

GAO

UNITED STATES GENERAL ACCOUNTING OFFICE
Report to the Honorable
John Cuyvers, Jr., Chairman
Committee on Governmental Operations,
House of Representatives

November 1989

LEASING REFINANCING

Observations on GSA's Proposed Master Leasing and Army's Lease Programs



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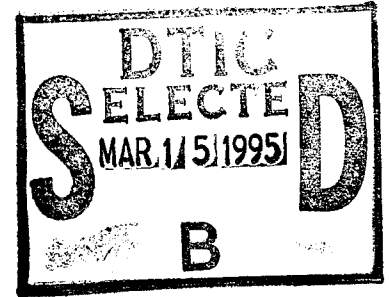
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Accounting and Financial
Management Division

B-235188

November 24, 1989

The Honorable John Conyers, Jr.
Chairman, Committee on Government
Operations
House of Representatives

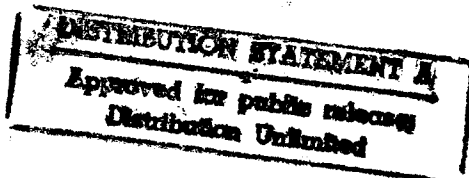


Dear Mr. Chairman:

In your letters of March 6, and 16, 1989, you asked us to evaluate the Master Installment Purchasing System (MIPS) program proposed by the General Services Administration (GSA) and the lease refinancing program which the Army currently has underway. You asked us to focus on determining whether separating lease financing from equipment procurement, as called for in the MIPS and Army programs, could significantly reduce costs to the government. This interim report discusses (1) current federal government equipment lease requirements, procedures, and practices, (2) GSA's proposed MIPS program to reduce future equipment lease costs, and (3) Army's ongoing lease refinancing program to reduce current equipment lease costs. This report also discusses the financial structure, scope, and overall objectives of the MIPS and Army programs. As agreed with your office, in a separate report, at a later date, we will discuss whether it is feasible to implement MIPS or Army-type lease refinancing concepts on a Department of Defense-wide basis and estimate the range of potential cost savings that could result.

Both the proposed MIPS and Army lease refinancing programs have the potential to reduce the finance cost component of total lease costs. This cost component includes interest costs the lessor incurs when acquiring equipment covered by the lease and other fees to cover the risk associated with special lease clauses required by the government. Finance costs on some leases are currently estimated to be as high as 20.5 percent per year. These high costs occur because, under current federal lease procedures, both the equipment and lease financing are usually procured from the equipment vendor/lessor. Consequently, finance costs are based on the borrowing rates available to the equipment vendor/lessor which, in many cases, can be significantly higher than the borrowing rates available to the government. Both the proposed MIPS and Army lease refinancing programs would separate the lease financing from equipment procurement.

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Agencies enter into high finance cost leases mainly because budget constraints preclude them from obtaining the budget authority for the outright purchase of equipment in a single fiscal year. Leases with purchase options allow agencies to procure needed equipment while spreading out the budgetary impact of the acquisition cost over several fiscal years. The additional cost of spreading out the budgetary impact of equipment purchases through leasing is the difference between the interest rates tied to Treasury securities and those available from the private sector. MIPS and Army lease refinancing programs are designed to reduce lease finance costs. The lowest acquisition costs, however, would result from the outright purchase of equipment.

Background on Current Equipment Leasing Requirements, Procedures, and Practices

The Federal Acquisition Regulation (FAR) provides, among other things, guidance on the acquisition of personal property—that is, equipment. The FAR provides two primary means for agencies to acquire needed equipment: (1) the one-time, outright purchase of equipment and (2) the lease (rental) of equipment. The FAR further provides that if a lease is warranted, a lease with a purchase option is generally preferable. These kinds of leases allow agencies to purchase leased equipment at a specified time throughout the life of the lease at a specified option price.

As a rule, equipment should be purchased outright when there is an established, long-term need for it and there is little chance that advances in technology will necessitate further changes to it. The outright purchase results in the lowest cost to the government to acquire needed equipment. On the other hand, equipment should be leased when the government has a short-term need for it and/or it is subject to rapid state-of-the-art changes and advances in technology of which the government wants to take advantage.

Agencies have used leases with purchase options to acquire equipment for which they have a long-term need instead of purchasing the equipment outright because of the budgetary bias against asset purchases. For example, in the federal budgetary environment, a \$50 million, one-time outlay for a capital asset in a given year impacts that year's budget deficit in the same way as a \$50-million outlay for an operating expense. However, the \$50-million outlay for a capital asset is not a true cost for that year. Instead, there has been an asset exchange—\$50 million in cash for an item of equipment valued at \$50 million.

Aggregating the budget recognition of asset acquisition costs in the early years of the acquisition project makes the proposed project appear more

costly, on a yearly basis, than it really is. Consequently, equipment purchases are often precluded because of their impact on budget outlays and the deficit in the year of purchase because the entire purchase price would be charged to that fiscal year.

In many cases, agencies use leases with purchase options to acquire needed equipment because these leases allow agencies to spread out the budgetary impact of acquisitions over a number of fiscal years. These leases are usually more costly than outright purchases because they are financed at the lessors' borrowing rates which are generally higher than Treasury's rates and because lessors charge additional fees to compensate them for risk and uncertainty in case the agencies do not renew the leases as expected. Generally, agencies with annual appropriations enter into 1-year leases with options to renew for several 1-year periods. Under this agreement, agency annual budget requests reflect only the lease payments due and payable in each fiscal year rather than the aggregate lease payments due and payable over the full term of the lease, or the full purchase price if purchased outright.

In addition to annual renewal clauses, leases may also include other clauses intended to protect the government's interest such as the termination for convenience, risk of loss, and right of offset clauses.

The annual renewal and other lease clauses designed to protect the government's interests build risk and uncertainty into the leases for which lessors will charge additional fees as part of the lease finance cost component. For example, the Army has estimated that finance cost components on some of its equipment leases could be as high as 20.5 percent interest annually.

We also addressed the issue of high-finance-cost leases in a 1985 report on the government's computer leasing practices.¹ This report focused on the excess costs incurred by agencies when they leased automated data processing (ADP) equipment. Although there was an established long-term need, the equipment was leased because GSA's ADP fund did not have available capital and the agencies themselves did not have the needed budget authority to purchase the equipment.

The report pointed out that agencies generally lease ADP equipment from the manufacturer under the following three types of leases:

¹Effective Management of Computer Leasing Needed to Reduce Government Costs (GAO/IMTEC-85-3, March 21, 1985).

- Straight rental lease. The lessor retains title to the equipment throughout the system life, and the leases are annual leases with options for annual renewals.
- Lease-with-option-to-purchase. The lessor retains title to the equipment until agencies exercise their purchase options. Under these leases, agencies earn rental or purchase option credits which can be used to reduce the purchase option price of the equipment. These are also annual leases, and agencies are under no obligation to exercise purchase options or to continue the lease beyond each annual lease period.
- Lease-to-ownership-plan. Title transfers to the agency after payment of a predetermined number of lease payments. These are annual leases with annual options to renew. Agencies are not obligated to renew the leases.

Our 1985 report pointed out that agencies holding leases could reduce their costs by refinancing their leases through a sale/leaseback transaction. Under this transaction, a third party exercises the agency's lease purchase option, obtains financing to support the purchase at more favorable interest rates than those available from the lessor, and leases the equipment back to the agency at a lower cost. The cost savings to the agency stem from the third party's ability to obtain lower cost financing than the original lessor.

Our 1985 report concluded that agencies could reduce their ADP leasing costs by exercising purchase options and using earned rental credits when they had a demonstrated need for the equipment beyond the term of the original lease. In these situations, however, agencies tended to renew their leases rather than to exercise their purchase options because they did not have the financial information needed to complete cost/benefit analyses for exercising their purchasing options.

The MIPS and the Army lease refinancing programs are both based on the principles of the sale/leaseback transaction discussed in our 1985 report. Both initiatives have the potential to reduce costs on equipment leases with purchase options.

Objectives, Scope, and Methodology

Our objectives were to determine the scope of current federal government lease requirements, procedures, and practices; the structure of GSA's proposed MIPS and Army's lease refinancing programs; and whether these programs, from a conceptual perspective, have the potential to reduce government equipment lease costs. In particular, we reviewed GSA's proposed MIPS program to determine how it is expected to

reduce equipment leasing costs and whether there are any impediments to its implementation. We reviewed Army's lease refinancing program to determine how it is financially structured, its current status, and how it compares to the proposed MIPS program.

In conducting our review, we obtained and evaluated available documentation such as memorandums, plans, and proposals on GSA's proposed MIPS and the Army's lease refinancing programs and discussed the programs with:

- GSA officials who developed the MIPS program proposal;
- Army officials who developed and are overseeing the implementation of the lease refinancing program;
- representatives of Chase Manhattan Capital Leasing Group; Bear, Sterns and Company; and Jones, Day, Reavis, and Pogue, Attorneys at Law, who are assisting the Army in implementing its lease refinancing program; and
- Office of Management and Budget (OMB) and Treasury Department officials responsible for reviewing GSA's MIPS program proposal and the Army's lease refinancing program.

We also completed a legal analysis of applicable laws and regulations to determine whether any impediments exist to the proposed MIPS program and the Army lease refinancing program.

We did not review any financial records relating to leases or any lease files maintained by Army, other military services, or other Department of Defense (DOD) agencies. Nor did we attempt to make any estimate of the potential dollar savings that might result from the DOD-wide implementation of a MIPS-type or Army-type lease refinancing program. We will include these areas in our ongoing work in response to your original request. We performed our work from April 1989 through August 1989 in accordance with generally accepted government auditing standards.

Proposed MIPS Program Could Reduce Future Equipment Lease Costs

The proposed MIPS program could appreciably reduce future equipment lease costs of current or prospective leases with purchase options and lease-to-ownership plans. It separates equipment procurement from lease acquisition financing by pooling equipment needs under a standard master lease and by using the principles of a sale/leaseback transaction to separately purchase the equipment and secure financing for the purchase from private investors. Because it covers a large pool and not

small groups or individual items of equipment, a master lease also lessens investor risk and uncertainty associated with clauses which would allow the lease to be terminated for the convenience of the government. MIPS-type master financing lease programs have been successfully used by states and large cities to reduce their leasing costs.

Under the MIPS proposal, agencies would acquire information technology equipment in the same manner they currently do; that is, agencies would solicit equipment purchases and lease prices from vendor/lessors. If they have sufficient budgetary authority, they would purchase the equipment outright. If they do not have sufficient budgetary authority to purchase the equipment, they could lease the equipment with purchase options or sign lease-to-ownership-plans offered by the equipment vendor/lessor which would entail purchasing the equipment and lease financing from the vendor/lessor. The MIPS program would provide an alternative financing methodology to support the acquisition of needed equipment. Under the MIPS proposal, agency equipment needs would be pooled under a master financing lease. The pooled equipment would be purchased from the vendors and leased back to the agencies. Funds to support the equipment purchases would be raised by selling interests in the master lease to private investors.

The MIPS program proposal would separate procurement of the equipment from lease financing. Specifically, GSA would retain a private contractor to develop and implement the MIPS program under which GSA and the contractor would periodically pool agency equipment needs under a master lease. The contractor would purchase the equipment and raise the funds to support the purchases by selling financial interests in the master lease to private investors. Using the master lease, GSA would enter into a multi-year lease with the contractor under the information technology fund's multi-year contracting authority. GSA would lease the equipment back to the agencies under an interagency agreement. Agencies would make lease payments to GSA's information technology fund which would, in turn, make one lease payment to the contractor who would repay the investors. At the end of the multi-year lease term, GSA would own the leased equipment.

Under the MIPS program, potential savings result from arranging lower lease financing than is available from the equipment vendor/lessors. Financing is procured in the private financial markets rather than being obtained from the equipment vendor. Using private financial markets to finance lease acquisitions generally lowers the government's lease financing interest rates from those the government could have obtained

from the equipment vendor/lessor. These lower interest rates would more closely reflect the government's cost of borrowing rather than the vendor/lessor's cost of borrowing.

The proposed MIPS program facilitates the use of private financial markets to finance lease acquisitions by creating pools of leases with aggregate dollar values large enough to attract investors and to allow the leases to be offered through established private securities markets. In addition, if the government decides to terminate the contract for the convenience of the government, it would be required to terminate or cancel all equipment in the pool covered by the lease. It could not selectively review or cancel individual items in the pool. Consequently, the MIPS program of pooling equipment leases helps spread the financial risks investors may have on any one lease because the government will be less likely to cancel an entire pool of leases than it would be to cancel a single lease, thus making them more attractive investments.

OMB has objected to the MIPS program on both policy and legal grounds. In a response to our April 13, 1989, request for its views on the MIPS program, OMB opposed MIPS-type programs for three reasons. First, OMB considers programs such as MIPS to be installment purchase contracts and thus more costly than outright purchases. While the outright purchase results in the lowest acquisition cost and is certainly the preferred way to acquire equipment, budget constraints do not always permit purchases. Second, OMB is concerned that MIPS-type programs enable agencies to purchase equipment without fully disclosing the total acquisition costs. Full financial disclosure does not occur even under current lease/purchase agreements since agencies spread the costs of an acquisition over several years and report only annual costs to OMB. Finally, OMB maintains that a MIPS-type program may violate the Antideficiency Act (31 U.S.C. 1341(a)) since agencies, in effect, would be entering into multi-year installment purchase contracts that commit the government to pay for the entire cost of the equipment acquisition while obligating only annual costs. Although all of the details of GSA's MIPS program proposal have not been finalized, we believe that, as discussed below, GSA can develop a MIPS program consistent with the Antideficiency Act.

The Antideficiency Act prohibits a government official from incurring an obligation or making an expenditure in advance or in excess of an appropriation adequate to cover the obligation or expenditure unless authorized by law. Thus, under the limitations imposed by the Antideficiency Act, an agency cannot enter into a valid multi-year lease unless it has specific statutory authority to do so or has sufficient funds,

which are not limited by fiscal year, available to obligate the entire amount due under the full term of the lease.

GSA does have specific statutory authority to enter into multi-year leases of ADP equipment through its information technology fund. Under 40 U.S.C. 757(c), the Administrator of GSA is authorized to enter into multi-year contracts for ADP and related equipment for periods up to 5 years while only obligating the contract costs for the initial fiscal year plus any costs that would result if GSA subsequently cancelled or terminated the contract. This provision would allow GSA to enter into a MIPS multi-year lease in which it would obligate costs on an annual basis, without violating the Antideficiency Act. However, unless the agencies leasing the ADP equipment from GSA have their own multi-year contract authority, the interagency leasing agreement between the agencies and GSA, which has not yet been drafted, will have to comply with the restrictions imposed by the Antideficiency Act.

Army's Lease Refinancing Program Could Reduce Current Equipment Lease Costs

The Army's lease refinancing program has the potential to appreciably reduce total lease costs by reducing the finance cost component and by reducing the fees lessors charge to compensate them for the risk and uncertainties associated with certain clauses in existing leases. The Army's program will involve creating pools of equipment under a standard master lease, securing financing to support equipment purchases by selling financial interests in the master lease to private investors, exercising equipment purchase options on pooled equipment, and having the purchased equipment leased back to the Army under a master lease agreement at a lower cost based on the lower cost of the financing secured for the master lease.

The Army's equipment lease refinancing program focuses on refinancing existing high-finance-cost leases. Army officials currently estimate that these costs could be as high as 20.5 percent per year in some cases. The Army program covers all types of equipment currently being leased by the Army, including ADP and telecommunications equipment, vehicles, and construction equipment. Army's program uses a master lease concept similar to the MIPS program, but with some fundamental differences.

- It will not result in a multi-year contract. The master lease may be renewed on an annual basis at the option of the Army.
- It is not an installment purchase program, but instead is based on exercising equipment purchase options on existing leases.

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- It does not involve new leasing, but rather makes existing leases more economical by reducing their finance costs.

Army equipment leases will be selected for refinancing under a master lease when (1) the existing lease includes an assignable purchase option, (2) appropriate separate arrangements can be made for equipment maintenance, and (3) there is a continuing need for the equipment. The master lease document will be for a 1-year term with 1-year renewal options. Accordingly, since these leases are annual leases with an option to renew for successive 1-year periods and are subject to the availability of appropriations, they would not violate the Antideficiency Act's restrictions on obligating funds in advance or in excess of appropriations.

The master lease will allow the Army to purchase any item covered by the lease throughout the life of the lease. Although it will not have a termination for convenience clause, the master lease will allow the Army to require the lessor, upon 60 days notice, to sell any lease items which the Army no longer requires. If the net sale proceeds are equal to or greater than the purchase option price for the items, then the Army has no further financial obligation under the lease. If, however, the net sale proceeds are less than the purchase option price, the Army shall reimburse the lessor the difference. Also, since the master lease will not cover equipment maintenance or any other performance obligations of the lessor, a right of offset clause is not included in the master lease. This type of clause allows the government to withhold lease payments and other payments (for example, for maintenance) from the lessor when it fails to perform maintenance and operation services stated in the lease contract, or the leased equipment fails to perform as stated in the lease contract.

The Army anticipates that the transaction structure of its lease refinancing program will be as follows. (See appendix I for a diagram of the transaction structure.)

- The Army will contract with a refinancing contractor to identify and create a pool of equipment leases and to develop a master lease for the pool of leases.
- A private sector lessor will take title to the equipment covered by the pool of leases and will sign a master lease with the Army which will cover the equipment represented by the leases in this pool. The lessor, in turn, will legally assign its rights, title, and interest in the equipment covered by the master lease to a trustee on behalf of the investors. The

lessor will also enter into a servicing agent agreement with the trustee through a servicing agent.

- The Army and the trustee will enter into a trust agreement that will describe how the trustee will represent the investors in the master lease with the lessor, servicing agent, underwriters, and Army.
- The trustee will enter into a paying agency agreement with the investors—certificate holders—which details the payments the investors will receive. The trustee or servicing agent will collect from the Army, on behalf of the lessor, all lease payments under the master lease, and the trustee will make all appropriate payments to the investors.
- The trustee will enter into an underwriting agreement with the underwriters. The underwriters will sell certificates of participation to investors and will also receive disclosure documents from the Army and issue disclosure documents to the investors.

Specifically, the Army's program will involve obtaining financing to support purchases of equipment pooled under a standard master lease more closely aligned to the federal government's credit rating rather than on the credit rating of the equipment vendor/lessor. Also, the risks and uncertainties, from the investors' point of view, of an annual lease that may or may not be renewed and which is subject to the availability of annual appropriations are reduced because renewal covers all pooled equipment items collectively, and the Army is less likely not to renew for an entire pool of equipment than for a single item of equipment.

Currently, the Army cannot estimate the dollar savings that will result from its lease refinancing program because of a lack of reliable and complete financial information on its equipment leases. Army and DOD financial management systems for leases do not record and report the detailed information needed to identify leases with high finance costs. Consequently, the Army has engaged a contractor to identify for it any such equipment leases. This manual, time-consuming effort is still underway and must be completed before the Army can determine which leases would be eligible for refinancing and what estimated savings can be achieved.

While information is not available to estimate potential lease cost savings, lease financing concepts used in the MIPS and Army programs have the potential for appreciable dollar savings. For example, in its initial MIPS proposal, GSA commented that if the financing cost on a 5-year, \$500 million lease can be reduced by 3 percent, aggregate lease payments, on a present value basis, would be reduced by almost \$51 million.

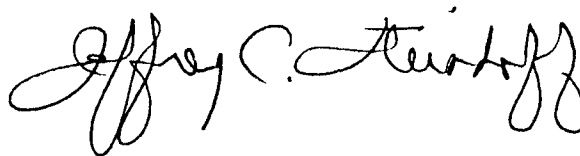
Observations

As a rule, the lowest cost means of acquiring needed equipment is the one-time outright purchase of that equipment. If, because of budgetary constraints, the outright purchase of equipment is not feasible, and a lease is selected to finance the equipment acquisition, a MIPS-type program has the potential to appreciably reduce the equipment leasing costs. While a MIPS program appears to be an overall improvement in the equipment lease acquisition process, it would still fall short of the optimum approach discussed in our recent report on capital budgeting.² Likewise, the Army's lease refinancing program appears to be a reasonable remedial method to reduce the financing costs associated with existing lease purchase contracts.

As agreed with your office, we did not obtain agency comments on a draft of this report. Unless you announce the contents of the report earlier, we will not distribute it until 30 days after the publication date. At that time, we will send copies to the Director of the Office of Management and Budget, the Administrator of the General Services Administration, the Secretaries of Defense and the Army, and other interested parties. Copies will also be made available to others on request.

Please contact me at 275-9454 if you or your staff have any questions concerning the report. The major contributors to this report are listed in appendix II.

Sincerely yours,



Jeffrey C. Steinhoff
Director, Financial Management
Systems Issues

²Budget Issues: Restructuring the Federal Budget—The Capital Component (GAO/AFMD-89-52, August 24, 1989).

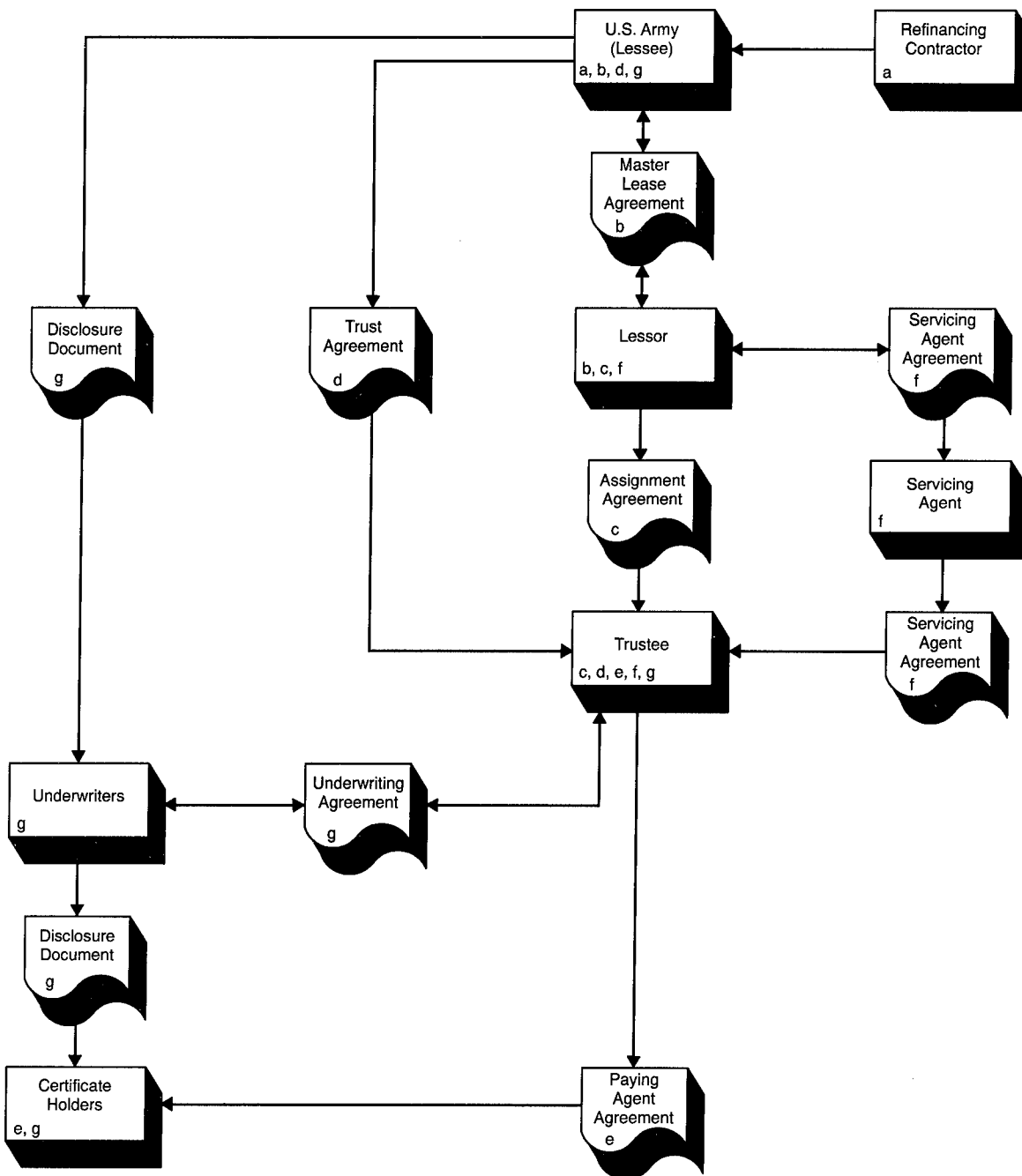
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Abbreviations

ADP	Automated Data Processing
DOD	Department of Defense
FAR	Federal Acquisition Regulation
GAO	General Accounting Office
GSA	General Services Administration
MIPS	Master Installment Purchasing System
OMB	Office of Management and Budget

Transaction Structure of Army's Lease Refinancing Program



Note: The diagram shows the contractual relationships among all parties involved in Army's lease refinancing program and the documents expressing these relationships. It does not show the timing or flow of documents in a lease financing transaction because some of these documents are executed simultaneously.

Appendix I
Transaction Structure of Army's Lease
Refinancing Program

^aThe Army contracted with a refinancing contractor to identify and create a pool of equipment leases.

^bThe Army and the lessor enter into a master lease agreement.

^cThe lessor and the trustee enter into an assignment agreement.

^dThe Army and the trustee enter into a trust agreement.

^eThe trustee enters into a paying agent agreement with the investors—certificate holders—and makes periodic payments to them.

^fThe lessor enters into a servicing agent agreement with the trustee through a servicing agent.

^gThe trustee enters into an underwriting agreement with the underwriters. The underwriters sell certificates of participation to investors and also receive disclosure documents from the Army and issue disclosure documents to the investors.

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Related GAO Products

Budget Issues: Restructuring the Federal Budget—The Capital Component (GAO/AFMD-89-52, Aug. 24, 1989).

Lease Refinancing: Observations on GSA's Proposed Master Leasing and Army's Lease Refinancing Programs (GAO/T-AFMD-89-9, Aug. 2, 1989).

Lease-Purchase: Corps of Engineers Acquisition of Building in New Orleans District (GAO/AFMD-88-56FS, June 7, 1988).

Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988).

Effective Management of Computer Leasing Needed to Reduce Government Costs (GAO/IMTEC-85-3, Mar. 21, 1985).