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Government-Sponsored Enterprises and the Proposed Resolution Funding Corporation (REFCORP)

Statement of
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Before the
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss government-sponsored enterprises, known as GSEs, and to address in particular the administration proposal to establish a Resolution Funding Corporation (REFCORP) as a GSE to help resolve the current crisis in the savings and loan industry. My statement will provide an overview of GSEs, discuss the budget treatment of GSEs, and, finally, provide GAO's views on whether REFCORP, if established and operated as currently described in draft legislation (H.R. 1278), should be treated in budget documents as an on-budget federal corporation or, as envisioned by the administration, as an off-budget GSE.

I should preface my remarks by saying that in recent testimony on the savings and loan problem, we have said that any use of federal money to resolve the problem should be on-budget, even if that means changing the Gramm-Rudman-Hollings deficit targets.

OVERVIEW OF GSEs

GSEs are chartered by the federal government pursuant to legislation, and they traditionally have been privately owned. Most current GSEs were established to buy and sell blocks of financial assets, primarily loan securities, to increase credit availability to certain target groups--such as home buyers, farmers, and students. Operating with various forms of federal backing, these GSEs are able to operate with relatively low money costs.

There are 10 GSEs currently operating. Attachment I lists them along with some pertinent details on each one. They range from the large Federal Home Loan Banks, with gross disbursements of about $189 billion in fiscal year 1988, to the smaller Federal Home Loan Mortgage Corporation ("Freddie Mac") with disbursements of about $6 billion. These GSEs disbursed about $326 billion in 1988, equivalent to about one-fourth the amount disbursed by the government.

Most GSEs finance their activities in part by selling securities to the public, just as the U.S. Treasury sells most of its securities to the public to finance the activities of federal agencies. In fiscal year 1988, GSEs borrowed about $95 billion from the public, which compares with similar Treasury borrowings that year of about $162 billion. One year earlier, in 1987, GSEs borrowed $125 billion. Such large GSE borrowings can compete with Treasury issuances in the securities market, and potentially affect interest rates paid by the Treasury and other borrowers. For this reason, GSEs by law or custom normally consult with the Treasury on their planned borrowings.

The GSEs reflect a variety of organizational and financing approaches. However, there are three features common to most GSEs that I would like to discuss.

Private Financing

GSEs normally obtain their funds from the private sector rather than the U.S. Treasury. They raise funds through a variety of means, including selling stock, securities, and financial assets in the private sector, and by collecting premiums and fees for services rendered. Most do not receive appropriations. This private side to GSE transactions is reflected in the fact that GSEs are not subject to Office of Management and Budget (OMB) apportionments, most GSE debt is not explicitly guaranteed by the U.S. government, and GSE receipts and outlays are not included in the U.S. government's budget totals. I will return to this last point later in my statement.

Mixed Control

Typically, most board members of a GSE are private persons selected by the GSE's shareholders or other nonfederal entities. Similarly, the employees are generally not part of the federal civil service and are not subject to federal pay limitations.

However, there is a degree of federal control. All GSEs are authorized in federal legislation, chartered by the U.S. government or one of its agencies, and their activities are limited by the terms of the charter. Most GSE charters provide that a federal official, sometimes the President, shall appoint a certain number (normally a minority) of the GSE board's members. That federal official also may be authorized to appoint the board's chairman. Some, such as the Federal Home Loan Banks, are explicitly mentioned in law as subject to audits by GAO.

Governmental Benefits

Federal legislation confers a number of benefits on GSEs not provided most private companies. Most GSEs are given a line-of-credit with the Treasury (which most have not used), and their investors' interest income is exempted from state and local taxation. Although they sell securities, most are exempted from Securities and Exchange Commission (SEC) registration requirements. As a result of these benefits and their ties to the U.S. government, GSEs are perceived to be instruments of federal policy enjoying an implicit federal guarantee of their liabilities. This allows them to borrow at rates only slightly above Treasury's cost of money.

THE BUDGET TREATMENT OF GSEs

OMB and Congressional Budget Office (CBO) budget documents show three kinds of totals: on-budget governmental, off-budget governmental, and governmentwide. The on-budget category includes the receipts and outlays of most governmental programs. The off-budget category includes the amounts of the two Social Security trust funds. By law, the Social Security amounts are excluded from the budget's totals. However, they are not excluded from the deficit calculation under Gramm-Rudman-Hollings. Both organizations also combine the on-budget and off-budget totals into a governmentwide total for purposes of fully disclosing the government's fiscal activities.

GSEs are not included in any of these totals. Their activities are not reported as part of the U.S. government's surplus or deficit, and are not covered by the Gramm-Rudman-Hollings deficit reduction legislation. Both OMB and CBO state that excluding GSEs from the government's totals generally follows a recommendation of the 1967 President's Commission on Budget Concepts, which held that government-sponsored enterprises that are "completely privately owned" should be excluded.

OMB's budget documents, however, contain special sections in which the activities and amounts of the GSEs are reported for information purposes. This, too, is in line with a recommendation of the 1967 Commission.

IMPLICATION FOR REFCORP

Mr. Chairman, you asked us to address whether REFCORP, if given the features described in the administration's proposal, should be considered a GSE, warranting off-budget status, or a federal agency, which would normally imply on-budget status. I should preface my remarks by stating that our conclusions could change if there are significant changes to H.R. 1278, entitled "The Financial Institutions Reform, Recovery and Enforcement Act of 1989." But first, let me outline in general terms how REFCORP would operate and describe the budgetary implications of treating REFCORP as an off-budget GSE instead of an on-budget federal corporation.

How REFCORP Would Operate

REFCORP would be established as an off-budget GSE to raise funds for a new on-budget federal corporation created by the same legislation, the Resolution Trust Corporation (RTC). The latter would be responsible for resolving currently insolvent savings and loan institutions and those which become insolvent during the 3 years after enactment of the legislation. The RTC would use funds provided by REFCORP.

REFCORP would fund the RTC by borrowing $50 billion in the securities market, through sales of 30-year REFCORP bonds, and then transferring the borrowed money to RTC by purchasing (using the borrowed funds) capital certificates of the RTC. The legislation would require savings and loan industry sources to provide about $5 billion to $6 billion to REFCORP by purchasing REFCORP nonvoting common stock. REFCORP would use this money to purchase 30-year, zero coupon Treasury bonds. Upon maturity, these bonds would provide REFCORP the $50 billion needed to pay off its debt principal.

Under the plan, no U.S. Treasury dollars would be needed to pay off the principal. Indeed, the legislation would stipulate that there is no federal government guarantee of REFCORP's repayment of this $50 billion. However, there would be a statutory requirement for the federal government to pay that portion of REFCORP's interest payments (on the $50 billion in borrowings) not covered by the proceeds from liquidating the assets of failed savings and loan institutions and from other industry amounts available to REFCORP.

Budgetary Implications of Treating REFCORP as a GSE

Let me now turn to the budgetary implications of treating REFCORP as a GSE. The existing provisions of H.R. 1278 do not stipulate that REFCORP's receipts and outlays would be excluded from the government's totals. However, the administration's explanations of the proposal clearly indicate that OMB would treat REFCORP like other GSEs and exclude its amounts from the government's totals. The theory is that REFCORP is essentially privately owned.

The budget advantage of classifying REFCORP as an off-budget GSE, and having it rather than the Treasury borrow the funds needed for savings and loan case resolutions, is that such an approach would minimize the short-term impact of resolution actions on the government's reported deficit. This, of course, would make it much easier for the government to meet or approach its Gramm-Rudman-Hollings deficit targets over the next few years.

Classifying REFCORP as an off-budget GSE would minimize the short-term deficit impact because REFCORP's $50 billion payment to the RTC would then be treated as private GSE money flowing from outside the government to a federal corporation. In other words, the money the government receives from REFCORP would be treated as a federal collection rather than a federal borrowing. Under established budgetary conventions, collections are offsets that reduce (by the amount of the collections) the budget's reported net outlays. On the other hand, amounts borrowed by the government are not counted as offsetting collections, and for good reason--to do so would permit the government to balance its books through borrowings.

We and others have pointed out that this off-budget REFCORP approach would have the longer-term consequence of increasing Treasury's interest costs over those that Treasury would pay if it, rather than REFCORP, borrowed the funds and made them available for resolution actions. This is because REFCORP's borrowings would carry higher interest costs than Treasury's. According to the administration, REFCORP would have to pay 25 basis points more than Treasury would have to on 30-year bonds, adding $3.8 billion to Treasury's interest costs over the life of the program. There are other estimates of higher added interest costs.

Partly out of concern over such added interest costs, some parties have advanced proposals or options that would fund the government's resolution actions through Treasury rather than REFCORP borrowings. I should add, though, that such an on-budget Treasury-financed approach would increase the budget's reported deficit, because the government's large resolution outlays would not be offset by collections from a GSE. Administration officials have stated that this would cause concern in domestic and international financial circles. Others, however, have testified that the financial markets already are recognizing the fiscal implications of the current problem and would not be adversely affected by an on-budget approach.

Also, some point out that an on-budget approach would increase reported outlays beyond fiscal year 1989, for any resolution actions that could not be completed in 1989, and add to the difficulties of reaching the Gramm-Rudman-Hollings deficit targets. Actions would be needed to either raise the Gramm-Rudman-Hollings deficit targets, or exempt the resolution outlays from the calculation of the deficit. As I stated earlier, we have expressed the view that the targets should be raised to accommodate any extra governmental spending to resolve the savings and loan industry crisis.

Ultimately, the question of whether Treasury or REFCORP borrowings are used will be a policy choice of the Congress and the President. And I would suggest that in making that choice, our elected officials should consider carefully whether it makes sense to treat REFCORP as a GSE. We expect that in this period of tight budgets, pressures will mount for more off-budget, GSE approaches.

However, if budget discipline is to be maintained, care should be taken to avoid creating new (off-budget) GSEs that, in reality, are more like federal agencies performing governmental functions. The label "GSE" should not be loosely given to justify off-budget approaches and make it appear that the government is staying within deficit targets.

Should REFCORP be Considered a GSE?

In our view, this question should be approached by looking at the ownership of REFCORP, and the substance of its transactions.

On the ownership matter, we would want to know who exercises control over the entity and who bears the financial responsibility for any losses. In the case of governmental agencies, the U.S. government directs and staffs the operations and generally is responsible for their incurred liabilities and losses. In the case of most GSEs, the direction of the entities is mixed but essentially private, with the boards of directors (most of whom are private sector persons) having considerable latitude to make decisions within the broad outlines of the GSE's charters. The legal liability for losses resides with the GSEs and their shareholders rather than the federal government. The Federal National Mortgage Associations ("Fannie Mae") is such a GSE.

Concerning the substance of the transactions, a judgment should be made about the purpose and function of the entity. Do its transactions directly benefit the federal government, with persons outside of the government benefitting indirectly (albeit perhaps in a significant way), or do its transactions directly benefit groups outside of the government? Looking at the substance of an entity's transaction can be particularly helpful in cases where it is not clear who controls the entity or bears the ultimate financial responsibility.

Let us now apply these standards to the proposed REFCORP. First, what about REFCORP's ownership? There are, indeed, certain private features. REFCORP's three board members would come from a GSE--two presidents of Federal Home Loan Banks, and the director of the Banks' Office of Finance. Also, REFCORP would rely upon employees of the Federal Home Loan Banks for its staff support. REFCORP would have no staff of its own.

Furthermore, the capitalization of REFCORP would come from the nonvoting common stock purchases of the private Federal Home Loan Banks. REFCORP would pay off the principal on its 30-year debt using the proceeds of zero coupon bonds it purchased using industry funds, and there would be no federal guarantee of REFCORP's debt principal.

There also are governmental features. The federal government would probably exercise closer control over REFCORP than it does over most other GSEs. The authorizing legislation would narrowly circumscribe the permissible activities of REFCORP, and provide for close supervision of REFCORP by the RTC's Oversight Board. As we stated earlier, RTC would be established as a federal corporation. The proposed law states that REFCORP, ". . . shall be subject to such regulations, orders, and directions as the Oversight Board may prescribe." According to the draft legislation, the Oversight Board would make the decisions on the amounts, timing, and methods of REFCORP's financing, including the amount of REFCORP stock that the private Federal Home Loan Banks would have to purchase.

Finally, the federal government would assume a legal liability for part or all of REFCORP's interest costs. To the extent that REFCORP's interest costs are not covered by designated REFCORP income (asset liquidations and Federal Home Loan Bank funds), Treasury must make up the shortfall. Administration officials estimate that this would cost the Treasury about $89 billion in interest outlays over the life of REFCORP's 30-year bonds.

When we consider on balance the various features of REFCORP, we are led to believe that REFCORP would more closely resemble a federal agency than a GSE.

This view is reinforced by the substance of REFCORP's transactions. REFCORP's relationship to the public would have a distinct governmental feature in its sole purpose and function--to borrow funds from the public and disburse those funds to a federal corporation, the RTC, for use in liquidating obligations of the federal government. Also, the funds REFCORP would receive from the savings and loan industry (to buy the zero coupons) would resemble tax revenues in their involuntary nature. The Federal Home Loan Banks would have little choice but to purchase REFCORP's stock, and the insured savings and loan institutions would have to pay their "assessments." We should add that these industry sources of REFCORP funds would have little or no expectation of ever getting their funds back: REFCORP is not designed to be a profit-making entity.

CONCLUDING REMARKS

In conclusion, Mr. Chairman, we believe that if REFCORP is used as part of the solution to the savings and loan crisis, it should be on-budget as a federal corporation. We have reached this conclusion after considering the ownership of REFCORP and the substance of its transactions. It is especially clear to us that the substance of REFCORP's activities is governmental--it is designed solely to raise funds for a federal corporation to satisfy federal obligations to the American public, and it relies upon tax-like collections from industry sources.

We are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions. These proposals, whose apparent purpose is usually to avoid the discipline required by constrained budget resources, are a serious threat to the integrity of the government's budget and financial management systems. If the proliferation of such entities continues, it will raise grave doubts about the credibility of the government's reports on its financial operations and condition, making it even more difficult for decisionmakers and the public to understand and deal meaningfully with the overriding problem of the budget deficit.

Thank you, Mr. Chairman. This concludes my prepared statement, and I would be glad to answer any questions you or members of the Committee may have.

GOVERNMENT-SPONSORED ENTERPRISES

Government-Sponsored Enterprise	Year Established	FY 1988 Borrowings (billions)	FY 1988 Disbursements (billions)
Financing Corporation	1987	$ 3.2	$ 0.0
Federal Home Loan Banks	1932	21.6	188.7
Federal Home Loan Mortgage Corp.	1970	15.4	5.5
Federal National Mortgage Assoc.	1938	50.0	35.0
Student Loan Marketing Assoc.	1972	3.7	10.1
College Construction Loan Insurance Assoc.	1986	0.0	0.0
Banks for Cooperatives	1933	2.3	67.3
Farm Credit Banks	1988	(2.2)	19.2
Farm Credit System Financial Assistance Corp.	1988	0.5	0.4
Federal Agricultural Mortgage Corp.	1988	0.0	0.0
Subtotal		94.5	326.2
Less: Borrowings from other GSEs		(0.4)	
Total		$ 94.1	$ 326.2