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Federal Government Credit Activities and How They Relate to Loan Sales

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Mr. Chairman and Members of the President's Commission on Privatization:

I am pleased to be here today to discuss GAO's views on the federal government's efforts to privatize--transfer to the private sector--its credit activities through the sale of financial assets in the form of federal loan portfolios.

My testimony today will focus on the key areas of consideration that must be addressed in evaluating proposals to privatize federal credit programs. First, privatization of federal credit programs involves different characteristics than privatization of more familiar government assets and programs, such as the sale of CONRAIL. Second, the federal government has already privatized several aspects of its credit programs through its loan guarantees and credit market facilitation programs. Third, loan asset sales as a privatization tool for federal credit programs will not achieve all objectives set for loan sales and such sales may not be appropriate for all portfolios.

The sale of loan assets is essentially different from the sale or privatization of governmental nonfinancial--that is, capital--assets, such as the sale of CONRAIL and the proposed sale of the Bonneville Power Administration at the federal level and the sale of trash collection and bus services at the local level. The basic difference between these sale programs concerns the governmental entity's continued involvement with the asset

after sale. After selling capital assets, the government entity conducting the sale ceases to be involved in the activity that has been sold. For example, since selling CONRAIL, the federal government is no longer involved in the railroad's operation.

The sale of financial assets, however, presents a different set of circumstances. Federal loan programs are the means to achieving policy or program goals as opposed to being ends in themselves. For example, student loan programs are used to achieve the policy goal of broadening access to higher education by providing funds to economically disadvantaged students. If the federal government sells to the public all or part of a loan portfolio, this does not mean that its role in providing higher education will end. It may continue to hold some of the loans or it may make new loans in the future. For example, the federal government could sell a portion of its disaster home loan portfolio but, when the next disaster strikes, it will make new loans.

My comments today will focus on the sale or privatization of federal credit programs through the sale of financial assets; in this case, loan assets. I would like to begin with an overview of the scope of government loan programs, then discuss the objectives of current programs to sell federal loan portfolios to

the public, and complete my comments with discussions of how the government has already achieved some of these objectives and the key issues surrounding these sales.

I would like to begin with a brief overview of government loan programs.

GOVERNMENT LOAN PROGRAMS

The federal government's credit programs fall into two broad categories--direct loan programs and loan guarantee programs. As of September 30, 1987, the federal government held direct loans with an estimated principal balance of $256 billion. It also was guarantor, in the event of borrower default, for loans held by private financial institutions with an estimated principal balance of $567 billion.

Under direct loan programs, the government acts like a banker. It makes loans directly to borrowers and collects the principal and interest payments over the life of the loans. Under loan guarantee programs, the government guarantees the loans made by private lending institutions which are generally responsible for servicing the loans until paid. In this instance, the government would only become involved if a borrower defaults on a loan. If this happens, the federal government often will repay the lender and assume title to the loan, which

means the borrower must repay the federal government. In some loan guarantee programs, default is resolved by the lender foreclosing on the loan and taking possession of the collateral. In that case, the government may either (1) take the collateral and pay off the loan or (2) require the lender to sell the collateral and then the lender receives any remaining shortfall from the outstanding loan balance.

The federal government manages about 100 direct loan and several loan guarantee programs which include widely diversified loan types with a wide range of terms and conditions. These direct loans and loan guarantees vary considerably as to the financial condition of borrowers, collateral securing the loans and guarantees, interest rates, repayment periods, and loan servicing policies. As a result, privatization initiatives such as loan asset sales cannot be uniformly applied across-the-board to all federal credit programs. Instead, such initiatives must be evaluated on a portfolio-by-portfolio basis to determine the costs and benefits to the government, the impact on policies and programs, and the impact on borrowers.

OBJECTIVES OF LOAN SALES

The proposals to sell federal loan assets to the public were initiated in January 1986 when the administration included a pilot sale of federal loan assets as part of the President's

fiscal year 1987 budget request. It is important to note that the primary thrusts of the administration's pilot loan sale proposal were federal credit reform and financial management improvements with a goal of maximizing budgetary receipts. During congressional budgetary debates for fiscal year 1987 and in the President's fiscal year 1988 budget request, the emphasis in the discussions regarding loan sales shifted from credit reform to generating budgetary receipts.

Nonetheless, the debate regarding federal loan asset sales continued to focus on five objectives:

-- reducing the government's cost of administering credit programs by transferring to the private sector--privatizing--the servicing, collecting, and other administrative activities of federal credit programs;

-- encouraging agencies to improve loan origination processes, make loan terms compatible with terms of similar private sector loans, and improve loan documentation;

-- determining the actual subsidy cost--the expense of making the loan--of federal credit programs;

-- generating additional federal cash receipts--revenue above that expected without loan sales--to help reduce the federal budget deficit; and

-- encouraging agencies to improve accounting systems and financial reporting for federal credit programs.

I would now like to turn to what the federal government has already done to achieve some of these objectives and follow this discussion with our views on the key issues of concern in the government's current loan sale initiatives as they relate to fulfilling the objectives of the loan sale program.

GOVERNMENT'S PAST AND PRESENT ACCOMPLISHMENTS IN PRIVATIZING FEDERAL CREDIT ACTIVITIES

One of the goals of the federal government's current loan asset sale initiatives is to transfer to the private sector the servicing, collection, and administrative activities of federal credit programs, thus reducing the federal government's cost of administering these programs. This goal has already been partially achieved in the federal government's loan guarantee programs and in its credit market facilitation programs, as I will now discuss.

Under the federal government's loan guarantee programs, the government establishes policies, regulations, and administrative procedures which guide private lending institutions in conducting day-to-day loan program operations. For example, under the guaranteed student loan program, private lending institutions carry out all activities related to originating the loans, servicing and collecting the loans, and maintaining the accounting records for the loans. The federal government only becomes involved with loan servicing and collection activities if a borrower defaults and the federal government buys the loan. Through loan guarantee programs, the federal government achieves the program goal of providing funds to individuals and private organizations who cannot obtain commercial credits, while also avoiding the administrative responsibilities associated with a direct loan program. Unfortunately, because most of these programs are 100 percent guaranteed, there is a lessened incentive for private organizations to ensure that the loans are all collected. Partial guarantees might well be a way to provide more of the needed incentive.

Similarly, the federal government, through its credit market facilitation programs, achieves the program goals of providing needed credits while avoiding the administrative burdens of a direct loan program. For example, the federal government assures the availability of home mortgage funds by ensuring the liquidity of mortgage loans. It does so by creating a secondary financial

market for these loans through the Government National Mortgage Association and the Federal National Mortgage Association. These are quasi-government corporations that fund their activities from fees they charge for buying and selling packages of home mortgage loans. Again, the government achieves a credit program goal without being involved in day-to-day program activities.

I would now like to turn to the government's current and proposed loan sale initiatives as privatization tools and the key issues regarding these initiatives.

KEY ISSUES RELATED TO THE GOVERNMENT'S LOAN SALE INITIATIVES

The government's current and proposed initiatives all involve the sale to the public of direct loans held by the government as opposed to the making of loan guarantees. Our review, during the spring of 1987, of six loan portfolios proposed for sale disclosed the following key issues related to these sales which were also confirmed during the recent loan sales that were consummated by the Farmer's Home Administration and the Department of Education.

-- The sale of loan assets--even when the government gets the full value of the loans when they are sold--will not

reduce the structural budget deficit because loan sales simply shift revenues from future years to the year of the sale.

-- Agencies selling loans should be allowed to structure their sales to achieve the greatest possible net return to the federal government.

-- Loans do not have to be sold to determine the subsidy cost.

-- Agencies need to upgrade to commercial market standards loan servicing, documentation, and accounting records to prepare themselves to conduct loan sales.

-- An independent audit of each loan sale should be performed to ensure the integrity of the loan sale program.

The results of our review also showed that the federal government may realize larger cash receipts over the term of the loans by retaining certain loan portfolios rather than selling them to the public.

In view of these issues and the fact that the federal government will most likely continue the various loan programs in

the future, we believe that decisions on whether or not to sell federal loan assets should be based on two key considerations: (1) the economic benefits to the government of a loan sale and (2) credit reform and other nonfinancial policy objectives.

Loan Sales Will Not Reduce Structural Budgetary Deficits

Sales of loan assets will not solve our structural deficit problems. Portfolio sales of $5 billion to $10 billion a year will accelerate collections, but they will not change the basic structural imbalance between governmental receipts and outlays. Specifically, the sale of existing loans could potentially have very different effects on short- and long-run budget deficits. After an initial surge in revenue generated in the year of the loan sale, total revenues from loan repayments will decrease substantially in later years. Sales of existing loans simply shift future loan payments to be received by the government to the year of sale and, as a result, do not create additional cash receipts above the revenues the government would have received through loan repayments had it continued to hold the loans. As a result, the annual federal deficit in these later years may be larger than is now projected. Further, if the sale of existing loans yields net sale proceeds or less than the present value to the government of future loan repayments, budgetary deficits over the long term will increase.

Loan Sales Should Be Structured To Achieve the Greatest Possible Net Return

Because of investor unfamiliarity with federal loan portfolios and the characteristics of some of these portfolios, the government will not realize maximum sale proceeds unless the sales are structured in ways that will provide incentives to encourage private investors to purchase these loans. Some federal loan portfolios include characteristics that differ from private sector loans and could adversely affect the sale of these loans. These characteristics include higher delinquency rates, loan documentation that does not meet commercial standards, and borrowers that cannot meet private lender creditworthiness criteria.

We earlier reported that structured sales with some form of credit enhancement should be followed where future loan loss rates can be reliably predicted and credit enhancement provisions can be structured so that both the government and investors share the future risks. With sales on a credit-enhanced basis, the government would protect, to some degree, the purchaser's investment and thereby increase loan sales and sales revenue. This flexibility is needed if the government is to realize the best possible net return on the sales of its assets.

Agencies--the Farmer's Home Administration and the Department of Education--that have conducted sales have done so

under negotiated sales structures with credit enhancement in the form of "overcollateralization." The sale structure for these consummated sales included establishing a shell corporation to which federal loan assets are transferred from the government. The corporation in turn sells to investors securities which are backed by the cash flows from the loan assets. These securities generally fall into two classes: senior and subordinate. In addition, the government holds an equity interest in the shell corporation through special securities issued by the corporation called "Certificates Of Beneficial Interest" (CBIs).

The CBIs are backed by a portion of the proceeds from the loan sale which are used as reserve funds to ensure the cash flow of payments to the purchasers of the senior securities. Together with the loans sold as subordinate securities, the CBIs represent the amount to which the senior securities are overcollateralized.

At Farmer's Home, the $2.9 billion Rural Housing loan portfolio netted $1.7 billion, and the $1.9 billion Rural Community Development loan portfolio netted $1.1 billion. The Department of Education sold its $237 million College Housing and Academic Facilities loan portfolios for $120 million. The net proceeds from the sales were largely influenced by the difference in the interest rate which the borrowers were originally charged for the loans and the current market rate.

Some Loan Portfolios Should Be Held to Term Rather Than Sold

From a financial perspective, the decision to sell existing loan portfolios should be evaluated by comparing the value to the government today of future loan repayments with the estimated net proceeds expected from the sale of the loans. For example, in our review of six proposed sales, we compared the present value of future loan repayments with the estimated net proceeds for three loan portfolios proposed for sale or prepayment by borrowers under the administration's pilot loan sale program. These comparisons showed that the present value to the government of future loan repayments was greater than the estimated net proceeds from sales or the amounts the government would receive from borrowers if they prepaid their loans.

The net proceeds from a loan sale are based on the present value of future loan principal and interest payments to be made under the loans. The present value is based on a discount rate expressed as an interest rate. A higher discount or interest rate will yield a lower present value. In the case of government loan portfolios, the government's borrowing rate will generally be lower than an investor's or borrower's discount rate; consequently, the present value to the government of future loan principal and interest payments, discounted at the government's borrowing rate, will generally be higher than the net proceeds from a sale.

For example, Education's College Housing loan portfolio has an unpaid principal balance of about $2.2 billion. The loans carry an average interest rate of about 3.2 percent, and are to be repaid over an average of 21.5 years. The present value of loan principal and interest payments, based on interest rates for Treasury securities for similar maturities, is about $1.5 billion, while it is estimated that the loans would yield about $1.2 billion in net proceeds if sold on the open market.

Loan Sales Are Not Needed To Determine Credit Program Subsidy Costs

The subsidy cost of a federal credit program can be measured without selling loans. This cost can be computed by determining (1) the difference between the interest the government will pay to borrow funds to make the loans and the interest income it will receive from borrowers, (2) the estimated amount of future loan defaults based on prior experience with similar types of loans, and (3) the estimated cost of administering the loan program.

Conversely, the subsidy cost for federal credit programs cannot be directly determined through loan sales of existing portfolios. Also, the subsidy, if calculated for new loan programs as planned by the administration, would be larger than the actual subsidy cost to the government of making that loan

because of changes in market interest rates between the time the loan was originally granted and the time the loan was sold.

Currently, the administration plans to measure the subsidy cost for existing federal loans based on the difference between the outstanding principal of the direct loans that are sold and the net sale proceeds the government receives. This difference would not provide a reasonable measure of the subsidy cost the government incurred in making the loans. This difference primarily measures fluctuations in market interest rates and, to a lesser degree, the creditworthiness of the borrower. To measure true subsidy cost, the portion of the difference between the present value of principal and interest payments of the sold loans and net sale proceeds relating to interest rate changes would have to be identified.

Some Agencies Need To Upgrade Loan Servicing

In our view, the government's management of credit activities can be improved. Specifically, we believe that documentation on borrowers and loans needs to be improved for some portfolios. This includes the need for better accounting records. Without proper loan documentation, agencies selling loans must bear the cost of bringing the loans up to commercial standards or offer some form of recourse to the purchaser. In addition, agency accounting systems and records must be updated

to collect and report the type of loan portfolio performance characteristics required by private investors such as portfolio delinquency and default rates. For example, in the recent sale of the Community Development Program loans conducted by the Farmer's Home Administration, an independent accounting firm was paid $2.6 million to review and "clean up" the loan portfolio's documentation, performance, and the related accounting records.

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 ensure accountability for these assets and to ensure the discipline and integrity of the financial amounts that are reported.

For example, as I just mentioned, before its loan asset sale could take place, the Farmer's Home Administration had to engage the services of an independent accounting firm to render opinions on the delinquency, default, and collection rates and on the outstanding principal balance for the loan portfolio sales and to "clean up" and correct the records. This action was taken to assure investors that the quality and characteristics of the portfolios, as portrayed by Farmer's Home, were accurate. Some of the audit costs for these services may have been avoided if

the government's loan servicing operations had been routinely subjected to an independent audit.

Independent audits of completed loan sales should also be done to develop objective evaluations of the sale results and to identify actions the government should take to improve loan origination, servicing, accounting, documentation, and financial reporting to facilitate future loan sales.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions you or members of the Commission may have.