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STATEMENT OF

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COMPTROLLER GENERAL

BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE,

HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

ON

THE GOVERNMENT'S LOAN ASSET SALES

PILOT PROGRAM

Mr. Chairman and Members of the Subcommittee:

In a May 5, 1986, letter, you asked us to evaluate several aspects of the administration's proposal to sell to the public loans that are held by the federal government as assets (loan assets).

The Congress is presently considering the amount of loan asset sales which are to be made in fiscal year 1987. In this connection, we are pleased to be here today to discuss our assessment of whether the administration's pilot program to sell federally held loan assets will adequately protect the government's interests and whether OMB's loan sale guidelines will meet program objectives.

OMB's guidelines to agencies for loan asset sales require that all sales be made without future recourse[1] to the federal government. They also require that responsibility for collecting and servicing loan assets be transferred to the purchaser when a loan asset is sold. We believe that these requirements will adversely affect the loan assets' marketability and the potential net proceeds from their sale. Furthermore, OMB proposes to treat the loan asset sales proceeds as borrowings if sales are made with recourse to the government, contrary to normal budgetary treatment of guarantees. However, this proposed budgetary treatment of loan asset sales does reinforce OMB's loan sales guidelines. Additionally, the guidelines' requirements, and OMB's proposed policy on subsidy determination, will not contribute to an accurate measure of credit program subsidies, one of the four program objectives. As a result of these policies, the government's best interests will not be protected and the objectives of the loan asset sales pilot program will not be fully achieved.

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[1]OMB's guidelines state that recourse includes any federal guarantees of principal and interest payments, repurchase contracts, agreements to replace bad loans with good loans, warranties relating to collateral value, or any other agreements requiring continued federal involvement or contingent liability.

BACKGROUND ON CURRENT LOAN ASSET SALES INITIATIVES

Loan asset sales is part of a growing overall effort to improve federal credit management and to generate budgetary receipts. The President's fiscal year 1987 budget request included a pilot program to sell a portion of government-held loan assets over a period of 5 years (fiscal years 1987 throuth 1991). Portions of 13 loan portfolios, worth $15 billion, are involved. Selected portions of 12 loan portfolios are proposed for sale in fiscal year 1987. These total $4.4 billion, and OMB projects proceeds of $2 billion, before considering sales expenses. (See appendix I.) Both the House and Senate fiscal year 1987 budget reconciliation bills provided for selling loan assets from a number of programs. The Senate bill and conference committee report, for example, proposed sales in 1987 that would result in proceeds of about $3.1 billion. In addition, major bills have recently been introduced in the Congress which address credit management issues and include provisions for loan asset sales. These include H.R. 4659, S. 2620, and S. 2142.

We recently completed a major governmentwide review[2] of debt collection activities that disclosed that many agencies are not effectively implementing and using available credit management and debt collection tools. One of these tools is the sale of government-held loans to the public. Our report stated that, because some agencies have little or no experience in this area, agencies should further examine the risks and benefits of loan asset sales on their programs and consider pilot programs of such loan asset sales.

To provide policy guidance to agencies in the loan asset sales area, on July 8, 1986, OMB issued guidelines for loan asset sales. (See appendix II.) These guidelines were developed by a federal credit policy working group, which is part of the Economic Policy Council and is composed of officials representing major agencies and OMB. Objectives of the loan asset sales pilot program, as stated by OMB, are to

--reduce the government's cost of administering credit programs by transferring responsibility for servicing, collecting, and other administrative activities to the private sector;

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[2]Debt Collection: Billions Are Owed While Collection and Accounting Problems Are Unresolved (GAO/AFMD-86-39, May 23, 1986).

--provide an incentive for agencies to improve loan origination [improve loan terms and conditions] and documentation;

--determine the actual subsidy of a federal credit program; and

--increase the government's receipts in order to reduce the budgetary deficit in the year of sale.

The guidelines include 10 specific requirements to help achieve these objectives. We believe two of these requirements have a major effect on the marketability of the loans and the ability to maximize potential net sale proceeds. These requirements are

--loan asset sales shall be made without future recourse to the federal government, and

--collection and servicing shall be transferred to the purchaser with sale of a loan asset.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to determine what effect OMB policies and procedures for conducting loan asset sales will have on loan marketability and sale proceeds. In particular, we reviewed OMB's loan asset sales guidelines to determine whether the prescribed procedures will result in the government realizing the maximum net proceeds practicable and whether they will permit the government to effectively use the available services of the secondary credit markets. In this connection, we reviewed an OMB proposed budgetary policy which we believe would also impact on the program's ability to fully achieve the guidelines' objective of increasing government collections (receipts). We also assessed OMB's proposed approach for determining the actual subsidy of federal credit programs, another of the guidelines' objectives.

In conducting our review, we discussed the guidelines and several alternative methods of selling loan assets with

--officials of OMB and the Department of the Treasury who participated in preparing and issuing the loan asset sale guidelines,

--representatives of the Federal National Mortgage Association and the Government National Mortgage Association, and

--seven major secondary credit market institutions. (See appendix III.)

We also reviewed one of the secondary credit market institution's marketability analysis of one loan portfolio planned for sale in fiscal year 1987--the Department of Education's college housing loans. Lastly, we reviewed loan sales by two agencies which have had recent programs to sell loan assets.

We did not have an opportunity to review individual agencies' proposed loan asset sales strategies and procedures because they were not required to be submitted to OMB until August 22, 1986. In addition, we did not attempt to estimate the potential proceeds that might result from sales of loan assets in the pilot program by agencies. We will include these areas in our ongoing work in response to your original request. We performed our work from July 1986 through August 1986 in accordance with generally accepted government auditing standards.

GUIDELINES WILL NOT PRODUCE MAXIMUM NET SALE PROCEEDS

One of the objectives of the loan asset sales pilot program is to increase the government's receipts. For purposes of the budget, this program is expected to increase receipts which would have the effect of reducing the budgetary deficit. We believe that this objective also includes an implicit responsibility to protect the government's interests by selling loan assets on a basis that produces the maximum net proceeds practical at the minimum risk. We believe that, because the OMB guidelines require that loan asset sales be made without future recourse to the government, the net proceeds from the sales will not be maximized.

Our study of existing credit markets, which are in the business of marketing loans, confirmed that sales of many loan assets without some form of partial recourse will not produce the highest possible proceeds. Representatives of two agencies with experience in selling loan assets told us that nonrecourse sales would result in expected proceeds lower than the net proceeds of partial recourse sales even after considering the government's maximum contingent liability under the partial recourse provision.
Similarly, the monetary advantages to the government of selling loan assets with recourse is further supported by a market analysis of the Department of Education's college housing loan portfolio.

Existing Financial Markets

Existing financial markets, referred to as the secondary credit markets, function as a potential vehicle for facilitating the government's loan asset sales. The secondary credit markets are the means established by the financial community for trading mortgage and nonmortgage loans and related securities. These secondary credit markets trade very large amounts of securities (for example, sales of newly issued mortgage-related securities alone were over $160 billion in 1985) and trade asset-backed individual and pooled financial instruments. Major investment institutions participate in the market by providing functions such as selling securities to the public that are backed by pools of loans. Purchasers of these securities include large pension funds, trust companies, and major individual investors. We believe these secondary credit markets represent a readily available way for the government to handle the sale of loan assets.

While studying secondary credit markets, we were advised by representatives of major institutions in the markets that, because major investors want to deal in large dollar volume, any loan asset sale, whether with or without recourse, should be structured as a pool of loans rather than as an individual loan sale.

In evaluating potential federal government participation in these markets, the institutions' representatives indicated that certain loan pools could be successfully sold without government recourse. These loan pools would include the types that investors are familiar with, such as residential mortgage loans. Conversely, however, the representatives unanimously agreed that OMB's guidance to sell loan assets without any form of recourse to the government would result, in many cases, in the government not realizing the maximum possible net sale proceeds. This belief was based on the representatives' experience that, for portfolios with certain characteristics, the lack of recourse would tend to depress net sale proceeds. These representatives also said that the characteristics of certain government loan portfolios have the potential for reducing proceeds unless some form of recourse or guarantee were provided. These characteristics were:

--Investor unfamiliarity with the various types of government loan assets being sold.

--Creditworthiness of borrowers under certain government loan programs not meeting commercial lending standards.

--Loan terms and supporting documentation for certain government programs not meeting commercial lending standards.

--High default rates on certain government programs compared to commercial lending standards.

--Modified loan terms or extended repayment periods for some types of loans whose borrowers experienced difficulties in meeting original loan principal and interest payments.

The secondary credit markets operate utilizing certain concepts, which would be beneficial to the government's proposed loan asset sales. Furthermore, these markets are readily available for the government's use in selling loan assets. Two major concepts utilized in these markets are sales on a "structured basis" with "credit enhancement." Our analysis and discussions led us to believe that for government-held loan portfolios having any of the above characteristics, the government should consider using a structured basis with credit enhancement to maximize net sale proceeds. These concepts are explained in the following paragraphs.

As used in the secondary credit markets, 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 or a participation certificate,[3] with the principal and future interest payments of the loans in the pool as collateral (that is, a collateralized security);

--arranging for a third party commercial organization to service the loans in the pool--that is, collecting periodic principal and interest payments from borrowers and making remittances to the entity issuing the security for subsequent payment to investors;

--obtaining credit ratings for the security; and

--providing some form of credit enhancement for the new security--that is, some form of recourse to the seller.

We believe that selling loan assets by issuing securities that are backed by a pool of loans has merit and should be applied on a case-by-case basis, considering the characteristics of the loan assets to be sold. We note that a similar process is used by the Government National

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[3]A participation certificate is a special security sold to the public which is backed by a pool of loans.

Mortgage Association (GNMA) and other institutions in the secondary credit markets. In addition, although not permitted by OMB's guidelines, we believe that allowing loans that have been sold to be serviced by an entity other than the purchaser is an integral part of selling loans using a structured basis. As such, this procedure would contribute to the marketability of loans to be sold and, hence, to the sales proceeds. An example of a typical structure, as suggested by the representatives, for selling loan assets by issuing a security with collateral is illustrated in appendix IV.

Based on the secondary credit markets' existing practices, "credit enhancement" for securities could include one or more of the following.

--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. Under this alternative, the government and the investors in the loan portfolios would share the potential risk of borrower default.

--Credit insurance from a private insurance company.

--Some degree of overcollateralization whereby the securities are backed by a pool of loans whose aggregate value is greater than the face value of the securities sold.

We believe that these represent sound financial practices that could be adopted as part of the government's loan asset sales program. We also support the idea of shared risk by the government and investors because of its potential for maximizing loan sale net proceeds.

Our discussions with representatives from major firms in these secondary markets indicate that, if the government's loan asset sales are not conducted using these concepts, major investment institutions in the secondary credit markets will generally not be interested in participating in the sales.

We believe that the secondary credit markets offer the kinds of services that would result in maximizing the net proceeds from the sale of government loan assets. Further, these markets attract the type of investors most likely to invest in large portfolio sales. In addition, we think that the secondary credit markets' concepts about loan asset sales are valid. These secondary credit markets should, therefore, be utilized in accomplishing these sales. We believe that the restrictive nature of the guidelines' requirements will hinder the secondary credit markets' participation in the loan asset sales program. This possibility would severely limit the available market in which these loans could be sold.

Prior Government Experience
With Loan Sales

In the past, the government has sold loan assets that were packaged in pools which, in turn, were used to collateralize new securities--participation certificates--which were then sold to private investors. These certificates carried a government guarantee as to the timely payment of principal and interest. In fact, several agencies have sold both mortgage and nonmortgage loans through GNMA by creating pools of loans which were used as underlying collateral for participation certificates. As of March 31, 1986, agencies, including GNMA itself, had about $2 billion in such participation certificates outstanding.

We recently reported (see footnote 2) that both the Department of Housing and Urban Development (HUD) and the Veterans Administration (VA) have had experience with loan asset sales. HUD has made sales using both recourse and nonrecourse methods, while VA has used only recourse. During our discussions with representatives of both agencies, we were told that both agencies have concluded that loan assets sold without recourse would reduce proceeds from the sale.

From 1982 through 1984, HUD sold loan assets direct to the public with and without insurance as a form of recourse. After receiving instructions from OMB in 1984 to discontinue selling mortgages with recourse, HUD officials discussed the feasibility of selling nonrecourse loan assets with representatives of the secondary credit markets. As a result, HUD officials concluded that such sales would not be practical because the expected proceeds would be low and the administrative cost of preparing the loan assets for sale by bringing the loans' documentation up to market standards would be high.

During fiscal years 1984 and 1985, VA realized $1.5 billion from sales of loan assets with recourse. VA plans to continue selling loan assets with recourse. The Deficit Reduction Act of 1984 specifically provides for VA to make such sales if the Administrator determines that they are necessary to maintain the effective functioning of the home loan guarantee program. According to VA loan officials, the marketability of its loan assets would be greatly reduced, and offers very low, if the loan assets were placed in the market for sale without recourse.

Private Investment Firm's Study of College Housing Loans

One of the larger loan portfolios proposed for sale is the Department of Education's college housing loans, a portfolio of loans which is considered by the secondary credit markets to be of relatively high quality and more creditworthy than many of the other portfolios proposed for sale by the government. College housing loan assets worth about $2.1 billion are scheduled for sale in the fiscal year 1987-88 period. The Department is ahead of other agencies preparing for the sales in that it contracted with a consultant to study the loans prior to sale. The consultant, Smith Barney, Harris Upham & Co., Inc., issued its final report on July 30, 1986. The report discussed two methods of selling the loan assets: selling loans in separate portfolios without recourse and pooling loans as collateral for a new issue of a security with recourse in the form of a limited guarantee.

The alternative of issuing a new security with a limited guarantee backed by the loan pool was the consultant's recommended method of selling the loan assets. The estimated proceeds from the separate portfolio sale without recourse were about $1.1 billion, while the net proceeds from the sale of a security with a limited guarantee were about $1.3 billion. Thus, under the limited guarantee alternative, the estimated net proceeds would be increased by more than $220 million, about a 20-percent increase in proceeds. Table 1 shows the consultant's estimated net proceeds for both methods.

Table 1: Consultant's Estimated Net Proceeds From Alternative Methods of Selling College Housing Program Loan Assets

Method	Gross proceeds	Cost of sale	Net proceeds
	---------(millions)--------		
Separate portfolio sales without recourse	$1,178.7	$ 90.8	$1,087.9
Security issue with limited guarantee	$1,319.5	$ 9.4	$1,310.1

Regarding the cost of sale, under the first method, the loan portfolios would need to be brought to a condition acceptable to the marketplace. This would include providing complete loan documentation and obtaining a commercial credit rating for each loan. The study estimated that the cost would be about $91 million to prepare the loan assets for sale, including sales commissions, which represent $16 million of this cost.

More significantly, because of the sub-standard condition of the portfolio's loan documentation, the study estimated that it would cost about $75 million to prepare adequate documentation to meet market standards and for associated services such as analyzing documents and obtaining a credit rating. This illustrates the high cost to the government when an agency has maintained poor records in support of its financial operations. In the second method, the total cost of pooling the loans and issuing a new security was estimated at about $9 million, since the loan portfolio would not have to be brought up to market standards.

Overall, agencies, as a matter of good financial management, should assure that documentation supporting individual loans meets commercial standards. Adequate documentation is essential to ensure minimum problems with collectibility, to protect the government's interests in case of defaults, and to provide for greater flexibility in the selection of sales methods if the government elects to sell loan assets to the public.

If the limited guarantee sale option is selected, the government could gain up to an estimated $220 million in additional sale proceeds in exchange for an estimated maximum guarantee risk of about $60 million. This alternative and additional information on its guarantee aspects are further discussed in appendix V.

We believe that the consultant's college housing loan market analysis demonstrates the potential monetary advantage to the government of selling loan assets with recourse. It also shows that selling loan assets using a structured basis is feasible and that it can be accomplished with the transfer of loan servicing to another party other than the purchaser. We believe that, if consideration were given to selling other loan portfolios using the same structured basis, additional opportunities for increased net sale proceeds are likely to be identified as well.

PROPOSED BUDGET TREATMENT OF LOAN SALE PROCEEDS NEEDS TO BE CHANGED

Until now, federal loan guarantees--loans with some type of recourse to the government--were considered contingent liabilities and were not classified as borrowings for budget purposes. For the loan asset sales, however, OMB has proposed classifying sale proceeds as borrowings for budget purposes if sales are made with any recourse to the government. This budgetary treatment is the opposite of OMB's previous position. The proposed treatment does, of course, reinforce OMB's guidelines concerning the nonrecourse method. For example, OMB plans to classify the proceeds of loan sales as budget receipts only if the sales are made without any recourse to the government. If agencies conduct recourse loan sales--no matter how limited the recourse--OMB proposes to classify the proceeds as borrowings rather than receipts for budget purposes. Consequently, any loan sale made with recourse will not contribute to the objective of increasing receipts. Therefore, OMB's loan sale guidelines and the proposed budget classification of loan sale proceeds would prevent the government from fully achieving the program's objectives.

Loan sales with some form of recourse to the government, as discussed earlier, will permit the government to take full advantage of existing secondary credit markets and to maximize the proceeds of loan sales. Limited recourse loan sales put a "cap" on the government's future liability in the event that sold loans go into default. This limited liability would be represented by some portion of the loan sale proceeds based on experienced default rates for the loan portfolio sold. Consequently, on a limited recourse sale, the government can define (1) the portion of loan sale proceeds that represents the government's maximum contingent liability under the limited recourse provisions of the sale and (2) the portion of loan sale proceeds that represents unencumbered sale proceeds. These unencumbered sale proceeds should be considered as budgetary receipts for deficit reduction purposes.

Under OMB's currently proposed budget classification for loan sale proceeds, the entire proceeds of a limited recourse loan sale would be classified as borrowings for budgetary purposes even though a portion of the proceeds are unencumbered by any contingent liability for borrower defaults. We believe that, if recourse is limited to a certain amount, the remainder of the sale proceeds represents funds that should not be treated as borrowings. These funds should be considered budgetary receipts for deficit reduction purposes. For example, in the case of the college housing loan portfolio discussed previously, the limited recourse sale provisions would "cap" the government's future contingent liability under the recourse provisions at $59.8 million out of total sale proceeds of $1.3 billion (given that the experienced default rate of 4 percent remains constant). The remaining $1.24 billion represents unencumbered sale proceeds that should be considered budgetary receipts for deficit reduction purposes.

We believe that the cost of any recourse to the government under a loan asset sale should be recognized in the budget. We disagree, however, with OMB's plans to classify, for budget purposes, the entire proceeds of a loan sale as borrowings if the sale includes limited recourse to the government. A major concern is that OMB's proposed budget classification for loan sale proceeds does not recognize the actual and potential economic consequences of limited recourse loan sales. Specifically, OMB's budget classification does not recognize the limited nature of the government's contingent liability as borrowings and the unencumbered portion of loan sale proceeds as receipts for budgetary purposes. OMB's approach is inconsistent with our 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 our treatment of limited recourse loan sales would permit the budget to reflect the actual and potential economic consequences of limited recourse loan sales and would be consistent with program objectives.

CREDIT PROGRAM SUBSIDIES WILL NOT BE ACCURATELY MEASURED

An objective of the loan asset sale pilot program, as stated in OMB's loan asset sale guidelines, is to determine the actual subsidies of federal credit programs. Federal subsidies can be defined generally as the support provided by government to a private person or a company for a specific purpose deemed advantageous to the public. We believe information used to determine subsidies must be accurate and pertain to the specific time when and purpose for which the subsidies were made. This would be consistent with OMB Circular A-70, dated August 2, 1984. This circular requires that agencies, with direct loan programs, calculate a subsidy cost when the federal government makes credit available to borrowers on more favorable terms than would otherwise be available from private sources. The circular directs agencies to calculate the subsidy at the time loans are granted by taking into account the cost of alternative private financing available to borrowers for the loan or type of loan proposed to be made by the agency.

Concerning loan asset sales, OMB presently proposes to determine the subsidies by measuring the difference between the face value of the loans offered for sale and the amount for which the loans are purchased. OMB's proposal is inconsistent with Circular A-70 and, in our opinion, does not measure loan program subsidies. Decisions to sell loan assets are made to meet various objectives, such as increasing budgetary receipts. These objectives differ from the credit program's original objectives. Therefore, the decision to sell loan assets is a different economic decision--separate and distinct--from the original decision to grant the loans.

Subsidies for federal loan programs can generally be determined based on one of two perspectives: (1) the loan subsidy cost to the government and (2) the economic subsidy to the borrower (the approach that is consistent with Circular A-70). A loan subsidy cost to the government arises when it makes loans at interest rates lower than the interest rates it incurs to borrow the money to cover the loans. Economic subsidies to borrowers arise when the interest rates the government charges are lower than interest rates borrowers could obtain for similar loans from commercial lenders. To our knowledge, there is no general agreement as to which perspective is most appropriate.

However, in our view, interest rates prevailing at the time loan decisions were originally made should be used to determine subsidy amounts because these rates reflect the economic conditions prevailing when the loans were originally made. If the prevailing interest rates at the time the loan assets are sold are used to determine subsidy amounts and if these rates are higher or lower than prevailing rates at the time the loans were originally made, then the apparent subsidy amounts will be overstated or understated, respectively.

In addition to interest rate changes, other factors relating directly to the sale decisions and the government's loan management practices would cause a difference between the face value of loans sold and the amount received for the loans. As pointed out by representatives from the secondary credit markets, these considerations include such things as familiarity of the investors with the type of loans offered for sale and adequacy of the underlying loan documentation. OMB's proposed method of measuring credit program subsidies would, therefore, improperly reflect these factors, which would cause the subsidy determinations to be inflated.

The proposed sale of the college housing loan portfolio can be used to illustrate the impact of OMB's proposed methodology for determining federal credit program subsidies. For the purposes of this illustration, we are defining the subsidy as the loan subsidy cost to the government--the differences between the government's interest rate to borrow funds and the interest rate it charges borrowers.

Treasury's long-term borrowing rate at the time the 3-percent college housing loans were made ranged between 5.96 and 6.85 percent. Consequently, the government's loan subsidy cost, in terms of interest rates, ranged between 2.96 and 3.85 percent when the college housing loans were originally made. In contrast, the Department of Education's financial consultant estimated that investors would require a return on their investment of between 9.5 and 13.25 percent in order to purchase the college housing loan portfolio without any recourse to the government. Consequently, following OMB's proposed approach would result in using interest rates ranging between 6.5 and 10.25 percent to determine subsidy costs. Using these rates would, therefore, materially overstate the subsidy because these rates reflect changes in economic conditions not related to the decisions to originally grant the loans.

In addition, the cost of improving the substandard condition of the Department's loan documentation is about $75 million. Since this cost reduces the sales proceeds which will be used in determining the subsidy, the subsidy would also be overstated by this amount.

Finally, since the OMB guidelines prescribe loan sales to be made on a nonrecourse basis, program subsidies will be higher than if recourse sales were allowed. For example, in the consultant's estimate for the sale of college housing loans, additional proceeds of $220 million could be realized if the sale was made with recourse. However, because OMB has prohibited sales with recourse, these additional proceeds will not be realized and thus the subsidies will be increased by those amounts.

CONCLUSIONS

OMB's guidelines on sale of loan assets require that all sales are to be made on a nonrecourse basis and that responsibility for collection and servicing is to be transferred to the purchaser with sale of a loan asset. We believe that OMB's guidance to agencies in these two areas will result in not protecting the government's best interests because the government will not be maximizing net proceeds on the sale of certain loan portfolios. Also, OMB's proposed budgetary treatment of loan asset sales with limited recourse does not reflect the actual and potential economic consequences of such sales and is incorrect budgetary treatment. In addition, several of the guidelines' requirements, as well as OMB's proposed policy on subsidy determination, will result in overstating the subsidies associated with credit programs. OMB's objectives for the pilot loan sales program will, therefore, not be fully achieved.

RECOMMENDATIONS

To fully maximize loan sale net proceeds and to fulfill the objectives of its loan asset sale program, we recommend that the Director, OMB

--revise OMB's guidelines for sale of loan assets to permit agencies to sell loan assets on a structured basis, which would include some form of future recourse to the government (or other credit enhancement) and permit servicing of sold loans by an entity other than the purchaser and

--classify, for budget purposes, the government's maximum contingent liability under limited recourse loan sales as borrowings and the unencumbered sale proceeds as receipts.

Furthermore, we recommend that the Director, OMB, not implement OMB's proposed policy for determining subsidies under the pilot loan assets sale program, but revise the policy by considering the two methodologies discussed in this report. In addition, the Director should report to the Congress on the method selected and include an appropriate justification for the selection.

PROPOSED LOAN ASSET SALES IN FISCAL YEAR 1987

Agency	Amount of Sale (millions)
Department of Agriculture	
Farmers Home Administration Rural Housing Loans	$ 100
Farmers Home Administration Rural Development Loans	100
Rural Electrification Loans	100
Rural Telephone Bank Loans	100
Department of Education	
Guaranteed Student Loans	200
National Direct Student Loans	48
College Housing Loans	1,102
Department of Housing and Urban Development	
Federal Housing Administration Multifamily Loans	300
Rehabilitation Loans	10
Small Business Administration	
Small Business Investment Company Loans	1,153
Disaster Loans	1,100
Veterans Administration	
Vendee Single Family Loans	78
Total loan asset sales	$ 4,391

OMB GUIDELINES ON LOAN ASSET SALES

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

July 8, 1986

MEMORANDUM FOR CABINET OFFICERS AND AGENCY HEADS

FROM: Joseph R. Wright
Deputy Director, OMB and Chairman,
Federal Credit Policy Working Group, EPC

SUBJECT: Loan Asset Sale Guidelines and Credit Reform

The President's 1987 Budget included a pilot program for the sale of loan assets with a face value of approximately $4.4 billion. Attached are the guidelines for these sales which were developed by the Federal Credit Policy Working Group.

Since this is a relatively new initiative for the Federal Government involving billions of dollars, we would like you to take a personal interest in seeing that this program gets off to a successful start and that the sales receive the proper attention and are handled in a professional manner. The Working Group, of which your agency is a member, will be developing an evaluation plan to assess its success.

As implementation gets underway, if you see reason to recommend a substitution in the composition of the portfolio proposed for sale or if you run into serious problems with any of the guidelines, please let me know promptly. The guidelines should be met whenever possible; as we gain experience, we may need to make revisions.

These asset sales are part of an effort to improve Federal credit management. They are intended to help us to identify the subsidies inherent in Federal credit programs as required by Circular A-70, and to improve the quality of loan origination, documentation, and servicing as required by Circular A-129.

Effective implementation of these Circulars will be increasingly important if the credit reforms and budget scorekeeping changes now under consideration are adopted. The Federal Credit Policy Working Group will be following these proposals, and working with credit programs to upgrade documentation to commercial standards and to establish commercial definitions of borrowers' rights.

Please send me a report on the progress of your loan asset sales effort by August 22 for review by the Working Group.

July 8, 1986

GUIDELINES FOR LOAN ASSET SALES

I. Introduction

The following guidelines for the sale of loan assets have been established and approved by the Federal Credit Working Group. The guidelines are designed to insure that agencies will meet the objectives of the loan asset sale pilot program which have been derived from the Administration's stated priority to reform Federal credit. These objectives are set forth as follows:

- o reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;
- o provide an incentive for agencies to improve loan origination and documentation;
- o determine the actual subsidy of a Federal credit program; and
- o increase unified budget offsetting collections in the year of sale.

II. Guidelines

The following guidelines shall be adhered to by each agency in its approach to, and implementation of, all loan asset sales.

A. Loan asset sales shall be made without future recourse to the Federal Government. For the purposes of these guidelines, recourse includes any Federal guarantees of principal and interest payments, repurchase contracts, agreements to replace bad loans with good loans, warranties relating to collateral value, or any other agreements requiring continued Federal involvement or contingent liability. Any credit enhancement measures, such as reserve funds, over collateralization, or insurance, shall be the responsibility of the purchaser.

B. Loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to full Federal income tax. This does not preclude sale to tax-exempt investors. Exceptions may be made in cases involving sale of loans on a whole loan basis.

C. Collection and servicing shall be transferred to the purchaser with sale of a loan asset.

D. Pilot program loan asset sales shall begin in FY 1987 after final approval of plans for sale.

E. Under the pilot program, agencies shall sell loans whose face value in the aggregate is equivalent to the amount stated in the FY 1987 budget. Agencies shall sell some newly issued loans and may sell seasoned loans from their portfolios.

F. Where appropriate, each agency shall choose, through a competitive process, a professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.

G. Loan asset sales may be conducted on a competitive bid or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.

H. In limited circumstances where the borrower is not an individual, agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price; borrowers who are not current on their principal and interest payments shall not be allowed to purchase their loans.

I. Loan asset sales shall be sufficiently large to assure market interest. This is particularly important when developing markets for new types of securitized loans. In such cases, we would expect sales to be over $100 million. Other details, including timing of sales, the composition and size of loan pools, and other marketing issues, shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

J. Agencies may sell loan assets held by the FFB.

SECONDARY MORTGAGE, INVESTMENT BANKING, AND COMMERCIAL INSTITUTIONS CONTACTED

Federal National Mortgage Association

Government National Mortgage Association

Chase Investment Bank

Chemical Bank

Continental Guaranty and Credit Corporation

Merrill Lynch, Pierce, Fenner & Smith Inc.

Shearson Lehman Bros., Inc.

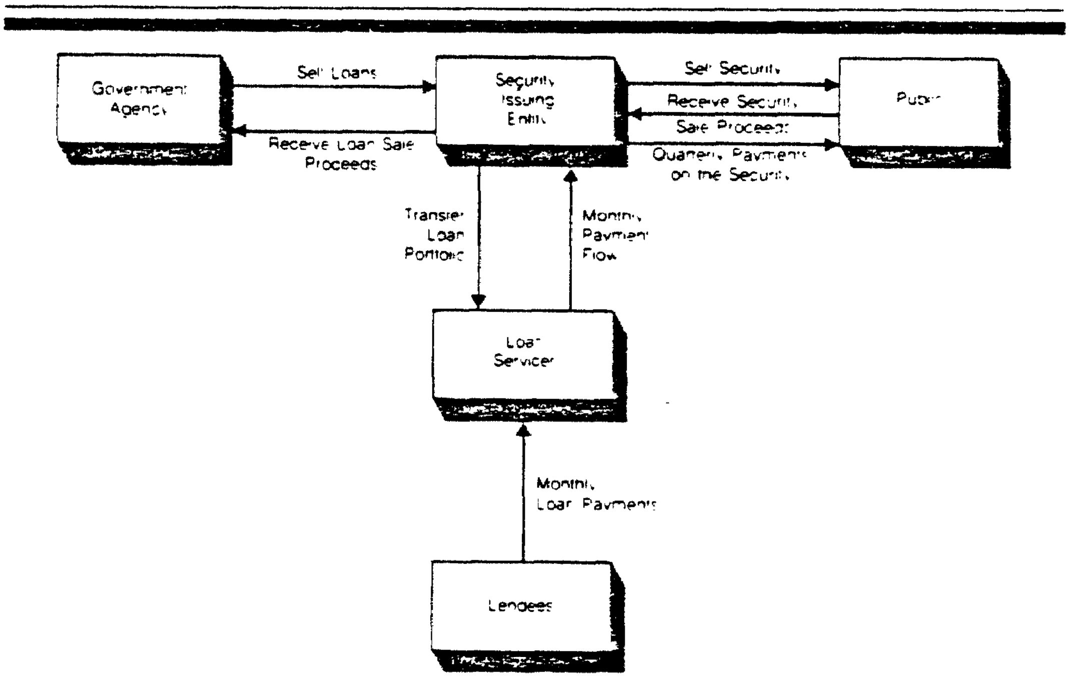
Smith Barney, Harris Upham & Co., Inc.

Salomon Bros, Inc.

EXAMPLE OF THE STRUCTURE FOR SELLING A LOAN PORTFOLIO THROUGH ISSUANCE OF A COLLATERALIZED SECURITY

A special entity, which would not be a federal government entity, would be created to issue a series of bonds. This special entity would be a single purpose corporation, created solely to issue the bonds and make payments thereon, and to enter into an agreement with a servicing corporation. This issuer will purchase a loan portfolio while simultaneously issuing bonds. The bonds would be fully collateralized by the loan portfolio. Principal and interest on the bonds would be paid quarterly, with the monthly cash flow from the loan portfolio reinvested at a contracted rate.

Figure IV.1: The Collateralized Security Process



INFORMATION ON SELLING COLLEGE HOUSING LOANS ON A STRUCTURED BASIS WITH LIMITED RECOURSE

A Smith Barney, Harris Upham & Co., Inc. market analysis dated July 30, 1986, proposed selling $2.1 billion of the $2.2 billion college housing loan portfolio on a "structured basis" with limited recourse to the government. The government would hold and continue to attempt to collect principal and interest payments on the $89 million in college housing loans currently in default. In order to accomplish the sale, a new security--a bond--would be created and backed by the $2.1 billion in loan assets. Loan servicing would be performed by a private party.

The proceeds of the sale of the $2.1 billion in loans would be $1.3 billion. The $1.3 billion is today's value of the loan principal and interest payments to be made by borrowers over the 21 years the loans will be outstanding. The current interest rate used in determining the $1.3 billion is substantially higher than the prevailing interest rate when the loans were originally made in the 1970's.

The limited guarantee in this particular sale would operate as follows. The government would guarantee investors repayment of the $1.3 billion sales price of the new security (rather than the undiscounted $2.1 billion in loan assets backing the new security) plus a maximum of 18 months' interest on the $1.3 billion. The average weighted maturity of the $2.1 billion in college housing loans is 21 years. Consequently, the government would assume the risk for 1-1/2 years of interest payments while the investor would assume the risk for 19-1/2 years of interest payments. In addition, contractual arrangements with the private loan servicer would be part of the guarantee arrangement.

The private loan servicer would pay the security holders principal and interest payments for any defaulted loan for a period of 18 months. During this period, the loan servicer would proceed with foreclosure action under the loan agreement. When foreclosure proceedings are completed, the government guarantee would be invoked. The government would then pay the differences between the principal plus 18 months' interest on the defaulted loans and the amount of net proceeds realized from foreclosure proceedings by the servicer.

The government's default rate experience on the college housing portfolios has been 4 percent. If this default rate held constant, we estimate that the government's maximum expected risk under this form of limited guarantee arrangement, before considering proceeds on foreclosures, would be about $60 million, determined as shown in table V.1.

Table V.1: The Government's Maximum Expected Risk Under Limited Guarantee for College Housing Loan Sales

Elements of the limited guarantee	Amount (millions)
Principal amount ($1.3 billion X 4%)	$52.0
18 months' interest at 10% (assumed)	7.8
Estimated maximum risk to the government	$59.8

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