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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON FEDERAL CREDIT PROGRAMS

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON

THE FEDERAL FINANCING BANK

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our views on the operations of and budgeting for the Federal Financing Bank (FFB) and congressional oversight and control of Federal credit programs. As I will point out later in my testimony, our concerns are not directed at the FFB, per se. Instead, they are directed at how transactions involving the Bank and other Government agencies are reflected in the unified budget and how these affect the understanding of Federal credit activities.

GROWTH AND HISTORY OF THE FEDERAL FINANCING BANK

The Federal Financing Bank began operations in 1974. By 1982, its portfolio had grown to about $124 billion. In the most recent years, from 1979 to 1982, the Bank's portfolio has grown an average of $20 billion per year. Thus, almost half of its total holdings have been added since 1979. The FFB held about 18 percent of the total Government portfolio of loans and loan guarantees at the end of fiscal year 1982, up from 12 percent in fiscal year 1979. In fiscal year 1981, FFB's portfolio was the largest of any of the top ten banks in the United States.

Before the FFB was established in 1973, all the borrowing and loan guarantees made by agencies put the U.S. Government in the public securities market 3 out of 5 days. In comparison to Treasury issues, most of these independent agency issues were small in dollar amount and lacked Treasury's firm secondary market. These differences, plus the market's unfamiliarity with specific agencies or unique issues, meant that agencies had to pay an interest rate higher than was paid on comparable Treasury issues, even though both were backed by the full faith and credit of the U.S. Government. Similarly, loans guaranteed by the full faith and credit of the U.S. Government were financed at higher interest rates than direct Treasury obligations with similar backing. Agencies also incurred additional administrative costs for financing staffs and underwriting expenses.

This prompted the Congress to establish the Federal Financing Bank. According to section 2 of the Federal Financing Act (12 USC 2281), the Bank was established to assure coordination of borrowing programs with the overall economic and fiscal policies of the Government, to reduce the costs of Federal and federally assisted borrowings from the public, and to assure that such borrowings are financed in a way that is least disruptive of private financial markets and institutions.

How the FFB operates

The FFB, an integral unit of the Department of the Treasury, functions as a financial intermediary or go-between. It either lends funds to or purchases the loans of Federal agencies responsible for administering Federal credit programs and to those directly benefiting from Federal credit assistance. The Bank obtains these funds by issuing its own securities.

Section 9 of the act authorizes the FFB to issue in the private markets and have outstanding up to $15 billion of its own securities. FFB is also authorized to borrow from the Secretary of the Treasury without limit, subject to the Treasury's approval. It was initially expected that the FFB would finance most of its activities by selling securities to the public, but since July 1974 all funding has been obtained through the Treasury. Since Treasury borrows to provide funds to the FFB, its borrowings from Treasury are translated into public debt.

Although the FFB is a financial intermediary, it should not be compared to private sector intermediaries because they are not alike: The FFB is a "blind" intermediary. By this I mean that decisions about such things as the use of proceeds are beyond the Bank's control. Neither the FFB nor the Secretary of the Treasury are allowed to make judgments about the purpose of Federal agency programs. Also, the Secretary is prohibited from withholding approval of an agency borrowing transaction for longer than 60 days unless there is a detailed explanation provided. But in no case can approval be withheld for longer than 120 days.

Types of FFB transactions

According to section 6 of the act, the FFB may purchase "any obligation which is issued, sold, or guaranteed by a Federal agency." The FFB engages in three types of transactions. It purchases on- and off-budget agency debt securities. It purchases agency certificates of beneficial ownership or agency assets that are guaranteed by the issuing agency. It also purchases federally guaranteed borrowings of nongovernmental entities. About 78 percent of FFB's $124 billion portfolio in fiscal year 1982 was for CBOs and agency guaranteed loans.

--Purchase of debt securities. Many on- and off-budget agencies have congressional authority to borrow to finance their activities in the same way as the Treasury offers bonds, notes, and bills to finance the deficit. On-budget agency debt accounts for just over 20 percent of the FFB's total portfolio, and off-budget agency debt accounts for about 1 percent. About half of the agency borrowing from FFB, in turn, is used to fund agency loan programs.

--Purchase of agency assets. The purchase of agency assets is the largest category of FFB holdings and includes certificates of beneficial ownership. These CBOs represent "ownership" of interests in a pool of loans made and still held by a selling agency. These securities are sold by the agency and guaranteed by the Government. When the securities are sold, they are by law treated in the budget as a sale of a loan asset, even though the loans that back CBOs are still held by the administering agency.

One of the largest sellers of CBOs is the Farmers Home Administration, which accounts for 90 percent of FFB's holdings of CBOs. Through its numerous loan programs, this agency has become the single largest user of the FFB, having outstanding CBOs of $54 billion.

--Purchase of guaranteed securities. The last category of FFB holdings is guaranteed securities issued by non-Federal borrowers. Under this arrangement, the FFB lends money directly to a non-Federal enterprise whose obligation to repay the funds is guaranteed by a government agency who has an interest in the activities performed by that enterprise. For example, NASA engaged Western Union Space Communications to build and operate a satellite communications system that NASA eventually leased. Western Union's $786 million project costs were financed by the FFB, with NASA's full guarantee of loan repayment. The FFB only accepts agencies' 100 percent guarantee of repayment; it assumes no risk in these transactions. Like CBOs, guaranteed loans are off-budget items. Since fiscal year 1980, guaranteed loans have grown from 25.7 percent of FFB's total portfolio to about 31 percent in fiscal year 1982.

In recent years the FFB guaranteed loans have been increasingly used as a source of short term funding. Although net FFB outlays to borrowers have grown from $6.8 billion to $8.7 billion from 1980 to 1982 gross loans made by the FFB have doubled from $10 billion to $20 billion. A large part of the growth in gross loan transactions is due to rapid rollover of borrowings, in some cases every 90 days. For example, while Amtrak's net borrowing from the FFB was increasing from $68.9 million in fiscal year 1980 to $78.8 million in fiscal year 1982, its real borrowing was going from $1.1 billion to $3.2 billion.

In case of guaranteed loan or CBO default, FFB is repaid by the guaranteeing agency. Some agencies, like the Department of Defense, have established reserve funds for this purpose. Since many agencies have made no such arrangements, reimbursements to the FFB are made from appropriated funds or from retained earnings, as in the case of public enterprise operations.

FFB OPERATIONS POSE BUDGETARY PROBLEMS

The FFB has been successful as a debt management and financing tool. As the Congress intended, the FFB operates as an intermediary to coordinate and consolidate agency credit functions, thus saving interest and administrative and underwriting costs. But the off-budget status of the FFB and the budgetary treatment of its CBO and loan guarantee transactions have caused budget decision problems since the Bank was created.

The FFB credit activities are given off-budget status, which means that outlays by the Bank and all other off-budget agencies (Rural Electrification Administration, Postal Service, U.S. Railway Association, U.S. Synthetic Fuels Corporation, Federal Reserve System, and Strategic Petroleum Reserve) are not counted in the unified budget totals. This practice understates outlay and deficit totals, and these are key points of control in the budget process. Because of the off-budget treatment of FFB operations, the budget deficit was understated by $14.1 billion in fiscal year 1982.

Mr. Chairman, you raised the question of whether it is appropriate for the FFB to have unlimited funding through the Treasury. Since inception, nearly all FFB funds have been obtained from the Treasury, where it is authorized unlimited borrowing. But we do not believe that is the real problem. Nor do we believe the FFB is the appropriate point of control. If FFB access to Treasury funding were limited, the FFB, in turn, would be required to limit agency access to it. That means that the FFB would have to choose among potential borrowers. Thus, the FFB would be put in a policymaking role with respect to the credit budget. That was not part of the original conception of the FFB and would duplicate the existing budget process. If the objective of such a limitation is to control the volume of

Federal credit programs, we believe this should be accomplished by controlling the programs directly through the budget process.

IMPACT OF FEDERAL FINANCING BANK ON CREDIT ACTIVITIES

Turning now to the question of whether the FFB has unduly increased Federal credit activities, I believe it is safe to say that it has not reduced them. And, there are reasons to believe that FFB's existence and, more precisely, its off-budget status, has caused some growth in credit activities that might not otherwise have occurred. It is not possible, however, to be precise about the extent to which this has happened.

For asset sales, and in particular the CBO financing instruments used by the Farmers Home Administration to finance its lending activity, the FFB serves as a captive market for the sale of these securities. Before the FFB was created, Farmers Home had to be concerned with arranging for investment bankers to originate, underwrite, and market its issues. Timing of the sale was an important consideration, and ill-timed issues resulted in unfavorable terms. As I indicated, the FFB was created to eliminate many of these problems and their associated expenses. So, the financing channel provided by the FFB has certainly made it easier for Farmer's Home to fund its lending operations. It is reasonable to assume that this increased ease of financing may have translated into greater level of lending activity.

Furthermore, the off-budget status of the FFB has perpetuated the lack of visibility associated with the use of CBOs as well as all other credit activities that are off-budget in their own right. Were the FFB on-budget and asset sales or fully guaranteed loans still financed through it, they would be recorded as outlays in the budget totals. It is reasonable to assume that the resulting visibility in an era of severe budgetary constraints would have led to greater restraint in the growth of many credit programs now financed by the FFB.

In addition to these considerations, the deepened interest rate subsidies associated with FFB lending for guaranteed loan programs may have stimulated the demand for Federal credit. The FFB makes guaranteed loans to private sector entities at the Treasury borrowing rate plus one-eighth of a point markup. Though fully guaranteed loans funded by private lenders are risk-free, interest rates are still higher than the cost of Treasury borrowing because private borrowing costs are higher and because of tax considerations.

Whether lower interest costs of FFB purchased guaranteed loans has affected credit markets and raised interest rates depends first, on whether their supply under various programs is unconstrained. If it is unconstrained, then the extent to which FFB's activities affect credit availability in commercial markets depends, in part, on whether the programs whose guarantees are purchased by the FFB are intended to reallocate credit in the first place. In certain cases programs do not reallocate credit. In large measure, they simply subsidize the financing of activities that would be engaged in anyway at prevailing rates by creditworthy borrowers. In other cases, programs assist non-creditworthy borrowers and financial resources are reallocated to borrowers who simply could not obtain credit on reasonable terms. In these cases, the deepened interest rate subsidy associated with FFB financing may stimulate demand and accentuate this resource reallocation. Since we have not carefully studied the loan guarantee programs that the Federal Financing Bank finances to determine whether there are supply constraints or which of the programs are for creditworthy versus non-creditworthy borrowers, and since the relationship between the level of interest subsidy and the demand for Federal credit has little precision, it is very difficult to be any more specific.

If there is an increase in FFB's purchase of loan guarantees to less than creditworthy borrowers, it may be expected to raise the level of interest rates to unassisted borrowers who must compete for a smaller supply of loanable funds. If we assume that private rates of return to unassisted borrowers are higher than those expected by assisted borrowers, then any displacement in the market of creditworthy by non-creditworthy borrowers will tend to lower the average rate of return from the economy's investments. This, in turn, will adversely affect economic growth.