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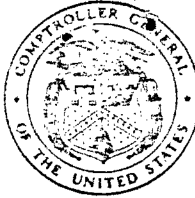
DECISION



THE COMPTROLLER GENERAL
OF THE UNITED STATES
WASHINGTON, D.C. 20548

FILE: B-194153

DATE: May 13, 1981

MATTER OF: Split-interest rates on guaranteed and non-guaranteed portions of loan

DIGEST: Economic Development Administration (EDA) has authority to allow guaranteed loans to be represented by two notes, with fully guaranteed note--representing 90 percent of loan amount--having a lower interest rate than unguaranteed note--representing remaining 10 percent of loan. Notwithstanding statements to contrary in B-194153, September 6, 1979, in which we said two note procedure could only be used if substantive terms of notes, including maturity dates and interest rates, were same, EDA is not prohibited from using split interest rates provided other substantive terms remain same.

This decision to the Administrator of the Economic Development Administration (EDA), an agency within the Department of Commerce, is in response to a request from its former General Counsel that we reconsider a statement we made in an opinion, B-194153, September 6, 1979, to Senator Charles H. Percy concerning the establishment of a then proposed pilot program designed to bring new industrial development projects to several depressed areas in the City of Chicago.

One of the issues we considered in that case was whether EDA's statutory authority under 42 U.S.C. § 3142 (1976) to guarantee loans to private borrowers "by private lending institutions" would allow EDA to implement a program whereby EDA would guarantee loans made by commercial banks with the guaranteed portions of those loans to be subsequently assigned to the City of Chicago, which would finance their purchase with funds raised through the "public credit markets." We held that, since the City of Chicago "is not private, is not a lending institution and could not have qualified for a guarantee initially," the proposed program, which would require EDA to guarantee notes held by the City, would allow EDA to do indirectly that which it could not do directly, and would therefore exceed its statutory authority.

EDA is not now questioning the ultimate conclusion we reached in that opinion. However, one issue we also considered was whether an EDA guaranteed loan could legally be evidenced by two notes--with one

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note representing 90 percent of the loan to be fully guaranteed by EDA, and the other note representing the remaining 10 percent of the loan to be wholly non-guaranteed. In this connection, we said the following in our decision:

> "In our view, whether two notes should be combined and treated as one loan (or one note considered to represent two loans) depends on the substance of a particular transaction, including the apparent intention of the parties to the transaction and the purpose of the statutory provision involved. In the matter at hand, we do not believe that the proposal to evidence each guaranteed loan by two notes is legally objectionable. Whether one note with a 90 percent guarantee, or two notes representing 90 percent and 10 percent of the total loan amount respectively--the first fully guaranteed and the second without any guarantee--are involved the end result is precisely the same in our view and conforms to the statutory requirement that no more than 90 percent of the outstanding balance of a loan be guaranteed by EDA. Finally, it appears that the primary purpose of the proposed two-note arrangement is to effectuate the basic legislative purpose rather than to circumvent it. Therefore, we have no objection to the use of two notes to represent one loan.* * *
>
> "Having reached this conclusion, we do have several caveats to point out, however. First, since the two notes involved represent only one loan, we believe that <u>the substantive terms of the two notes, such as the maturity dates and interest rates, must be the same</u>. Secondly, the Government's potential liability must in no way be increased by adoption of the two-note mechanism." (Emphasis added.)

EDA's question here is whether we intended the underlined portion of the opinion to prohibit the use of two notes whenever the interest rate on each note varies--even if the interest rate on the EDA guaranteed note is lower than the interest rate on the unguaranteed note for the same loan. In this respect, EDA's submission reads in pertinent part as follows:

> "* * * Obviously, it would be improper for the agency to consider a loan guarantee where the terms applicable to an EDA guaranteed note were in any way less favorable than the term applicable to a

note representing the same loan, which note is not EDA guaranteed. We believe that this is the intent of the quoted portion of your opinion.

"It is presently proposed, however, to use two notes—one EDA guaranteed and one non-guaranteed —to represent a single loan under provisions where the substantive terms of the two notes are the same, save only that the interest rate applicable to the guaranteed note would be lower than the interest rate applicable to the unguaranteed note.

"Because of the guarantee, a note representing a guaranteed portion of a loan would carry a lower interest rate than a note for the unguaranteed portion. If the single interest rate is required for both the guaranteed and unguaranteed portions of a loan, that interest rate will be an average of the higher rate which would have applied to the unguaranteed portion and the lower rate for the guaranteed portion. Therefore, the allowance of varying rates of interest for the two notes can result in a lower interest rate for the guaranteed portion and therefore lower cost for the Government if EDA is required to redeem the guarantee.

"We are aware of no substantive objection to the practice, but obviously it would violate the strict meaning of the language in your opinion."

EDA is authorized by 42 U.S.C. § 3142(c) (1976) to guarantee up to 90 percent of the outstanding unpaid balance of a loan. For this reason we stated in our opinion to Senator Percy that EDA could only use the two-note mechanism if the substantive terms of the two notes are the same. From a conceptual standpoint, it would be very difficult, if not impossible, to view two notes having substantially different terms as representing one and the same loan. Logically, if the two notes were significantly different, we would have to conclude that each represented a separate loan, one fully guaranteed and one not guaranteed at all. Of course, in that event the two-note mechanism would necessarily fail, since, as noted, EDA may only guarantee up to 90 percent of any loan.

For the reasons set forth hereafter, however, we are now inclined to agree with the view espoused by EDA that it is not prohibited from allowing a guaranteed loan to be represented by two notes, each with a different interest rate, provided that the fully guaranteed note has a lower interest rate than the unguaranteed note.

First, nothing in either the statute or its legislative history suggests that Congress intended to prohibit the establishment of different interest rates for the guaranteed and non-guaranteed portions of a loan, regardless of whether each loan was represented by one or two notes. In fact, Congress never even expressed any intention to impose any limitations on lenders concerning the much more basic question of the establishment of maximum interest rates for guaranteed loans. Although the interest rate on direct loans made under this statute is limited pursuant to 42 U.S.C. § 3142(b)(8), Congress chose not to set any such limit on the amount of interest charged by private lenders on guaranteed loans when it enacted the Public Works and Economic Development Act of 1965, Pub. L. No. 89-136, August 26, 1965, 79 Stat. 556. See H. Rep. No. 539, 89th Cong., 1st Sess. (1965). No such statutory restriction or limitation on the interest rates for guaranteed loans has ever been imposed on this program.*/

Moreover, when the matter is considered from a broad programmatic perspective, we see no legal reason to prohibit the split-interest rate mechanism. The primary reason most Federal loan guarantee programs are not made on a 100 percent guaranteed basis but require some private participation, is to insure that both borrowers and lenders, in addition to the Federal Government, are exposed to some degree of commercial risk. The General Accounting Office has consistently taken the position that such risk-sharing is a very important element of any loan guarantee program, since otherwise "the normal incentives for successful completion and management of the project * * * are absent" and "the probability that the loan guarantee program will achieve its intended objective is diminished." (See audit report entitled "Government Agency Transactions with the Federal Financing Bank Should Be Included On The Budget," PAD-77-70, August 3, 1977, at p. 16.) As we understand it, the split interest rate mechanism will in no way harm or injure this principle of risk sharing, since at least 10 percent of every loan will still have to be represented by a fully unguaranteed note, albeit at a high rate of return for the lender. In this connection, we agree with EDA that it is reasonable to allow the holder of the unguaranteed note to receive a higher interest rate than the holder of the guaranteed note because of

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*/We note that the applicable regulations adopted by EDA with respect to interest rates on guaranteed loans as set forth at 13 CFR § 306.11(c)(1980) as follows:

> "Interest on guaranteed loans by private lending institutions must be at not more than their prevailing rates and must be reasonable with respect to the project."

the substantially higher risk of the former. It is understood that all payments under either note will be credited so as to retain the appropriate ratio between the guaranteed and unguaranteed undertakings.

Furthermore, we also agree with the statement made by EDA that the Government actually stands to gain under the split interest mechanism since the interest rate for the guaranteed portion would be lower than would be the case if a uniform "average" interest rate was charged for the entire loan, including both the guaranteed and non-guaranteed portions. Accordingly, the cost to the Governent would be less in the event of a default requiring EDA to honor its guarantee.

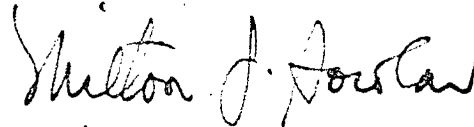
Finally, we understand that for some time the loan guarantee programs of other agencies which operate under similar statutory authority, have allowed for split interest rates on the guaranteed and non-guaranteed portions of a loan. For example, in its business loan program authorized pursuant to 15 U.S.C. § 636(a), the Small Business Administration (SBA) allows lenders to establish different interest rates on the guaranteed and non-guaranteed portions of a loan. Although SBA's procedure is to use only one note representing the entire loan, SBA allows the initial lender to sell the guaranteed portion of the loan to other participating lending institutions with which SBA has entered into what is known as a "Secondary Participation Guarantee Agreement."

The Farmers Home Administration (FmHA) has a loan guarantee program that operates in a manner that is even closer to what EDA is proposing here. In its Business and Industrial Loan program established pursuant to 7 U.S.C. § 1932, FmHA allows lenders to use a multi-note system, with one note representing the non-guaranteed portion and up to 10 notes for the guaranteed portion. Moreover, its regulations specifically provide for the establishment of different interest rates for the guaranteed and non-guaranteed notes. In this connection, 7 C.F.R. § 1980.423(a)(4) (1980) provides in pertinent part as follows:

> "(4) It is permissible to have one interest rate on the guaranteed portion of a loan and another interest rate on the unguaranteed portion of the loan, provided the Lender and borrower agree and:
> (i) The rate on the unguaranteed portion does not exceed that currently being charged on loans of similar size and purpose for borrowers under similar circumstances.
> (ii) The rate on the guaranteed portion of the loan will not exceed the rate on the unguaranteed portion."

Thus, with statutory authority not unlike that under which EDA operates, FmHA (and to a lesser extent SBA) is carrying out a program, without objection, that is substantially the same as that which EDA is now proposing to adopt.

In accordance with the foregoing, and notwithstanding anything to the contrary in B-194153, September 6, 1979, which decision should now be considered as modified, it is our view that EDA is not prohibited from allowing the interest rates on the guaranteed portions of a loan--represented by one note--to be less than the interest rate on the non-guaranteed portion of the loan--which is represented by a separate note. However, as stated above, in order for us to continue to view the two notes as representing one and the same loan, the other substantive terms of the notes should remain the same. Furthermore, based on the existing language in EDA's regulations (13 C.F.R. § 306.11 (1980)) and following the model established by FmHA, the interest rate on the non-guaranteed note should not exceed the prevailing rates on comparable private sector loans and the overall effective interest rate (based on the average of the guaranteed and non-guaranteed loan rates) should not be greater than would be the case had only one uniform rate for the entire loan been used.



Acting Comptroller General
of the United States