

CBO TESTIMONY

Statement of
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before the
Task Force on Urgent
Fiscal Issues
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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 to comment on the sale of federal loans through asset-backed securities. In my **statement**, I will discuss the current method of valuing federal loans, which differs from private valuation, and then raise the issue of the desirability of loan asset sales for the federal **government**.

THE VALUE OF FEDERAL LOAN ASSETS

For budgetary purposes, federal loans that originated after fiscal 1991 are valued using the rate on U.S. Treasury securities of comparable maturity. For example, if the government expects to receive a single loan repayment of \$100 one year from now, and if the **12-month** Treasury rate is **6 percent**, the loan is valued at \$94.34, which is the present value of \$100 discounted by **6 percent**.

Financial markets use interest rates that are higher than Treasury borrowing rates to value uncertain repayments. For example, if market participants also **expect--but** with some **uncertainty--a** single repayment of \$100 one year from **now**, and if the rate of interest on assets of similar uncertainty is 8 percent, the market

will value the loan at only \$92.59, or \$1.75 less than the federal **government's** valuation.

These values differ because, under current practice, the government uses a risk-free rate of interest to value income whose receipt is uncertain. By contrast, financial markets discount uncertain promises of income more heavily than riskless amounts, reflecting the aversion of investors to risk. Thus, even when the government and market participants have the same expectations about repayments, loan sales appear to impose additional losses on the federal government.

The desire to avoid such losses may constitute an institutional barrier to sales of loan assets. This desire to avoid loss is reinforced by the restructuring of accounts under credit reform, and by Gramm-Rudman restrictions on counting the proceeds of such sales as deficit reduction. Whether these obstacles ought to be in place depends on whether sales of loan assets can be useful to the federal government.

ARE SALES OF LOAN ASSETS BENEFICIAL TO THE GOVERNMENT?

In at least one case, sales of loan assets clearly do not serve the interests of taxpayers or the government. That

case is when the sale is not really a sale, but rather a high-cost **form** of borrowing. One example is securitized sales in which, to obtain the highest possible price, the asset-backed securities are structured to be as safe as **U.S.** Treasury debt. To do **this**, however, the government must retain all the risk on the underlying loans. Thus, the government ends up with as much risk as before the "sale," but pays about one percentage point higher interest on the asset-backed securities than it was paying on Treasury debt.

Where a genuine transfer of risk from the government to investors occurs, the desirability of securitized sales is more ambiguous and must be analyzed case by case. One common mistake, however, is to assume that because sales of loan assets have proved to be a low-cost source of financing for private firms, they are also the lowest-cost option for the federal government. In fact, no financing instrument available to the federal government is less costly than borrowing by issuing general obligation Treasury debt.