United States General Accounting Office 132319

GAO

Testimony

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

Proposals for Improved Credit Program Budgeting

Statement of
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Before the
Committee on the Budget
United States Senate

132319

038183-132319

GAO/T-AFMD-87-5

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,

--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.

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 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.

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.

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).

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.

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

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.