United States General Accounting Office

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GAO

Testimony

For Release
on Delivery
Expected at
10:30 a.m. EDT
Thursday
May 21, 1987

The Export-Import Bank of the U.S.: Financial Condition and Budget Issues

Statement of
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Accounting and Financial Management Division

Before the
Subcommittee on International Finance,
Trade and Monetary Policy
Committee on Banking, Finance
And Urban Affairs
House of Representatives

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GAO/T-AFMD-87-15

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear today to discuss various issues related to the Export-Import Bank of the United States (the Bank). Specifically, I will discuss the Bank's deteriorating financial condition, its financial reporting practices which do not provide a true picture of the Bank's financial condition, and implications of its weakened capital position. Further, I will discuss the Bank's loan sale and interest subsidy programs established under recent legislation, and the related budgetary effects of such programs. Finally, I will discuss the status of our ongoing review of the Bank's export credit insurance program.

THE BANK'S FINANCIAL CONDITION

As early as 1975, we expressed concern that the Bank's financial condition was deteriorating because of its declining income and the growing amount of problem loans in its loan portfolio. In April 1983, we went on record before this subcommittee expressing our concern over these matters. Moreover, since fiscal year 1983, we have reported that the Bank's financial statements present a misleading picture of its true financial condition because they do not reflect the losses that are likely to occur due to the probable uncollectibility of a significant portion of the Bank's loans.

Even without recognizing losses attributable to uncollectible loans, the Bank's recent financial statements have shown a steady trend of large operating losses. These losses amounted to $160, $247, $343, and $344 million respectively, for fiscal years 1982, 1983, 1984, and 1985. The Bank will again report a loss for fiscal year 1986, which we estimate to be about $340 million.

The primary reason for these losses has been the Bank's negative interest rate differential--the amount by which the Bank's cost to borrow funds exceeds the interest it earns on loans it makes with the borrowed funds. This differential was 3.2 percentage points at the end of fiscal year 1986. Another factor contributing to the Bank's losses has been the amount by which insurance and guarantee claims have exceeded the amount earned through insurance premiums and guarantee fees.

These operating losses have reduced the Bank's reported equity from $3.2 billion at September 30, 1981, to $1.8 billion at September 30, 1986. For fiscal year 1987, the Bank is projecting losses of $600 to $700 million, which would reduce its reported equity to $1.2 to $1.1 billion.

This trend of large reported operating losses is only part of the story. It is also important to recognize the increasing impact of problem debt, which increased from 13 percent of the

Bank's loan portfolio in 1982 to 29 percent in 1985. We consider loans that are currently delinquent, under rescheduling, or acquired under guarantee when a borrower defaults to be "problem" debt because they exhibit characteristics suggesting that a significant portion will ultimately prove to be uncollectible. By the end of fiscal year 1986, the Bank's problem debt had grown to $5.8 billion, or about 38 percent of its total outstanding loan portfolio.

Delinquent debt, one of the major components of problem debt, has also increased. The Bank reported delinquent loans in 1982 of $1.4 billion, or 8 percent of its loan portfolio. By the end of fiscal year 1986, delinquent loans had increased to $3.5 billion, or 23 percent of the loan portfolio.

Rescheduled loans are another problem component of the Bank's loan portfolio. Reschedulings generally arise when debtors who are unable to meet their obligations are granted extended repayment terms. It is important to note that loans in this category were delinquent prior to being rescheduled. As of September 30, 1986, rescheduled debt amounted to about $3.6 billion or 23 percent of the Bank's total loan portfolio. Some rescheduled debt was also delinquent at September 30, 1986, and is included in the delinquent debt category.

As shown on the attached analysis of the Bank's financial condition (attachment I), the amount of problem loans is increasing while the Bank's retained earnings are dwindling. At September 30, 1982, problem debt was roughly equal to the Bank's retained earnings. By September 30, 1986, problem debt was more than 7 times its retained earnings. Clearly, the Bank's present financial condition is not adequate to deal with the losses that would result if a significant portion of this problem debt proves uncollectible, which, as I shall discuss, seems likely.

REPORTING PRACTICES

In our view, the Bank's financial statements are misleading because the Bank has not established an allowance for the uncollectible portion of its problem debt and financial guarantee obligations as required by Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies." Fair presentation of loans receivable requires recognition of the diminished value of loans through a charge against the current year's income and a corresponding increase in an allowance for loan losses.

However, the Bank has consistently not recognized that its loans are impaired, even when foreign governments stop making payments on the debts. For example, the Bank carries, at full face value, loans of $26 million it made to China in 1946 that have been delinquent since 1949, and $36 million of loans to Cuba that have been delinquent since 1960. Far more important than these examples, is that there has been no significant amount of repayment on the billions of dollars in loans that are in arrears or that have gone through several reschedulings. Because the Bank has not recognized such impairments to its loans, we believe the Bank's loans receivable balance and its equity are considerably overstated.

One significant result of not recognizing loan losses is the potential impact on congressional oversight and other users. Since the Bank does not recognize an allowance for loan losses on its financial statements, the Bank's financial condition appears stronger than it is in reality. Therefore, the Congress and other users could be led to make decisions based upon misleading information.

As you know, the Export-Import Bank is not the only financial institution with problem foreign debt. Much recent congressional and media attention has focused on difficulties certain U.S. banks have with problem loans to less developed countries--often referred to as LDC debt. Our consistent position has been that masking such difficulties by optimistic and improper accounting practices only exacerbates the problem and postpones its ultimate solution. In our view, as a government entity, the Bank should take a leadership role in openly and fairly reporting its loan portfolio and financial condition in accordance with generally accepted accounting principles.

1986 FINANCIAL AUDIT

For fiscal year 1986, we expect to issue an adverse opinion on the Export-Import Bank's financial statements, as we have done since 1983. The basis for our opinion will again be the Bank's failure to record a provision for uncollectible loans. We estimate that a loan loss reserve in the range of $2.6 billion to $3.7 billion should have been established. This reserve would, in turn, reduce the Bank's equity from the $1.8 billion figure reported in its financial statements to a deficit of between $0.8 billion and $1.9 billion, thus eliminating the U.S. government's equity in the Bank.

To ensure that the Congress has an opportunity to prevent the Bank's equity position from deteriorating below a level at which the Bank would lose its credibility as an independent institution, the Congress enacted the Export-Import Bank Act Amendments of 1983. This act added section 14 to the Export-Import Bank Act of 1945 (12 U.S.C. 635i-2) to require the Bank to report to the Congress if its equity falls below 50 percent of its capital and retained earnings as of September 30, 1983.

Since the Bank's capital and retained earnings were almost $2.8 billion as of September 30, 1983, a capital level of almost $1.4 billion would activate the reporting requirement.

If the Bank had been following generally accepted accounting principles by recording an allowance for losses on loans, the Bank would have had to notify the Congress as early as 1983 regarding its weakened capital position. However, because the Bank refuses to record such an allowance, this formal notification has not occurred and probably will not occur until the fourth quarter of fiscal year 1987. Even using the Bank's liberal accounting practices, the Bank's projected 1987 losses would clearly mandate a report to Congress on the Bank's deteriorating capital position.

OTHER IMPLICATIONS OF A WEAKENING CAPITAL POSITION

Because the Bank is expecting to incur operating losses that will soon place it in a deficit position, Bank officials have stated that the Bank needs to strengthen its financial condition and is considering several options. One of the options is a request for recapitalization. If the Bank makes this request, there are several factors that the Congress should consider.

First, a direct infusion of capital into the Bank from Treasury could have budgetary implications, depending on how the

Bank uses these funds. If the Bank were to use the funds to prepay its Federal Financing Bank (FFB) debt, the capital infusion would not directly affect the overall budget deficit because the cash outflow from and inflow to the Treasury would offset each other. On the other hand, if the Bank were to use funds for new programs, then the budget deficit would increase to the extent such funds were used.

Second, the Bank could continue to operate without recapitalization as long as it could borrow from FFB. However, with the Bank's increasing operating costs resulting from interest rate differentials, and its decreasing cash flow due to the increasing number of loans on which it is not receiving payments, the Bank may be required to increase its borrowing from FFB, which it may be unable to repay.

Third, the practice of allowing the Bank's capital position to deteriorate, while its potential liabilities and problem debt increase, sharply contrasts with policies that the Congress is following to ensure the safety and soundness of commercial banks. In 1983, the Congress directed the federal banking agencies to require banks to maintain adequate capital levels and to set up "special reserves" for certain categories of international debt, such as loans for which there were no definite prospects for the orderly restoration of debt service. Since then, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Reserve have acted to require the banks that they supervise to increase the ratio of their capital and reserves in relation to loan risks. The Bank, as we continue to point out, has not taken similar precautions.

IMPACT OF RECENT LEGISLATION

You also requested that we discuss the impact of recent legislation on the Bank. Specifically, we will discuss the loan sale program and the interest subsidy program.

Loan Sale Program

As part of a growing overall effort to improve federal credit management and to generate budgetary receipts, the administration's budget request for fiscal year 1987 included a pilot program to sell a portion of government-held loans over a 5-year period. The Congress, in enacting the Omnibus Budget Reconciliation Act of 1986, expanded the administration's fiscal year 1987 pilot program to generate a total of $6.8 billion in net cash receipts, estimating that about $9.3 billion in outstanding principal balances from nine programs would have to be sold to the public or redeemed by borrowers.

Under the current loan sale program, the Bank is required to sell sufficient loans to generate no less than $1.5 billion by the end of fiscal year 1987. In addition to the legislative mandate, the administration's plans call for additional Bank loan sales of $5.2 billion through fiscal year 1992.

In lieu of selling its loans on the open market, the Bank has requested and received permission from the Office of Management and Budget (OMB) to apply prepayments received from obligors against its statutory obligation. The Bank believes that this method of complying with the act would save tax dollars because the prepayments would be made at 100 percent of the outstanding balance plus accrued interest. On the other hand, sales of loans on the open market would result in discounts from the face value of the obligations and would probably involve additional costs, such as the services of a financial advisor and an underwriter.

After receiving OMB's permission, the Bank notified certain creditworthy obligors, whose outstanding debt to the Bank consisted of fully disbursed loans greater than $5 million, that the Bank was being required to liquidate a portion of its loan portfolio and that a portion of their loans may be considered for sale on the open market. Several of these obligors decided to exercise their option to prepay their loans directly to the Bank.

As of April 30, 1987, Bank records indicate that the Bank has already received approximately $524 million in prepayments that will be applied to its $1.5 billion statutory obligation. The Bank estimates that it will be able to fulfill its quota of receipts for 2 years by accepting loan prepayments. However, after fiscal year 1988, it expects to have to resort to loan sales to meet its program targets because the remaining obligors either will not want to or will not be able to prepay their loans. Of course, the Bank's approach to loan sales leads to early collection from the most creditworthy borrowers and tends to leave the Bank with loans of diminished value or problem status, thereby exacerbating its problems.

As I testified on March 26, 1987, before the Legislation and National Security Subcommittee of the House Committee on Government Operations, we believe that sales or prepayments of loans should not be viewed as a way to resolve our fundamental deficit problem. Portfolio sales will not change the basic structural imbalance between governmental receipts and outlays. More specifically, the sale of existing loans could potentially have very different effects on short- and long-run budget deficits.

The sale or prepayment of existing loans will not, over the long term, reduce budgetary deficits even if net sales proceeds equal the present value to the government of future loan payments based on the government's borrowing costs--that is, the interest rates on Treasury securities. In fact, this program could increase the budget deficit in the long run. By accepting prepayments, most of which are on high interest-rate loans, the Bank is forgoing interest income in excess of any savings that may result from it not having to borrow additional funds from FFB. Such a loss of net interest income is not readily calculated because it depends on which loans obligors prepay and on an undeterminable amount of debt to FFB that the Bank will not incur.

In addition to the loss of net interest income, we understand that the Bank will incur substantial additional costs when countries prepay their loans because the Bank expects to use any excess cash from the proceeds to prepay its outstanding FFB debt, as it has done in the past. The terms of the FFB loans dictate that the Bank must pay a prepayment penalty to FFB if the Bank pays off its debt prior to maturity. The Bank expects that these penalties will be approximately $250 million in fiscal year 1987 and approximately $180 million in fiscal year 1988. These penalties, of course, have no impact on the total federal government and raise the question as to whether penalties paid from one federal entity to another serve any purpose.

Interest Subsidy Payments

The Export-Import Bank Act Amendments of 1986 amended section 9 of the Export-Import Bank Act to require GAO to report to the Congress not later than March 1, 1988, "on the manner in which and the extent to which the Bank is exercising its authority to make interest subsidy payments" under the amendments. Your subcommittee specifically requested that we comment on the current status of this program.

Under this program, established to counter foreign government-supported export credit subsidies, the Bank would provide interest subsidies to commercial lenders making export loans. The Bank intended to provide these subsidies on loans on which it fully guarantees the payment of principal and interest. Since the interest rate arranged for an export loan may be below the market rate at which the commercial lender would normally make such a commitment, the Bank would pay the commercial lender the difference between the rate committed on the loan and the market rate. Although the Bank requested authority to make interest subsidy payments on $1.8 billion in loans in fiscal year 1987, estimating that the present value of the subsidy would be about $100 million, the Congress did not authorize any funds for the program. Consequently, the Bank has not exercised its authority under the program. Further, the Bank has not requested any funds for the interest subsidy program for fiscal year 1988.

BUDGET SCORING FOR DIRECT LOANS AND LOAN GUARANTEES

You also asked us to comment on budget scoring for loans and loan guarantee arrangements, about which I testified on March 4, 1987, before the Senate Committee on the Budget (attachment II). Current budget scorekeeping for Bank loans is like that of other federal agencies. For direct loan programs, the Bank makes loans directly to the borrowers and collects the principal and interest payments over the life of the loan. These direct loans are scored like any other federal program outlay--as outlays when disbursed and offsetting collections when collected. Under loan guarantee programs, private lending institutions make loans to the borrowers and can be responsible for servicing the loans until paid. Guarantees are not scored as budget outlays. However, if the borrower defaults on the loan, the Bank pays the lender and assumes title to the loan. Once title is assumed, the amount paid by the Bank under the guarantee is scored as a budget outlay.

Many have found this budget scoring to be misleading, and there are currently various proposals for reform. The administration's proposal for credit reform requires new direct loans to be sold, and would show subsidy outlays involved in new loans. The subsidy amounts reported for direct loans would be the difference between the proceeds from the sale of the loans and the face value of the loans sold. For loan guarantee programs, the government would transfer its contingent liability to private insurers by purchasing insurance to cover the potential liabilities and, for budgetary purposes, would score any net costs of such reinsurance as an outlay.

We believe that current budget scorekeeping of loans and guarantees is misleading, and support the need for credit reform. However, we do have some questions about and caveats to the OMB program and would note that budget scorekeeping can be corrected without wholesale sales of loans. One concern we have about OMB's proposal is the manner in which it measures the direct loan subsidy. In our view, the best measure of the subsidy cost would essentially be the difference between the borrowing cost incurred by the government when it financed the loan, and the present value (at the time of the loan) of the borrower's future repayments. This method would tie the subsidy recognition to interest rates and the government's cost of money at the time the loan is made.

Until such time as credit reform is in place, we believe all agencies, including the Bank, should follow current budget scorekeeping policies. To do otherwise is inconsistent, makes understanding the budget deficit more difficult, and would lead to even more scorekeeping biases and problems.

REVIEW OF THE BANK'S EXPORT CREDIT INSURANCE PROGRAM

You also asked that we discuss the status of our current review of the Bank's export credit insurance program, under which the Bank aids exporters and others by insuring them against risks of nonpayment by foreign buyers on export transactions. About $3.4 billion in export shipments were insured under this program in fiscal year 1986, making it the Bank's principal means of providing export assistance. The Bank uses the Foreign Credit Insurance Association (FCIA), an association of private insurance firms, to provide export insurance services. Currently, FCIA has four member firms which assume no risks on the association's transactions but act as the Bank's agent for major functions such as marketing, underwriting, claims, and recovery activities.

Our review was mandated in October 1986 by section 16 of the Export-Import Bank Act amendments of 1986. The act requires that we study and report by October 1, 1987, on (1) the need for U.S. government involvement in export credit insurance, considering the activities of private insurers in this area, (2) the need to employ an agent in administering the government insurance programs determined to be necessary, and (3) the efficiency and effectiveness of continuing to use FCIA as the Bank's agent.

We are still gathering and analyzing data on our review and have drawn no conclusions yet on the three issues. We are obtaining data from a wide variety of sources including Bank and FCIA records, FCIA's current and former policyholders, private export credit insurance firms or their agents, insurance associations, insurance brokers, and current and former member firms of FCIA. We expect to complete our analysis and report to the Congress by October 1987.

Mr. Chairman, this concludes my statement. I will be pleased to respond to any questions you may have.

GAO ANALYSIS OF
THE FINANCIAL CONDITION OF THE
EXPORT-IMPORT BANK OF THE UNITED STATES
(ALL AMOUNTS IN MILLIONS)

	FY 86 1/	FY 85	FY 84	FY 83	FY 82
LOANS RECEIVABLE	$15,285	$16,860	$17,504	$16,883	$16,565
PROBLEM LOANS:					
DELINQUENT LOANS	$3,470	$2,673	$2,707	$1,904	$1,377
% OF TOTAL LOANS	22.7%	15.9%	15.5%	11.3%	8.3%
RESCHEDULINGS	$3,562	$3,052	$1,546	$1,194	$1,178
% OF TOTAL LOANS	23.3%	18.1%	8.8%	7.1%	7.1%
LOANS PURCHASED	$978	$984	$757	$397	$289
% OF TOTAL LOANS	6.4%	5.8%	4.3%	2.4%	1.7%
TOTAL PROBLEM LOANS 2/	$5,751	$4,912	$4,663	$2,654	$2,098
GROWTH (FY 1982 BASE)	274.1%	234.1%	222.3%	126.5%	100.0%
REVENUE:					
INTEREST REVENUE	$1,410	$1,478	$1,458	$1,342	$1,272
FEES, PREMIUMS & MISC.	77	86	99	82	124
EXPENSES:					
INTEREST EXPENSE	1,769	1,828	1,746	1,624	1,479
NET CLAIMS & LOAN WRITE-OFFS	29	83	119	19	57
ADMIN EXPENSES AND OTHER	32	(3)	35	27	20
NET LOSS	($343)	($344)	($343)	($247)	($160)
CAPITAL	1,000	1,000	1,000	1,000	1,000
RETAINED EARNINGS	762	1,106	1,450	1,792	2,040
TOTAL CAP & RETAINED EARNINGS	$1,762	$2,106	$2,450	$2,792	$3,040
UNREALIZED INTEREST INCOME					
RESCHEDULED	(605)	(395)	(268)	(199)	(126)
DELINQUENT	(232)	(305)	(278)	(186)	(149)
TOTAL CAP & REALIZED EARNINGS	$925	$1,406	$1,904	$2,407	$2,765
TOTAL PROBLEM LOANS	$5,751	$4,912	$4,663	$2,654	$2,098
% OF RETAINED EARNINGS	755%	444%	322%	148%	103%
% OF CAP & RETAINED EARNINGS	326%	233%	190%	95%	69%
% OF CAP & REALIZED EARNINGS	622%	349%	245%	110%	76%

1/ UNAUDITED
2/ EXCLUDING DOUBLE-COUNTING AMONG CATEGORIES

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Testimony

For Release
on Delivery
Expected at
2 p.m. EST
Wednesday
March 4,
1987

Proposals for Improved Credit Program Budgeting

Statement of
Frederick D. Wolf, Director
Accounting and Financial Management Division

Before the
Committee on the Budget
United States Senate

GAO/T-AFMD-87-5

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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present our views on the administration's plans for improving the management of, and budgeting for, federal credit assistance activities. It is encouraging to see steps being proposed to improve the way the government administers and budgets for it credit activities. We have long held that improvements are needed in these areas. With new direct loan obligations running at about $40 billion a year, and annual new loan guarantee commitments at about $160 billion, the government certainly needs procedures that fully disclose the costs and provide for adequate congressional controls.

Until a credit reform bill is presented by the administration, we will not know the final details of their proposal. However, I can address the administration's general approach as set forth in the President's budget for fiscal year 1988, and elaborated on in some materials provided by the Office of Management and Budget (OMB).

SYNOPSIS OF THE ADMINISTRATION'S PROPOSAL

The key objectives of the proposal are to:

--reduce the government's costs of managing credit programs,

--provide incentives to federal credit program managers to develop better documentation on their loan portfolios,

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--measure and budget for the subsidies of credit programs, and

--reduce the deficit in the years of portfolio sales.

To accomplish these objectives, the administration is proposing a market plan approach under which all new direct loans would be promptly sold. They would be sold without federal guarantees or other recourse provisions, and the purchasers would assume all of the responsibilities and costs of servicing the loans. Proponents believe that the requirement to sell the loans would give federal managers an incentive to assure that all new loans have documentation that meets commercial standards.

Furthermore, unlike in present practice, the budget would show the subsidy outlays involved in the new loans. The subsidy amounts reported would be the difference between the sale proceeds and the face value of the loans sold.

In the case of loan guarantee programs, the government would transfer the contingent liability of the guarantees to private insurers by purchasing insurance covering the potential liabilities. Any net costs to the government of this "reinsurance" would be scored in the budget as a subsidy outlay. This would exclude any portion of the reinsurance costs covered by premiums paid by program participants.

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There would be a central budgetary mechanism for handling these transactions, a new "Credit Revolving Fund." The Fund would have permanent, indefinite authority to borrow funds to initially finance the "nonsubsidy" part of new direct loan disbursements. The nonsubsidy part would be the estimated market value of the loans--that is, the amount the government expects to get when it sells the loans to private investors. When the loan sales occur, the sales proceeds would be given to the Fund, and presumably used to liquidate the Fund's borrowings from the Treasury.

In addition, the agencies that originate loans would pay the Fund amounts for the estimated "subsidy" parts of their direct loans. The agencies would pay these subsidy amounts before the loans are disbursed, and the payments would come from appropriations received in advance by the agencies.

A similar approach would be followed for loan guarantees. Reinsurance costs not covered by program participants' premiums-- the "subsidy"-- would be covered by payments to the Fund from the originating agencies' appropriations.

GAO VIEWS

Let me turn now, Mr. Chairman, to our views on the

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administration's credit reform initiative. We think that there are some positive features, and some problem areas.

First, the positive features. We agree that there is a need to reduce the government's costs of managing credit activities, and believe that the market plan could accomplish that in some loan programs where our administrative efforts are not producing desired results. Some programs are not managed very efficiently. Our work on debt collection problems shows that billions are uncollected, and additional billions are written off annually. Furthermore, much of this problem stems from deficiencies in agencies' debt collection procedures. If the government can't do a better job in those cases, then perhaps we should let the private sector try its hand. Properly structured loan sales in such cases could be one way of doing this.

We also agree that documentation on the borrowers and loans needs to be improved in some cases. This includes the need for better accounting records. A program of loan asset sales, or purchasing reinsurance for guarantees, would provide an added incentive to develop and maintain sound records. Both the government and potential investors would need to know the quality of the portfolios before entering sales agreements.

We see problems, however, in the administration's proposed approach to measuring the subsidy part of credit programs.

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Proposal Would Not Provide a Measure of the Subsidy Cost

In the administration plan, the direct loan subsidy amount that would be reported and budgeted for would be the difference between the face amount of a direct loan and the amount the government receives in selling that loan on a nonrecourse basis. The idea according to material provided to us is to measure the subsidy "based on the benefit to the borrower." Presumably, the purchase price would approximate the loan amount that the borrower would have been able to get on the open market, and the difference between that and the higher face amount of the government loan would be the subsidy benefit conferred by the loan.

Unfortunately, this would not provide a measure of the actual cost to the government of making that loan. In all likelihood, the subsidy benefit so calculated would be larger than the actual subsidy cost to the government of making that loan.

We think that for budgeting purposes, the subsidy measure should reflect the cost to the government of credit activities, not the subsidy benefit provided to the borrowers. We have two reasons for favoring this approach. First, measuring subsidy costs to the government would be consistent with a primary function of the federal budget, which is to provide a statement of the costs (in outlays) of governmental operations. If the budget measured something other than the costs to the Treasury of programmatic decisions, it would become a more confusing document. We agree that it is important to know what benefits are conferred by credit activities, but this should be done outside of the budget's totals.

The second reason for favoring the measurement of subsidy costs rather than subsidy benefits is that the former approach would correct a problem in current budget scorekeeping conventions. At this time, the budget treats direct loan and regular expenditure programs alike even though they are different in a key way: true direct loans entail some repayment of funds to the government. To better compare the costs of the two kinds of programs, it would be necessary to focus upon that part of the loan programs that represents the net cost to the government--in other words, the subsidy cost. Reporting subsidy costs would permit lawmakers to make valid comparisons between loan and regular expenditure programs.

As we have stated elsewhere[1] the best measure of the subsidy cost would essentially be the difference between the borrowing

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1 Statement of Charles A. Bowsher, Comptroller General of the United States, before the Legislation and National Security Subcommittee, House Committee on Government Operations, September 26, 1986; and GAO comments on S. 2142 provided to the Chairman, Senate Committee on Governmental Affairs, December 8, 1986.

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cost incurred by the government when it financed the loan, and the present value (at that time) of the borrower's future repayments. This would tie subsidy recognition to interest rates and the government's cost of money at the time it made the loan.

In contrast, the administration's focus on subsidy benefits in effect shifts the calculation to interest rates and the private investor's cost of money at the time of the loan sale. The private investor's cost of money would be built into the investor's computation of the present value of the borrower's future repayments. This would determine the price the investor is willing to pay.

Because the investor's cost of money would be higher at any time than the government's--the government is a better credit risk--the present value to the investor of a future repayments stream likely would be less than the present value of that same income stream to the government. This alone would make the loan worth less to the investor than to the government, and have the effect of depressing the purchase price.

In short, basing the subsidy calculation on the private investor's lower present value would likely result in a subsidy amount higher than the actual subsidy cost to the government. This would reflect the realities of the private market at the time of the sale, but would not reflect the subsidy cost to the government when officials originally made the loan. Our approach would recognize the costs to the government when the loan was made. This, by the way, is the approach that was recommended in 1967 by the President's Commission on Budget Concepts.

Proposal May Not Adequately Protect the Financial Interest of the Government

We also think that the plan may not adequately protect the financial interest of the government. I am referring to the plan provisions to sell the loans "promptly" and without recourse. Although we don't know exactly what is meant by "promptly" (one draft bill being considered would require sales within 90 days) a requirement to sell loan assets within a certain number of days, and without any federal guarantee, insurance, or similar agreement to cover all or part of any future losses to the purchaser, could work against the government's financial interests in several ways.

First, sales without recourse provisions could artificially depress proceeds. We have reported[2] that revenues to the government are likely to be greater if loans of a similar nature are packaged together and are sold with some form of credit

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2 Loan Asset Sales: OMB Policies Will Result in Program Objectives Not Being Fully Achieved (GAO/AFMD-86-78 and 79, September 25, 1986).

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enhancement. This is particularly true when the loans are of a type not normally negotiated in the private sector, since the financial markets tend to underprice assets with which they are not familiar unless the creditworthiness of the assets is assured. Because of this, credit enhancements such as partial recourse provisions would likely result in greater sale proceeds than would be expected under nonrecourse provisions. These credit enhancements should be expressly provided for in the plan.

Related to this, we note that OMB has adopted a budget scorekeeping rule designed to discourage the Congress and agencies from undertaking loan sales with any recourse provisions. Specifically, OMB proposes to classify sale proceeds as deficit-reducing receipts only if the sales are made entirely without recourse to the government. Under the OMB plan, if a sale is made with any recourse to the government, no matter how limited, the entire sale proceeds are to be classified for budget purposes as borrowings rather than as receipts. This means that the proceeds would not count toward agency or congressional deficit reduction targets. It is easy to see how this would discourage sales with recourse provisions.

This OMB scorekeeping rule is also contrary to OMB's own scorekeeping policy in established loan guarantee programs. The policy does not require the guarantees to be counted as borrowings.

We believe that under a recourse loan sale, the portion of the sale proceeds that represents the estimated amount the government would have to pay under the recourse provision should be treated for budget purposes as borrowings. The balance of the sale proceeds should be treated as receipts. This approach is consistent with GAO's position on budget treatment for other federal loan guarantee programs, which is that a guarantee should be accounted for at its estimated cost to the government.

We further note that a rigid requirement for "prompt" sales could hurt the government. For example, it may be that adequate documentation and loan preparation is not possible for some portfolios in 90 days. If agencies are forced to sell loans before adequate documentation has been prepared, proceeds may be further reduced. Also, in a period of rising interest rates (and falling prices for loan notes and other securities), it may be in the best interest of the government to delay a sale until the market price for securities has risen, although we would caution against the government "speculating" on the future course of interest rates as a matter of policy. Furthermore, the bill's requirement that all new loans be sold would not leave the government the option of retaining in its loan portfolio high quality loans with good principal and interest returns to the government.

Finally, with regard to reducing the federal deficit, we feel that the market plan could potentially have very different effects on short- and long-run budget deficits. The immediate effect of selling loans would be to accelerate cash collections and thereby reduce the deficit in the short run. However, if the proposal's requirements--that all new loans be sold promptly and without recourse--artificially depress sale proceeds, the immediate, positive effect on the deficit could be more than offset by a longer run increase in the deficit. Even after adjusting for the time value of money, the stream of repayments that the government forgoes by selling a loan could be worth more than the revenue derived from the sale of the loan. We are currently studying this issue on several specific portfolios for another committee, and expect to provide testimony on the subject in late March or early April.

A further observation, Mr. Chairman, on the deficit problem. Sales of loan assets should not be seen as a way to resolve our fundamental deficit problem. Portfolio sales of $5 to $10 billion a year will accelerate collections but not change the basic structural imbalance between governmental receipts and outlays. More fundamental changes are needed to really address a deficit that has been running at about $200 billion a year.

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Need to Avoid Unintended Effects on Borrowers

Care also should be taken before undertaking loan asset sales to ensure that borrowers would not be affected in any way counter to their lawful rights or the policy of the government. Without adequate guidelines and sale provisions, portfolio sales could have unintended consequences for borrowers. For example, the government may, as a matter of policy, adopt certain debt collection and refinancing polices for a certain class of borrowers. Sales of their loans to private lenders could subject the borrowers to different debt collection and refinancing policies.

Need for Financial Statements and Independent Audits

Finally, let me conclude by stressing that credit program reform should not occur in a financial management vacuum. The dollar amounts involved are in the billions, and great care should be taken to assure accountability for these assets, and to ensure the discipline and integrity of the financial amounts that are reported. A critical first step in this regard would be annual financial statements for any new credit revolving fund, providing useful information on the fund's yearly operating results, and assets and liabilities. But to assure the accuracy of the reported amounts, we also would want to see independent audits of those statements. Audited statements would alert the

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Congress to major financial problems, and provide a strong incentive to administering officials to manage well and fully disclose the results.

This concludes my prepared statement Mr. Chairman. I would be glad to answer any questions.