

**Statement of
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Congressional Budget Office**

**before the
Committee on Ways and Means
U.S. House of Representatives**

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NOTICE

**This statement is not available
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Tuesday, April 18, 1989.**

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss borrowing by government-sponsored enterprises (GSEs) and off-budget agencies, as well as the Resolution Funding Corporation (REFCORP), which is part of President Bush's proposal to address the savings and loan problem. In my remarks today, I will make three main points:

- o First, while government-sponsored enterprises provide certain favored borrowers with the benefit of ready access to the capital markets, they do so at a cost of unrecognized and largely uncontrolled financial risks to the government.
- o Second, the two off-budget borrowing corporations created in 1987 and 1988 and the proposed REFCORP differ significantly from government-sponsored enterprises in that their sole purpose is to finance the liquidation, outside the budget, of federal losses on GSEs and deposit insurance.
- o Third, both types of entities impose costs on the federal government, but the nature of these costs and the means of limiting them differ. For GSEs, the key to federal cost control is to limit the risk assumed by the enterprises. For the new borrowing corporations, the key is to use the least costly means of financing available to the federal government.

GOVERNMENT-SPONSORED ENTERPRISES AS RISKY FINANCIAL INTERMEDIARIES

Before 1987, there were five GSEs--the member institutions of the Farm Credit System (FCS), the Federal Home Loan Banks (FHLBs), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Student Loan Marketing Association (Sallie Mae). Table 1 provides information about these institutions. A sixth GSE--the Federal Agricultural Mortgage Corporation (Farmer Mac)--was created in 1988 but is not yet operating.

Government-sponsored enterprises have three outstanding characteristics:

- o First, they are instrumentalities of the federal government, chartered for the purpose of borrowing in capital markets and channeling the money to favored borrowers--farmers, homebuyers, savings and loans, and students.

- o Second, although they have public purposes, government-sponsored enterprises are wholly owned by and operated for the benefit of private investors.

TABLE 1. GOVERNMENT-SPONSORED ENTERPRISES

Enterprise	Established	Privatized	Assets ^a	Major Asset
Farm Credit System				
Farm Credit Banks	1988 ^b	1988 ^b	48.6	Farm loans and agricultural mortgages
Banks for Cooperatives	1933	1951	13.1	Loans to cooperatives
Federal Home Loan Banks	1932	1968	174.5	Savings and loan advances
Federal National Mortgage Association	1938	1970	112.3 ^c	Residential mortgages
Federal Home Loan Mortgage Corporation	1970	1970	34.4 ^d	Residential mortgages
Student Loan Marketing Association	1972	1982	28.6	Guaranteed student loans and "warehouse" loans

SOURCE: Congressional Budget Office.

- a. Total assets at the end of 1988, in billions of dollars.
- b. The Agricultural Credit Act of 1987 required the Federal Land Bank and the Federal Intermediate Credit Bank in each Farm Credit District to merge into a single Farm Credit Bank by July 6, 1988. The Land Banks had been established in 1916 and privatized in 1947; the Intermediate Credit Banks had been established in 1923 and privatized in 1968.
- c. Amount does not include \$178 billion in residential mortgages held in pools to back securities issued and guaranteed by the Federal National Mortgage Association.
- d. Amount does not include \$226 billion in residential mortgages held in pools to back securities issued and guaranteed by the Federal Home Loan Mortgage Corporation.

- o Third, their authority to borrow from the Treasury, the exemption of their securities from the registration requirements of the Securities and Exchange Commission, and other benefits they enjoy under federal law imply a government guarantee of their liabilities. This implicit guarantee leads investors to accept yields on their debt that are quite close to the yields on Treasury securities. To illustrate this effect of government sponsorship, Table 2 compares the market yields on debt securities issued by several GSEs with the market yields on comparable Treasury debt, for a recent trading day. The spreads shown--between 30 and 50 basis points--are fairly typical and tend to be relatively stable over time.

TABLE 2. SPREADS BETWEEN YIELDS ON GOVERNMENT-SPONSORED ENTERPRISE DEBT AND COMPARABLE U.S. TREASURY DEBT (In basis points)

Enterprise	Spread
Five-Year Maturity	
Fannie Mae	34
Federal Home Loan Banks	41
Sallie Mae	41
Farm Credit System	41
Thirty-Year Maturity	
Fannie Mae	42
Freddie Mac (subordinated)	49

SOURCE: Congressional Budget Office based on information from the trading desk, Salomon Brothers. Yields are as of 1:00 p.m., April 12, 1989.

In addition, the federal budget excludes lending and borrowing by GSEs. This exclusion follows the suggestion of the President's Commission on Budget Concepts, which recommended in 1967 that the government adopt a unified budget that would provide a comprehensive statement of all federal financial transactions. The Commission recommended that GSEs be excluded from the unified budget when they "are completely privately owned." This criterion has guided decisions about the budgetary treatment of GSEs since the unified budget was adopted in 1968.

Risks Posed by Government-Sponsored Enterprises

The special legal benefits granted GSEs and the implicit federal guarantee of their liabilities indicate that the government will provide assistance to them if they get into serious financial trouble. The Agricultural Credit Act of 1987 provided such assistance to the Farm Credit System after it lost \$4.6 billion in 1985 and 1986. The act set a second precedent by not requiring the owners of FCS member institutions to forfeit their equity investment as a condition of federal assistance.

The government's willingness to assist troubled GSEs means that it bears most, if not all, of the financial risks that they take. Although

the government does not quantify these risks or the cost of bearing them, some general observations can be made about the risks posed by the five active GSEs.

Three GSEs--the FHLBs, Freddie Mac, and Sallie Mae--currently pose little risk to the government. The assets of the FHLBs consist largely of collateralized advances to savings and loans. Private mortgage insurance or low loan-to-value ratios minimize the risk of the residential mortgages that Freddie Mac holds in portfolio or has packaged and sold through mortgage-backed securities. Most of Sallie Mae's assets are federally guaranteed student loans. Changes in interest rates are unlikely to impose significant losses on these three GSEs. These enterprises also are well capitalized, given the risks they have assumed.

Fannie Mae and the Farm Credit System pose greater risk to the government. Both are exposed to some interest-rate risk. That is, everything else being equal, when interest rates increase, the marked-to-market net worth of each of these GSEs--the market value of its assets less the market value of its liabilities--declines measurably. Fannie Mae's capital-to-asset ratio, which is only 2.1 percent measured on a book-value basis, is low for a portfolio mortgage lender, even one with a large mortgage-backed securities business. The value of the FCS's portfolio of farm and cooperative loans and agricultural

mortgages is sensitive to fluctuations in farm income and farm real estate values.

Federal regulation is the most important means of controlling the risks of government-sponsored enterprises. Four of the five active GSEs have federal regulators. The Federal Home Loan Bank Board has broad authority to regulate the FHLBs, and its members constitute the board of directors of, and thus directly control, Freddie Mac. The Department of Education has no authority to regulate Sallie Mae. The Department of Housing and Urban Development (HUD) has general regulatory authority over Fannie Mae, but this power extends to the internal affairs of the GSE only when necessary to protect the financial interests of the government. HUD also may limit Fannie Mae's debt-to-capital ratio. This authority is of little value, however, because the enterprise's subordinated debt, which carries an implicit federal guarantee, is considered to be capital. The Farm Credit Administration (FCA) has authority to assure the safety and soundness of FCS member institutions, including the power to prescribe minimum capital levels. The FCA will also regulate the safety and soundness of Farmer Mac when that GSE begins operating.

Last year, this Committee considered but did not approve legislation that would have created a new GSE--the Corporation for Small Business Investment (COSBI). The government would have

provided over 95 percent of COSBI's capital. COSBI would have financed Small Business Investment Company debentures, which are very risky assets. The corporation also would have been free to assume interest-rate risk. The bill would have authorized the Secretary of the Treasury to disapprove any debt or guarantees issued by COSBI that would have impaired its financial safety and soundness, but it is uncertain whether he could have used this authority to limit the credit or interest-rate risk assumed by the corporation.

Government-Sponsored Enterprises in the Federal Budget

Other than the annual reports of government-sponsored enterprises, federal budget documents are the principal source of public information on their activities. As I noted earlier, the budget authority and outlay totals in the unified budget do not include the spending of sponsored enterprises. However, the *Appendix* to the President's budget includes summary financial information about each GSE and a projection of its aggregate borrowing and lending during the budget year. Discussions of each enterprise--the government's implicit guarantee of its securities, the legal benefits that it enjoys under federal law, and its lending and borrowing--appear in the *Special Analyses* volume of the budget. In the *Special Analyses*

volume and the *Statement of Liabilities and Other Financial Commitments of the United States Government* published by the Treasury each year, GSE borrowings and guaranteed mortgage-backed securities are not considered to be contingent liabilities of the government, because the implicit federal guarantee is not legally binding.

The budget documents, like the annual reports of GSEs, present the activities and financial condition of GSEs in accordance with Generally Accepted Accounting Principles (GAAP) for private firms, which measure assets, liabilities, and capital on a book-value basis. Financial information based on book values cannot be used to measure accurately the financial risk of a financial intermediary. Accurate measurement of risk requires estimates of the marked-to-market net worth of the firm and of the uncertainty of its future performance. In 1986, the government published estimates of the marked-to-market net worth of one GSE, Fannie Mae. At present, no effort is being made to estimate this variable for the other enterprises, or to quantify the risks that the five active GSEs pose to the government.

Borrowing by Government-Sponsored Enterprises
and by the Treasury

The outstanding debt and mortgage-backed securities of GSEs have increased at an extraordinarily rapid rate--18 percent a year on average since 1970. This growth has made the implicit federal guarantee of sponsored enterprises a significant form of government intervention in the credit markets. As shown in Table 3, at the end of

TABLE 3. GSE SECURITIES OUTSTANDING AT END OF YEAR
(In billions of dollars)

	1970	1975	1980	1985	1986	1987	1988	<u>Estimated</u>	
								1989	1990
Farm Credit System									
Banks for Cooperatives	1.5	3.2	8.4	8.1	8.5	8.9	11.2	11.1	11.7
Farm Credit Banks ^a	11.3	23.7	53.6	61.8	55.6	35.3	43.4	42.0	42.0
Federal Home Loan Bank System									
Banks	11.2	20.6	36.6	73.6	88.1	105.1	126.7	145.0	160.0
Freddie Mac									
Debt	b	5.1	4.7	13.8	14.9	17.1	20.6	22.6	22.4
Mortgage-backed securities	b	1.2	16.8	92.0	146.9	208.9	220.7	252.7	279.5
Fannie Mae									
Debt	13.2	28.2	52.3	91.7	91.6	92.6	106.0	103.8	106.5
Mortgage-backed securities	b	b	b	48.8	86.4	130.5	167.2	185.3	205.7
Sallie Mae	<u>b</u>	<u>0.2</u>	<u>2.3</u>	<u>12.7</u>	<u>15.5</u>	<u>21.3</u>	<u>25.0</u>	<u>29.1</u>	<u>33.5</u>
Total	37.2	82.3	174.8	402.4	507.5	619.7	720.7	791.6	861.3

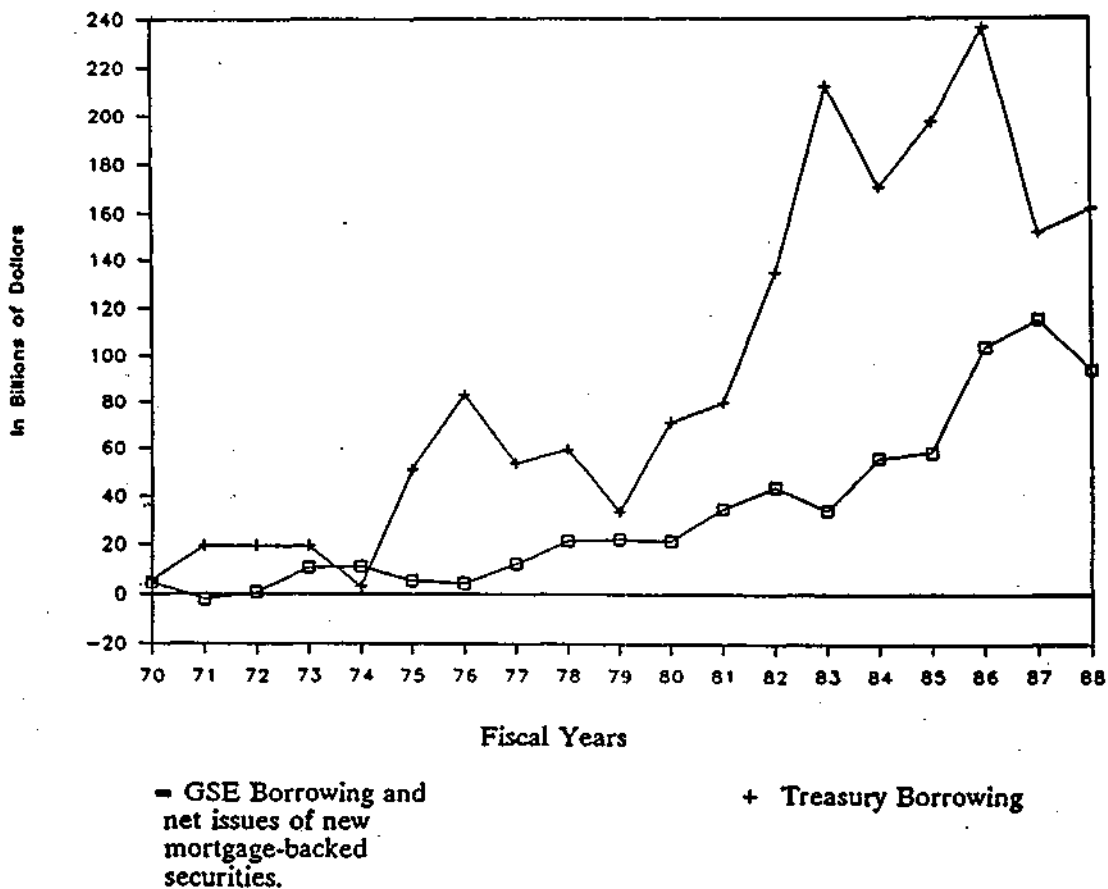
SOURCE: Congressional Budget Office based on information from the Office of Management and Budget.

a. Before fiscal year 1987. Includes the Federal Intermediate Credit Banks and the Federal Land Banks.

b. Not yet chartered.

fiscal year 1988, outstanding GSE debt and mortgage-backed securities totaled over \$720 billion. This amount was more than one-third of the outstanding federal debt held by the public and 8 percent of total debt outstanding in the United States. As shown in Figure 1, in recent years the amount of new debt issued and

Figure 1. New GSE and Treasury Borrowing From the Public



Source: Congressional Budget office based on information from the Office of Management and Budget.

mortgage-backed securities guaranteed by GSEs has exceeded 50 percent of Treasury borrowing from the public.

Considering the amount of borrowing by GSEs, it is reasonable to ask whether intermediation by GSEs raises the interest rates that the Treasury must pay to borrow. Broadly speaking, the answer is "No, or not by much." Overall, GSE operations should have little effect on interest rates. While GSE borrowing may raise rates, subsequent relending of the proceeds should reduce rates in an offsetting way. There is a possibility of some net upward pressure on Treasury rates, since securities *issued* by GSEs are apparently closer substitutes for Treasury debt in the eyes of the investors than are the securities that GSEs purchase when relending their funds. Evidence shows, however, that these factors lead only to temporary upward pressures on Treasury rates.

The main issue determining whether GSE operations raise Treasury and other interest rates has to do with whether GSEs result in more borrowing by farmers, students, homebuyers, and other assisted parties than would have been true if GSEs did not exist, and whether any such increases in borrowing are offset by a rationing of credit to other borrowers. If there is an increase in overall borrowing by the parties assisted by GSEs, it is likely that interest rates--for Treasury securities and other instruments--will be higher than they

would otherwise have been. As yet, however, little evidence exists on this issue. Many analysts believe that the increase in net borrowing caused by GSEs is slight. If this is true, any upward pressure on Treasury borrowing rates is likely to be slight as well.

OFF-BUDGET BORROWING CORPORATIONS

In 1987, the government began to create off-budget borrowing corporations to finance the liquidation, outside the federal budget, of losses previously realized by the government. The losses had been incurred on risks assumed by the government through the implicit federal guarantee of the liabilities of GSEs and federal insurance of deposits at savings and loans. The government created the first of these--the Financing Corporation (FICO)--in 1987 to raise money to enable the Federal Savings and Loan Insurance Corporation (FSLIC) to resolve insolvent thrifts. Early in 1988, the Financial Assistance Corporation (FAC) was authorized to finance assistance to ailing parts of the Farm Credit System.

FICO and FAC were given federal charters and nearly all the other legal attributes of government-sponsored enterprises. Two GSEs--the FHLBs and the FCS member institutions--were required by law to contribute funds to the new borrowing corporations. The

mandatory contributions were defined in law to be purchases of stock in FICO and FAC. The stipulation created the appearance that they would be privately owned financial intermediaries. This appearance was used as an argument for calling the borrowing corporations GSEs and excluding them from the federal budget.

The Administration's bill to address the savings and loan crisis would authorize a new borrowing corporation, REFCORP, to raise \$50 billion over three years to finance thrift resolutions. REFCORP would continue the practice begun with FICO and FAC and would greatly increase the use of off-budget borrowing to liquidate losses from government guarantees.

The emergence of borrowing corporations raises the question of how they should be treated in the budget. The President's Commission on Budget Concepts did not envision the creation of entities like FICO, FAC, or REFCORP. Nor is it likely to have foreseen the incentive that its "private ownership" criterion and the Balanced Budget Act now provide to create such entities.

There are numerous arguments for considering the borrowing corporations to be parts of the federal government, and for including their borrowing and spending in the unified budget. The case of REFCORP can be used to illustrate this point. The government would

create the corporation for the sole purpose of borrowing funds and transferring them to a federal agency--namely, the Resolution Trust Corporation (RTC). REFCORP's actions would be controlled by the RTC Oversight Board, which would consist of three federal officials. Although the bill would designate the transfer of FHLB earnings to REFCORP as purchases of "nonvoting capital stock" in the latter, the FHLBs could not be paid "dividends" on the "stock" or otherwise benefit financially from REFCORP's activities. Furthermore, they could not recoup the money they contributed. The federal government would be the sole beneficiary of the existence of REFCORP and the contribution of funds by the FHLBs. The Administration's proposal would give REFCORP the authority to levy and collect assessments on federally insured thrifts. These assessments would be indistinguishable from those collected by federal agencies and included in the budget. Finally, payments by the Treasury, not these assessments, would finance over 90 percent of REFCORP's debt.

A reasonable conclusion from these facts is that REFCORP should be treated as part of the federal government, rather than as a GSE. Ultimately, the Congress and the President will decide how REFCORP and the other borrowing corporations are to be classified. If the decision is made to treat REFCORP as part of the government, the question remains whether the spending it financed should be

counted in deficit calculations under the Balanced Budget Act. I will return to that issue later in my statement.

THE BENEFITS AND COSTS OF OFF-BUDGET BORROWING CORPORATIONS

The purpose of using FICO, FAC, and REFCORP to liquidate losses realized on federal guarantees is to prevent the spending so financed from causing a large, short-term increase in federal outlays and the deficit. The borrowing corporations shift the recognition of nearly all of these costs far into the future. This result is accomplished by showing in the budget only the relatively small annual amounts that the government will pay to service and retire the debt of the borrowing corporations. The larger initial expenditure of the borrowed funds does not add to budget outlays.

This practice has both positive and negative consequences. On the plus side, limiting any short-term budgetary impact to the government's portion of the interest payments minimizes the effect of the spending on the baseline deficits calculated under the Balanced Budget Act.

On the minus side, the approach is inconsistent with the concept of the unified budget. It also tends to reinforce the misconception that federal guarantees of the liabilities of private financial intermediaries are not very risky--a view that makes it less likely that the government will improve existing, or develop new, regulatory or budgetary means to control that risk.

FICO, FAC, and the proposed REFCORP also raise the cost of financing the liquidation of the government's losses, relative to borrowing the funds through the Treasury. The spreads between the market yields of FICO bonds and Treasuries with comparable maturities have ranged from 55 to 100 basis points. CBO estimates that REFCORP would pay between 20 and 40 basis points more to borrow than the Treasury. This difference would raise the cost of the interest payments on \$50 billion in debt by between \$100 million and \$200 million a year, or by \$1 billion and \$2 billion in present value terms. Finally, borrowing through off-budget corporations reduces the Treasury's control over debt issued to finance federal spending.

The Administration has argued that the \$1 billion to \$2 billion more that REFCORP borrowing will cost is an acceptable price to pay to preserve the credibility of the government's commitment to achieve the Balanced Budget Act deficit targets. In CBO's view, this argument gives too little weight to the acumen of Wall Street analysts,

who surely recognize that to treat REFCORP borrowing as if no binding federal obligation were involved is merely an expensive way to exalt form over substance in a manner that will provide no discernible benefit to the taxpayers.

POLICY OPTIONS FOR THE CONGRESS

Both GSEs and the newer borrowing corporations impose costs on the government, but the means of controlling those costs differ.

Controlling the Risk of Government-Sponsored Enterprises

Controlling the cost of federal risk-bearing for GSEs requires limiting their risk. Basically, the government can use three policy tools to assess and control risk. First, government officials can closely monitor the activities and accurately measure the marked-to-market net worth and risk of GSEs. Second, regulators can require the enterprises to maintain sufficient capital to ensure that any losses they incur will be borne by owners, not the government. Third, regulators can impose management controls on GSEs that are losing money before the institutions become insolvent.

The government has recently taken steps to improve the use of these tools to control the risks posed by federally insured depository institutions. Last year, banking regulators in the United States and several other nations agreed to a risk-based capital requirement of 8 percent for commercial banks, which will be phased in by the end of 1992. The Federal Home Loan Bank Board has proposed risk-based capital standards for thrifts. In order to implement risk-based capital requirements, federal banking regulators and the Bank Board are improving their ability to monitor the marked-to-market net worth and the risk of insured depository institutions. The Administration has proposed that by 1991, federally insured thrifts must--as banks do now--maintain capital of not less than 6 percent. The Federal Deposit Insurance Corporation (FDIC) recently took control of a thrift that was not insolvent, but which FDIC felt was engaged in management practices that were too risky.

The government could use these and related policy tools to measure and control the risks posed by government-sponsored enterprises. Continuing the current policy of not measuring or controlling the risks of GSEs could lead to large, unanticipated federal outlays, similar to the assistance provided to the Farm Credit System in 1988. One approach would be to authorize a single agency, such as the Treasury, to collect and analyze information about the risks of

each GSE and to issue and enforce regulations that control the risks borne by the government.

The implicit federal guarantee of the liabilities of a GSE has a subsidy cost to the government, just as does an explicit federal guarantee of a single loan to a single borrower. If the government regularly collected detailed information about the risk and marked-to-market net worth of each GSE, that data could be used to calculate the subsidy cost of the implicit federal guarantee. This cost could be included in the unified budget or the budget documents and compared with the cost of other federal spending and credit assistance.

Two other approaches exist to control the risks that GSEs impose on the government: charge them risk-related user fees, or remove all the special benefits they enjoy under federal law. The Reagan Administration proposed several different versions of user fees for GSEs and endorsed severing the government's ties to Fannie Mae and Freddie Mac, but the Congress has not enacted either policy. Calculating user fees that accurately reflected the risks of GSEs would require collecting the same information and performing the same analyses that would be needed in order to improve oversight and regulation of GSEs and to calculate the subsidy cost of federal risk-bearing.

Sponsored Enterprises or Explicit Federal Guarantees?

In CBO's view, the most important factor in the decision to use an off-budget sponsored enterprise or an on-budget program of explicit federal guarantees is whether the government can measure and control the cost of subsidizing the assisted parties. If the costs to the government of explicit federal guarantees and of GSEs were equally well measured and controlled, then from a budget process point of view there would be no difference between either policy instrument. However, although the budgetary treatment and control of on-budget credit programs have many defects, at this point they are far superior to the budgetary treatment and control of GSEs. Until the measurement and control of GSE risk and cost is improved, the Congress may want to exercise great caution in creating new GSEs or expanding the powers of existing ones.

Limiting the Cost of Federal Borrowing

The cheapest way for the government to borrow to finance the liquidation of losses arising from federal guarantees is through the Treasury. The higher cost of using REFCORP to borrow \$50 billion to resolve insolvent thrifts--\$1 billion to \$2 billion in present value terms--could be saved by having Treasury borrow the money. This

approach could be combined with a decision to exclude the spending so financed, but not the Treasury interest payments on the borrowing, from the baseline budget deficit calculations under the Balanced Budget Act.

The exclusion could be justified by the nature of the economic effects of the spending and borrowing. Increases in the federal deficit to finance resolution of insolvent thrifts have few of the adverse economic effects of ordinary federal deficits. Unlike much of the present federal deficit, federal borrowing for thrift resolution does not detract from national saving. As a result, borrowing for thrift resolution does not raise interest rates, increase the trade deficit, or reduce living standards for future generations--aspects of existing federal deficits that have long troubled many observers. Thrift-related deficits also do not increase aggregate demand, and thus do not exacerbate the inflationary pressures that have become a growing concern during the past year. Moreover, borrowing the money would have no permanent structural effect on the deficit beyond the interest payments on the debt issued.

CONCLUSION

In conclusion, Mr. Chairman, let me recapitulate the main points I have made this morning.

- o Government-sponsored enterprises are an important type of federal credit assistance, but they expose the government to considerable financial risk. The Congress could reduce the likelihood of more financial assistance being provided to troubled GSEs in the future by improving ways to measure and control their risk.

- o Off-budget borrowing corporations such as REFCORP raise the cost of financing the liquidation of losses arising from federal guarantees, at no discernible benefit to taxpayers. By having the Treasury raise the funds, the Congress could save the higher cost and maintain Treasury control over federal borrowing.