An LAO Report

Rethinking the Cal-Vet Loan Program

Background

The California Veteran Farm and Home Purchase Program, known as the Cal-Vet loan program, has provided more than 400,000 California veterans of various wars the opportunity to buy a farm or home through state assistance.

LAO Findings

The Cal-Vet loan program is currently not competitive with other private- and public-sector loan programs which now offer better interest rates and terms. Significant financial and operational problems have eroded the state's equity (assets less liabilities) in the Cal-Vet fund by $200 million. Recently, the Department of Veterans Affairs has undertaken an effort to fix the program's major problems and stem Cal-Vet's financial losses. Nonetheless, the total number of Cal-Vet loans is likely to continue to dwindle. Veterans do have other growing needs that are likely to create pressure for more General Fund spending.

LAO Recommendations

In the short term, the Legislature should:

- Strengthen internal and external oversight of the Cal-Vet program to ensure its proper management.
- Restructure the program so that future Cal-Vet loans could be issued at an interest rate different, if necessary, from the rate established for previous Cal-Vet borrowers. Other short-term program improvements should also be encouraged.

In the long term, the Legislature should:

- Amend state law to direct the orderly phase-out of issuance of new Cal-Vet loans by the year 2007. This recommendation reflects (1) the declining nature of the Cal-Vet loan portfolio due to federal restrictions on tax exempt state bonds (which fund the loan program) and the aging of the war veteran population and (2) the availability of loans through the private sector and other governmental programs.
- Subject to voter approval, direct surplus Cal-Vet funds to programs that will benefit both aging war veterans and state taxpayers. This should be accomplished carefully by means that ensure that all obligations of the state to bondholders are met and that the program retains adequate reserves to meet the requirements of the program.

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January 16, 1998

BACKGROUND

Legal Authority for the Program

Program Creation. The California Constitution (Article XVI, Section 6) authorizes the use of state money or credit to help war veterans acquire or pay for farms or homes. In 1921, the Legislature created the California Veteran Farm and Home Purchase Program, known as the Cal-Vet program, to provide such assistance to the veterans returning from World War I. The program currently operates under the authority of the Veterans Farm and Home Purchase Acts of 1943 and 1974 and various bond acts set forth in the state Military and Veterans Code.

Since its inception 77 years ago, the state has assisted more than 400,000 California veterans of World War I and World War II, as well as those serving on active duty during the Korean, Vietnam, and Persian Gulf conflicts. The vast majority of state assistance has been provided for the purchase of single-family homes, although some farm and mobilehome purchases have also been financed through the Cal-Vet program. California is one of five states to operate such a program. The others are Alaska, Oregon, Texas, and Wisconsin.

A Home Purchase Program

Contracts for Loans. Technically, the Department of Veterans Affairs (DVA) operates a *home purchase* rather than a *home loan* program. The DVA purchases new and existing homes, farms, and mobilehomes that have been selected by an eligible war veteran. The state then resells the property in accordance with a contract requiring installment payments by the veteran. Despite this technical distinction, the program operates very much like a conventional home loan program. In effect, Cal-Vet makes home loans similar to those of other lenders. War veterans participating in the program make monthly mortgage payments just like any typical borrower.

All loans are only for owner-occupied property. Moreover, Cal-Vet does not refinance loans on property a veteran already owns. However, a veteran who received a Cal-Vet loan and paid it off may apply for a subsequent loan.

Statutory Purpose. Notably, state law does not explicitly mandate that the Cal-Vet program provide loans at lower interest rates or with easier terms than could be obtained from other lenders. Rather, the statutorily defined mission of the Cal-Vet program is "to provide veterans with the opportunity to acquire farms and homes." Historically, however, war veterans have often been able to obtain Cal-Vet contracts with more favorable terms than they would otherwise have been able to receive from private-sector banks or savings and loans. The DVA has adopted a mission statement declaring the purpose of the program as providing "low-cost, low-interest financing" to eligible veterans "to recognize the sacrifice and service of our veterans in the armed forces."

Except for some older loans carrying an interest rate of 4.4 percent and some mobilehome loans set at 9 percent, most borrowers currently pay the equivalent of an 8 percent interest rate under the Cal-Vet program. In accordance with state law, this interest rate is subject to upward or downward revision throughout the life of the loan by the DVA. By law, Cal-Vet may provide up to 95 percent of the financing needed for most home purchases, with the veteran providing a 5 percent down payment.

During 1996-97, the Cal-Vet program provided $143 million in financing for 967 new property purchases, for an average of about $148,000 each. The Cal-Vet program also provided about $2.8 million for 242 home improvement loans averaging about $12,000 during the same fiscal year.

State law also authorizes the DVA to operate several insurance programs in conjunction with the Cal-Vet program. Veterans participating in the program are charged fees to pay for (1) fire and hazard insurance; (2) a disaster indemnity plan covering losses for floods, earthquakes, and other perils; and (3) insurance coverage providing for repayment of the Cal-Vet loan in the event a veteran dies or becomes disabled. However, conventional property mortgage insurance is not now required for Cal-Vet loans.

Program Financing

Bonds Are Funding Source. The Cal-Vet program has been funded over its life through the sale of more than $9 billion in general obligation bonds and revenue bonds. The current outstanding state debt, which amounts to about $3 billion, is being repaid from payments made by Cal-Vet borrowers and cash generated from other investments of Cal-Vet funds. As of last year, the interest rate on the outstanding debt of the Cal-Vet bonds ranged from about 3.5 percent to 11 percent.

Roughly 90 percent of the outstanding debt for the program consists of general obligation bonds, so-called because the full faith and credit of the state is pledged for repayment in the event that contract payments from veterans were ever insufficient to pay the debt service. (This situation has never occurred.) California voters have approved 25 such bond acts, most recently authorizing $400 million in additional debt through Proposition 206 on the November 1996 ballot.

The remaining 10 percent of debt for the program has originated from revenue bonds that lack full state backing, and which are secured instead by a pledge of the fund into which contract funds from participating veterans are deposited. The sale of mortgage revenue bonds commenced in 1980.

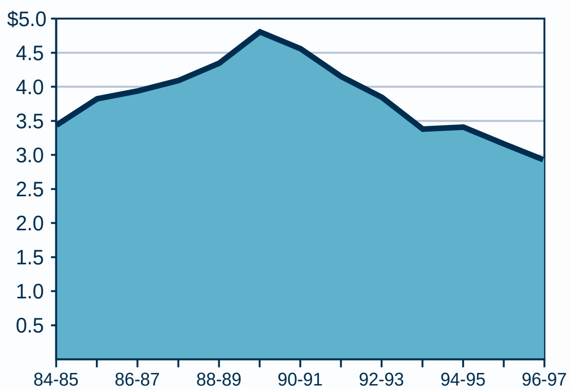
As can be seen in Figure 1 (see page 4), the overall level of debt in the Cal-Vet program peaked about the beginning of this decade and his been dropping steadily since that time.

Noncallable Bonds. About $900 million of the current outstanding Cal-Vet debt—roughly one-third of the debt total—originated from the sale of bonds that are deemed "noncallable." Noncallable bonds contain provisions that prohibit the Cal-Vet program from paying off the bonds ahead of schedule. In addition, about $575 million in bonds contained provisions that prohibited prepayment until the last five years of the life of the bonds. About $1.5 billion

Figure 1

Cal-Vet Program Debt Has Dropped

Outstanding Debt (In Billions)



of the debt is subject to being "called" and can be paid off at any time.

The proceeds of both general obligation and revenue bonds are continuously appropriated by state law, and are specifically exempted from the regular state budget process.

At the time this analysis was prepared, the DVA was proceeding with a major refinancing of its existing bond debt as well as the issuance of additional bonds. The transaction, when completed by May 1998, will amount to $1.6 billion in new and refinanced debt. The main purposes of the transaction are to (1) replace some older, higher-cost bonds with new, lower-cost bonds; and (2) make new funds available to finance additional home purchases for veterans. We discuss and comment on the DVA's debt transaction later in this report.

PROGRAM ELIGIBILITY

General Rules. The eligibility of veterans for the Cal-Vet home purchase program is subject to various state and federal restrictions, including the period of a veteran's military service, the duration of the military service, the cost of the property to be purchased, and, in certain cases, the property location, the veteran's family income, and whether the veteran is a "first-time home buyer."

Until now, assistance has been limited to veterans who served on active duty for a statutorily defined wartime period—primarily World War I, World War II, and the conflicts in Korea, Vietnam, and the Persian Gulf—and who also received an honorable discharge. Under a new DVA-sponsored state law (Chapter 155, Statutes of 1997 [Knight, SB 574]) which took effect on January 1, 1998, *peacetime* veterans who served outside of those defined wartime periods will be eligible for Cal-Vet home purchase assistance for the first time. Whether his or her military service was in wartime or peacetime, an applicant for Cal-Vet assistance generally must have served at least 90 consecutive days on active duty unless the veteran was discharged for a service-connected disability.

It is no longer necessary that a veteran be a California resident at the time he or she entered military service in order to qualify for a Cal-Vet loan. A 1992 California Supreme Court ruling (*Del Monte v. Wilson*) struck down such a Cal-Vet requirement as a violation of the federal constitutional right to equal protection of the laws.

Further restrictions apply to Cal-Vet applicants, depending on whether assistance is provided using the proceeds of general obligation bonds or revenue bonds. In both cases though, these restrictions apply to ensure that the bonds issued by the state are tax exempt for the purposes of federal tax law. The bonds' tax exempt status makes it possible for the state to sell them at a lower interest rate than would otherwise be possible.

The details regarding who may qualify for a Cal-Vet loan are discussed in the shaded box (see page 6).

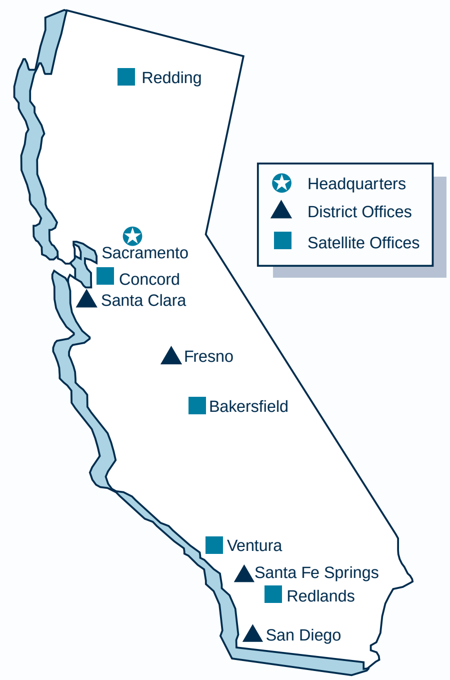
Program Administration

Shift to Department in 1943. At the time of its creation, the Cal-Vet program was administered by the Veteran's Welfare Board. In 1943, the board was eliminated and its operational duties shifted to the DVA.

During 1996-97, the program operated ten California branch offices—eight full district offices and two satellites with minimal staffing—under the supervision of the central headquarters in Sacramento. The DVA is now realigning the office config-uration to provide five full district and five satellite offices. The location of each of the office sites under the new configuration is shown in Figure 2.

Figure 2

Cal-Vet Loan Program Offices



Of the 232 authorized positions associated with the Cal-Vet program, about 90 consist of personnel in either district or satellite offices, about 60 are program staff located at the Sacramento headquarters, 66 are administrative support functions (mainly data processing, personnel, accounting, and legal services) in Sacramento, and 16 are DVA managers.

The staffing and operating expenses of the Cal-Vet program amounted to $20.2 million during 1996-97. Of this amount, only about $1.2 million for administrative support was directly appropriated by the Legislature through the *1996-97 Budget Act*, with the balance coming out of the off-budget Cal-Vet fund.

Applications for Cal-Vet loans have historically been marketed and processed exclusively through the program's network of branch offices. Although other government loan programs give private lenders the authority to place loans, that is not the case in the Cal-Vet program. Subsequent servicing of loans that have been funded, including such activities as billing, delinquent accounts, and repossession of defaulted property, has also been handled by DVA branch offices in the past. The Cal-Vet program is in the midst of a reorganization that we discuss later in this report that will consolidate key loan servicing operations in Sacramento while leaving most marketing and loan origination activities in the branch offices.

What Are the Cal-Vet Program Eligibility Rules?

Loans Financed With General Obligation Bonds. Cal-Vet loans financed with general obligation bonds may be provided only to veterans who served on active duty prior to January 1, 1977, and who also were released from active duty within the last 30 years. The maximum loan on a single-family home purchase is $250,000, with a maximum of $300,000 for farm purchases and $70,000 for mobilehomes. There is no limit on the price of the home purchased through the program, and no limit on the income of the veteran, as long as general obligation bonds are the source of Cal-Vet assistance.

Loans Financed With Revenue Bonds. Cal-Vet participants who receive loans funded from revenue bonds are subject to different eligibility rules even though their loans carry the same interest rate and terms as those funded through general obligation bonds. For example, there is no requirement that the veteran had served on active duty before 1977 and no requirement that the veteran apply for benefits within 30 years of active military duty. Also, loans cannot be made to buy farms or for some mobilehome purchases.

Some nonveterans are eligible for revenue bond-supported loans. The surviving spouse of a veteran who was eligible for a Cal-Vet loan may also be eligible for a loan if the veteran died during the application process, if the veteran died from injuries received in the line of duty, or if the veteran was a prisoner of war or was declared missing in action. Spouses are not eligible for Cal-Vet loans supported by general obligation bonds.

A veteran who receives a revenue bond-funded loan must either be a "first-time home buyer" or live in a neighborhood "targeted" for assistance due to low incomes of residents or economic distress. A first-time home buyer is considered by law to be anyone who has not owned the home in which they have lived for the last three years.

Unlike loans funded through general obligation bonds, those funded with revenue bonds are subject to price limits. The price limits permit a larger amount of Cal-Vet assistance in targeted areas and a lower amount of assistance in nontargeted areas. For example, as of July 1996, a veteran receiving Cal-Vet assistance to purchase a new home in a targeted neighborhood in Los Angeles could buy a home costing up to $281,800. A veteran buying a home in a nontargeted Los Angeles neighborhood would be limited to a purchase of a home costing $230,563.

A veteran purchasing a home outside of a targeted area is also subject to family income limitations. For example, a family buying a home in a nontargeted Los Angeles neighborhood could have had an annual income of no more than $58,995 annually.

Veterans Board and Finance Committee. The California Veterans Board also plays a significant role in the operation of the Cal-Vet program. The panel is composed of six members, who are appointed by the Governor and confirmed by the Senate to terms of four years, and a seventh ex officio member, the Secretary of Veterans Affairs.

A 1946 state law provides that the board "shall determine the policies for all operations of the department," and a more recent measure (Chapter 1145, Statutes of 1996 [SB 1470, Johannessen]) mandates that the Secretary of the DVA not make policy changes to DVA programs, including Cal-Vet, without "fully briefing" the board. The board is also empowered to decide appeals of departmental decisions on applications for Cal-Vet program benefits.

The board is empowered to set the interest rate for Cal-Vet loans. A new state law (Chapter 197, Statutes of 1996 [SB 785, Johnson]) deletes a requirement that two-thirds of the board consent to that decision, leaving the matter to a board majority. A two-thirds vote would continue to be required only if the board sought to change the interest rate more than once within a calendar year.

Another panel, the Veterans Finance Committee of 1943, comprised of the Governor, the State Controller, the State Treasurer, the Director of Finance, and the Secretary of Veterans Affairs, or their representatives, also has responsibility for the Cal-Vet program. A majority of the finance committee must consent to any decision by the Veterans Board to change the Cal-Vet program interest rate. Chapter 197 deleted the requirement that the finance committee, as well as the Veterans Board, review and take action on the Cal-Vet interest rate each year. Henceforth, the two panels need take no action at all if the DVA concludes that no change is needed in the Cal-Vet interest rate.

LAO FINDINGS

Our review and analysis of the Cal-Vet program has led us to reach a number of conclusions regarding its benefit to veterans and the effectiveness of its operation. Our findings are discussed in detail below and are summarized in Figure 3.

Figure 3

LAO Findings

- ☑ Cal-Vet loan program not competitive with other private or public sector lenders.
- ☑ Past mismanagement of the program eroded the state's equity.
- ☑ The Department of Veterans Affairs initiated a model program reform effort.
- ☑ Some program changes raise concerns but the reform plan is reasonable overall.
- ☑ Veterans' need for Cal-Vet loans declining, but need for other services growing.

CAL-VET PROGRAM NOT COMPETITIVE

In its present form, the Cal-Vet program is not competitive with other private- and public-sector loan programs. Creditworthy veterans can currently obtain better interest rates and terms from private lenders with the help of other federal and state agencies, including programs which specifi-

cally target veterans and low-income home buyers—Cal-Vet's customer base—for assistance. Cal-Vet lending activity has dropped off dramatically and many past participants in the program are paying off their loans early and borrowing from Cal-Vet's competitors because the private-sector mortgage market and other governmental mortgage assistance programs are meeting veterans' needs.

Cal-Vet Loans Attractive in Past

The DVA's stated goal is to provide eligible veterans with Cal-Vet loans on rates and terms that are better than can be found elsewhere. Throughout the 1970s and 1980s, the DVA accomplished that goal and provided substantial benefits to veterans. For example, when market interest rates on 30-year fixed-rate home loans peaked at above 17 percent during 1982-83, the rate for most Cal-Vet loans was less than half of that—8 percent. For a Cal-Vet veteran, that meant a savings in the hundreds of dollars on their monthly mortgage payment.

The fees and terms for Cal-Vet borrowers also have compared favorably with its competitors in the past. Unlike many private-sector borrowers, Cal-Vet loan recipients are not required to pay any "points" to obtain their loan, which sometimes can cost several thousand dollars; the loan origination fee is $50.

Moreover, unlike most private borrowers, Cal-Vet has not in the past required a borrower to obtain conventional property mortgage insurance whenever the amount borrowed exceeds 80 percent of the value of the purchased property. It is not unusual for the premiums for such insurance policies to cost a borrower in excess of $100 per month. Cal-Vet's fire, disaster, and life and disability insurance programs were low in cost and carried favorable terms with low deductibles, providing an additional incentive to a veteran to obtain a Cal-Vet loan instead of one from the private mortgage market.

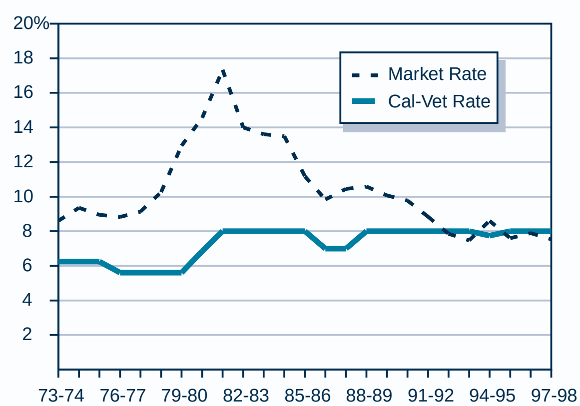
Cal-Vet Not Competitive Now With Private Lenders

As can be seen in Figure 4, the Cal-Vet program has largely lost the competitive advantage it had long held over the private-sector loan market. While Cal-Vet's rates have remained level, the prevailing private-sector interest rates have dropped steadily since their peak in the early 1980s. In December 1997, at a time when most Cal-Vet loans carried an 8 percent interest rate, fixed-rate private-sector

Figure 4

Cal-Vet Interest Rate No Longer Competitive

Home Loan Interest Rate



mortgages were available bearing about a 7 percent rate.

Cal-Vet's marketplace disadvantage is even more pronounced if Cal-Vet loans—which technically are variable- and not fixed-rate loans—are compared to variable-rate private-sector loans. In December 1997, 30-year adjustable-rate loans could be obtained at an initial rate of 5.5 percent.

Thus, Cal-Vet has been unable to compete with the private sector on the basis of interest rates in a highly price-sensitive mortgage market. This market disadvantage appears to have overwhelmed the benefits Cal-Vet borrowers would otherwise enjoy from lower fees and better insurance coverage.

Cal-Vet Faces Competition From Federal VA and Other Government Programs

Cal-Vet also appears at a severe disadvantage in competing effectively with the federal VA loan guarantee program.

Under the VA program, the federal government guarantees the repayment of a significant portion of a home loan if a private lender issues loans in accordance with federally established terms that are beneficial to veterans. Among VA's advantages over Cal-Vet:·

- Qualified veterans are able to purchase a home at the prevailing market interest rate, which, as discussed earlier, is now lower than the Cal-Vet rate.
- A VA borrower often may purchase a home with no down payment. Most Cal-Vet loans require at least a 5 percent down payment.
- The eligibility requirements for the VA program are easier to meet. For example, VA borrowers are not subject to the family income, first-time home buyer, price limits, and other restrictions that apply to some Cal-Vet borrowers.

Cal-Vet retains one significant marketplace advantage: its fees are significantly lower than those charged to borrowers under the VA loan guarantee program. However, that advantage is partly negated because the VA fees—which in some cases can exceed $1,000—can be financed through the loan and not paid up front. Cal-Vet and VA loans are similar in that no additional property mortgage insurance is required in order to obtain a VA loan even when the loan exceeds 80 percent of the value of the property being purchased.

Federal Housing Administration. The Federal Housing Administration (FHA) also competes with Cal-Vet in the California housing market through a loan guarantee program (the Section 203 [b] program). The program is focused on assisting lower-income home buyers and includes an element targeted specifically at assisting military veterans.

As is true for the VA program, FHA borrowers pay a prevailing market rate that may be less than Cal-Vet charges to borrowers. The FHA loans can cover up to 97 percent of the cost of purchasing a home, slightly more than the 95 percent allowable under the Cal-Vet program. A special 203 (b) program for veterans allows an even smaller down-payment.

Although FHA purchasers are subject to higher fees than under a Cal-Vet purchase, some of those costs need not be paid up front and can be added to the amount borrowed. However, the amount of an FHA-guaranteed loan is much smaller than one can obtain under the Cal-Vet program. As of 1997, the maximum loan in high-cost areas was about $155,000 compared to the $250,000 loan allowed under Cal-Vet. Lower FHA loan limits applied in other areas where living costs were lower.

California Housing Finance Agency. Some California veterans have also obtained single-family loans through the California Housing Finance Agency (CHFA). Unlike the Cal-Vet program, which markets its loans directly to customers, the CHFA makes advance commitments of funds to its network of private-sector lenders, who in turn lend the funds to loan applicants. The program focuses on assisting first-time home buyers and fostering home ownership in neighborhoods targeted for revitalization efforts.

Except for the lack of any requirement of prior military service, the eligibility rules for the CHFA loans are very similar to those established for the Cal-Vet revenue bond loan program. The CHFA loans, however, have a significantly lower interest rate than Cal-Vet loans. As of October 1997, at a time when the Cal-Vet interest rate was 8 percent, a 30-year fixed-rate CHFA loan carried a rate of between 6.5 percent to 6.75 percent depending on the location of the home purchase. At least 3,000 outstanding loans in the CHFA portfolio (the full number is not known) were made to veterans.

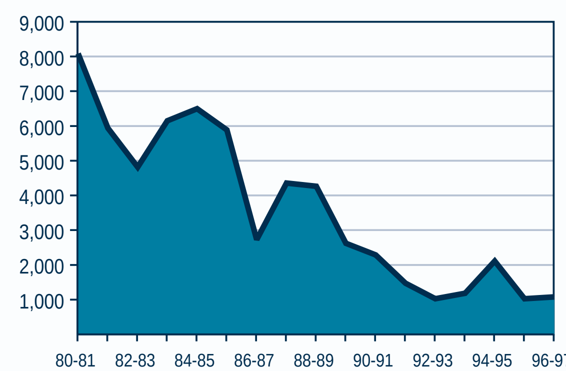
How Lack of Competitiveness Has Affected Cal-Vet

Cal-Vet New Loans Declining. Figure 5 shows that the number of new loans issued each year by the Cal-Vet program has fallen sharply since the early 1980s. Loan activity in 1996 exemplifies this trend. The 1996-97 DVA business plan for the program anticipated that almost $170 million in new loans would be issued. About $146 million in loans were actually issued.

Figure 5

Participation in the Cal-Vet Program Declining

Loans Issued Annually



About five Cal-Vet loans were paid off and retired for every one new borrower during 1996-97. Some of the loans were retired on a normal pay-off schedule and others due to the death or delinquency of the borrower. About 68 percent were taken off of the Cal-Vet program's books because a home sale or a loan refinancing resulted in the early pay-off of the loan.

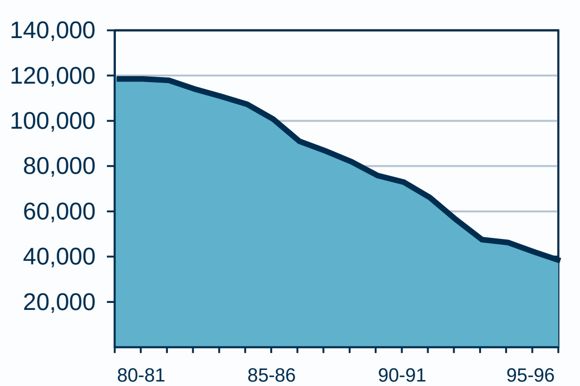
Certain demographic factors, which we discuss later in this report, appear to have contributed partially to the fall-off of new loan activity. We also believe the trend is related to the corresponding decline in market interest rates during the period in which these rates came in line with or dropped below the Cal-Vet program's rates.

Cal-Vet Portfolio Shrinking. This declining trend of new loans has sharply diminished the total number of loans in the Cal-Vet program portfolio, as seen in Figure 6. That portfolio dropped by 9 percent (about 4,200 loans) in 1995-96 and dropped another 9 percent (another 3,900 loans) in 1996-97. The 39,000 loans in the Cal-Vet portfolio as of June 30, 1997 is *less than a third* of the number the program had at the start of the 1980s.

Figure 6

Number of Cal-Vet Loans Has Dropped

Loans in Portfolio



Cal-Vet's Loan Market Share Disappearing. Cal-Vet's share of the California home mortgage market has always been small, but now has become even smaller. In 1990, about four-tenths of 1 percent of the $56 billion in home loans issued each year were issued by Cal-Vet. Now Cal-Vet has about a two-tenths of 1 percent share of a $59.6 billion loan market.

In addition, the number of loans made each year to California veterans under the VA, FHA, and CHFA loan programs dwarf the number issued by Cal-Vet. During federal fiscal year 1995-96, $4.6 billion in VA-backed loans were issued to 32,976 California veterans. The FHA, also active in the California market, assisted in financing almost 105,000 loans involving $11.2 billion during the 1995-96 federal fiscal year. (Of this total, 683 loans totaling $80 million were issued to California veterans.) Meanwhile, CHFA originated 6,166 loans amounting to $656 million during the overlapping 1995-96 state fiscal year. Cal-Vet issued only 984 new loans amounting to about $115 million during 1995-96.

After years of contending otherwise, the DVA now has recognized that its loan terms are no match for others in the private and public sector. Its pending $1.6 billion plan to restructure its debt is designed to lower the interest rate for most outstanding Cal-Vet loans to between 6.75 percent and 7 percent, and thus again make the program competitive with the private market. The new interest rate is expected to go into effect on April 1, 1998.

Even without these efforts by the DVA, however, the private-sector home mortgage market and other governmental mortgage assistance programs are meeting veterans' needs. Creditworthy veterans have many options for obtaining home purchase assistance in the current economic environment.

Mismanagement Eroded State's Equity in Program

Significant financial and operational problems in the Cal-Vet home purchase program, some resulting from past mismanagement by the Department of Veterans Affairs and others not of its making, eroded the state's equity in the Cal-Vet fund. Almost every major element of the program—from bond sales, investment of cash, and handling of delinquent accounts to loan origination, insurance programs, and customer service operations—has suffered because longstanding problems were allowed to continue without corrective action and proper oversight for many years.

Financial Losses Suffered Five Years in a Row

Audited financial statements indicate that Cal-Vet program expenses exceeded revenues by $22.5 million during 1996-97. As can be seen in Figure 7, this is the fifth year in a row that the program has recorded a financial loss. It is also the eighth year in the last eleven that a loss has been recorded.

These losses are not what administrators of the program had projected. A 1988 cash-flow projection prepared for the DVA suggested that Cal-Vet revenues would outpace expenses by $87 million during the five fiscal years ending in 1996-97. The actual result was a combined loss of about $125 million.

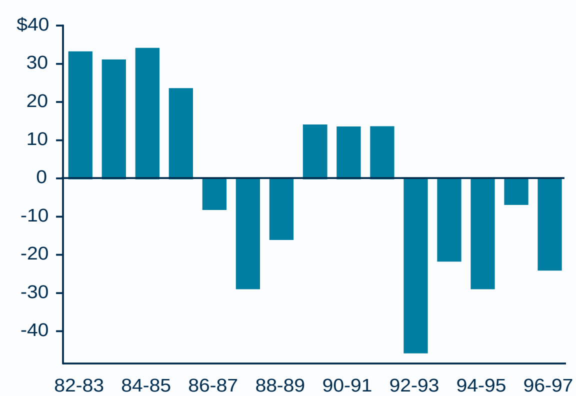
The cumulative effect of these successive annual losses has been an erosion of the state's equity in the program. By state equity, we mean the retained earnings that belong to the state after all liabilities, such as the outstanding bond debt, have been subtracted from the combined assets of the program, such as its cash and pool of purchase contracts. The equity essentially represents the financial return that has accrued over many years to state taxpayers for the billions of dollars they have invested in Cal-Vet mortgages for eligible veterans.

This equity, which was generated largely from the interest veterans paid on their loans and from other investments of the program's cash reserves, amounted to almost $458 million as of June 30, 1986. Because of the recurring losses over the last

Figure 7

Cal-Vet Program
Lost Money Five Years in a Row

Net Income/Loss (In Millions)



11 years of operation of the Cal-Vet program, the state's equity has dropped to about $258 million as of June 30, 1997. That is a $200 million, or 44 percent, decline during that period. This downward trend is evident in Figure 8.

The *long-term* impact of these losses on the state's equity appears to be even more significant. Long-term cash-flow projections released by the DVA in 1991 indicated that, once all outstanding bonds had been retired and all Cal-Vet mortgages were paid off, the state's remaining equity in the program would exceed $1.6 billion. More recent projections indicate that the state's remaining equity at program's end would be less than $600 million—$1 billion less than the prior forecast. Part of the $1 billion differential is interest earnings that were foregone because of the unexpected decline in the Cal-Vet loan portfolio. Another part of the $1 billion differential is the long-term impact of past mismanagement of program finances and operations.

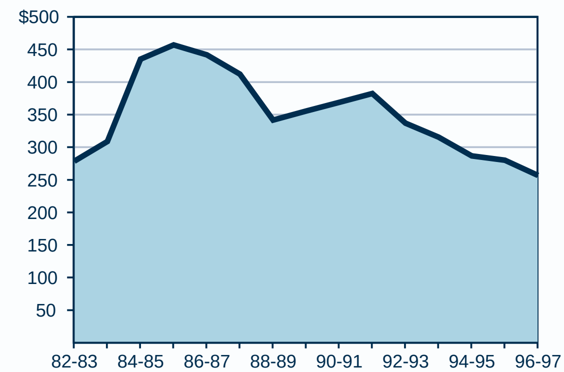
Forces outside of the DVA's managerial control, we note, have contributed to Cal-Vet's financial problems. These include statutory restrictions that were imposed on the program long ago that are not appropriate in the highly competitive loan market of the 1990s, major shifts in the California economy and interest rates, and constraints imposed through the federal tax code that have limited the program's potential market of eligible veterans.

On the other hand, other governmental loan programs, such as CHFA, faced their own set of constraints yet appear to have done a much better job of responding to changing conditions in the California mortgage market. While the Cal-Vet program was posting a $6.7 million loss in 1995-96, for example, the CHFA Home Mortgage Revenue Bond Program was experiencing a $21.5 million profit.

Figure 8

State's Equity in Cal-Vet Program Is Eroding

State's Equity (In Millions)



Program Remains Financially Secure

We do not believe the recent losses pose any danger to the state's ability to pay off the bonds out of program revenues. Cal-Vet continues to have more than sufficient cash and other assets on hand to meet its obligations to borrowers and bondholders. A September 1997 status report on the program issued by the DVA stated that "cash reserves of the Farm and Home Fund are more than adequate for forecasted requirements." The Cal-Vet program balance sheet shows that the program held almost $1.2 billion in cash and other investments as of June 30, 1997.

Notably, program assets as of that date exceeded 108 percent of the liabilities shown on its balance sheet, in an enterprise where a 103 percent asset coverage ratio is considered to be financially secure by loan program experts. Assets in excess of 103 percent may be removed from the program and used for other purposes where (1) other specific reserve requirements required for insurance and bond issuance are met and (2) program revenues will meet expenses for the remaining life of the outstanding indebtedness.

Why Has the Program Lost Money For Five Years in a Row?

The main reasons for the program's losses are (1) a mismatch between interest earned by the program and interest paid out for bonds, (2) problems in Cal-Vet insurance programs, and (3) a wave of delinquencies and foreclosures on Cal-Vet properties. Underlying all of these problems was a history of weak program operations and management. We discuss these problems in more detail below.

The Interest Rate Gap. For many years, the Cal-Vet program borrowed money by selling bonds at relatively high interest rates and invested the proceeds at lower interest rates. The results were tens of millions of dollars in losses, known in the bond business as "negative arbitrage." In 1994-95 alone, for example, interest payments by the program exceeded interest earned by $15.6 million.

These losses occurred in part as a result of earlier decisions by program managers and the State Treasurer to issue noncallable bonds, thereby locking in for 25 years relatively high interest rates that the Cal-Vet program paid to bondholders. For example, during 1980 through 1984, at a time when interest rates were at their peak in modern times, the Cal-Vet program issued more than $1.5 billion in noncallable bonds at relatively high interest rates ranging between 7.8 percent and 11 percent. At the time, the sale of noncallable bonds lowered the program's borrowing costs by making them more attractive to prospective buyers. While issuance of noncallable bonds might have been to the Cal-Vet program's advantage had rates been at a low point, the decision program officials made was to lock in interest rates on bonds for 25 years at their peak in modern times.

In addition, other Cal-Vet cash was heavily invested in the State of California's Surplus Money Investment Fund (SMIF). In the early 1980s, SMIF earned as much as a 12 percent return and such an investment made sense. But, as can be seen in Figure 9, the interest rate earned for cash invested in the fund dropped steadily over the years and by 1994 was only about 4 percent. Cal-Vet officials were slow to withdraw cash from SMIF and shift it to higher-earning investments, resulting in financial losses to the state in the tens of millions of dollars.

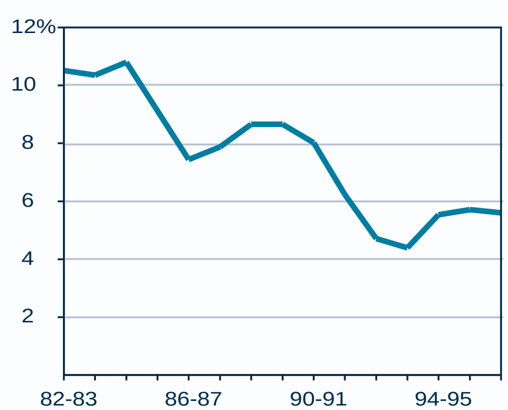
The problem was magnified during the 1980s as more and more Cal-Vet borrowers paid off their loans early. Because such a large share of the Cal-Vet debt consisted of noncallable bonds, the DVA could not use the surge of incoming cash from the paid-off loans to pay off the high-interest bonds and lower its debt burden. Instead, it was required to set that cash aside to retire the noncallable bonds in installments over their 25-year life. In effect, the Cal-Vet program was compelled to amass a large amount of cash, which was invested at a substantial loss to the state.

Another critical factor in these losses is the single-interest rate structure of the program, which is established in statute and not subject to change by the DVA. During periods such as the early 1980s when it was costly for the Cal-Vet program to borrow money through bond issues, the DVA did not have the flexibility to charge a correspondingly higher rate to *new* Cal-Vet borrowers unless the interest rate was also increased for almost all other *existing* Cal-Vet loans. Had Cal-Vet been granted the authority to more closely match the interest rate it charges to veterans getting Cal-Vet loans with the interest rate it paid on the bonds used to fund those loans, the financial losses might have been minimized.

Figure 9

Interest Rate Earned for Cal-Vet Investments Declined

SMIF Interest Rate



Life and Disability Insurance Program Problems. In its marketing efforts, Cal-Vet program officials have long stressed its low-cost, high-coverage, and low-deductible insurance coverages as an inducement to potential borrowers. However, the DVA's past failures to set aside adequate reserves, collect adequate premiums from borrowers, or to properly limit the program's financial risks have contributed significantly to the overall financial losses suffered by the Cal-Vet program in recent years.

Most of the losses since 1994 stem from the life and disability insurance program. A review of the program by the State Controller released in April 1996 found that insurance claim payments have generally exceeded premiums since 1983. This is occurring because the population of Cal-Vet loan recipients is aging and thus, not surprisingly, suffering more frequently from physical disabilities and filing claims against their coverage. The Controller concluded that, from 1984 through 1995, the life insurance program lost $29.6 million while the disability insurance component lost $18.4 million.

The statutes authorizing the Cal-Vet program make clear the Legislature's intent that the DVA maintain "appropriate and prudent" reserves for the life and disability insurance programs and that surplus funds are permitted to be used for the general purposes of the loan program.

It now seems clear that the DVA did not maintain adequate reserves to support the program in the long term. A 1993 actuarial analysis conducted by a DVA consultant found that the programs were underfunded by $38.4 million as of June 1992. The consultant concluded the programs had an unfunded liability due to, among other factors, (1) insufficient premium rates, (2) use of funds to subsidize a 1 percent cut in Cal-Vet interest rates from 1987 to 1989, and (3) transfers of funds to subsidize other Cal-Vet insurance programs. The Controller concluded in a 1996 review that "the financial instability of the program appears to have continued to deteriorate" since 1992.

In order to remedy the underfunding problem, the DVA is now implementing changes in life and disability coverage and premium levels, along with the transfer of the program to a private insurance firm. However, these actions are being challenged in a pending Los Angeles Superior Court lawsuit by Cal-Vet borrowers who contend that any changes in premiums and benefits should be overturned and that $71 million of the state's equity in the program should be placed in a special reserve for the two insurance programs.

Although the reserves set aside for the insurance programs were insufficient, it may well have been legally permissible for them to be operated in that fashion. Nonetheless, if the courts rule against the state on this issue, it could create further financial problems for the program.

Other Insurance Difficulties. The Cal-Vet program has in the past often operated without sufficient reserves in its other insurance programs. During some years, these other programs have suffered significant losses from fires, earthquakes, and floods that have contributed to the program's overall unprofitability.

A DVA consultant concluded that the programs have, at times, left the state vulnerable to even greater financial losses. The financial weakness in the programs was attributed to the insufficient premiums charged to Cal-Vet borrowers and the deductibles and other terms of coverage that have been much more generous than comparable commercial insurance policies. For example, the disaster indemnity plan provides only a $250 deductible for each claim—significantly less than commercial insurance policies requiring a deductible equal to 25 percent or more of the value of the insured property.

Delinquencies and Repossessions. The Cal-Vet program has suffered major financial losses in recent years as many borrowers became delinquent or defaulted on their loans. In addition to the lost mortgage payments, the program has lost substantial sums of money on the resale of the properties upon which it foreclosed for nonpayment. Also contributing to the program's losses were historically weak loan underwriting practices and poorly coordinated efforts and procedures for handling delinquent contracts and repossessions of property.

As of the end of 1995-96, about when the problem reached its peak, 2,317 Cal-Vet loans were delinquent but still active, another 326 Cal-Vet contracts had been canceled due to delinquency but not yet foreclosed upon by the program, and another 459 foreclosed-upon properties were in the Cal-Vet program's possession. Thus, 3,100 loans, or about 7.2 percent of the total Cal-Vet portfolio, consisted of troubled loans and foreclosures, compared with about 4.3 percent for private-sector lenders. Figure 10 shows the growth that occurred in the Cal-Vet inventory of repossessed property in 1995 and 1996. At one point, the value of the repossessed property on the Cal-Vet program's books was estimated to be more than $75 million.

The cost of a loan foreclosure to the Cal-Vet program can be high. During the recent surge of foreclosures, each Cal-Vet property that had to be foreclosed upon and resold typically resulted in lost interest payments of $5,900. Cal-Vet also typically lost $26,100 on the resale of a foreclosed-upon home. The program usually lost an average of 27 percent of its investment in a resold property. This is a significant change from the past, when Cal-Vet usually was able to resell repossessed property at a small profit.

Thus, repossessions have taken an increasing toll on the Cal-Vet program's bottom line, as can be seen in Figure 11. The program recorded an $8.3 million loss in 1996-97 on the disposal of repossessed property for that year. Financial statements provided by the DVA also indicated that program officials had reduced the value of the real estate assets on its books by $18 million to account for projected future losses on repossessed property.

Even larger losses are reflected on Cal-Vet's financial statements to account for the failure of veterans to make payments on delinquent loans. The statements indicate that $22.7 million in bad debts were written off by the program during 1996-97.

For many years, Cal-Vet underwriting standards were lax compared to those applied by commercial

Figure 10

The Inventory of Repossessed Property Has Grown

Repossessed Properties Held

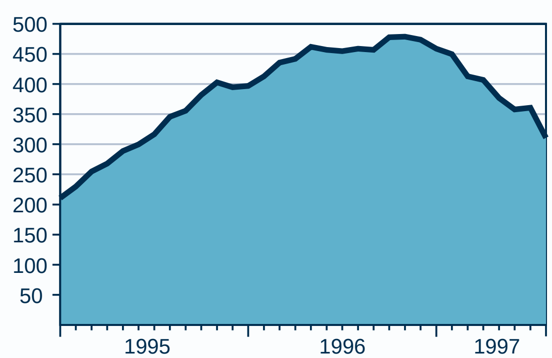
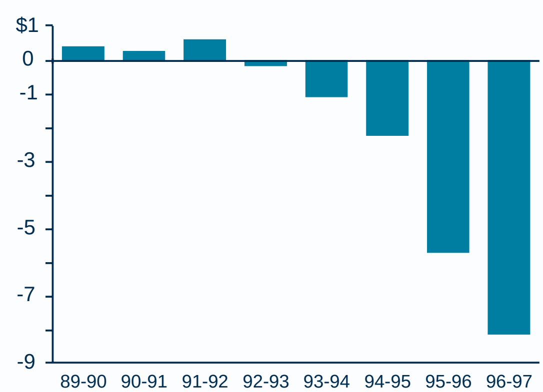


Figure 11

Repossessions Taking Toll On Cal-Vet's Bottom Line

Annual Repossession Profit/Loss (In Millions)



lenders and other governmental loan programs. For example, incomplete credit reports were sometimes used to determine the eligibility of applicants, and loans were sometimes granted to individuals with prior bankruptcies and foreclosures or an excessive amount of other debt that would have automatically disqualified them with other lenders. These Cal-Vet practices may have helped the program to compete for a greater share of the lending market in the short run, but proved costly to the state in the long run.

The failure of program managers to require property mortgage insurance for Cal-Vet loans involving a low down payment also led to sizable financial losses for the program. When California's severe recession early in the 1990s depressed housing prices—in some cases by as much as 40 percent—a number of veterans found that their houses were worth less than what they owed Cal-Vet and walked away from the properties. Because the loans were not backed up with property mortgage insurance policies, the millions of dollars in losses that resulted fell entirely on the Cal-Vet program.

Cal-Vet often failed to intervene early, when a veteran first missed a payment, to provide financial counseling or assistance that could prevent a default from occurring. When a wave of foreclosures did hit the Cal-Vet program, district offices appeared ill-prepared for the task of taking legal steps to reacquire control of the property, bringing it to marketable condition, and marketing it aggressively for resale.

The DVA's initial sluggishness in coping with the surge of defaulted loans results from a number of factors, including inadequate training of Cal-Vet personnel, the lower priority given repossessions by some district offices, excessive paperwork, and inadequate case-tracking systems. Some district offices were aggressive about fixing up repossessed property for resale, while others were reluctant to fix even minor cosmetic problems that could drive away potential buyers.

It should be noted that some delays in processing of foreclosures were due to factors outside of the program's control, such as backlogs in the processing of necessary documents by county recorders and filings for personal bankruptcies by Cal-Vet borrowers. In the latter case, such filings automatically stay the repossession of a veteran's property.

Weak Management and Operations

In the past, the DVA has mismanaged Cal-Vet program operations, historically overstaffing field offices and understaffing critical cash and debt management operations in ways that have contributed to its financial losses and the $200 million loss in the state's equity. A lack of effective internal and external checks-and-balances over the DVA's decision making is also an underlying factor. For example:

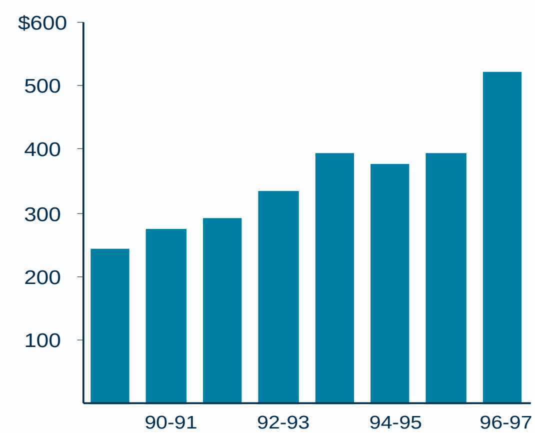
- A consultant retained by the DVA concluded that the bond and cash management operations "would appear to be understaffed to appropriately operate and manage $3.4 billion in bond liabilities and $1.3 billion in investment assets." This lack of management capability has been aggravated by inadequate and poorly integrated computer information systems for tracking the loan portfolio and program finances.

- The DVA reports show that each Cal-Vet staff member in the field assigned to loan origination and loan duties handled an average of 41 funded loans during 1996-97, a little more than three and a half completed loans per month. By way of comparison, a private-sector loan processor is likely to generate at least 20 funded loans per month.
- Cal-Vet staffing has remained fairly fixed as the volume of loans applied for and funded through the program has fluctuated greatly from year to year. For example, Cal-Vet was able to process nearly three times as many funded loans in 1994-95 with about the same size staff as it has now.
- Weaknesses have also been demonstrated in Cal-Vet's field operations, where the application of program rules and policies has varied significantly from district office to district office. Some offices have been more lax than others in scrutinizing which applicants were creditworthy. Some were slow to address the wave of delinquencies and foreclosures that has proved to be very expensive to the program.
- Financial statements document that annual overhead costs (mainly payroll and other reported program support expenditures) have increased modestly in the Cal-Vet program over the last seven years even though the number of active loans has dropped almost in half. Figure 12 shows that the overhead costs of the program have more than doubled during the last seven years, climbing from $241 per contract in 1989-90 to $519 per loan as of 1996-97. The program might have saved millions of dollars and offset some of its losses due to other causes had it been able to keep a tighter rein on staff and operational expenditures.

Figure 12

Cal-Vet Overhead Costs Growing

Overhead Cost Per Contract



The lack of external or internal systems to hold the DVA accountable has hidden the overstaffing and other problems in the Cal-Vet program from public view.

Because it is engaged in an entrepreneurial and competitive activity, the Cal-Vet program is off-budget and its appropriations have not been subject to the review normally provided by the Legislature in annual budget hearings. The California Veterans Board's part-time status, advocacy role for veterans, and lack of an independent staff mean that few decisions by Cal-Vet program administrators are challenged or publicly debated by board members.

THE "REENGINEERING" OF CAL-VET

The Department of Veterans Affairs has undertaken a process to "reengineer" the Cal-Vet home purchase program, curtail its financial losses, and again make the program beneficial to veterans.

Reform Process Under Way. In 1996, in response to growing concern over mounting annual losses in the Cal-Vet program, the DVA embarked on an effort to reexamine its operations.

First, the department retained an outside consultant and assigned the firm to conduct a "baseline review" to assess its performance. That review focused on (1) the processing and servicing of loans, (2) insurance program and tax collection issues, (3) financing of the program, (4) the computerized communications "infrastructure" of the program, and (5) statutes and regulations governing Cal-Vet operations. The consulting firm completed a comprehensive report by mid-1996 calling for a major overhaul of almost every facet of Cal-Vet's operations.

The DVA next initiated what it has termed a "business process reengineering" program to assess the findings of the consultants and to determine specifically how those findings deemed to be worthwhile could be implemented. The DVA created ten internal teams with direction to return within a few months with recommendations for program changes. The DVA's managers subsequently reviewed the team recommendations, in some cases rejecting team proposals but in many other cases issuing orders for specific program changes that they proposed. Some have already been implemented, while other more complex tasks will take longer to carry out.

Among the changes being made as a result of the DVA reengineering process:

- ***Restructuring of Staff Operations.*** While district offices will continue to play a leading role in marketing the loan program and processing loan applications, loan underwriting and certain loan-servicing functions will be centralized in Cal-Vet's Sacramento headquarters. The number of full district offices was reduced to five and the number of satellite offices increased to five. The changes are intended to generate staff savings and make underwriting decisions more consistent.

- ***Dealing With Delinquent Loans.*** New processes have been established for early intervention when loans become delinquent. A new management position was established with the responsibility to allow Cal-Vet to repossess nonpaying properties more quickly and to shorten the turnaround time for reselling those properties.

The DVA believes the reforms are part of the reason the number of delinquent loans and foreclosed properties has begun to decline after two years of steady increases.

- ***Establishing an Integrated Information System.*** The DVA has initiated the process of procuring a new Integrated Loan Processing and Financial Information System (ILPFIS) to weave together the multiple, and often dysfunctional, data systems that have made the Cal-Vet program so difficult to manage in the past. The DVA's schedule for the project calls for installation of the new system to be completed by June 1998.

- ***Reforming Insurance Programs.*** With the consent of the California Veterans Board, the DVA has been reviewing and revising the fees, deductibles, and coverages provided under its various insurance programs to ensure their solvency in the short term and reduce the state's exposure to financial losses in the long term. Except for a pool of the most aged Cal-Vet borrowers, life and disability coverage is now provided by an outside vendor. Fire and hazard policy terms have been rewritten to keep fees stable. The DVA-sponsored legislation to reform the disaster indemnity plan by increasing the deductible and limiting coverage has been approved, and a $10 million reserve for claims has been established for the disaster insurance program.

The DVA has established a tracking system to ensure that the changes in the Cal-Vet program directed by management are carried out in a timely manner. A new program manager was also named and given direction to implement the proposed reforms.

Financial Restructuring. In an effort to restore the competitiveness of Cal-Vet loans, the DVA has undertaken a $1.6 billion financial restructuring of the program. The key elements of the proposal, as announced in September 1997, are as follows:

- ***Bond Sales.*** About $1.3 billion in outstanding callable bonds sold in the past at relatively high interest rates (some as high as 10.9 percent) are being refunded through a new bond sale at current, and much lower, interest rates (about 5 percent). About $1 billion in old general obligation bonds and $300 million in old revenue bonds will be retired in the transactions to save about $100 million a year on interest payments. Also, about $340 million in new general obligation bonds are being sold under the authority of Proposition 206, a bond issue approved by California voters in November 1996, as well as unused authority left over from previous ballot measures.

- ***Lower Interest Rates on Existing Loans.*** The interest rate charged on most of the 39,000 loans in the Cal-Vet portfolio will be lowered from its present 8 percent level to between 6.75 percent and 7 percent starting in April 1998. The new Cal-Vet rate is anticipated to be in line with interest rates charged in the private sector. The DVA says that this will generate a surge of new Cal-Vet loan applications and stop veterans who already have loans from paying them off and refinancing them with other lenders. Because of the cut in what Cal-Vet borrowers must pay, the state will incur annual losses probably ranging between $1 million and $15 million per year at least through the year 2010. The losses are unavoidable under the plan because of ongoing high cost to the program of older, noncallable bonds.

- ***Stretch Out Retirement of Outstanding Debt.*** As a result of the issuance of new bonds to replace existing bonds, the timetable for retiring the state's outstanding debt for the Cal-Vet program will be stretched out another 13 years. Instead of paying off almost all its bonds by the year 2019, the new payment schedule means the Cal-Vet's bond debt will not be retired until the year 2032.

- ***Require Mortgage Insurance.*** Cal-Vet borrowers who make low down payments will be required to have some form of mortgage insurance or loan guarantee in place, usually through the VA loan guarantee program, to reduce the risk of default or loss of payments to the state.

- ***Eliminate Single Interest Rate.*** The DVA advises that it will seek legislation this year that would do away with the single-interest rate structure of the program. Henceforth, if such legislation is approved, new Cal-Vet loans could be made at rates that are in keeping with the rates the program would pay to borrow money. Existing borrowers would not see the interest rate on their loans go up even if the DVA established a higher rate for new borrowers.

- ***Make Loans to Peacetime Veterans.*** A new revolving loan pool of up to $100 million would be established to make loans to peacetime veterans who do not qualify for either of the existing general obligation or revenue bond loan programs. The funding source would be bond funds that predate federal tax code restrictions and other Cal-Vet cash that the DVA contends "unrestricted."

A Model Process. We believe the program that the DVA has developed is more likely to be successful because of the Total Quality Management (TQM) process the department employed in its development.

The TQM is a formal process by which an organization can successfully initiate and manage major changes in its operations. It is characterized by a customer-service orientation, a focus on delivering quality products or services, the involvement of both employees and managers, the use of "benchmarking" of the practices of competitors to assess past performance, and the development of measurable standards to judge future performance.

LAO Concerns About Reform Plan

We have concerns about some elements of the Cal-Vet reform plan—particularly its impact on the state's equity and the expansion of benefits to peacetime veterans—but believe it is reasonable overall in the short term.

Reform Plans Have Merit

We have reviewed in detail the DVA's business reengineering and financial restructuring plans and have concluded that, on the whole, they represent a significant improvement in the operation of the program that is likely to be of great benefit to veterans and state taxpayers in the short term.

We believe, first of all, that it makes sense for the DVA to take advantage of what appears to be a low point in interest rates to lower its bond interest payments. A corresponding reduction in the interest rates paid by Cal-Vet borrowers also appears justifiable, given that veterans are now paying rates that are higher than can be obtained from private lenders.

Preliminary calculations indicated that the DVA's plan to stretch out Cal-Vet debt payments another 13 years would require the state to make $400 million in additional principal and interest payments to retire that debt. However, our analysis indicates that the state would effectively postpone the payment of dollars in the short term and increase the payment of dollars in the long term that, due to inflation, will be less valuable. Once these effects of inflation are taken into account (we assume an average inflation rate of 3.5 percent per year over the long term), the state could realize a net savings of $50 million.

Most of the changes now being made in Cal-Vet operations and programs appear to be warranted. The DVA has so far avoided the imposition of higher insurance premiums on Cal-Vet borrowers for fire and hazard and disaster indemnity coverages, electing instead to rein in program costs by tightening coverages of insured losses. These coverages have been more generous than any to be found in the private insurance market. The focus on getting district offices to more aggressively resell repossessed Cal-Vet properties already appears to have paid off; the number of properties held by the state has begun to decline.

LAO Concerns

Based upon our analysis of the Cal-Vet program, we are concerned with several aspects of the reform package being implemented by the DVA.

Impact on State Equity. One major cause for concern is the failure of the DVA and the California Veterans Board to fully assess and consider how the restructuring of Cal-Vet finances would affect the state's equity in the program.

At the time that the board approved a resolution of support for the restructuring plan, neither the DVA nor the board had obtained any analysis comparing how the state's equity would be affected if it proceeded with the plan versus a decision for the status quo. Given the significant amount of state funds at stake, we find this lack of analysis and consideration of the interests of the state's equity to be worrisome.

In fact, the implementation of the restructuring program will significantly reduce the state's equity in the short term. We have estimated that the state's equity in the program in 2001 could be as much as $80 million to $90 million lower than would otherwise have been the case, depending upon how much the Cal-Vet interest rate is lowered later this year. The long-term impact is unknown. At the time this report was prepared, the DVA had not responded to our requests for a long-range comparison of state equity under the DVA restructuring plan versus a decision not to proceed with restructuring of the debt and a lowering of the Cal-Vet interest rate. The DVA has advised us that it intends to conduct such an analysis after it has largely completed its financial restructuring of the Cal-Vet program.

No Analysis of Veterans' Needs. Our second major concern is that the DVA appears to be focused upon finding ways to perpetuate the Cal-Vet program without any analysis of whether its loan program is really needed.

In recent years, in an effort to prevent its loan pool from shrinking further, the DVA has sponsored and won passage of several state legislative measures to expand the pool of veterans eligible for Cal-Vet loans. This has included legislation over the last three years to bump up the amount of money that can be borrowed to buy a home from $90,000 to $250,000; to liberalize the rules to make it easier for a veteran to get a second Cal-Vet loan; and to expand the periods defined in state law as wartime service qualifying a veteran for Cal-Vet. (The DVA is also pursuing federal legislation that would allow use of general obligation bonds for Cal-Vet loans without regard to when and how a veteran served in the military, but four legislative attempts to do so have failed.)

Each time it sought these changes, the DVA predicted that they would boost participation in the program. Instead, the number of active contracts has continued to diminish. This decline in Cal-Vet loans in part reflects the fact that there are other private-sector and governmental loan programs that are meeting the needs of veterans.

Instead of trying to "compete" with other taxpayer-supported programs, we believe the DVA should consider whether the needs of California veterans are being met adequately by those competitors. For example, the VA loan program provides a generous loan package for both wartime and peacetime veterans, making the expenditure of state resources to compete with it unnecessary.

Voters Have Not Approved Use of Existing Bond Funds to Aid Peacetime Veterans. Last year, the DVA sponsored and won passage of Chapter 155 authorizing the granting of loans to peacetime veterans for the first time in the 77-year history of the program. Based on that legislative authority, the DVA initially announced plans in September 1997 to create up to a $100 million loan pool for peacetime veterans not otherwise eligible for loans from its general obligation or revenue bond funds.

In December 1997, we were advised by the DVA that it does not now intend to use the $100 million pool of "unrestricted" funds to make loans to peacetime veterans. The DVA states that it will instead only make loans to peacetime veterans using the proceeds of revenue bonds that were not subject to voter approval. We remain concerned, however, that the difficulty in finding loan applicants who meet these strict eligibility rules for loans financed with revenue bonds might prompt the DVA to revise its policies in the future to again use the $100 million pool for peacetime veterans.

In our view, granting loans to peacetime veterans is inconsistent with the Cal-Vet bond issues approved by California voters. The electorate was told at the time these measures went on the ballot that the bond issues would be used for the benefit of war veterans, not peacetime veterans. If the Legislature wishes to expand Cal-Vet benefits to peacetime veterans, it may wish to consider placing a new general obligation bond issue before the voters seeking their approval for such a program.

The DVA contends, based on the legal advice it has received from private counsel, that it already has all the legal authority it needs to use "unrestricted" funds for loans to peacetime veterans. However, we have been advised by the Office of Legislative Counsel that the proceeds of bond issues enacted by the voters prior to the effective date of the new Military and Veterans Code section cannot be used for loans to peacetime veterans. We have been advised that the proceeds of future bond acts could be used for such a peacetime loan program if the voters approved such a bond measure. Thus, the new code section appears to be legal, but is not effective for "unrestricted" funds until ratified by voters in a future bond act.

Veterans' Needs Are Changing

The Cal-Vet loan portfolio is likely to continue to dwindle because of federal legal restrictions on tax exempt state bonds and because the aging war veteran population is buying fewer homes and has less need for loan assistance. Veterans do have other growing needs that are likely to create pressure for more General Fund spending.

Restructuring Will Only Slow Program Decline. The DVA has publicly stated that its financial restructuring plan is intended to stabilize the Cal-Vet portfolio after years of decline in the number of active loans. Our analysis suggests that, while the DVA's latest efforts may in fact slow the decline in the program, the number of active contracts is likely to continue to drop.

We agree with the DVA that the number of new home loans generated is likely to increase. The number of new loans issued annually could double and may well exceed 2,000 as the department has suggested. However, based on our analysis of the situation, we expect that the number of loans taken off Cal-Vet's books each year for various reasons will continue to exceed the number of new loans that are issued.

We believe the decline in the Cal-Vet portfolio is likely to continue because of several factors:

- ***Underlying Trends in Loan Portfolio.*** Even if Cal-Vet interest rates are more attractive, many veterans will continue to terminate their loans early. In today's real estate market, the average life expectancy of home loans is ordinarily only 10 to 12 years, much less than the 30-year term provided for most loans. This is due to a more mobile society, major swings in mortgage interest rates, and the incentive to refinance loans because tax-deductible interest payments decrease on older loans. In addition, many Cal-Vet borrowers—more than 900 per year—are paying off their loans at the end of their regular term. That trend is likely to continue regardless of changes made now in the Cal-Vet program. And finally, almost 200 loans per year go off the books each year because of the death of the borrower.

- ***Federal Restrictions on Tax Exempt Status of Cal-Vet Bonds.*** Growth in the issuance of new loans will be hampered by the longstanding federal restrictions on the tax deductibility of general obligation bonds used for loans to veterans. Fewer and fewer veterans meet the federal criteria limiting the use of tax exempt bonds to loan applicants who had active military service before 1977 and who applied for the loan within 30 years of that service. We believe other legal constraints will hamper the use of alternate funding sources, such as revenue bonds or the program's cash reserves, to avoid the federal limitations imposed on use of bond funds to make loans to veterans.

- ***Aging of Eligible Population.*** The aging of the eligible veteran population will continue to significantly depress the demand for new Cal-Vet loans. Most of the veterans who are eligible for Cal-Vet loans left the service in 1972 near the end of the Vietnam War and now are in their 50s and 60s. As can be seen in Figure 13, real estate marketing data show that only 7.6 percent of homes are bought by persons age 55 to 64 and only 5.5 percent are bought by persons age 65 or older. Many veterans no longer need Cal-Vet loans because they are no longer purchasing single-family homes.

Figure 13

Age of California Home Buyers

Age	Percent for 1995
24 years or less	1.9%
25 to 34 years	29.6
35 to 44 years	39.7
45 to 54 years	15.7
55 to 64 years	7.6
65 years or more	5.5
Median age: 38 years	

- ***Competition From Other Lenders.*** Veterans who are eligible for Cal-Vet loans will continue to turn to other lenders. The FHA and VA loan programs are likely to continue assisting far larger numbers of veterans than Cal-Vet, in part because of their less restrictive eligibility rules and because they are being more aggressively and effectively marketed by private lenders who have a stake in the programs. Private lenders will also continue to erode Cal-Vet's

> customer base. Data provided to us by the DVA indicate that the average family income of a Cal-Vet borrower is $62,784 per year. Persons in that income level are not likely to be dependent on governmental programs such as Cal-Vet for assistance, especially with conventional mortgage interest rates near the lowest level in 25 years.

What these factors generally indicate, in summary, is that the need for the Cal-Vet program is steadily declining along with the size of the Cal-Vet portfolio. The population of wartime veterans that Cal-Vet has traditionally served is exiting the home-buying market. The new group of peacetime veterans to whom Cal-Vet would like to begin making loans has other generous lending programs available, including several tailored specifically for veterans, to provide them with such assistance.

Other Veterans' Problems Are Growing. While their need for mortgage assistance is ebbing, California's population of veterans (estimated variously at 2.8 million to 3.2 million) has large and growing problems.

While precise numbers are not available, some estimates suggest that tens of thousands of younger veterans in California are homeless and lack job-training, mental health, substance abuse, housing, and outreach services. A 1994 report by the General Accounting Office (GAO) surveyed eight communities across the country, including San Francisco, and concluded that the U.S. Department of Veterans Affairs' "current programs constitute a small portion of what is likely needed to fully address the needs of the home veteran population."

Hundreds of thousands of aging veterans are likely to require living assistance at home, nursing home care, and hospital services, special treatment for Alzheimer's, dementia, and alcoholism, and other support services. In anticipation of such needs, the state is already building four new veterans' homes in Southern California to complement the Civil War-era home operated at Yountville in Northern California. Veterans' groups are also voicing concern about the lack of adequate and available cemeteries in which to bury and honor military veterans.

However, the state faces significant fiscal constraints that could hamper efforts to address these problems. Given current forecasts for the growth in state revenues, significant expansion of any state program generally will create pressure to either make cuts in other existing programs or increase state revenue sources.

Major Expansion of Federal Aid Not Likely. Although all military veterans became so as employees of the federal government, a major expansion of federal support for veterans' programs does not appear likely. A reduction of federal assistance for such programs in the future appears to be more probable.

For example, the veterans' home at Yountville depends on the federal government for about 53 percent of the funding needed to support its operation. The federal balanced-budget agreement approved by Congress and the President last year may eventually result in significant cuts in Medicare, Medi-Cal, and U.S. Department of Veterans Affairs' expenditures—the very three programs upon which the home is most heavily reliant. The shortfall experienced by the state could be millions of dollars annually, depending on how the balanced-budget accords in Washington are implemented.

An erosion of federal support for Yountville and the other veterans' homes now under development would likely leave the DVA with essentially only three difficult choices: (1) increasing fees for veterans who reside at the homes; (2) cutting the cost of operating the homes, potentially affecting services to residents; or (3) backfilling lost federal money with the state General Fund.

There are other indications that federal assistance to California veterans is likely to be limited in the future. For example, a 1994 GAO report on homeless veterans cast doubt as to whether any additional aid for that group was likely to be forthcoming from the federal government. "In an era of tight budget constraints, enhancing the services for the homeless could require curtailing services to other veterans," the GAO concluded.

LAO RECOMMENDATIONS

THE SITUATION HAS CHANGED

Time for a New Direction. Much has changed since the Cal-Vet program was established 77 years ago:

- The private-sector mortgage marketplace has become more efficient and competitive, and the federal and state governments have established VA, FHA, and CHFA programs to provide single-family housing assistance.

- The economy has changed, with a reduction in home mortgage interest rates to their lowest point in the past 25 years, thereby opening up the opportunity to buy a home to many Californians previously shut out of the housing market.

- After suffering significant financial losses, Cal-Vet managers are implementing the most aggressive and comprehensive reform in the program's history. Long-outmoded operations are being reengineered and a $1.6 billion restructuring of program finances is being implemented.

- The needs of most California veterans are changing. This population now constitutes a fraction of the single-family home buying market and its need for loan assistance is declining as this population ages. But the population has other important needs for general and specialized medical assistance, nursing care, and other services.

Given this changing environment, we believe it is time to rethink the basic direction that was set for the Cal-Vet program in 1921 and establish a fundamentally new state approach to veterans' assistance that reflects the realities of the 1990s. In the short term, we believe the state should follow through on the ongoing reengineering process and ensure that the Cal-Vet program runs more effectively. In the long run, we believe the provision of new loan assistance through the Cal-Vet program should be phased out and the state's significant remaining equity in the program be redirected in a way that will benefit both state taxpayers and veterans.

Our specific recommendations to carry out this approach are described below and are summarized in Figure 14.

Improve Cal-Vet Checks-and-Balances

We recommend that both internal and external oversight of the Cal-Vet program be strengthened to ensure that the program is properly managed and that an appropriate balance is struck between providing tangible benefits to deserving California veterans and protection of the interests of state taxpayers.

Strengthening Oversight. To accomplish this end, we propose that the Legislature modify the statute that created the California Veterans Board to ensure that the panel has the expertise needed to supervise a program with $3 billion in outstanding debt and 39,000 active loans. The seven-member board should be expanded to nine, with both the State Treasurer and the Director of Finance, or their appointed representatives, given ex officio positions on the panel. In addition, three of the other board positions should be reserved for veterans with experience in accounting, the mortgage lending industry, and financial investments. These requirements could be phased in over time to ensure that no current board member loses his or her present position and would ensure that the board has the financial expertise and balanced perspective to ensure proper operation of the program. Establishing this expertise on the board could be especially important if the Legislature wishes to consider any proposals to transfer authority over issuance of debt and investment of funds from the State Treasurer to the DVA.

To strengthen legislative oversight of the program, we further recommend that state law be changed to make the California Veterans Board a separate item in the state budget subject to annual line-item appropriation by the Legislature. The source of funding for the board would continue to be the 1943 Act Fund, and not the General Fund. Because of the entrepreneurial nature of its loan-making activity, we do not propose that other Cal-Vet program operations be placed in the budget beyond those administrative positions already appropriated through the budget act. This is because, in our view, such a step would make it

Figure 14

Summary of LAO Recommendations

- ☑ Internal and external oversight of program should be improved.
- ☑ Abandon single-interest rate structure and make other operating improvements.
- ☑ Legislate the orderly phase-out of program in accordance with federal limits on the use of tax exempt bonds.
- ☑ Subject to voter approval, shift surplus Cal-Vet funds to other programs that benefit veterans and state taxpayers.

difficult for the DVA to respond and adjust to rapid changes in the mortgage market and the economy.

The new and separate budget for the California Veterans Board should include a newly created staff position, who would be hired by and be held accountable to the board and who would be independent of the administrators of the DVA. This staff position would be charged with providing independent analysis and advice to the board on the major policy issues and decisions on its agenda.

Because the Legislature's oversight of the Cal-Vet program would remain limited, we believe that state law should also be modified to strengthen the decision-making role of the board to ensure accountability in program decision making. An important first step in that direction was taken with the enactment of Chapter 1145, Statutes of 1996 (SB 1470, Johannessen), which required that the Secretary of the DVA "fully brief" the board before making any policy change in veterans' programs. We believe the board's role should be additionally enhanced by requiring that off-budget staffing and administrative expenditures of the Cal-Vet program be reviewed and approved each year by the board and justified by the DVA on a workload basis. (Expenditures reviewed and approved by the Legislature would not be subject to board approval a second time.) Finally, the DVA's business plan, which outlines how the program will be financed, operated, and marketed in the coming fiscal year, should be subject to advance review and approval by the board. The new staff analyst position we propose would assist the board with independent review and advice in these matters.

In order to preserve program flexibility, the DVA would retain its broad, existing authority to make new loans to veterans, invest program funds, issue debt, and make other key operational decisions without the specific preapproval of the board. The board would continue to function as an appeals board for persons denied Cal-Vet benefits by the DVA.

Improved Reporting Requirements. The current legislative reporting requirements for the Cal-Vet program, in our view, need to be strengthened.

State law requires the board to report by August 1 of each year on "the activities, accomplishments, and expenditures of the board" during the prior calendar year. We recommend that the board's report be changed to require that it cover the activities of the prior fiscal year, not the prior calendar year. The deadline for reporting could be changed to September 1 to ensure that the board has sufficient time to prepare its report.

Existing law also requires that the Secretary of Veterans Affairs annually commission an independent financial audit of the Cal-Vet fund. By law, the completed audit is to be provided to the legislative policy committees and the board. We recommend that state law be changed to specify that the auditor is to be commissioned by and held accountable to an audit committee of the California Veterans Board, not the Secretary of the DVA.

In addition, the DVA should be mandated to provide a comprehensive annual report to the

Legislature regarding the operation of the Cal-Vet program. That report should detail information about loan issuance and repayments, debt levels, loan interest rates, the return on the investment of program cash, trends in delinquencies and foreclosures, the solvency and reserves achieved in insurance programs, and other measures of program activity to be defined in state legislation. The report should be submitted to legislative committees with jurisdiction over fiscal affairs, veterans' issues, and housing policy.

Given the extensive reengineering process that is ongoing at the DVA, we do not believe there is a need at this time for another broad performance review of the Cal-Vet program. However, we recommend that, once the DVA has had a chance to substantially complete its reform efforts, the Bureau of State Audits (BSA) should be commissioned to conduct a more narrowly targeted financial audit and program compliance review of the program.

The BSA audit would check the accuracy of Cal-Vet financial reports, verify that eligibility rules for the program are being enforced, determine whether staffing levels are consistent with program workload, review cash- and debt-management practices of the program, and determine whether the state equity in the program is being properly preserved. Because such audits are time-consuming both for auditors and the agency being audited, we propose that the BSA review be delayed until DVA reform efforts, such as the installation of a sophisticated new computer information system, have been completed. Thus, we recommend the BSA review of the Cal-Vet program be completed by September 1999, if the BSA agrees that timetable is feasible.

We believe the steps outlined above will establish the appropriate checks-and-balances needed to ensure better operation of the Cal-Vet program without unduly intruding on the authority of the executive branch or the ability of the program to adjust to changing economic conditions. Our recommendations for improving oversight of the Cal-Vet program are summarized in Figure 15.

Figure 15

Recommendations for Improving Cal-Vet Program Oversight

- ☑ Expand California Veterans Board from seven to nine members and add needed expertise.
- ☑ Make the board budget subject to annual legislative review and appropriation.
- ☑ Create an independent staff analyst position for the board.
- ☑ Require board approval of administrative spending and annual business plan for the Cal-Vet program.
- ☑ Require independent auditor report be submitted to the board's audit committee.
- ☑ Provide a more comprehensive annual report on Cal-Vet program activity to the Legislature.
- ☑ Bureau of State Audits conducts review of the program after Cal-Vet reengineering completed.

PROGRAM RESTRUCTURING NEEDED

We recommend that the Cal-Vet program be restructured so that future Cal-Vet loans could be issued at an interest rate different, if necessary, from the rate established for previous Cal-Vet borrowers. Other short-term program improvements to complete the reengineering process begun by the Department of Veterans Affairs should also be encouraged.

Abandon Single-Interest Rate. As we discussed earlier in this report, virtually all Cal-Vet loans—with the exception of about 800 loans issued before 1974—bear the identical interest rate. If the DVA determines that the interest rate for newly issued single-family home loans should be adjusted, it must by law also adjust the interest rate for all outstanding post-1974 loans at the same time. The single-interest rate requirement makes it very difficult to manage the program in periods of economic change.

Consider the difficult situation in which interest rates are rising and it becomes more expensive for the program to borrow funds through bond issues. In such an event, the program can leave unchanged the rate it charges to its borrowers, and issue loans to new borrowers at rates that will result in financial losses to the program year after year. In the alternative, the interest rate can be raised for all borrowers—an unpopular step likely to create financial difficulties for many veterans.

We recommend that state law be changed to allow the program to issue new loans at rates commensurate with the cost to the state of borrowing the bond funds used to fund those new loans. Veterans may have to pay a higher rate than prior Cal-Vet borrowers, but they would still receive a real benefit from the state. Even those higher interest rates could be lower than they might obtain in the private sector.

One additional benefit of this approach is that the Cal-Vet program could essentially "lock in" the new, lower loan rates it hopes to achieve through its ongoing restructuring of program finances. Most of the 39,000 present Cal-Vet borrowers would be assured that the rate reduction that they are scheduled to receive this April will never be reversed.

Report on Reengineering Progress. We recommend that, at the time of its budget hearings, the DVA also update the Legislature regarding its progress in implementing the operational improvements specified in its Cal-Vet reengineering program. In particular, the DVA should indicate:

- When and how the department will expand its staffing and resources for critical debt- and cash-management operations of the program as recommended by its own consultant.

- The status of the DVA's implementation of the new Cal-Vet computer information program (known as ILPFIS). The DVA should provide full documentation of the costs and benefits of the program in a completed feasibility study report, as required by policies in the State Administrative Manual.

- The DVA's progress to date in testing and implementing the marketing of Cal-Vet loans through private-sector lenders or brokers instead of through its traditional use of civil service staff in branch offices.

- How the DVA plans to monitor and adjust its personnel levels at regular intervals to ensure that excess staffing is eliminated as the loan portfolio declines.

- How the revised life and disability insurance program will affect Cal-Vet borrowers and Cal-Vet program finances.

Limit Use of Revolving Fund to War Veterans. We also recommend that the $100 million pool of "unrestricted" funds that the DVA is now setting aside for veterans of recent wars (primarily the Persian Gulf, Panama, and Grenada military incursions) be limited to that purpose and not be used for loans to peacetime veterans. As we noted earlier in this report, Legislative Counsel has advised that the proceeds of bond issues enacted by the voters for the benefit of war veterans cannot be used to make loans to peacetime veterans. Lacking such voter approval, we believe that loans from the $100 million revolving fund should go only to war veterans of these more recent conflicts who until now have had only a limited opportunity to obtain Cal-Vet benefits. The exact criteria for eligibility should be determined, as current law provides, by the California Veterans Board.

We believe these recommendations would ensure that the Cal-Vet program operates more efficiently, fairly, and with fewer financial problems.

Our recommendations for improving the current operations of the Cal-Vet program are summarized in Figure 16.

Figure 16

Recommendations for Restructuring Cal-Vet Program Operations

- ☑ Abandon the single-interest rate structure of the program.
- ☑ Department of Veterans Affairs report at budget hearings on progress in reengineering program.
- ☑ Limit use of $100 million loan pool to war veterans.

Time for an Exit Strategy

We recommend the enactment of state legislation directing the orderly phase-out of issuance of new Cal-Vet loans by the year 2007. The legislation would also ensure the proper stewardship of the Cal-Vet loan and bond portfolios until their expiration.

Program Slowdown Inevitable. While it is important to follow through with the reforms of the Cal-Vet program discussed in this report, we believe it is important for the Legislature to evaluate whether new lending activity ultimately can and should continue over the long term. Three reasons argue for the phase-out of the program. First, as we noted earlier in this report, federal tax restrictions will have the effect of prohibiting the use of tax-deductible general obligation bonds for loans to war veterans after January 1, 2007. By 2002, large numbers of Vietnam War veterans, the vast majority of whom were discharged before 1972, will no longer be eligible for loans financed with such tax-deductible bonds. Second, even if legal restrictions on the program were to be eliminated—a step requiring congressional action that appears unlikely given last year's federal balanced-budget agreement—the aging of the veteran population will sharply reduce their demand for loan assistance anyway. Finally, both the private-sector housing market and various governmental programs appear to be meeting the home loan needs of veterans.

For these reasons, we believe the state needs an "exit strategy" for the Cal-Vet program. In our view, it is time to enact state legislation establishing a clear timetable and process for phasing out all new Cal-Vet loan activity as of January 1, 2007. At that point, the state will have no choice under federal tax law but to terminate the issuance of loans using the proceeds of general obligation bond funds, which has been the source of 90 percent of program finances. We recommend that issuance of new loans using other sources of funds and revenue bonds also be phased out at the same time.

We are *not* recommending that all program functions be terminated in 2007. Loan-servicing, debt management, and cash management operations must continue in some form until all outstanding loans and bonds have been retired sometime before the year 2032. New loan activity, however, would cease.

No outstanding Cal-Vet loan to any veteran would be affected; a Cal-Vet borrower would continue making monthly loan payments long after 2007 unless the borrower chose to retire his or her debt ahead of schedule.

Needs of Peacetime Veterans Would Be Met. The phase-out of new loan activity in 2007 that we have proposed also means the state would not carry on in the long term with a new home loan program for peacetime veterans. This is because we believe the needs of creditworthy peacetime veterans for substantial housing assistance will continue to be met through both the private-sector housing market and various governmental programs.

Future governmental assistance from other quarters does not appear to be in question. For example, federal VA and FHA assistance programs are now self-funded operations largely immune from federal budgetary constraints and thus are highly likely to continue to provide home loans to veterans. Moreover, many veterans will continue to qualify for assistance under the state's CHFA loan programs, which offer loans at interest rates well below what Cal-Vet has been charging.

Put Loan Servicing Out to Bid. As part of the Cal-Vet phase-out legislation, we recommend that the Legislature direct the Department of General Services (DGS) to conduct a procurement of loan services for the Cal-Vet portfolio by January 1, 2006. The DGS would be empowered to determine which specific loan-servicing functions would be procured and would issue and administer the request for proposals. If the DVA could demonstrate, through the bidding process, that it is the most cost-effective and highest-quality service provider, it would continue these services. If another governmental or private-sector entity submitted the best bid, however, it would take over those operations under state contract. In that event, the contract would be administered by the DVA. The cost comparisons should take into account the expense the DVA would have to incur to monitor a private-sector vendor, should one win the bidding.

We believe these recommendations would ensure that the Cal-Vet program is phased out in an orderly and cost-efficient manner, preserving the state's equity in the program while ensuring proper management of the outstanding loans and debt. Our recommendations for the orderly phase-out of new Cal-Vet loan activity are summarized in Figure 17.

Figure 17

Recommendations to Implement an Exit Strategy

- ☑ Enact legislation to phase out new Cal-Vet loans by 2007.
- ☑ Put loan-servicing operations up for bid by 2006.

Shift Resources to Needed Veterans' Programs

We recommend that surplus funds be shifted to programs that will benefit both California veterans and state taxpayers. This should be accomplished carefully by means that ensure that all obligations of the state to bondholders are met and that the program retains adequate reserves to meet the requirements of the program.

Tap Reserves to Meet Growing Needs. In the short term, the DVA has proposed to use its considerable cash surplus to lower the interest rate paid by most Cal-Vet borrowers and to create a new $100 million loan pool for veterans of more recent conflicts. Even with these financial commitments, a DVA consultant projects that as much as $600 million in state equity will remain at the termination of the program.

Given this projection, and the substantial and growing needs of California's aging veteran population, we believe it makes sense to begin using those resources in a prudent fashion to address those needs. Thus, we recommend that, if California voters concur, surplus funds should be channeled into other programs that will benefit both veterans and state taxpayers.

The first task is to determine the size and the timing of the availability of that surplus. Accordingly, we recommend the enactment of budget bill language directing the DVA to provide the Legislature with an analysis of the 1943 Act Fund, the main revolving fund for Cal-Vet operations.

This analysis, which will probably require the assistance of the DVA's cash-flow and debt-management consultants, should detail how much of the current cash and investment assets of the program are now needed for prudent reserves to ensure the repayment of the outstanding Cal-Vet debt and to provide all funding needed for loan and related insurance program operations. The analysis should also project how much reserve funding is needed year by year for the duration of the program, and the amount of surplus funds that could be available for appropriation for other purposes in each year. The analysis would be based upon the assumption that the issuance of new Cal-Vet loans would cease by the year 2007 in accordance with federal restrictions on general obligation bonds.

The DVA would also analyze its existing agreements with bondholders, bond insurers, and bond rating agencies, as well as any relevant sections of the federal tax code, to ensure that they would not be violated by a future redirection of surplus Cal-Vet funds.

We further recommend that state law require that the Veterans Finance Committee of 1943 conduct a review to verify that only truly surplus funds are transferred from the Cal-Vet fund, that all obligations to bondholders are met, and that any transfers would not violate federal tax code restrictions. Their analysis, along with any comments of the Veterans Finance Committee, should be completed and submitted to the Legislature by January 1, 1999.

How Surplus Funds Could Be Used. Once the DVA has determined if and when surplus Cal-Vet funds could be available for other programs, the next major task is to determine how they could best be used to benefit both veterans and state taxpayers. In our view, the funds should be used for the benefit of veterans because they were generated through loan repayments by veterans to the Cal-Vet program. But the funds also belong to all state taxpayers, and should also be used in ways that benefit the state generally and implement good public policy.

We can suggest several possibilities that would meet both of our criteria. For example:

- The surplus could be used to help renovate, operate, and expand the state's growing system of veterans' homes, including the three new homes planned for Southern California. Veterans would benefit from expansion of the system and ensuring that adequate state funding is available if federal support for them is eroded. State taxpayers could benefit by avoiding a significant new demand on the state General Fund.

- Recent state legislation, Chapter 335, Statutes of 1997 (SB 335, Johannessen) commissioned a study by the DVA by July 1, 1998, of the operational and capital outlay needs for providing services for veterans who suffer from Alzheimer's disease and dementia. Should the study find a need for additional programs and facilities, they could be funded with surplus Cal-Vet funds, benefiting veterans and saving state taxpayers a new demand on the General Fund.

- County Veteran Service Office (CVSO) programs appear to have been underfunded in some counties, especially in those counties suffering fiscal problems. Expansion of state assistance to CVSOs might assist more veterans in obtaining federal VA pension and medical benefits and reduce their reliance upon state-funded Medi-Cal and Supplemental Security Income/State Supplementary Program (SSI/SSP) programs. The Legislature and the Governor recently enacted Chapter 318, Statutes of 1997 (SB 608, Johannessen) specifying legislative intent that $5 million be provided to expand CVSOs. Surplus Cal-Vet funds could be a source of such funding in the future.

- Surplus Cal-Vet funds could also be used to assist homeless and unemployed veterans. The Governor has announced his intention to end the use of state armories as homeless shelters, and has also indicated his plan to terminate local grant funding to support such shelters. Tapping the Cal-Vet surplus to continue such assistance could benefit the general public by easing the financial burden on local government agencies related to the presence of homeless veterans in their communities if state use of armories as shelters is ended.

Before appropriation of any surplus Cal-Vet funds could occur, we recommend that the California Veterans Board be directed to conduct public hearings to solicit testimony of veterans and the general public as to the best use of the funds that ultimately become available. The board, with the assistance of the DVA, should also be directed by law to recommend policies and priorities to the Legislature for the expenditure of the anticipated surplus.

Seek Voter Approval of Funding Shift. Before any shift of surplus Cal-Vet funds to other purposes occurs, we recommend that California voters be asked to authorize such an action. We recommend that such approval be sought for limited purposes specified by the Legislature in a future statewide ballot measure. The DVA has indicated that another Cal-Vet general obligation bond issue may need to be placed on the statewide ballot in the year 2000 if the proceeds of previous bond issues are exhausted. In that event, it may be possible to include a funding-shift provision in the next bond issue submitted to voters.

Under our proposal, funding for any new program would be determined by the Legislature on the basis of the hearings conducted and subsequent recommendations of priorities received from the California Veterans Board. The new programs for veterans that would be designated as potential recipients of surplus funds would be specified in the ballot measure presented to voters.

The DVA concluded in a 1995 memorandum that surplus Cal-Vet funds could not be reallocated to other programs by statute alone. The memorandum by DVA's then-chief attorney referenced a 1974 Third District Court of Appeal ruling (*Veterans of Foreign Wars v. State of California*). In that case, the court struck down the legislative redirection of $500,000 per year of the Cal-Vet operating fund to support of CVSOs' operations between 1965 and 1973. The court held that the redirection of the funds was not permissible because the redirection of funds through the state budget act amounted to an illegal, partial repeal of the various Cal-Vet bond acts approved by the voters.

The Legislative Counsel's office has advised us that, given the 1974 court precedent, voter approval would be needed before surplus Cal-Vet funds could be redirected to other purposes. Legislative Counsel has also advised us that use of surplus funds also faces potential legal hurdles stemming from federal tax code restrictions on the use of the proceeds of tax exempt bonds and the state's obligation to bondholders. Accordingly, we have recommended above that the Veterans Finance Committee of 1943 review any plan to redirect Cal-Vet funds to other purposes to verify that all of the state's legal obligations are met.

Circumstances have changed significantly since the court issued its ruling almost 24 years ago. At the time of the ruling, issued just as the Vietnam conflict was ending, the court noted that the ranks of veterans were growing and that the DVA was planning another bond issue to meet the anticipated heavy demand for a new wave of veterans being discharged from military service. These factors led the court to conclude that no surplus was actually available in the 1943 Act Fund to be redirected.

The situation is now different. Demand for Cal-Vet loans, and the size of the Cal-Vet loan portfolio, has been dropping since the early 1980s. Federal restrictions on use of general obligation bonds will have the practical effect of halting any issuance of new loans from this funding source as of 2007. Meanwhile, the veteran population is aging and faces significant needs that may go unmet unless that surplus becomes available for new programs. This near to the conclusion of the Cal-Vet program, we believe it is considerably easier to demonstrate to the events that a substantial surplus will accrue to the state in the future.

In any event, we believe it is prudent to require that any redirection of surplus funds for other purposes be ratified by the electorate. California voters financed Cal-Vet loans through their repeated approval of bond issues and, thus in our view, it is reasonable that they should have a say in regard to the use of funds generated by the program. We believe such a measure needs to be well-crafted to include strong protections for the loan program and bondholders.

The alternative, if the DVA's projections prove accurate, is to allow as much as $600 million in state equity in the Cal-Vet program to accumulate and be left unused over the next 34 years. If none of the state's equity can be accessed until all Cal-Vet bonds are retired as scheduled—a date the financial restructuring plan will delay until as late as the year 2032—few veterans alive today will receive any benefit from the surplus they helped generate through their participation in the Cal-Vet program.

We believe the above recommendations will ensure that the changing needs of California's veteran population are met without creating additional fiscal demands on state government. Our recommendations for shifting Cal-Vet program resources for these purposes are summarized in Figure 18.

Figure 18

Recommendations to Shift Resources to Needed Veterans' Programs

- ☑ Adopt budget bill language directing Department of Veterans Affairs to conduct analysis of amount and availability of surplus Cal-Vet funds.
- ☑ California Veterans Board advises Legislature on potential future uses of surplus.
- ☑ Legislative ballot measure submitted to voters in 2000 seeking permission to use Cal-Vet surplus for programs that benefit veterans and state taxpayers.

CONCLUSION

In our view, our recommendations would ensure that the work the DVA has already begun to reform the Cal-Vet program is carried though to a successful conclusion. We also propose an exit strategy for the orderly phase-out of the program. Further, we propose to revamp the state's array of veterans' programs with the voters' permission to meet the changing needs of the veteran population using the anticipated surplus no longer needed for the program.

Figure 19 (see page 40) shows the timetable of activities we recommend be set in motion by state legislation.

Figure 19

LAO Time Line for Reform of the Cal-Vet Program

1998

- ☑ Policy legislation enacted to revise Cal-Vet program, including interest rate structure.
- ☑ Department of Veterans Affairs (DVA) reports to Legislature at budget hearings on progress in reengineering of the Cal-Vet program.
- ☑ Language adopted in 1998-99 Budget Act requiring DVA analysis of surplus Cal-Vet cash by end of calendar year.

1999

- ☑ Bureau of State Audits completes limited review of Cal-Vet program by September.
- ☑ California Veterans Board completes hearings on uses of Cal-Vet surplus by May.
- ☑ Governor submits and Legislature acts upon budget request for California Veterans Board; funding for board, including an independent staff analyst position, appropriated for the first time through the 1999-00 Budget Act.
- ☑ Beginning July 1, board commences review and approval of administrative expenditures for the Cal-Vet program and review of annual Cal-Vet business plan.
- ☑ New legislative reporting requirements for Cal-Vet program and California Veterans Board take effect.

2000

- ☑ Legislature acts by January to place measure on June statewide ballot to allow redirection of surplus Cal-Vet funds (possibly in conjunction with bond measure).
- ☑ Voters consider June ballot measure authorizing redirection of surplus Cal-Vet funds.
- ☑ If enacted by voters, Legislature begins redirecting Cal-Vet surplus to other veteran programs through the 2000-01 Budget Act, or whatever subsequent year that surplus funds are first determined to be available.

2005

- ☑ Department of General Services (DGS) conducts procurement of Cal-Vet loan services.

2006

- ☑ Loan service operations procured by DGS are transferred to new vendor if not retained by DVA.

2007

- ☑ Federal law prohibits use of general obligation bonds for home loans for veterans.
- ☑ Cal-Vet program ceases issuing new loans.

2032

- ☑ All Cal-Vet loans and debt retired.

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