United States General Accounting Office

GAO

Report to the Chairman, Committee on the Budget, U.S. Senate

July 1994

CREDIT REFORM

Case-by-Case Assessment Advisable in Evaluating Coverage and Compliance

GAO/AIMD-94-57

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

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July 28, 1994

The Honorable Jim Sasser
Chairman, Committee on the Budget
United States Senate

Dear Mr. Chairman:

You requested that we evaluate several highly technical issues related to implementation of the Federal Credit Reform Act of 1990 (Public Law 101-508). This report, the fourth in a series, addresses your questions regarding

- whether the budgetary treatment of the Government National Mortgage Association (GNMA), which is part of the Department of Housing and Urban Development, conformed to credit reform requirements;[1]
- whether the cost of programs which reduce the credit subsidy rate (referred to as cross subsidies) should be considered in determining total credit subsidy costs and, if so, whether the cost of the Department of Agriculture's Farmers Home Administration (FmHA) rental assistance provided to participants in FmHA's section 515 direct loan program should be added to the cost of the credit program; and
- whether the 1990 act's exclusion of the credit activities of the Resolution Trust Corporation (RTC) and Federal Deposit Insurance Corporation (FDIC) from its requirements was appropriate.

We will report separately on the other areas in your request.

Results in Brief

GNMA's guarantees of mortgage-backed securities are covered by the Credit Reform Act. However, the budgetary treatment of this program did not conform to all credit reform requirements in fiscal years 1992 through 1994 because GNMA did not use the date of the guarantee when determining

[1]Credit reform requirements are embodied in the Federal Credit Reform Act of 1990 and implementation guidelines issued by the Office of Management and Budget and the Department of the Treasury.

whether the transactions should be recorded in the credit financing[2] or liquidating[3] accounts.

It is appropriate for a credit program to capture the cost of a closely linked cross-subsidy program—which we defined as one required by law to provide specific sums or levels of assistance to participants of the credit program it is subsidizing and obligated concurrently with that credit program. Cross subsidies decrease the likelihood that borrowers will default by either increasing the likelihood of income for the borrowers or decreasing borrowers' costs. In this situation, not including the cost of cross subsidies that are closely linked to credit programs understates the subsidy costs of such credit programs. While we believe it would be appropriate for the Credit Reform Act to require that the cost of closely linked cross subsidies be included in the cost of the related credit program, this would not affect FmHA's section 515 program. Neither FmHA's rental assistance program nor any other cross-subsidy programs in the fiscal year 1994 budget meet the criteria to be considered closely linked to the section 515 program. For programs with cross subsidies that do not meet the rather narrow criteria for being considered closely linked, a supplemental table in the Budget Appendix showing the size and cost of the cross subsidies and their effects on the credit subsidy rate would provide decisionmakers with more complete data on the interactions of such programs.

It is appropriate to exclude credit activities of the Federal Deposit Insurance Corporation and the Resolution Trust Corporation from credit reform requirements when their sole purpose is to resolve and dispose of the assets of failing and failed financial institutions. We looked at two programs that have an additional purpose—the affordable housing programs of RTC and FDIC which are operated to promote wider homeownership and rental opportunities for very low-income, low-income, and moderate-income families. In our view, it would be appropriate to impose credit reform requirements on the RTC and FDIC credit programs such as the seller financing components of the affordable housing programs of FDIC and RTC because, in addition to fulfilling their asset disposition requirements, they fulfill other key objectives which do not necessarily require RTC and FDIC to seek maximum returns to the government in disposing of assets.

[2]The financing account is a nonbudgetary account which holds all cash flows to and from the government resulting from direct loan obligations and loan guarantee commitments made on or after October 1, 1991.

[3]The liquidating account is a cash-based account that includes all cash flows to and from the government resulting from direct loan obligations and loan guarantee commitments made prior to October 1, 1991.

Background

The Federal Credit Reform Act of 1990 was enacted to measure more accurately the costs of federal credit extended during or after fiscal year 1992, to record these costs on a budgetary basis equivalent to other federal spending, and to improve resource allocation among credit programs and between credit and other spending programs. The act specifically excluded the credit or insurance activities of FDIC, RTC, and several other government agencies.

Implementation of credit reform has been a challenge for agencies covered by the act. Each of the major domestic lending agencies recognized that substantial changes in its financial systems were necessary to meet the requirements of credit reform. Further, agencies have found that they have needed, or will need in the future, additional staff, including financial analysts, accountants, and systems experts to fully implement the act.

Appendix I contains a more detailed description of the history and principles of credit reform and describes the budgetary treatment of federal credit programs.

Scope and Methodology

In order to evaluate the application of credit reform requirements to GNMA and FmHA's Rural Rental Assistance Program, we (1) reviewed the Federal Credit Reform Act of 1990, relevant appropriation and authorization legislation, and OMB guidance, (2) reviewed budget proposals and OMB and congressional actions for fiscal years 1992 through 1995 for GNMA and FmHA's Rural Rental Assistance and section 515 programs and compared them with the appropriate criteria mentioned in item one, above, (3) discussed and confirmed this information with Office of Management and Budget (OMB) and Congressional Budget Office (CBO) officials, obtaining their rationales for proposals and actions, and (4) analyzed the information and supporting rationales.

To evaluate whether the credit programs of FDIC and RTC are appropriately excluded from the Credit Reform Act's requirements, we (1) reviewed the Credit Reform Act and relevant authorizing legislation, (2) obtained program information from officials of FDIC and RTC, (3) obtained the views of OMB and CBO officials, and (4) analyzed the information we obtained.

We performed our work in Washington, D.C., between October 1992 and April 1994, in accordance with generally accepted government auditing standards. OMB provided written comments on a draft of this report. We have addressed these comments in the Agency Comments and Our Evaluation section, and they are reprinted in appendix II.

GNMA's Budgetary Treatment Does Not Fully Comply With Credit Reform Requirements

GNMA's mortgage-backed securities program is covered by the Credit Reform Act of 1990. However, its budgetary treatment, designed to facilitate program operations, does not comply in all respects with credit reform requirements.

The GNMA guarantee program was designed both to increase the overall supply of credit available for housing and to ensure that credit is available to home buyers at reasonable interest rates. Issuers (generally financial institutions) obtain approval from GNMA to issue securities backed by pools of mortgages (loan pools) that are federally insured or guaranteed by the Federal Housing Administration, FmHA, or the Department of Veterans Affairs. These securities are sold to investors who receive dividend payments of interest and principal. Issuers pay GNMA a fee to provide a secondary guarantee to the private investor that dividends will be paid by either the issuer or GNMA. An issuer's current securities (and the mortgage loan pools that back them) comprise the issuer's portfolio.

Under credit reform, the GNMA program would have the same budgetary treatment as other loan guarantee programs; that is, guarantees would be attributed to the financing account if they were issued on or after October 1, 1991, and to the liquidating account if they were issued before that date. However, the way GNMA reports its guarantee program in the budget differs from what is required by credit reform. This is due in part to the way GNMA implements its guarantee program. GNMA takes over an issuer's entire portfolio when the issuer has defaulted on a payment for one security. This is because issuers are likely to have borrowed from the proceeds of other securities in their portfolios before defaulting on any payments. These portfolios may include securities with GNMA guarantees issued both before and after credit reform became effective—October 1, 1991. Nevertheless, GNMA pays for all costs of the guarantees associated with one issuer from either the financing or liquidating account based on either the default status of the issuers or the date the issuers first participated in the GNMA program.

The President's fiscal year 1993 budget released on January 29, 1992, proposed transferring $2 billion in holdings from GNMA's liquidating account to its financing account. This proposed transfer represented the investments associated with the GNMA guarantees for existing issuers in good standing. Thus, beginning in fiscal year 1993, the financing account would have held balances associated with issuers in good standing, those which defaulted on or after October 1, 1992, and all new issuers. The residual in the liquidating account would have represented balances associated with GNMA guarantees held by issuers which had defaulted before October 1, 1992. In effect, GNMA proposed to divide issuers between the financing and liquidating accounts by date of default.

The administration reversed this position in the July 1992 mid-session review of the budget with a transfer of almost $2 billion back to the liquidating account. Under this budgeting arrangement, GNMA would budget for and administer the portfolios of all issuers participating in its mortgage-backed securities program before fiscal year 1993 from the liquidating account and all portfolios of issuers that began participation during or after fiscal year 1993 from the financing account. That is, it divided issuers between the liquidating and financing accounts by date of initial participation rather than by date of default.

Neither of these fiscal year 1993 budget treatments was consistent with the Credit Reform Act requirement to use the date of GNMA's guarantee—not the default status of issuers or the date issuers first participated in GNMA programs—to allocate transactions between the liquidating and financing accounts. However, both treatments allowed GNMA to continue its practice of having an issuer's entire portfolio in only one account. The fiscal year 1994 and 1995 budgets allocated loan guarantees between the financing and liquidating accounts according to the date issuers first participated in GNMA's programs.

OMB prefers to use the date an issuer began participation in the GNMA program to divide transactions between the liquidating and financing accounts because GNMA's risk of loss is a function of the cash flow of an issuer's entire portfolio, not the issuer's performance on an individual security or 1 year's securities from all issuers. This approach allows GNMA to estimate the default risk in credit reform using an issuer's entire portfolio. Having each issuer's portfolio in just one account simplifies the calculation.

However, the appropriate way for GNMA to comply with credit reform requirements is to use the issuance dates of each of its guarantee commitments to determine whether transactions will be handled by the financing or liquidating accounts.

Credit Reform Coverage Is Appropriate for Closely Linked Cross Subsidies

Federal program participants sometimes receive benefits from two or more federal programs, one of which may be a credit (direct loan or loan guarantee) program. In these instances, the government's cost for the credit program may be lowered because its participants also receive benefits from, or are subsidized by, another government program. These benefits—referred to as cross subsidies—include housing grants, income tax credits, and international trade grants. Cross subsidies reduce the risk that a borrower will default.

Credit reform does not provide for the associated costs of the cross subsidies to be included in calculating the cost of credit programs. Therefore, credit programs with cross subsidies appear less costly when compared with programs without cross subsidies because they show the benefit of cross subsidies (in the lowered subsidy rate) but not their related costs.

One way to better measure the government's cost of extending credit would be to include the costs of closely linked cross subsidies as part of the credit subsidy cost. In the absence of other guidance, we developed two criteria for defining a closely linked cross-subsidy program. They are (1) the appropriation for the cross-subsidy program directs assistance to the credit program participants, and (2) the government's commitment for the two programs is obligated concurrently.

Also, for credit programs with cross subsidies that are not closely linked, the budget currently does not provide any information about the effect of one program's benefits on the other. For such credit programs, supplemental tables in the Budget Appendix showing the size and effect of the cross subsidies would assist budget comparisons.

FmHA's Section 515 Program Does Not Have Closely Linked Cross Subsidies

The purpose of FmHA's section 515 program of the Rural Housing Insurance Fund is to increase the availability of low-cost rental and cooperative housing for rural residents with very low, low, or moderate incomes. It provides direct loans to individuals, state or local public agencies, profit or non-profit corporations, and others for construction, purchase, improvement, or repair of rural housing.

These loan recipients also are eligible for benefits from a number of non-credit programs. Section 515 program borrowers may receive payments from FmHA's Rental Assistance Program (RAP), Federal Housing Administration section 8 housing assistance payments, or Internal

Revenue Service tax credits. In addition, their tenants may receive vouchers from the Department of Housing and Urban Development. Participation in these other programs lowers the risk that an eligible section 515 loan borrower will default, either by providing greater certainty of the rental income stream or by reducing the borrower's costs. Therefore, the subsidy cost of the section 515 loans is lowered (or cross-subsidized) by a loan recipient's or a recipient's tenants' participation in other programs.

In fiscal year 1994, none of these cross subsidies meets our criteria for a closely linked cross subsidy. Prior to fiscal year 1994, RAP met both criteria—it had an appropriation that directed a specific level of assistance to newly constructed units under the section 515 credit program, and it was obligated with the loan commitment. The Congress removed the directed assistance in the fiscal year 1994 appropriations language for RAP but instructed the agency to give appropriate priority to funding for renewal of expiring RAP contracts and servicing of vacant units. The President's budget for fiscal year 1995 continues this approach.

Credit Reform Requirements Are Appropriate for Some FDIC and RTC Credit Activities

The Federal Credit Reform Act of 1990 specifically excluded the credit and insurance activities of RTC and FDIC from budgetary treatment specified by the act.[4] FDIC may provide credit, called open assistance, to troubled institutions trying to avoid failure. FDIC provides this assistance when it determines that doing so would be less costly than closure or another resolution strategy. Undercapitalized institutions may receive loans from FDIC or may issue promissory notes against equity to FDIC to help avoid failure.

The RTC extends credit, and the FDIC plans to extend credit, as a strategy for disposing of real estate assets of failing and failed financial institutions through seller financing components of their affordable housing programs. The purpose of the affordable housing programs is, in addition to asset disposition, to promote homeownership and rental housing opportunities for families with very low, low, and moderate income. For this purpose, maximum return to the government on asset disposition is not necessarily required.

[4]The Credit Reform Act also excludes the credit or insurance programs of the National Credit Union Administration, Pension Benefit Guaranty Corporation, National Flood Insurance, National Insurance Development Fund, Crop Insurance, and Tennessee Valley Authority. We do not address these exclusions in this report.

Based on our analysis of these credit activities and discussions with CBO and OMB officials responsible for budget policy and analysis of FDIC and RTC budgets, we believe that the exclusion from credit reform is appropriate only when a program's sole purpose is to resolve and dispose of the assets of failing and failed institutions such as the open assistance program. It would be appropriate to include under credit reform credit programs, such as the seller financing components of the affordable housing programs which have purposes that do not necessarily require maximum return on asset disposition.

RTC's asset management and sales program, which disposes of real estate assets of failed savings and loan institutions, offers loans on residential and commercial property. RTC's affordable housing program, a component of the asset management and sales program, is operated to fulfill RTC's legal mandate to provide homeownership and rental housing opportunities for families with very low, low, and moderate incomes. To achieve the affordable housing program goals, one of the tools available to RTC is seller financing under which RTC may sell lower-valued residential property at below-market prices and provides below-market rate financing to facilitate expedited sales to eligible purchasers. The seller financing loans made under the affordable housing program represent about 55 percent of the total number of properties financed by RTC but only 11 percent of the aggregate dollar amount financed between March 1, 1991, and September 30, 1993. The administrative and subsidy costs of this program are provided by RTC's revolving fund.

FDIC's asset disposition program sells real estate assets of failed financial institutions to, among other things, maximize the government's return. Lower-valued residential properties are eligible for FDIC's affordable housing program, a component of the asset disposition program which, like RTC's affordable housing program, is not necessarily required to maximize the government's return on asset dispositions. Begun in fiscal year 1993, FDIC's program is authorized to operate for 3 years and, like RTC's affordable housing program, is operated to fulfill the legal requirement to provide market rate and subsidized homeownership and rental housing opportunities for very low-income, low-income, and moderate-income families. It receives a separate general fund appropriation for administration and subsidy costs. It is not funded from either the Bank Insurance Fund or the Savings Association Insurance Fund, nor are costs associated with the program passed on to creditors of failed institutions. Sales of affordable housing to qualified buyers represented 10 percent of FDIC's sales of owned real estate for calendar year 1993. Beginning in August 1994, FDIC plans to provide seller financing for affordable housing similar to RTC's program.

The RTC Completion Act requires RTC and FDIC to operate a unified affordable housing program by August 17, 1994. According to an FDIC official in the affordable housing program, a draft implementation plan calls for the programs to operate separately until the planned end of RTC in 1995 because RTC staff and systems for affordable housing also support other RTC programs. Both agencies plan to make changes such as adopting the same terms for seller financing, similar income qualification forms, and a unified computer listing of available properties to ensure that their programs will look alike to a potential borrower.

FDIC's open assistance program, which has as its sole purpose the resolution of failing institutions, is properly excluded from credit reform requirements. However, credit reform requirements are appropriate for other credit activities of RTC and FDIC that have additional purposes not necessarily requiring maximization of the government's return on asset disposition, such as the seller financing components of their affordable housing programs. Officials of OMB and CBO concur with our views.

Conclusions

Although subject to the Credit Reform Act, the budget treatment of GNMA guarantees has not complied in all respects with credit reform requirements. In the near term, compliance—dividing transactions between the liquidating and financing accounts using the date of GNMA's guarantee—may cause GNMA to budget for an issuer in both the liquidating and financing accounts. This is because the portfolios of some existing issuers would include outstanding securities with GNMA guarantees made both before and after the effective date of credit reform. For those issuers, GNMA would have to combine the value of securities in both accounts to retain its practice of calculating annual default rates based on issuers' entire portfolios. It also would have to combine funds from both accounts to make guarantee payments in the case of default. However, the need to do this would decrease over time as the older guaranteed securities in the liquidating account reach maturity.

Expanding coverage under the Credit Reform Act to include the costs of closely linked cross subsidies would more accurately measure the costs of credit programs and would permit better comparisons among credit programs and between credit and other programs. Such an approach also may require amendment of program authorizing legislation. Including a supplemental table in the Budget Appendix for credit programs with cross subsidies that are not closely linked also would further these goals. The cost of the cross subsidy, the number of credit participants who receive the cross subsidy, and its effect on the subsidy rate of the credit program are key data to include in this table.

Exclusion of all of the credit programs of the FDIC and RTC from coverage under the Credit Reform Act is too broad. It is appropriate to exclude FDIC and RTC programs whose sole purpose is to resolve and dispose of the assets of failing and failed financial institutions. However, credit reform requirements are appropriate when RTC and FDIC credit programs have an additional purpose which does not necessarily require the maximization of the government's return on asset disposition, such as the affordable housing programs which promote expansion of homeownership and rental housing opportunities for lower-income families. Including these programs under the Credit Reform Act should result in more accurate measurement of program costs and better allow these programs to be compared to other credit and spending programs with similar purposes.

Experience in implementing credit reform has brought out problems for some programs covered under the Federal Credit Reform Act and has led to questions about whether other, currently excluded, programs should be included. Case-by-case review is appropriate to ensure that the decision is consistent with an individual agency's missions and policies.

Matters for Congressional Consideration

The Congress may wish to consider amending the Credit Reform Act to

- include in the cost of credit programs the costs of closely linked cross subsidies and
- exclude from credit reform requirements only those FDIC and RTC programs whose sole purpose is the resolution and disposition of the assets of failing and failed financial institutions.

Recommendations

To appropriately implement credit reform, we recommend that the Director, Office of Management and Budget, require the Government National Mortgage Association to budget for guarantees using the issuance dates of its guarantees to determine whether the cost of the guarantee should be included in the financing account or the liquidating account.

For cross subsidies that do not meet the criteria for being closely linked to a credit program, we recommend that the Director, Office of Management and Budget, include a supplemental table in the Budget Appendix for the associated credit programs showing, for each cross subsidy, the size, cost, and effect on the credit subsidy rate.

Agency Comments and Our Evaluation

In commenting on a draft of this report, OMB concurred with our views on credit reform coverage of cross subsidies and the affordable housing programs of the FDIC and RTC. Further, its letter noted that credit reform requirements also are appropriate for the National Credit Union Association's Community Development Revolving Loan Program. OMB also said that it is studying alternatives to GNMA's current budgetary treatment. In addition, some technical comments were transmitted informally and have been incorporated where appropriate.

OMB is examining a credit reform treatment for GNMA for the long term, and we would be pleased to work with OMB in evaluating alternatives. OMB said that because GNMA's risk is tied to an issuer's potential for default rather than the dates of securities GNMA issues, the current GNMA budgetary treatment allocates between the financing and liquidating accounts based on the date issuers become eligible to use the GNMA guarantee. However, as we noted, this treatment does not comply with the Credit Reform Act's requirement to use the date of the GNMA guarantee commitment to determine whether individual transactions should be allocated to the financing account or liquidating account. Complying with the Credit Reform Act would permit GNMA to continue to analyze data by issuers.

OMB agreed with our view that including the costs of grants in the subsidy cost of closely linked credit programs would better measure the government's cost of extending credit. If our recommended budgetary treatment were implemented, the net total of the budgets for two closely linked programs would be unchanged if the grants were for 1 year and would be decreased for multi-year grants (because of the effect of using present value based costs). OMB reviewed our criteria in the context of FmHA and said that we should revise the definition of a closely linked cross subsidy to call two programs closely linked if appropriations language specified the amount of grants to be used with new loans.

We have two concerns with OMB's suggestion. First, we believe that it is important for criteria to be more broadly applicable. Therefore, we have retained our requirement that appropriations for the cross-subsidy program must direct assistance to a specific credit program's beneficiaries. Second, rental assistance grant renewals to beneficiaries of existing loans also should be considered closely linked and, under credit reform requirements, the subsidy costs of the existing loans would be modified to reflect the additional federal assistance. In applying our criteria to the FmHA programs, the absence of a directed level of rental assistance grants to section 515 program beneficiaries—not the absence of an allocation between renewals and grants to new loans—is the key element in the fiscal year 1994 appropriation act that meant that the two programs no longer were closely linked.

For cross subsidies that do not meet the criteria for being closely linked to a credit program, we recommended that OMB include supplemental information in the budget displays of associated credit programs showing, for each cross subsidy, the size, cost, and effect on the credit subsidy rate. OMB requested clarification of the appropriate vehicle and format for this display. We clarified the report to indicate that a separate table in the Budget Appendix would be most appropriate.

We will send copies of this report to the Director, Office of Management and Budget; the Director, Congressional Budget Office; the Secretary of Agriculture; the President, Government National Mortgage Association; the Acting Chairman, Federal Deposit Insurance Corporation; the Interim Chief Executive Officer, Resolution Trust Corporation; the Acting Director, Office of Thrift Supervision; and interested congressional committees. We will make copies available to others upon request.

Please contact me at (202) 512-9142 if you or your staff have any questions about this report. Other major contributors to this report are listed in appendix III.

Sincerely yours,

Susan J. Irving

Susan J. Irving
Associate Director, Budget Issues

Contents

Abbreviations

CBO	Congressional Budget Office
FDIC	Federal Deposit Insurance Corporation
FmHA	Farmers Home Administration
GAO	General Accounting Office
GNMA	Government National Mortgage Association
OMB	Office of Management and Budget
RAP	Rental Assistance Program
RTC	Resolution Trust Corporation

Background: Credit Reform

This background appendix also will be a part of three other reports on credit reform implementation: the use of estimated future credit savings to offset current spending,[1] an evaluation of the use of negative subsidy credit receipts, and an evaluation of foreign loan and loan guarantee costs.

The federal government uses direct loans and loan guarantees as tools to achieve numerous program objectives such as assistance to housing, agriculture, education, small businesses, and foreign governments. At the end of fiscal year 1993, the face value of the government's direct loans and loan guarantees totaled a reported $861 billion, of which $201 billion was in direct loans and $660 billion was in loan guarantees.

After over 20 years of discussion about the shortcomings of using cash budgeting for credit programs and activities, the Federal Credit Reform Act of 1990 was enacted on November 5, 1990, as Title 13B of the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508. The Credit Reform Act changed the budget treatment of credit programs so that their costs can be compared more accurately with each other and with the costs of other federal spending. It also was intended to ensure that the full cost of credit programs over their entire lives would be reflected in the budget when the loans were made so that the executive branch and the Congress might consider them when making budget decisions.

In addition, it was recognized that credit programs had different economic effects than most budget outlays, such as purchases of goods and services, income transfers, and grants. In the case of direct loans, for example, the fact that the loan recipient was obligated to repay the government over time meant that the economic impact of a direct loan disbursement could be much less than other budget transactions of the same dollar amount.

Credit Reform Was Designed to Remove Difficulties Caused by Cash Treatment

Before credit reform, it was difficult to make appropriate cost comparisons between direct loan and loan guarantee programs and between credit and noncredit programs. Credit reform requirements were formulated to address the factors that caused this problem.

Two key principles of credit reform are (1) the definition of cost in terms of the present value of cash flow over the life of a credit instrument and (2) the inclusion in the budget of the costs of credit programs in the year

[1]See Credit Reform: Speculative Savings Used to Offset Current Spending Increase Budget Uncertainty (GAO/AIMD-94-46, Mar. 18, 1994).

in which the budget authority is enacted and the direct or guaranteed loans are disbursed.

Credit Reform Was Designed to Allow Appropriate Cost Comparisons

Before credit reform, credit programs—like other programs—were reported in the budget on a cash basis. This cash basis distorted costs and, thus, the comparison of credit program costs with other programs intended to achieve similar purposes, such as grants. It also created a bias in favor of loan guarantees over direct loans. Loan guarantees appeared to be free while direct loans appeared to be very expensive because the budget did not recognize that at least some of the loan guarantees would default and that some of the direct loans were to be repaid.

For direct loans, the budget showed budget authority and outlays in the amount that loan disbursements exceeded repayments received in that budget year. This cash approach overstated direct loan costs in the initial years of a program when loan disbursements were likely to be greater than repayments. Conversely, this treatment understated costs in later years when loan repayments were more likely to be much larger relative to disbursements. Cash-based budgeting did not recognize that at least a portion of the loan outlays would be repaid in the future. In contrast, for loan guarantees, the budget did not record any budget authority or outlays when the guarantees were made (except the negative outlay resulting from any origination fees), even though they were likely to entail future losses. It showed budget authority and outlays only when, and if, defaults occurred.

Credit reform changed this treatment for direct loans and loan guarantees made on or after October 1, 1991. It required that budget authority to cover the cost to the government of new loans and loan guarantees (or modifications to existing credit instruments) be provided before the loans, guarantees, or modifications are made. Credit reform requirements specified a net cost approach using estimates for future loan repayments and defaults as elements of the cost to be recorded in the budget. This puts direct loans and loan guarantees on an equal footing; it permits the costs of credit programs to be compared with each other and with the costs of noncredit programs when making budget decisions.

Credit Reform Identifies the Government's Cost of Credit Activities

Credit reform requirements separate the government's cost of extending or guaranteeing credit, called the subsidy cost, from administrative and unsubsidized program costs. Administrative expenses receive separate appropriations. They are treated on a cash basis and reported separately in the budget. The unsubsidized portion of a direct loan is expected to be recovered from the borrower.

The Credit Reform Act defines the subsidy cost of direct loans as the present value—over the loan's life—of disbursements by the government (loan disbursements and other payments) minus estimated payments to the government (repayments of principal, payments of interest, and other payments) after adjusting for projected defaults, prepayments, fees, penalties, and other recoveries. It defines the subsidy cost of loan guarantees as the present value of cash flows from estimated payments by the government (for defaults and delinquencies, interest rate subsidies, and other payments) minus estimated payments to the government (for loan origination and other fees, penalties, and recoveries).

According to OMB guidance, credit programs have a positive subsidy, that is, they lose money, when the present value of estimated payments by the government exceeds the present value of estimated receipts. Conversely, negative subsidy programs are those in which the present value of estimated collections is expected to exceed the present value of estimated payments; in other words, the programs make money (aside from administrative expenses).

Credit Programs Now Use Three Budgetary Accounts

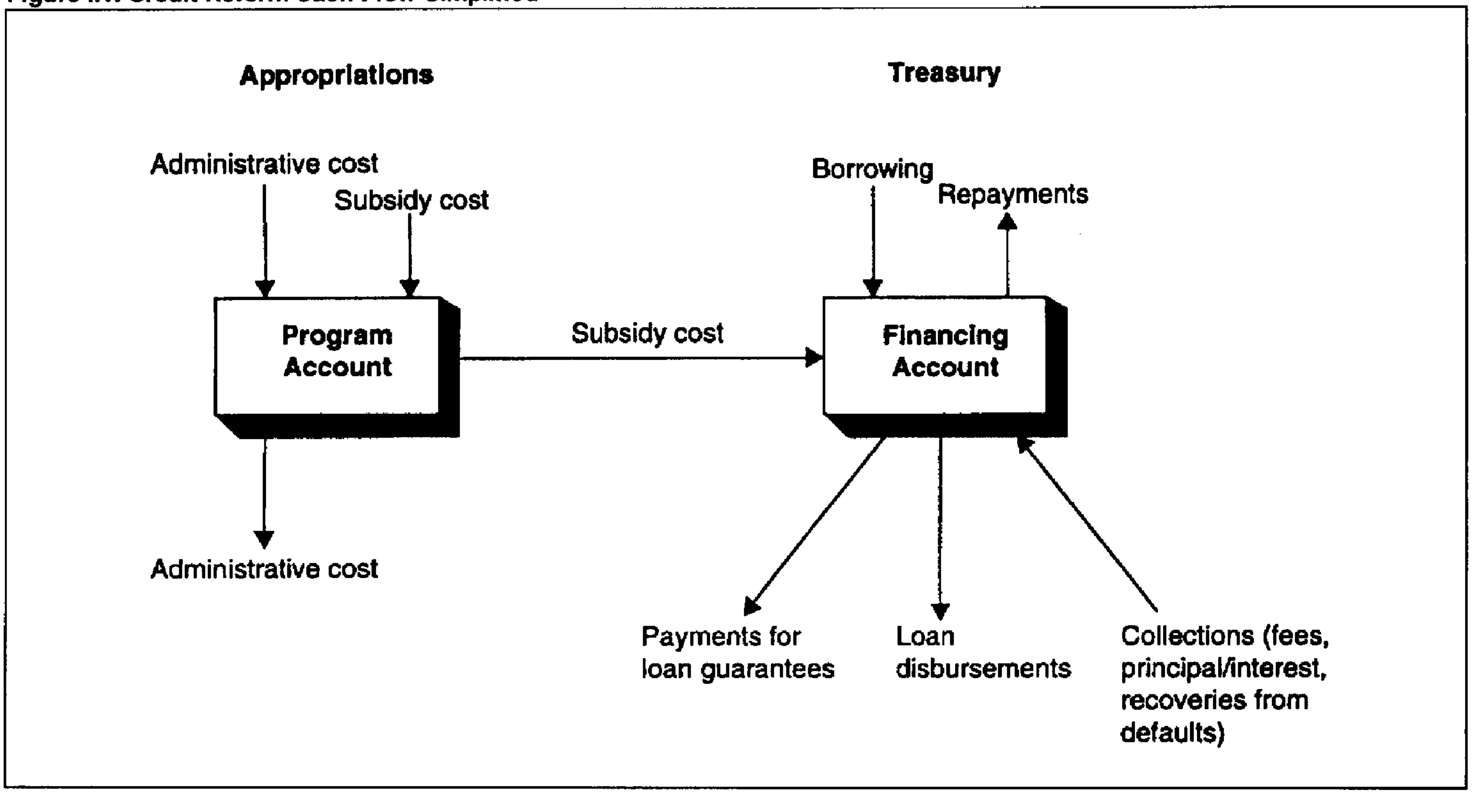
The Credit Reform Act set up a special budget accounting system to record the budget information necessary to implement credit reform. It provides for three types of accounts—program, financing, and liquidating—to handle credit transactions.

Credit obligations and commitments made on or after October 1, 1991—the effective date of credit reform—use only the program and financing accounts. The program account receives separate appropriations for administrative and subsidy costs of a credit activity and is included in budget totals. When a direct or guaranteed loan is disbursed, the program account pays the associated subsidy cost for that loan to the financing account. The financing account, which is nonbudgetary,[2] is used to record the cash flow associated with direct loans or loan guarantees over their

[2]Nonbudgetary accounts may appear in the budget document for information purposes but are not included in the budget totals for budget authority or budget outlay. They do not belong in the budget because they show only how something is financed, and do not represent the use of resources.

lives. It finances loan disbursements and the payments for loan guarantee defaults with (1) the subsidy cost payment from the program account, (2) borrowing from the Treasury, and (3) collections received by the government. Figure I.1 diagrams this cash flow.

Figure I.1: Credit Reform Cash Flow Simplified



If subsidy cost calculations are accurate, the financing account will break even over time as it uses its collections to repay its Treasury borrowing.

Direct loans and loan guarantees made before October 1, 1991, are reported on a cash basis in the liquidating account. This account continues the cash budgetary treatment used before credit reform. It has permanent, indefinite budget authority[3] to cover any losses. Excess balances are transferred periodically—at least annually—to the Treasury.

[3]Permanent budgetary authority is available as a result of permanent legislation and does not require annual appropriation. Indefinite budget authority is budget authority of an unspecified amount of money.

In addition to the three accounts specified in the Credit Reform Act, OMB has directed that credit programs or activities with negative subsidies must have special fund receipt accounts to hold receipts generated when the program or activity shows a profit. OMB guidance provides that these funds cannot be used unless appropriated.

OMB and Treasury Provide Implementation Guidance

OMB and the Department of the Treasury provide guidance on implementing credit reform. OMB's written guidance is contained primarily in OMB Circulars A-11, A-34, and A-129.[4] OMB also has issued memoranda to provide additional implementation guidance addressing specific situations. The Treasury's guidance is provided in materials such as Basic Transactions Relating to Guaranteed Loans and Subsidies (Apr. 30, 1992) which contains a number of illustrative cases developed by its Financial Management Service and distributed to agencies as examples of how to account for credit reform transactions.

Individual Program Characteristics Raise Credit Implementation Questions

Fiscal year 1994 is the third year that credit programs have been required to comply with credit reform. Both agencies that operate credit programs and those that provide implementation guidance—OMB and Treasury—have had to address a variety of situations for which the Credit Reform Act does not provide explicit direction. Questions have arisen and continue to arise as the agencies implement credit reform. Several groups have been created, such as the Federal Credit Policy Working Group and the Credit Reform Steering Committee, to address these implementation issues and questions.

[4] OMB Circular No. A-11 is entitled Preparation and Submission of Budget Estimates, Circular No. A-34 is entitled Instructions on Budget Execution, and Circular No. A-129 is entitled Managing Federal Credit Programs.

Comments From the Office of Management and Budget

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

May 31, 1994

Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Dodaro:

Thank you for the opportunity to comment on the draft GAO report evaluating the coverage of several programs under the Federal Credit Reform Act of 1990. In accordance with Section 236 of the Legislative Reorganization Act of 1970, this letter provides our comments on the draft report. We have also transmitted informally some technical comments.

GNMA issues:

GAO advises that the budget treatment of the "Government National Mortgage Association (GNMA) did not conform to credit reform requirements in fiscal years 1992 through 1994," and recommends that GNMA, "use the date of its guarantee when determining whether the transactions should be recorded in the credit financing or liquidating accounts."

GNMA's current scheme distinguishes between "new" business, residing in the financing account, and "old" business, residing in the liquidating account, based on the date a securities issuer becomes eligible to use the GNMA guarantee. Because GNMA issues secondary guarantees, its risk is tied to the fate of its issuers rather than the dates of security issues. FHA, VA and FmHA take the credit loss on defaulted mortgages in GNMA pools; GNMA assumes the management risk for timely payments to investors in its securities. Its risk is based on the danger that security issuers will default on pools of Government-guaranteed loans. Consistent with this view, GNMA includes pools securitized by "new" issuers, who have become eligible since 1992, in the financing account, whereas pools securitized by issuers who were eligible prior to FY 1992 are in the liquidating account.

The draft suggests an alternative to GNMA's current treatment, but it does not discuss the costs and benefits of that alternative. OMB is examining a credit reform treatment for GNMA for the long-term, and addition of a discussion of the costs and benefits of alternatives would be extremely useful in assessing the systems and administrative changes required.

Cross subsidies:

OMB staff concurs with GAO's view that including the additional costs caused by grants of closely linked programs in the calculation of credit subsidy cost would provide a better measure of the government's cost of extending credit.

In discussing the FmHA Rental Assistance Program (RAP) grant funds, the report should specify that if grant funds are specifically allocated in appropriations language to be used in conjunction with new loans, this would constitute a cross subsidy with grant funds to be included in the loan subsidy appropriation. This past year the appropriators did not divide RAP appropriations between renewals and new construction. In the past they have made this split. Using the logic proposed by GAO in this report, if the appropriators return to the practice of prior years, the Rural Housing Insurance Fund Section 515 subsidy rate would be substantially higher (and a piece of the RAP appropriation would be lower).

The draft recommends requiring additional information for cross-subsidies that are not closely enough linked to credit programs to be included in the subsidy estimate. The draft should make clear: a) which vehicle would be more appropriate -- the Budget Appendix, or the Credit Supplement to the Budget, and b) the format for presenting this information.

Deposit Insurance:

OMB staff concurs with GAO's view that credit reform requirements are appropriate for non-deposit insurance related credit transactions. OMB staff believes that the cost of credit transactions for the affordable housing programs of the FDIC and RTC are not a necessary or even incidental part of carrying out the deposit insurance commitment. This is also consistent with OMB's pay-as-you-go treatment of banking-related legislation that seeks to achieve non-deposit insurance objectives. Furthermore, credit reform requirements could be relatively easily administered for the affordable housing programs. The FDIC affordable housing program is already tracked separately from insurance transactions, and is subject to the annual appropriations process.

Although the scope of this study was limited to the FDIC and RTC, OMB staff believes that credit reform requirements are also appropriate for the NCUA's Community Development Revolving Loan Program.

OMB staff would be glad to continue working with your staff in this and future efforts.

Sincerely,

Richard P. Emery, Jr.

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Related GAO Products

Credit Reform: Speculative Savings Used to Offset Current Spending Increase Budget Uncertainty (GAO/AIMD-94-46, Mar. 18, 1994).

Federal Credit Reform: Information on Credit Modifications and Financing Accounts (GAO/AIMD-93-26, Sept. 30, 1993).

Federal Credit Programs: Agencies Had Serious Problems Meeting Credit Reform Accounting Requirements (GAO/AFMD-93-17, Jan. 6, 1993).

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