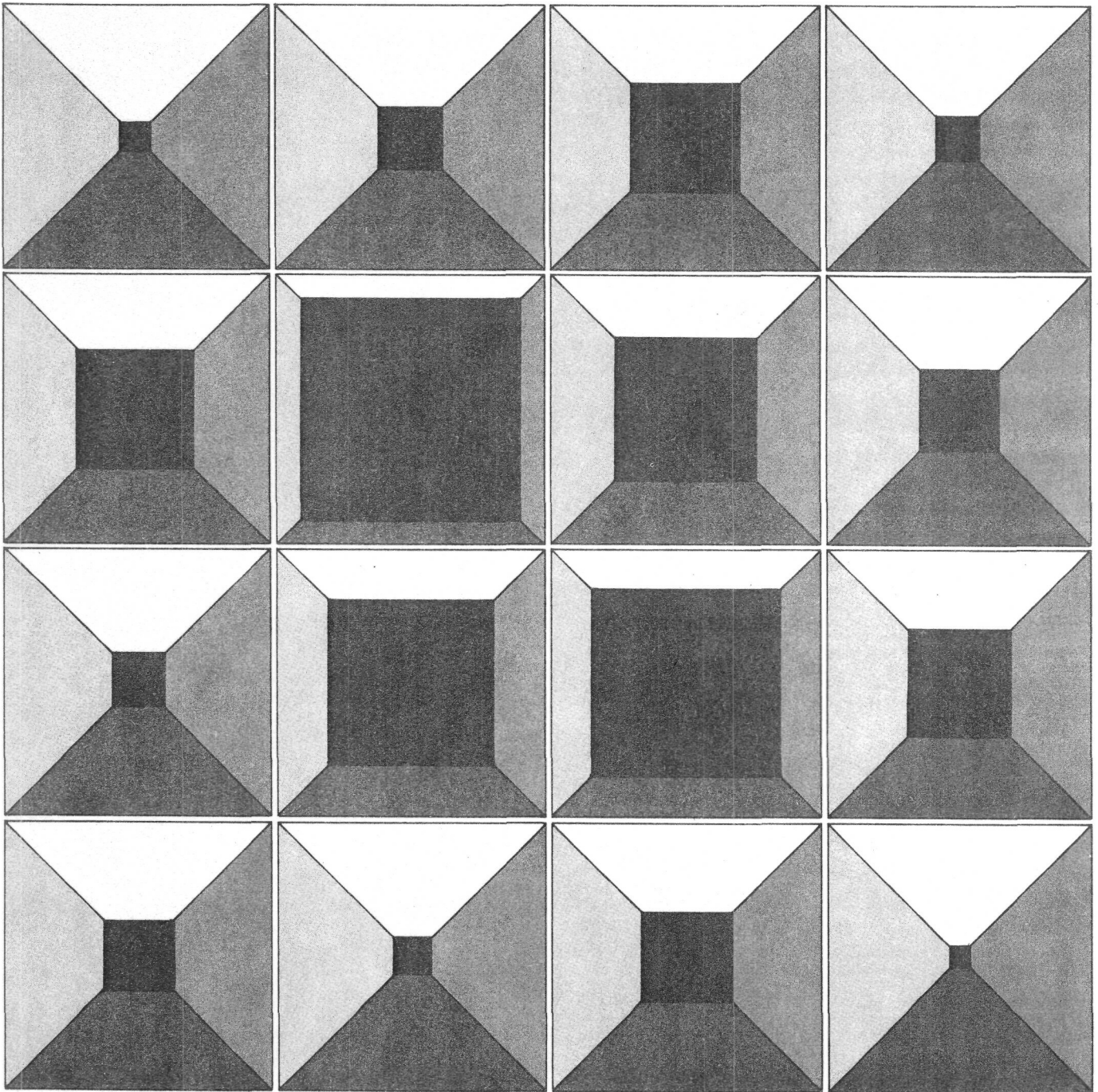


The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities

ACBO Study
January 1982



THE FEDERAL FINANCING BANK
AND THE BUDGETARY TREATMENT
OF FEDERAL CREDIT ACTIVITIES

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PREFACE

At the request of the House and Senate Budget Committees, the Congressional Budget Office (CBO) prepared this report on the Federal Financing Bank (FFB). The paper explains why the bank was established and what it does. It examines the problems created by the budgetary treatment of some of the FFB's transactions and alternative solutions to those problems.

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SUMMARY

THE FFB: DESCRIPTION AND ACTIVITIES

The Federal Financing Bank (FFB) is a unit of the Treasury Department whose function is to assist federal agencies in financing marketable agency-issued or agency-guaranteed securities. During the late 1960s and early 1970s, there was a dramatic increase in the number and volume of such securities offered in the government securities market by federal agencies or by borrowers with federal guarantees.

The proliferation of these agency-backed securities strained the capacity of the government securities market. Compared to the rates on the billions of dollars of securities regularly marketed by the Treasury Department, these newer securities--with their small size and unfamiliar provisions and terms--traded at wider spreads and higher interest rates. In addition, agencies and their guaranteed borrowers found it more expensive to finance their securities in the market because of the administrative costs of maintaining a financing staff or because of underwriting expenses.

Types of Securities

Three types of agency-backed securities were offered for sale: agency debt, certificates of beneficial ownership, and guaranteed securities.

Agency Debt. Agencies with authority from the Congress to borrow to finance their activities sold their own debt securities, in the same manner as the Treasury offers bonds, notes, and bills to finance the government's deficit.

Certificates of Beneficial Ownership. Federal agencies that made direct loans pooled a number of loans together and then sold certificates representing a share of ownership in that loan pool. These certificates of beneficial ownership (CBOs) could be sold in larger units than individual loans and were guaranteed by the selling agency. By selling CBOs, the lending agencies could refinance their loan portfolios, in effect generating new capital for further loans.

Guaranteed Securities. To allow nonfederal enterprises to tap the government securities market as a source of financing, some agencies fully guaranteed the repayment of interest and principal on securities issued by these enterprises. This approach evolved as the size of projects proposed for guaranteed financing grew larger, and as banks and other lending institutions became more hesitant to make long-term large commercial loans for these ventures.

Establishment and Growth of the FFB

To lower the borrowing costs of agency-issued and agency-guaranteed securities, the Federal Financing Bank was established in 1974 as a central financing authority for marketable federal securities (other than the Treasury's own borrowings). The bank was given the authority to borrow up to \$15 billion through the issuance of its own debt and unlimited authority to borrow from the Treasury.

Although it was originally expected that the bank would finance its activities through the issuance of its own debt, the Treasury officials who manage the FFB found it cheaper for the bank to borrow directly from the Treasury. The bank borrows at the Treasury's current rates; it lends to agencies and agency-guaranteed borrowers at the Treasury rate plus one-eighth of a percentage point. This is probably one-half a percentage point, or more, below the rate that agencies or guaranteed borrowers would have to pay if they offered their securities in the market, thus saving them millions of dollars annually in interest costs.

The demand for the favorable financing terms available through the FFB has grown rapidly since the bank's inception in 1974. Today, the FFB buys practically all debt issues and certificates of beneficial ownership offered by federal agencies. It also has become a major source of financing for the securities of guaranteed borrowers that otherwise would be sold in the government securities market. When the FFB purchases a guaranteed security, it is in effect making a direct loan to the security issuer. Initially, it was anticipated that the bank would lend \$6 to \$7 billion annually. During fiscal year 1975, its first full year of operation, it made new loans, net of repayments, totaling \$12.7 billion. After dropping to about \$9 billion in fiscal years 1976 and 1977, net lending by the FFB increased from \$12.7 billion in 1978 to \$24.8 billion in 1981. At the end of fiscal year 1981, outstanding loans by the FFB totaled \$107.3 billion.

Among the three categories of FFB financing, purchases of CBOs and other loan assets have predominated, accounting for 48.3 percent, or nearly half, of the bank's outstanding holdings at the close of fiscal year 1981 (see the Summary Table). The Farmers Home Administration (FmHA) has been the principal seller of CBOs to the FFB. In 1981, \$48.8 billion of CBOs sold by FmHA accounted for 94 percent of the bank's loan asset holdings, and over 45 percent of all FFB holdings.

Direct loans to guaranteed borrowers accounted for nearly 29 percent of the FFB's total holdings at the end of fiscal year 1981. Rural electric cooperatives, with guarantees from the Rural Electrification Administration (REA), and foreign governments, with guarantees from the Department of Defense (DoD), constituted the largest groups of borrowers in this category in terms of the dollar volume of loans made. Outstanding direct loans by FFB to these two groups totaled \$21.4 billion by the end of 1981, or 20 percent of total FFB holdings. Holdings of outstanding agency debt accounted for the remaining 23 percent of the FFB's portfolio, with the Export-Import Bank and the Tennessee Valley Authority (TVA) taking the lion's share (\$23.3 billion, or 94 percent of all debt holdings).

BUDGETARY PROBLEMS AND CONSEQUENCES OF FFB ACTIVITIES

Problems

Although the FFB has been a success as a debt management and financing tool, its purchases of CBOs and its direct loans to guaranteed borrowers pose two budgetary problems. First, the direct loans represented by these two transactions are counted neither in the initiating agencies' budgets nor in the unified budget totals. Instead, they appear in the off-budget FFB's budget. Consequently, agency budget totals and the budget deficit are understated by the amount of CBO sales to the FFB and FFB direct loans to guaranteed borrowers. 1/ This advantageous

1/ The unified budget totals and deficit are also understated by the activities of the other off-budget entities: the Rural Electrification and Telephone Revolving and Rural Telephone Bank of REA, the Postal Service, the Regional Rail Reorganization Program of the U.S. Railway Association, and the Synthetic Fuels Corporation.

SUMMARY TABLE. FFB OUTSTANDING HOLDINGS, BY TYPE OF ACTIVITY (End of fiscal year, in billions of dollars)

Activity	1980	1981
Agency Debt		
Export-Import Bank	10.1	12.4
Tennessee Valley Authority	8.9	10.9
Other	<u>2.1</u>	<u>1.6</u>
Subtotal, Agency Debt	21.1	24.9
Loan Assets <u>a/</u>		
Farmers Home Administration	38.0	48.8
Rural Electrification Administration	1.9	2.6
Other	<u>0.5</u>	<u>0.4</u>
Subtotal, Loan Assets	40.4	51.8
Direct Loans to Guaranteed Borrowers		
REA guaranteed loans to rural electric cooperatives	8.4	12.3
DoD guaranteed loans for foreign military sales	7.2	9.1
Other	<u>5.9</u>	<u>9.2</u>
Subtotal, Direct Loans to Guaranteed Borrowers	<u>21.5</u>	<u>30.6</u>
Total, FFB Outstanding Holdings	83.0	107.3

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981).

a/ Primarily certificates of beneficial ownership.

budgetary treatment creates a second problem: the possibility that resources may be overallocated to activities financed through the FFB.

CBO Sales: Transferring Direct Loans Off-Budget. The sales of certificates of beneficial ownership by FmHA and REA to the FFB are treated in the budget as loan asset sales, notwithstanding the fact that they are not really asset sales. Special provisions of law require this treatment, although it is contrary to established budgetary principles.

In an outright loan asset sale, an agency sells a loan or group of loans to an investor, transferring possession of the loan note or instruments to the new owner. The investor assumes the risk of default and the responsibilities for servicing the loan. Because the outright sale of a loan asset results in the agency recovering its loan capital and being relieved of any risk, such a sale is recorded in the budget in the same way as a loan repayment--as a negative outlay or offsetting receipt--thus reducing the agency's or program's outlay total.

A CBO sale differs from a true asset sale in several respects. First, the agency retains possession of the loan instruments; all it sells is a security representing ownership in a pool of loans. Second, the agency retains responsibility for servicing the loans; it collects interest and principal payments and then pays these to the CBO purchaser. Finally, the agency retains all the risk; it guarantees in full timely payment of interest and principal on the certificate. In reality, an agency selling a CBO is borrowing from the CBO purchaser.

By treating CBO sales as asset sales, an agency, such as FmHA, is able effectively to transfer outlays off-budget to the FFB. By selling loans to the FFB in the form of CBOs, FmHA is able to offset the outlays for the loans with the receipts of the CBO sales. Thus, FmHA could make \$5 billion of loans in a fiscal year, sell a \$5 billion CBO to the FFB, and have an outlay total of zero for the year. The FFB, however, would record outlays of \$5 billion for the CBO purchase. The practical effect is merely that of transferring an on-budget loan to off-budget status. The loans do not disappear, however, by virtue of being removed from the unified budget. They merely become part of the off-budget deficit, which itself must be financed by Treasury borrowing (the FFB's borrowing to purchase the FmHA's CBO, for example).

If, however, FmHA sales of CBOs were treated as borrowing by FmHA to finance its direct loans, as recommended by the 1967 President's Commission on Budget Concepts, the effects on the FmHA budget, and unified budget as a whole, would be dramatic. FmHA could not reduce its outlay totals; instead, its budget would show the full amount of its net lending each year. For instance, FmHA reported outlays in 1980 of \$3.0 billion. Not included in that figure, however, were net new loans of \$6.9 billion financed through CBO sales to the FFB. If these sales had been treated as FmHA borrowing, its outlays would have more than tripled, to \$9.9 billion.

In the case of FmHA and REA CBO sales to the FFB, the problem is not really the FFB; it is the special legislative provisions that allow these two agencies to treat CBO sales as asset sales although they should be treated as borrowing. In the absence of the FFB, the transfer of direct loans off-budget would continue. Instead, however, of the loans being transferred to the visible, albeit off-budget FFB, they would be transferred to a nonfederal investor and truly become invisible. And FmHA would pay more in interest costs as well.

FFB Direct Loans to Guaranteed Borrowers: Originating Loans Off-Budget. When the FFB purchases a security or underwrites an entire issue of securities issued by a nonfederal enterprise with a federal agency guarantee, it is in effect making a direct federal loan to that enterprise. The loan is recorded off-budget, and is not charged to the agency that guaranteed the securities in the first place.

The transfer of loans off-budget that occurs when FmHA and REA sell CBOs to the FFB results from the violation of a budgetary principle. The origination of direct loans to guaranteed borrowers off-budget is consistent with the budgetary principles governing loan guarantees, however. The problem in this case is the off-budget status of the FFB. If the FFB were put on-budget, then FFB direct loans to guaranteed borrowers would be included in the unified budget totals, but they still would not be charged to the originating agency's budget.

In actuality, however, the fundamental problem is in the inadequacies of existing budget concepts to deal with credit transactions that are in the "grey area" between direct federal loans and loan guarantees. A federally guaranteed security that, before the FFB's establishment, would have been sold in the government securities market has practically the same characteristics as a

direct loan by a federal agency to a nonfederal enterprise, financed by the agency borrowing with its own debt issuances. The treatment of the two transactions is quite different, however. The guarantee transaction does not affect the agency's outlay total or the unified budget deficit. If, instead of guaranteeing the loan, the agency made a direct loan financed by borrowing, its outlay total and the unified budget's total outlays and deficit would both be increased by the amount of the loan.

Consequences

Because both CBO sales, whether financed by the FFB or not, and FFB direct loans to guaranteed borrowers transfer direct loans off-budget, they cause total budget outlays and the unified budget deficit to be understated, as explained at the beginning of this section. This was amply demonstrated in fiscal year 1981 when the FFB's purchases of \$11.5 billion of CBOs and its direct loans of \$9.4 billion to guaranteed borrowers caused total outlays and the deficit to be understated by \$21.0 billion. The reported 1981 deficit of \$57.9 billion was in fact 26.6 percent below the level of a combined unified budget deficit and FFB deficit. This treatment undermines the utility of the budget deficit as a measure of the amount of federal activity that requires financing by borrowing.

Moreover, FFB-financed CBO sales and direct loans to guaranteed borrowers frustrate the setting of priorities among competing programs in the budget process, because they permit agencies to undertake activities that are never charged to them, and that never show up in their budgets. In fact, the ability of agencies to finance activity "invisibly" through the FFB raises the possibility that resources may be overallocated to such activities, because of their apparent, although not real, "costlessness." One has only to look at the examples of FmHA and REA, the FFB's two biggest clients, for evidence that this may be occurring. It took from fiscal year 1951 until 1974 for the annual level of new direct loans by FmHA to climb from \$128 million to \$3.9 billion. In the next six years, that level increased from \$5.6 billion in fiscal year 1975 to \$15.8 billion in 1980. Similarly, the annual level of new loans by REA grew from \$268 million in fiscal year 1951 to \$802 million in 1974, but jumped in fiscal year 1975 to \$1.1 billion, and reached \$3.7 billion by 1980.

These two problems (understatement of the deficit and misallocation of resources) result from the budgetary treatment of CBO

sales and the off-budget status of the FFB. The existence, however, of the FFB as a source of apparently limitless credit at rates only slightly above Treasury's borrowing costs has no doubt played a part, particularly with the explosion of FmHA and REA lending levels in the FFB era.

ADDRESSING THE PROBLEMS POSED BY THE FFB

As awareness of the problems posed by FFB financing of CBOs and direct loans to guaranteed borrowers has increased in recent years, various proposals have been advanced to address these problems. Some proposals focus on the FFB itself. Others address the underlying issue: the budgetary treatment of CBO sales and direct loans to guaranteed borrowers. One final proposal would resolve the problems posed by FFB financing as part of a general restructuring of the unified and credit budgets.

Three criteria should be used to evaluate the proposals to change the FFB and its activities. First, the proposed change should improve the utility of the budget deficit as a measure of federal borrowing requirements. Second, it should improve the process of allocating resources through the budget process. And third, the proposal should ensure that the gains in financing efficiency achieved through the FFB are not lost.

Changing the FFB Itself

Abolishing the FFB. Some observers think that the problems resulting from the FFB as a source of off-budget financing could be resolved simply by abolishing the bank. This proposal would effectively restore the situation that existed prior to 1974, before the bank's establishment. It would, therefore, lose all the gains in FFB financing efficiency as agencies returned to selling CBOs and guaranteed securities in the government securities market. Because it would not change the underlying budgetary treatment of CBO sales or remedy the inconsistency in the treatment of fully guaranteed securities sold in the market, this option would not improve the process of allocating resources in the budget process nor would it reduce the understatement of total federal lending, and thus of total outlays and the deficit.

Putting the FFB On-Budget. H.R. 2566, the Federal Financing Bank Act Amendments of 1981, would repeal the statutory exclusion of the FFB from the unified budget; would require appropriation

act approval of the total amount of FFB activity for any fiscal year; and, in order for a guarantee to be effective, would require that the FFB purchase federally guaranteed securities rather than allow agencies to sell them in the government securities market. The effects of these provisions would be to:

- o Include the budget authority and outlays for FFB purchases of CBOs and FFB direct loans to guaranteed borrowers in the unified budget totals and deficit;
- o Set a ceiling on total FFB activity. In the absence, however, of Congressional decisions on which of the FFB's clients should get financing and how much, a race would develop among agencies to get to the FFB "window" before the allotment for the year was exhausted; and
- o Prevent agencies from undermining the FFB ceiling by returning to the market to sell CBOs or finance fully guaranteed securities, since such securities would have to be bought by the FFB for the guarantee to be effective.

By including FFB-financed CBO sales and direct loans to guaranteed borrowers in the budget, the deficit would increase substantially. In fiscal year 1980, it would have increased from \$59.6 billion to \$73.9 billion; in 1981 it would have increased from \$57.9 billion to \$78.9 billion. These increases in the deficit do not represent new or additional federal activities; they merely acknowledge in the deficit total the federal activities already taking place. H.R. 2566 would improve the comprehensiveness of the budget deficit, but it would not completely improve the allocation process. FFB's activities would be recorded in a separate FFB budget, not in the originating agencies' budgets. Thus, there would still be an advantage to using the FFB: agencies could make their own budgets look smaller.

Focusing on the Transactions, Not on the FFB

Using the Credit Budget. The Congress could expand the credit budget concept used in the concurrent budget resolutions for fiscal years 1981 and 1982 to include separate limitations, by agency and program, on the amounts of CBOs that could be sold to the FFB or of direct loans to guaranteed borrowers that the FFB could originate. This alternative, however, totally avoids the outlay impact, and leaves the unified budget understated by the

amount of the FFB's activity. It does improve the process of allocating resources by placing limitations at the point of initiation--the agencies, not the FFB. To the extent that FFB-financed activities are viewed as being less costly because they have no unified budget impact, the potential would remain for overallocation of resources to FFB-financed activities.

Changing the Budgetary Treatment of CBO Sales and Direct Loans to Guaranteed Borrowers. If the Congress treated the sales of CBOs as borrowing--which is consistent with established budgetary principles--the funds from the sales would not be treated as off-setting receipts; therefore, by selling a CBO an agency would not be able to reduce its outlays. Agencies could sell as many CBOs to the FFB as they wished; however, the new loans represented by the CBOs would continue to be recorded as outlays in the agencies' budgets.

The Congress could also choose to change the budgetary treatment of FFB direct loans to guaranteed borrowers. These could be redefined as direct loans by the guarantor agencies and borrowing by the agencies from the FFB. Instead of the agencies recording a loan guarantee and the FFB recording budget authority and outlays, this alternative would record the budget authority and outlays in the agencies' budgets, and treat the agency-FFB transaction as borrowing, which would not affect the agencies' budget totals.

Making these changes in the budgetary treatment of agency transactions with the FFB would satisfy all three criteria outlined above. The deficit would not be understated by FFB activity; the budget would be inclusive of most activities; and agencies would be charged for the activities they initiated. Agencies could continue to finance their credit instruments at Treasury rates; they simply would not receive any budgetary advantage by doing so.

The effect of making these changes in budgetary treatment on the budget deficit would be the same as the proposal to put the FFB on-budget: increasing the budget deficit by as much as \$14 to \$20 billion. In this alternative, however, agency budgets would also increase by the amount of their FFB-financed CBO sales or direct loans to guaranteed borrowers.

Restructuring the Unified and Credit Budgets

The foregoing alternatives would make changes to the FFB or the budgetary treatment of financing transactions within the

existing framework of the unified budget. An entirely different approach would be to address the issues raised by the FFB and its activities as part of a general restructuring of the unified and credit budgets.

The unified budget includes direct lending on a net basis, but it does not include off-budget lending or loan guarantees. The experimental credit budgets for fiscal years 1981 and 1982 set targets for gross new direct loan obligations, both on- and off-budget, and for gross new loan guarantee commitments. By excluding net lending from the unified budget and adding to the credit budget a "deficit" constituted by net direct lending (on- and off-budget) and net new loans guaranteed, the status of the credit budget could be enhanced. At the same time, the advantage of using the FFB as a means of financing direct loans off-budget would be nullified. Direct lending would not be included in the reconstructed unified budget deficit, but it would be included in a credit budget deficit. Whether or not a loan was financed by the FFB would be inconsequential; in either case, it would be included in the credit budget deficit. The total of the unified budget and the credit budget deficits would be a measure of the volume of federal activities financed through the nation's credit markets in any given fiscal year. Establishing these two deficits--one for lending and one for spending--would not create additional federal activities, but would simply recognize explicitly those existing activities that must be considered in any determination of the federal government's effect on the credit markets.

Conclusion

The last of these approaches--restructuring the unified and credit budgets--is the most comprehensive and ambitious. It would result in a new dual budgetary system for the allocation of resources. It would enhance the visibility of the credit budget deficit, which now receives little or no attention relative to the unified budget deficit.

Of the four alternatives that operate within the framework of the unified budget, the two that focus on the transactions themselves are clearly superior to those that focus solely on the FFB. Of the two transaction alternatives, changing the budgetary treatment of CBO sales and FFB direct loans to guaranteed borrowers is preferable. Its sizable impact on the unified budget deficit, however, might make it unpalatable to any Congress or Administration unless it were phased in, perhaps by setting a date for

implementation in a future fiscal year. Until then, limiting the annual volume of transactions with the FFB through the credit budget could be an intermediate step that would assist the Congress in addressing the resource allocation effects of the FFB's activity without forcing it to absorb the large outlay effects immediately. This option could also be used as an intermediate step if it were decided to establish a budget concepts commission to consider the restructuring of the unified and credit budgets.

The Federal Financing Bank (FFB) was established in 1974 as an agency within the Treasury Department to coordinate the issuance or guarantee by federal agencies of marketable federal securities. These include debt issued by federal agencies, loans and loan instruments sold by agencies, and securities issued by nonfederal borrowers but guaranteed by federal agencies. The number of such financial instruments sold in the government securities market increased dramatically in the 1960s and early 1970s; by coordinating the issuance of these securities, the FFB was intended to lower the borrowing costs for the participants.

As a debt management tool, the FFB has been a success: federal agencies and guaranteed borrowers have saved millions of dollars in interest costs each year. FFB purchases of loan instruments sold by agencies and of guaranteed securities cause total budget outlays, and thus the deficit, to be understated, however. This presents two problems. First, the utility of the unified budget deficit is undermined as an indicator of the borrowing that is necessary to finance the federal government's activities. Second, the absence of effective limits on the annual volume of FFB financing poses the potential for misallocation of resources.

Various proposals have been advanced in recent years to remedy the problems posed by the FFB and its activities. In some cases, the proposals address the FFB itself; these include abolishing the FFB or setting an annual limitation on its total activity. Other proposals address the underlying issue--the budgetary treatment of credit activities financed through the FFB. These proposals include changing the budgetary treatment of loan asset sales to the FFB and of FFB direct loans to guaranteed borrowers, or setting annual limitations by program on the amounts of such transactions.

This paper reviews the establishment of the FFB, its operations, the resulting problems, and the proposals to remedy the situation. Chapter II describes why the FFB was established and what it does. Chapter III discusses the budgetary treatment of the FFB's activities. Chapter IV describes the problems that result

from FFB-financed activity and delineates the extent to which these result from the existence of the FFB itself and the extent to which they result from factors other than the FFB. The final chapter presents some proposed solutions to these problems and evaluates those proposals according to various criteria.

CHAPTER II. THE FEDERAL FINANCING BANK: A TREASURY TOOL FOR
ORDERLY MARKETING OF FEDERAL SECURITIES

This chapter describes the practices of financing activity in the government securities market that gave rise in the early 1970s to the need for a central financing authority. It then discusses the FFB's establishment and operations.

TAPPING THE SECURITIES MARKET FOR FINANCING

Since World War II, the federal government has provided some goods or services indirectly or through third parties. By using grants-in-aid, tax expenditures, direct loans, loan guarantees, and regulations, federal agencies have been able to encourage or give incentives to state and local governments, individuals, or private enterprises to undertake activities that the agencies might otherwise have provided directly to the beneficiaries. ^{1/} Third-party provision of services also has sometimes taken the form of independent public and quasi-public entities designed to operate on a businesslike basis. For instance, the Export-Import Bank was established to lend money to promote exports of American products, and the Student Loan Marketing Association (SLMA) was designed to promote the flow of credit into loans for students.

One consequence of this trend to indirect or third-party provision of government services was an increase in the 1960s and early 1970s in the number of federal agencies issuing or guaranteeing securities offered in the government securities market. As part of its policy of encouraging third-party delivery of services, the federal government created new financing mechanisms that allowed agencies or nonfederal entities to tap the government securities market to finance federally sponsored activity. These new mechanisms took three different forms.

^{1/} Lester Salamon has called this indirect provision of services "third-party government." See Lester M. Salamon, "The Rise of Third-Party Government," The Washington Post, June 29, 1980.

New Financing Mechanisms

Debt Issued by Federal Agencies. To encourage the provision of services to the public on a businesslike basis, the Congress authorized several agencies--notably the Export-Import Bank, the Tennessee Valley Authority (TVA), and the Postal Service--to sell their own bonds in order to finance their operations. ^{2/} These agency debt securities were generally backed by the full faith and credit of the federal government and, thus, had the same backing as the Treasury's own debt securities. ^{3/} Agencies sometimes marketed their debt directly; in other cases, they used the services of an underwriter.

Sales of Loans from Agency Portfolios. By selling loans from their portfolios to third-party investors, federal agencies could generate new capital for further loans. These sales were known as loan asset sales. As a result, the role of the federal lending agency became much like that of a broker: arranging loans and providing for their private financing. In addition to mobilizing private capital for public purposes, such sales had the advantage of lowering the selling agency's net outlays because the sales are treated in the agency's budget in the same way as repayments on a loan--that is, as offsetting receipts.

Originally agencies sold individual loans to private investors. Later, however, some agencies pooled together a large number of small loans and sold shares of ownership in such loan pools. These shares, called participation certificates or certificates of beneficial ownership (CBOs), were more attractive to investors, especially institutional investors. They could be sold in units of a million dollars or more. Furthermore, because the issuing agency made up the difference between market rates and the return on below-market-rate federal loans, they could be sold at attractive prices and yields. Finally, the issuing

^{2/} This authority, technically known as authority to spend agency debt receipts, is one of two forms of borrowing authority (the other being authority to borrow from the Treasury, known as authority to spend public debt receipts).

^{3/} In some cases, however, the federal government's backing is only implicit. For example, TVA's debt is not explicitly backed by the full faith and credit of the government; instead, it is backed by the revenue from TVA's sales of electric power.

agencies fully guaranteed the interest and principal due on such certificates. These features of CBOs made them easy to sell in the government securities market.

Guaranteed Securities. Since the 1930s, loan guarantees have provided incentives to lending institutions to make home mortgages. In the 1960s and early 1970s, the federal government began using loan guarantees to make credit available for other publicly desired purposes. In particular, loan guarantees were used to allocate credit to large, discrete ventures, such as financing the construction of an ocean vessel. Because of their larger size and longer terms, banks or other lending institutions were often hesitant to originate such guaranteed loans. It was found, however, that borrowers with 100 percent federal guarantees could sell bonds or notes in the government securities market like Treasury bonds or notes. Thus, through 100 percent guarantees, federal agencies could help nonfederal borrowers tap the government securities market for financing.

Crowding in the Government Securities Market

In addition to the Treasury's own marketing of bills, notes, and bonds, by 1973 as many as 18 different agencies or programs were offering financial instruments in the government securities market: either their own debt securities, securities backed by direct loans from their own holdings, or securities issued by private concerns that they had guaranteed. ^{4/} On average, some type of federally assisted financing was being offered in the market three out of every five business days.

This proliferation of marketable federal securities strained the capacity of the securities markets. As one observer noted:

What's happening is that the new agencies are crowding the financing calendar with issues whose purposes, credit terms, guarantees, sinking fund provisions, and the like, cannot be readily understood or appraised by investors. Many of these

^{4/} Statement by Paul A. Volcker, Under Secretary for Monetary Affairs, Department of the Treasury, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 15.

new issues are of such small size that broad ownership appeal and distribution is not being accomplished. 5/

Because of their small size and the lack of broad ownership, many of the new types of issues cost their agencies more money:

Whenever you have small issues and few owners, you have an imperfect market. Imperfect markets mean there is a wide spread between the bid price and the asked price. Imperfect markets also cost borrowers more interest. 6/

The market for these securities contrasted markedly with the market for Treasury securities which, with their large unit sizes and broad distribution of ownership, operates very efficiently and at lower costs. It is possible, for example, to trade Treasury bills on which the difference between the bid and asked prices of \$1 million or more of bills may be only \$50.

The results of the proliferation of agencies tapping the securities market for financing were higher costs. First, the agencies had to pay higher interest rates in order to sell their securities, thus increasing their interest costs. Second, the agencies had higher administrative costs because they had to maintain a financing staff to market the securities. And third, when an agency used an underwriter to market an offering, it paid underwriting fees.

THE SOLUTION: A CENTRAL FINANCING AUTHORITY

The Treasury Department, with its responsibility for the efficient and economical management of the federal government's debt, viewed the overcrowding in the government securities market--with the resulting higher financing costs for agencies--as a debt

5/ Statement of Robert H. Bethke, Vice Chairman, U.S. Government and Federal Agencies Committee, Securities Industry Association, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 49.

6/ Statement by Robert H. Bethke in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 51.

management problem. Although federal agency debt issues, loan asset or CBO sales, and guaranteed securities usually had the same full-faith-and-credit backing as the Treasury's own debt issues, they were being charged higher interest rates than Treasury issues of comparable maturity.

To remedy this problem, the Nixon Administration proposed and the Congress--with some amendments--passed the Federal Financing Bank Act of 1973 (Public Law 93-224). The act established a bank within the Treasury Department to be a central financing agent for marketable securities issued or guaranteed by federal agencies. The bank would be off-budget; that is, its receipts and disbursements would not be included in the totals of the unified budget. 7/

When the bank was established, it was presumed that it would buy securities from agencies or guaranteed borrowers, financing its purchases by issuing its own debt. This would reduce the number of issuers of marketable federal securities to two: the Treasury and the FFB. It was further presumed that the market, with fewer types of securities to contend with, would purchase the FFB's debt at rates comparable to those of the Treasury's own debt. Thus, it would be possible for the FFB to finance agency debt, loan asset sales, and guaranteed securities at near-Treasury interest rates, saving the agencies, their guaranteed borrowers, and the federal government millions of dollars in interest costs. Witnesses testifying before the Ways and Means Committee on the Administration's proposal estimated that securities financed through the FFB would bear interest at rates about one-half of one percentage point below those on separately financed agency issues. 8/ Estimates of the annual volume of new FFB purchases ranged from \$4 billion to \$7 billion, implying annual interest savings over the term of those obligations of between \$20 million and \$35 million.

7/ The bank's budgetary treatment and the rationale for placing it off-budget are described in the next chapter.

8/ See the statement by Paul A. Volcker, Under Secretary for Monetary Affairs, Department of the Treasury, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 20. Also see the statement by Robert H. Bethke, Securities Industry Association, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 52.

THE FFB IN OPERATION: A TOOL OF DEBT MANAGEMENT

The Federal Financing Bank began operating in May 1974. In seven years it has become well-established as a tool of debt management. The number of entrants in the government securities markets has been reduced dramatically, and the bank's operations save the federal government millions of dollars in interest costs annually. The following sections describe the bank's levels of activity and its financing.

Levels of Activity

Since 1974 the FFB has become an important source of financing for marketable securities issued or guaranteed by federal agencies. As seen in Figure 1, the FFB's portfolio has grown rapidly and steadily since its inception. Its outstanding holdings totaled \$107.3 billion at the end of fiscal year 1981 and are expected to continue increasing during fiscal year 1982.

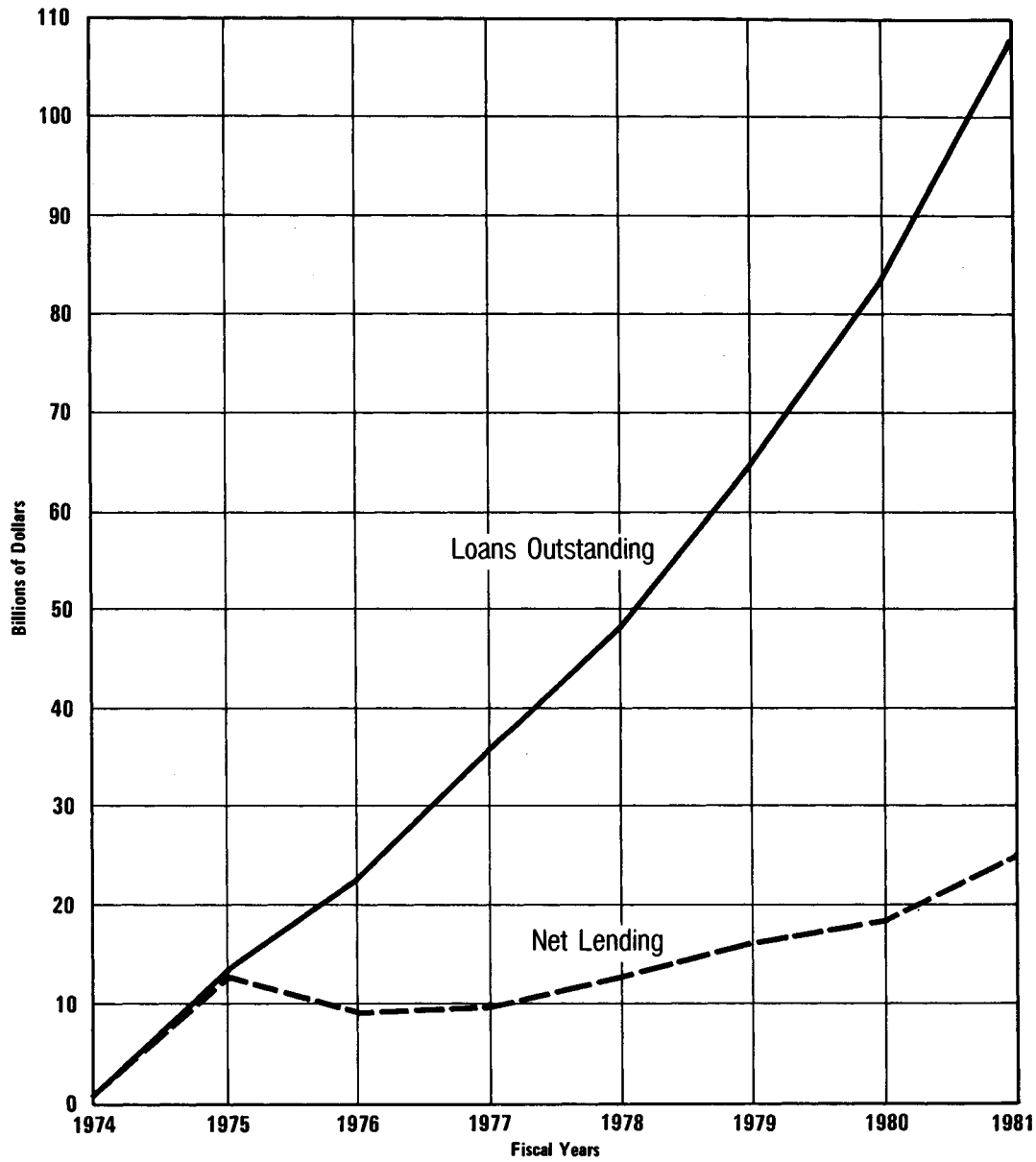
FFB activity levels have been greater than was anticipated during the Congressional hearings on the proposals to establish the bank. Treasury Under Secretary Volcker estimated that during its first two years the bank would purchase about \$15 billion of agency securities, or \$6 to \$7 billion annually. ^{9/} As Figure 1 illustrates, however, net new lending fluctuated between \$9 billion and \$12 billion during the bank's first four years (fiscal years 1975 to 1978). Since 1978 net lending has climbed steadily, reaching \$24.8 billion in fiscal year 1981, or twice the 1978 level.

In terms of the categories of FFB activity, purchases of loan assets from agencies have predominated, accounting for 48.3 percent of the FFB's total holdings at the end of fiscal year 1981. Direct loans to borrowers holding agency guarantees accounted for 28.6 percent of all holdings, followed by purchases of agency debt (23.2 percent). The following sections briefly describe the levels of activity for each type of activity.

Loan Assets. The FFB has become the primary purchaser of loan assets sold by federal agencies. In 1975, its first full year of operation, the FFB purchased 63.8 percent of all loan

^{9/} Volcker in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 28.

Figure 1.
Net Lending and Loans Outstanding of the Federal Financing Bank,
Fiscal Years 1974-1981



SOURCES: *Budget of the United States Government*, Fiscal Years 1976-1982, Special Analyses on Credit; and Department of the Treasury, FFB News, September 1981 Report (October 26, 1981).

assets offered for sale by federal agencies. By 1980 the FFB's share had increased to 92 percent, or \$12.1 billion of the \$13.2 billion of assets offered for sale. ^{10/} The Farmers Home Administration (FmHA) has been the principal seller of loan assets to the FFB. As seen in Table 1, FFB holdings of FmHA CBOs totaled \$48.8 billion by the end of fiscal year 1981, or 94 percent of the bank's loan asset holdings. This pattern is expected to continue in 1982.

TABLE 1. FFB HOLDINGS OF OUTSTANDING LOAN ASSETS, FISCAL YEARS 1980-1982 (In billions of dollars)

Agency	1980	1981	1982 <u>a/</u>
Farmers Home Administration	38.0	48.8	54.1
Rural Electrification Administration	1.9	2.6	3.0
All Other Agencies	<u>0.5</u>	<u>0.4</u>	<u>0.6</u>
Total, Loan Asset Holdings	40.4	51.8	57.7

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981); and estimates based on Mid-Session Review of the Budget, July 1981.

a/ Estimates.

Direct Loans to Guaranteed Borrowers. Instead of issuing securities to be bought by investors in the government securities market, borrowers with a guarantee from a federal agency may have the FFB purchase the entire security issue. Thus, the FFB, in effect, makes a direct loan to that borrower. At the end of fiscal

10/ The bulk of loan assets not sold to the FFB consist of home mortgages sold by the Government National Mortgage Association in the secondary mortgage markets.

year 1981, the FFB's holdings of this type of loans totaled \$30.6 billion. In terms of dollar volume, the two largest categories of borrowers were rural electric cooperatives under guarantees by the Rural Electrification Administration (REA) and foreign countries purchasing U.S.-made military equipment under guarantees by the Department of Defense (DoD). These two categories of borrowers accounted for \$21.5 billion of the loans outstanding at the end of 1981, or 70 percent of the total (see Table 2). Rapid growth in FFB direct loans is expected to continue: at the end of fiscal year 1982 loans outstanding are estimated to total \$41.5 billion, nearly twice the volume at the close of 1980.

Agency Debt. Since its inception in 1974, the FFB has been the sole financing agent for nearly all new issues of agency debt. At the close of fiscal year 1981, its holding of agency debt approached \$24.9 billion, up 18 percent over the previous year (see Table 3). During 1981 the FFB advanced \$2.3 billion to the Export-Import Bank and \$2.0 billion to the TVA, on a net basis. The U.S. Railway Association and the Postal Service both reduced their outstanding loan balances owed to FFB during 1981.

Financing

To finance its purchases of agency debt and loan assets and its direct loans to guaranteed borrowers, the FFB may either sell its own securities directly to the public or it may borrow from the Treasury. Although, according to the bank's charter, the FFB may borrow only \$15 billion from the public at any time, it may, with the Secretary's approval, borrow without limits from the Treasury. Originally, it was thought that the FFB would borrow from the Treasury on an interim basis, repaying these borrowings periodically through the sale of its own securities in the market. It was assumed that the bank's securities would pay the same low interest rates paid by the Treasury on its own obligations.

This did not turn out to be the case. In July 1974, the bank auctioned its own bills for the first time. As these issues subsequently were traded in the market, they began to trade at rates above those on Treasury securities with comparable maturities. Unhappy with this turn of events, the Treasury officials who manage the FFB's operations decided that thereafter the FFB would borrow exclusively from the Treasury.

Typically, to arrange financing for an agency, the FFB allows the agency to specify the terms of the loan with respect to amount,

TABLE 2. OUTSTANDING FFB LOANS TO GUARANTEED BORROWERS, FISCAL YEARS 1980-1982 (In billions of dollars)

Agency and Borrower	1980	1981	1982 <u>a/</u>
REA Guaranteed Loans to Rural Electric Cooperatives	8.4	12.3	16.5
DoD Guaranteed Loans for Foreign Military Sales	7.2	9.1	11.1
Department of Education Guaranteed Loans to Student Loan Marketing Association	2.3	4.3	5.3
HUD Guaranteed Loans to Low-Rent Public Housing	0.1	0.9	3.5
TVA Guaranteed Loans to Seven States Energy Corporation	0.7	0.9	1.2
Other	<u>2.8</u>	<u>3.1</u>	<u>3.9</u>
Total, Loans Outstanding	21.5	30.6	41.5

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981); and estimates based on Mid-Session Review of the Budget, July 1981.

a/ Estimates.

maturity, and payment dates. The FFB then borrows the necessary funds from the Treasury Department, paying interest rates that the Treasury would have to pay to borrow the funds in the market. The FFB then executes the loan to the agency, charging it one-eighth of a percentage point more than the rate it is paying to the Treasury.

TABLE 3. FFB HOLDINGS OF OUTSTANDING AGENCY DEBT, FISCAL YEARS 1979-1981 (In billions of dollars)

Agency	1979	1980	1981
Export-Import Bank	8.0	10.1	12.4
Tennessee Valley Authority	7.1	8.9	10.9
National Credit Union Association	--	0.1	0.1
U.S. Railway Association	0.4	0.5	0.2
Postal Service	<u>1.6</u>	<u>1.5</u>	<u>1.3</u>
Total, Debt Holdings	17.1	21.1	24.9

SOURCES: Budget of the United States Government, Fiscal Years 1981 and 1982, Special Analyses on Credit; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981).

The difference is used to cover the FFB's administrative costs and possible contingencies and to pay dividends to the Treasury. Risk is not a factor in these pricing decisions; the determining factor is the Treasury's current cost of money.

Explaining FFB's Growth

Two factors may explain why the FFB's activity levels have outstripped initial expectations. First, the bank buys everything that is offered to it. It does not exercise any discretion--as long as a security is guaranteed or sold by an agency, the FFB will buy it. This method of operating is intentional. Treasury officials maintain that the bank is merely a financing authority, not a program agency, and should, therefore, make no judgments about projects presented to it.

Second, since the FFB borrows all its funds from the Treasury, it has practically unlimited available funds. This has enabled the FFB to increase greatly the scope of its operations without having to seek Congressional approval for increases in borrowing authority. For example, at the end of fiscal year 1981, all but \$10,000 of the FFB's total holdings of \$107.3 billion of agency debt, loan assets, and direct loans to guaranteed borrowers had been financed by borrowing from the Treasury. This is over seven times what the FFB could have financed if it had been limited to its initial \$15 billion of authority to borrow from the public.

CHAPTER III. BUDGETARY TREATMENT OF FFB'S ACTIVITIES

FFB purchases of certificates of beneficial ownership (CBOs) and FFB direct loans to borrowers with federal guarantees cause the annual total of direct lending recorded in the unified budget to be understated. To understand why this occurs, it is first necessary to understand the principles governing the budgetary treatment of federal credit transactions, the first topic discussed in this chapter.

BUDGETARY TREATMENT OF FEDERAL CREDIT TRANSACTIONS: A PRIMER

Although they are all credit transactions, borrowing, lending, and guaranteeing of loans by federal agencies are treated very differently in the budget process. Borrowing, as a means of financing, does not affect either the borrowing agency's outlays or those of the budget's totals. Lending by an agency, on the other hand, is considered a federal activity, and, as such, is counted in the budget. Loan guarantees represent only contingent liabilities of the federal government, and have been defined in law as non-budgetary transactions. The following sections explain the resulting differences in the budgetary treatment of these three credit activities.

Borrowing by a Federal Agency: A Means of Financing

Some federal agencies have specific authority granted by the Congress to borrow funds, either from another agency, the Treasury, or a nonfederal lender, as a means of financing their prescribed activities. A typical sequence of transactions runs as follows: the agency sells its bond or note, recording the funds it receives from the sale as an increase in its fund balance, with a corresponding increase in its liabilities. Only when it disburses the funds for one of its program activities does the agency record outlays. When the bond or note comes due, the agency repays the lender (that is, the security holder) and records a decrease in its fund balance and a corresponding decrease in its liabilities. Thus, the agency's outlay totals, and total budget outlays as well, are unaffected by the borrowing transactions. Because the

borrowing is only a means of financing other direct federal activity, the borrowed funds are not counted as receipts, nor are the funds repaid recorded as outlays.

If the lender is another federal agency, it too records no outlays for the borrowing transaction. Instead, it records the extension of the loan as a decrease in its fund balance and an increase in its assets. When the loan is repaid, the lending agency's fund balance increases while its assets decrease. 1/

The exclusion of the flows of loan principal and repayments from agency outlays and receipts mirrors the treatment of borrowing by Treasury to finance the deficit. Treasury borrowing is not counted as receipts to the government; otherwise the budget would always be balanced. Nor are Treasury repayments on federal borrowing considered outlays. 2/ Instead, both Treasury and agency borrowing are considered a means of financing.

Lending by a Federal Agency: Program Activity

Lending by a federal agency to a nonfederal borrower constitutes program activity, rather than a means of financing. Federal agencies make loans to spur certain types of economic activity or to assist particular borrowers to undertake specific transactions. Because the loan is disbursed to an entity outside the federal budget, the disbursement of the loan principal is recorded as an outlay on the lending agency's books. When the loan is repaid, the payments of loan principal are counted as

1/ This discussion refers only to the extension and repayment of loan principal. Interest paid by a borrowing agency to a lender, whether another agency or a nonfederal entity, is recorded as an outlay. If the lender is a federal agency, it records the interest as an offsetting receipt, or negative outlay; thus, the unified budget outlay total remains unchanged. If the lender is outside the federal government, total budget outlays increase by the amount of the interest payment. In any case, these interest flows are small, compared to the flows of loan principal, and the discussion in this paper of the budgetary effects of lending and borrowing does not consider them.

2/ The sizable payments of interest on the federal debt (\$82.6 billion in 1981) are recorded as outlays in function 900.

offsetting receipts, or negative outlays. If a loan is repaid in the same year that it is extended, the agency's books show no outlay effect for the year. If the term of the loan is longer than one year, then the agency records outlays in the year in which the loan is disbursed, increasing total budget outlays as well as the agency's total outlays. In succeeding years, as principal payments are received, the agency's budget records negative outlays, and the unified budget's outlay total decreases. At the end of the loan's term, if the loan is fully repaid, the final budgetary cost to the federal government is zero.

Federal Loan Guarantees

When an agency pledges to repay the principal and interest due on a loan in the event of a default, it removes or lowers the lender's risk in making that loan. The result is an allocation of credit to the borrower by the lender, who, in the absence of the guarantee, might have denied the loan, or have offered it only at very high interest rates. Because the federal government's liability is contingent--only if the borrower defaults does the government have to repay the loan--a loan guarantee is not considered a budgetary transaction. The Congressional Budget Act of 1974 specifically excludes loan guarantees from the definition of budget authority or spending authority. The guaranteeing agency's budget total and the unified budget totals do not reflect either the extension of a guarantee when a loan is made, or its cancellation once the loan is repaid. Outlays are recorded only if, and when, the government must pay a claim on a defaulted loan.

An Anomaly: Sales of CBOs

The current budgetary treatment of the sales of certificates of beneficial ownership by the Farmers Home Administration (FmHA) and the Rural Electrification Administration (REA) is an anomaly. According to accepted budgetary principles, CBO sales should be treated in the budget as agency borrowing; special provisions of law, however, state that CBO sales are to be treated as asset sales. This special treatment does not affect the manner in which the programs operate; it does, however, greatly affect the size of the programs as they appear in the budget.

Sales of CBOs: Loan Assets or Borrowing? As noted in Chapter II, some federal lending agencies have sold loan assets--individual

notes or pools of loans, first called participation certificates and later certificates of beneficial ownership--from their loan portfolios in order to recover the loan capital without having to wait for the loans to mature and be repaid. These loan asset sales are treated in the budget as repayments--that is, by selling the loan the agency gets back its loan principal, as if the loan were repaid. Thus, an agency can make a loan during a fiscal year, which would increase its outlays, but by selling the loan (at par) in that same year, offset those outlays, resulting in net outlays of zero for the year.

An outright sale of a loan asset by a federal agency results in the transfer of the loan note to the purchaser, along with the responsibilities for servicing the loan and the risk of default. After the sale, payments of interest and principal go directly to the purchaser rather than the federal agency, which is relieved of any liability or risk.

Few, if any, federal loan assets are sold under the exacting conditions of an "outright" sale, however. Most sales take the form of participation certificates or certificates of beneficial ownership. These differ markedly from the outright sale of a loan asset. First, the selling agency fully guarantees the certificate with respect to the timely payment of principal and interest; thus, the buyer assumes no risk. Second, the loans backing a CBO or participation certificate are not transferred to the buyer, nor does the buyer assume any responsibilities for servicing the loans. These remain with the originating agency, and the borrowers make payments to the agency, which in turn makes payments to the purchaser of the CBO.

The use of the term "loan asset sales" for these transactions is, thus, a misnomer. The agencies are not selling loans; in fact, they are selling guaranteed securities that only incidentally represent a pool of loans. As such, sales of CBOs are identical to agency borrowing, not asset sales.

One of the recommendations of the President's Commission on Budget Concepts in its 1967 report was that sales of participation certificates be treated as agency borrowing. 3/ In the fiscal year

3/ The Commission's Report stated:

In one sense, the sales of shares in a pool of loans is but a short, logical step beyond the sale of the asset itself; but this is a critical step

1969 budget, many participation certificates were reclassified as agency debt. Agencies began, however, to search for means of circumventing the Commission's recommendation. They tried to develop new instruments--the sale of block notes, certificates of beneficial indebtedness, and certificates of beneficial ownership--that would be easy to use but still be treated as an asset sale. 4/ In 1973, the Congress enacted special provisions that permit the Farmers Home Administration and the Rural Electrification Administration to count the sales of certificates of beneficial ownership as asset sales. The laws simply overrode the principle established by the Commission on Budget Concepts. 5/

Consequence of Anomalous Treatment of CBOs. As a consequence of the anomalous treatment of CBO sales, the level of direct federal lending for any fiscal year is understated, as is the budget deficit. In comparison with agencies unable to take advantage of these techniques, FmHA and REA, through their CBO

The Commission is firm in its conviction, therefore, that participation certificates, regardless of their advantages or disadvantages on other scores, represent a means of financing the budget deficit rather than an offset to expenditures in determining the amount of the deficit to be financed.

See the Report of the President's Commission on Budget Concepts (Washington, D.C.: GPO, October 1967), pp. 54-55.

4/ See Congressional Budget Office, "Loan Asset Sales: Current Budgetary Treatment and Alternatives," Loan Guarantees: Current Concerns and Alternatives for Control--A Compilation of Staff Working Papers, Chapter III--Sales of Loan Assets: Controversy and Problems (January 1979).

5/ The relevant statutory language states:

Any sale . . . of notes or of beneficial ownership therein shall be treated as a sale of assets for the purpose of the Budget and Accounting Act, 1921 . . .

See Title II, Public Law 93-135 and Section 304, Rural Electrification Act of 1936, as amended by Section 2, Public Law 93-32.

sales, are able to record lower outlay totals for the same volume of new lending, because they, in effect, can transfer the outlays outside the budget to the purchasers of the CBOs. 6/

BUDGETARY TREATMENT OF FFB FINANCING

After its establishment, the FFB became the primary financing agent for agency debt, CBO sales, and fully guaranteed securities that had previously been sold in the government securities market. Although, strictly speaking, FFB financing of these federal credit activities has not changed the interactions of the transactions with the unified budget, it has increased their visibility. Thus, a growing number of policymakers are now aware of the understatement of direct lending levels resulting from the anomalous budgetary treatment of CBO sales and the conversion of loan guarantees into off-budget direct loans by the FFB.

FFB's Budgetary Status

One of the basic premises underlying the establishment of the FFB was that it should not affect the treatment in the unified budget of the activities it financed. To accomplish this, the bank was established as an off-budget entity. Section 11(c) of the Federal Financing Bank Act of 1973 states:

Nothing herein shall affect the budget status of the federal agencies selling obligations to the Bank . . . or the method of budget accounting for their transactions. The receipts and disbursements of the Bank in discharge of its functions shall not be included in the totals of the budget of the United States Government and shall be exempt from any general limitation imposed by statute on expenditures and net lending (budget outlays) of the United States.

6/ In REA's case, the Rural Electrification and Telephone Revolving Fund (RETRF) is already off-budget. So the effect of the sales of CBOs is to transfer outlays from the off-budget RETRF to the FFB.

During the hearings on the FFB proposal, Treasury Under Secretary Volcker explained:

The Federal Financing Bank is not a device to remove programs from the federal budget; nor is it a device to bring programs back into the budget. The Bank would in no way affect the existing budget treatment of federal credit programs. If a program is now financed outside of the budget, the treatment would continue. If a program is now financed in the budget, that treatment would continue. The Bank is intended to improve the financing of all federal agencies' borrowing activities, regardless of their budgetary treatment. 7/

Budgetary Consequences of FFB Activities

Agency Debt. Agency borrowing from the FFB has no impact on the unified budget totals, just as agency borrowing from any lender has no impact. The FFB functions in this case as an invisible financing agency.

Loan Asset Sales. Prior to the FFB's establishment, when FmHA or REA sold a CBO to a nonfederal investor, the special provisions of law governing the treatment of CBO sales effectively hid the transaction in an invisible "netherworld" outside the federal government instead of recording it as an agency outlay in the budget. The outlay was, in effect, absorbed by the investor purchasing the CBO.

When the FFB purchases a CBO, the effect on the unified budget remains the same. The understatement of direct lending, and of unified budget outlays that results, however, becomes more visible. Instead of the outlays being incurred by a nonfederal invisible investor, they are incurred by a more visible, but off-budget, entity of the federal government.

Direct Loans to Guaranteed Borrowers. When the FFB buys a fully guaranteed security that a nonfederal issuer would have otherwise sold in the government securities market, it in effect makes a direct loan to that nonfederal issuer. The effect on the

7/ Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 20.

unified budget remains the same--that is, the loan guarantee issued by the federal agency does not affect unified budget outlays whether the guaranteed loan is financed in the securities market or by the off-budget FFB. FFB origination of the loan, however, increases the visibility of an inconsistency in budgetary treatment: outlays are incurred by the off-budget FFB for a direct loan initiated and guaranteed by an on-budget agency.

Consider the following two examples. The Export-Import Bank (Eximbank) has the authority to borrow to finance direct loans to promote exports of American goods. Eximbank may borrow from the FFB, by selling a bond to it, and then use the funds to make a direct loan to the national airline of a foreign country to assist it to buy a U.S.-built commercial jetliner. The loan from the FFB to Eximbank is treated as a means of financing, and has no effects on the unified budget. The direct loan by Eximbank to the foreign airline, however, is recorded as an outlay in the Eximbank budget and in the unified budget totals.

Contrast that transaction to the following one. The Department of Defense issues a guarantee to the same foreign government for a loan to finance the purchase by that nation's armed forces of U.S.-made military equipment. The loan is financed by the FFB. In this case no outlays are recorded in the unified budget, although the transaction was initiated by the Defense Department. Instead, the outlays are recorded by the off-budget FFB.

The characteristics of the two transactions are identical, save in one respect. The source of the funds is the same: the FFB borrows from the Treasury which borrows in the government securities market. The action taken is a direct loan to a borrower outside the federal government. The only difference is who incurs the outlays. In the first case, they are absorbed by the on-budget Eximbank; thus, they are included in total budget outlays and the deficit. In the second case, they are absorbed by the FFB and contribute to the off-budget deficit.

Is the FFB Neutral with Respect to Budgetary Transactions?

The FFB's charter was specifically designed so that the effect on the unified budget would be the same with FFB financing of agency debt, CBO sales, and guaranteed securities as it had been when individual agencies sold these instruments in the government securities market. In fact, the FFB is not neutral in all of its budgetary transactions. It is neutral with respect to agency debt.

Strictly speaking, it is neutral with respect to CBO sales; it does, however, make more visible the understatement of direct lending that results from the anomalous budgetary treatment of CBOs sold by FmHA and REA. But it is not neutral in its handling of direct loans to guaranteed borrowers. Instead, it converts a loan guarantee into an off-budget direct loan.

CHAPTER IV. PROBLEMS POSED BY FFB-FINANCED CBO SALES AND DIRECT
LOANS TO GUARANTEED BORROWERS

The understatement of total direct lending in the unified budget that results from FFB financing of CBO sales and direct loans to guaranteed borrowers contributes to two problems involving the unified budget deficit:

- o That deficit inadequately measures the amount of direct federal activity that must be financed by government borrowing. To calculate a more precise measure, it is necessary to add the unified budget deficit and the off-budget deficit. 1/
- o Resources may be overallocated to activities that can be financed off-budget because of their apparent, though not real, costlessness, as measured by the unified budget.

The understatement of total direct lending and, thus, of the unified budget deficit stems from the budgetary treatment accorded sales of CBOs and direct loans by the FFB to guaranteed borrowers. As the analysis of this chapter shows, the existence of the FFB may also contribute to the misallocation of resources. By providing a source of unlimited credit, at just above Treasury interest rates, the bank has enabled the rapid growth of activities using its financing, and, in the absence of Congressional control, has made such growth a matter of executive discretion.

1/ The off-budget deficit is the total of outlays by the six off-budget entities: the FFB, the Rural Electrification and Telephone Revolving Fund of REA, the Rural Telephone Bank (also of REA), the Postal Service, the Regional Rail Reorganization Program of the U.S. Railway Association, and the Synthetic Fuels Corporation. In recent years, the FFB, whose outlays result from CBO sales and direct loans to guaranteed borrowers, has constituted 90 percent or more of total off-budget outlays.

UNDERSTATING THE UNIFIED BUDGET DEFICIT

As discussed in Chapter III, the net effect of the budgetary treatment of CBO sales, whether financed by the FFB or not, and of FFB direct loans to guaranteed borrowers is to transfer off-budget the outlays for some direct loans initiated by on-budget agencies. Consequently, outlay totals at agency, program, and unified budget levels are understated.

The result is that these transactions distort the interpretation of the unified budget deficit as an indicator of the amount of federal activity that must be financed by borrowing. In fiscal year 1981, for instance, the FFB's purchases of \$11.5 billion of CBOs and its direct loans of \$9.4 billion to guaranteed borrowers caused total outlays and the deficit to be understated by nearly \$21 billion (see Table 4). The reported 1981 deficit of \$57.9 billion was in fact 26.6 percent below the level of a combined unified budget deficit and FFB deficit. Between the FFB's inception in 1974 and the end of fiscal year 1981, CBO sales and direct loans to guaranteed borrowers financed through the FFB caused the actual deficit of the federal government to be understated by \$82.3 billion.

Anyone wishing to gauge the extent of the federal government's borrowing in the credit markets to finance the deficit must consider both the on- and off-budget (mostly FFB) deficits. The unified budget deficit alone is no longer an accurate measure. Nor are the unified budget deficit combined with trust funds surpluses sufficient to explain the need for increases in the debt subject to limit. ^{2/} Even if the Congress were to balance the budget, the ceiling on the debt would have to be raised to accommodate the off-budget deficit, of which FFB-financed activity is 90 percent or more each year. In fact, of the more than \$500 billion increase in the debt subject to limit between fiscal years 1974 and 1981, the FFB accounted for about 15 percent. About one in every six dollars of net new debt issued in the last seven years was for FFB activity. Thus, the utility of the unified budget deficit as an indicator of the federal government's budgetary policy has been reduced.

^{2/} Some of the trust funds included in the unified budget receive more funds during a fiscal year than they pay out. These trust fund surpluses are invested in Treasury securities. Thus, the increase in the debt subject to limit each year is equal to the deficit plus the debt financed by the trust fund surpluses plus any off-budget deficit.

TABLE 4. UNDERSTATEMENT OF THE UNIFIED BUDGET DEFICIT BY FFB FINANCING OF DIRECT LOANS, FISCAL YEARS 1974-1981, (In billions of dollars)

Fiscal Year	Reported Unified Budget Deficit	Amount by Which Budget Deficit Was Understated Because of FFB-Financed:		
		Loan Asset Sales	Direct Loans to Guaranteed Borrowers	Total FFB Credit Activity
1974	4.7	<u>a/</u>	0.1	0.1
1975	45.2	5.1	1.0	6.1
1976	66.4	4.1	1.9	6.0
TQ <u>b/</u>	13.0	2.1	0.5	2.6
1977	44.9	5.1	3.0	8.1
1978	48.8	6.8	3.9	10.7
1979	27.7	9.4	3.9	13.3
1980	59.6	9.4	6.8	14.4
1981	<u>57.9</u>	<u>11.5</u>	<u>9.4</u>	<u>21.0</u>
Total	368.2	51.7	30.5	82.3

SOURCES: Budget of the United States Government, Fiscal Years 1976-1982, Special Analyses on Credit; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981).

NOTE: Details may not add to totals because of rounding.

a/ \$50 million or less.

b/ Transition Quarter.

POSSIBLE MISALLOCATION OF RESOURCES

FFB-financed CBO sales and direct loans to guaranteed borrowers distort the setting of priorities among programs competing for limited budgetary resources because they permit agencies to undertake activities that are never charged to them, and that never show up in the agencies' budget totals. For instance, in fiscal year 1980 the Farmers Home Administration reported outlays of \$3.0 billion. Not included in that figure, however, was a net increase of \$6.9 billion in loans financed through CBO sales to the FFB. If these outlays had been charged to FmHA, its outlays would have tripled. Similarly, REA caused the FFB to make direct loans of \$2.5 billion in 1980 by guaranteeing notes issued by rural electric cooperatives. During the same year, the Defense Department issued guarantees for \$1.9 billion of FFB direct loans to foreign countries for the purchase of military equipment. Not one cent of these loans was charged to these agencies' budgets during 1980. Thus, an agency that can use FFB financing mechanisms can present budget totals that appear smaller than other programs unable to take advantage of these techniques. This offers a significant advantage in the competition for resources over both other loan programs that do not sell loan assets and all direct spending programs--particularly during an era of budget-cutting.

SOURCE OF THE PROBLEMS

To what extent are the problems of understating the budget deficit and the possible misallocation of resources caused by the budgetary treatment of CBO sales and of FFB direct loans to guaranteed borrowers, and to what extent do they result from the existence of the FFB itself?

Budgetary Treatment: Root of the Problem

The budgetary treatment of CBO sales and direct loans to guaranteed borrowers is ultimately at the root of these two problems. The provisions of law that permit FmHA and REA to treat CBO sales as loan asset sales, rather than as borrowing by the agencies, allow these two agencies to lower their outlay totals, thus understating total budget outlays as well. 3/ Prior

3/ Because the RETRF (REA's financial operating arm) is off-budget, even if CBO sales were treated as borrowing, the

to the FFB's establishment, sales of CBOs caused outlays to be understated and resource allocation to be skewed. Thus, even if the FFB were abolished, they would continue to cause these problems.

The understatement of total budget outlays that results from FFB direct loans to guaranteed borrowers is also a matter of budgetary treatment. It results from the combination of the off-budget status of the FFB and the nonbudgetary status of loan guarantees. It can be argued that this problem is really the result of the FFB's existence and that it would disappear if the FFB were abolished or put on-budget. If the FFB were put on-budget, the outlays for FFB direct loans to guaranteed borrowers would at least be included in the unified budget totals; they would not, however, be charged to the agencies that made the guarantees.

More fundamentally, however, the problem existed before the FFB was established. In the absence of the FFB, agency guarantees of securities sold in the government securities market would still cause the level of direct lending by the federal government to be understated. This would occur because the characteristics of such securities are practically identical to those of a direct loan by a federal agency to the insurer of the securities, financed by agency borrowing. The source of funds is the same: the securities market. The borrower is the same: the security issuer. The security received by the purchaser is risk-free in both cases: a fully guaranteed instrument versus a Treasury bill, note, or bond. And the assessment of risk and of the borrower's ability to repay devolves on the agency in both instances: either as the guarantor or as the lender.

The budgetary treatment of a fully guaranteed security and a direct loan financed by borrowing, however, are quite different. A direct loan by the guarantor agency is recorded as an outlay, increasing both the agency and the unified budget outlay totals.

deficit would continue to be understated. The off-budget status of the RETRF and of the other off-budget entities is contrary to the recommendations of the 1967 President's Commission on Budget Concepts. All the off-budget agencies should be returned to the unified budget to be consistent with accepted budgetary principles.

The borrowing by the agency is considered a means of financing and does not offset those outlays. Under the current budgetary treatment of a fully guaranteed security, however, the agency extending the guarantee does not record an outlay and the unified budget outlay totals remain unchanged.

Thus, the budgetary treatment of a direct loan financed by agency borrowing and of a fully guaranteed security sold in the government securities market is inconsistent. Although the practical effects are the same, the effects on the unified budget are not. Moreover, this inconsistency does not result from the violation of a budgetary principle, as in the case of FmHA and REA CBO sales; instead, it arises from the consistent application of budgetary concepts. The inconsistent budgetary treatment of these two financing methods does, however, illustrate the inadequacy of the existing concepts to deal with the variations of federal credit activities.

The FFB: Source of Unlimited Capital

Both the understatement of direct lending levels by CBO sales and fully guaranteed securities and the potential for misallocation of resources resulting from the apparent costlessness of these financing mechanisms occurred before the FFB was established. It can be argued, however, that the existence of the FFB, and the access it provides to an unlimited source of credit at near-Treasury interest rates, has facilitated the rapid rates of growth experienced since 1974 by programs using these financing techniques, and has played a role in the possible misallocation of resources. 4/

Indeed, in this period of budgetary constraints, the access afforded some agencies to abundant credit at near-Treasury rates through the FFB may have caused an overallocation of resources

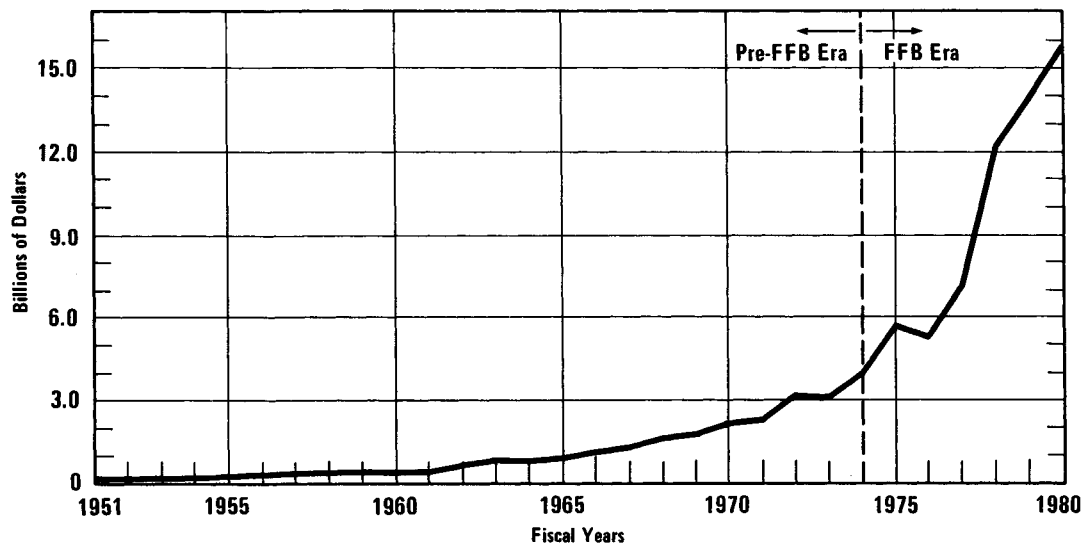
4/ As noted in Chapter II, by virtue of obtaining all its funds through borrowing from the Treasury, the FFB has effectively no limits on its activity levels during any year. Even in tight monetary conditions, the Treasury will always be able to borrow as much money as it needs. During such periods, interest rates on Treasury borrowing will rise, but compared to other rates, Treasury rates will still be less expensive. Thus, the FFB, through the Treasury, will always be able to obtain funds at good rates.

to those activities, compared to the levels of resources they would likely have received had they been forced to compete directly with all other programs. While this cannot be proved conclusively, the following examples suggest that the possibility of overallocation of resources should be considered seriously.

Farmers Home Administration Lending. The Farmers Home Administration lends directly, through three revolving funds, to farmers, small businesses, and rural communities for a wide variety of purposes. Figure 2 illustrates the levels of gross new lending in fiscal years 1951 to 1980. The level of new loans started to increase rapidly in the late 1960s and early 1970s, the period when sales of loan assets were first used extensively. New lending levels, however, exploded between fiscal years 1975 and 1980 (with the exception of 1976), right after the FFB's establishment. Between 1974 and 1980 new lending levels more than quadrupled.

Figure 2.

**New Direct Loans by the Farmers Home Administration,
Fiscal Years 1951-1980 (End of year)**



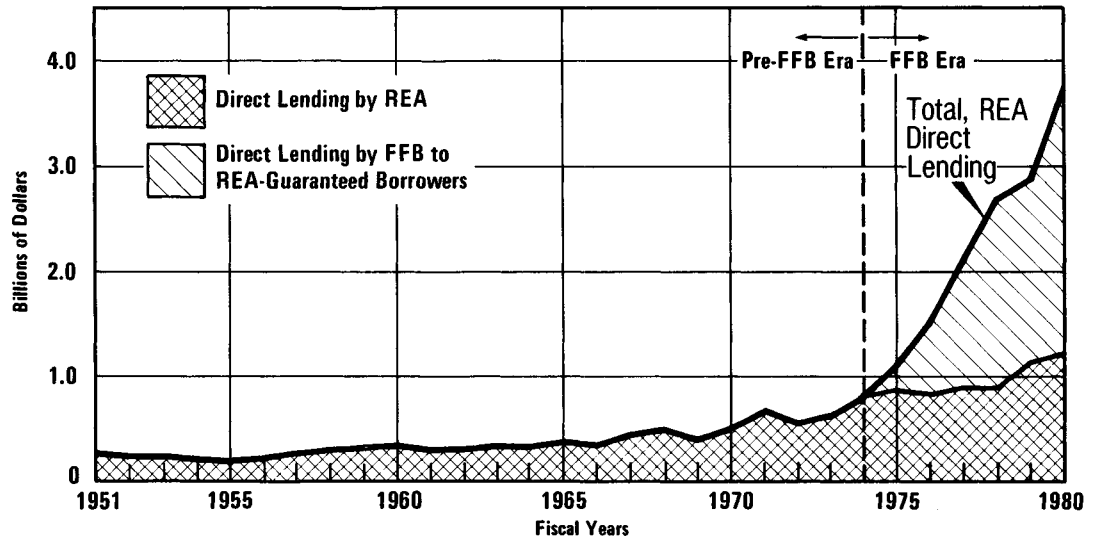
SOURCE: *Budget of the United States Government*, Fiscal Years 1952-1982, Special Analyses on Credit.

Rural Electrification Administration Lending. An even more dramatic illustration is provided by the growth in REA direct loans. As shown in Figure 3, between fiscal years 1951 and 1974,

new direct loan levels increased from about \$250 million annually to about \$850 million annually. Six years later, at the end of fiscal year 1980, new REA loans, counting both direct loans by REA and direct loans by the FFB to REA-guaranteed borrowers, totalled \$3.7 billion. Most of the growth of the FFB era occurred in the new program of FFB direct loans to guaranteed borrowers. In six years, this program went from zero to \$2.5 billion in new loans annually.

Figure 3.

**New Direct Lending by the Rural Electrification Administration,
Fiscal Years 1951-1980 (End of year)**



SOURCE: *Budget of the United States Government, Fiscal Years 1952-1982, Special Analyses on Credit.*

CHAPTER V. SOLVING THE PROBLEMS

As awareness of the problems posed by FFB financing of CBOs and guaranteed loans has increased in recent years, various proposals have been advanced to address these problems, including:

- o Changing the FFB;
- o Improving the budgetary treatment of certain federal credit activities; and
- o Restructuring the unified and credit budgets.

Of those proposals that focus on the FFB itself, one alternative would be simply to abolish the FFB. A second alternative would be to include the FFB in the unified budget and put limits on its annual activities. Other proposals address the underlying issue--the budgetary treatment of certain credit activities that is at the root of the problems. For example, the evolving credit budget could be expanded to include limits on the volume of such transactions between various agencies and the FFB. Or, more fundamentally, the budgetary treatment of the credit transactions between agencies and the FFB could be changed to reflect their true nature, namely, as borrowing by the agencies from the FFB. Finally, one proposal would be to address the problems of budgetary treatment of CBOs and fully guaranteed loans as part of a general restructuring of the unified budget, one aspect of which would be to separate all forms of credit activity into a distinct credit budget.

Each of these proposals addresses different aspects of the problems posed by the FFB financing of federal credit activities. The following questions should be asked about each alternative:

- o Does the alternative improve the utility of the budget deficit as an indicator of federal borrowing requirements?
- o Does the alternative improve the allocation of resources through the budget process?

- o Does the alternative ensure that the financing of all obligations backed by the full faith and credit of the United States government is accomplished efficiently and at the lowest possible interest rates?

Ideally, any proposal to solve the problems posed by FFB transactions would satisfy all three criteria: it would eliminate the understatement of the budget deficit; it would improve the budgetary treatment and control of credit activities, thus improving the allocation of resources; and it would facilitate the financing of all full faith and credit debt at the lowest possible interest rates. The current budgetary treatment of the FFB and its transactions satisfies only the last of these. The following sections describe the alternatives and evaluate them according to these criteria.

CHANGING THE FFB ITSELF

Two proposals would change the FFB itself. The first would simply abolish the FFB, while the second would put the FFB on budget and limit its activity levels. Neither proposal addresses the underlying issue: the budgetary treatment of CBOs and of FFB direct loans to guaranteed borrowers.

Abolishing the FFB

Removing the FFB as a source of off-budget financing for loans and loan guarantees could be accomplished by simply abolishing the bank. As a result, agencies attempting to sell loan assets and borrowers with guarantee commitments from federal agencies would be forced to turn to the private credit market and pay higher-than-Treasury rates of interest. In addition, agencies selling their own debt, under borrowing authority, would have to sell it in the market. Thus, this alternative would effectively return federal credit activities to the pre-1974 situation, before the bank's establishment.

By returning to the pre-1974 conditions, the gains in efficient financing that were achieved through the FFB, particularly those for the financing of agency debt, would be lost. This advantage could be retained by including in the legislation to abolish the FFB provisions requiring agencies with borrowing authority to sell their debt to the Treasury Department. Forcing

loan asset sales and fully guaranteed securities back into the private securities market, however, would result in higher interest rates on these obligations, because of the degradation of the market's efficiency by the entry of a large number of relatively small offerings.

Abolishing the FFB might reduce, in part, the understatement of the budget deficit that occurs through FFB financing of credit instruments outside of the unified budget. It would also eliminate the access to an unlimited source of cheap credit for qualifying agencies, and thus, the potential for overallocation of resources to these programs. Because this option would not change the underlying budgetary treatment of CBO sales and FFB direct loans to guaranteed borrowers, it would not, however, eliminate the basic problems. In particular, this solution would do nothing to reduce the impact of federal credit activities in the market.

Putting FFB On-Budget

A second proposal that addresses the FFB directly would put the FFB on-budget. Legislative proposals to amend the FFB's charter to that effect have been introduced in recent years. The most recent version, H.R. 2566, the Federal Financing Bank Act Amendments of 1981, would:

- o Include the receipts and disbursements of the FFB in the unified budget; 1/
- o Limit the extent to which the FFB could purchase obligations during any fiscal year to amounts approved in advance in appropriation acts; and

1/ Treasury officials, testifying on H.R. 2566 and its predecessor legislation, have argued that the language mandating inclusion of the bank's receipts and disbursements in the budget would require counting as outlays FFB's purchases of agency debt, which are now treated as intragovernmental transactions between agencies. This would cause double counting--once when the money is borrowed by the agency and again when it is spent. The Treasury officials suggest merely repealing the existing statutory language excluding the bank's receipts and disbursements from the budget, and then allowing normal accounting rules to determine the bank's budget authority and outlays.

- o Provide that a guarantee by a federal agency of any obligation ordinarily bought and sold in the investment securities markets should not be effective unless the obligation is held by the FFB or the guaranteeing agency.

The first provision, repeal of the FFB's statutory exclusion from the unified budget, would cause the budget authority and outlays for loan asset purchases and direct loans to guaranteed borrowers to be included in the unified budget totals. The result would be to increase the deficit. The fiscal year 1980 deficit would have increased from \$59.6 billion to \$73.9 billion under these conditions. The deficit for 1981 would have increased from \$57.9 billion to \$78.9 billion and the 1982 deficit is estimated to increase by \$16.6 billion. 2/

The second provision requires the Congress to set a ceiling on total FFB purchases for a fiscal year. Simply setting a ceiling on total FFB activities, however, would not significantly improve the ability of the Congress to allocate resources efficiently. Even if the FFB was placed on-budget as a separate entity, the initiating agencies would still not be charged with the budget authority and outlays for their FFB-financed lending. In the absence of any Congressional decisions on which of the FFB's clients should receive financing, and how much they should receive, Treasury officials would be forced either to ration credit administratively among competing claimants, or simply to allow the allocation to be determined by a "race" among the competing clients to get to the "FFB window" before all funds were exhausted for a fiscal year. Neither alternative would result in a satisfactory allocation of FFB financing.

If agencies requested more loan financing than the FFB's ceiling would allow, those agencies not able to obtain FFB-financing for direct loans might then turn to the securities market. This raises the possibility that guaranteed loan assets or fully guaranteed securities sold to investors would bear interest at rates exceeding the Treasury's borrowing rates, thus

2/ This is the OMB July Mid-Session Review estimate for 1982 FFB outlays. Putting the FFB on-budget would increase the deficit by that amount if one assumes that there would be no change in the amounts of FFB financing desired by its client agencies. It is possible that the amount of FFB financing requested would decline if that financing were recorded in the budget totals.

sacrificing the gains in financing efficiency that the FFB was established to provide. It would also mean that those agencies could continue to finance their activities outside the budget, meaning that the budget deficit would again be understated and the possible misallocation of resources would occur.

The third provision of H.R. 2566--rendering guarantees of obligations sold in the investment securities market invalid unless the obligation was held by the FFB or a federal agency--is an attempt to address this problem by closing the door to market financing for 100 percent guaranteed securities and CBO sales. If this limitation could be effected, then the integrity of the budget process and the efficiency of financing might be preserved. 3/

CHANGING THE BUDGETARY TREATMENT OF CREDIT TRANSACTIONS

Both of the preceding proposals would make only marginal improvements over the existing situation because they, in effect, would treat the symptom of the problem--the FFB--instead of the problem itself: the budgetary treatment of the underlying transactions. A second pair of proposals would focus on the transactions themselves. The first, which would use the newly established credit budget, would set annual limits on the volume of CBOs sold to the FFB and direct loans to guaranteed borrowers made by the FFB without affecting their budgetary treatment. The second would change their budgetary treatment from that for lending transactions to that governing agency borrowing.

Controlling FFB Activities Through the Credit Budget

Incorporating FFB-financed activities into the unified budget totals would be politically painful: the deficit could increase by as much as \$14 to \$20 billion if the impact was absorbed in a single fiscal year. It might be desirable to phase in the incorporation of these activities into the unified budget, either by setting a future date for its occurrence, or by incorporating one

3/ Treasury officials have expressed concerns about how it would be determined which obligations are of the type normally sold in the securities market and, thus, which would be required to be held by an agency or the FFB to continue the guarantee's effectiveness.

kind of activity in the budget one year, loan asset sales for instance, and then picking up FFB direct loans to guaranteed borrowers the next year. In any case, the Congress might wish to begin controlling the annual level of agency transactions with the FFB prior to, or instead of, incorporating them in the unified budget. This could be done, as part of the Congressional credit budget, by adding additional language to the limitations on gross new direct loan obligations or gross new loan commitments included in the appropriations for credit programs. ^{4/} The new limitations language would set ceilings not only on the amounts of new loans or new guarantees that could be extended to the public, but also on the portion of those loans or guarantees that could be financed by the FFB.

This alternative would enhance Congressional control of annual credit activity and efficient resource allocation by placing limitations on the agencies, not the FFB. The improvement in allocative efficiency would not be as complete as it could be, however, since the budget authority and outlays would still be off-budget. If the Congress devoted more attention to the effects of credit programs on outlays rather than to the levels of limitations on gross activity and on the portion of that activity financed through the FFB, agencies utilizing CBO sales and direct loans by the FFB to guaranteed borrowers could still enjoy an advantage in the competition for resources. This alternative would also maintain efficiency of financing, except if an agency could exceed the limitation on its FFB financing by going to the market to sell any loan assets or to finance guaranteed securities issued by nonfederal borrowers.

Changing the Budgetary Treatment of Loan Asset Sales and Direct Loans to Guaranteed Borrowers

As noted in Chapter III, it is misleading to consider the sale of a CBO as a sale of a loan asset for three reasons: (1) the agency does not transfer title to the loan or loans when they are sold; (2) the agency continues to service the loan or loans; and (3) the agency fully guarantees the repayment of principal and interest on the loans sold. In effect, the agency is borrowing by

^{4/} In a sense, the appropriation limitations on new lending and guarantees set on individual programs under the credit budget already set an upper bound on the amount of loans or guarantees that may be financed through the FFB.

issuing a security that is backed by the full faith and credit of the government, and that, only incidentally, represents the pool of loans. If the Congress required the sale of a CBO to be recorded as borrowing, the funds from the sales would not be treated as offsetting receipts; therefore, by selling a CBO an agency would not be able to reduce its outlays. In other words, agencies could not transfer on-budget loans to off-budget status. Agencies could sell as many CBOs to the FFB as they wished; however, the new loans represented by the CBOs would continue to be recorded as outlays in agency budgets.

The Congress could also choose to change the budgetary treatment of FFB direct loans to guaranteed borrowers. These could be redefined as direct loans by the guarantor agency and borrowing by the agency from the FFB. Instead of the agency recording a loan guarantee and the FFB recording budget authority and outlays, this alternative would record the budget authority and outlays in the agency's budget, and treat the agency-FFB transaction as borrowing, which would not affect the agency's budget totals. This treatment would accurately depict the transaction for what it is: a direct loan initiated by a federal agency.

Making these changes in the budgetary treatment of agency transactions with the FFB would satisfy all three criteria discussed on pages 33 and 34. The effect on the budget deficit would be identical to the proposal of simply putting the FFB on-budget: it would increase the budget deficit by the amount of FFB's financing of CBO sales and direct loans to guaranteed borrowers, which could be as much as \$14 to \$20 billion in any year. By recording FFB-financed lending in agency budgets, the allocation of resources through the budget process would be improved. ^{5/} The efficiency of financing would not be affected, unless agencies turned to the securities markets to finance 100 percent guaranteed securities. This loophole could be closed by prohibiting any agency from extending 100 percent guarantees for obligations to be sold in the securities market, or by rendering invalid any guarantee of an obligation of the type ordinarily sold in the securities market, as does H.R. 2566. ^{6/}

^{5/} The budget submitted by the President in January each year already attributes FFB outlays by agency and function on an information basis. These outlays still are not recorded in the agency, function, or unified budget totals, however.

^{6/} If this change in the budgetary treatment of FFB direct loans to guaranteed borrowers was implemented, it is possible that

RESTRUCTURING THE UNIFIED AND CREDIT BUDGETS

All the alternatives discussed above would make changes in the FFB or in the treatment of budgetary transactions within the existing framework of the unified budget. An entirely different approach would be to address the issues raised by the FFB and the budgetary treatment of federal credit activities as part of a general restructuring of the unified and credit budgets.

Some advocates of direct loan programs have argued that the current budgetary treatment of direct lending is inappropriate. They contend that there is a difference between an expenditure, on which there is no return to the government once the funds are disbursed, and a direct loan, on which the government can expect to receive repayments and interest in the future. ^{7/} Yet current practice treats the extension of a loan as an outlay in the year in which the funds are disbursed and the repayments in future years as negative outlays. Thus, the adherents of some direct loan programs have suggested that direct loans, which are an exchange of assets, should be removed from the unified budget and not treated in the same way as direct expenditures. Viewed over its entire term, a loan may not cost the government anything--repayments of principal and interest may exceed the government's cost of lending the funds. But recording the principal extended in the first year gives the appearance of a high "cost," proponents of this approach argue. A desire to avoid these high first-year budgetary "costs" may well have impelled lending program managers and their constituents to develop CBO sales or to push for off-budget status as a way of lowering their budget visibility. ^{8/}

there would be an increase in the volume of partial loan guarantees--those covering less than 100 percent of the principal--as agencies tried to avoid the outlay effect of the reclassified FFB loans. This pressure for additional partially guaranteed loans could be addressed through the credit budget.

^{7/} The counter to this argument is that not all direct spending activities are alike in their effects or operations, yet they are treated the same way. Advocates of the current budgetary treatment of direct spending programs note that all federal activities should be treated consistently in the budget, even if they are different in nature or purpose.

^{8/} For instance, in a report accompanying the Export Expansion Act of 1971, H. Report 92-303, 92:1 (1971), p. 4, a bill to put the

Recognizing the near impossibility of controlling new extensions of direct loans and loan guarantees through the unified budget, which includes direct loans only on a net basis and loan guarantees not at all, the Congress has experimented with a credit budget in fiscal years 1980 and 1981. Through the credit budget, the Congress can set aggregate targets and ceilings on gross commitments for new direct loans and new loan guarantees, as well as limitations on the gross activity of individual programs through the appropriation process. Whether or not a direct loan is financed by the FFB is irrelevant in the credit budget, because the controls are on gross new loan and loan guarantee commitments by agency. The FFB financing of CBO sales and direct loans to guaranteed borrowers is important only as a means of lowering or eliminating a program's outlay effect on the unified budget. By removing direct loans from the unified budget, FFB financing would no longer pose a problem.

Excluding net lending from the unified budget could enhance the status of a credit budget. It would give the Congress two deficits to work with: the unified budget deficit and a credit budget deficit, which would be made up of net direct lending and net loan guarantees extended. ^{9/} To determine the total amount of federal activity to be financed in the credit markets, the Congress

Export-Import Bank off-budget, the House Banking Committee noted:

Since the adoption of the unified budget concept, however, borrowings from the private market through issuance of the Bank's own obligations, such as debentures, are considered as borrowings and not receipts, and therefore cannot be accounted for as budget offsets. Thus, the Bank, in order to have the proceeds from such sales credited as budget receipts, has been compelled to use a complicated and costly form of asset sale (certificates of beneficial interest), which is difficult to market because it is non-negotiable and not a familiar instrument to investors. In fact, the low net budget outlays attributable to the Bank in the last 2 fiscal years were realized through this procedure.

^{9/} The credit budget used in the fiscal years 1980 and 1981 budgets does not contain a deficit based on net figures. It consists only of gross new commitments to extend credit.

would have to add the two deficits together--a situation similar to that which pertains today. The unified budget deficit alone is not a complete indicator of the government's demands on the credit markets. To it must be added the off-budget deficit and net loans guaranteed. Therefore, explicitly separating direct loans from the unified budget deficit does not create a new deficit that the Congress must worry about; instead, it simply explicates more clearly the elements that the Congress ought to be considering today.

Removing direct lending from the unified budget could either be done as part of legislation establishing the credit budget as part of the Congressional budget process, or it could be accomplished as part of a general restructuring of the budgetary process. In its 1982 budget, the Carter Administration proposed the creation of a budget concepts commission to consider various unresolved issues concerning credit budgeting. In addition to the issue of FFB financing of CBO sales and direct loans to guaranteed borrowers, such a commission could examine the adequacy of credit program administration, uniform rules and procedures for federal credit programs, and the relationship of tax-exempt financing to overall credit and tax policies. The agenda of a budget concepts commission could also be expanded beyond credit issues to consider the structure of the entire budget, including ways to simplify its presentation and improve the nature of the information it provides.

CONCLUSION

Of these approaches, the last--restructuring the unified and credit budgets--is by far the most comprehensive and ambitious. It could result in a new dual budget system for the allocation of resources. Because credit programs would have no outlay effects, except for defaults and subsidies, the question of how to treat the FFB activities would become nearly moot. This approach would also avoid the outlay impact of changing the unified budget treatment of these activities. In addition, it would enhance the visibility of the credit budget deficit, which now receives little or no attention, as compared to the unified budget deficit.

Of the four alternatives that operate within the framework of the unified budget, the two that focus on the transactions themselves are clearly superior to those that focus only on the FFB. Of these two, changing the budgetary treatment of CBO sales and FFB direct loans to guaranteed borrowers is preferable. The sizable impact on the unified budget deficit of this alternative,

however, might make it unpalatable to any Administration or Congress unless it were phased in, perhaps by implementation in a future fiscal year. Until then, controlling the transactions with the FFB through limitations in the credit budget could be an intermediate step that would assist the Congress and the Administration to come to grips with the resource allocation question without forcing them to absorb the large outlay effects immediately. This option could also be used as an intermediate step if it were decided to establish a budget concepts commission to consider the restructuring of the unified and credit budgets.

