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GAO

Report to Congressional Requesters

February 1988

LOAN ASSET SALES

An Assessment of Selected Sales

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GAO

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Accounting and Financial
Management Division

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The Honorable Jack Brooks
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

The Honorable William V. Roth, Jr.
Ranking Minority Member, Committee on
Governmental Affairs
United States Senate

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.

This report addresses several issues involving the sale of loan assets and borrower prepayments and builds on and summarizes our prior work in this area.

Our review showed the following regarding sales and prepayments: (1) the federal government has a wide range of loan portfolios with a varying degree of financial characteristics which require that sale and prepayment decisions be made on a portfolio-by-portfolio basis; (2) credit enhancements are key to loan sales; (3) full costs and benefits of sales will not be known for some time; (4) loan sales will not decrease the structural budget deficit; and (5) loan sales are not needed to effectively measure subsidy costs.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time, we will send the report to the Director, Office of Management and Budget; the Secretaries of Education, Housing and Urban Development, and Agriculture; the Administrators of the Veterans Administration and Small Business Administration; and interested parties. Copies will also be made available to others on request.

Frederick D. Wolf
Director

Executive Summary

Purpose

The federal government is the largest single provider of credit in the United States with more than $230 billion in loans outstanding. An initial January 1986 pilot proposal to sell over $4 billion in loan assets has been followed by increasingly larger and more comprehensive proposals. This report addresses several issues surrounding the sale of loan assets. It builds on and summarizes GAO's prior reports and testimony in this area and completes the analysis requested by the Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations; and the former Chairman, Senate Committee on Governmental Affairs.

Background

In January 1986, the administration initiated a proposal to improve federal credit management and to generate budgetary receipts through the sale of $4.4 billion in loan assets. This initiative expanded to $6.8 billion of sales in the 1986 budget reconciliation act, and to $12.6 billion in the President's fiscal year 1988 budget. Further, the proposed Credit Reform Act of 1987 would require the immediate sale of all new federal loans to private investors. To date, seven agencies have completed loan asset sales or borrower prepayment programs under these initiatives.

GAO issued two previous reports and testimony on the Office of Management and Budget's (OMB) 1986 guidance to agencies on conducting the pilot sale of loan assets. These reports and testimony pointed out that OMB's guidelines would have an adverse effect on the federal government's ability to both market loans and to maximize net sales proceeds. OMB is currently revising its guidance on nonrecourse sales and warranty provisions.

In this current review, GAO analyzed direct loan programs of the federal government in five of six broad classes of loans by (1) identifying the characteristics of the loans within each class, (2) examining the feasibility of selling loans under the existing and proposed credit reform proposals, (3) examining the costs and benefits associated with the loan sales completed thus far and their impact on the federal budget deficit, and (4) examining whether loan sales will achieve the objectives of measuring subsidy costs and fostering credit reform.

Results in Brief

GAO's review of completed loan asset sales and borrower prepayments showed the following.

- Sales and prepayment decisions must be made on a portfolio-by-portfolio basis because of the wide range of terms, collateral, and borrowers in federal loan programs.
- Investor acceptance and maximization of net sale proceeds directly depend on the government's willingness to share post-sale loan losses with investors.
- Sales should not be promoted as deficit reduction tools because such sales simply shift future cash receipts to the budget year in which sales are completed. The budget deficit in the year of sale will be reduced, but future deficits will be increased.
- Sales are not needed to identify the subsidy of federal credit programs. In addition, OMB's initial methodology for determining the subsidy will overstate the actual subsidy cost of federal credit programs.

Overall, loan asset sales, in the short term, will result in the government incurring some additional costs. If these sales foster improvement in federal loan origination, documentation, and collection policies, these costs may be offset in the future. It is too early to tell, however, the extent of loan management improvement savings.

Principal Findings

Wide Variations Make Generic Considerations Difficult

The financial characteristics, including required documentation collateral and loan servicing policies, for the five classes of loan portfolios GAO reviewed varied widely. In addition, the federal government's loans are designed to help achieve a broad range of policy objectives. Many federal loan programs are intended to provide credit to individuals or organizations not adequately served by private credit providers. Because of this diversity, loan asset sales must be managed and structured on a portfolio-by-portfolio basis. (See chapter 2.)

Credit Enhancements Key to Loan Sales Feasibility

GAO's analysis of the loan assets sold to date confirmed that credit enhancements, providing required incentives to private investors, are needed to maximize net sale proceeds. None of the completed loan asset sales were sold in accordance with OMB's original guidance which called for investors to assume the full risk of loss after the sale. Each of the loan asset sales GAO reviewed included some form of credit enhancement—indemnification to private investors against loan losses after the sale. (See chapter 3.)

Full Costs and Benefits of Pilot Loan Asset Sale Not Determinable

The costs and benefits associated with the loan sales and borrower prepayments under the pilot sale program involve several factors, many of which are not readily quantifiable, and others which cannot be fully determined until after the full term of the loans have expired. Costs resulting from (1) any interest rate differential between Treasury's borrowing rate and the market interest rate, (2) credit enhancements included in the sale agreements, and (3) additional loan servicing requirements can be reasonably estimated. Other costs or benefits, such as those which may ultimately accrue to the government if the private investor is unable to recover the expected future stream of cash payments or if the government achieves a higher than anticipated collection rate on loans, will not be known until the end of the life of the loans.

The pilot loan asset sale program may provide benefits to the federal government in terms of improved loan management. The government has begun to adopt private sector loan origination, documentation, and collection procedures. However, GAO could not, at this time, quantify the extent to which these improvements will result in reduced costs or increased loan collections. Loan servicing costs are not likely to be reduced since the government will continue to (1) originate new loans needed to help achieve continuing program objectives and (2) service loans that are delinquent or in default. (See chapter 4.)

Impact of Loan Asset Sales on Budget Deficit

GAO's prior reports and testimony concluded that loan asset sales are not an effective technique for resolving our fundamental deficit problems. GAO's current study confirmed this conclusion by showing that loan asset sales will increase, over the long term, the structural federal budget deficit. In general, the budget reduction that will occur in the year of the loan sale or prepayment will be offset by the aggregate amount of loan principal and interest payments forgone had the government not sold or offered the loans for prepayment. An overall increase in the federal government's budget deficit will occur if the proceeds from a loan sale or prepayment are less than the present value of forgone loan principal and interest payments. (See chapter 5.)

Loan Asset Sales Do Not Effectively Measure Subsidy Costs

The administration's plan to define the subsidy cost of federal credit programs as the monetary benefit—interest cost savings—to a borrower will overstate both government cash costs and the related cost to operate credit programs.

Measuring the federal credit program subsidy is a key objective of the administration's pilot loan sale program and proposed Credit Reform Act. Both initiatives propose measuring the federal credit program subsidy cost as the difference between net sale proceeds and the unpaid principal balance of the loans sold—the interest cost savings to the borrower. This method is likely to overstate the subsidy cost to the federal government because it focuses on measuring the interest subsidy to the borrower rather than the interest cost to the government.

Subsidy costs determined through the sale of existing loans are also inaccurate in that they do not account for any change in interest rate levels between the time the loans were initially granted and the time they were sold. Lastly, GAO's analysis has shown that the subsidy cost—cash cost to the government—can be estimated without selling loans. (See chapter 6.)

Recommendations

The purpose of this report was to provide information and assessments of loan sale programs. Recommendations regarding changes in OMB policies were made in prior reports, and credit subsidy recommendations will be made in a future report.

Agency Comments

As agreed to with the requesters' offices, GAO did not obtain agency comments on this report. However, GAO recognizes that in the President's 1989 budget submission released in February 1988, OMB included changes in terminology and procedures federal agencies are to follow when identifying federal program subsidies. Although GAO did not review these changes as part of this review, it will address them in other work now under way and report on them later.

Contents

Abbreviations

AID	Agency for International Development
CCC	Community Credit Corporation
CONRAIL	Consolidated Rail Corporation
DOT	Department of Transportation
FFB	Federal Financing Bank
FmHA	Farmers Home Administration
GAO	General Accounting Office
HHS	Department of Health and Human Services
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
OPIC	Overseas Private Investment Corporation
REA	Rural Electrification Administration
SBA	Small Business Administration
TVA	Tennessee Valley Authority
VA	Veterans Administration

Introduction

The federal government is the largest single provider of credit in the United States with an estimated more than $230 billion dollars in loans held by 29 agencies under more than 110 federal direct loan programs. In addition, 21 of these agencies manage about 35 loan guarantee programs with an aggregate unpaid principal balance of $513 billion as of September 30, 1987. (See appendix I.)

In January 1986, the administration initiated a pilot sale of selected existing federal loan assets as part of the President's fiscal year 1987 budget request. The goal of the pilot sale proposal was federal credit reform and financial management improvements with an ancillary goal of generating budgetary receipts. Loan asset sale initiatives have since grown from the initial $1.8 billion pilot sale in fiscal year 1987 to a proposed $12.6 billion sales program in the 1988 budget. To date the government has completed borrower prepayment programs at six agencies and consummated direct loan sales at four agencies. In addition, the administration's proposed Credit Reform Act of 1987 would require that (1) selected direct new loans made by the federal government be sold shortly after being made and (2) the government transfer loan guarantee programs to the private sector by buying private credit insurance to replace the government's guarantee.

This report addresses the status of a series of issues related to the sale of loan assets and the results of the pilot loan sale program, including information on financial characteristics of federal loan programs, the feasibility of selling loan assets, and the costs and benefits of such sales. This report completes our work for the Chairmen, Legislation and National Security Subcommittee, Committee on Government Operations, House of Representatives; and Committee on Governmental Affairs, United States Senate.

Background

On July 8, 1986, the Office of Management and Budget (OMB) issued loan asset sale guidelines for agencies to use in conducting the initial pilot sale of federal loan assets proposed in the President's 1987 budget submission. These guidelines included 10 specific loan sale requirements designed to achieve the loan sale objective of federal credit reform and a secondary objective of generating budgetary receipts to help reduce the budget deficit. We reviewed OMB's guidelines and issued reports[1] on them

[1] Loan Asset Sales: OMB Policies Will Result in Program Objectives Not Being Fully Achieved GAO/AFMD-86-78 and GAO/AFMD-86-79, September 25, 1986.

to the Chairman, Legislation and National Security Subcommittee, Committee on Government Operations, House of Representatives; and the former Chairman, Committee on Governmental Affairs, United States Senate, on September 25, 1986, pursuant to requests received from both to evaluate several aspects of the administration's proposed pilot sale of federal loan assets.

Our reports focused on requirements in OMB's loan asset sale guidelines that would have had a major impact on the marketability of the loans and the ability to maximize net sale proceeds. In addition, in testimony[2] on the guidelines, we disclosed that the total amount of principal and interest payments forgone by selling a loan is generally worth more than the revenue derived from a loan sale, that loan sales are likely to have some positive impact, albeit difficult to quantify, on credit management, and that loan asset sales will not resolve our fundamental deficit problem.

These prior reports and testimony pointed out that in order for the government to maximize net sale proceeds, existing market structures should be utilized and that loan asset sales would have to be consummated on a negotiated, structured basis with some form of credit enhancement—that is, some form of recourse to the government. The report also showed that (1) OMB's proposed budget scorekeeping for sale proceeds, which reinforced its prohibition against sales with any recourse to the government, was inconsistent with established budgetary rules and (2) sales of existing loan portfolios will not accurately measure the subsidy cost of federal credit programs.

In consonance with these findings, our reports and related testimony recommended that the Director of the Office of Management and Budget

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

[2] "The Government's Loan Asset Sales Pilot Program," GAO/T-AFMD-87-6, March 10, 1987, and "An Assessment of the Government's Loan Assets Sale Program," GAO/T-AFMD-87-7, March 26, 1987.

- not implement proposed OMB policy for determining subsidies under the pilot loan assets sale program, but rather revise the policy to more accurately measure the subsidy in terms of cost to the government; and
- report to the Congress on the subsidy cost measurement method selected and include an appropriate justification for the selection.

OMB is revising its loan asset sale guidelines to better define its position on non-recourse sales and warranty provisions. These guidelines, however, have not yet been issued. The recent sales of the Farmers Home Administration's (FmHA) Rural Community Development Loan and Rural Housing Loan portfolios, and the Department of Education's College Housing and Academic Loan portfolios, were both made to private investors under a negotiated sale structure which included credit enhancements. The net proceeds from these sales were classified, for budget purposes, as budgetary receipts and were available for deficit reduction purposes.

In the January 1987 budget submission, the administration introduced a loan asset sale plan, the "Market Plan," under which the government, among other things, would sell to the public all new loans after they were made. The primary focus of the "Market Plan," like the earlier 1987 pilot loan asset sale proposal, was federal credit reform with a secondary focus of generating budgetary receipts to help reduce the budget deficit.

In March 1987, the administration submitted a proposed bill to the Congress entitled the Credit Reform Act of 1987 to implement its "Market Plan" initiatives. The bill would measure the subsidy benefit to borrowers of federal credit programs by selling to private investors all new federal loans after they were made. It also proposed that the government transfer loan guarantee programs to the private sector by buying private credit insurance to replace the government's guarantee.

During congressional budgetary debates for fiscal year 1987 and in the President's fiscal year 1988 budget request, the focus of loan asset sales shifted from federal credit reform to generating budgetary receipts and has taken this program from the $1.8 billion program involving five agencies to the current $12 billion program at nine agencies proposed for 1987. However, the ongoing debate regarding federal loan asset sales has continued to consider the relative importance of achieving credit reform and generating budget receipts within the context of five overall objectives:

- reduce the government's cost of administering federal credit programs by transferring to the private sector—privatizing—the servicing and other administrative activities related to these programs;
- encourage federal agencies to improve loan origination processes, servicing systems, documentation, and collection practices;
- determine the subsidy cost of federal credit programs, that is, the cost to the federal taxpayers of granting loans;
- encourage agencies to improve accounting and financial reporting systems for federal credit programs; and
- generate budgetary receipts to help reduce deficits in the year of sale.

Objectives, Scope, and Methodology

Our September 25, 1986, report focused on assessing the impact OMB's loan sale guidelines would have on agencies achieving loan asset sale objectives. This report builds on our earlier reports and completes our overall review of the administration's loan asset sale initiatives requested by the Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations and the former Chairman of the Senate Committee on Governmental Affairs. This report focuses on the financial characteristics of federal loan programs, the feasibility of selling federal loan assets, and the costs and benefits of such sales. Specifically, our objectives included determining and assessing the

- full range and characteristics of federal loan programs;
- feasibility of selling existing and new loans;
- costs and benefits of the sale of existing loans;
- short- and long-term impact of loan sales on the federal budget deficit;
- feasibility of determining the subsidy costs of federal loan programs through the sale of loans as proposed in the credit reform bill; and
- feasibility of achieving the credit management objectives of the proposed credit reform legislation.

Although the credit initiatives included some aspects related to guarantee programs, this report focuses primarily on the government's direct loan programs and does not consider the issues related to federal loan guarantee programs.

To address the issues regarding federal loan asset sales, we first categorized all federal direct loan portfolios into six broad loan classes: (1) single family housing loans, (2) multifamily housing loans, (3) commercial loans, (4) secured consumer loans, (5) unsecured consumer loans, and (6) loans to foreign governments and businesses. We selected and reviewed loan portfolios included in the President's fiscal year 1987 loan asset sale/prepayment program and also reviewed the results of additional borrower prepayments and loan sales conducted in fiscal year 1986. Table 1.1 shows the loan portfolios, by loan class, which were selected and included in our detailed review.

Table 1.1: Loan Portfolios Included in Our Review

Dollars in millions

Loan class	Loan portfolio selected	Outstanding principal
Single family housing	Veterans Administration's Vendee Loans	$1,241
Multifamily housing	Department of Housing and Urban Development's Multifamily Housing Loans	2,799
Commercial	Department of Agriculture's Rural Electrification Loans	14,678
	Department of Education's College Housing Loans	2,181
Secured consumer	Small Business Administration's Disaster Home Loans	700
Unsecured consumer	Department of Education's Guaranteed Student Loans	1,051
Foreign government and business	a	0
Total		**$22,650**

[a]None selected for review.

In analyzing the characteristics of those loan portfolios, we selected a sample of more than 2,000 loans for review. Our sample was a statistically valid random sample of loans included in five loan portfolios. To determine (1) the financial characteristics, including loan default, loss, and repayment rates, and the adequacy of loan documentation records, and (2) the legal provisions of the loan programs that would affect their sale, we reviewed the loan files, validated the loan principal and interest repayment default and loss rates, and documented the legal provisions of the loan agreements and any specific loan servicing requirements.

We discussed the administration's loan sale plans with officials of OMB, the Department of the Treasury, and several major secondary credit market institutions. We also met with officials from each of the five agencies responsible for administering the loan portfolios we selected for review and with other officials from the agencies responsible for selling loans to the public during fiscal year 1987 to discuss their proposed sales strategies and progress in actually culminating sales.

In addition to reviewing the loans originally selected for review, we also reviewed the results of loan sales at three agencies which have recently sold loan assets to the public: the Department of Education, FmHA, and the Veterans Administration (VA). We have also reviewed the Export-Import Bank's prepayment program, and we will report on this issue separately.

As discussed in chapter 2 of this report, the characteristics of the loan portfolios of each loan program differ markedly in a number of significant aspects. As a result, the programs selected for review are not necessarily representative of all loan programs. However, based on our work, and on our knowledge of many of other loan programs gained through our financial and programmatic audits, we believe our conclusions and recommendations are applicable to most loan programs and not just those we looked at in detail as part of this review.

We performed our review between May 1986 and October 1987. As agreed to with the Chairmen's offices, we did not obtain official agency comments. We conducted our work in accordance with generally accepted government auditing standards. Our work was performed at the Veterans Administration, the Small Business Administration (SBA) and the Departments of Housing and Urban Development (HUD), Education, and Agriculture and also included work at those agencies' regional offices. Our work also incorporated the views of a number of experts in industry, academia, state government, and public policy research.

The succeeding chapters address the characteristics of the federal loan programs and loans proposed for sale as well as a number of financial and policy issues which need to be considered in implementing loan sale programs. Chapter 2 provides an overview of federal direct loan portfolios, the administration's loan asset sale initiatives, and the characteristics of the loans which directly affected the loan sale program. Chapter 3 addresses the feasibility of selling federal loan assets to private investors and includes a discussion of the structuring or use of credit enhancements in accomplished loan sales. Chapter 4 reviews the costs and benefits of selected loan asset sales and prepayments included in the administration's pilot program and points out the need for sale decisions to be made on a portfolio-by-portfolio basis. Chapter 5 addresses the impact of loan sales and prepayments have on the budget deficit, and chapter 6 addresses the appropriateness of various methodologies proposed for measuring the subsidy costs of federal credit programs.

Overview of Federal Direct Loans and Loan Portfolios Involved in the Sales Programs

At the beginning of fiscal year 1988, the federal government held more than $230 billion in direct loans in over 110 portfolios. These loan portfolios have a broad range of terms and conditions including collateral, interest rates, repayment periods, and servicing policies. They also vary considerably as to the financial condition of the borrowers and the types of borrowers—from students to small electric utilities to foreign governments.

The government's loan portfolios also vary widely in terms of the policy objectives they are intended to address. The government makes loans to provide funds to individuals, public and private organizations, and foreign governments, to achieve a wide range of policy and program goals. Because the government's primary goal in operating direct loan programs is to achieve a broad range of policy and program goals, loan documentation, terms, and conditions vary. In some cases they vary from the documentation, terms, and conditions of comparable private sector loans whose primary goal is to make a profit.

It is important to recognize that sales of loan assets involve different issues and considerations from sales of other capital assets, such as the sale of the Consolidated Rail Corporation (CONRAIL) or the often-proposed sale of the Bonneville Power Administration. The key difference between the sale of loan and capital assets concerns the governmental entity's continued involvement in a program after the sale of the assets. Specifically, after selling a capital asset, the governmental entity generally ceases to be involved in the activity that has been sold. For example, since selling CONRAIL, the Department of Transportation is no longer financially involved in the railroad's operation.

In contrast, the government will continue to be involved in a loan program, even though all or part of the program's loans may be sold. Federal loan programs are the means to achieving policy or program goals as opposed to being ends in themselves. For example, student loan programs are used to help achieve the policy goal of broadening access to higher education by providing funds to economically disadvantaged students. If the federal government sells to the public all or part of an education related loan portfolio, it does not mean that its role in providing support for higher education will end. It may continue to hold some of the loans or it may make new loans in the future. Similarly, the federal government could sell its disaster home loan portfolio, but, as new disasters occur, it will make new loans. The government's continued involvement in programs underlying its credit-granting activities will affect the degree to which loan sale objectives—such as privatization of a program or transferring loan servicing activities to the private sector—can be achieved.

Range of the Government's Direct Loan Portfolios

Table 2.1 summarizes the government's more than 110 direct loan programs according to the six broad classes of loans presented in chapter 1. The financial information presented is the estimated aggregate unpaid loan principal balances, by loan class, due the federal government as of September 30, 1987.

Table 2.1: Summary of Government Loan Portfolios by Loan Class

Dollars in billions

Loan class	Number of portfolios	Aggregate unpaid principal balances as of Sept. 30, 1987
Foreign loans	17	
Agriculture's foreign assistance		11.4
Defense's foreign military sales		22 2
Agency for International Development's foreign development		8.0
Export Import's foreign trade		15.0
Other foreign loans		12.3
		68.9
Single family residential mortgage loans	5	
Agriculture's rural housing		26 1
VA's housing		.9
Other single family residential mortgage		4
		27.4
Multifamily residential mortgage loans	1	
HUD's low rent public housing		2.1
		2.1
Commercial loans	72	
Agriculture's commodity		13.7
Agriculture's rural electrification and telephone		8.7
Agriculture's export guarantee claims		3 2
SBA's small business		4.1
Transportation's ship financing		1 2
Education's college housing		4
Navy Industrial Fund, Federal Financing Bank		1.7
Other commercial		87.5
		120.5
Secured consumer loans	6	
SBA's disaster		2.8
Other secured consumer		1 2
		4.0
Unsecured consumer loans	10	
Education's national direct student loans		5 4
Education's defaulted guaranteed student loans		4.8
Other unsecured consumer loans		1
		10.3
Total	**111**	**$233.2**

Notes
1 The information presented in this table was provided by agency officials and was not audited as part of this review
2 Individually, the dollar value of the loans listed in "Other commercial" is too small and the number of loans is too numerous to list here, but they are included in appendix I

Loan Asset Sale Initiatives

The main objective of the original pilot sale plan was to foster federal credit reform. It was envisioned that the pilot program would bring about reforms in federal credit programs such as improving loan documentation, records, and collection practices and procedures. We discussed the specific objectives for this initial proposal in chapter 1. The initial proposal for a pilot loan asset sale program for fiscal year 1987 involved the sale of loan assets from 12 loan portfolios with outstanding principal balances totaling about $4.4 billion. The administration projected that these sales would generate $1.8 billion in net sales receipts which could be used to reduce the federal deficit.

The Congress, through the Budget Reconciliation Act of 1986, built on the administration's pilot loan sale program by directing the administration to generate $6.8 billion in net cash receipts through the sale and or prepayment of additional selected loan assets. In order to achieve that goal, the administration estimated that loans with about $9.3 billion in outstanding principal balances, from nine programs, would have to be sold to the public and, in addition, $2 billion in outstanding Rural Electrification Administration (REA) loans would be offered to borrowers to prepay in order to meet the requirements of the act.

The President's fiscal year 1988 budget request also included a program of loan asset sales to generate cash receipts and to achieve credit reform objectives. Specifically, it provided for the sale of loan assets with a total outstanding principal balance of $12.6 billion from 23 loan programs to generate $5.9 billion in cash receipts.

The following figures summarize the administration's initial loan asset sale pilot program, the Congress' actions through the Budget Reconciliation Act of 1986, and the President's fiscal year 1988 budget request. Detailed reconciliations of the above are presented in appendix II. Figure 2.1 compares aggregate outstanding principal balances of loans to be sold with estimated net sale proceeds under the pilot sale, the reconciliation act, and the fiscal year 1988 budget request.

Figure 2.1: Comparison of Aggregate Outstanding Principal Balances of Loans To Be Sold With Estimated Net Sale Proceeds

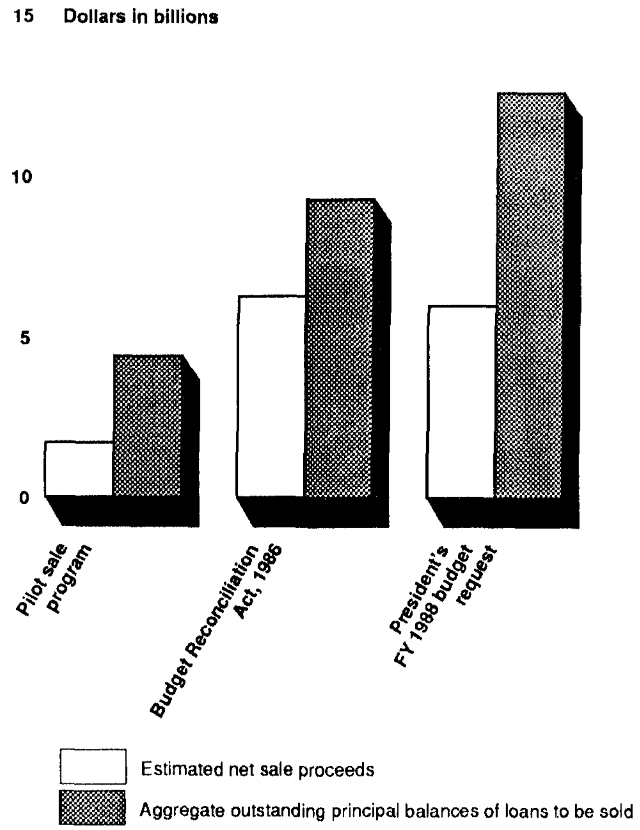
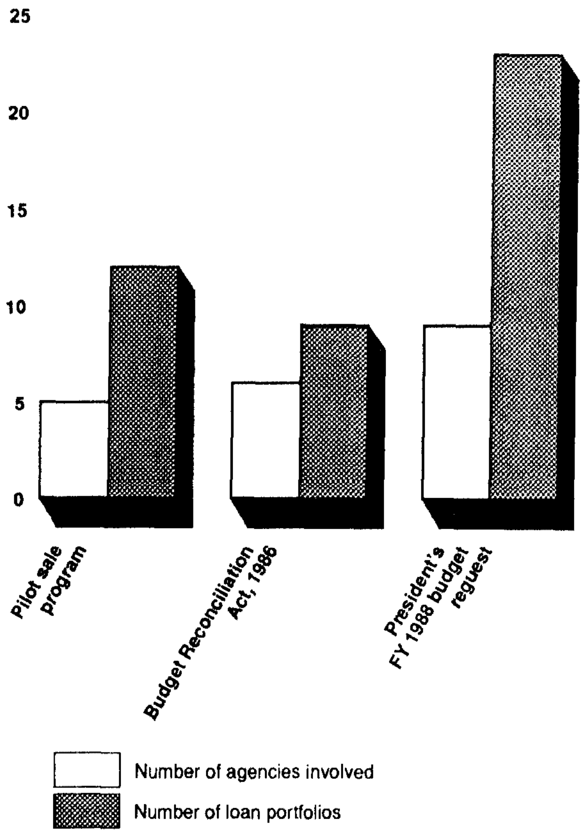


Figure 2.2 compares the number of agencies and loan portfolios involved in the pilot loan asset sale initiatives, the Budget Reconciliation Act of 1986, and the President's fiscal year 1988 budget request.

Figure 2.2: Comparison of the Number of Agencies and Loan Portfolios



In addition to budget initiatives for selling existing federal loan assets, the administration's proposed Credit Reform Act of 1987 would require that selected new direct federal loans be promptly sold to the public after they are granted. Just as provided for under OMB's guidelines directing the conduct of the original pilot sale, these loans would be sold without federal guarantees or other recourse provisions, and the purchasers would assume all of the responsibilities and costs of servicing the loans. For loan guarantee programs, it is proposed that the government transfer the contingent liability of the guarantees to private insurers by purchasing credit insurance to cover the potential loan defaults by borrowers.

Through the end of fiscal 1987, six portfolios have been offered for prepayment to borrowers: REA's Rural Electrification Loans, Education's College Housing Loans and Academic Facilities Loans, FmHA's Rural

Community Development Loans, SBA's Disaster Home Loans, and Export-Import Bank's foreign loans. In addition, portions of five loan portfolios were sold to the public: (1) Education sold a mix of its College Housing and Academic Facilities Loans, (2) FmHA sold its Rural Community Development and its Rural Housing Loans, and (3) VA sold its Vendee Loans. To date, no sales of new loans have yet been made.

In order to gain an understanding of the characteristics of federal direct loan portfolios, we selected for detailed review portfolios from each of the six previously discussed classes of federal direct loans, except for the foreign loan class, that were included in the administration's pilot sale. The characteristics we were interested in included:

- loan maturities and interest rates,
- special loan provisions, and
- collection, delinquency, and loan rates.

Characteristics and Performance of Selected Government Direct Loan Portfolios

Loan maturities for the six loan portfolios we reviewed ranged between 16 and 25 years, and interest rates ranged between 3 and 10 percent. All loan agreements included special provisions, and except for Education's college housing loan portfolio, which involved contractor records, loan documentation was in good condition. Except for Education's portfolio of defaulted guaranteed student loans, all of which are, by definition, delinquent, since the only loans the federal government has are those on which defaults have occurred, delinquency rates—that is, the percent of loans for which borrowers were not current as to loan principal and interest payments—ranged between zero and 26 percent.

Overall, for the portfolios we reviewed, except for the Department of Education's portfolio of defaulted guaranteed student loans, the government ultimately collects between 93 and 100 percent of loan principal and interest payments. On the other hand, our other ongoing, and recently completed audit work has disclosed considerably higher loan delinquency and default rates with several other loan programs. For example, our audit work at the Farmers Home Administration has developed indications of major losses and problems with records and collateral, and our audit of the Export-Import Bank reflects significant collectibility problems as have our reviews at the Maritime Administration. We will be reporting on these audits at a later date. As a result, the

loss ratios for the portfolios we reviewed in this report should not be considered representative of the total government loss experience.

Table 2.2 presents the aggregate unpaid principal balances due for the six loan portfolios selected for review, along with the interest rates and loan maturities for each portfolio.

Table 2.2: Characteristics of Loan Portfolios Reviewed

Dollars in billions

Portfolio	Aggregate unpaid principal	Weighted average years to maturity (years)	Weighted average interest rate (percent)
VA's Vendee Loans	$1.2	22.1	10 16
HUD's Multifamily Housing Loans	2.8	24 5	6 90
Agriculture's Rural Electrification Loans	14.7	24.5	3 77
SBA's Disaster Home Loans	.7	15.9	3.39
Education's Defaulted Guaranteed Student Loans	1.0	a	7.24
Education's College Housing Loans	2.2	21.5	3.16

[a]The weighted average years to maturity is not applicable for this portfolio. Once a borrower defaults on a Guaranteed Student Loan or Federally Insured Student Loan, the loan, according to the promissory note, becomes immediately due and payable. The lender then files a claim and returns the delinquent loan to the Department of Education. Because of the default, the loans have no remaining years to maturity.

Loan Documentation

The following is an overview of the condition of loan documentation for the portfolios we reviewed, particularly the key documents of the loan contract, the mortgage or note, any liens against loan collateral, any appraisals of loan collateral, and any required certificates for recording the mortgage or note.

Table 2.3: Status of Loan Documentation in Portfolios Reviewed

Portfolio	Percent of files not available	Percent of key documents in loan file	Percent of key documents missing
VA's Vendee Loans	5.6	86.7	7.7
HUD's Multifamily Housing Loans	16.0	79.6	4.4
Agriculture's Rural Electrification Loans	0	100 0	0
SBA's Disaster Home Loans	1.5	98.5	0
Education's Defaulted Guaranteed Student Loans	8.0	86 3	5.7
Education's College Housing Loans	10.2	24.5	65.3

Collateral Supporting Loans Selected for Review

The collateral supporting the loans selected for review ranged from real property to personal property to unsecured. VA's vendee loans, HUD's multifamily housing loans, Agriculture's Rural Electrification loans, and Education's college housing loans are collateralized by real property. SBA's disaster home loans were collateralized primarily by real property and by borrower personal property such as automobiles, furniture, and other property. Education's defaulted guaranteed student loans are uncollateralized.

Special Provisions and Borrower Concessions

Loan agreements for the six portfolios we reviewed all contained special provisions that either placed limits on the purposes for which borrowers could use loan proceeds or authorized government portfolio managers and loan administrators to modify loan payback terms in the event of borrower financial hardship.

For example, some of HUD's multifamily program properties are involved in rent subsidy programs which provide rental assistance to eligible tenants. The loan agreements for these properties include covenants which cover issues such as rent subsidies, rent restrictions, eviction policies, and tenant criteria.

In another instance, the Rural Electrification Act of 1936 permits REA to extend the time for payment of interest or principal amounts from borrowers for up to 5 years beyond the date they became due. Similarly, the law provides that the Administrator of SBA can extend or suspend principal or interest payments for up to 5 years in case of extreme borrower financial hardships and extend the terms of the loan for up to 10 years if SBA expects to foreclose on the loan.

Another example involves the VA's mortgage loan program. Public Law 89-754 gives the Administrator of Veterans Affairs the authority to grant mortgage relief to a "distressed mortgagor," whose employment by the United States or assignment as a military service member was terminated due to the close of a military base or federal installation, through the issuance of a moratorium to avoid foreclosure. The VA has policies which are intended to help delinquent borrowers become current, such as:

- executing a modification agreement to extend the terms of a loan,
- allowing the borrowers to avoid foreclosure proceedings by voluntarily relinquishing the deeds to the mortgaged property, thereby avoiding public embarrassment and damage to their credit,

- giving financial counseling to the veteran borrowers, and
- allowing borrowers to defer payments longer than normal (3 to 4 months) under extenuating or emergency circumstances.

The provisions in many government loan agreements that give federal portfolio managers and loan administrators the authority to stretch-out or otherwise modify original loan payback provisions result in many government borrowers not being current with loan principal and interest payments—being delinquent—in terms of the loan payback requirements in the original loan agreement.

Table 2.4 presents, for the six loan portfolios selected for review, portfolio collection, delinquency, and loss rates. The loss rates show the percentage of loans for which borrowers do not ultimately make all principal and interest payments.

Table 2.4: Delinquency and Loss Rates for Portfolios Reviewed

Portfolio	Portfolio collection percentage	Portfolio delinquency percentage	Portfolio loss percentage
VA's Vendee Loans	67	26	7–17[a]
HUD's Multifamily Housing Loans	70	23	7
Agriculture's Rural Electrification Loans	100	0	0
SBA's Disaster Home Loans	93	6	1
Education's Defaulted Guaranteed Student Loans	9	91	b
Education's College Housing Loans	96	4	c

[a]Our sample of selected loans disclosed a 7 percent loss percentage, whereas our current financial statement review at VA disclosed a loss percentage on vendee loans of approximately 17 percent

[b]Education has not written off as uncollectible any of these loans. Consequently, its records did not include the information necessary to calculate the loss rate. However, we believe that most of these loans will ultimately not be collected because they were loans already in default when they were taken over

[c]Data was not available to calculate the loss rate because Education considers these loans to be collectible and, as such, does not write them off. Consequently, Education's accounting records did not include the information necessary to calculate the loss rate.

As noted previously, these portfolios are representative of the programs we sampled. However, since other portfolios may vary widely as to loss and delinquency rates, the above percentages are not intended to be projected to the entire government.

Case-by-Case Analysis and Credit Enhancements Key to Loan Sale Feasibility

The financial characteristics, legal provisions, and servicing policies of federal loan programs vary widely among portfolios, and consequently decisions regarding whether or not to sell a portfolio and the structure of the sale must be decided on a portfolio-by-portfolio basis. Most federal loan programs are intended to accomplish certain policy goals by providing credit to organizations and individuals the federal government believes would not be adequately served by the private sector. Consequently, some loan agreements contain special legal provisions designed to foster achievement of loan program objectives. Furthermore, the servicing policies of some federal agencies allow them to be more lenient in their collection efforts. The loan programs also vary widely in terms of loan collateral and other financial characteristics. Our review of selected loan sales and borrower prepayments showed that, overall, investor acceptance of government portfolios offered for sale will primarily depend on the government's willingness to share with investors the risk of future loan losses. This is perhaps best portrayed by looking at the diversity of experience found in the pilot sales program carried out in 1987.

Portfolio Characteristics Highlight Need for Case-by-Case Feasibility Studies

Our review of selected loan sales and borrower prepayments demonstrated that the feasibility of selling government loan assets to private investors must be determined on a portfolio-by-portfolio basis. For the portfolios that were sold, none could be sold in accordance with OMB's original guidelines which called for investors to assume the full risk of all loan losses after sale. Portions of five portfolios were sold to the public with some form of recourse—the government protecting investors in whole or in part for future losses. The sale of one portfolio was blocked by a court action because special loan provisions could not be enforced after sale. Portions of six portfolios were offered to borrowers for prepayment, a process which obviates the recourse issue, instead of sale to the public. The sale of one portfolio was abandoned because of lack of investor interest. Table 3.1 summarizes the status of proceeds from portfolio sales and borrower prepayments.

Table 3.1: Proceeds on Portfolio Sales and Prepayments

Dollars in millions

Loan portfolio	Net proceeds goal for fiscal year 1987	Net proceeds from direct loan sales to private investors	Net proceeds from borrower prepayments
Pilot program			
VA's Vendee Loans	$673[a]	$849	$0
HUD's Multifamily Housing Loans	200	0	0
Agriculture's Rural Electrification Loans	100	0	427
SBA's Disaster Home Loans	144	0	3
Education's Defaulted Guaranteed Student Loans	200	0	0
Education's College Housing Loans and Academic Facilities Loans	579	119	438[b]
Budget reconciliation			
FmHA's Rural Community Development Loans	1,025	1,078	80
FmHA's Rural Housing Loans	1,715	1,803	0
Export-Import Bank Loans	1,500	0	1,900
Total	**$6,136**	**$3,849**	**$2,848**

[a]Congressional Budget Office baseline figure as of November 6, 1987.

[b]Amount applies to College Housing Loans only.

In April 1987, the VA offered a portion of its vendee loan[3] portfolio for sale to private investors on a nonrecourse basis. Private investor bids on the loans VA offered for sale were so low that VA withdrew its offer to sell the loans. In October 1987, VA received legislative authority (Public Law 100-136) to sell vendee loans to the public on a 100 percent recourse basis. In keeping with this authority, in November 1987, VA sold $905 million in vendee loans to private investors. This sale yielded $849 million in net proceeds.

HUD's sale of a portion of its multifamily housing loan portfolio was blocked by federal court injunction. Some HUD multifamily loan agreements include covenants regarding rent subsidies, rent restrictions, and tenant eviction limitations. HUD offered $500 million worth of multifamily low income rental housing loans for sale to private investors. In order to protect the interest of the housing unit tenants, a housing advocacy organization initiated a suit on their behalf. As a result, a federal judge

[3]Vendee loans are single family residential mortgage loans held by VA which resulted from sales of homes it acquired when veterans defaulted on mortgage loans it guaranteed.

issued an injunction blocking the sale. It was felt that tenants living in the housing projects could be injured because federal restrictions regarding rents could not be enforced after the sale. HUD is currently discussing with OMB the possibility of offering the multifamily home loans for sale with recourse to the government.

Agriculture's Rural Electrification Administration conducted two prepayment sales with the borrowers. One prepayment was offered at the "Bbb" bond discount rate, and returned $427 million back to REA. Another prepayment was offered at par and yielded $580 million.

The Department of Education abandoned its plan to sell its defaulted guaranteed student loans because of a lack of investor interest. For its college housing loan portfolio, Education conducted both a borrower prepayment and a direct sale program. Education received $438 million in net borrower prepayments and $119 million in net sale proceeds. The sale of college housing loans and academic facilities loans to private investors was made on a credit enhanced basis. The credit enhancement technique used by Education was overcollateralization. (This and other credit enhancement features are explained in the following section.)

SBA originally planned to offer a portion of its disaster loan portfolio for sale to private investors. Instead, SBA offered borrowers with loans with outstanding principal balances of $5,000 or less the opportunity to prepay their loans generally at a discount rate of 8.9 percent. Overall, more than 2,700 of SBA's borrowers elected to prepay loans which represented an aggregate outstanding principal balance of $4.2 million. The borrower prepayment program yielded SBA $3.4 million in net proceeds.

The Farmers Home Administration offered borrowers under its rural community development loan program the opportunity to prepay their loans at Treasury's borrowing rate. Borrowers prepaid loans with an outstanding principal balance of $111 million. The prepayment yielded net proceeds of $80 million. Similarly, the Export-Import Bank conducted a borrower loan prepayment program at face values. Under this program, borrowers prepaid loans with an outstanding principal balance of $1.9 billion.

The Farmers Home Administration also sold portions of its rural community development and rural housing loan portfolios to private investors that had principal balances of $1.9 billion and $3 billion, respectively. Both loan sales were consummated on a credit-enhanced basis. The credit enhancement techniques used by Farmers Home

Administration were overcollateralization and private credit insurance. (These techniques are explained in the following section on the structure of loan asset sales.)

Credit Enhancements Key to Completing Loan Sales

The government has conducted loan asset sales covering portions of five loan portfolios to private investors. Each sale, although sale formats and approaches varied, included some form of government protection of private investors against loan losses after sale. One sale was conducted on a full recourse basis to the government. The other three sales were consummated on a credit enhanced basis.

As previously mentioned, the Veterans Administration offered a portion of its Vendee Loan portfolio for sale on the basis of full recourse to the government. In addition, to the Veterans Administration's Vendee Loans, the government has sold portions of four other loan portfolios to private investors in which the private investors were indemnified against the estimated loan losses after sale.

In addition to the sale by the VA, four of the loan sales involved portions of the Department of Agriculture's Farmers Home Administration's Rural Community Development and Rural Housing loan portfolios and the Department of Education's College Housing and Academic Facilities loan portfolios.

To increase the marketability of these loans, the administration offered three principal forms of investor protection and credit enhancement; sale warranties, credit insurance, and overcollateralization. The government protected private investors against future losses because of incomplete or incorrect information from the government at the time of sale by issuing warranties as to the quality of the loans at time of sale. In addition, the government protected the investors against future loan losses through the use of credit enhancement features such as the purchase of credit insurance and or the overcollateralization of the net sale proceeds received by the government. An overview of each of these types of credit enhancements and investor provisions is provided in the following subsections.

Sale Warranties

Included in the sales agreements were government warranties regarding the characteristics, at the date of sale, of the loans being sold. Through these warranties, the government guaranteed, among other things, that the historic loan collection, delinquency, and loss rates as shown by the government's accounting records at date of sale were accurate. The warranties provided that if, after sale, these rates were shown to be inaccurate at the time of the sale and if investors could demonstrate that they suffered a loss because of the inaccuracies, the government would compensate investors for these losses. For details on these warranties see appendix III.

In order to ensure that these warranties were appropriate, the agencies and the sale underwriters carried out extensive reviews of the underlying credit files for the loans, credit history verifications, and other due diligence actions. For example, for Agriculture's rural community development loan sale, the underwriters retained a public accounting firm to audit the loans being offered by Agriculture for sale to verify, among other things, the accuracy of loan unpaid principal balances and delinquency and loan rates. Importantly, these actions identified not only things which needed correction to facilitate the sale of the loans but also actions which would enhance the agencies' future loan portfolio management and collection activities.

Credit Insurance

Using credit insurance, the government, at the time of a loan sale, makes a single premium payment to a private insurance company to purchase private credit insurance on behalf of investors that will pay them the principal and interest payments they would have received from borrowers in the event of borrower defaults on loans that have been sold. The amount of credit insurance purchased and the premium paid by the government are based on the loan portfolio's historic collection, delinquency, and loss rates as shown on the government's loan accounting systems.

Overcollateralization

In overcollateralization, the government transfers to investors loans with an aggregate unpaid principal balance sufficient to guarantee (based on historic loan collection, delinquency, and loss rates) repayment to investors of the purchase price they paid for the loans plus agreed upon interest. Specifically, overcollateralization operates as follows:

- The government designates the net cash proceeds it wants to receive from a loan asset sale.
- Investors' loan sale underwriters determine—based on market interest rates in effect at the time the loans are to be sold, and the remaining life of the loans—the aggregate unpaid principal balance of loans that have

to be transferred to investors to yield the net sale proceeds desired by the government.

- Underwriters also determine—based on historic loan collection, delinquency, and loss rates reported by the government for the loans that are sold—an additional aggregate unpaid principal balance amount of loans that the government will also transfer to the investors, generally through a form of escrow fund, to guarantee repayment to investors of the amounts paid for the loans plus interest. This is the amount of overcollateralization. Any portion of the proceeds from these additional loans transferred in excess of the amounts needed to pay the investor's guaranteed return reverts to the government.

Results of Completed Sales Confirm Our Prior Report Findings

The results of those loan sales thus far completed confirmed our September 1986 report which notes that some form of credit enhancements would be necessary both in terms of facilitating loan asset sales and to maximize net proceeds to the government. As a result of that review, we identified the willingness of the government to share the risk of future loan losses with investors (credit enhancement) as one key factor. We reported that the three primary credit enhancement tools, discussed previously of sale warranties, credit insurance, and overcollateralization will help offset private investors concern over:

- the government's willingness to share the risk of future loan delinquencies and losses,
- the creditworthiness of the borrowers,
- any restrictions in the loan agreements as to the purposes for which the loan proceeds can be used,
- any provisions in the loan agreements to materially alter loan payback terms in the event of borrower financial hardship,
- the past performance of the loan portfolio—that is, loan delinquency and loss rates, and
- providing 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.

Observations

Our previous reports analyzing private credit markets, as well as our recently completed reviews of the structure of the administration's pilot loan asset sale program and consummated loans have identified several keys to the feasibility of loan sales. In short, the unique features of the government's varied loan portfolios combined with the incentives required by private credit markets, necessitates that loan feasibility be considered on a portfolio-by-portfolio basis, and that loans be offered through a structured sales agreement utilizing existing credit market vehicles and on a recourse, or credit enhanced, basis both to interest private investors and to maximize net sale proceeds.

Costs and Benefits of Loan Asset Sale/ Prepayment Programs

Our analysis of three borrower prepayment programs and one loan sale undertaken as part of the pilot sale program showed that overall costs of these transactions exceeded related quantifiable benefits by an estimated $170 million. As a result of these sales, government portfolio managers have begun to adopt, to the extent practicable, private sector loan origination and documentation and credit management techniques. The effects of these techniques on federal loan program operations cannot be readily quantified. Our review of an additional three loan sales and one borrower prepayment program consummated in calendar year 1987 showed that, on those sales, the government incurred costs which cannot be accurately determined until the loans have matured. Likewise on those sales, the agencies have begun to adopt credit management techniques which showed improved overall credit management; the impact of such improvement is not readily quantifiable.

In addition to interest rate cost considerations, there are several factors—including some not readily quantifiable—which must be considered in analyzing the overall costs and benefits to the government on loan asset sales and prepayments. These include the following:

- The cost of credit enhancements included by the government in the structure of a loan asset sale,
- The cost of purchasing loan servicing services from private sources after the loans are sold,
- Potential reductions in the government's costs of operating its credit programs, and
- Any benefits accruing to the government as a result of the sale, such as improved origination, management, and improved collection for the loans retained by the government.

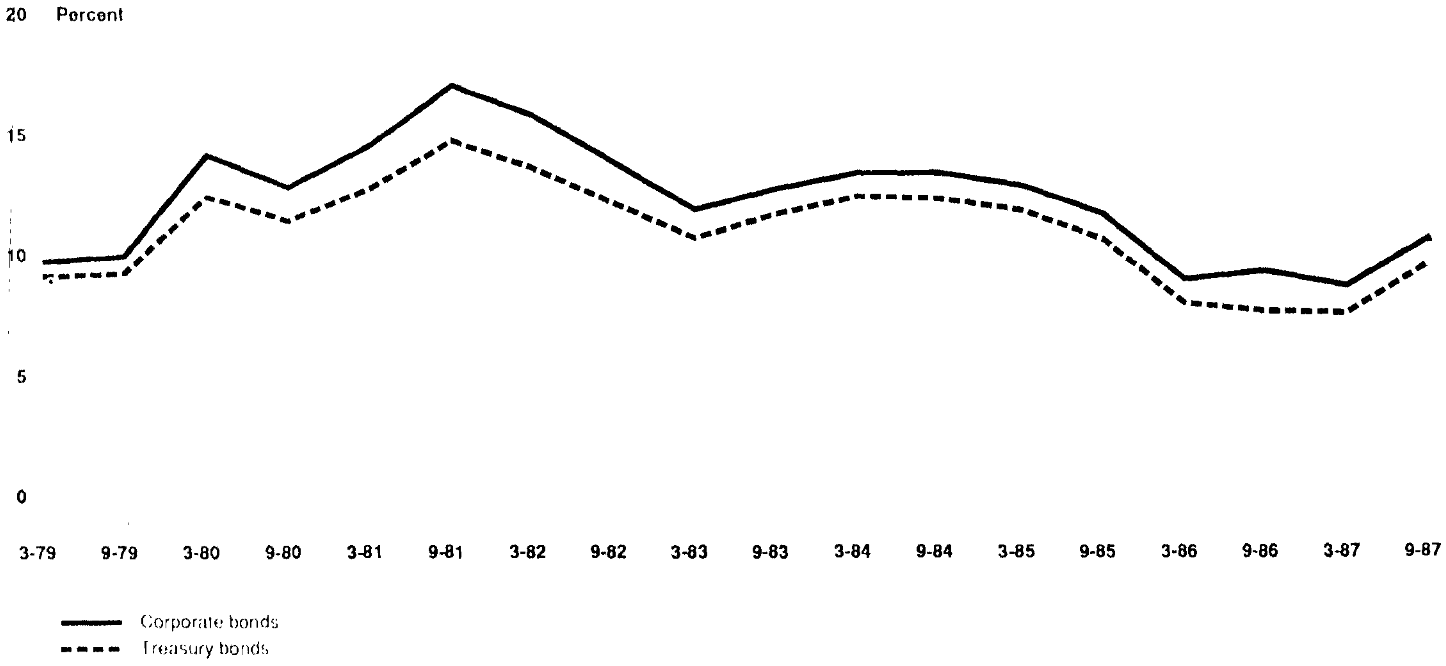
Loan sale decisions must also consider any unique loan portfolio provisions and their effect on achieving program and policy goals.

How to Determine the Current Value of a Loan Package

A loan is a financial asset which is designed to produce a stream of interest and principal payments to the lender over a period of years. The value of that stream of payments at any point in time can be determined by discounting the future payment stream by an appropriate interest rate to determine its present value or "discounted present value". For the federal government, the appropriate interest rate to use in determining the discounted present value is the current Treasury borrowing rate since Treasury is a net borrower of funds and it represents the rate at which Treasury would borrow money if the sale had not taken place. In other words, it is the opportunity cost for the federal government.

As shown in figure 4.1, Treasury's historical cost of borrowing funds is less than that of the corporate sector. For example, in September 1987, the average yield of 30-year Treasury bonds was 9.59 percent, while the yield for new corporate Aa[4] bonds was 10.63 percent.

Figure 4.1: Monthly Average Yields of 30-Year Treasury and Corporate Bonds



Corporate bond rates are for securities rated Aa.

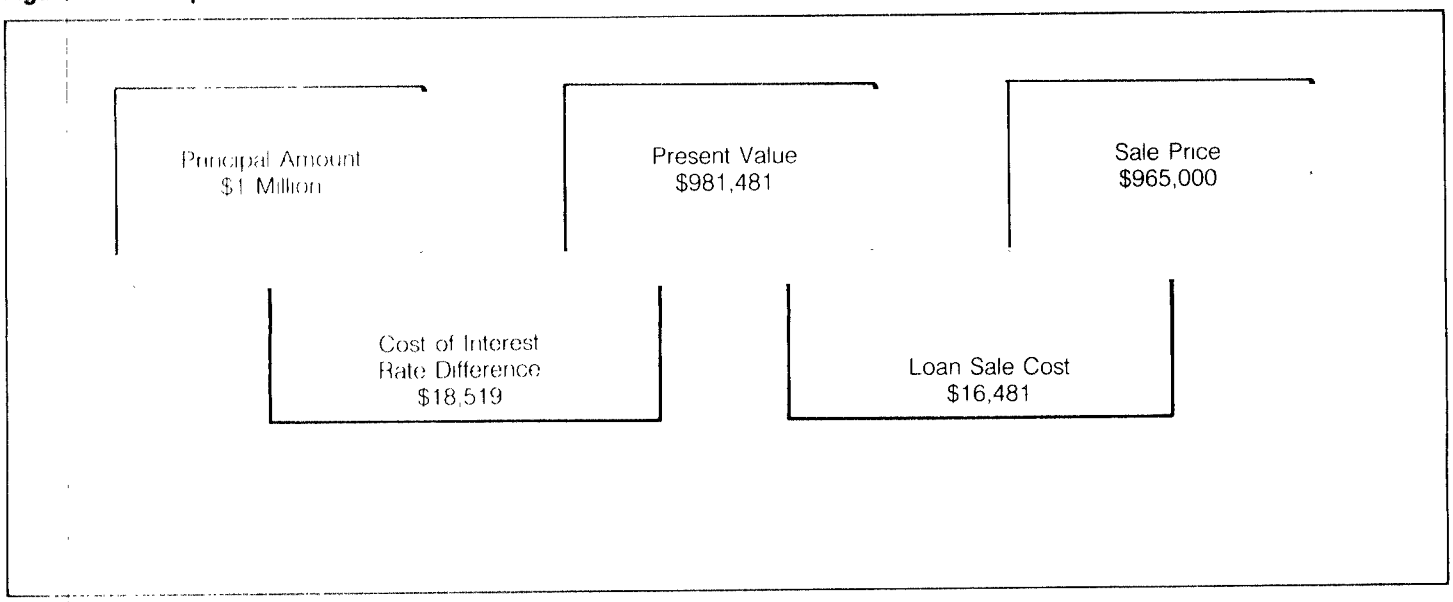
Source. Treasury Bulletin, Fall Issue, December 1987

[4]According to Moody's Investors Service, bonds which are rated Aa are judged to be of high quality by all standards. Together with the Aaa group, they comprise what are generally known as high-grade bonds. They are rated lower than the best bonds because (1) margins of protection may not be as large as in Aaa securities, (2) fluctuation of protective elements may be of greater amplitude, or (3) there may be other elements present which make the long-term risks appear somewhat larger than Aaa securities.

If the net proceeds of a loan asset sale are equal to the present value of the loan, no gain or loss is incurred from the sale by the federal government. Conversely, if the rate of return investors use to determine the net sale proceeds is higher than Treasury's borrowing rate at the date of the sale, then the government incurs a cost equal to the difference between Treasury's borrowing rate and the discount rate used. For prepayment programs, if the loan has an interest rate equal to the current Treasury borrowing rate, the prepayment of the loan at "par" or face value has no cost to the government. However, prepayment at par of loans with rates higher than the current Treasury borrowing rate has a cost to the government.

Determining the cost to the government of a sale is different than determining the costs associated with (1) subsidized loans and (2) effects of changing interest rates since the loans were issued. Interest rate subsidies occur when the government issues loans at a rate lower than its cost of funds and are discussed in detail in chapter 6. Figure 4.2 shows the relationship between a 1-year loan which carries a 6 percent loan rate when Treasury's cost of funds is 8 percent and which is sold at a discount rate of 9.9 percent.

Figure 4.2: Example of Possible Loan Costs



Loan Sale/ Prepayments Have Resulted in Costs

Our review of the loan sales and prepayments associated with the pilot program and the budget reconciliation program disclosed that the government has incurred quantifiable costs related to the sale of loan assets because the government has sold loans at discount rates which are higher than Treasury's borrowing rates. In addition, it has permitted prepayments at par of loans with interest rates higher than Treasury's borrowing rate. In several cases, the total cost cannot be identified because costs associated with certain loan provisions were not separately identified and because of uncertainties relating to future economic events.

Pilot Program—$170 Million Cost

Three prepayment programs and one loan portfolio sale were conducted at an estimated cost of $170 million. The administration proposed to sell six loan portfolios and conduct three prepayment programs as a pilot project. As previously discussed in chapter 3, efforts to sell loans from one portfolio were abandoned because of a lack of investor interest and efforts to sell another portfolio were stopped by legal action regarding the enforcement of special loan provisions after the sale of the portfolio to investors.

Table 4.1: Computation of Costs on Pilot Loan Sales

Dollars in millions

Loan portfolio	Present value	Proceeds	Loss
VA Vendee Loans - S	$925.0	$849.0	$76.0
Agriculture REA Loans - P	474.0	427.0	47.0
SBA Disaster Loans - P	3.6	3.4	.2
Education College Housing Loans - P	485.0	438.0	47.0
Total	**$1,887.6**	**$1,717.4**	**$170.2**

Notes:
1 P represents prepaid
2 S represents sold
3 The present value of the loan sales and prepayments were adjusted to show the government's loan loss rate

This $170 million cost results primarily from the difference (or spread) between the current Treasury borrowing rate (used to determine the present value of the loans to the government) and the rate of return required by the private sector (including such costs as loan servicing and credit insurance) which is used to establish the net proceeds on the sale program and the prepayment at par of loans with interest rates higher than Treasury borrowing rates.

Costs Resulting From Subsequent Sales/ Prepayments

In addition to the sale and prepayments transactions we reviewed in detail under the pilot program, we also reviewed other loan sales and prepayments consummated during calendar year 1987. We found that it was extremely difficult to determine the costs associated with these sales because the sale agreement and financial reports prepared on the results of these transactions did not include sufficient details to allow us to perform a similar analysis as we did on the pilot project. This review also demonstrated that a uniform set of rules cannot be used to determine the cost associated with a sale, i.e., sales must be reviewed individually because they are unique. Below are some examples of the unique characteristics that need to be considered when evaluating these sales/ prepayments.

On the surface it would appear that it cost the federal government $1.2 billion for Agriculture's Rural Housing loan sale if one just takes the present value of the loans sold ($3 billion) and compares it to the $1.8 billion net proceeds received. However, it is misleading to call this difference a cost since it reflects the costs of conducting the sale, the interest rate spread, future loan servicing costs, and the overcollateralization and credit insurance required to protect the investor for loan defaults. Although the cost associated with each item was not disclosed, our review has shown that by far the largest part of the $1.2 billion is associated with overcollateralization and credit insurance. Therefore, if future loan losses on those loans which are sold are comparable to the loan losses experienced by the government, then the government would have incurred most of the $1.2 billion cost even if it had not sold the loans and, as a result this is not a cost of the sale. On the other hand, should the actual losses be less than previous history indicates, the loan agreement specifies that the federal government will receive a portion of the $1.2 billion difference when the loans mature.

The apparent costs of selling Education's College Housing and Academic Facilities and Agriculture's Community Development loan portfolios also appear to be significant if you compare the loans' present value to the net sales price. As with the Agriculture program, a portion of these costs can be attributed to overcollateralization. In addition, a large portion of these costs must also be attributed to the spread between the interest rates carried by the sold loans and market rates at the date of sale. For these portfolios, the interest rates carried by the loans were below current market rates. Because financial reports on the sales were not sufficiently detailed, the actual amounts of these costs cannot be readily identified.

In addition to the costs related to the interest rate differential, other costs and benefits must also be considered in evaluating the economic impact of these sales and/or prepayments on the government. These impacts are discussed in the following sections.

Credit Enhancement Costs

In the loan sales we reviewed, the government, as the seller, included some form of credit enhancement. The types of credit enhancements fall into three broad areas:

- agreeing to repurchase or replace a specified dollar amount of loans which go into default after the sale,
- overcollateralizating the loans, and
- purchasing credit insurance from the private sector.

The amount that these enhancements add to the cost of a loan sale depends on which option(s) is used. Furthermore, the government will incur additional costs if losses experienced under such agreements exceed those the government would have incurred if the government held rather than sold the loans. Conversely, if, either through better collection practices or for other reasons, the purchasers achieve a higher collection rate on the loans than the government was achieving, then a monetary benefit accrues to the government from the sale.

Recourse Agreements

If the sale is made with recourse to the government, the government pledges to compensate the investor if a borrower defaults on a sold loan by either buying back the loan or replacing the loan with a new loan containing the same terms. The government will incur costs only if loan losses experienced under such recourse agreements exceed those it would have incurred had it held rather than sold the loans.

Overcollateralizating Loans

As discussed in chapter 3, overcollateralization entails transferring to purchasers an aggregate unpaid principal balance greater than that needed to support the purchase price paid by purchasers for the portion of the loan portfolio they bought. The excess principal balance transferred to purchasers provides them with a financial reserve to absorb any losses due to borrower defaults on the loans that are sold. The amount of excess loan principal balance to be transferred to purchasers is determined, in part, on the historic loan default and loss rates for the portfolio being sold.

Like loan recourse agreements, overcollateralization does not necessarily increase the government's loan sale costs as long as the loan loss rates experienced by investors are equal to the government's historical loss rate. If the loss rates experienced by the investor after the loan sale are less than the government's historic loss rates and the balance of the overcollaterization reverts to the government, as is the case in the sales to date, then the government will not incur any additional cost from overcollaterization and in fact will derive a benefit.

Credit Insurance

Another form of credit enhancement, also discussed in chapter 3, is the purchase by the government, on behalf of investors, of private credit insurance. This insurance guarantees repayment of principal and interest payments by borrowers for loans sold to investors. Under this option, the government, at the time of the sale of all or part of a loan portfolio, pays a lump sum premium to a private insurance company to buy insurance to indemnify purchasers of a loan portfolio against losses of loan principal and interest payments because of borrower defaults on purchased loans. Whether the premium results in additional costs to the government depends on whether the loan loss rate used in computing the premium equals the actual loan losses that will occur throughout the life of the loans. If losses are greater than the expected default rate, then the insurance is cost-effective; if losses are less than expected, the insurance results in an additional cost.

Loan Servicing Costs

Private investors, as part of the sale structure, have required that loan servicing be transferred from the government to a private loan service. Such loan servicing costs are borne by the government since these costs are reflected as (1) a reduction of the initial net sale proceeds to the government and/or (2) as a reduction in any residual sale proceeds the government receives after investors have recouped their initial investment and agreed upon interest payments. If the government does not reduce its own costs accordingly, this expense also increases the costs associated with the sale.

Reductions in credit program operating costs are a potential benefit of loan asset sales and borrower prepayments. However, loan asset sales and prepayments, as currently structured, will only result in minimal credit program operating cost reductions—benefits—because the government will (1) continue to originate loans and (2) service loans that are in trouble. Reductions in credit program operating costs would be a major benefit of loan sales or borrower prepayments only for programs for which the government will:

- no longer be granting new loans,
- include in the sale and/or prepayment program current loans as well as delinquent loans and loans in default, and
- dispose of substantial amounts of or the entire loan portfolios being liquidated.

To date only active loans that are not delinquent or in default have been sold or offered to borrowers for prepayment. Consequently, the government will continue to operate the high cost aspects of federal credit programs. In addition, current sale and borrower prepayment programs primarily involve small portions of large portfolios with the result that the sale or prepayments will not reduce to any great extent the government's cost to service these portfolios.

The lowest cost aspect associated with a loan program is the servicing of a loan in which the borrower is meeting the financial obligation. Therefore, since this is the only category of loans the government is including in its portfolios, the sales or prepayments will only affect the lowest cost aspect of credit program operations. Overall, reductions in the government's costs to operate credit programs currently are not major benefits of the loan sale and borrower prepayment programs.

Improved Loan Administration Benefits

One of the objectives of the loan sales initiatives has been to improve overall credit management activities of the federal government. Our discussions with agency officials and their private sector financial advisors and loan sale underwriters indicate that government credit program administrators and loan portfolio managers have begun to bring into government, to the extent practicable, private sector loan origination and documentation techniques. A major objective of the government's initial loan sale initiative was to foster federal credit reform by bringing to the government, through the loan sale process, an understanding of the requirements of private credit investors and an understanding of private sector loan organization, servicing, and collection practices. Loan sales were also designed to help federal credit program administrators bring private sector loan documentation standards into the federal government. The most measurable impact, long term, would be a reduction in loan losses due to improved borrower screening to eliminate ineligible borrowers, improved government protection through better documentation and collateral and better collection practices. It is too early to tell the extent to which these new techniques will affect federal credit program costs.

Observations

Loan asset sales and prepayment programs conducted to date have resulted in $170 millon in additional costs to the federal government. These costs resulted primarily from the interest rate spread between the Treasury rate and the investors discount rate or, for prepayment, the fact that only loans with an interest rate higher than Treasury's current rates are prepaid. In addition, other gains or losses may arise from the credit enhancements required by the private investors' but these will not be known for several years. The increased costs to the government associated with these loan sales may be offset to some extent by reductions in program costs associated with improvements in credit program operating costs and better loan collection practices. Specifically, if loan sales, in fact, encourage agencies to more effectively evaluate the creditworthiness of borrowers and make better loan origination decisions, to maintain better loan documentation and accounting records, and to implement better collection practices, then the government will realize increased loan repayments. At the same time, however, loan sales are not likely to reduce the administrative costs associated with loan programs.

We also noted that certain loan portfolios, because of special loan provisions related to government policy and program objectives and because of poor payment histories, will not be attractive to investors and are not likely to be sold.

Loan Sales and Borrower Repayments Should Not Be Justified as Budget Reduction Tools

In addition to credit reform objectives, loan sales have been viewed, in the last two budgets, as a means of reducing the budget deficit. However, as we have noted in previous reports and testimony, and as our current analysis indicates, loan sales and borrower prepayments will not reduce the structural budget deficit. Such sales and prepayments simply shift the present value of loan principal and interest payments, which the federal government expected to receive in future years, to the year of the sale or prepayment. Consequently, budget cash receipts are increased in the year in which sales and/or prepayments take place—thereby reducing the budget deficit for that year. However, in the future years that span the payback periods of the sold and/or prepaid loans, budgetary cash receipts are similarly reduced.

Our evaluation confirmed our previous reports that for most government loan sale and prepayment programs, quantifiable costs of the sales will exceed benefits at least in the near term. As such, these costs will increase, rather than decrease, budget deficits. Our previous reports and testimony, listed in chapter 1, discuss in greater detail why we believe loan sales do not reduce the deficit and why we believe a change in budgetary accounting for loan programs and loan sales should be made to more properly reflect the true nature of loan programs and sales.

Restrictions on Using Loan Sale Proceeds

In addition to the issue of whether loan sales reduce the deficit, we noted that, for three of the federal loan programs that were actually sold, loan sales proceeds can only be used to reduce related program outlays. For these programs, loan sales proceeds must be deposited in the applicable revolving fund. However, there are different provisions for transferring the funds to the Treasury's miscellaneous receipt accounts. Limitations on the use of loan sale proceeds are shown in table 5.1.

Table 5.1: Legal Provisions Governing Use of Loan Sale Proceeds

Dollars in millions

Loan portfolio	New loan asset sale proceeds	Purpose for which proceeds can be used
VA's Vendee Loans	$849.0	All proceeds must be deposited in VA Loan Guaranty Revolving Fund. Annually, VA Administrator may transfer any surplus amount to Treasury's general fund.
Agriculture's Rural Electrification Loans	427.0	All proceeds must be deposited in Rural Electrification and Telephone Revolving Fund to be used for REA purposes. Congress may authorize transfer of excess cash to be deposited into the Treasury as miscellaneous receipts.
SBA's Disaster Loans	3.4	All proceeds must be deposited in Disaster Loan Revolving Fund to be used only for program purposes. SBA may transfer any excess revolving fund moneys into the Treasury as miscellaneous receipts.

Observations

Loan asset sales and borrower prepayment programs should not be justified as deficit reduction tools. These programs will only reduce budget deficits in the year the sale and prepayment transactions take place. In future years that span the payback period of the sold and prepaid loans, budget deficits will be increased. Overall, loan asset sales and borrower prepayments will most likely increase budget deficits over the long-term unless substantially increased overall collections are achieved as a result of the transfer of collection activities to the private sector and agency credit management is improved.

Loan Asset Sales Are Not Needed To Determine Subsidy Cost

The subsidy cost—cost to the government—of a loan program can be estimated without selling loans. This cost can be computed by determining the total of (1) the difference between the interest costs the government incurs to make the loans and the interest income the government will receive from borrowers, (2) the estimated amount of future loan defaults at the time these loans are made, and (3) the estimated cost of administering the loan program.

The administration's plan to define federal credit program subsidy cost as the monetary benefit—interest cost savings—to a borrower will overstate both government cash costs and the related cost to operate credit programs. We believe a more accurate measure of federal credit program subsidies is the government's cost to make loans. Loan subsidy costs would be more accurately estimated using the government's borrowing rate in subsidy cost computations.

Determining Subsidies of Federal Credit Programs

A key objective of the administration's two major credit reform initiatives is to identify the subsidy cost of federal credit programs. How much is it costing the American taxpayer to support government loan programs? Both initiatives—its pilot program of loan asset sales and "Market Plan" credit reform legislation—propose using loan asset sales as the vehicle for identifying subsidy cost. In those proposals, the subsidy cost is defined as the difference between net sale proceeds and the unpaid principal balance of the loans sold. Loan asset sales were selected as the means of identifying subsidy cost because it is believed that sales measure the difference between the interest cost to the borrower of a government loan and the interest cost of a similar commercial loan. The administration's federal credit reform initiatives define credit program subsidy cost as the monetary benefit—interest cost savings—to the borrower rather than as the cost to the government of granting the loan.

Our analyses of federal loan sales disclosed that there are two approaches for determining credit program subsidies. The first is to determine the loan subsidy cost to the government; the second is to determine the economic—interest cost—subsidy to the borrower. These are explained below.

- An interest subsidy cost is incurred when the government loans money at interest rates lower than the interest rates it incurs to make the loans.
- Interest subsidies to the borrowers arise when the interest rates which the government charges are lower than those interest rates borrowers

could hypothetically obtain on similar loans from private financial institutions.

We believe the loan subsidy cost to the government, not the borrower's subsidy cost, will more accurately estimate federal credit program subsidies.

OMB's Policies for Determining Federal Credit Program Subsidies

On August 2, 1984, OMB issued Circular A-70, which defines federal credit program subsidies as the interest subsidies to borrowers. It requires federal agencies with direct loan programs to calculate a subsidy cost when they make credit available to borrowers on more favorable terms than are available from private sources. Agencies are required to calculate the subsidy at the time loans are granted.

OMB restated the same position in its guidelines for loan asset sales. These guidelines provide agencies with the basis for conducting loan asset sales pursuant to the administration's pilot program of loan asset sales. These guidelines, as well as the administration's "Market Plan" for selling new loans, define federal credit program subsidies as the interest subsidy to the borrower.

The administration's definition of federal credit program subsidies as the interest subsidies to borrowers is based on the assumption that commercial credit markets are efficient. In efficient credit markets, all borrowers seeking loans are able to obtain loans, and the only difference between borrowers is in the interest rate they are charged. Borrowers who are poor credit risks will be charged a higher rate of interest than those who are good credit risks. The higher interest rates compensate lenders for the potentially higher losses they can expect. The interest rate charged a borrower who is a poor credit risk reflects normal market rates for loans and an additional charge for the credit risk assumed by the lender.

The administration's pilot program of loan asset sales and its market plan propose determining the government's interest subsidies to borrowers by selling loans to private investors. Through loan sales, the administration proposes to determine these costs by subtracting net loan sale proceeds from the outstanding principal balance of the sold loans.

OMB's Approach Overstates Cost

The approach discussed above would overstate the government's loan subsidy cost (cash outlays) because the government's net sale proceeds will reflect factors in addition to the creditworthiness of the borrowers (loan risk) and cost to service the loans. Among these factors are the following:

- the investor's rate of return on alternative investments, which is generally higher than Treasury's borrowing rate;
- the degree of risk the investor assumes for estimated future loan losses;
- the investor's lack of familiarity with the type of loans the government is offering for sale;
- the investor's cost to service the loans; and
- the investor's cost to consummate the sale, including the cost to obtain credit ratings on loans offered for sale.

In addition to the above factors, subsidy costs determined through the sale of existing (as opposed to new) loans will also reflect those interest rates prevailing at the time the loans are sold rather than the interest rates in effect at the time the loans were originally granted. If there has been a significant change in interest rates between the time the loans were originally made and the time they are sold, then net sale proceeds for the loans will be significantly different than they would have been had the sales been based on the interest rates in effect at the time the loans were granted. As noted in chapter 4, for existing loans, the interest subsidy cost is different from the cost of selling a loan. The interest subsidy cost should be based on the interest rate spread at the time the loan is made, not later when it is sold.

For example, Treasury's long-term borrowing rate, at the time the 3-percent college housing loans and academic facilities loans were made, ranged from 5.96 to 6.85 percent. Consequently, the government's loan subsidy cost, or interest rate spread, ranged from 2.96 to 3.85 percent when the college housing loans were originally made. In contrast, the net sale proceeds of a portion of these loan portfolios were based on an interest rate of 12.5 percent. Following the administration's proposed approach would result in using an interest rate of 9.5 percent to determine subsidy costs. Using this rate would, therefore, materially overstate the subsidy because these rates reflect changes in economic conditions which are unrelated to the original decisions to grant the loans. In this case, loan subsidies determined by subtracting net sale proceeds from the aggregate unpaid principal balance of the sold loans would be significantly overstated.

We discussed these approaches with finance and economics experts in selected private financial and investment institutions, public policy organizations, and major universities. They stated that the administration's assumption of efficient credit markets is not a valid assumption. Specifically, not all borrowers seeking commercial loans will be able to obtain loans. In fact, it is for this reason that federal credit programs were established. These programs are designed to provide loans to borrowers who cannot obtain loans from commercial lenders.

The experts stated that, for many federal borrowers, interest rates for commercial loans equivalent to the federal loans the borrowers obtained could not be objectively determined because these borrowers could not obtain commercial loans. In cases where interest rates could objectively be determined for such loans, the loan subsidies, based on these interest rates, would overstate the cash costs to the government to make the loans because the government's borrowing costs are lower than similar costs for private borrowers.

Loan Subsidy Costs Can Be Measured Without Selling Loans

Federal credit program subsidies should be based on the loan subsidy cost to the government of credit activities, rather than the interest subsidy provided to the borrowers. This means of measurement would be consistent with a function of the federal budget, which is to provide a statement of the cash costs—outlays--of governmental operations.

Based on our analysis, the loan subsidy cost to the government can be calculated without selling loans and should include the following elements:

- the difference between (1) the present value of the future principal and interest payments discounted at the government's long-term interest rate and (2) the amount of money loaned out;
- the present value of future loan program administrative costs, based on the Treasury's long-term interest rate; and
- the present value of future principal and interest payments, based on the Treasury's long-term interest rate on loans that are expected to go into default during the life of the loan program.

Our previous reports and testimony[5] on this subject expand on our positions and rationale for why we believe the subsidy of a federal credit program should be the subsidy cost to the government rather than the

[5]See footnotes 1 and 2 in chapter 1.

interest subsidy to the borrower. We are also currently preparing an in-depth analysis of this subject which we expect to issue later this year.

Observations

Sales of existing and new loan assets are not needed to determine the subsidies of federal credit programs. As discussed above, the subsidy cost—cash outlays—to the government for a loan program can be estimated without selling the loans.

Federal credit program subsidies should reflect the subsidy cost to the government of credit activities, not the interest subsidy provided borrowers. 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 (cash outlays) of governmental operations. We agree that it is important to know the interest subsidies provided to borrowers, but such calculations should not enter into the budget's totals.

In the President's 1989 budget submission released in February of this year, OMB included changes in terminology and procedures to be followed by federal agencies in identifying federal program subsidies. We have not reviewed these changes as part of this report. We will, however, address them in other work currently underway and report on them at a later date.

Summary of Federal Government Loans Per Fiscal Year 1987 Budget Estimate

Dollars in thousands

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Funds appropriated to the President				
International Security Assistance				
Foreign Military Sales Credit	$4,281,383	$0	$0	$140,000
Foreign Military Sales Guarantees, Federal Finance Bank Direct Loans	0	0	17,969,031	0
Economic Support Funds	6,855,707	0	0	0
Guarantee Reserve Fund	1,331,853	0	0	0
International Development Assistance				
International Organizations and Programs	48,376	0	0	0
Agency for International Development Functional Development Assistance Programs	3,581,332	0	0	0
AID Miscellaneous Appropriations	155,999	0	0	0
AID Housing and Other Credit Guaranty Programs	65,374	0	0	1,360,131
AID Private Sector Revolving Fund	21,447	0	0	0
AID Development Loans Revolving Fund	8,143,172	0	0	0
Overseas Private Investment Corporation	39,339	0	0	259,887
OPIC, FFB Loan Asset Purchases	0	438	0	0
Total	**$24,523,982**	**$438**	**$17,969,031**	**$1,760,018**
Department of Agriculture				
Foreign Assistance Program				
General and Special Funds	$11,367,876	$0	$0	$0
Commodity Credit Corporation				
Short-and Medium Term Export Loans	747,506	0	0	0
Commodity Loans	13,698,399	0	0	0
Storage Facility Loans	28,952	0	0	0
Export Guarantee Claims	3,196,932	0	0	0
CCC Export Guarantee Program	0	0	0	9,902,251
Rural Electrification Administration				
Rural Communication Development Fund	21,707	0	0	9,964
Rural Electrification and Telephone Revolving Fund Loan Authorizations	8,743,642	0	0	1,300,789
Rural Electrification Administration, FFB Direct Loans	0	0	23,710,456	0
Rural Electrification Administration, FFB Loan Asset Purchases	0	4,127,007	0	0
Rural Telephone Bank	1,425,661	0	0	0
Farmers Home Administration				
Agricultural Credit Insurance Fund	501,719	0	0	4,069,726

(continued)

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Agricultural Credit Insurance Fund, FFB Loan Asset Purchases	$0	$28,960,835	$0	$0
Self-Help Housing Land Development Fund	735	0	0	0
Rural Housing Insurance Fund	422,463	0	0	595,069
Rural Housing Insurance Fund, FFB Loan Asset Purchases	0	26,102,000	0	0
Rural Development Insurance Fund	201,856	0	0	2,534,809
Rural Development Insurance Fund, FFB Loan Asset Purchases	0	6,045,978	0	0
Rural Development Loan Fund	36,832	0	0	0
Total	**$40,394,280**	**$65,235,820**	**$23,710,456**	**$18,412,608**
Department of Commerce				
Economic Development Administration Miscellaneous Appropriations:				
Financial and Technical Assistance	$8,805	$0	$0	$2,140
Trade Adjustment Assistance	7,778	0	0	11,757
Fisheries Loan Fund	9,091	0	0	0
Federal Ship Financing Fund	10,129	0	0	167,980
Drought Assistance Program	82,859	0	0	0
Economic Development Revolving Fund	544,043	0	0	170,094
National Oceanic and Atmospheric Administration Coastal Energy Impact Fund	90,456	0	0	0
Total	**$753,161**	**$0**	**$0**	**$351,971**
Department of Defense				
Revolving and Management Funds:				
Defense Production Guarantees, FFB Direct Loans	$0	$0	$17,821	$0
Defense Stock Fund	1,210	0	0	0
Navy Industrial Fund, FFB Direct Loans	0	0	1,721,366	0
Total	**$1,210**	**$0**	**$1,739,187**	**$0**
Department of Education				
Office of Postsecondary Education:				
Student Financial Assistance	$5,369,850	$0	$0	$0
Guaranteed Student Loan	4,777,157	0	0	43,849,362
Higher Education	34,158	0	0	0
Higher Education Facilities Loans and Insurance	116,538	0	0	0
College Housing Loans	344,064	0	0	0
Guarantee of Student Loan Marketing Associated Obligations, FFB Direct Loans	0	0	4,970,000	0
Total	**$10,641,767**	**$0**	**$4,970,000**	**$43,849,362**

(continued)

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Department of Energy				
Energy Programs:				
Energy Supply, Research and Development Activities	$1,101	$0	$0	$0
Geothermal Resources Development Fund	12,400	0	0	10,000
Power Marketing Administration:				
Bonneville Power Administration Fund	42,400	0	0	0
Total	**$55,901**	**$0**	**$0**	**$10,000**
Department of Health and Human Services				
Health Resources and Services Administration:				
Health Resources and Services	$491,889	$0	$0	$45,607
Health Professions Graduate Student Loan Insurance Fund	48,143	0	0	1,265,350
Health Education Loans	2,942	0	0	0
Nurse Training Fund	3,031	0	0	0
Medical Facilities Guarantee and Loan Fund	27,609	0	0	865,327
Medical Facilities Guarantee and Loan Fund FFB Loan Asset	0	110,891	0	0
Health Maintenance Organization Loan & Loan Guarantee Fund	2,175	0	0	0
Health Maintenance Organization Loan & Loan Guarantee Fund FFB Loan Asset Purchase	0	100,388	0	0
Social Security Administration:				
Refugee and Entrant Assistance	13,796	0	0	0
Human Development Services:				
Community Development Credit Union Revolving Loan Fund	1,751	0	0	0
Total	**$591,336**	**$211,279**	**$0**	**$2,176,284**
Department of Housing and Urban Development				
Public and Indian Housing:				
Low-Rent Public Housing Loans & Other Expenditures	$2,074,371	$0	$0	$8,240,286
Government National Mortgage Association:				
Management Liquidating Functions Fund	375,180	0	0	0
Guarantees of Mortgage-Backed Securities	3,891	0	0	265,458,085
Community Planning and Development:				
Community Development Grants, FFB Direct Loans	0	0	416,373	0
Rehabilitation Loan Fund	712,493	0	0	0
Revolving Fund (Liquidating Program)	349,049	0	0	61,369
Revolving Fund (Liquidating Programs), FFB Direct Loans	0	0	30,575	0
Total	**$3,514,984**	**$0**	**$446,948**	**$273,759,740**

(continued)

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Department of Interior				
Water and Science:				
Loan Program for Construction of Distribution Systems	$519,356	$0	$0	$0
Emergency Fund	12,993	0	0	0
Fish and Wildlife and Parks:				
Construction	8,000	0	0	0
Indian Affairs:				
Revolving Fund for Loans	119,981	0	0	0
Indian Loan Guaranty and Insurance Fund	7,790	0	0	189,302
Territorial & International Affairs:				
Administration of Territories, FFB Direct Loans	0	0	60,343	0
Total	**$668,120**	**$0**	**$60,343**	**$189,302**
Department of Labor				
Pension Benefit Guaranty Corporation:				
Pension Benefit Guaranty Corporation Fund	$3,311	$0	$0	$0
Total	**$3,311**	**$0**	**$0**	**$0**
Department of State				
Administration of Foreign Affairs:				
Emergencies in Diplomatic & Consular Services	$3,863	$0	$0	$0
International Organizations and Conferences:				
Contributions to International Organizations	4,570	0	0	0
Total	**$8,433**	**$0**	**$0**	**$0**
Department of Transportation				
Federal Highway Administration:				
Liquidation of Contract Authority Trust Fund	$76,488	$0	$0	$0
Right-of-Way Revolving Fund	115,552	0	0	0
Federal Railroad Administration:				
Railroad Rehabilitation and Improvement Financing Funds	587,601	0	0	0
Railroad Rehabilitation and Improvement Financing Funds (Section 511), FFB Direct Loans	0	0	57,386	0
Urban Mass Transportation Administration:				
Miscellaneous Expired Accounts	0	0	0	997,000
Federal Aviation Administration:				
Aircraft Purchase Loan Guarantee Program	55,266	0	0	310,635
Maritime Administration:				
Federal Ship Financing Fund	1,216,371	0	0	5,163,792

(continued)

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Office of the Secretary:				
Transportation Planning, Research, and Development	11,002	0	0	0
Total	**$2,062,280**	**$0**	**$57,386**	**$6,471,427**
Department of the Treasury				
Financial Management Service:				
Biological Mass Energy Development	$0	$0	$0	$1,072,292
Total	**$0**	**$0**	**$0**	**$1,072,292**
Environmental Protection Agency				
Federal Funds.				
Abatement, Control, and Compliance	$63,553	$0	$0	$0
Construction Grants	34,329	0	0	0
Total	**$97,882**	**$0**	**$0**	**$0**
General Services Administration				
Real Property Activities:				
Federal Building Fund	$0	$0	$0	$636,692
Federal Building Fund, FFB Direct Loans	0	0	397,044	0
Total	**$0**	**$0**	**$397,044**	**$636,692**
National Aeronautics and Space Administration				
Federal Funds:				
Space, Flight, Control, and Data Communications, FFB Direct Loans	$0	$0	$808,606	$0
Total	**$0**	**$0**	**$808,606**	**$0**
Small Business Administration				
Federal Funds				
Business Loan and Investment Fund	$4,097,892	$0	$0	$8,376,788
Small Business Development Company Loans, FFB Loan Asset Purchases	0	12,929	0	0
Disaster Loan Fund	2,831,586	0	0	2,941
Pollution Control Equipment Contract Guarantee Revolving Fund	0	0	0	376,640
Total	**$6,929,478**	**$12,929**	**$0**	**$8,756,369**
Veterans Administration				
Federal Funds:				
Burial Benefits and Miscellaneous Assistance	$15	$0	$0	$0

(continued)

Agency/department—program	Agency direct loans to public	Direct loans to public held by FFB	Direct loans to public held by FFB and guaranteed by agencies	Agency guaranteed loans outstanding
Veterans Insurance and Indemnities	$864	$0	$0	$0
Loan Guaranty Revolving Fund	780,310	0	0	144,820,247
Direct Loan Revolving Fund	93,061	0	0	1,850
Service Disabled Veterans Insurance Fund	40,232	0	0	0
Veterans Reopened Insurance Fund	30,873	0	0	0
Education Loan Fund	41,910	0	0	0
Vocational Rehabilitation Revolving Fund	390	0	0	0
Trust Funds:				
National Service Insurance Fund	995,078	0	0	0
U.S. Government Life Insurance Fund	22,910	0	0	0
Veterans Special Life Insurance Fund	79,773	0	0	0
Total	**$2,085,416**	**$0**	**$0**	**$144,822,097**
Other independent agencies				
District of Columbia:				
Loans to D.C. for Capital Outlay	$1,498,205	$0	$0	$0
Export-Import Bank	14,997,683	0	0	7,357,010
Federal Deposit Insurance Corporation	3,795,153	0	0	0
Federal Home Loan Bank Board:				
Federal Savings and Loan Insurance Corporation Fund	2,734,716	0	0	3,134,439
Interstate Commerce Commission	0	0	0	1,200
National Credit Union Administration:				
Credit Union Share Insurance Fund	28,000	0	0	0
Central Liquidity Facility	180,000	0	0	0
Tennessee Valley Authority:				
Tennessee Valley Authority Fund:				
Nonpower Program	2,692	0	0	0
Power Program	255,337	0	0	1,150
TVA Fund, Seven States Energy Corporation, FFB Direct Loans	0	0	1,640,492	0
United States Information Agency:				
Salaries and Expenses	565	0	0	0
United States Railway Association:				
Regional Rail Reorganization Program	91,682	0	0	0
United States Synthetic Fuels Corporation	0	0	0	19,564
Total	**$23,584,033**	**$0**	**$1,640,492**	**$10,513,363**
Total	**$115,915,574**	**$65,460,466**	**$51,799,493**	**$512,781,525**

Source: Budget of the U.S. Government, Appendix—1987

Status of Fiscal Year 1987 Agency Loan Asset Sales

Dollars in millions

	Pilot program fiscal year 1987 budget		Final fiscal year 1987 budget[a]		Budget call for fiscal year 1988	
Pilot sales	Amount to be sold[b]	Estimated net revenue[b]	Amount to be sold[c]	Estimated net revenue[c]	Amount to be sold[c]	Estimated net revenue[c]
Education:						
Guaranteed Student Loans	$200	$30	$0	$0	$0	$0
National Direct Student Loans	48	7	0	0	0	0
College Housing Loans	1,102	579	983	579	931	522
Higher Education Facilities Loans	0	0	0	0	142	83
Small Business Administration:						
Business Loan Investment Fund	1,153	251	0	0	1,000	140
Disaster loans	1,100	403	600	277	670	168
Development companies	0	0	0	0	500	249
Veterans Administration:						
Vendee loans	78	55	0	0	300	176
Housing and Urban Development:						
FHA fund	300	267	300	217	350	212
Rehabilitation loans	10	4	0	0	350	35
Community development	0	0	35	21	200	120
Housing for elderly and handicapped	0	0	0	0	500	444
Agriculture:						
Rural Housing Loans	100	26	2,200	1,715	1,200	830
Rural Development loans	100	52	1,870	1,000	1,200	502
Rural Electrification Administration Loans	100	46	0	0	1,000	653
Rural Telephone Bank	100	36	0	0	500	449
Export-Import Bank Loans	0	0	2,018	1,500	1,200	312
Interior, Bureau of Reclamation	0	0	0	0	358	154
Health and Human Services:						
Medical Facilities	0	0	0	0	132	38
Health Maintenance Organization	0	0	0	0	97	24
Transportation:						
Railroad Rehabilitation	0	0	0	0	583	206
Subtotals	**$4,391**	**$1,756**	**$8,006**	**$5,309**	**$11,213**	**$5,317**
Programmatic sales						
Housing and Urban Development:						
GNMA Tandem Plan[d]	0	0	650	413	329	(49)
Education:						
Guaranteed Student Loans[d]	0	0	0	0	250	38
Perkins (National Direct Student Loan) Loans[d]	0	0	0	0	33	5

(continued)

Pilot sales	Pilot program fiscal year 1987 budget		Final fiscal year 1987 budget[a]		Budget call for fiscal year 1988	
	Amount to be sold[b]	Estimated net revenue[b]	Amount to be sold[c]	Estimated net revenue[c]	Amount to be sold[c]	Estimated net revenue[c]
Veterans Administration						
Vendee Loans[d]	$0	$0	$690	$552	$745	$596
Subtotals	**$0**	**$0**	**$1,340**	**$965**	**$1,357**	**$590**
Totals	**$4,391**	**$1,756**	**$9,346**	**$6,274**	**$12,570**	**$5,907**

[a]Figures include Budget Reconciliation Act requirements.

[b]Figures as reported in the mid-session review of 1987 budget.

[c]Figures as reported in Special Analysis F, Budget of U.S. Government, 1988

[d]Amounts noted under these programs are part of a previously established programmatic loan sales effort

Sample Government Sales Warranty

The following is an example of a representative model of warranties and remedies made for a securitized loan sale that we reviewed.

Representations and Warranties of the Government

In the Loan Sale Agreement, the government will represent and warrant as of the Closing Date, with respect to (i) through (vii), inclusive, and will warrant as of the Closing Date with respect to (viii) through (xviii), inclusive, to the Trust substantially as follows:

(i) The agency is a department within the executive branch of the United States Government;

(ii) The government has the power and authority to execute, deliver and perform the Loan Sale Agreement and all of the transactions contemplated thereby. The government has taken all actions necessary to authorize it to perform its obligations under the Loan Sale Agreement and to consummate the transactions contemplated to be performed by it thereby. The Loan Sale Agreement and all other instruments and agreements executed and delivered by the government in connection with the transactions contemplated thereby on or prior to the Closing Date have been duly executed and delivered by the government and constitute legal, valid and binding obligations of the government, enforceable in accordance with their terms;

(iii) No consent, license or approval of, or registration with, any other Federal government agency and no rule-making proceedings under the Administrative Procedure Act or otherwise is required in connection with the execution, delivery or performance by the government of its obligations under the Loan Sale Agreement, other than approvals which have been obtained;

(iv) The execution, delivery and performance of the Loan Sale Agreement by the government does not violate any provision of any existing Federal law or regulation applicable to the government or any order or decree of any court (except insofar as there may exist an order or decree of any court which prohibits the sale of a particular Loan by the government pursuant to the Loan Sale Agreement) or any material mortgage, indenture, contract or other agreement to which the government is a party or by which it, the Loans or any significant portion of its properties are bound;

(v) The transfer of the right and power to service the Loans from the government directly or indirectly to a private servicer will not (a) violate, conflict with, constitute a material default under or permit termination of any material agreement or instrument to which the government is a party, (b) violate or conflict with any Federal law, regulation or order or decree of any court or Federal governmental authority or executive order applicable to the government (except insofar as there may exist an order or decree of any court or Federal governmental authority or executive order applicable to the government which prohibits the transfer of the right and power to service a particular Loan from the government directly or indirectly to a private servicer) or (c) require, by virtue of the government's relationship to the transactions contemplated by the Loan Sale Agreement, including its prior ownership of the Loans, the consent, waiver, approval or authorization of, or filing or registration with, or require any rule-making proceeding on the part of the government under the Administrative Procedure Act before any other Federal governmental authority that has not been obtained or performed;

(vi) There are no legal proceedings or formal investigations to which the government is a party or against any significant portion of the government's properties and, to the government's actual knowledge, no other legal proceeding or formal investigation pending or threatened, which would, in the opinion of the government, have a material adverse effect on the transactions contemplated by the Loan Sale Agreement;

(vii) Certain specified information included in the Registration Statement and in this Prospectus relating to the government, the Loans, Delinquency Information, the Portfolio and the government's loan discounting programs does not contain an untrue statement of a material fact or omit to state any material fact related to such information necessary to make such statements, in light of the circumstances under which they were made, not misleading, except that the government does not make such representation or warranty with respect to information included in the Prospectus under the caption "Special Considerations—Sovereign Immunity."

(viii)(a) The files of the Primary Loan Documents (as defined in the Loan Sale Agreement) relating to each Loan are accurate, correct and complete and include documents which are accurate, correct and complete evidencing any waivers or material alterations or modifications of each Loan arising from a course of dealing between the government and the Borrower thereunder (except any such waivers, alterations or modifications arising from the operation of principles of equity, including doctrines of estoppel, laches or waiver, but only insofar as such principles of equity do not operate so as to render unenforceable the Borrower's obligations to make scheduled payments of principal, premium, if any, or interest on such Loan) or otherwise; and (b) the information on the computer tape with respect to the Loans (the "Computer Tape") prepared by the Federal Reserve Bank of Richmond ("FRB") and provided by the government to the Trust is accurate, correct and complete;

(ix) No Loan has been past due in payment of principal or interest when due for thirty days or more at any time within the year ended on the Cut-off Date;

(x) The full amount of each Loan has been disbursed and no obligation exists for future advances thereunder. No Loan has been satisfied, rescheduled, reamortized or liquidated, and no collateral securing any Loan has been released from the lien of such Loan, in whole or in part, except as disclosed on the Computer Tape (with respect to modifications relating to scheduled payments or principal of or interest on the Loans) or in a Primary Loan Document included in the file for such Loan;

(xi) Each Loan is transferable to the Trust, and on the Closing Date the government will have transferred to the Trust all of the right, title and interest of the government in and to each Loan (including, without limitation, the right to service the Loan, to receive payments of principal of and interest on each Loan and the rights of the government under any insurance policy covering any Loan or collateral), free and clear of any liens, claims or encumbrances of any nature;

(xii) The government has duly and validly transferred and assigned to the Trust each note, bond, or other evidence of indebtedness relating to each Loan and its entire and complete security interest in all collateral securing each Loan;

(xiii) There are no existing legal proceedings or formal investigations to which the government is a party and, to the government's actual knowledge, no other legal proceedings or formal investigations pending or threatened, which proceeding or investigation, if determined adversely, would materially affect the ability of any Borrower to pay or discharge such Borrower's obligations under or the validity or enforceability of any Loan or security interest or lien securing any Loan;

(xiv) No Borrower is insolvent, in receivership or the subject of any bankruptcy, insolvency, receivership or similar proceeding;

(xv) The government has good title to, and is the sole owner of each Loan, free and clear of liens, claims or encumbrances of any nature;

(xvi) Each bond or note evidencing a Loan, each indenture, resolution or loan agreement creating a Loan or pursuant to which a Loan was made and each security agreement or mortgage creating a security interest or lien for the benefit, directly or indirectly, of the owner of a Loan constitutes a legal, valid and binding obligation of the related Borrower, enforceable in accordance with its terms and without regard to statutes or regulations not otherwise applicable to the Trust but applicable to the government or that would be applicable to such Loan if it were held in the government's Portfolio, except insofar as enforceability may be limited by applicable bankruptcy, insolvency, reorganization and other laws relating to creditors' remedies generally or principles of equity including doctrines of estoppel, laches or waiver, but only insofar as such principles of equity do not operate so as to render unenforceable the Borrower's obligations to make scheduled payments of principal, premium, if any, or interest on such Loan;

(xvii) The government or the trustee under the related indenture, as the case may be, has a valid, subsisting, perfected and enforceable lien on all collateral securing each Loan purporting to be granted or conveyed by the relevant indenture, resolution, loan agreement or security agreement and each such lien has the priority so purported to be granted or conveyed, not subject to any other lien or other encumbrance, except as explicitly permitted by, and made a part of, the note, bond, or indenture, resolution, loan agreement or security agreement relating to such Loan;

(xviii) No Loan is subject to any right of rescission, set off, counterclaim or defense, and the operation of any of the terms of such Loan or the exercise of any right thereunder by the Trust will not render the Loan unenforceable or subject to the right of rescission, set off, counterclaim or defense (except for defenses based on legal or equitable doctrines of estoppel, laches, or waiver for actions or omissions by the government that the Borrower may have with respect to covenants contained in the Primary Loan Documents, but only insofar as such covenants do not relate to the Borrower's obligation to pay principal, premium, if any, or interest on such Loan) and no such right of rescission, set off, counterclaim or defense has been asserted with respect thereto; and

(xix) The files of the Primary Loan Documents relating to each Loan are accurate, correct and complete.

Remedies for Breach of Representations and Warranties

The representations and warranties of the government will survive the closing of the sale of the Loans to the Trust. The representations and warranties set forth in clauses (i) through (vi), inclusive, (viii), except insofar as the breach of such warranty relates to the absence of accurate, correct and complete information evidencing any material waiver, alteration or modification in effect with respect to a Loan as of the Closing Date, or to the outstanding principal balance or scheduled payments of principal and interest on such Loan, (ix), (x), except insofar as the breach of such warranty relates to the absence of any disclosure on the Computer Tape or in any Primary Loan Document as of the Closing Date regarding a reamortization or rescheduling of any Loan, (xii), (xiii), (xiv), and (xv) will expire on the second anniversary of the Closing Date (or in the case of any Loan substituted after the Closing Date, the later of the first anniversary of its date of delivery and such second anniversary of the Closing Date). The warranties which do not so expire (including the exceptions described in the previous sentence) will remain in full force and effect (the duration of each representation or warranty as described in this paragraph, the "Warranty Period").

The governments obligations and liabilities with respect to the warranties described above in clauses (viii) through (xix), inclusive, made by the government under the Loan Sale Agreement will be limited solely to the following remedies:

Upon breach of any such warranties and satisfaction of the requirements set forth in the Loan Sale Agreement within the applicable Warranty Period, the government will promptly either (i) cure the breach or (ii) provide a substitute loan or loans ("Substitute Loans"). In addition, if, as a result of a breach of warranty, there were delinquent scheduled payments of principal or interest on a non-conforming Loan, the government would be required to provide a Substitute Loan or Loans which provide (or may elect at its sole discretion to pay) an amount equal to such delinquent scheduled payments plus the reinvestment income. In addition, the Trust will have a remedy under the Loan Sale Agreement with respect to a breach of the warranty described in clause (xvii) above with respect to a purported grant or conveyance of pledged revenues only if there did not exist a valid, subsisting, perfected and enforceable lien on such pledged revenues on both the Closing Date and the date such breach was notified to the government.

The government may also elect, at its sole discretion, to make a cash payment to the Trust in lieu of curing a breach or providing a Substitute Loan or Loans.

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