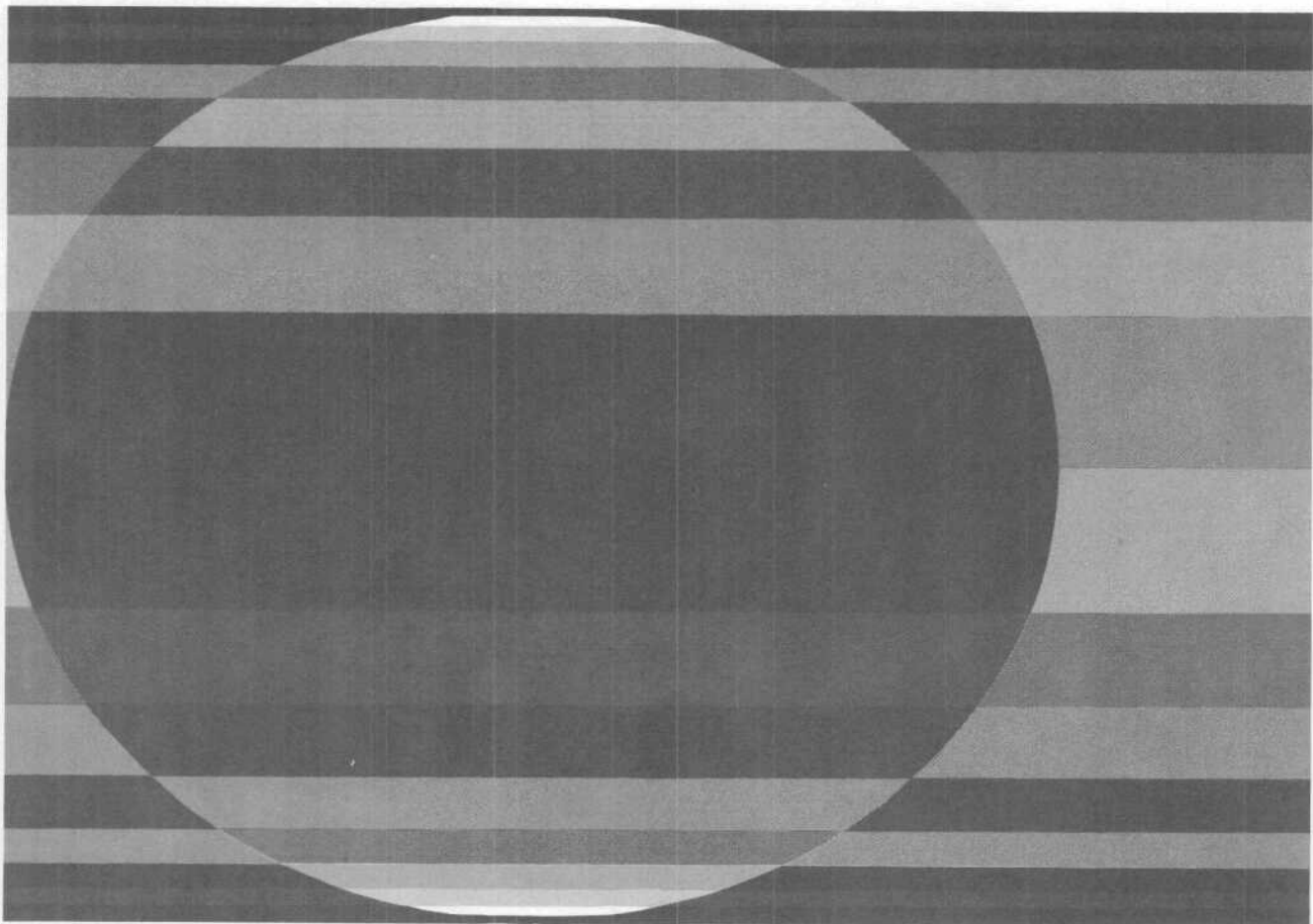


BACKGROUND PAPER

Loan Guarantees: Current Concerns and Alternatives for Control

August 1978



Congress of the United States
Congressional Budget Office

**LOAN GUARANTEES:
CURRENT CONCERNS AND ALTERNATIVES FOR CONTROL**

**The Congress of the United States
Congressional Budget Office**

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PREFACE

At the request of the Senate Budget Committee, CBO has prepared Loan Guarantees: Current Concerns and Alternatives for Control, a study of the use and growth of loan guarantee programs, current concerns about the appropriateness of using them, and alternative methods of controlling them. John D. Shillingburg of CBO's Budget Process Unit prepared the report, with the assistance and supervision of Richard P. Emery, Jr. W. Donald Campbell of the Senate Budget Committee contributed extensively to the report through his review and suggestions. The author also wishes to acknowledge the helpful comments of Richard D. Morgenstern, Helmut Wendell, and Brent G. Shipp of CBO; and John Mitrisin of the Congressional Research Service. Patricia H. Johnston edited the manuscript, and Kathryn A. Quattrone and Susan L. Bailey typed the many drafts.

Appendix A provides summary answers to the specific questions contained in the request from Chairman Muskie and Senator Bellmon. A number of specialized background reports were prepared in the course of this study. They will be published shortly in a companion volume.

Alice M. Rivlin
Director

August 1978



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SUMMARY

Loan guarantees have been a useful federal policy tool since the Depression. Billions of dollars of loans have been guaranteed by the federal government, enabling countless families to buy their own homes, farmers to buy their own farms, and even fishermen to buy their own boats. Recently, the nature of loan guarantee programs and proposals has changed dramatically, raising questions about how they should be used and how they can be controlled as part of the federal budget process.

LOAN GUARANTEES: THEIR CHANGING NATURE

Loan guarantees were first used on a large scale during the Depression to help families purchase their own homes. Essentially insurance programs, these programs operate on an actuarially sound basis, charging premiums for insuring the loan. The premiums are set high enough to pay operating costs and probable losses. The government pools the risk of a number of small loans; the borrowers as a class bear the risks through their insurance premiums.

A second group of programs evolved out of the first as the insurance programs were extended to marginal borrowers--such as students and low-income families seeking to purchase homes--who posed greater than ordinary risks, either because of a greater than normal probability of default or a lack of acceptable collateral. These programs for marginal borrowers operate much the same as the insurance programs with one important exception: although the risks of individual loans are pooled across a large number of loans, the government bears a portion of the risk. Since the premiums charged are set below the levels required to cover operating costs and losses, the programs carry an element of subsidy.

Recently, a third class of guarantee programs has emerged. Characteristically for large loans to a single borrower or to a small group of borrowers running common risks, these programs represent decisions by the government to finance discrete ventures or projects by allocating them credit. These programs have often been proposed in the energy field, for plants using new technologies not yet proven successful or profitable. These programs cannot be operated as insurance programs since the numbers of loans guaranteed are small and the risks cannot be pooled across different borrowers. Because the size of each loan is large, any default can have serious budgetary consequences.

LOAN GUARANTEES: RECENT CONCERNS

The shift in the focus of loan guarantee proposals from actuarially sound programs to the financing of discrete ventures has raised new questions about the use and effects of loan guarantees. Proposals to use loan guarantees as a means of financing have great appeal: the appearance of low budgetary costs and minimal federal intervention in the economy. Budgetary costs appear low because guaranteed loans are excluded (by statute) from the definition of budget authority, and hence, are not adequately addressed in a budget process designed to control new budget authority and outlays. Federal intervention in the economy through loan guarantees appears minimal because loan guarantees are assumed to leave intact the decisionmaking processes of lenders and borrowers.

These perceptions of minimal intervention and low cost can be far from accurate, however, and may cause inappropriate legislative decisions. For example:

- o Misunderstanding the actual effects of guarantees on the behavior of lenders and borrowers can lead to creation of programs that presuppose effective screening of project feasibility by lenders when no such screening will actually occur.
- o The perception of low cost can cause the allocation of resources to a program that would not be undertaken if a full evaluation of project benefits in relation to costs had been made.
- o Incomplete knowledge about the credit flow stimulated by guarantees complicates the coordination of fiscal policy.

In each of the above cases, the result could be failure of the program, high and unforeseen costs to the government, and costs to the economy as a whole. The changing nature of proposals for loan guarantee programs and the problems resulting from inadequate Congressional review and control have heightened Congressional concern about the use of federal guarantees.

LOAN GUARANTEES: HOW THEY CAN BE CONTROLLED

Credit programs in general and loan guarantees in particular are on the boundary between the public and private sectors of the economy. In the private sector, the marketplace is the mechanism for allocating resources. The budget process performs that role for the public sector. While there may be strong elements of private sector involvement in guaranteed loans, the government supplants critical market calculations, for example, by assuming default risks, selecting borrowers, and determining interest rates. Thus, loan guarantees should be controlled in the public sector's principal resource allocation mechanism, the budget process.

Six alternative methods for integrating loan guarantees into the budgetary process are discussed below.

Redefining Budget Authority to Include Loan Guarantees. Loan guarantees are excluded from the definition of budget authority and new spending authority contained in sections 3(a)(2) and 401(c)(2) of the Congressional Budget Act of 1974. As a result, they are excluded from the targets and ceilings of the concurrent budget resolutions, as presently constituted. This approach would delete the exclusion of loan guarantees from the definitions and would cause the principal of loans being guaranteed to be counted as budget authority. While this approach would subject guarantees to the disciplines of the process, it could reduce the usefulness of budget authority totals by weakening the relationship of budget authority to expected outlays.

Credit Section in the Federal Budget. A credit section in the budget could operate as follows: the President would recommend and the Congress would enact targets and ceilings for the total volume of new direct loans and new guarantees to be extended by the federal government. Authority to enter into commitments for new direct loans and new guarantees would be shown in the budget. 1/ Such a proposal could be implemented either formally, through legislation enacted by the Congress, or informally, through the Budget Committees' authority to include in the budget resolutions "such other matters relating to the budget as may be appropriate." 2/

1/ In his fiscal year 1979 budget, President Carter stated that the Administration would be presenting a credit control proposal along such lines to the Congress later this year.

2/ The Congressional Budget Act of 1974, Public Law 93-344, Section 301(a)(6).

This proposal has several advantages. First, by combining direct and guaranteed lending, it would be possible to compare credit programs with direct spending programs, in total and by functional category. Second, it would also be possible to determine better the federal impact on the domestic credit markets. Finally, the proposal for a credit section in the budget is compatible with the present budget process, permitting the Congress to vote on targets for direct and guaranteed lending each year as part of the concurrent budget resolutions.

Informational Credit Analysis. This approach would provide to the Congress essentially the same information that would be used in a credit section of the budget--roughly the same data now contained in the special analysis on credit that accompanies the budget each year. Decision-makers could use the informational analysis to inform themselves about the extent of current federal activity credit before making decisions creating new programs or extending older ones. Better Congressional control could result simply from greater understanding by the Congress of guarantee programs and their effects.

Indirect Control Through the Federal Financing Bank. The Congress could require loan guarantees to be financed through the Federal Financing Bank (FFB). By limiting the amount of annual activity of the FFB, the Congress could control the level of credit activities. Under this approach the government would not only guarantee the loans, it would also supply the funds. Thus, all guaranteed loans would actually become direct federal loans. Unless the off-budget status of the FFB were changed, however, none of this activity would be reflected in the budget authority and outlay totals.

Two other methods of control could be adopted separately from, or in combination with, one of the above alternatives:

Direct Program Controls. Loan guarantee activities could be controlled directly by subjecting new commitments to annual appropriations, or by requiring that all programs have default reserves appropriate to the government's risk and permitting outstanding obligations only in amounts proportional to the reserves on hand.

Self-policing Elements. Standards of program design could be refined so that individual guarantee programs would create incentives for borrowers and private lenders to act in a manner consistent with prudent federal policy. Guarantee programs could require credit needs tests for borrowers, coinsurance by lenders, equity participation by private investors, and other elements to prevent program abuse. These instruments are not so much a means of aggregate control as elements of adequate program design.

CONCLUSION

CBO considers the establishment of a credit section in the federal budget to be the most effective way to improve Congressional control of the total volume of federal financing guarantees. The credit section should be used in combination with direct controls on individual program activity and self-policing elements in the design of the programs. This combination of aggregate and individual program controls would provide the Congress a means of effectively planning for and overseeing the federal government's credit assistance programs.

The federal government has a broad array of policy tools available to accomplish the diverse and complicated objectives of its various programs. These tools--direct expenditures, grants-in-aid, direct loans, loan guarantees, regulatory measures, and tax expenditures--each have their particular strengths and weaknesses. A knowledge of these strengths and weaknesses permits policymakers to tailor the federal government's response to a particular situation. Decisionmakers should, however, understand the likely effects of each tool on the economy and the budget before using it. Unfortunately, these effects are not as easy to determine as has often been supposed.

Determining the effects of individual programs is only part of the problem. Attention must also be given to determining the combined effects of various policies enacted separately but implemented simultaneously. In the past the accomplishment of federal objectives usually involved only direct federal expenditures. The budgetary process was perceived to be an adequate forum for making choices among competing federal activities and for setting national priorities. The recognition in recent years that the federal government significantly influences the economy and the allocation of economic resources by means other than direct expenditures has uncovered a problem. Coordination of these activities--loan guarantees, regulations, and the like--with direct federal activities is not completely possible through the budgetary process. For example, the budget fully reflects a federal decision to spend \$300 million for education, but federal regulations requiring state and local governments to spend an equal amount or loan guarantees redirecting \$300 million in credit to student loans are not reflected in the budget. Making federal decisions that allocate private resources, such as these do, on an ad hoc basis outside of a framework considering all such decisions may result in less efficient and productive use of the nation's economic resources. The Congress should continuously review the budgetary process to assure consideration, when possible, of all allocative activities in which the federal government plays a role.

This paper considers one type of allocative decision not now fully encompassed in the budgetary process: federal guarantees of loans and other credit. The next chapter discusses what loan guarantees are and how they operate. The third chapter enumerates various problems in the current operation of many loan guarantee programs. Some of these problems stem directly from the inability of policymakers to coordinate loan guarantee and direct spending programs. The final chapter examines various options for improving Congressional control of federal guarantee programs.

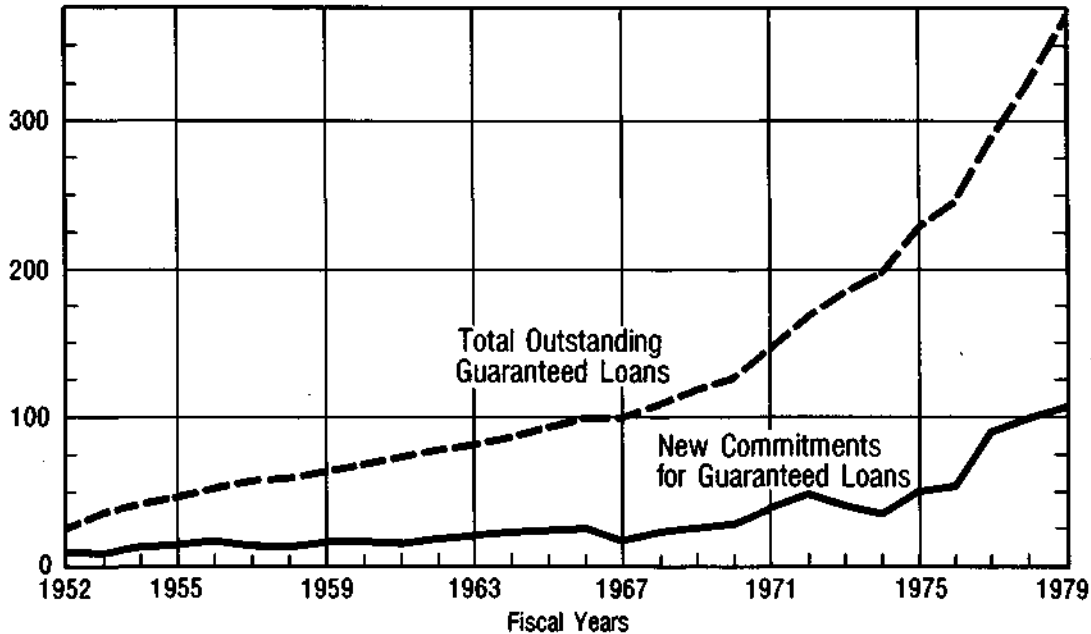
CHAPTER II. LOAN GUARANTEES: WHAT THEY ARE AND WHAT THEY DO

A guaranteed loan may be simply defined as a loan or security on which the federal government has removed or reduced a lender's risk by pledging to repay principal and interest in case of default by the borrower. ^{1/} Guaranteed or insured lending has been an important component of credit advanced by the federal government during the post-World War II era. As Figure 1 illustrates, the annual growth in new

Figure 1.

Growth of New Commitments and Total Outstanding Guaranteed Loans^a for Fiscal Years 1952-1979^b

Billions of Dollars



SOURCE: *Budget of the United States Government, Special Analysis on Credit, Fiscal Years 1952-1979.*

^a Unadjusted figures

^b Fiscal year 1978 and 1979 figures are estimates.

^{1/} As used in this paper, guaranteed loans include those designated as "insured."

guarantees was relatively steady throughout the 1950s and 1960s. This steady annual growth, however, caused the amount of total guarantees outstanding--that is, the total amount of loan principal the government has pledged to repay in case of default--to grow rapidly. Annual growth since 1970 has sharply accelerated; in fiscal year 1979 the federal government will guarantee an estimated \$53.4 billion of loans, an increase of 19 percent over the previous year. These rapid increases in annual growth in recent years have caused an even sharper acceleration in the amounts outstanding. Total guarantees outstanding will increase by \$23.2 billion during fiscal year 1979, from \$200.4 billion at the close of fiscal year 1978 to \$223.6 billion by September 30, 1979. ^{2/}

The steady annual growth of new guarantees has meant that guaranteed lending continues to be a major share of the federal government's credit assistance. Throughout the post-World War II era, the volume of guaranteed lending was roughly twice that of direct federal lending. This two-to-one proportional mix is indicative of a long-standing policy to use private credit whenever it can be made available on reasonable terms, such as through the introduction of a federal guarantee. As Table I illustrates, the two-to-one ratio has remained valid in recent

TABLE I. NEW FEDERAL CREDIT EXTENDED, BY TYPE, FISCAL YEARS 1977 TO 1979: IN MILLIONS OF DOLLARS

Type of Credit Assistance	1977	1978 ^{a/}	1979 ^{a/}
Direct Loans, On-budget	21,854	29,361	26,575
Direct Loans, Off-budget	13,558	16,871	17,575
Guaranteed Loans ^{b/}	40,794	44,669	53,354
Total	76,206	90,901	97,504

SOURCE: Budget of the United States Government, Fiscal Year 1979, Special Analysis F.

^{a/} Estimates.

^{b/} Primary guarantees, adjusted.

^{2/} Unless otherwise indicated, all estimates in this paper are derived from the Budget of the United States Government, Fiscal Year 1979, Special Analysis F. Note that unadjusted data are used in Figure 1; adjusted data have been available only since 1970.

years for guaranteed loans and direct loans by on-budget agencies. The rapid growth in lending by off-budget agencies, however, has reduced the ratio of guaranteed lending to all federal direct lending to something less than two-to-one. 3/

The year-to-year growth in new guarantees in Table I shows that the rapid growth of guarantees in the early 1970s is continuing. In part this growth may stem from a perception that loan guarantee programs are a free good--that they cost the government little or nothing and result in only negligible government intervention in the private sector. This perception, however, reflects a lack of understanding of the workings and effects of loan guarantee programs.

LOAN GUARANTEES: HOW THEY WORK

As noted earlier, the effect of a federal guarantee is to reduce a lender's risk of nonrepayment in case of default by a borrower. This can be done explicitly: the federal government, as a third party in a loan agreement, pledges to repay to the lender all or part of the principal or interest in the case of a default by the borrower, as in the FHA mortgage insurance programs. Or it may be done by more subtle arrangements, such as the federal government entering into long-term contracts or leases with a borrower, who then assigns part of the proceeds of such contracts or leases to the lender to pay all or part of the debt service on the loan. In this case the lender's risk is reduced because the borrower can demonstrate a long-run, stable income stream from a project, based on the lease by or contract with the federal government. The federal government has helped finance office buildings, college dormitories, and ocean-going vessels by these means. 4/

3/ For additional discussion of the various types of federal credit assistance, their budgetary treatment, and current magnitudes, see Appendix B of this paper and the forthcoming background paper Federal Credit Programs: A Statistical Compilation.

4/ Although these long-term contracts are not explicit guarantees of credit, the Office of Management and Budget (OMB) considers them and several other financing mechanisms to be loan guarantees for purposes of inclusion in the special analysis on credit programs. (See OMB, Circular A-11, Section 42.2, May 25, 1978.) These mechanisms include lease guarantees, contingent direct loan commitments to guarantee private financing, direct loans sold with an agreement to repurchase them, and callable capital contributions. These mechanisms are explained in greater detail in Appendix C.

By reducing the risks associated with certain types of lending, federal loan guarantees are intended to influence lenders to make more credit available in certain sectors of the economy and to aid borrowers in obtaining that credit. Borrowers find the lessened risks mean lower interest costs. Guarantee or insurance programs have two effects: allocation of credit to specific purposes and the reduction of the costs of credit.

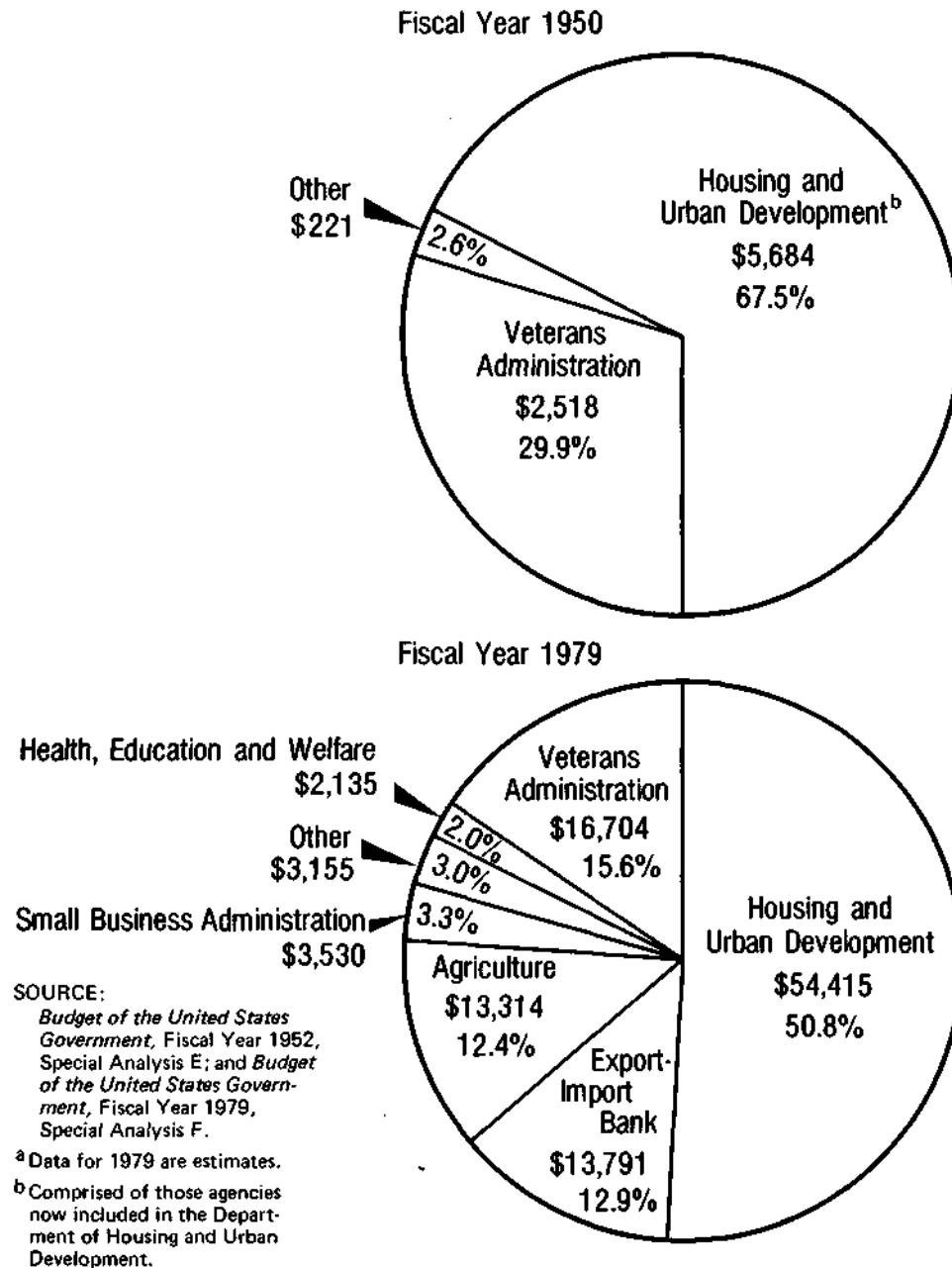
Allocation of Resources

Loan guarantees act to allocate credit in two ways. For some projects for which credit is available, the interest costs may be too high for a borrower to pay. The effect of a guarantee may be to reduce the interest costs to within the range a borrower can afford. Alternatively, the risks of some projects are so great that commercial lending institutions do not consider them credit-financable at any interest rate. ^{5/} For such projects, a government guarantee may shift a sufficient portion of the risk from the lender to the government to persuade lenders to extend the credit needed. In the first case, guarantee programs act to make a project credit-financable for the borrower; they allow individuals to purchase homes, small businessmen to expand their operations, and farmers to secure loans to buy seed, fertilizer, livestock, equipment, or even the farm itself. In the latter case, guarantee programs make a project credit-financable from the lender's perspective; lenders are induced to lend funds to railroads to help them modernize and buy rolling stock, to manufacturers of electric vehicles, or to utilities producing synthetic fuels.

Until recently the largest share of the resources allocated through loan guarantees has been in the housing field. These programs are designed to allow individual borrowers to finance their own homes with credit. As Figure 2 illustrates, housing programs in the Veterans Administration and the agencies now included in the Department of

^{5/} The risk of default imposes costs--primarily in terms of monitoring or overseeing a project--that are reflected in the interest rates lenders charge. If the risk is perceived to be very high, lenders may refrain from extending credit. Typically, credit is used to finance only low-risk ventures for which the lender provides funds in return for a fixed yield. Riskier ventures are ordinarily financed in the equity or venture capital markets (through sale of stock primarily). In such cases the investor not only bears the risk of loss but also stands to share proportionally in the profit of a successful venture through dividends or capital appreciation.

Figure 2.
Relative Shares of New Commitments for Guaranteed Loans,
by Agency, Fiscal Years 1950 and 1979^a: In Millions of Dollars



Housing and Urban Development (HUD)--principally the Federal Housing Administration (FHA)--accounted for 97 percent of the new commitments for guarantees in fiscal year 1950. While housing programs have continued to grow in absolute volume, the lower panel of Figure 2 illustrates that they have declined in terms of the relative share of credit allocated through the guarantee mechanism. Numerous new guarantee programs have allocated guaranteed credit to a wider variety of purposes. Many of these programs are designed to make credit-financable projects that lenders otherwise would consider more suitable for equity financing. The different nature of these new programs is one source of concern about the proliferation of new guarantee programs in recent years, an issue to be discussed later in this chapter.

Reduction of the Costs of Credit

Most federal guarantee programs provide credit to private borrowers on more favorable terms than are available in the private markets. These more favorable terms take three principal forms:

- o Interest rate reductions--that is, rates lower than those charged nonguaranteed loans;
- o Fees or premiums set at rates lower than those required to cover operating costs and losses; or
- o Waivers of such fees or premiums.

Interest rate reductions occur in guaranteed or insured loan programs in two ways. The reduction may be explicit, in the form of an interest rate subsidy, as in the HUD College Housing Program, in which the government contracts to pay annually the difference between the average annual debt service on loans obtained in the private market and the average annual debt service that would be required if the loan were made at a three percent interest rate. ^{6/} Such subsidies are provided through contract authority and subsequent liquidating appropriations included in the budget. Or, the interest rate reduction may be implicit, resulting from the fact that the government, by assuming risks, lowers the cost of borrowing below that charged for nonguaranteed borrowing in the private market. Such implicit interest rate reductions may have no direct budgetary costs to the government.

^{6/} Long-term agreements for annual contributions to pay all or a portion of the debt service of projects are considered guarantees of the underlying credit. (See OMB Circular A-11, Section 42.2, May 25, 1978.)

The value of the interest rate reduction to a borrower in a guaranteed or insured loan program may be calculated as the difference between the cost of borrowing under the federal program and the cost of borrowing at market rates. In practice the calculation of that difference is very difficult because of the need to estimate the interest rate that the borrower would have had to pay for a nonguaranteed loan in the private credit markets. For some loans, particularly those for housing, private credit market rates are readily available, and can be used in calculating the subsidy. For other programs--student loans and public housing, for example--no comparable private loans exist. Therefore, assumptions must be made about the rates private markets would charge.

In the mid-1970s OMB attempted to calculate the value of the interest rate reductions occurring in guaranteed or insured loan programs. It deferred calculation of the value of such reductions in the fiscal year 1979 budget because of significant differences of view among experts on the way such calculations should be made. OMB has never estimated the benefits derived under the other favorable credit terms found in many guarantee programs--reduced or waived fees or premiums. The fact that the value of these favorable terms has not been calculated does not, however, mean that they are costless to the government. For example, if the fees or premiums charged a borrower for a guarantee are set below the actuarially computed levels necessary to cover operating expenses and losses, or if such fees or premiums are entirely waived, then the guarantor agency bears these costs. These must be paid with federal funds--funds that must be included in the budget totals.

IMPACT OF GUARANTEE PROGRAMS ON THE BUDGET

The foregoing discussions of the allocative and subsidy effects of guarantee programs tend to suggest that such programs are not alike in terms of their effects on the federal budget. For example, HUD's Section 203(b) program of home mortgage insurance is actuarially sound and costs the government nothing. On the other hand, the student loan program in HEW is experiencing significant losses, and all loans guaranteed by the HUD New Communities program are undergoing difficulties. Three general classes of loan guarantee programs, in terms of their effects on the budget, can be identified. 7/

7/ This classifying structure was used in a Senate Budget Committee report on federal energy financing and subsequently in a Congressional Research Service report on the growth of loan guarantee programs from 1960 to 1976. (See Senate Budget

The First Class: Actuarially Sound Programs

The first class of guarantees includes relatively small loans to individuals or households, the risks of which are pooled across a large number of such loans by the guarantor agency. As a result the borrowers actually bear such risks as a class. Fees or premiums are based on actuarial estimates of the receipts required to cover operating costs and probable losses. Typically such programs require no budgetary resources and are financed out of revolving funds. The receipts finance future operations of the fund and are deducted from the outlays, thus leaving only a net figure to appear in the budget. Some of these programs actually have negative outlays, receipts of fees and premiums being greater than costs and expenses. By pooling risks across a large number of borrowers, these programs may result in lower interest costs to individual borrowers.

Guarantees in this class were first used in the housing field in the Depression as a means of correcting perceived imperfections in the capital markets. The Mutual Mortgage Insurance Program of the Federal Housing Administration (FHA) in HUD is the prime example. General acceptance had to be created during the Depression for self-amortizing, long-term residential mortgages, covering 80 percent or more of a property's value. Prior to that time, home loans had short maturities and required large down payments. Bankers were reluctant to offer the new type of mortgages because they had no experience with which to estimate default rates.

In 1934, FHA mortgage guarantees were instituted. Federal policymakers believed that the actual risks of new mortgages of the long-term type were less than private lenders were estimating on the basis of incomplete information. By pooling the risks of each loan across a large group of loans, the government was able to reduce the costs of borrowing. After several years' experience, sufficient information was collected to provide the private market data on which to estimate defaults. As a result, the long-term, self-amortizing mortgage gained general acceptance, and such loans began to be offered even without government guarantees.

Committee, Federal Energy Financing, Committee Print, August 30, 1976, and CRS, Federal Loan Guarantees and Their Use as a Mechanism to Correct Market Imperfections, Assist Marginal Borrowers, and Finance Discrete Ventures, April 27, 1977.)

Although the number of these actuarially sound guarantee programs is not large, their volume of activity is substantial. Of the 59 major loan guarantee programs in the CRS study sample, 8/ only four could be classified in this group of actuarially sound programs:

- o Farmers Home Administration, farm operating loans;
- o Federal Housing Administration, property improvement loans;
- o Federal Housing Administration, mortgage insurance; and
- o Veterans Administration, guaranteed mortgages.

These four programs, however, accounted for \$48 billion, or 93 percent, of the total guarantees outstanding for the 59-program sample in fiscal year 1960 and \$116 billion, or 65 percent, of the amount outstanding in fiscal year 1976.

The Second Class: Programs Requiring Subsidy

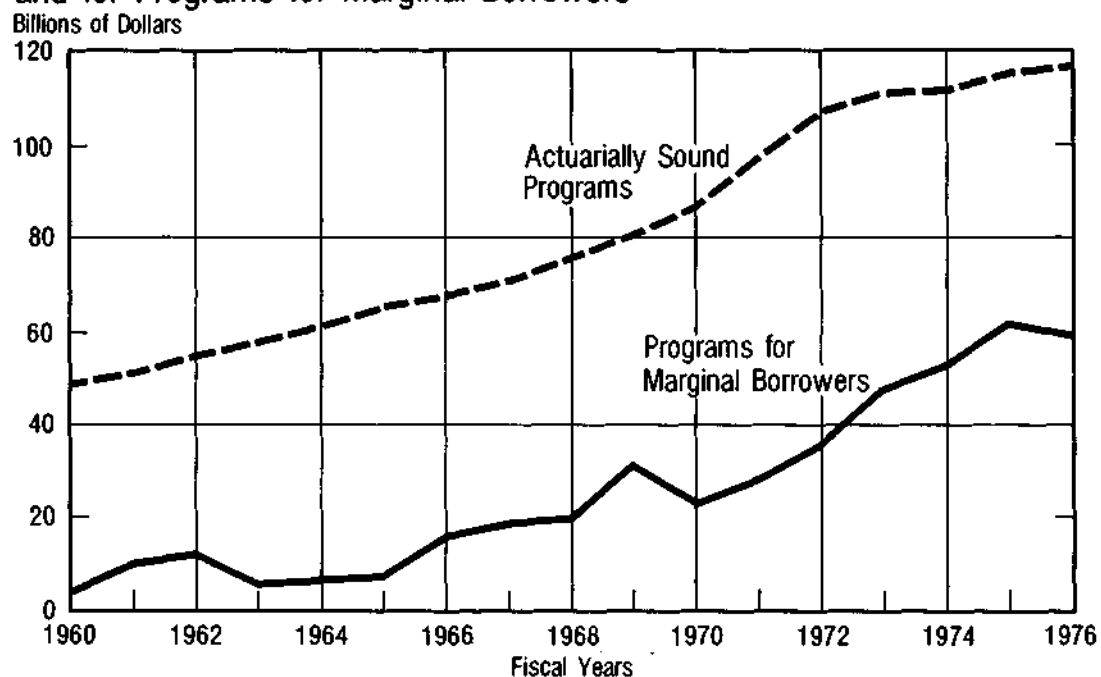
The first class of guarantees pools the risks of small loans for ordinary borrowers, and the borrowers as a class bear the risks. A second class includes guarantees of small loans to firms or individuals who pose greater than ordinary risks, either because of a greater than normal probability of default or a lack of acceptable collateral. Again, risks of individual loans are pooled across a large number of loans. In this case, however, the government bears a portion of the risk. Any fees or premiums charged borrowers are set below the levels required for actuarially sound operations. The federal government bears the costs of operation and losses above the receipts, usually by appropriations to the revolving fund through which the program is financed.

Guarantees were first extended for this purpose for home loans in urban renewal areas and for replacement housing for people displaced by urban renewal projects. Other examples include guaranteed loans for students and small businesses.

8/ The CRS study uses a sample of 59 major loan guarantee programs for which continuous data could be collected over the 16-year sample period. While this sample does not include all loan guarantee programs, it accounts for 97 percent of all guarantees outstanding reported by the Treasury in fiscal year 1960, 80 percent in fiscal year 1965, 87 percent in fiscal year 1970, and 86 percent in fiscal year 1976. (Federal Loan Guarantees and Their Use as a Mechanism to Correct Market Imperfections, Assist Marginal Borrowers, and Finance Discrete Ventures, April 27, 1977.)

Guarantee programs of this second class are more numerous than the actuarially sound programs; the 59-program sample of CRS lists 37 of these guarantee programs. While the dollar volume of subsidized guarantees is smaller than the volume of actuarially sound guarantees, the former grew more rapidly and erratically during the 1960-1976 period, as illustrated in Figure 3. In fiscal year 1960, they accounted for only \$3.4 billion, or 6 percent, of the total guarantees outstanding for the 59 program sample. By 1976 they had grown seventeen fold to \$58.8 billion, or 32 percent of the total guarantees outstanding.

Figure 3.
**Total Guarantees Outstanding for Actuarially Sound Programs
 and for Programs for Marginal Borrowers**



SOURCE: CRS, "Federal Loan Guarantees and Their Use as a Mechanism to Collect Market Imperfections, Assist Marginal Borrower's and Finance Discrete Ventures", April 27, 1977.

The Third Class: Financing Large Ventures

A third class includes guarantees of large loans to a single borrower or a few borrowers with commonly shared risks. These guarantee programs arise out of the government's decision to finance discrete ventures by allocating them credit. Often these ventures involve new processes yet to be proven technologically or economically successful, such as new energy technologies. Or they may be projects the assets of which are not easily disposed of in the event of a default. Examples of these latter programs include the Emergency Loan Guarantee Board, which helped restore the Lockheed Corporation to financial stability, and guarantees of loans to Amtrak and Conrail.

It is impossible to anticipate the timing and magnitude of losses associated with these guarantees. The number of such guarantees have been small, and their circumstances so individual that their default rates cannot be compared from program to program. Nor can the risks be pooled across different borrowers. Because the guarantees are for large amounts, the default of only one or two borrowers can impose large financial burdens on the government.

This third class of guarantees has been characterized by only a few large loans made each year. As a result, the amount of such guarantees outstanding each year has oscillated sharply. In 1960, these guarantees outstanding totalled \$79,000 or less than 1 percent of the outstanding volume of the 59-program sample. At the end of fiscal year 1976, \$3.1 billion of these guarantees were outstanding, still only 1 percent of the sample's outstanding volume, but almost a 40 thousand-fold increase over the period. Figure 4 illustrates the growth of this third class of guarantees for that period. The growth of this class and the large number of recent legislative proposals that fall into it are part of the concern about loan guarantees today.

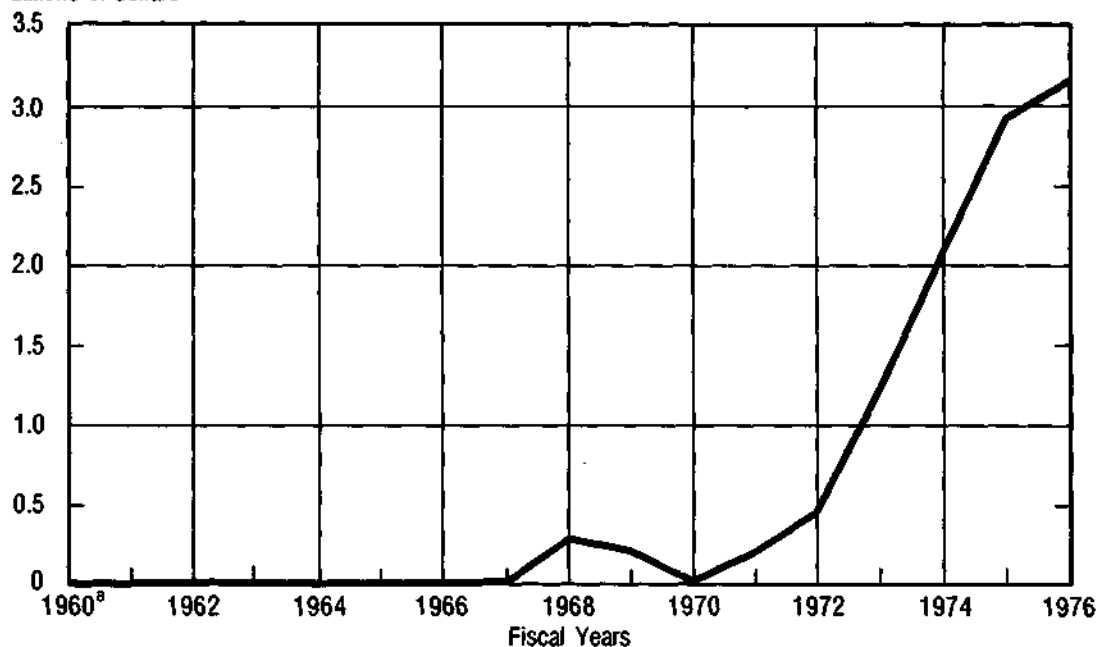
RECENT GROWTH OF GUARANTEES

Loan guarantees have become increasingly popular in recent years as a financing mechanism, especially in the energy field. Loan guarantee programs have been enacted in the last several years to stimulate activity in all phases of the energy field: research and development, demonstration of untried technologies, new production, and conservation. For example:

Figure 4.

Total Loan Guarantees Outstanding for Discrete Ventures

Billions of Dollars



SOURCE: CRS, "Federal Loan Guarantees and Their Use as a Mechanism to Collect Market Imperfections, Assist Marginal Borrower's and Finance Discrete Ventures," April 27, 1977.

^a During fiscal years 1960 - 1967, total guarantees outstanding were less than \$50 million.

- o The Geothermal Energy Research, Development, and Demonstration Act of 1974 (Public Law 93-410), as amended, authorizes guarantees of up to \$100 million per project for research, development, and construction of demonstration facilities using geothermal energy.
- o The Energy Policy and Conservation Act (Public Law 94-163) authorizes guarantees of up to \$30 million each for the development of new underground coal mines, up to a limit of \$750 million in outstanding indebtedness guaranteed.

- o The Electric and Hybrid Vehicle Research, Development, and Demonstration Act of 1976 (Public Law 94-413), as amended, authorizes guarantees of up to \$3 million each for borrowers seeking to develop prototype electric or hybrid vehicles, up to a limit of \$60 million in outstanding guaranteed loans.
- o The Energy Conservation and Production Act of 1976 (Public Law 94-385) authorizes guarantees of up to \$5 million each on loans to states and localities for the purchase and installation of conservation or renewable resource equipment, up to a limit of \$2 billion in outstanding guaranteed loans.
- o The Department of Energy Act of 1978--Civilian Applications (Public Law 95-238) added a new section to the Federal Non-nuclear Energy Research and Development Act of 1974 (Public Law 93-577), providing the Secretary of Energy generic authority to guarantee loans for alternative fuel demonstration facilities. There is no limit on outstanding guaranteed indebtedness for projects under \$50 million. Projects with costs greater than \$50 million will require specific authorization by the Congress.

Guarantee programs have also been enacted recently for purposes other than energy. For example, the Railroad Revitalization and Regulatory Reform Act of 1976 (Public Law 94-2210) authorizes \$1 billion in total guarantees outstanding for the purpose of rehabilitating the nationwide rail freight system.

The 95th Congress has considered a number of loan guarantee proposals. Major elements of the national energy program, as adopted by the Senate include guarantee provisions. For instance:

- o The Senate-passed version of the Natural Gas and Petroleum Conservation and Coal Utilization Policy Act of 1976 (H.R. 5146) authorized guarantees of \$10 billion of loans for the installation of pollution control devices attendant upon conversion to coal.
- o The Senate-passed version of the Public Utilities Regulatory Policy Act of 1977 (H.R. 4018) authorized guarantees of \$100 million of loans for the financing of small hydroelectric projects.

In both cases these guarantee provisions were not included in the final versions of the bills agreed to by the conferees.

Among other energy-related guarantee proposals is S. 419, the Federal Oil Shale Commercialization Act. As passed by the Senate, this bill authorizes the Secretary of Energy to guarantee state and local obligations for the purpose of financing essential community development stemming from oil shale commercialization projects. Under this impact authority, the Secretary may guarantee \$20 million of state and local borrowing in both fiscal years 1978 and 1979.

Guarantee programs also figure prominently in the Carter Administration's urban program. The proposed National Development Bank would have authority to guarantee up to \$15 million of long-term debt to finance the capital costs of a private business investing in new plant and equipment in distressed urban areas. It is hoped that the guarantees and associated interest rate subsidies and grants would create jobs and improve the fiscal and economic base of the distressed areas. The Administration is proposing a total of \$8 billion of loans to be guaranteed during fiscal years 1979, 1980, and 1981.

CONCERNS ABOUT SUCH GROWTH

In recent years Congressional concern over loan guarantees has grown because of the increased number of proposals to use this mechanism and the shift of such proposals from the actuarially sound, small-loan programs to the more venturesome proposals for financing specific projects, especially large capital plants. At the end of the 94th Congress, in an oversight hearing conducted jointly by three House subcommittees, Chairman William S. Moorhead of the House Banking Subcommittee on Economic Stabilization noted the following about proposals for loan guarantee programs:

...In the past, they were small, secured generally by readily marketable assets, and since individual risks usually were small and broadly diversified, program portfolios meant that the risk per program was generally small. Indeed, much of the past criticism of the guarantee centered on the belief it usually was conducted in a much too conservative fashion.

This would appear no longer to be the case.

First, many of the guarantee proposals introduced in the 94th Congress, particularly those associated with energy programs, were large relative to the program portfolios. Second, they tended also to be plagued by substantial technical uncertainty since it was not known whether the technology to be supported by the guarantee would succeed. Third, there was significant uncertainty regarding the costs and the profitability of the project, even in the event of technical success. Fourth, assets offered tended to be highly specialized--which was a polite way of stating they tended to have limited resale value. 9/

The attractiveness of loan guarantees as a financing mechanism is in part based on a perception of low budgetary cost and negligible intervention by the federal government, a perception that may be shared alike by government policymakers and the public. While this perception may be reasonably valid for the first class of guarantees--the actuarially sound programs of small loans to individuals--it is less valid for the second and third classes of guarantees. Of the latter, it may be completely misleading, as a Senate Budget Committee staff report noted in assessing energy financing proposals:

In fact, loan guarantees...can be costly policy tools. They may reallocate capital, and drive up interest rates in sectors which receive less capital. Some other projects--possibly worthwhile projects--may be unable to secure financing. They thus have an overall impact on the economy that should not be ignored. They also can have a major impact on budget totals, should a default occur. 10/

9/ Statement of Honorable William S. Moorhead in Loan Guarantees and Off-Budget Financing, Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Currency, and Housing; the Subcommittee on Oversight of the Committee on Ways and Means; and the Tax Expenditure Task Force of the Committee on the Budget, House of Representatives, 94:2, (November 10, 1979), p. 2.

10/ Federal Energy Financing, Staff Report of the Task Force on Energy of the Senate Committee on the Budget, 94:2, (August 30, 1976), p. 1.

Thus, particular caution is appropriate when designing a guarantee program that proposes to capitalize on one of the two basic aspects of loan guarantees: allocation of credit or reduction of borrowing costs. As the next chapter will show, the consequences of a guarantee may be quite different from its intended effects, with the result being costs to the government and the economy as a whole.

CHAPTER III. CONCERNS ABOUT THE USE OF LOAN GUARANTEES

Proposals to use loan guarantees as a means of financing new activities have seductive appeal: their budgetary costs appear low and they seem to involve only minimal federal intervention in the economy. These perceptions of low cost and minimal intervention may lead to the use of loan guarantees when other financing mechanisms are, in fact, more suitable. Undesirable consequences may result from the employment of loan guarantees without a knowledge of their full costs and effects--costs resulting from the billions of dollars of contingent liabilities placed on the government for as long as forty years, and effects such as the unintended redirection of national resources from some high-priority activities.

This chapter begins by reviewing briefly the current practices of accounting for loan guarantee programs in the federal budget and the reasons why these practices prevent the Congress from fulfilling its budgetary responsibilities with respect to loan guarantees. It then explores concerns and problems resulting from policymakers' inability to make rational decisions about loan guarantee programs within the framework of the functions of the budget.

GUARANTEED LENDING IN THE FEDERAL BUDGET

The federal budgetary accounting system is designed to control expenditures in the form of budget authority and outlays. Budget authority is defined as "authority provided by law to enter into obligations which will result in immediate or future outlays involving government funds." ^{1/} Outlays are the sum of checks issued, interest accrued on most public debt, and other payments in a given year under budget authority. Loan guarantees, however, result in obligations of the federal government that are only contingent, not inevitable; outlays occur only if there is a default by the borrower. As a result, loan guarantees have been excluded from the accounting for budget authority. Instead, the budget totals include only the direct expenditure effects of loan guarantee programs, such as budget authority for appropriated default reserves, outlays for

^{1/} The Congressional Budget Act of 1974, Section 3(a)(2), Public Law 93-344, 31 USC 1302.

administrative costs, and payments for defaults. Thus, current budgetary practice reflects changes in the government's financial position. It does not, however, account for such important fiscal activities as the volume of the credit being guaranteed or insured by government agencies.

The volume of new loans being guaranteed by the federal government in a given year is not explicitly considered when the Congress establishes budget totals or allocates resources to competing needs. The level of new guarantees should be subject to explicit public decision. Moreover, the budgetary treatment of guarantees should stimulate the Congress to ask key questions in reviewing program design and operation, questions that would help coordinate the allocation of resources by loan guarantees with other federal resource allocations:

- o Is guaranteeing or insuring the repayment of a loan the most appropriate mechanism to allocate resources to the given purpose? Or would direct spending, direct loans, or a tax expenditure function more effectively?
- o What is the true cost of such a program to the government?
- o How do the credit flows stimulated by loan guarantees affect federal fiscal policy?

These questions are central to the three functions of the budget process: choosing between public and private means to accomplish a given purpose, allocating resources among competing uses, and coordinating fiscal policy. Without knowing the answers to these questions, the Congress cannot fully understand the implications of using loan guarantees for a particular purpose. The next three sections consider the problems resulting from incomplete analysis of these issues for loan guarantee programs.

CHOOSING BETWEEN PUBLIC AND PRIVATE ACTIVITIES

A basic function of the budget is to set out the choices between public and private activities to achieve various goals. When the private sector is unwilling or unable to provide a service deemed necessary by elected policymakers, the public sector must do it. Loan guarantees, one of the policy tools available, fall on the boundary between the public and private sectors. They are a means by which the federal government can influence private lenders to finance a publicly desired venture. Program

advocates often claim that loan guarantees will overcome imperfections in the credit markets that prevent the flow of credit to such projects. They further claim that guarantees can redirect private investment toward public purposes with only minimal government intervention, leaving intact the decision processes and institutional relationships of the private credit markets.

Loan guarantees operate by changing the calculations of risks by lender and borrower. Lenders are attracted to make funds available by the prospect of a guaranteed investment. Borrowers find the lessened risks of their borrowing mean lower interest costs. Despite these changed calculations, lenders and borrowers are still assumed to be motivated to evaluate the soundness of a financing proposal as if it were being completely financed privately. That assumption may not be valid.

Knowledge of the full effects of loan guarantees on the behavior of borrowers and lenders is incomplete. Guarantees do change the calculations of risks by both lenders and borrowers. These changed calculations can affect the behavior of lenders and borrowers in ways that policymakers did not intend or anticipate when programs were designed. This lack of understanding impairs the ability of the Congress to choose rationally between public and private activities.

Changed Calculation of Risks by Lenders

Loan guarantees are supposed to change the calculations of risk by lenders to encourage them to make more credit available for certain types of borrowing. This can occur several ways:

- o By reducing the risk of an unfamiliar form of lending, guarantees can lower interest costs, as they did in the FHA mortgage insurance programs of the 1930s.
- o By reducing the risks associated with lending to marginal borrowers, guarantees can influence lenders to make credit available to borrowers in this class.
- o By reducing the risks of uncertainty of success or profitability of large, discrete ventures, guarantees can make credit available to these types of projects.

- o By making borrowings more uniform as well as insuring the investment, guarantees can stimulate growth of a secondary market for various types of borrowing, thus reducing a lender's risk of tying up his funds for extended periods of time.

Guarantee programs, however, may not always work as intended. Private participation in a guaranteed loan--either in terms of sharing the risk or performing servicing and originating functions--has been considered by policymakers to be a strong point of the guarantee mechanism. Private participation is assumed to cause a lender to evaluate the viability of an entire financing proposal even though the government's guarantee limits his personal stake in the project. Private lenders, however, may be more concerned about evaluating the extent of the government's guarantee commitment than they are about evaluating the viability of a proposed project in order to eliminate ill-conceived ventures. Consider the following examples in which guarantees erode the evaluation of risks by private lenders and distort the choice between public and private activities.

Unconditional Guarantees. Guarantees in which the government's liability to repay indebtedness is unconditional are often called full-faith-and-credit guarantees. These full-faith-and-credit guarantees are considered by the financial markets to be almost the same as government securities; more important than the standing of the borrower or the project being financed is the nature of the government guarantee. This factor is of such importance that the major banking houses typically purchase and sell these securities through their government securities divisions, rather than through their corporate lending divisions, in which the normal analysis of risk and return of individual ventures takes place.

Partial Guarantees--Riskless Investment. Some guarantee programs offer practically riskless investments for lenders, even though they may have been designed with provisions thought to ensure private participation. By guaranteeing only 90 percent of a loan, policymakers may assume that the lender, who bears the risk for the other 10 percent, will evaluate the riskiness of a project. Often, however, the ability to write off losses against tax liabilities in effect means that the private lender bears little or no risk on his portion of the loan. This can lead investors to enter riskier ventures, with higher probabilities of default than would prudently be accepted. This happened before 1973 in the HUD Section 235 Homeownership Assistance Program. This program, designed to assist marginal borrowers in obtaining access to mortgage credit, combined a guarantee with interest subsidy provisions. The government's

guarantee, while not 100 percent of the loan, often covered more than 90 percent of the loan. The small percentage of private participation, it was assumed, would encourage lenders to scrutinize the individual applications. In practice, however, lenders made many loans without adequate risk assessment, feeling themselves protected against loss by the guarantee. The Section 235 program experienced a substantial number of defaults. The federal government still holds a large number of foreclosed properties, and the program has incurred large losses through default payments.

Partial Guarantees--Speculative Investments. Partial guarantees may also encourage speculative investing by lenders. From the lender's perspective, a partially guaranteed loan has two components: a risk-free investment (the guaranteed portion) that justifies a yield equal to similar government securities, and a nonguaranteed loan that should have a higher yield to compensate the lender for the risk he is bearing. Since only one interest rate is charged for the entire loan, however, the added risk premium incurred by the lender on the nonguaranteed portion of the loan may be concealed.

For example, a secondary market for Small Business Administration (SBA) Section 7(a) business guaranteed loans has emerged. SBA guarantees 90 percent of loans up to \$500,000. Commercial banks originating these loans charge interest rates in the 10 percent range. Originating banks have begun selling the 90 percent guaranteed portion of the loan to other investors through bond brokers. The original borrower continues to make principal and interest payments on the total loan to the bank. The bank then forwards to the second investor interest on the 90 percent guaranteed portion. The interest rate the bank pays to the second investor on this portion is above the cost of Treasury borrowing, but below the 10 percent rate it receives overall. As a result, its effective rate of interest on its 10 percent investment may be 20 percent or more. This rate would justify far riskier loans than commercial banks would normally agree to finance for fully private ventures. Thus, the effect of the guarantee is to reduce sharply the bank's incentive for evaluating the risk and return of the individual project. Or, if the bank makes only prudent loans, the high yield provides it with a windfall profit on its investment.

Changed Calculation of Risks by Borrowers

The terms of a guarantee program can also affect the way in which a borrower calculates his own risks when entering a project. For example, if his liability is limited by a guarantee to the assets of the particular

project being financed, a borrower may be more willing to attempt a risky venture than if all his assets were liable, as would probably be required by lenders in the absence of a guarantee.

Consider the situation of a firm wishing to build a synthetic fuel plant. It faces great uncertainty about the future market in which its products are to be sold. If the cost of producing fuel from oil shale, coal, or urban waste is greater than the price of competing fuel sources, the project will fail. The financial uncertainty would ordinarily prevent the plant from receiving major credit financing. To replace the uncertain future in which the product must be sold at prices set by changing market forces, the government could guarantee to make up the difference between the project's cost of production and a lower market price. In so doing it shifts the risks of changing market prices or production costs from the producer to the guarantor agency. The guarantees could thus make it attractive to the firm to finance the synthetic fuel plant with borrowed capital.

Through such a price guarantee mechanism--an idea that has surfaced recently in connection with several energy programs--the government can encourage the private market to develop and operate risky ventures, such as synthetic fuel plants. Combined with a limitation of the borrower's loss to his equity in the particular project, price guarantees may, however, change the calculation of risks by the borrower in a way unintended by government. Because of his limited liability, a borrower may undertake a project without adequately evaluating the probabilities of success, or may undertake riskier projects with an expectation of windfall profits. Also given the limited liability, both borrowers and lenders may be more likely to abandon prematurely a troubled project, instead of investing additional resources and attempting to salvage the venture. The government stands the major risks and could be left "holding the bag"--vainly attempting to recover its losses by disposing of the specialized assets of such a plant.

Summing Up--Choosing Between Public and Private Activities

Guarantee programs are often assumed to leave the private market relationships between borrower and lender intact, so that private risk and return analysis continues to be exercised. Often, lenders are more occupied with evaluating the guarantee commitment itself. The guarantee can change the calculation of risks so that ventures normally considered too risky for financing are financed, based on the strength of

the government's guarantee. While such guarantees reduce the risk of loss to lender and borrower, they cannot reduce the project's risk of economic failure. As a result, the government may be saddled with a number of failing ventures on which it must repay losses.

ALLOCATING RESOURCES AMONG COMPETING USES

A second major function of the budget process is to allocate resources among competing needs. If loan guarantee programs were fully subject to the discipline of the budget process, they could more effectively be coordinated with each other and with other credit and expenditure programs. On the other hand, if exclusion of guarantees from the budget should lead the Congress to consider them costless, guarantee programs might direct national resources into uneconomic and unsound ventures that could not have survived in real competition with other national needs.

For example, the Housing and Urban Development Act of 1968 (P.L. 90-448) established the New Communities program by authorizing the appropriation of \$30 million in grants and authorizing federal guarantees of obligations issued by public and private developers of new communities in amounts up to \$250 million outstanding at any one time. Subsequent amendments increase that authority to \$500 million and then to \$698.5 million. Financing was needed for large scale land assembly, site preparation, and construction of roadways and water and sewer lines. Cash returns from such investments in new communities could be expected only after long delays and even then would be highly uncertain and irregular. This pattern of cash flows is ill-suited to the need for regular payment of principal and interest as required by credit financing. These investments are thus ordinarily financed with federal grants, private equity, or relatively small increments of municipal borrowing. The Administration proposed, and the Congress agreed, to terminate the grant program at the end of fiscal year 1973. HUD was able to proceed with the new communities program by continuing to finance the projects with the authorized loan guarantees. As of June 30, 1976, HUD had guaranteed financing for thirteen very large, highly speculative development projects. At that time, the outstanding guaranteed indebtedness of the program peaked at \$280 million.

The results have been bitter. Not one of the thirteen new communities has been financially successful. Six have now been reorganized and are operating with direct federal assistance. The other

seven were foreclosed; the government is now acquiring and liquidating four of them and trying to restart the remaining three projects under new management. The federal government must retire the outstanding guaranteed debt by repaying the principle and interest due lenders and provide additional operating funds where cash resources are exhausted. The experience demonstrates that guarantees are far from costless to the government. The fiscal year 1979 budget projects a net loss of \$76.6 million by the end of fiscal year 1979.

Ironically, the use of loan guarantees not only facilitated ill-considered ventures, it also hastened the financial collapse of new communities by saddling developers with heavy debt burdens. In fact, the New Communities Guarantee Fund itself had drawn \$9.4 million in fees and premiums from the developers as of September 30, 1976, before the loans got into serious trouble.

COORDINATING FISCAL POLICY EFFECTS

The last principal budgetary function is the coordination of fiscal policy. If loan guarantees were fully subject to the discipline of the budget process, the Congress would have a way to coordinate guarantee programs with other fiscal activities through which the government intervenes in the economy. This coordination would not be easy, however, because much remains to be learned about the effects of guaranteed programs on the capital markets and economic activity. Among major unanswered questions are the following:

- o How do guaranteed loan programs affect the total volume of credit available in the economy?
- o For any given sector of the credit markets, how much of the lending would have occurred anyway, in the absence of federal guarantees? How much represents new credit attracted into the sector by the guarantee?
- o How do guarantee programs affect the total national spending for activities the programs are intended to foster?

The evidence in the economic literature on these questions is mixed. The failure to coordinate loan guarantees with other federal fiscal policies could, however, produce some significant problems.

One possible problem is the unintended "crowding out" of private borrowers during periods of tight credit. If guarantees do stimulate additional credit expansion, then the costs of guarantee programs to the total economy would be balanced by the benefits of additional growth. Additional guarantees could increase total gross national product (GNP), and the increased income effects might filter throughout the economy. If total credit is relatively fixed, however, as in periods of tight monetary policy, the effect of guarantee programs may be simply to reallocate credit from one group of borrowers to another. As guarantee programs bring strong new demanders of credit into the markets, the price of unguaranteed credit would rise, as unassisted borrowers are forced to bid on shares in a smaller pool of unguaranteed credit. In effect, the unguaranteed borrowers would subsidize guaranteed borrowers and would pay higher interest costs as a result. Those borrowers who could not afford to pay the higher costs would be forced out of the market. The borrowers most likely to be pushed out of the market are small businesses, homebuyers, and state and local governments.

The effects of loan guarantees may vary across economic sectors. In a period of tight money and limited credit, guarantee programs may buffer some sectors and shift the pressure of tight money onto other sectors. Loan guarantees have, for instance, been used in an effort to buffer the housing sector from sharp fluctuations in mortgage credit. Federal guarantees have made possible the development of secondary mortgage markets that can ease the flow of mortgage funds during periods of tight credit. Thus the effort to buffer some housing from fluctuations may build pressure on the whole economy and cause other borrowers, perhaps other housing, to be forced out of the market.

Guaranteed lending programs may, during periods of high inflation, bring higher borrowing costs to the federal government. The issuance of large amounts of federally guaranteed debt produces a large class of borrowers who are relatively insensitive to market interest rates. The Federal Reserve may have to force much higher interest rates in order to accomplish a desired cooling of the economy. Higher federal borrowing costs would be the result, and all taxpayers would end up paying the cost of loan guarantee programs.

Although the effects of loan guarantee programs cannot be completely measured, the preceding discussion suggests that guarantees should not be used unless their potential effects on the economy are carefully assessed.

The federal budget does not at present encourage the Congress to review and control federal credit activities. Increasingly, Members of Congress are recognizing this to be an urgent problem. When the President's Commission on Budget Concepts presented the unified budget concept in 1967, it expressed uneasiness that it was unable to make a recommendation about the budgetary treatment of loan guarantees. The commission also recognized that the inclusion of direct loan programs within the budget totals would intensify incentives to use loan guarantees. As earlier chapters have shown, subsequent experience has justified the commission's fears.

In violation of the principles of the President's commission, the federal budget excludes a rapidly growing class of important fiscal activities. The commission stated in its 1967 report:

In the private sector of the economy, the efficient allocation of resources is best performed in a decentralized fashion by the disciplines of the market place. In the public sector, however, it is the budget process which performs the resource allocation function.

To work well, the governmental budget process should encompass the full scope of programs and transactions that are within the Federal sector and not subject to the economic disciplines of the marketplace. 1/

Loan guarantees are powerful tools of federal policy. With them federal agencies can supplant the most basic decisions of the private credit markets, for example, by removing risks of default and selecting eligible borrowers. With them the government allocates national resources. Therefore, guarantees should be fully considered and controlled within the federal budget process.

1/ Report of the President's Commission on Budget Concepts (October 1967), p. 24.

This chapter considers the following options for improving Congressional control of guarantee programs:

- o Including guaranteed loan principal in the totals for budget authority;
- o Creating a credit section in the budget;
- o An informational credit analysis;
- o Institutional control through the Federal Financing Bank (FFB);
- o Direct program controls; and
- o Self-policing elements in the design of individual programs.

The first two of these options would refine the structure of the federal budget to make it a better tool for controlling guarantees. The next two options would seek to control guarantees outside the structure of the budget. The final two methods of control could be implemented separately or in conjunction with one of the first four alternatives.

GUARANTEED LOAN PRINCIPAL AS BUDGET AUTHORITY

This option would maintain the structure of the federal budget and Congressional budget resolutions essentially as they are, but would count guaranteed lending as budget authority. Administrative costs and default losses would be counted as outlays, as at present.

Early versions of the Congressional Budget Act of 1974 would have implemented this option. As enacted, however, the act excludes loan guarantees from the definitions of budget authority in section 3(a)(2) and new spending authority in section 401(c)(2). In both of these definitions the act states, "Such term does not include authority to insure or guarantee the repayment of indebtedness incurred by another person or government." ^{2/} Thus, loan guarantees are not effectively subject to the ceilings and targets of the concurrent budget resolutions, to controls on backdoor spending, and to the discipline of the budget process.

^{2/} This exclusion was included in the amendment-in-the-nature-of-a-substitute to S. 1541 reported by the Senate Rules and Administration Committee (S. Rept. 93-688). It was specifically added to avoid any confusion about the applicability of the controls to guarantee programs:

Under this option, the Congressional Budget Act would be amended to delete the specific exemptions of loan guarantees from the definition of budget authority. The effects of such a change would be to add \$63.1 billion to the budget authority totals for fiscal year 1979, if new commitments for loan guarantees were used as the measure of required budget authority. The action of the federal government in making a commitment to guarantee a loan is much like entering into obligations to make direct expenditures. Table 2 summarizes the changes to the budget aggregates resulting from such a proposal.

TABLE 2. ESTIMATES OF FISCAL YEAR 1979 AGGREGATES, INCLUDING NEW COMMITMENTS FOR LOAN GUARANTEES AS BUDGET AUTHORITY: IN BILLIONS OF DOLLARS

	Fiscal-Year 1979 Budget	New Commit- ments as Budget Authority	Total
Revenues	439.6		439.6
Budget Authority	568.2	63.1 <u>a/</u>	631.3
Outlays	500.2		500.2
Budget Deficit	-60.6		-60.6

SOURCE: Budget of the United States Government, Fiscal Year 1979.

a/ Adjusted basis. On an unadjusted basis \$107.0 billion would be added to budget authority for a total of \$675.2 billion.

2/ (Continued)

The Committee substitute clarifies the status of insured and guaranteed loans. Such loans are not direct obligations of the United States and a liability is incurred only in the case of default. Thus, it would not be appropriate to regard such contingent liabilities as budget authority for purposes of determining the appropriate levels in the budget resolution. Nor should loan guarantees be subjected to the new procedures for handling backdoor spending authority. Of course, if the United States is required to make any outlays pursuant to its guarantee of loans, such outlays are included in the budget. (p. 13)

Advantages. This alternative would require only minimal changes in the budget structure and process. The Congressional budget deliberations would not be burdened with new concepts or a larger number of decisions. A proposed program would compete for budget resources against the same set of programs regardless of whether it was financed with guaranteed loans, direct loans, grants, or other direct spending. This would remove incentives to use guarantees as a way to avoid budgetary impact.

Disadvantages. The usefulness of the budget authority totals in the concurrent budget resolutions would be weakened by the inclusion of large amounts of authority that would never result in federal outlays. This might lead the Congress to consider less seriously the budget authority totals for all programs, thus relaxing restraints on future outlays.

A second disadvantage of this option would be its treatment of the extension of guaranteed credit the same as direct federal spending. The two transactions, however, would likely have sharply different effects on the economy and on federal outlays.

CREATING A CREDIT SECTION IN THE BUDGET

The structure of the federal budget and Congressional budget resolutions could be changed by adding a section to control credit activities separately from budget receipts and expenditures. Such a credit section could include both direct and guaranteed lending, or, perhaps, just guaranteed lending. The Congressional budget resolutions could include targets and ceilings for new authority to make or guarantee loans and for annual activity under that authority. These targets and ceilings would be comparable to budget authority and outlay controls on expenditures.

A credit section in the budget could be established either by amending current law or by using existing authority. The Budget and Accounting Act of 1921 could be amended to require estimates of new lending, both direct and guaranteed, to be included in the President's annual budget. The Congressional Budget Act of 1974 could be amended to require targets and ceilings for credit activities in the concurrent resolutions on the budget. Alternatively, the Budget Committees could include a credit section in the Congressional budget resolutions under the authority of section 301(a)(6) of the Congressional Budget Act of 1974, which states that the budget resolutions shall set forth "such other matters relating to the budget as may be appropriate to carry out the purposes of this Act."

A credit section in the budget could, in general, operate as follows: 3/

- o In his annual budget, the President would provide estimates of the total prospective capital market resources and flows. He would then propose a target on the volume of credit to be extended under federal auspices during the fiscal year.
- o The Congress would consider this proposal and include in its concurrent budget resolutions a target or ceiling for federal credit activities, perhaps with allocations by functional categories.
- o Authority to make or guarantee loans could be limited for each program annually in appropriation acts, just as the level of new budget authority is set for expenditure programs.
- o The volumes of new credit authority and of annual activity under available authority would be reflected in CBO Scorekeeping Reports.
- o The direct expenditures of credit programs would continue to be recorded in the budget authority and outlay totals. These include such items as administrative expenses, subsidies, default losses, or loans forgiven.

A separate section in the budget for the control of credit programs has been advocated for some time because of the different economic effects of credit programs compared to regular spending programs. Lending programs involve two types of actions--exchanges of assets and expenditures--whereas spending programs involve only the latter.

Every credit transaction involves an exchange of financial assets. A lender provides cash now in exchange for another financial asset--a promise of future repayment of that cash plus payment of an interest charge to compensate the lender for the time value of his money, the risk of default, and the costs of collection on the loan.

An expenditure transaction, on the other hand, involves the payment of funds for goods or services or a transfer of wealth. Expenditures are recorded in the federal budget for both direct lending and guarantee programs for default losses, interest rate subsidies, and administrative

3/ This proposal is consistent with the basic outlines of the credit control proposal announced by the Administration in the fiscal year 1979 budget.

costs of the programs. To the extent that these three types of costs are not covered by interest payments on direct loans and fees or premiums on guaranteed or insured loans, they become expenditures of the federal government. Budget authority must be provided in a sufficient amount, and outlays will result when they are paid.

For direct loan programs, net lending--the difference between new loan disbursements and repayments--is also currently recorded as an expenditure or a receipt because of its effects on the government's cash reserves. This practice has evolved to balance the federal government's cash accounting: budget authority and outlays being recorded for any excess lending, and an offsetting receipt reducing outlays in the amount of any excess repayments. Proposals for a separate section in the budget for controlling the volume of federal credit have raised questions, as yet unanswered, about the treatment of net lending.

Thus, the credit section of the budget would have to be designed to describe accurately the economic effects of federal lending activities and to maintain the integrity of the budget as a plan for federal spending.

Advantages. This option could provide the Congress with effective control of aggregate credit activities while respecting important differences between credit activities and direct expenditures. The option could involve relatively little change in current budget and accounting procedures. It would achieve better control over credit activities by refining and strengthening the federal budget structure and process. Incorporating credit activities within the annual budget debates, and thus giving them increased visibility, could stimulate more sophisticated analyses of the economic impact of federal credit programs.

Disadvantages. This option would increase the number of decisions that the Congress has to make in adopting budget resolutions. It would also require the Congress to become familiar with new budget concepts. Under this option, a program would compete for budget resources against one set of programs if it were financed with credit and against a different set if it were financed with direct spending. Thus, budgetary treatment could continue to influence the choice of program financing.

Current economic knowledge does not permit the levels of aggregate credit activity to be chosen with the same degree of confidence with which expenditure and revenue totals are established. It cannot yet be determined how powerful a set of controls the new credit targets and ceilings would be.

AN INFORMATIONAL CREDIT ANALYSIS

Another option would establish an annual informational credit analysis that would contain much of the same information as the proposed credit section in the budget. Rather than serve as a means to control credit activities, this analysis would provide a comprehensive display of the volume of such activities. It could help inform the Congress about the size and profile of federal credit activity as decisions are made to create new programs or change old ones. As in the previous alternative, an informational analysis could include both direct and guaranteed lending, or just guaranteed lending. Hearings could be scheduled or other steps could be taken to give the analysis high visibility.

Advantages. An informational analysis could provide the Congress with information about federal credit activities without adding new burdens to Congressional decisionmaking. Although the Congress would not exercise the discipline of a budgetary process, it could make its decisions about new activities with more knowledge about the whole range of federal activities.

Disadvantages. An informational analysis has for many years been included in the special analysis on credit programs in the President's budget. Although this analysis has provided an indispensable tool for specialists, it has not provided the Congress with an effective mechanism for understanding or controlling credit activities. A new analysis likely would not improve Congressional control.

INDIRECT CONTROLS THROUGH THE FFB

A fourth alternative would require all guaranteed loans to be financed through the Federal Financing Bank (FFB). ^{4/} Guarantees could then be controlled by limiting FFB purchases of guarantees in appropriations.

^{4/} The FFB was established in December 1973 as an off-budget agency operating under the Treasury Department. Its principal purpose is to coordinate and assist agency- and government-guaranteed borrowings from the public. Instead of going individually to the securities markets, agencies now borrow from the FFB, which in turn borrows

This alternative has been embodied in several bills introduced in the House of Representatives during the 95th Congress. ^{5/} These bills would (1) put the FFB's operations on budget; (2) limit purchases of obligations by the FFB in any fiscal year to such amounts as may be provided in appropriation acts; and (3) require guaranteed obligations that would otherwise be financed in the securities markets to be financed by the FFB. ^{6/}

Advantages. Indirect control of guarantees, such as proposed by H.R. 7416 or its companions, may be politically more acceptable than direct control through a credit section in the budget. Since some programs, such as primary mortgage guarantees, would not be affected, their advocates may find this form of control more palatable.

This option would require no new procedures. Limitations on annual activities have been used in a variety of programs for a number of years.

Disadvantages. Controlling guarantees through the FFB would create three problems. First, the FFB activity would convert guaranteed loans into direct federal loans. The government would not only guarantee the loan; it would also provide the funds for the loan. ^{7/} This would prohibit the involvement of private lenders in some programs in which they may have an important role to perform.

from Treasury or the public. The FFB can obtain funds at or just above the Treasury's own borrowing rates, thus offering government agencies lower interest costs than they would have incurred if they had borrowed directly in the securities markets.

^{5/} See H.R.s 7416, 7597, 7918, 10416, 11124, and 11177.

^{6/} For a discussion of how the FFB finances guarantee programs see Appendix B. H.R. 7416 and its companions would exempt guaranteed obligations not ordinarily bought and sold in the investment securities markets, presumably primary mortgages, from the requirement of FFB financing.

^{7/} When the FFB buys a federally guaranteed obligation, the flow of funds is identical to that of a direct loan--from the public through the Treasury and a federal agency to a nonfederal borrower.

A second disadvantage to this option is that the FFB may be forced to allocate credit among federal programs if the demand for guaranteed credit exceeds the level of activity permitted the FFB. The FFB is not equipped or authorized to make such allocation decisions.

A third problem is that the control of guarantees would not be comprehensive. Since this option would affect only those guaranteed obligations that are ordinarily traded in the securities markets, it would be difficult to coordinate guarantee programs in the aggregate with other government activities.

TWO SUPPLEMENTARY OPTIONS

The first four general options are alternative ways to improve Congressional control of federal guarantees. The next two methods of control are supplementary and could be adopted separately from or in combination with one of the above options.

Direct Program Controls

Loan guarantee activities could be controlled directly by subjecting new commitments to annual appropriations, or by requiring that each program have a default reserve appropriate to the government's risk and permitting outstanding obligations only in amounts proportional to the reserves on hand. Such direct controls would involve items that would be visible and trackable in the budget process. For example:

- o Individual program ceilings on new commitments for direct loans and loan guarantees could be enacted annually in appropriations acts.
- o The maximum amounts of contracts to make future debt service payments could also be specifically authorized in appropriations acts.
- o Default reserves for all direct and guaranteed loan programs could be required. Agencies could then be allowed to make commitments under these programs up to a ceiling established as the mathematical product of some factor times the level of the reserves. By permitting outstanding obligations only in amounts proportional to the level of reserves, the Congress could control program activity by controlling the level of the reserves.

Advantages. This option would subject guarantee programs to many of the same forms of oversight and control that are applied to expenditure programs. A committee other than the one that authorized a program would recommend the proper level of annual activity. Used in conjunction with one of the general options, decisions on individual program levels could be made consistent with the aggregate targets or controls.

Disadvantages. This would increase the number of decisions that the Appropriations Committees would have to make within an already tight schedule. If this option is not used in conjunction with one of the general options, it may not provide an effective form of control. A number of guarantee programs now have limits such as authorized ceilings on outstanding guarantees or appropriated fractional reserves. Rather than limiting annual activity, however, authorized ceilings have been enacted for the entire period of a three- or five-year authorization; they are not reviewed annually for consistency with current economic conditions. Also they are routinely increased during reauthorizations.

Self-Policing Elements in Program Design

Standards of program design could be refined so that individual guarantee programs would create incentives for borrowers and private lenders to act in conformity with prudent federal policy. The Congress can protect the public's interest by building into loan guarantee programs self-policing elements, such as variable interest rates, credit needs tests for borrowers, coinsurance by lenders, and equity participation by private investors. 8/ Improperly designed guarantee agreements and programs can have undesirable results, such as windfall profits to lenders through unjustifiably high yields, indifference of program participants to imprudent risks, and premature abandonment of troubled ventures by lenders and borrowers with no stake in the projects.

8/ Coinsurance denotes the practice of requiring the lender to share a portion of the risk. Partial guarantees, wherein the government guarantees less than 100 percent of the principal and/or interest of a loan, are examples of coinsurance.

Equity participation denotes the practice of requiring borrowers to invest their own capital as a portion of the total financing package.

What is suggested here is not a set of program design elements that could be applied uniformly to all programs. Rather, this option would require detailed program-by-program analysis of the incentives that are appropriate for borrowers and lenders in particular market environments. Then, loan guarantee programs should be tailored to create and maintain those incentives. The federal government needs to develop in guarantor agencies banker-like skills so that the agencies' intervention in credit transactions will protect the interests of the public and will foster activities that are consistent with public policy.

Developing these standards of program design falls beyond the scope of this paper. However, it is a promising area of inquiry for the Congress and the executive branch.

CONCLUSION: THE PREFERRED ALTERNATIVE

Understanding of federal government activity through the budget process is incomplete to the extent that an estimated \$53.4 billion of guaranteed loans are not included in the fiscal year 1979 budget. The current budgetary treatment of guaranteed lending hinders the coordination of loan guarantee programs with other important elements of federal fiscal policy. Each of the general options outlined above could be implemented under several variations. Thus, the Congress has many ways to improve its control of loan guarantees. CBO believes that guarantees, as well as other federal fiscal activities, should be reviewed and controlled within the Congressional budget process. Efforts to improve control of guarantees should focus on refining the budget structure and strengthening the budget process.

Of the alternatives considered in this chapter, CBO finds the establishment of a credit section in the federal budget to be the most promising option for further analysis and development. This alternative would permit the Congress to set aggregate levels of new guaranteed loans within the current budget process. Enhanced controls over individual programs could be achieved by adoption of individual program controls and self-policing elements to supplement the aggregate controls of the credit section.

A credit section in the budget could be implemented either formally through legislation enacted by the Congress or informally under the authority granted the Budget Committees by section 301 of the Congressional Budget Act. Direct program controls and self-policing

elements would be included in the legislation enacting credit programs. This combination of aggregate and individual program controls would provide the Congress the means to plan effectively for and oversee the federal government's credit assistance programs.

APPENDIXES

APPENDIX A. RESPONSES TO QUESTIONS IN ORIGINAL INQUIRY

The letter from Chairman Muskie and Senator Bellmon requesting CBO to undertake a study of federal loan guarantees included five specific questions. While all of these questions have been addressed in the preceding paper, the questions are restated here and summary answers provided.

1. What additional programs would be included in the federal budget if the "authority to insure or guarantee the repayment of indebtedness incurred by another person or government" were not excluded from the definition of "budget authority" in Section 3(a)(2) of the Budget Act?

Inclusion of loan guarantees in the definition of budget authority would add over 150 programs, totaling an estimated \$53.4 billion of new guarantees, to the fiscal year 1979 budget. These programs have grown rapidly in recent years, from \$8.5 billion in fiscal year 1950 to over \$50 billion in the last several years. The largest part of the assistance provided by loan guarantees has been for small borrowers: families buying homes, small businessman expanding their operations, students financing their education. In recent years proposals for loan guarantees have focused more on financing discrete ventures, which are so unique and so large that private investment is not forthcoming. Recent proposals have included the development of synthetic fuel plants, pollution control devices for industries converting to coal as a fuel source, and the promotion of aquaculture.

2. How have these programs been accounted for to date?

Current practices include only the expenditure aspects of loan guarantee programs in the budget. The exclusion of loan guarantees from the definition of budget authority means that only administrative costs and payments for defaults are counted in the budget totals. The amounts of the principals of new guaranteed loans are nowhere included in the budget and thus are largely uncontrolled. The purchase of guaranteed loans by the Federal Financing Bank (FFB) has the effect of converting guaranteed loans into direct federal loans, which are not included in the budget totals but do affect Treasury borrowing requirements.

3. What has been the actual default experience under these programs?

There are no good estimates of the default experience of guarantee programs. A study prepared for CBO surveyed the experiences of 22 major loan guarantee programs. Its principal conclusion was that differences in definitions and data collection procedures make it impossible to compile estimates of defaults and claims paid. This study, Loan Insurance and Guarantee Programs: A Comparison of Current Practices and Procedures, will be included in the compilation of staff working papers to be published shortly as a companion to this paper.

4. What options, suggested by this experience, would improve the treatment of credit and other guarantees in the budget?

Six options for improved treatment of credit programs in the budget are discussed in Chapter IV of the paper. The options are:

- o Inclusion of loan guarantees as budget authority;
- o A credit section in the federal budget;
- o An informational credit analysis;
- o Indirect control through the FFB;
- o Direct program controls; and
- o Self-policing elements in program design.

5. What other activities (such as project guarantees, price guarantees, leasing arrangements and other contingent liabilities) involve significant exposure of future federal budgets?

OMB considers price guarantees, project guarantees, lease guarantees, and the like to be guarantees of the underlying credit. Accordingly, such programs are included in the special analyses on credit as loan guarantees. Separate data are not kept on the various types of loan guarantee mechanisms. Other noncredit activities imposing contingent liabilities on the federal government include:

- o Depositor's insurance;
- o War risk insurance programs;
- o Flood, riot, and crime insurance programs; and
- o Unfunded retirement and pension liabilities.

The contingent liabilities of the various insurance programs of the government stood at \$1.6 trillion as of September 30, 1976. 1/ These programs are reflected in the budget only for their administrative expenses and any fees or premiums collected. The liabilities of the retirement and pension programs have been variously estimated by OMB and Treasury as several trillions of dollars. These programs are accounted for in the current operations of the trust funds through which they operate.

1/ Department of the Treasury, Statement of Liabilities and Other Financial Commitments of the United States Government as of September 30, 1976.

APPENDIX B. FEDERAL CREDIT ACTIVITIES: AN OVERVIEW

To understand the implications of the use of loan guarantees as a financing mechanism, it is essential to place loan guarantees in the context of all federal credit activities. Three federal credit mechanisms can be identified:

- o Direct loans, made by both on- and off-budget agencies;
- o Guaranteed loans, again made by on- and off-budget agencies; and
- o Loans and secondary market operations by government-sponsored credit enterprises.

The four sections of this appendix describe these credit mechanisms and their accounting in the budget, and the operations of the Federal Financing Bank (FFB) with respect to loan guarantee programs.

Data on federal credit activities have been collected systematically only since 1952. Since that year, a special analysis of federal credit programs has been included in the volume of special analyses that accompanies the Budget of the United States Government for each fiscal year. The data used in the following discussion of credit activities are taken from an aggregation of the 25 years of data in these special analyses. ^{1/}

DIRECT LENDING

The federal government makes direct loans to individuals, businesses, nonprofit organizations, and local governments for a variety of purposes:

- o The Commodity Credit Corporation makes loans to producers to finance next year's crop.

^{1/} A forthcoming CBO background paper, Federal Credit Programs: A Statistical Compilation, consolidates the 25 years of special analyses on credit in order to describe the growth of federal credit programs during this period.

- o The Veterans Administration makes loans to veterans for home purchases in rural areas and small towns, where other credit is not available.
- o The Small Business Administration makes loans to small businesses for expansion.
- o The Economic Development Administration makes loans to local governments for public works and to businesses for commercial expansion in economically distressed areas.
- o The Export-Import Bank makes loans to businesses to assist them to compete in overseas markets.

New commitments for direct loans have grown from \$3.5 billion annually in 1950 to over \$20 billion in the mid-1970s.

Direct loans are also made by the various off-budget agencies. Loans are made by the U.S. Railway Association to various railroads as part of the reorganization and consolidation in Conrail. Also direct loans for Rural Electrification Administration programs are made by the Rural Electrification and Telephone Revolving Fund. By far the largest volume of off-budget direct loans are made by the Federal Financing Bank, discussed later in this appendix.

Table B-1 summarizes the estimated direct loan activity of the federal government for fiscal year 1979. It demonstrates how direct loans are counted in the federal budget.

- o New commitments are agreements by the government to extend direct loans contingent upon prospective borrowers fulfilling specified conditions, such as securing financing of the private share of a project, or completing requirements, such as planning and impact statements. As such, estimates of new commitments are a good indicator of future financial flows.
- o New loans extended represent actual lending in a given year, that is, the volume of new credit extended directly by the federal government. Because project financing is often a complicated process, new commitments in a given year do not always result in new loans extended, just as obligations in a given year do not always result in outlays.

- o Net lending is derived by deducting repayments on direct loans previously extended against new loans extended. This net lending figure is the amount actually included in the budget totals for the on-budget agencies.

TABLE B-1. SUMMARY OF DIRECT FEDERAL LENDING, FISCAL YEAR 1979: IN MILLIONS OF DOLLARS

	On-Budget Agencies	Off-Budget Agencies
Commitments for New Loans	28,942	22,591
New Loans Extended	26,575	17,575
Less Repayments on Lending (Loan Asset Sales)	-22,246 (10,272)	- 4,618 (720)
Net Lending	4,329	12,957

SOURCE: Budget of the United States Government, Special Analysis F, Fiscal Year 1979.

The treatment of direct loans on a net basis in the federal budget presents a serious problem: it distorts the picture of federal credit activity by understating the amount of current activity. The fact that there are repayments on loans made in previous years does not alter the amount of credit extended in new loans in the current year. Of the estimated \$26.6 billion of new direct loans (on-budget) in fiscal year 1979, the budget totals reflect only \$4.3 billion. That \$22.2 billion of repayments are deducted from the total does not mean that \$22.2 billion in new loans were not extended.

Current practices include in repayments the sales of loans by originating federal agencies to third parties. Of the \$22.2 billion of estimated repayments in fiscal year 1978, \$10.3 billion, or 46 percent, are sales of loan assets. These do not signify the termination of a borrowing transaction--the repayment of principal and interest--but only the transfer of the loan obligation to another owner. While there are valid

policy reasons for loan asset sales--the intermediation role performed by the Farmers Home Administration or the countercyclical role sometimes performed by GNMA, for example--this practice poses a potential problem.

As these loan asset sales increase--they have reached as high as 70 percent of repayments in recent years (see Table B-2)--it is possible for agencies to manipulate their budget totals by selling off their direct loan portfolios. By selling all its new loans extended in a given year, an agency could create a net entry of zero in the budget, giving the picture of no activity. Conceivably, by selling additional holdings from its loan portfolios, the agency could reduce its net lending to a negative figure and thus reduce the budget deficit. For instance new loans extended by the Farmers Home Administration in fiscal year 1979 are estimated to be \$8,421 million. After deducting \$9,644 million of repayments and \$41 million of other adjustments, the net lending charge in the budget is a negative \$1,264 million. Of the \$9,644 million in repayments, \$7,368 million, or 76 percent, represent loan asset sales. While the negative outlay figure of \$1,264 million is an appropriate picture of the government's cash flow position, it is not a valid representation of the level of federal lending activity for the fiscal year.

GUARANTEED LENDING

Table B-3 summarizes federal loan guarantee activity for fiscal year 1979. Comparable to the accounting for direct loans, commitments for new guarantees forecast future activity. Current activity, however, is recorded as total loans guaranteed. This total includes some double-counting. For example, the GNMA tandem plan pools small guaranteed loans together and then guarantees the certificates of participation in those pools sold to third parties. The first adjustment deducts these guarantees of guarantees, or secondary guarantees as they are known. A second adjustment is required because some guaranteed loans are bought by federal agencies, thus converting the guaranteed loans into direct loans since the federal government provides the funds. Deducting these two adjustments leaves a total for adjusted total guarantees, the most useful figure for understanding the volume of new guarantee activity in a fiscal year. For fiscal year 1979 it is estimated to be \$53.4 billion. A final statistic, net guarantees extended, is derived by deducting the principal of guaranteed loans that have been repaid.

TABLE B-2. LOAN SALES AS A PERCENT OF LOAN REPAYMENTS:
BY FISCAL YEARS

Fiscal Year	Loan Repayments <u>a/</u> (in millions of dollars)	Loan Sales On-Budget <u>b/</u> (in millions of dollars)	Loan Sales as Percent of Repayments
1963	6,930	1,142	16.5
1964	6,597	1,077	16.3
1965	6,188	1,564	25.3
1966	8,123	2,961	36.5
1967	7,091	4,229	59.6
1968	7,227	5,300	73.3
1969	9,567	2,005	21.0
1970	9,413	2,210	23.5
1971	10,035	2,548	25.4
1972	9,376	3,356	35.8
1973	13,209	6,254	47.4
1974	10,325	3,911	37.9
1975	13,744	7,922	57.6
1976	18,859 <u>c/</u>	13,312	70.6
TQ	5,019 <u>c/</u>	3,634	72.4
1977	19,300 <u>d/</u>	10,068	52.2
1978 <u>e/</u>	21,422 <u>d/</u>	9,985	46.6
1979 <u>e/</u>	22,246	10,272	46.2

SOURCE: Budget of the United States Government, Special Analyses on Credit, Fiscal Years 1965-1978.

a/ Including adjustments to balances, write-offs, etc.

b/ Including GNMA tandem plans.

c/ Does not include Export-Import Bank, as OMB figures do.

d/ Does not include Housing for the Elderly program, as OMB figures do.

e/ Estimate.

TABLE B-3. SUMMARY OF GUARANTEED LENDING, FISCAL YEAR 1979: IN MILLIONS OF DOLLARS

	Fiscal Year 1979
Commitments for New Guarantees	107,044
Loans Guaranteed	89,788
Less Secondary Guarantees and Guaranteed Loans Acquired for Government Direct Loan Portfolios	-36,434
Total, Primary Guarantees (Adjusted)	53,354
Less Reductions because of Repayments of Loans	-30,166
Net Guarantees Extended	23,188

SOURCE: Budget of the United States Government, Special Analysis F, Fiscal Year 1979.

THE ROLE OF THE FFB

By combining Tables B-1 and B-3, it is possible to derive a picture of the role of the FFB in converting guaranteed loans into direct loans. Table B-4 illustrates this conversion. Of the \$36.4 billion deducted from total guarantees extended for secondary guarantees and purchases of guarantees for direct loan portfolios, \$16.2 billion was for purchases by the FFB. The figure included for the FFB in the direct lending activities of off-budget federal agencies is exactly \$16.2 billion. The extent of the FFB's activity in its short existence is illustrated in Table B-5. In its first year, fiscal year 1974, FFB purchases of guaranteed loans amounted to less than one percent of the total; two years later the FFB was purchasing almost one-fifth of all guaranteed loans. While this level of activity appears to have remained constant, the Congress has not yet made any efforts to control the level of FFB activity to ensure stability.

TABLE B-4. ROLE OF THE FEDERAL FINANCING BANK, FISCAL YEAR 1979: IN MILLIONS OF DOLLARS

Fiscal Year 1979	
<u>Direct Lending</u>	
On-budget Loans	26,575
Off-budget Loans	17,575
FFB	(16,158)
Other	(1,417)
Gross Total Direct Lending	<u>44,150</u>
Less Repayments	<u>-26,864</u>
Total Direct Lending	17,286
<u>Guaranteed Lending</u>	
Guarantees Extended	89,788
Less Secondary Guarantees	-15,640
Less Guarantees Acquired for Government Direct Loan Portfolios	
FFB	-16,158
Others	<u>- 4,635</u>
Total Primary Guarantees (Adjusted)	53,354

SOURCE: Budget of the United States Government, Special Analysis F, Fiscal Year 1979.

SECONDARY MARKET OPERATIONS

A third form of federal credit activity arises out of the government's attempts to establish secondary market operations for direct and guaranteed loans as a means of encouraging private participation in public credit activities. To that end the government has sponsored various

TABLE B-5. FFB PURCHASES OF NEW GUARANTEES, FISCAL YEARS 1974-1978: IN MILLIONS OF DOLLARS

Fiscal Year	Primary Guarantees	FFB Purchases	FFB Purchases as Percentages of New Guarantees
1974	33,461	102	0.3
1975	41,290	6,958	16.8
1976	44,278	8,876	20.0
TQ	13,312	2,859	21.5
1977	56,168 <u>b/</u>	12,379	22.0
1978 <u>a/</u>	64,829 <u>b/</u>	15,626	24.1
1979 <u>a/</u>	74,148 <u>b/</u>	16,158	21.8

SOURCE: Budget of the United States Government, Special Analysis F, Fiscal Years 1976-1979.

a/ Estimated.

b/ Primary guarantees are adjusted subtotals of the totals for guaranteed lending. Prior to the fiscal year 1979 budget, the adjustment for secondary guarantees was deducted from total guarantees extended to arrive at primary guarantees extended. Beginning with the fiscal year 1979 budget, OMB began including in the adjustment for secondary guarantees the purchase by GNMA of guarantees for its direct loan portfolio. This change was made to distinguish between the purchase of guarantees for direct loan portfolios by on-budget agencies (only GNMA) and by off-budget agencies and federally sponsored credit intermediaries. Since this table is concerned with the relationship of FFB purchases as a part of primary guarantees before other adjustments have been made, the data for fiscal years 1977, 1978, and 1979 have been adjusted to reflect the pre-1979 budget practices.

private and mixed-ownership enterprises to function as financial intermediaries. The Farm Credit System, the Federal Home Loan Banks, the Federal National Mortgage Association, and the Student Loan Marketing Association (SLMA) fall into this category.

Although they are privately owned, all these enterprises are chartered by the government, are subject to various kinds of federal supervision, consult the Treasury in planning their operations, and frequently include federal officials on their boards of directors. Because these enterprises are given special tax preferences and can point to their federal relationship, their securities receive a preferred position in the capital markets. This enables them to borrow money at rates only moderately above the Treasury's own borrowing rates.

Some of these agencies began with the purpose of establishing secondary market operations for housing, such as FNMA, or as facilities providing advances of reserves to financial institutions. They have a basic function of providing liquidity to primary lenders in times of tight money conditions, either by buying loans or making advances. These loans are then sold back or the advances repaid when capital market conditions improve. In recent years, however, these institutions have expanded their roles. In addition to buying and selling loans to facilitate the flow of mortgage credit in tight and easy money markets, they are also seeking to draw new funds into the mortgage markets. By borrowing additional funds themselves, they can provide more funds to the basic lending institutions in the mortgage markets.

Table B-6 summarizes direct lending by these federally sponsored credit intermediaries for fiscal year 1979. The accounting treatment is comparable to that for direct and guaranteed loans, although an additional adjustment has to be made to deduct from gross lending funds advanced to the credit intermediaries by federal sources. A prime example of this is FFB purchases of SLMA obligations.

TABLE B-6. SUMMARY OF LENDING BY FEDERALLY SPONSORED
CREDIT INTERMEDIARIES, FISCAL YEAR 1979:
IN MILLIONS OF DOLLARS

	Fiscal Year 1979
New Commitments	66,969
Gross Direct Lending	62,004
Less Funds Advanced from Federal Sources	-130
Total, Primary Lending	61,874
Less Repayments	-47,029
Total, Net Lending	14,845
Total Outstanding	130,082

SOURCE: Budget of the United States Government, Special Analysis F,
Fiscal Year 1979.

APPENDIX C. FORMS OF LOAN GUARANTEES

A recent cataloging of loan guarantee programs identified 164 separate programs, and this listing is not considered to be exhaustive. ^{1/} These programs developed over a number of years in response to specific problems or needs. As a result of this profusion of ad hoc programs, a variety of guarantee mechanisms has developed, each tailored to specific program needs. This wide variety of forms and practices makes it difficult to understand how individual programs operate and to compare programs to each other.

Defining distinct types of guarantee mechanisms is complicated by the combination within a single program of loan guarantees with other credit mechanisms--interest subsidies, direct loans, etc. Using OMB's definition for classifying programs as loan guarantees within the special analysis on credit, one can identify at least six more or less distinct mechanisms.

Explicit Guarantees of Principal and Interest. This is a formalized commitment by a guarantor agency to repay indebtedness on behalf of a borrower, such as FHA home loan guarantees. Typically such a program charges the borrower a fee or premium, is administered through a revolving fund, and is designed to operate on an actuarially sound basis.

Explicit Guarantees of Leases or Long-Term Contracts on Behalf of Private Parties. This mechanism is very similar to the first form, but the guarantee is applied to a lease or long-term contract made by an individual. The Small Business Administration's lease guarantee program is the primary example of this mechanism. It is designed to help small businesses obtain leases of commercial and industrial space that, because of insufficient credit standing, they would otherwise be unable to obtain on reasonable terms.

^{1/} Catalog of Federal Loan Guarantee Programs, (Committee Print) Subcommittee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs, 95:1 (1977).

Long-Term Contracts for Government Purchases, Leases, or Contributions. This category in reality covers a variety of forms. A guarantor agency may sign a long-term contract to purchase various goods or services from a private concern. Or, the agency may enter into long-term contracts to lease property toward payment of debt service on behalf of a private borrower. Examples include price guarantees for financing energy generating facilities, Department of Defense contracts to lease oil tankers, and the HUD College Housing Program. In all these cases there is no formalized guarantee attached to the actual indebtedness incurred by the private borrower. Instead, the operative factor is the existence of a long-term, stable income stream resulting from the government contract.

Contingent Direct Loan Commitments to Guarantee Financing. In some programs for which an agency has the authority to make direct loans, the agencies will make direct loan commitments to borrowers, who then pledge those loan commitments as collateral in securing private financing. Although some programs, such as the temporary loan program of the Urban Renewal Administration, have specific statutory authorization to make such commitments as a means of guaranteeing credit obtained in the private markets, it is not clear whether an agency must have such authority to use its direct loan programs as a guarantee mechanism.

Direct Loans Sold with an Agreement to Repurchase. In some cases the federal government can convert a direct loan it has made into a privately financed, guaranteed loan by selling that loan note to a third party. It then guarantees the loan by agreeing to repurchase it from the third-party buyer if the borrower defaults. Because such sales to third parties are considered loan asset sales, the receipts are counted as repayments and deducted from new lending. As a result this practice can be used to reduce recorded budget outlays.

Callable Capital Contributions. The assets of various international financial institutions are composed of capital contributions subscribed by member nations. Only a portion, 7 to 10 percent, of the subscribed capital is paid into the international banks, the remainder being "callable capital"--funds the subscribers stand ready to supply if ever needed. None of the international banks has ever had to call in these pledges to date.