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Loan guarantees constitute a major portion of the Federal credit assistance program, representing an investment of about $200 billion. The effects of loan guarantees are far-reaching: (1) they confer large benefits on credit recipients; (2) they impose large budgetary costs on the Federal Government, and therefore, on taxpayers; and (3) they impose indirect costs on firms and individuals who are not directly involved with the programs. Like other subsidy programs, the cost effectiveness of loan guarantees should be evaluated to determine whether they are meeting their objectives in an efficient manner. The preliminary findings of an ongoing study at the General Accounting Office show that, although loan guarantee programs have expanded rapidly in recent years, their cost effectiveness has not been carefully evaluated. For 1975, losses on guaraneed loan programs were about $2.3. billion; benefits to borrowers due to interest rate reduction were about $2.6 billion. Evaluating a proposed loan guarantee program requires answers to three questions: (1) Is it desirable to stimulate investment in the sector to which the guarantee would be directed? (2) Is a loan guarantee the most appropriate form of subsidy? and (3) How can the program be designed to operate most efficiently? The budget authority needed to make good on the guarantees should be explicit in the legislation and adequate to provide the reserves necessary to carry out the planned level of activity. The budget should, of course, be subject to full disclosure and to executive and congressional reviews. (LDM)

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Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify before your Subcommittee on loan guarantees by the Federal Government. Loan guarantees are a major portion of the wide array of Federal credit assistance programs--the total of outstanding guaranteed loans is about $200 billion.

According to OMB's Special Analyses of the Budget, the principal objective of Federal credit programs is to "encourage certain types of economic activity by providing individuals, businesses, and government bodies with credit at more favorable terms than would otherwise be available in the private market."

In fact, Federal loan guarantees do much more than this. They:

-- confer large benefits on credit recipients;

-- impose large budgetary costs on the Federal Government and, therefore, taxpayers; and

-- impose indirect costs on firms and individuals who are not directly involved with the program.

Federal credit programs are subsidy programs.

Like other subsidy programs, their cost-effectiveness should be evaluated to determine whether they are meeting their objectives, how much these objectives are worth to society, and how much the programs cost. Objective evaluation might, in some cases, show the advantages of alternative policies--direct subsidy, price guarantees, or even no program at all.

My testimony today deals mainly with loan guarantees and is based on a study which is now underway in GAO. Because the study is not yet complete, these remarks should be considered preliminary.

Loan guarantee programs have expanded rapidly in recent years. Nevertheless, the evaluation questions I have mentioned have not been answered in any systematic fashion.

In my remarks today, I will emphasize some of the problems of congressional control over loan guarantees. My object is not to describe the many guarantees now outstanding, but rather to point out areas which we believe should be of concern to the Congress. These affect both existing programs and new proposals which will undoubtedly be considered during this session of Congress.

There is great diversity among the numerous loan guarantee programs.

-- They range from hundred-million dollar loans to large corporations down to loans of several hundred dollars to college students.

-- Some guarantee the full amount of the loan, some only part of it.

-- Some loans are backed by collateral, some are not.

-- Some loans are individually negotiated, some are almost entitlement programs.

-- Some programs show slight profits to the government, others lose money.

-- The amount of control over the money by the government varies widely from program to program.

In our analysis of loan guarantees, we have compared features of the various programs in order to develop a means for determining when guarantees are the appropriate form of subsidy and when some other form of aid might be more effective.

HOW LOAN GUARANTEES WORK

Different guarantee programs involve different degrees of subsidy, and costs to the government. The most effective programs are those that correct some imperfection in the market or lead to the creation of a market where one did not exist. Such programs typically serve many relatively small borrowers. For example, FHA loans back in the 1930's filled a certain gap in the credit market, perhaps caused by a reluctance of banks to accept the risks of long-term home mortgages. Whether these banks overestimated the risks or were simply adverse to taking risks is not clear. The point was that by pooling the risks, the FHA created a new credit market, and many homes were financed by a self-supporting government program.

In later years, credit assistance programs began to include a greater degree of actual subsidy from the government. These programs--in the aggregate--are currently running at a loss.

By our estimates, for 1975, losses on guaranteed loan programs were about 1.4 percent of loans outstanding--about $2.3 billion. For direct loans, losses were about 2.3 percent of loans outstanding--about $1.7 billion.

We have also estimated the benefits, or subsidy element, to borrowers due to interest rate reduction. For guaranteed loans in 1975, it was about 1.6 percent, or $2.6 billion. For direct loans, the benefit or subsidy figure was about 5.4 percent, or about $4.0 billion. These are preliminary and rough estimates.

The Office of Management and Budget, in its Special Analyses of the Budget, also estimates the subsidy element, but by a different approach.

It calculates the present value of the subsidy element in new loans and guarantees during a given year, i.e., how much the subsidy will be worth over the life of the loan. Our figures are for the subsidy element during a year for all loans and guarantees then outstanding. These two approaches are not at all in conflict--they are different ways of looking at the subsidy. OMB's estimates of the subsidy element exceed ours, because they are looking at the future of a growing list of programs, while we look at only one particular year of existing programs.

These figures emphasize my point that credit assistance programs are subsidy programs, and can be costly ones at that.

Although our subsidy figures exceed our cost figures, it should not be concluded that these programs have delivered a "free lunch." Our figures do not include other costs of loan guarantees such as the cost of using up, or "crowding out," credit that would otherwise have been available on the private sector or increase interest costs elsewhere in the economy.

Loan guarantees have generally escaped the discipline of the budget process, and they have, by and large, escaped the discipline of program evaluation. Regardless of how loan guarantees are scored in the budget, there is a growing need for information on how they are working and what they are accomplishing.

Recently, loan guarantee proposals have moved away from the concept of pooling risk for large numbers of relatively small borrowers. Increasingly, they have been used as a means to encourage single large ventures. The subsidy element, due to risk reduction and interest rate reduction,

has been viewed as a policy instrument, quite apart from any consideration of whether there is any particular imperfection in the market.

How does the subsidy element come into being? The rate of interest charged by a private lender includes a "risk premium," which is the excess interest over what would be charged to the least risky borrower. The riskier the borrower, the larger the risk premium required by the lender, and the higher the interest rate the borrower would have to pay in the market.

Loan guarantees lower the risk borne by the lender, thereby inducing the lender to drop the risk premium. The borrower benefits by the reduction in interest, as well as by other features of the guarantee which may reduce the risk to the borrower. Due to the reduced interest and other advantages of a guarantee, the borrower can be viewed as willing to pay a certain amount of money for the privilege of having his loan guaranteed. The benefit to the recipient does not correspond directly to a government cost. In fact, the benefits (to which we refer as the "subsidy element") can exceed the cost borne by the government.

The government may recover part of this subsidy by charging a loan guarantee fee to the borrower. This fee may be high enough to cover expected losses, but still leave room for a subsidy. Such was the case in early FHA mortgage guarantees, when the risk premium charged by the market may have been needlessly high.

The magnitude of the subsidy clearly depends upon the riskiness of the borrower--this is the peculiarity of the loan guarantee as a subsidy. The riskier the borrower appears in the eyes of the lender, the more valuable the guarantee.

This feature makes loan guarantees a powerful policy instrument in some circumstances, but ineffective in others. For example, if the government wished to induce General Motors to build smaller cars, offering a loan guarantee would probably have no effect because the guarantee would have little or no effect on the rate of interest at which GM could borrow.

If the borrower is in precarious financial condition, or if the project is risky, then loan guarantees could be expected to have fairly significant effects on the rate of interest. If the program in question is open to all applicants, then there will be a tendency for the more risky firms or individuals to apply.

This logic is applicable to such programs as guaranteed student loans. The "riskier" students--insofar as they could be identified in advance by lenders--received greater benefits through reduced interest costs. Needless to say, additional savings accrued to those who could not or did not repay the loans.

Despite the problem with existing programs, student loans are a prime example of how loan guarantees can solve problems in certain credit markets. Education--viewed as investment in human capital--is difficult to finance in existing capital markets, mainly because there is no tangible asset to be used as collateral.

However convincing the rationale for a guaranteed loan program, it must be administered properly. Under the student loan program, the Office of Education has paid out more than $280 million to lending institutions because about one of every six loans had been defaulted after the student had completed or withdrew from school. Of this, OE has

collected only about $25.1 million, and the collection program is not keeping pace with defaulted loans.

Surely the degree of effort which is put into enforcing repayment has some effect upon the number of defaults. If an agency is known to be lax in recovering its defaulted loans, there is little incentive to repay.

There is nothing inherently wrong with loan guarantees. They can be applied in the wrong circumstances, they can be poorly designed, and they can be poorly administered. On the other hand, loan guarantees can be useful, particularly if they are well designed and well administered. Good evaluation can help assure that they are used appropriately.

EVALUATION OF INDIVIDUAL LOAN GUARANTEE PROGRAMS

What is the future of loan guarantees? Even though they owe much of their popularity to their off-budget status, it is clear they are here to stay. Regardless of how loan guarantees are treated in the budget, we need to develop evaluation techniques for assuring that they are used effectively when they are appropriate. In fact, more rigorous budget treatment would highlight the need for evaluation of these commitments of public funds.

Evaluating a proposed loan guarantee program should consist of answering three questions. First, is it desirable to stimulate investment in the sector or to reach a group in society to which the guarantee would be directed? Second, is a loan guarantee an appropriate form of subsidy? Third, how can the program be designed to operate most efficiently? After the program is established, periodic review and evaluation is necessary.

When zero-based budgeting is used, it should be applied just as rigorously to loan guarantees as to on-budget programs.

Appropriateness of the Program

The first questions that should be asked about any Federal program are whether its objectives serve a useful function of government and where those objectives rank in the hierarchy of public priorities. Although these questions involve value judgments, some economic considerations are also involved.

In particular, one should consider why the objectives of the program are not being met through the market mechanism and whether any subsidy could correct the problem. That is, will a subsidy actually alter the state of affairs? It seems reasonable to conclude, for example, that without a subsidy, few commercial ships would be built in the United States because of high construction costs. Other times the riskiness of a loan means that lenders will not make funds available at a reasonable price, such as to students and small businesses. On the other hand, we should be alert to the possibility that a subsidy program merely rewards people for what they would do any way or, alternatively, is too small to influence their behavior.

We must also be alert to the side-effects of a program. For example, if the economy is near full capacity, one particular investment may be obtainable only if another is given up. Thus, there is a tradeoff between the subsidized investment and the one which is being sacrificed. Unfortunately, these side-effects are very difficult to quantify even though we know they exist.

Type of Program

Once it has been decided that a subsidy is appropriate to achieve a particular objective, attention should focus on the way in which the subsidy is to be provided. Loan guarantees are one possible approach, but there are many alternatives--direct subsidies, tax credits for investment, price supports, direct government ownership, tariff protection, and so forth.

The basic question is how to achieve program objectives most effectively, at the lowest cost to the government and with the least disruption to the private sector.

In evaluating loan guarantees, we must distinguish the mechanism from the ultimate objective. A loan guarantee will make funds available to the borrower at lower interest rates. But this is a means, not an end. The final desired impact might be to increase consumption of some good, such as housing, or to increase domestic production of some goods, such as ships or energy. In some cases, the objective may be simply to transfer money to recipients through interest rate reduction. The underlying question is: How effective and efficient is the mechanism of loan guarantees in achieving the ultimate goals of the program?

Loan guarantees are at their best when there is some element of risk that has been overestimated in the private market. Again, we come back to the old FHA experience, when loan guarantees helped make a new market in long-term mortgages. But capital markets are much more sophisticated than they used to be, and it is not clear whether there are still many cases where financial markets overestimate riskiness. If there were,

it is not clear that the government would necessarily evaluate riskiness more accurately than the private market.

Even if the market has properly assessed risk, loan guarantees can be an effective policy instrument. They reduce interest costs to the borrower, because they eliminate the risk premium, and may not cost the government anything. There would still be a kind of "crowding out" cost born by other private borrowers who would face higher interest costs. This cost is important, but here we are comparing loan guarantees with other forms of subsidy, such as direct cash grants, which will have their own "crowding out" effects. The burden of loan guarantees probably falls more heavily on the investment sector of the economy, whereas other subsidies--financed by taxes--are likely to be more of a burden on consumption.

The effectiveness of loan guarantees in accomplishing their ultimate objectives is likely to turn on the effect of interest rate reduction on the investment behavior of the recipient--a much disputed question among economists. It is widely believed that lower interest rates stimulate investment, but little is known about the magnitude of the effect. Incidentally, this question also applies to assessing the effect of other forms of subsidy, such as the investment tax credit.

Although loan guarantees are subsidies and do incur costs, they may be, in some cases, relatively efficient forms of subsidy. Consider a guarantee that is worth $100 to the recipient. In other words, suppose that the guarantee had lowered the interest rate and reduced risk to the extent that the recipient would have been willing to pay $100 in order to

have his loan guaranteed by the government. It is quite possible that this guarantee would cost the government less than $100 in administration, defaults, and other costs. If it works out this way, a subsidy worth $100 has been provided at a cost of less than $100. A direct subsidy of the same value would presumably have cost the full $100. It is in this sense that guarantees may, in some circumstances, be more efficient than direct subsidies.

In considering what type of program to adopt, the choice between direct loans and guaranteed loans deserves discussion. Direct loans are usually made at lower interest rates, mainly because the government does not usually attempt to make a profit. Even though the guarantee removes risk, the private lender usually must pay more than the Federal Government to obtain the funds in the first place, and he also tries to make a profit. Though direct loans have lower interest rates, there are good reasons why the government should not compete too extensively in the banking business.

The interest rate for direct loans is not determined by the market. As a result, the government might grant more of a subsidy than is actually needed by setting interest rates too low. With guarantees, the borrower has an incentive to seek out the best terms he can find.

Design of Loan Guarantees

According to the Hoover Commission report, written in 1955, "The government is not a canny lender." However careful the government must be in lending, it must be equally careful in guaranteeing loans, for the risk is essentially the same.

In the private sector, the lender decides upon the provisions of the loan after judging both the borrower and the project. In a guaranteed loan program, however, the lender sometimes bears none of the risk and thus has very little incentive to guard against default. When the government assumes all the risk, it also must assume responsibility for choosing among applicants and for judging the acceptability of the risks.

A fundamental decision must be made at the outset--is the program intended to be self-supporting or does Congress intend an additional subsidy in the form of losses on defaults? For programs meant to be self-supporting, the loan guarantee fee theoretically can be set high enough to cover expected losses. If the program involves a large number of relatively small loans, it is often possible to estimate future losses through statistical analysis. It is much more difficult to predict the default rate for a program involving a small number of large loans. Statistical estimating techniques generally cannot be applied in these situations and we must depend much more heavily on individual judgment.

There are two main mechanisms available to control risk. The first is to make the loan recipient subject to certain operating restrictions. For firms receiving loan guarantees, these could include such things as limiting dividends and additional investments, requiring purchase of insurance or requiring operation within certain constraints on financial statement data. For example, recipients of Maritime Administration loan guarantees are initially classified as weak or strong firms depending on certain financial ratios. As long as these ratios are maintained, firms must meet certain "positive covenants." If the financial requirements

are not met, additional "negative covenants" are placed on the firm.

The second mechanism for controlling risk is through recourse to the assets of the borrower in the event of default. Full recourse loans are those in which the government can recover the full value of the loan guarantee (except in the case of bankruptcy) from the defaulted borrower. The government recovers nothing from default on a non-recourse loan. A partial recourse loan means that the government may recover some part of the value of the loan in the event of default. In the partial recourse case, the recourse is usually to the asset for which the loan was made.

Non-recourse and partial recourse loans increase the value of the loan to the borrower, because limits are placed on the borrower's risks. Simultaneously, of course, the government's risks (and costs) increase. Partial recourse loans might be appropriate, for example, when the government wishes to encourage investment in a new and uncertain technology, but firms are unwilling to gamble their other assets on the venture. Of course, loan guarantees are not the only way to overcome this hurdle. Government might undertake the investment itself, rather than depending on private industry to do so. Since non-recourse or partial-recourse reduces risk to the borrower, and may be costly to the government, consideration should be given to charging a fee for this extra benefit.

How large a fraction of the asset should the loan be for? If the market would loan 80 percent, but the government program will loan 95 percent, the subsidy may well show up as a loss to the government later on. If the value of the asset drops by more than 5 percent, then the borrower may find that default is a perfectly rational course of action, especially if the government has no recourse to the borrower's other assets.

Administration of Loan Guarantees

In designing a loan guarantee program, careful thought should be given to who will assess the merits of each loan, and how much flexibility there will be in setting loan terms. The budget authority needed to make good on the guarantees should be explicit in the legislation and adequate to provide the reserves necessary to carry out the planned level of activity. The budget, of course, should be subject to full disclosure and to executive and congressional reviews.

Plans should also be made for allocating credit when the demand for guarantees exceeds the available authority. From the standpoint of program effectiveness, the best criteria would probably be compatibility with long-run objectives of the program if this can be measured. Alternatives include allocating on the basis of need, risk, first-come-first-served, random, or allocation through a market mechanism. The market mechanism often provides appropriate and efficient incentives, and we believe that this approach should receive careful consideration.

By a market mechanism, we mean allowing the price for the guarantee to be established in a "market for guarantees", thus linking the cost of the guarantees to their value to the recipient. Let me give an example: When it is feasible, guarantees could be granted on the basis of competitive bidding on certain features of the guarantee, such as equity participation by the firm, the guarantee fee, the amount of the assets pledged as collateral in case of default, or the portion of the loan that is guaranteed. By making prospective borrowers compete for terms, the expected cost and risk to the government can be reduced. Furthermore,

by increasing the equity participation of the firm and by leaving part of the loan uninsured, both the borrower and the lender have a greater incentive to manage the venture efficiently so as to avoid default. Such competition would result in a higher equity/debt ratio for the borrower, which reduces risks to the government as compared to a more highly leveraged project.

Such bidding procedures would not be appropriate in all cases, but they might be useful, for example, when the government wants to encourage some large project, wants to minimize the subsidy element of the guarantee, is uncertain of how private borrowers and lenders view the risks, and wants to draw the more efficient firms into the project.

Mr. Chairman, this completes my prepared statement. We would be happy to respond to any questions.