

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Subcommittee on Legislation and National Security
Committee on Government Operations
U.S. House of Representatives

September 26, 1986

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Friday, September 26, 1986.

Mr. Chairman, I am pleased to have the opportunity to discuss the budgetary treatment of loan asset sales.

Section 11004 of the House-passed Omnibus Budget Reconciliation Act of 1986 (H.R. 5300) provides that any sale of loan assets, whether with or without recourse, shall be treated as a sale of assets and counted as offsetting collections which reduce the federal deficit for purposes of the budget estimates required by the Balanced Budget Act. The Congressional Budget Office believes that only sales of loan assets without recourse should be counted as offsetting collections, and that sales of loan assets with recourse should be treated as borrowing in the federal budget. My statement this morning will cover the reasoning behind our position.

SALES OF LOAN ASSETS

The sale of federal loan assets with complete recourse to the government, or with a 100 percent federal guarantee, is a form of borrowing because the government has retained all of the risks involved in the loans. In effect, the government has taken on an obligation to make good on any losses realized by the investor because of defaults or late payments. If loan assets were removed from the books of the federal government by such "sales," the government would be left with unrecognized, but potentially sizable liabilities.

From the investors point of view, the purchase of loan assets with recourse would be the equivalent to the purchase of Treasury securities.

Aside from the fact that they would be less liquid, they would be as good as Treasury securities because the investor assumes no credit risk. Accordingly, CBO believes that the sale of loan assets with recourse should be treated as a form of borrowing.

In contrast, loan asset sales that are final and without any recourse to the government entail only an exchange of one asset--cash--for another--loans. The investor is entitled only to the stream of payments on the purchased assets, and is without further claim on the federal government. All of the risk inherent in the assets has been transferred from the government to the investor. The proceeds of such sales are equivalent to early repayment of principal and would be counted as offsetting collections under current unified budget accounting practices.

This budgetary treatment of loan asset sales is similar to related rulings of the Financial Standards Accounting Board (FASB) and the Federal Financial Institutions Examination Council (FFIEC). In FASB'S Statement No. 77 (December 1983), the Board ruled that a transfer of assets with recourse can be recognized as a sale only under certain conditions, including the condition that the seller's obligation under the recourse provisions can be reasonably estimated. Otherwise, the sale of assets with recourse should be treated as borrowing.

The Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (acting as the Federal Financial Institutions Examination Council) have taken a more restrictive position.

The FFIEC requires the financial institutions they supervise to treat all loan sales as debt obligations even if the seller's risk of loss is limited to some fixed percentage of the value of the assets sold.

The FFIEC takes this more restrictive position because it doubts that reasonable estimates of expected loss can be made for most loans, including commercial loans, construction loans, international loans, or loans to financial institutions. Based on information available to us, CBO believes it would be just as difficult to reasonably estimate the expected loss on the federal government's loan portfolio. This leads us to adopt the FFIEC rule rather than the FASB rule for government loan asset sales. In addition, it seems to us appropriate that the government should apply the same accounting standards to itself that it applies to institutions it regulates.

The FFIEC rule for loan asset sales with recourse recognizes an exception only if the risk retained by the seller is limited to some fixed percentage of losses that might be incurred. In such cases, there is risk sharing between the seller and the buyer, and a portion of the proceeds can be treated as a sale. The maximum amount of possible loss, on the other hand, is to be treated as borrowing.

BUDGET SCORING

If section 11004 of H.R. 5300 is retained in the final reconciliation bill and becomes law, we will have no option but to count loan asset sales with

recourse as offsetting collections which have the effect of reducing the deficit. We believe that this outcome, however, would represent a step backward in good budgeting and would set a dangerous precedent for dictating accounting practices in legislation. If the deficit were to be reduced by statutory accounting requirements rather than by substantive policy changes, the integrity of the budget would be undermined and its usefulness to the Congress and to the public would be reduced.