Statement of
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before the
Legislation and National Security Subcommittee
of the
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NOTICE

This statement is not available for public release until it is delivered at 2:00 p.m. (EDT), on Monday, May 4, 1987.

Mr. Chairman, I am pleased to have the opportunity today to discuss the Administration's proposed sale of federal loan assets. I will make three points in my statement:

- First, loan asset sales are simply asset exchanges and should not reduce a properly defined federal deficit;

- Second, no public policy justification exists for selling federal loans with recourse or any other form of federal guarantee; and

- Third, nonrecourse loan asset sales can be useful in validating estimates for subsidy costs and in improving the management of federal credit programs.

LOAN ASSET SALES AND THE FEDERAL DEFICIT

Loan asset sales do not improve the government's financial position. By selling loans today, the government is merely shifting future loan re-payments to the present. Any acceleration of inflows is temporary and is offset by the decline in receipts in subsequent years. For example, if the President's loan asset sale were adopted exactly as proposed, federal credit inflows would increase during the 1987-1990 period but would decrease compared with the baseline from 1991 onward. The overall impact on the future cash deficit is negligible because the government's reduced interest payments approximately offset the government's loss of future receipts.

Hence, the short-term improvement in the deficit from loan sales is illusory. If the government sells a loan for its full current value in cash, the government has not improved its financial condition one iota. It has merely exchanged one asset (a claim on future cash flows) for another (cash now). While this transaction would reduce the deficit under cash basis accounting, this treatment does not accurately reflect the effect on the government's financial condition. This failure of the current system is one reason the Congressional Budget Office (CBO) believes the budgetary treatment of federal credit activity needs reform. On March 10, I had an opportunity to present our views on credit reform to the House Committee on Small Business and I have attached a copy of that statement to my testimony today.

THE PUBLIC POLICY OF LOAN SALES WITH RECOURSE

Selling loans with recourse will not contribute to any recognized goal of public policy but will raise the cost of financing the government. Recourse loan sales neither reduce the federal deficit, nor reveal the subsidy cost of federal loans, nor improve the management of credit programs. Instead, they constitute a high cost form of borrowing. Thus, selling federal loans with recourse is both pointless and costly.

Selling loans, enhanced with investor recourse to the federal government, is a form of federal borrowing. Cash is being obtained today in exchange for cash later. But the cost of borrowing from the future through loan asset sales is always higher than the cost of borrowing through the sale of U.S. Treasury securities, even if the loans are backed by a 100 percent federal guarantee of interest and principal. The cost is higher because these loans will be traded in markets less liquid than those for U.S. Treasury securities. Financing federal outlays with loan asset sales is inefficient compared with the readily available alternative of issuing Treasury debt.

Loan sales can perform useful budgetary and management functions but only if the market price of the loans reflects their expected return and risk. If the government provides investors with a partial or complete guarantee against loss, the market price of the loan will also include the value of the federal guarantee. Disentangling the value of the guarantee from the value of the loan will be as difficult as it would have been to value the loan without selling it. Selling loans with guarantees frustrates the budgetary objective of loan sales.

In addition, if the government guarantees the loans it sells, investors will not need to evaluate the loans and price them accordingly. Rather, investors will need only to evaluate the federal guarantee. This shift of focus will relieve federal agencies of the market discipline that would have compelled them to improve their loan documentation and underwriting standards.

In short, we are unable to discern any justification for selling federal loan assets with federal guarantees.

BUDGETARY AND ADMINISTRATIVE COSTS AND BENEFITS OF NONRECOURSE LOAN SALES.

It is more difficult to determine whether the government should engage in nonrecourse loan sales than to decide that it should not sell them with guarantees. Whereas sales with recourse have costs but no benefits, nonrecourse sales have benefits as well as costs. The task of evaluating nonrecourse loan sales has been muddied further by a host of misplaced objections to the proposal.

Benefits

The original and principal justification for federal loan asset sales is to enable the government to validate its method of measuring the cost of subsidies. The estimation methods currently in use attempt to determine the market prices that would be observed if various federally originated credit contracts were traded in competitive markets. But if these estimates are to be used in budget decisions, they must be credible. One direct means of evaluating these estimates is to sell loans and to create secondary (or resale) markets where prices can be directly observed.

For this policy to succeed, the loans must be sold without recourse but with all the grace and forbearance to which borrowers are entitled written into the loan contract. To assure trading in a variety of federal credit instruments, a substantial quantity of loans should be sold from as many credit programs as possible. Similarly, in order to obtain market valuations of all types of federally originated loans, the decision to sell loans should not be made on the basis of whether the loans are especially high or low in quality, or whether the program is well or poorly managed. Ideally, to use market prices for government valuation, a large but random sample of loans from all programs should be sold, with the possible exception of some specific instances that I will identify.

The Administration has emphasized another benefit--namely, that sales may force agencies to adopt improved underwriting and documentation practices. For example, to comply with SEC registration requirements--which would be necessary for secondary market trading--agencies would be required to collect and disclose accurate information about these loans including: terms of repayment, collateral, delinquency and loss experience, date of origination, remaining life of loan, loan principal as a percent of the value of collateral, and prepayment experience. This is information which the government ought to have whether or not these loans are sold but which is often unavailable now.

Costs

Nonrecourse loan sales also have disadvantages and costs that need to be recognized in deciding whether loan sales are desirable on balance. For example, if markets are to value federally originated loans, a substantial amount of information about the loans and borrowers will have to be collected and communicated to investors. Transmitting large amounts of detailed information is costly. Means exist for minimizing these costs, such as creating loan pools and issuing different classes of securities that require only a relatively small number of investors to evaluate all risks. These costs can be substantial, though, and they will reduce the net proceeds of the sale.

A second difficulty is raised by the possibility that net cash-flows from some loans may be higher if they are held by the government rather than by private investors. This may be the case where the federal government has access to and is willing to use collection agencies, such as the Internal Revenue Service and the Department of Justice, that are unavailable to private firms. In cases where a higher rate of cash flow can be demonstrated with government ownership, the loans should be retained rather than sold.

A third difficulty with nonrecourse loan sales is the high cost of contracting that may be incurred by efforts to write current policy forbearance and leniency into the loan or loan sale contracts. That is, from a budgetary perspective, the terms on federally originated loans should be unaffected by their sale. To assure this result, it will be necessary to draw detailed--and perhaps nonstandard--contracts. The cost of doing so will reduce the net proceeds of the sale.

Other Arguments Against Nonrecourse Sales

Although a policy of nonrecourse loan sales has its real disadvantages and costs, many arguments that have been offered publicly against such sales will not endure close inspection. For example, some analysts have dismissed loan asset sales with the assertion that markets do not exist for loans that private lenders would not originate. This is not true. Most investors do not originate loans. If federally originated loans are sold into pools and converted into securities representing an interest in the pool, loans can be sold to investors who otherwise would not have had an opportunity to make or purchase the loans.

Second, critics of nonrecourse loan asset sales have argued that markets will systematically and persistently underestimate the value of federal loan assets. But they have not shown why this undervaluation is unique to federal loan assets. The mere fact of federal origination is not sufficient to explain undervaluation. Some observers have suggested that undervaluation of federal assets might be caused by poor documentation, lack of market familiarity, and high levels of risk. Given time and effort, however, loan documentation can be improved; given information, markets can learn to assess unusual levels of risk.

Third, some analysts have suggested that it is pointless to sell existing loans if the object is to determine the subsidy cost of newly obligated loans. But if the terms on existing loans are representative of the terms on new loans, the subsidy cost of new loans can be determined from the prices of old loans. This is one of the reasons why it is important from a budgetary perspective to develop secondary markets for federal loan assets.

In sum, nonrecourse loan sales may have net positive benefits for federal budgeting and credit management. Loan asset sales, however, should not reduce the federal deficit if it is properly measured, and no purpose is served by selling loans with a continuing federal liability.