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Federal Credit and Insurance Programs: Actions That Could Minimize a Growing Risk

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Urgent Fiscal Issues Task Force
Committee on the Budget
House of Representatives

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Mr. Chairman and Members of the Task Force:

I am pleased to be here today to discuss the government's far-reaching credit and insurance programs. Our deficit and growing national debt emphasize the extreme importance of focusing on ways to control the government's losses from these programs.

Credit and insurance programs fall into four categories: (1) direct loans of federal funds to borrowers, (2) privately held loans guaranteed by the government, (3) government-sponsored enterprise (GSE) loans, and (4) commitments for insurance programs, such as those covering bank deposits and pension benefits. Specific government programs in these categories are identified in our recent report, Federal Credit and Insurance: Information on the Dollar Amount of Direct Loan, Loan Guarantee, and Insurance Programs (GAO/AFMD-91-81FS, July 29, 1991).

Mr. Chairman, after I give you a brief overall perspective on credit and insurance programs in relation to the government's other hidden liabilities and the economy, I will address these programs from the standpoint of

-- growth and risk of loss,

-- underlying causes of the increasing losses being experienced, and

-- actions taken and actions that could be taken to minimize government losses.

Overall, the government's exposure from its credit and insurance programs has mushroomed from roughly $438 billion 25 years ago to over $6.2 trillion today. In the most recent 5 years, the exposure has almost doubled. Some of the increase in recent years is attributable to new programs, but most of the increase comes from growth in existing programs. Just how much of the total exposure will ultimately be paid by the taxpayer is unknown. However, recent losses have been high, and the risk of future loss is in the hundreds of billions of dollars.

PUTTING CREDIT AND INSURANCE PROGRAMS INTO PERSPECTIVE

Credit and insurance programs are but one part of the range of liabilities to which the government is exposed. Liabilities arise from entitlement and other mandatory programs. Outlays from these programs (excluding deposit insurance spending) represent about 43 percent of the government's total outlays. Many of these outlays are reasonably predictable and controllable. On the other hand, the Commodity Credit

Corporation's price support programs can fluctuate widely with changes in farm prices. Medicare costs are still growing faster than general inflation or the gross national product, and getting Medicare spending under control is an important step in controlling the federal budget.

The government also has other major commitments, which though yet unfunded and often postponable until future years, will eventually require huge expenditures. These include infrastructure maintenance and cleanup of the government's nuclear plants, both of which have potential price tags in the hundreds of billions of dollars.

Some of these liabilities, including the credit and insurance programs, are already a major burden and will continue to be so. However, there is insufficient information now to provide a clear picture in advance of what the exposure is going to cost and when it will arise. The government does not presently have the financial management capability that would help to fully array and evaluate all of these kinds of liabilities.

Now let me turn specifically to the government's credit and insurance programs. As of September 30, 1990, the exposure for these programs--in billions of dollars--was as follows:

Direct loans	$210	
Guaranteed loans	641	$ 851
Government-sponsored enterprises		856
Insurance		4,496
Total		$6,203

Details of these amounts appear in attachments I through IV.

Credit programs are intended to meet a number of the nation's social and economic needs by providing financial assistance to such groups as students, home buyers, and businesses. The insurance programs meet the needs for financial security of (1) depositors, which are vital to the nation's monetary system and (2) others, where the magnitude of public need and national interest have resulted in government backing. As such, the credit and insurance programs touch a very large segment of our economy.

By their nature, changes in the economy can increase or reduce credit and insurance program losses, and, in any event, based on the nature of the programs, some losses must always be expected. An economic downturn reduces income and employment, causing loan delinquencies and defaults. The current recession and the decline in real estate values further weakened many banks and thrifts and no doubt contributed to additional failures and the continuing drain on bank insurance funds.

But other factors, such as administrative and financial management weaknesses and regulatory failures, have also contributed to credit and insurance program losses. Lack of good information systems and controls has exacerbated the problems.

DIRECT AND GUARANTEED LOAN PROGRAMS-- MUCH REMAINS TO GAIN CONTROL OVER LOSSES

Direct and guaranteed loans increased from $667 billion to $851 billion between fiscal years 1985 and 1990. During this same period, losses escalated. In fiscal year 1990, agencies wrote off $3.4 billion in loans. The Office of Management and Budget (OMB) estimated that at September 30, 1990, of almost $210 billion in outstanding direct loans, over $57 billion, or 27 percent, were expected to result in losses.

Guaranteed loans that have been terminated for default have almost doubled from $6 billion in 1985 to $11.9 billion in fiscal year 1990. OMB has estimated that future losses on guarantees as of September 30, 1990, will be $30 billion.

Federal loan programs are designed to provide credit to target groups that are not being served by the private sector or that require below-market rate loans. Under these programs, defaults and credit subsidy costs are expected. The question is whether the resulting losses are minimized and under control, given program goals. For many years, the answer to that question has been no.

Steps have been taken to better account for these losses, which should also lead to improved management. The Credit Reform Act of 1990 called for recognizing, for budget purposes, the estimated future losses on both direct and guaranteed loan programs when loans are made. Required annual reestimates of future losses on outstanding loans and guarantees will help track these costs. The Congress will have a better understanding of the effect of loan program legislation. The agencies administering the loans will need to develop better information about loss exposure and improve their monitoring processes. This very important legislation, when fully implemented, should help control and manage losses from federal loan programs. As agencies begin implementing the accounting and budgeting systems and procedures necessary to carry out this law, a transition period is likely and understandable. Agencies must work out any initial systems problems to meet the act's requirements and to solve long-standing weaknesses in accounting systems.

The Congress has also helped improve lending program management through the Debt Collection Act of 1982 and legislative authority to offset tax refunds for delinquent debts. Further, OMB has a nine-point credit management program which should help get to the root causes of agencies' problems in managing direct and guaranteed loan programs.

OMB's credit program and the related Department of the Treasury guidance need to be fully implemented by the agencies. We believe that the Congress could strengthen implementation of sound credit management practices and OMB's program with legislation which builds on the provisions of the Debt Collection Act. In an April 1990 report, we recommended that the Congress enact legislation which would require, for example, that agencies, where consistent with program legislation, prescreen loan applicants to determine credit worthiness and, if applicants owe delinquent debts to the federal government, deny them credit.

The agencies have acted to improve the financial management of federal loan programs, but progress has been slow. We have issued numerous reports which point to problems in managing these programs and in basic accountability.

For example, the financial audit of the Federal Housing Administration for the 1988 fiscal year disclosed $4.2 billion in losses and identified major weaknesses in systems and controls that contributed to those losses. Despite termination of a major program and other administrative actions, in the following year (1989), another $3.9 billion was lost, and we reported that progress in improving systems and controls was slow

(GAO/T-RCED-91-62, June 12, 1991). Also for the fiscal year 1989 financial audit, an independent auditor reported that some systems and control weaknesses still remained and top priority must be placed on upgrading financial management systems. Fiscal year 1990's losses were an additional $1.3 billion.

Our recent attempt to audit the Student Loan Insurance Fund disclosed internal control and accounting weaknesses that were so serious they affected the Department of Education's ability to carry out its stewardship responsibilities for over $50 billion in loan guarantees and precluded an audit of the fund's financial statements. Among the major problems we noted was a lack of a reserve for billions of dollars of estimated losses (GAO/AFMD-91-53ML, April 12, 1991).

Through its "High Risk" program under the Federal Managers' Financial Integrity Act of 1982, OMB is attempting to address specific problems in the management and administration of a wide range of federal programs, including a number of credit and insurance programs. GAO has its own high risk program and has targeted the following credit and insurance programs:

-- the Farmers Home Administration loan programs,

-- the Department of Education's Guaranteed Student Loan Program,

-- the Resolution Trust Corporation (RTC),

-- the Bank Insurance Fund, and

-- the Pension Benefit Guaranty Corporation (PBGC).

In our on-going efforts, we have already made specific recommendations that get to the root cause of the problems in certain of these programs.

One thing that has been consistent with the government's credit and insurance programs are weaknesses in financial management and the lack of reliable financial information. Federal financial management systems and controls have seriously deteriorated over the years. The Congress recognized the need for comprehensive and meaningful change when it enacted the Chief Financial Officers (CFO) Act of 1990. This legislation is an extremely important step to remedy the basic financial management problems that are at the heart of efforts to improve government control over federal credit and insurance programs.

The CFO Act provides for broad reforms that will (1) properly organize the financial management function in government agencies, (2) provide the necessary systems and control to manage government programs, and (3) measure performance through audited financial statements, cost information, and other data, so that prompt corrective actions can be taken. Successful implementation of the CFO Act should result in (1) improved financial systems and information with which to manage credit programs, (2) better ability to foresee problems, and thus deal with them, and (3) greater accountability by those managing loan programs. The government's long-neglected financial management system has been very costly. Although major improvements will take years, they promise to deliver substantial reductions in unexpected losses and costs in federal credit programs.

GSE RISK IS NOT IMMINENT BUT PREVENTIVE ACTION IS REQUIRED

At the end of fiscal year 1990, outstanding lending of GSEs exceeded $855 billion, whereas they were $370 billion by the end of fiscal year 1985. The 11 GSEs are off-budget, and most GSE debt and contingent liabilities are not explicitly guaranteed by the federal government, although investors assume that the federal government stands behind GSEs and their obligations. With few exceptions, the federal government has not assumed large losses from GSEs. However, in 1988, the government authorized $4 billion in federally guaranteed bonds to assist the troubled Farm Credit System.

However, there are several reasons why federal assistance would be an option for resolving a GSE crisis. One of these is the perceived moral obligation on the part of the federal government (because of the GSEs' close ties to the federal government) and the resulting implied guarantee of investor funds. Assistance may also be provided to ensure that a GSE can continue to meet its public policy purpose and prevent financial difficulties in other segments of the economy which are tied to a GSE.

At the present, we have no evidence that suggests that GSEs pose an imminent risk for the government. However, considering the relatively low level of capital invested in certain of these organizations, future changes in management strategies, economic downturns, or other adverse events could precipitate future GSE losses which could conceivably require government assistance. Should this occur, the Congress will be asked to decide on any financial assistance that may be requested.

The sheer size of the GSEs' financial obligations and the probability that the federal government would assist a financially troubled GSE make it appropriate for the government to supervise GSE risk-taking activities and establish minimum levels of capital.

In August 1990, we reported that shortcomings in current federal oversight of GSEs inhibit the government's ability to identify future problems that could lead to taxpayer losses and deal with any such problems (GAO/GGD-90-97, August 15, 1990). To correct the problems addressed in that report, in May 1991, we recommended that the Congress establish the independent Federal Enterprise Regulatory Board to oversee the activities of GSEs (GAO/GGD-91-90, May 22, 1991). We recommended that the Board be given the authority and responsibility to establish and enforce rules of safe and sound operations and monitor compliance with these rules. We also recommended that the Congress direct the Board to establish minimum required capital standards based on the risks GSEs undertake. We believe that such action on the part of the Congress would help to significantly reduce the risk that GSEs pose to the federal government.

SIGNIFICANT INSURANCE PROGRAM LOSSES ARE CONTINUING AND REFORMS ARE NECESSARY

The government's insurance commitments stood at $4.5 trillion at the end of fiscal year 1990, up from $2.8 trillion 5 years earlier. This increase can be attributed mostly to increased deposits in financial institutions and amounts of pensions insured.

Losses from the savings and loan (S&L) debacle continue to grow. Estimated costs of assisting troubled thrifts before the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 were $74 billion. Since then, RTC has gone through an additional $80 billion. Another $80 billion has been requested by the administration to provide funds to enable RTC to continue to resolve troubled S&Ls. In addition to this amount, an $80 billion increase in working capital, for a total of $160 billion, has been requested. Not all of the working capital will be returned to the Treasury if losses exceed administration estimates. We believe that the cost of the S&L crisis could reach $500 billion, not counting any U.S. Treasury borrowing costs.

Additional losses from bank insurance could materialize. The Federal Deposit Insurance Corporation (FDIC) is nearly bankrupt, and the administration has proposed legislation which would allow FDIC to borrow $30 billion for losses in resolving troubled institutions and an additional $45 billion in funds for working capital. The hope is that future bank insurance premiums and sales of FDIC assets will be sufficient to repay these sums and rebuild the Bank Insurance Fund. However, because of the size of potential losses, it is not likely that the fund will be rebuilt in the foreseeable future, and taxpayer assistance may be needed to protect insured deposits.

Other insurance programs are in trouble. PBGC has a $1.8 billion deficit, which it hopes to recover through future insurance premiums from corporate members. At the same time, PBGC is exposed to billions of dollars in pension plan underfunding by relatively weak companies.

Losses from insurance programs, like losses from direct loans and loan guarantees, have proven to be hard to estimate. This has affected the ability of the Congress and the administration to get a handle on the deficit numbers. One of the major causes of the wide swings in the budget deficit estimates and reestimates for fiscal year 1991 has been deposit insurance. OMB's initial 1991 President's Budget request (January 1990) included an estimate of outlays for deposit insurance (RTC, FDIC's Bank Insurance Fund, and the FSLIC (Federal Savings and Loan Insurance Corporation) Resolution Fund) of $7.3 billion. This 1991 outlay estimate was increased in the July 1990 Midsession Review of the Budget to $67.7 billion, an increase of $60.4 billion. The 1992 President's Budget (February 1991) further increased the estimated 1991 deposit insurance outlays by $43.9 billion, to arrive at a total of $111.6 billion. The Midsession Review (July 1991) showed a reduction in deposit insurance outlays of $28.1 billion, due primarily to slower-than-anticipated resolutions of failed thrifts. Next to the effects of Desert Storm, the $28.1 billion reduction in deposit insurance outlays was the largest component of the downward revision in the 1991 deficit estimate that was published in July.

There are many reasons for this volatility, including delays in congressional funding and other factors related to the fact that the budget for insurance programs is now on a cash basis rather than an accrual basis. But more significant reasons are problems with the regulatory process and financial management weaknesses, some of which are accrual accounting deficiencies that limited the ability of FDIC and RTC to see ahead and provide good information to OMB and the Congress. Also, the behavior of the insured institutions has in many ways increased the volatility. For example, bank call reports, which are to depict a bank's financial condition, have been inaccurate.

With no insurance fund cushions to protect the taxpayer and a significant number of banking institutions experiencing difficulty, adverse economic conditions can have a huge effect on taxpayers' future costs. Even if an economic upturn occurs, the insurance funds and the financial institutions will remain burdened with troubled real estate and real-estate-backed loans that will be hard to sell at their carrying values, thus adding to the government's losses. It is widely believed that the depressed real estate market may take years to recover. We cannot estimate the effect a continuing weak market would have on the losses the government will absorb. But to stem losses, the most important issues that need to be addressed are banks' accounting, internal control, and corporate governance deficiencies, as well as regulatory weaknesses, which collectively have allowed and will allow failure at huge costs to the taxpayer.

There are a number of steps being considered to control and minimize bank insurance losses to the government. The lower general level of interest rates established under the influence of the Federal Reserve may permit banks to increase their interest rate spreads and thus their profitability. Greater profitability may avert some government losses that would otherwise occur. The administration's recent regulatory actions may also delay resolutions of weak banks, but this may not prove to be a good idea and could well cost the government more money in the long term. RTC is working to strengthen its controls and administrative processes, which our preliminary work has shown to be weak (1) at receiverships and (2) in valuing assets acquired from failed S&Ls. We also believe that FDIC should recognize losses from failing banks sooner than current generally accepted accounting principles require. Had this been done, the fund would have reported a deficit at December 31, 1990, instead of a $4 billion balance.

A case can be made for extending accrual accounting for budgetary purposes from loans and loan guarantees, as has been done under the Credit Reform Act, to other parts of the budget including federal insurance programs. Developing appropriate methods of estimating these accruals will not be easy, but if done properly, it would tend to reduce the volatility of the estimates and might bring greater focus to the severe problems of government insurance programs.

The Congress is considering a range of banking legislative proposals. Pending legislation passed by both the House and Senate Banking Committees (H.R. 6 and S. 543) contains provisions, which we support, that would help to control and minimize deposit insurance losses to the government. Briefly, these would require that

-- the Bank Insurance Fund be funded to permit resolution activity;

-- a tripwire approach to bank regulation, which requires prompt regulatory action tied to specific unsafe banking practices, be implemented;

-- annual, full-scope, on-site bank exams be conducted;

-- accounting standards and internal controls be improved;

-- audit committees of banks be strengthened; and

-- annual independent audits and other related reforms be required.

Exposure to losses from PBGC can be minimized by a number of steps, including better management controls, more effective oversight of private pension plans both at the federal level and by external auditors, and clarification of PBGC's rights in bankruptcy losses.

In summary, losses from the government's credit and insurance programs have been high and have the potential to go even higher in the future. In addition to economic factors, problems with administration and financial management adversely affect the government's ability to minimize and control these losses. A number of actions have been taken. But it will take time for them to be fully effective. The additional actions mentioned in this testimony are appropriate.

The Congress has taken important steps in passing the Credit Reform Act, the Chief Financial Officers Act, and other legislation directed at credit and insurance programs. OMB Director Darman's September 19, 1991, statement before the Senate Budget Committee is most supportive of improved financial management in government and of bringing the accounting and budgeting process closer together. If the effort is sustained, the federal government's credit and insurance programs can be brought under control and losses can be minimized. However, this will require strong congressional support augmented by the additional actions highlighted today.

Mr. Chairman, this concludes my prepared statement. I will be pleased to answer any questions you and the other members of the Task Force may have.

DIRECT LOANS OUTSTANDING, FISCAL YEARS 1988 THROUGH 1990

Dollars in millions

	Fiscal year		
Agency/program	**1988**	**1989**	**1990**
Agency for International Development	$12,869	$12,325	$18,186
Department of Agriculture	118,332	111,968	109,171
Department of Defense — Foreign Military Sales	23,997	16,021	16,584
Department of Housing and Urban Development	15,073	15,742	17,997
Export-Import Bank	9,905	9,349	9,367
All other	42,968	41,780	38,641
Total	**$223,144**	**$207,185**	**$209,946**

Sources: Information in this appendix was taken from audited agency financial statements, where available, and the U.S. budget for fiscal years 1991 and 1992.

FUNDS WITH GUARANTEED LOANS OUTSTANDING, FISCAL YEARS 1988 THROUGH 1990

Dollars in millions

Agency/fund	Fiscal year 1988	1989	1990
Agency for International Development			
Housing Guarantee Program	$1.409	$1.555	$1.591
Department of Agriculture			
Commodity Credit Corporation	6.022	8.366	7.508
Farmers Home Administration			
Agricultural Credit Insurance Fund	3.618	3.692	4.666
Rural Development Insurance Fund	965	822	1.280
Rural Electrification Administration	2.868	2.557	2.529
Department of Defense			
Foreign Military Sales	2.600	8.650	8,602
Department of Education			
Guaranteed Student Loans	47.610	48.522	52.866
Department of Health and Human Services			
Health Profession Graduate Student Insurance Fund	1.850	1.873	2.080
Department of Housing and Urban Development			
Federal Housing Administration	303.412	328.688	356.316
Low-Rent Public Housing	5.998	5.734	5.463
Department of Transportation			
Maritime Administration Ship Financing Fund	3.864	3.602	3.014
Department of Veterans Affairs[a]			
Loan Guaranty Revolving Fund	149.705	152.099	152.115
Guaranty and Indemnity Fund	[b]	[b]	9.350
Export-Import Bank			
Export-Import Bank Fund	14.263	13.572	16,698
Federal Savings and Loan Insurance Corporation			
Federal Savings and Loan Insurance Corporation Resolution Fund	1.600	1.186	304
Small Business Administration			
Business Loan Investment Fund	9.711	10.801	12,200
All other	4.733	4.467	4.606
Subtotal	**560,228**	**596,186**	**641,188**
Less guaranteed loans held as direct loans[c]	34	0	0
Total[d]	**$560,194**	**$596,186**	**$641,188**

[a]Formerly the Veterans Administration. The figures are the full principal of the outstanding loans. The guarantee portion is about 40 percent of the amounts shown.

[b]Fund did not exist in fiscal years 1988 and 1989.

[c]When agencies acquire guaranteed loans due to defaults, the loans are counted as direct loans.

[d]These totals differ from those reported in the budgets because, where available, we used the amounts from audited financial statements. For example, the 1990 amount in the budget for Export-Import Bank was $5.045 billion, whereas the audited financial statements showed $16.7 billion.

Sources: Information in this appendix was taken from audited agency financial statements, where available, and the U.S. budget for fiscal years 1991 and 1992.

OUTSTANDING AMOUNTS FOR FEDERAL INSURANCE PROGRAMS, FISCAL YEARS 1988 THROUGH 1990

Dollars in billions

Program/organization	Fiscal year 1988	1989	1990
Deposit insurance			
Federal Deposit Insurance Corporation			
Bank Insurance Fund	$1 726 0	$1 848 2	$1.910 5
Savings Association Insurance Fund	889 2	874 5	726.1
National Credit Union Administration	157 6	165 0	178.3
Subtotal deposit insurance	**2,772.8**	**2,887.7**	**2,814.9**
Other insurance			
Pension Benefit Guaranty Corporation	791 0	814 4	943 0
Aviation War Risk Insurance	199 0	227 7	474 1
Federal Insurance Administration (Flood)	169 4	179.3	203 4
Veterans Life Insurance	27 0	26 4	26.7
Federal Crop Insurance Corporation	7 0	13 3	12 8
Maritime War Risk Insurance	10.8	10.9	11 0
Overseas Private Investment Corporation	8 4	8 9	9.9
Nuclear Risk Insurance	72.5	[a]	[a]
Subtotal other insurance	**1,285.1**	**1,280.9**	**1,680.9**
Total deposit and other insurance	**$4,057.9**	**$4,168.6**	**$4,495.8**

[a]Amount not reported by OMB.

Source: Information in this appendix was taken from audited agency financial statements, where available, and the U.S. budget for fiscal years 1991 and 1992

TOTAL OUTSTANDING LOANS BY GOVERNMENT-SPONSORED ENTERPRISES AS OF SEPTEMBER 30, 1990

Dollars in millions

Government-sponsored enterprise	**Year established**	**Total outstanding loans**
Student Loan Marketing Association	1972	$27,896
College Construction Loan Insurance Association	1986	[a]
Farm Credit Banks	1988	39,204
Banks For Cooperatives	1933	10,693
Farm Credit System Financial Assistance Corporation	1988	1,261
Federal Agricultural Mortgage Corporation	1988	[a]
Federal Home Loan Banks	1932	119,373
Federal Home Loan Mortgage Corporation	1970	322,305
Federal National Mortgage Association	1938	398,335
Financing Corporation	1987	[a]
Subtotal		**919,067**
Less: Lending between government-sponsored enterprises and amounts included as direct and guaranteed loans in appendixes I and II		63,563
Total		**$855,504**

[a]Amount not reported by OMB.

Source: U.S. budget for fiscal year 1992.

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