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The Government's Loan Asset Sales Pilot Program

Statement of
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House Committee on Small Business

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our assessment of the administration's current pilot sale of existing federal loan assets under the OMB guidelines and fiscal year 1988 sales plans. In September 1986, we testified and reported[1] on our review of OMB's guidelines for the sale of federal loan assets to Chairman Brooks, House Committee on Government Operations, Legislation and National Security Subcommittee. We said that OMB policies will result in loan asset sales pilot program objectives not being fully achieved. Since our report was issued, we have testified several times that OMB's loan sale guidelines will not result in the government maximizing the net proceeds of loan sales. In recent testimony we pointed out that over the long term, the government may be forgoing revenue to meet short-term deficit reduction goals.

OMB's original proposal to sell loan assets was presented in the fiscal year 1987 budget request. The proposal called for selling $4.4 billion in Federal loan assets on a pilot basis before embarking on a full-scale sales effort that would reform Federal credit programs by

-- reducing the government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;

-- providing an incentive for agencies to improve loan origination and documentation;

-- determining the actual subsidy of a Federal credit program; and

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[1] Loan Asset Sales - OMB Policies Will Result in Program Objectives Not Being Fully Achieved. GAO/AFMD-86-79, September 1986.

-- increasing unified budget offsetting collections in the year of sale.

Subsequent to OMB's original sales proposal, the Congress passed the fiscal year 1987 Budget Reconciliation Act, which directed the Administration to sell enough loan assets, within certain programs, to generate initially an estimated $6.8 billion in revenue. As a result, the administration's pilot sale program was modified with the sale of certain loan portfolios being deferred from fiscal year 1987 to fiscal year 1988 so that sales of other loan portfolios required by the act could be accomplished. Accordingly, $9.3 billion in loan assets are to be sold during fiscal year 1987 with a currently projected return of $6.3 billion, and $12.5 billion in loan assets are to be sold during fiscal year 1988 with projected return of $5.9 billion. To date, however, no loan asset sales have taken place.

In our September 1986 testimony and report, we pointed out that OMB's loan sale guidelines and proposed policies would not protect the government's interests and would preclude the government from fully achieving the objectives of the pilot sale program. We, therefore, recommended among other things that OMB revise its loan sale guidelines to permit agencies to sell loan assets on a structured basis and to allow agencies, where appropriate, to conduct sales with some form of future recourse to the government.

OMB, in responding to our report, commented that it would permit recourse sales if the primary objective of loan sales was to generate receipts. OMB's position, however, is that the primary objective of its pilot loan sale program is credit reform and not raising receipts, and consequently, OMB still requires nonrecourse sales. The provisions, however, relating to the sale of loan assets in The Fiscal Year 1987 Budget Reconciliation Act and the President's fiscal year 1988 budget request, which look to the sale of loan assets to generate cash receipts to help close the budget deficit, have shifted the emphasis of loan sales from a credit reform tool to a revenue enhancement tool.

SALES PROCEEDS WILL NOT BE MAXIMIZED

A major focus of loan asset sales, in our opinion, in both the fiscal year 1987 Budget Reconciliation Act and in the President's fiscal year 1988 budget request is to generate receipts to help reduce the budget deficit. Consequently, we believe that sales of loan assets should be made on a basis that produces the maximum proceeds. Because OMB's guidelines still require that loan asset sales be made without future recourse to the government, the result will be that the proceeds from the sales will not be maximized.

In September 1986, we reported that our analysis of the secondary credit markets--the means established by the financial community for trading mortgage and nonmortgage loans and related securities--showed that any loan asset sales, with or without recourse, should be structured as a pool of loans rather than as individual loan sales. This is because major investors want to deal in large dollar volumes. Certain loan pools could be successfully sold without government recourse. These loans would include the types that investors are familiar with, such as residential mortgage loans. There was unanimous agreement among the secondary credit market representatives that OMB's guidance to sell loan assets without any form of recourse to the government would result, in many cases, in artifically depressing net sale proceeds and in the government not realizing the maximum possible proceeds.

Our report pointed out that some form of recourse sale is needed to maximize sale proceeds because investors are not familiar with the various types of government loans being sold and borrowers under certain government programs do not--often by definition--meet commercial lending standards for creditworthiness. In addition, the government experiences high loan default rates for many of its loan programs. Finally, government loans are not always supported by adequate documentation.

Consequently, we reported that for government-held loan portfolios that have any of the above characteristics, consideration should be given to allowing sales on a "structured basis" with "credit enhancement." Let me briefly explain these concepts.

A "structured basis" for selling loan assets usually includes

-- forming a pool of loans with similar terms, interest rates, and established default rates;

-- creating a new security, such as a bond, which has the principal and future interest payments of the loans in the pool as collateral--in other words, create a "collateralized security"; and

-- arranging for a commercial organization to collect periodic principal and interest payments from borrowers under the pool and remit funds to the security issuing entity for subsequent payment to investors.

"Credit enhancement" for a security could include such techniques as the Government's pledge to guarantee or indemnify investors for a certain percentage of defaults on loans in the pool based on default rates experienced for the pooled loans at the time of sale. This alternative would have the government and the investors in the loan portfolios share the potential risk of borrower default.

Our September 1986 report pointed out that both the Department of Housing and Urban Development and the Veterans Administration have experience with loan sales. During our discussion with these agencies, we were told that both agencies have concluded that loan sales without recourse would result in lower expected proceeds. Specifically, the price investors would bid for a portfolio on a sale without recourse would fall by more than a reasonable estimate of the future cost of providing recourse.

In addition, we reported that one of the larger loan portfolios proposed for sale is the Department of Education's college housing loans. Education contracted with a consultant to study the loans prior to sale. The consultant's report discussed two methods of selling the loans: selling loans in separate portfolios without recourse, and pooling loans as collateral for a new issue of a security with a limited guarantee as a form of recourse.

The consultant estimated that the loan-backed security sale would provide the greatest proceeds. Net proceeds from the separate portfolio sale without recourse would be about $1.1 billion, while the net proceeds from the sale of a security with a limited guarantee would be about $1.3 billion. Issuing a new security with a limited guarantee backed by the loan pool would therefore increase net proceeds by at least $220 million. We estimate that the maximum guarantee risk associated with this sales method would be about $59.8 million, leaving about $160 million in unencumbered additional proceeds.

ACTIONS NEED TO BE TAKEN TO AVOID UNINTENDED EFFECTS ON BORROWERS

OMB's pilot loan sale guidelines require that servicing of loan portfolios that are sold be transferred to the investor. The investor, in turn, could contract with a private loan servicing company to handle day-to-day loan servicing activities. Care needs to be taken in transferring loan servicing from the government to private loan services so that borrowers would not be affected in any way counter to their lawful rights or the policy of the government. Without adequate guidelines and sale provisions, portfolio sales could have unintended consequences for borrowers. For example, the government may, as a matter of policy, adopt certain debt collection and refinancing policies for a certain class of borrowers. Sales to private lenders, without adequate guidelines and sales provisions, could subject borrowers to collection and refinancing policies that could work against the original intent of the loan programs.

CREDIT PROGRAM SUBSIDIES FOR NEW LOANS WILL NOT BE ACCURATELY MEASURED

We believe that the subsidy costs to the government for credit programs should be measured and reflected in the budget. This is a positive step in federal credit reform. However, we believe that the administration's plan for determining subsidy amounts will result in overstatements of subsidies. Specifically, the direct loan subsidy amount that would be reported and budgeted for would be the difference between the face amount of a direct loan and the amount the government receives in selling that loan on a nonrecourse basis. The idea according to material provided to us is to measure the subsidy "based on the benefit to the borrower." Presumably, the purchase price would approximate the loan amount that the borrower would have been able to get on the open market, and the difference between that and the higher face amount of the government loan would be the subsidy benefit conferred by the loan.

Unfortunately, this would not provide a measure of the actual cost to the government of making that loan. In all likelihood, the subsidy benefit so calculated would be larger than the actual subsidy cost to the government of making that loan.

We think that for budgeting purposes, the subsidy measure should reflect the <u>cost to the government</u> of credit activities, not the subsidy benefit provided to the borrowers. We have two reasons for favoring this approach. First, measuring subsidy costs to the government would be consistent with a primary function of the federal budget, which is to provide a statement of the costs (in outlays) of governmental operations. If the budget measured something other than the costs to the Treasury of programmatic decisions, it would become a more confusing document. We agree that it is important to know what benefits are conferred by credit activities, but this should be done outside of the budget's totals.

The second reason for favoring the measurement of subsidy costs rather than subsidy benefits is that the former approach would correct a problem in current budget scorekeeping conventions. At this time, the budget treats direct loan and regular expenditure programs alike even though they are different in a key way: True direct loans entail some repayment of funds to the government. To better compare the costs of the two kinds of programs, it would be necessary to focus on that part of the loan programs that represents the net cost to the government--in other words, the subsidy cost. Reporting subsidy costs would permit lawmakers to make valid comparisons between loan and regular expenditure programs.

As we have stated elsewhere,[2] the best measure of the subsidy cost would essentially be the difference between the borrowing cost incurred by the government when it financed the loan, and the present value (at that time) of the borrower's future repayments. This would tie subsidy recognition to interest rates and the government's cost of money at the time it made the loan.

In contrast, the administration's focus on subsidy benefits in effect shifts the calculation to interest rates and the private investor's cost of money at the time of the loan sale. The private investor's cost of money would be built into the investor's computation of the present value of the borrower's future repayments. This would determine the price the investor is willing to pay.

Because the investor's cost of money would be higher at any time than the government's--the government is a better credit risk--the present value to the investor of a future repayments stream likely would be less than the present value of that same income stream to the government. This alone would make the loan worth less to the investor than to the government and have the effect of depressing the purchase price.

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[2]Statement of Charles A. Bowsher, Comptroller General of the United States, before the Legislation and National Security Subcommittee, House Committee on Government Operations, September 26, 1986; and GAO comments on S. 2142 provided to the Chairman, Senate Committee on Governmental Affairs, December 8, 1986. Statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Committee on The Budget, United States Senate, March 4, 1987.

In short, basing the subsidy calculation on the private investor's lower present value would likely result in a subsidy amount higher than the actual subsidy cost to the government. This would reflect the realities of the private market at the time of the sale but would not reflect the subsidy cost to the government when officials originally made the loan. Our approach would recognize the costs to the government when the loan was made. This, by the way, is the approach that was recommended in 1967 by the President's Commission on Budget Concepts.

LOAN SALE'S IMPACT ON BUDGET DEFICIT

With regard to reducing the federal deficit, we feel that the market plan for selling new loans could potentially have very different effects on short- and long-run budget deficits. The immediate effect of selling loans would be to accelerate cash collections and thereby reduce the deficit in the short run. However, if the proposal's requirements--that all new loans be sold promptly and without recourse--artificially depress sale proceeds, the immediate, positive effect on the deficit could be more than offset by a longer run increase in the deficit. Even after adjusting for the time value of money, the stream of repayments that the government forgoes by selling a loan could be worth more than the revenue derived from the sale of the loan. We are currently studying this issue on several specific portfolios for another committee and expect to provide testimony on the subject in late March or early April.

PROPOSED BUDGET TREATMENT OF LOAN SALES IMPEDES MAXIMIZING SALE PROCEEDS

OMB's proposed budget classification for loan sale proceeds is an impediment to agencies selling loan assets with recourse and thereby maximizing sales proceeds. Specifically, OMB proposes to classify loan sale proceeds as deficit reducing receipts only if the sales are made without recourse to the government. However, if sales are made with any recourse to the government, no matter how limited, the sale proceeds are to be classified for budget purposes as borrowings rather than as receipts. Consequently, if sales with any form of recourse are made, the sales will not be considered as having contributed to deficit reduction. The proposed classification procedure reinforces OMB's guidelines, which call for loan sales without recourse.

We believe that under a limited recourse loan sale, the portion of the sale proceeds that represents the estimated amount the government would have to pay under the limited recourse provisions should be treated for budget purposes as borrowings. The balance of the sale proceeds should be treated as receipts. This approach is consistent with GAO's position on budget treatment for other federal loan guarantee programs, which is that a guarantee should be accounted for at its estimated cost to the government.

We believe that OMB loan asset sale guidelines do not place sufficient focus on maximizing sales receipts. Further, OMB's proposed budget treatment of loan sales impedes the sale of loans with recourse. We also believe that the costs to the government of credit programs should be used when measuring subsidies.

We are still doing work in the areas discussed under a request from Chairman Brooks. Our ongoing work includes reviews of specific loan portfolios to determine loan loss rates and to assess their marketability. We expect to report more on this and other matters when we complete our review this spring.

This concludes my formal remarks. I will be pleased to answer any questions you or other members of the Committee may have.