

CBO TESTIMONY

Statement of
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before the
Task Force on Urgent
Fiscal Issues
Committee on the Budget
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NOTICE

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Mr. Chairman and Members of the Task Force, thank you for inviting the Congressional Budget Office (CBO) to participate in your examination of hidden federal liabilities arising from the government's credit and insurance commitments. As the deposit insurance disaster demonstrated, unrecognized and uncontrolled contingent liabilities can consume federal financial resources with alarming speed. Effective budgeting, therefore, requires information on the likelihood that these contingencies will become actual liabilities and on their expected size.

Beginning with the President's 1991 budget, it has become customary to refer to these hidden liabilities as a \$6 trillion problem. In my statement today, I will suggest that while the magnitude of the expected liability is large, \$6 trillion vastly overstates the claim on federal resources. I **will** also point out that early recognition and control can further reduce the cost of these commitments, and that the Congress and the Administration are taking a series of steps that could significantly reduce the chances of another Federal Savings and Loan Insurance Corporation (**FSLIC**)-type catastrophe. It would be premature to claim that the \$6.2 trillion pacman monster has been tamed, but some proposals and plans for doing so are in hand.

At the same time, I would emphasize that much remains to be done. Not all proposals will be equally effective in recognizing and controlling risk, and establishing them in a weak manner can mute the effects of strong legislation. Vigilant Congressional oversight will continue to be necessary.

HOW GREAT IS THE FEDERAL EXPOSURE TO RISK? _____

The Office of Management and Budget originally compiled a list of contingencies for which the federal government would be explicitly or implicitly liable through its credit or insurance programs, and the General Accounting Office recently updated the list (see Table 1).

Such a list represents a huge volume of financial claims that can be usefully broken up into more manageable components. Three of these components (deposit insurance, federal direct and guaranteed loans, and government-sponsored enterprises) account for nearly 75 percent of the total. The residual category, other

Table 1. Total Federal Risk Exposure from Credit and Insurance Programs, End of Year 1990
(In billions of dollars)

Program	Amount Outstanding
Deposit Insurance	\$2,815
Direct and Guaranteed Loans	851
Government-Sponsored Enterprises	856
Other Insurance	<u>1,681</u>
Total	\$6,203

Source: Congressional Budget Office based on data from the General Accounting Office.

insurance, includes a miscellany of federal liabilities: termination of private pensions, losses of civilian aircraft and maritime losses during war, overseas private investment, and flood, crop, and veterans' life insurance.

The exposure to risk from each of these sources is usually measured in terms of the total of insured values, which is the maximum dollar amount of possible loss. For example, the liability for deposit insurance is the total amount of federally insured deposits in commercial banks, thrifts, and credit unions. At \$2.8 trillion, it is easily the largest of the listed federal contingencies. No expectation exists, however, that the federal government would have to pay out such a sum because of deposit insurance. For such a calamitous event to occur, the value of assets, including cash and U.S. Treasury securities, held by all insured financial depositories would have to plummet to zero. Similar near-impossible events would be required before the federal government would be liable for the full \$6.2 trillion.

A more useful measure of federal contingent liabilities would focus on the various possible amounts of loss weighted by the probability of that loss. Such a measure, by forcing attention to the determining factors of losses, would provide guidance in controlling these potential losses and better inform budget decisions about the realistic expectations of loss. In general, expected losses for federal insurance and credit depend on the likelihood of the insured event, the coinsurance or deductible amount, the probability of timely action by the government, the value of collateral available to the federal government for recovering losses, and the

insurance premium or fee collected. The government's expected losses go up with the likelihood of the insured event and down with increases in the deductible, collateral values, probability of timely intervention, and level of insurance premiums.

Unfortunately, attempts to calculate such expected losses are just beginning for many federal programs, so it is not possible to offer a precise estimate of the realistic exposure of the federal government. The expected value under current policy, however, is a small fraction of the indicated \$6 trillion. Substantial portions of the expected amount are already being recognized and controlled in deposit insurance, federal direct loans and guaranteed loans, and government-sponsored enterprises.

DEPOSIT INSURANCE

Federal losses occur when insured banks, savings associations, and credit unions become insolvent and are unable to pay off their depositors with their own resources. Insolvencies arise when the value of assets held by the insured depository drops below the value of the depository's liabilities. The likelihood of insolvency increases with the riskiness or volatility in value of assets the insured institution holds and decreases with the value of the owners' investment in the firm.

The value of the owners' stake or equity is also the amount of the deductible for deposit insurance because the owners lose all of their investment before the federal government incurs any loss. The value of assets held by the insured insolvent institution serves as collateral, which reverts to the federal government in the case of a payoff of depositors. Sale of these collateral assets offsets some of the federal cost from honoring commitments on deposit insurance. In addition, the premiums collected from insured institutions further reduce the loss from deposit insurance. For most years, collections of premiums have exceeded the cost of deposit insurance.

Today, of **course**, the cost of deposit insurance is not a mere contingency but an actual and continuing drain on federal financial resources. In CBO's August report on the budget and the economy, we projected that outlays for losses by the Resolution Trust Corporation, the **FSLIC** Resolution Fund, and the Bank Insurance Fund would exceed \$220 billion between 1991 and 1996. These outlays can be anticipated for insolvencies that have already occurred or can be foreseen. In a sense, therefore, such costs are no longer hidden but are now being recognized.

Recognizing these costs has spurred efforts to control them. For institutions that are already insolvent and in **conservatorship**, little can be done to control costs other than to close the institutions quickly. Otherwise, these losses simply must be paid. Prompt intervention can reduce costs not yet incurred, however, especially by controlling risk-taking by insured depositories as their equity capital declines toward

zero. One CBO study suggests, for example, that simply closing institutions when they become insolvent could have cut the federal cost of S&L failures in **half**.¹

CBO has also identified longer-term approaches to controlling the cost of deposit insurance, including earlier recognition of insurance losses in the **budget**.² Recognizing losses could also be used to trigger equal and offsetting increases in deposit insurance premiums. Such adjustments in premiums would be especially helpful in minimizing the cost of deposit insurance if individual bank and thrift premiums varied directly with the risk of loss to the insurance fund.

Some legislation now before the Congress would require early intervention by the regulators, establish risk-based insurance premiums, and, in the case of the credit union insurance fund, create an automatic link between the condition of the insurance fund and the level of insurance premiums.

1. Congressional Budget Office, "**The** Cost of Forbearance During the Thrift Crisis," Staff Memorandum (June 1991).

2. Congressional Budget Office, **Budgetary** Treatment of Deposit Insurance: A Framework for Reform (May 1991).

FEDERAL DIRECT AND GUARANTEED LOANS

Before the Credit Reform Act of 1990, federal direct and guaranteed loans were treated in the budget on a cash basis. For direct loans, funds advanced were scored dollar for dollar as outlays, whereas loan guarantees were recognized as costly only when defaults occurred and federal payments were made. In neither case did the budget recognize expected losses when the loans were made. In that sense, federal exposure to risk on these loans and guarantees was a hidden liability. Nor did the credit budget subject this liability to much control. Instead, the **credit** budget attempted to set ceilings on the gross amount of new loan obligations and guarantee commitments, without explicitly referring to the variations in costs among specific programs.

The Credit Reform Act, however, adopted procedures for recognizing and controlling the expected cost of new direct and guaranteed loans when these costs are still subject to **control**.³ Under the act, budget authority recognizes the estimated loss when the obligation or commitment is issued and budget outlays do so when the loan is disbursed rather than when the default occurs.

For 1992, CBO estimates that the projected \$9.1 billion in direct loan obligations will entail a federal loss of \$2.2 billion and that the projected **\$179** billion

3. Congressional Budget Office, "An Explanation of the Budgetary Changes Under Credit Reform," Staff Memorandum (April 1991).

in new guarantee commitments will cost an additional \$2.7 billion, for a total of \$4.9 billion. For discretionary credit programs, the requisite amount of budget authority will have to be provided before the agency can extend assisted credit. For mandatory programs, the use of budget authority in an amount sufficient to cover cost will be scored as the obligations and commitments are issued.

More timely recognition has encouraged more effective control. Up-front recognition of the cost of credit programs appears to have succeeded in piquing greater interest in the factors that affect expected losses. At least for new credit program proposals, CBO has observed instances in which subsidy costs have been lowered through such means as lower loan-to-collateral ratios, increased equity participation by the owners of benefitted projects, larger deductibles for guaranteed lenders, and higher insurance fees.

GOVERNMENT-SPONSORED ENTERPRISES

Government-Sponsored Enterprises (GSEs) are privately owned, federally sponsored financial entities created to mediate between the capital markets and targeted borrowers. They perform this function by issuing securities such as bonds and mortgage-backed securities in highly organized financial markets. They then use the proceeds to make loans to or purchase assets from lenders. The federal exposure to risk arises from the market perception that because the government created

GSEs, afforded GSEs lines of credit at the U.S. Treasury, and exempted them from the investor protection laws, securities issued by GSEs are implicitly guaranteed. Federal assistance to the financially distressed Farm Credit System in 1987 reinforced this perception.

Factors affecting expected losses from this guarantee are quite similar to those governing expected losses from deposit insurance. Federal losses could occur if the value of a sponsored enterprise's assets fell below the value of its liabilities. In that case, the federal loss could be the difference between the value of the GSE's assets that could be realized and the amount owed.

Although there are no active Congressional proposals to recognize expected costs of the GSE contingency in the budget, both Houses are considering legislation to increase federal control of this exposure to risk. The strategy to improve control consists of three steps: establish a regulatory structure to oversee and assure that the riskiness of GSE operations is no greater than the Congress intends; force the regulators to intervene promptly; and require that owners bear an acceptable share of risk through their equity **investment**.⁴

4. Congressional Budget Office, Controlling the Risks of Government-Sponsored Enterprises (April 1991).

OTHER INSURANCE

The other insurance category includes such disparate programs as insurance for pension termination, insurance against the expropriation of U.S. investments abroad, veterans' life insurance, maritime and civilian aircraft war insurance, and crop and flood insurance. Pension termination insurance provided by the Pension Benefit Guaranty Corporation (PBGC) accounts for over half of the total dollar value this category insures.

The PBGC ensures that workers receive certain retirement benefits promised by their employer, even if their pension plan is terminated with insufficient assets to pay these benefits. The corporation now guarantees private pension plans whose liabilities exceed \$900 billion. In total, these plans hold assets that exceed their liabilities. In fact, many plans have significantly more assets than would be required to pay promised benefits if the plans were terminated today.

PBGC's exposure to risk, **however**, is concentrated in plans sponsored by financially troubled companies that are now underfunded, or whose current assets are less than their current liabilities. In these plans, underfunding is estimated to total roughly \$10 billion. Any amounts that the PBGC could obtain from the sponsors of plans that are actually terminated with insufficient funds would reduce the amount of PBGC's net liability. At present, PBGC has an accumulated shortfall in funding of about \$2 billion from terminations that have already occurred. Like

many other federal insurance programs, PBGC charges a fee for this coverage. Premiums charged to covered plans have been increased significantly since the program was created in 1974, and in recent years the premium has been partially based on the risk the plan represents to the PBGC. The federal exposure to risk could be further controlled by increasing incentives for the plans' sponsors to fully fund their pension plans, to improve the correspondence between plan risks and PBGC insurance premiums paid, and to give PBGC a priority claim when a plan's sponsor is in bankruptcy.

The remaining, relatively small programs that make up the other category are a mixed assortment: the risk of losses **from** wars and foreign seizure of U.S. properties is extraordinarily difficult to assess; flood and veterans' life insurance appear to be self-supporting from fee income, though crop insurance depends on general fund support.

In all cases, however, the dollar value of the maximum liability substantially overstates expected federal losses in the program. To arrive at a more realistic expected value, one must examine the nature of risk insured and the factors that ultimately determine the federal loss. Simply looking at the total exposure to risk can be misleading about the size of the problem. Moreover, it can divert efforts from program reforms to ineffective attempts at placing limits on the gross amount of contingent liability.

CONCLUSION

Several years ago, it was correct to say that the U.S. government had a large, unrecognized, and uncontrolled contingent exposure to risk from its credit and insurance programs. Today, such a statement would be less accurate. The **FSLIC** financial disaster, directly and indirectly, has led to a series of steps to recognize and bring many of these contingencies under increased control. It is too early to declare victory, but credit reform and some legislative proposals designed to reduce the expected cost of deposit insurance and **GSEs--if carried out--could** reduce the chances of a replay of recent experience with these contingencies.