

Statement of
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before the
Committee on Small Business
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 9:00 a.m. (EST), on Tuesday, March 10, 1987.

Mr. Chairman, I am pleased to have the opportunity today to discuss the Administration's proposals for credit reform and pilot loan sales. I will make three points in my statement.

First, the current budgetary treatment of federal loans and guarantees is **deficient** and needs to be improved.

Second, the Administration's credit reform plan would substantially improve the treatment of new credit activity by **substituting** the subsidy cost of credit for the cash flows now shown in agency accounts. The Congressional Budget Office (CBO) believes, however, that credit reform should be carried one step further to correct the distortion in the deficit, as well as in the agency accounts, that results from all credit cash flows.

Third, the characteristics of the Small Business Administration (SBA) loan assets proposed for sale are such that they illustrate many of the advantages and difficulties of loan sales. On balance, these considerations suggest that SBA loans might be sold, without federal guarantees, in a manner that would not harm taxpayers or borrowers. The proceeds of these sales, however, should not be treated as deficit reduction.

SHORTCOMINGS OF CURRENT BUDGETARY TREATMENT OF CREDIT

As discussed in **CBO's** 1987 Annual Report and its Analysis of the President's Budgetary Proposals for Fiscal Year 1988, the current budgetary treatment

of federal credit activities gives a misleading picture of program costs and can distort the federal deficit. These difficulties arise because cash-based accounting, designed to capture the cost of spending programs, is ill-suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

Under current cash-based accounting, when a loan by the federal government is disbursed to a borrower, the full amount is scored as outlays (increasing the deficit) just as if the loan were a grant. This treatment overstates the true cost of the loan because it ignores the repayments that the federal government expects to receive in the future. On the other hand, repayments are scored as offsetting collections (reducing the deficit) when received. As a consequence of netting disbursements and repayments, if repayments from old loans equal new disbursements, credit agencies may show net lending of zero in a year in which a large volume of deeply subsidized loans were originated.

Similarly, loan guarantees do not count as outlays until a default occurs. The substantial delay between commitment and outlays for guarantees results in an understatement of the costs of new guarantees, and the budget deficit, in the year in which the government commits itself to this liability. Treating guarantees on a cash basis requires that the current-year budget accounts show current-year guarantee fees as offsetting collections in the year received; they also show current disbursements to honor old guarantees.

A GENERAL SOLUTION

This present treatment of federal credit programs fails to produce useful information because current-year cash flow is an inappropriate measure of the cost of new direct loans and guarantees. Cash **flows** are **often** incidental to and separated by time from the delivery of the subsidy. Instead, it would be more informative if the budget included a grant-equivalent measure of the costs of all current-period loan obligations and guarantee commitments entered into in that year. The best such measure is subsidy **cost**--or the present value of future defaults, interest losses, capital costs, and administrative expense. Specifically, outlays would more closely approximate long-run cost and the deficit would not be distorted by incidental monetary flows associated with credit if current period outlays:

- o Included the subsidy cost of new direct loans and new guarantees; but
- o Excluded new loan disbursements, repayments from old and new loans, receipts from the sale of loans, and disbursements to meet guarantee commitments.

This observation **is** not new. The President's Commission on Budget Concepts recommended in 1967, for example, that only the subsidy elements in **federal** loans be included in the expenditure portion of the budget.

THE ADMINISTRATION'S PROPOSAL

By including the subsidy costs of new transactions in the agency accounts, the Administration's credit reform proposal takes a major step toward improving the budgetary treatment of credit programs. Credit subsidy costs of new credit activity would be reported in the agency budget accounts, and the associated cash **flows for** new loans and guarantees would be included in the account of a new revolving fund in the Treasury. Agencies operating federal credit programs would request annual appropriations equal to the amount of subsidy to be provided to borrowers during the fiscal year. As loans are originated and guarantee commitments issued, agencies would use these appropriations to pay the estimated subsidy value of those credits to the central revolving fund. The central fund would then disburse loans and make guarantee payments. It would finance these outlays with subsidy payments from the agencies, repayments, recoveries, loan sales, and with borrowing from Treasury.

Subsidy cost is defined as the additional payments a borrower would have had to make for a fully private, rather than a government-assisted, loan. The size of the subsidy can be estimated either by sampling market interest rates and performing the calculations or, more directly, by making and then selling loans, and by reinsuring guarantees with private insurers. The subsidy cost is the government's loss on the transaction: for loans, it is the amount advanced less the sale price; for guarantees, the insurance fee paid to the insurer less the fee collected by government from the borrower.

The Administration proposes that subsidy cost estimates could be obtained both by calculation and by sales and reinsurance. Loans that could be readily sold would be marketed to investors. Where private credit insurance is available, the government would reinsure its risk. In the case of loans regarded as unsuitable for sale, such as those to foreign countries and for uninsurable guarantees, the central fund would calculate the subsidy and charge the agencies that amount.

A serious misconception exists among some critics of the plan who assert that market transactions will always overstate true subsidy costs because private financial firms have higher costs than the federal government. These higher costs are attributed to federal taxes paid by private firms and a higher cost of money.

It is doubtful that government costs are lower than private costs in any economically or socially meaningful sense. To have the government hold loans because it is exempt from federal taxation is a false economy. Government is the recipient of these higher costs. The higher cost of borrowed money for private firms is also irrelevant to the pricing of financial assets. Private financial firms, for example, whose cost of money is higher than the government's, purchase billions of dollars of U.S. Treasury securities that yield only "the **government's** cost of money." It is important to recognize also that the use of capital has a cost no matter who is using it. Finally, government, like all other entities, must use a risk-adjusted interest rate to discount risky income streams. In sum, I am unaware of any

evidence that market prices for federally-originated financial instruments would be consistently biased because private costs are higher than the government's cost.

SHORTCOMINGS OF THE ADMINISTRATION'S PROPOSAL

While it is a step in the right direction, the Administration's proposal does not go far enough in reforming the budgetary treatment of credit transactions. There are two shortcomings:

- o The proceeds from sales of old loans will still be scored as short-run deficit reductions even after credit reform. The Administration's proposal for loan asset sales from the existing loan portfolio is projected to reduce the deficit by more than \$5 billion in 1988. The proceeds from such transactions result in deficit reduction because they represent accelerated loan repayments that will be scored as offsetting collections. Under the logic of their own proposal, however, the budget deficit should not be affected by the receipt of repayments already expected or induced prepayments of existing loans.
- o The Administration's plan would also permit short-run deficit reductions to be achieved by new credit initiatives which convert direct loans into guarantees and/or refinance existing loans with federally guaranteed private loans. For example, if a direct loan were to be replaced by an equally subsidized loan guarantee, the

true deficit would not be reduced, but the present cash-based deficit would still be reduced by the switch in the form of credit assistance. Similarly, refinancings of existing loans with federally guaranteed private borrowing would still result in a short-run deficit reduction even though a new subsidy cost is charged.

AN ADDITIONAL REFORM STEP

One way to immunize budget outlays and the deficit from the distorting effects of repayments, existing guarantee disbursements, asset sales, and switches ~~from~~ direct loans to guarantees would be to include subsidy cost in the agency accounts, as the Administration has proposed, and make the further reforms proposed above.

The consequences of such a change for the budget deficit are illustrated in Table 1, which uses data from the President's proposed budget for 1988. For example, the first line of the table shows the current cash-based deficit of \$212.3 billion in 1985. Then, it adds subsidy cost of \$16.3 billion, which is the objective of credit reform. Next, net loan disbursements of \$32.5 billion, which inappropriately increase budget outlays and the deficit, are subtracted. Similarly, loan sale receipts of \$1.5 billion are added to the deficit because they have been used to reduce ~~inappro-~~riately the cash-based deficit. In our view, the adjusted deficit of \$197.6 billion is a more meaningful measure of the changes in the financial condition of the government.

The difference between the Administration and CBO proposals is that, whereas the Administration would substitute subsidy cost for cash flows in the agency accounts, it would not permit this substitution to affect total outlays and the deficit. The CBO proposal is an "additional step" in that it extends this substitution to the entire budget. In order to dispel the incorrect notion that this change somehow moves federal credit off-budget, the recommended budget structure that incorporates this change again for the 1985-1988 period is shown in Table 2.

TABLE 1. EFFECT ON THE DEFICIT OF SUBSTITUTING **SUBSIDY COST** FOR CREDIT CASH FLOWS, 1985-1986 ACTUALS, AND THE **PRESIDENT'S PROJECTED** AND PROPOSED BUDGETS, 1987-1988 (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Cash-Based Deficit	212.3	220.7	173.2	107.8
Credit subsidy cost	16.3	16.9	15.0	12.7
Less: loan disbursements (including outlays for guarantees, net of repayments, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Plus: loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Deficit	197.6	224.0	179.2	116.5

SOURCE: Congressional Budget Office; Office of Management and Budget.

NOTE: Excludes Commodity Credit Corporation price support loans from credit; also excludes subsidy cost for **GNMA** secondary guarantees. Details may not add to totals because of rounding.

The credit revolving fund shown in the next to last line is the fund proposed in the Administration plan, but here includes credit cash flows from old as well as new loans and guarantees. The total financing requirement and borrowing from the public is not affected by this accounting modification. This is a sensible result inasmuch as no real change in activity results from a mere accounting adjustment.

The consequences for the deficit of this restructuring, however, are significant. Using the **President's** budget figures, the deficits for 1987 and 1988 increase by \$6.0 billion and \$8.7 billion, respectively. Adding in other CBO **reestimates** of the **President's** budget, the deficit for 1988 under Administration policies would be in the neighborhood of \$142 billion. If this accounting convention were adopted, therefore, some revision of the **deficit** targets in the Balanced Budget Act might be necessary.

TABLE 2. RECOMMENDED BUDGET STRUCTURE (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Revenues	734.1	769.1	842.4	916.6
Expenditures				
Direct spending	915.4	976.2	1,006.6	1,020.4
Credit subsidies	<u>16.3</u>	<u>16.9</u>	<u>15.0</u>	<u>12.7</u>
Total expenditures	931.7	993.1	1,021.6	1,033.1
Deficit	197.6	224.0	179.2	116.5
Credit Revolving Fund	14.7	-3.3	-6.0	-8.7
Total Financing Requirements	212.3	220.7	173.2	107.8

SOURCE: Congressional Budget Office; Office of Management and Budget.

Carrying out the Budget Commission recommendation for credit effectively protects the budget from distortion by disbursements, repayments, and loan asset sales. In addition, this change will assure that if loan asset sales are carried out, it will be for programmatic reasons rather than artificial "deficit reduction."

PROPOSED SALES OF SBA LOANS

It is important to distinguish the **Administration's** proposal for credit reform from the pilot sale program for loans. Although newly originated SBA loans would be sold under credit reform, the Administration proposes to sell SBA loans from three programs, independently of credit reform, as shown in Table 3. These are general business loans, disaster loans, and 5BA-guaranteed, Federal Financing Bank (FFB) originated development company loans. In 1988, the face value of loans proposed for sale, and artificial deficit reduction, exceeds \$2 billion. The aggregate, however, obscures a wide range of variation in loan characteristics.

TABLE 3. **PRESIDENT'S PROPOSED SBA LOAN ASSET SALES 1987-1990**
(By fiscal year, in millions of dollars)

	1987	1988	1989	1990
Business Loan Investment Fund	0	1,000	1,000	0
Disaster Loans	600	670	670	670
Development Companies	0	500	397	0

SOURCE: Office of Management and Budget.

The loans to development companies for commercial real estate purchase, construction, renovation, and development are relatively large (they average \$200,000), bear fixed interest rates in excess of 10 percent, with maturities of up to 25 years, and are fairly well documented. The general business loans are about half as large in principal amount as the development loans, have an average interest rate in excess of 8 percent, and have maturities up to 30 years. The disaster loans average \$21,000 in outstanding balances, bear an average interest rate of less than 5 percent, and are often poorly secured. Over 200,000 of these disaster loans are outstanding to individuals, farmers and small businesses.

The prospect of selling these loans raises several programmatic and technical questions. The principal programmatic concern appears to be the possible loss of forbearance granted by SBA to the borrower. That is, SBA ~~has--in~~ virtually all of its loan ~~programs--~~**adopted** a policy of being more lenient with borrowers than is consistent with either the loan contract or minimizing the loss to the government. Private investors may not be willing or able to continue these practices. Two possible means of continuing the present level of forbearance after sale are: (1) originating new loans to troubled borrowers on terms that reflect the desired degree of leniency or (2) **specifying** conditions of forbearance in the loan sale contract.

A second concern is whether it would be feasible to sell 200,000 individual disaster loans, many of which are poorly collateralized. This same concern applies to the **4,000** development company loans and also

reflects the high cost that would be incurred if the government attempted to provide the information necessary to evaluate each loan to each potential buyer.

A third concern is raised by the diversity of loans within and among the various program portfolios. Some of the loans mature within a year; others have 25 years or more to run. Most borrowers are current in their payments, but over \$1.5 billion in general business loans are more than 90 days in arrears on payments. The fear is that such a hodge-podge of credits will appeal to no one and that any sale will occur at very low prices.

A technical solution to the latter two concerns about cost of information and portfolio diversity may be provided by the multiclass collateralized security. The portfolios could be sold, under competitive conditions, in large pools, to an investment banking firm that would issue securities backed by the loans. The securities might consist of three classes. Class I would be entitled to a fixed rate of interest and would receive all principal repayments from the pool until their investment was returned and their securities retired. Class II would receive only interest payments until the Class I securities were retired. Class III security holders would be the last to receive principal repayments and, hence, would be the residual absorbers of all risks.

Multiclass collateralized securities have the advantage that the government would have to provide detailed information about the loans to only a few dozen firms rather than all potential investors. Moreover, the

securities issued from the same pool can have vastly different maturity and risk characteristics. This factor enables the government to obtain the advantage of tailoring the securities to the demand of various investors. Class I securities, for example, would appeal to the most conservative investors, while Class III would have more speculative characteristics. The pool arrangement also lends itself to private credit enhancement such as is provided by a standby letter of credit or a surety bond. Also, the securities can be registered so that secondary markets can develop for these issues. The development of such markets would enhance the liquidity of the securities and enable the "after-sale" price to be monitored. These advantages are such that virtually all of the loan sales proposals that have been made to the government propose the use of multiclass collateralized securities.

A fourth concern is whether federally-originated loans should be sold with recourse to the government. CBO believes strongly that loan sales should be without recourse or other **federal** guarantees. Only final sales will reveal the real subsidy conveyed by the loan. On this matter, your letter requested my reaction to the GAO report: Loan Asset Sales, OMB Policies Will Result in Program Objectives Not **Being** Fully Achieved, September 1986. This report is a criticism of the OMB guidelines for loan asset sales. In particular, GAO alleges that the OMB prohibition on federal guarantees will reduce the net proceeds from loan asset sales. As evidence, GAO cites a proposal for the sale of a college housing loan in which the government purportedly could receive an additional \$220 million in cash now for

agreeing to issue a guarantee with a future "estimated maximum risk to the government" of \$60 million. From this case, GAO argues that "sales without recourse provisions could artificially depress proceeds" and urges that recourse to the government be permitted by loan investors.

The GAO report is deficient in at least three respects. First, the effect on the net proceeds to the government of selling with a guarantee is mixed with the effect of converting the individual loans into securities. CBO agrees that the successful purchaser of federal loan assets is likely to use the multiclass security approach and that the sale price will reflect the potential gains from security financing. This packaging makes a federal guarantee unnecessary and still provides the information the government needs. Second, GAO appears to base its recommendation for recourse on the assumption that unexploited opportunities for profit will persist in financial markets. It is inconceivable that investors will be willing to pay or insurers able to charge \$220 million for \$60 million of insurance. A long-term policy for loan sales should not be based on such an assumption. Third, the GAO report does not explain how partial guarantees would enable the market to assess these loans more accurately. More accurate assessment will result **from** better information, not from guarantees. If the government has useful information about these loans, it should make it available. Loan asset sales with recourse are a high-cost **form** of government borrowing that yields no program benefits. Rather than sell assets with recourse, it would be less costly for Treasury to borrow directly from the public. I would suggest, therefore, that the GAO report does not provide any grounds for revising the OMB guidelines.