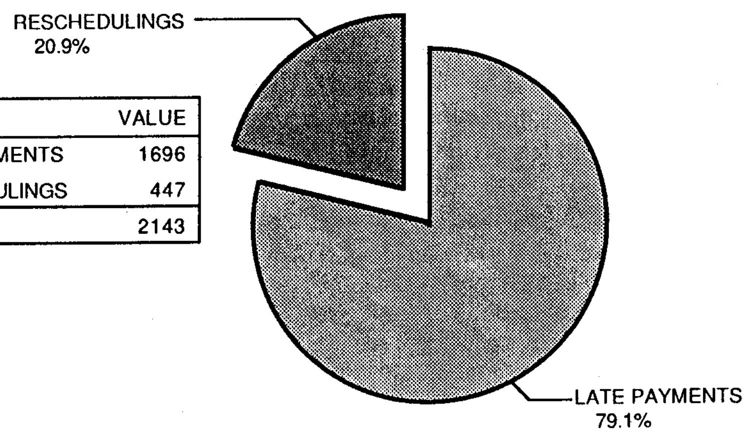
CONTINGENT LIABILITY AND THE GRF BALANCE



NOTE: CONTINGENT LIABILITY FIGURES INCLUDE PRINCIPAL AND INTEREST

GRF DISBURSEMENTS SINCE DECEMBER 1980

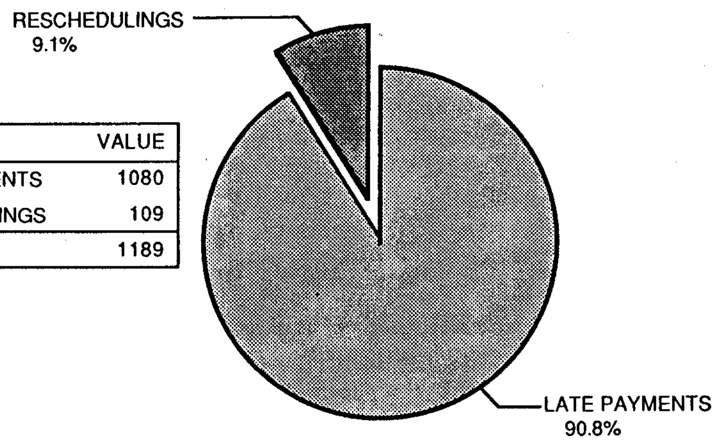
(DOLLARS IN MILLIONS)



LABEL	VALUE
LATE PAYMENTS	1696
RESCHEDULINGS	447
TOTAL	2143

GRF RECOVERIES SINCE DECEMBER 1980

(DOLLARS IN MILLIONS)

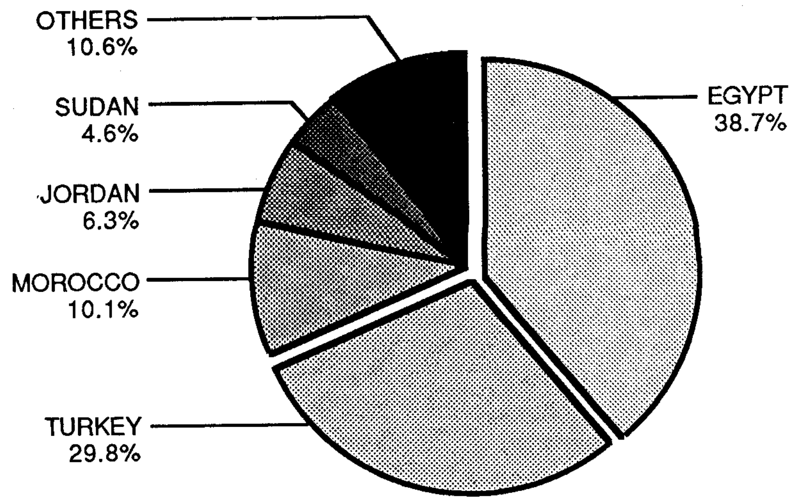


LABEL	VALUE
LATE PAYMENTS	1080
RESCHEDULINGS	109
TOTAL	1189

Two countries, Egypt and Turkey, account for more than two-thirds, or nearly $800 million, of the $1.2 billion due the Guaranty Reserve Fund on 30 September 1985. While these two countries have the greatest potential to affect the cash position of the Guaranty Reserve Fund over the next few years, three other countries could be factors as well. Morocco ($117 million), Jordan ($73 million), and Sudan ($53 million) account for nearly 21% of the aggregate fund receivables (see following chart). While individually neither of these three countries could suddenly bankrupt the fund, one or two in combination with Egypt or Turkey could jeopardize the cash position in a relatively short time.

GRF RECEIVABLES FOR SELECTED COUNTRIES
AS OF 30 SEPTEMBER 1985
(DOLLARS IN MILLIONS)

LABEL	VALUE
EGYPT	451
TURKEY	347
MOROCCO	117
JORDAN	73
SUDAN	53
OTHERS	123
TOTAL	1164



Looking at the Turkish situation in somewhat more detail, Turkey rescheduled approximately $427 million of missed payments on guaranteed loans between 1979 and 1983. While about $100 million of this amount has been recovered to date, along with their unrescheduled payments that have fallen due, $328 million in rescheduled payments still remain outstanding. On the positive side, however, assuming Turkey continues to make its rescheduled payments, these recoveries will represent a net plus to the fund's cash position. We expect that collections from this source will be approximately $60 million per year over the next 5-6 years.

Egypt's situation can be traced to the rapid build up in FMS debt service requirements tied to the very large guaranty loans extended in the early 1980s at relatively high interest rates. This country now accounts for almost 25% (over $13 billion) of the Guaranty Reserve Fund contingent liability.

By 1983 Egypt had begun to show the first signs of debt service difficulty and in 1984 was late on a number of payments that totaled $393 million. During FY 1985, Egypt missed on all regular payments ($451 million) that were due that year and avoided Brooke sanctions by paying only the FY 1984 carryover late payments.

In summary, Egypt appears to be making its regularly scheduled payment about one year late. This means that the Guaranty Reserve Fund must make each payment for Egypt when it falls due and recover the payment in arrears about one year later. In a period when Egypt's debt service requirements are increasing, this draws down the Guaranty Reserve Fund because larger current payments are being made from the fund while smaller one-year-old arrearages are being recovered.

Looking at this condition through 1988, Egypt's repayments to the GRF from previous arrearages will approximate current disbursements. The net impact of Egyptian missed payments on the fund balance will be minimal because the payments made to avoid Brooke Amendment sanctions will approximately equal new delinquencies in payments due.

While a casual examination of the relationship between worldwide economic conditions over the past ten years and activity of the Guaranty Reserve Fund would appear to provide cause for alarm, it is important that such an analysis be placed in proper perspective. An important point to recognize is that, of the $1.164 million owed to the Guaranty Reserve Fund at the end of FY 1985, $530 million, over 45%, is attributable to loan reschedulings. This point is significant because, for the most part, the countries involved are making the rescheduled payments on time. Barring another major worldwide economic crisis, it is reasonable to expect the U.S. Government (and therefore the fund) will recover the rescheduled amounts, albeit over the long term.

The remaining amount outstanding that is attributable to missed payments also presents a slightly different picture when examined in detail. This amount, $634 million, represents late loan payments, substantially *all* of which were due in FY 1985. This means that, of all the late payments which remained outstanding at September 30, 1985, with one exception (Nicaragua), none was over one year in arrears. When compared to the worldwide debt service situation for developing nations, both commercial and official debt, the payment record on FMS guaranty loans is relatively good.

Guaranty Reserve Fund Forecast. Projecting the future cash position for the Guaranty Reserve Fund is a complex process. Assumptions must be made with respect to disbursements from the fund, recoveries into the fund, and reschedulings. It should be obvious from the foregoing discussion that any assumptions made should focus on the five or six key countries that represent the bulk of the threat to the Guaranty Reserve Fund. Presently those countries include Israel, Egypt, Turkey, Jordan, Morocco and Sudan. Given the wide range of economic and political factors that could affect the assumptions and the tendency of those factors to fluctuate over the short term, we have not attempted to make assumptions that extend beyond the next two fiscal years. Additionally there may be other countries that have historically met their FMS debt service obligations but may encounter currently unforeseen financial problems in the future.

The assumptions we have made as a basis for the projections that will follow are:

(1) **Israel** has maintained its excellent payment record and will continue that record.

(2) **Turkey** will continue to pay both regular and rescheduled payments on time for the next two years.

(3) **Egypt** will continue to make each regular payment up to one year late but will not reschedule or fall subject to Brooke Amendment sanctions through FY 1987.

(4) **Jordan** will not reschedule and will make sufficient regular payments in time to avoid Brooke Amendment sanctions. **Sudan** will face similar considerations.

(5) **Morocco** will reschedule most of the payments that will fall due in FY 1986 and FY 1987 and will repay only the amounts due from previously rescheduled loans.

Based upon the above assumptions and the fact that the Guaranty Reserve Fund cash balance stood at $271.7 million at the end of FY 1985, the forecast is as follows:

-- **For FY 1986** - Disbursements from the fund will exceed collections by approximately $130 million. The fund balance at the end of FY 1986 will be about $141 million.

-- **For FY 1987** - Net disbursements from the fund will be approximately $36 million. Cash in the account at end of year is estimated at $105 million.

The following chart reflects the historical trend of Guaranty Reserve Fund activity, as well as projections for FY 1986 and FY 1987 based on the considerations outlined above.

Guaranty Reserve Fund
Fiscal Year Activity Summary
($ Thousands)

	(1) Beginning Balance	(2) Disburse-ments	(3) Collec-tions	(4) Net Outlays	(5) End Balance
FY81	1,116,590.[1]	-110,420.	54,274.	-56,146.	1,060,444.
FY82	1,060,444.	-216,875.	74,993.	-141,882.	918,562.
FY83	918,562.	-439,878.	321,169.	-118,709.	799,853.
FY84	799,853.	-613,396.	365,447.	-247,949.	551,904.
FY85	551,904.	-762,225.	373,050.	-389,175.	271,729.
				109,000.[2]	
Est FY86	271,729.	-808,155.	677,908.	-130,247.	141,482.
Est FY87	153,932.	-801,392.	765,034.	-36,358.	105,124.

[1]Beginning balance--16 December 1980.

[2]Funds appropriated to replenish GRF.

Alternatives for Replenishment of the GRF. Our best estimate is that the fund will not be depleted in 1986 or 1987. However, it is very important to note that this estimate is more likely to be optimistic than pessimistic. There is virtually no probability that repayments will be received more quickly than we have estimated; there is a much higher probability that there will be one or more unforeseen defaults or reschedulings.

Current law [Section 24(c) of the AECA], as recently amended, which authorizes use of new country program funds to pay GRF claims, is not a satisfactory long-term solution. The size of the FMS credit program should be based on an assessment, by the Administration and the Congress, of U.S. national interests and the security and financing requirements of our allies and friends. The unpredictability introduced by potential, let alone actual, diversions of program funds to pay GRF claims would have a devastating effect on the confidence of our allies and other recipients in our reliability as a security partner. Meaningful program planning by the U.S. and prospective recipients would be extremely difficult, even subsequent to Congressional appropriations of funds. Rational planning and implementation of the FMS financing program depends, in part, upon a workable approach to GRF replenishment that is independent of country program funding. An approach that leaves the FMS program hostage to the vicissitudes of GRF claims payments undermines the credibility and stability of our FMS program.

Before discussing various replenishment alternatives it is important that several principles be understood. First, the GRF is a policy neutral instrument. It exists to meet commitments made at the time the Congress approved and the Administration issued guarantees to cover FMS loans by the FFB. Second, the very nature of the problem indicates there will be no easy solution. The issue is clearly one of resources, and it is evident that a situation could easily arise where additional capital must be provided. The major issues would be: (1) how much, (2) when, and (3) from what source. The third principle to recognize is that, barring a major catastrophe in the world economy, the resources in question will eventually come back to the U.S. Government with interest, whether as late payments or as rescheduled payments recovered over the long term. These payments must eventually be made by the country or they face foregoing any new FMS financing due to Brooke Amendment sanctions.

Five alternatives have been identified to replenish the GRF. These include:

#1 Legislation that would provide for a permanent indefinite appropriation to replenish the GRF.

#2 Appropriations in the FY 1987 budget in an amount that would restore the fund to an agreed level.

#3 Appropriations in the FY 1987 budget that would be the first increment of several which would be requested during the next several years to restore the fund to an agreed level.

#4 Legislation that would authorize the GRF to be replenished with principal and interest repayments on outstanding FMS direct loans.

#5 Appropriations at the time it is determined replenishment is necessary at an amount equal to the projected deficit in the GRF balance.

The Administration believes these are the only viable options currently available to replenish the GRF. A very important aspect of these approaches relates to the question of Congressional participation and control. We believe that each alternative insures that the Congress participates fully in determining both the amount that would be used to augment the fund each year and the GRF level at which no further replenishment would occur.

Another important consideration in connection with replenishment is the budget impact. Since the Government will meet its guaranty loan liability whenever it occurs, there is *no* difference in the budget impact outlay between the various replenishment alternatives. However, the various alternatives imply different amounts of budget authority each year.

The Administration recommends that it work with the relevant committees to adopt one of the alternatives outlined above in a timely fashion so as to avoid a situation where the fund is depleted and the loan guarantor is unable to satisfy valid guaranty claims.