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CASHING IN ON THE FEDERAL QUARTER—TRILLION DOLLAR LOAN PORTFOLIO

INTRODUCTION

The recent decision by Congress, after months of intensive debate, to sell the federally owned Conrail freight railroad has been hailed as the first major step toward the Reagan Administration's goal of "privatizing" federal assets by selling them to the private sector. Yet almost unnoticed, Congress has embarked on another privatization program that promises to dwarf the Conrail sale. With strong bipartisan support, lawmakers have agreed to launch a pilot program to explore the potential of selling the federal loan portfolio, which has a book value of $257 billion. The portfolio's sizable assets range from $65 billion in notes held by the Farmers Home Administration and $16 billion by the Export-Import Bank to the Rural Electrification Administration's $37 billion and the Veterans Administration's $2.7 billion.

The sale of loan portfolios is common practice in today's banking industry. By aggregating relatively smaller loans and mortgages into larger packages, bankers are able to sell investors participation shares that receive interest and principal. Banks receive the spread between the lending and selling rates as a service fee. The proceeds from the sale of mortgage-backed securities (MBSs) or asset-backed obligations (ABOs) provide banks with an injection of capital to make additional loans.

The federal government is the largest financial intermediary in the U.S., borrowing money through the issue of Treasury securities and relending the money to private firms and individuals at subsidized rates of interest. It does this through loan programs operated by such agencies as the Farmers Home Administration and the Small

Business Administration. The $257 billion value of these outstanding loans at the end of 1985 was a third larger than the combined loan assets of the two largest U.S. commercial banks. Another $410 billion in loans made by private lenders has been guaranteed by the federal government.[1]

The problems associated with managing federal credit activity are immense and systemic. Unlike the practice in most banks, a federal direct loan or guarantee program uses no performance standard, such as profit, to measure its success. As a result, over 15 percent of the debt owed the U.S. is delinquent, compared with only 3 percent for private commercial debt.[2] Late payments run at over 90 percent for some programs. And in the absence of government-wide standards for writing off direct loans, loans are carried on the books at their nominal value regardless of their market value--often even after they go into default. In fact, the Export-Import Bank still holds, at par value, $81 million in loans made to Cuba between 1951 and 1958.[3]

The lack of a performance standard is compounded by the fact that no one is quite sure what these loan programs cost the taxpayers. Interest rate subsidies and contingent liabilities are either improperly accounted for, or (as in the case of guarantees) totally unaccounted for. Virtually none of the loans is worth its nominal sum.

There would be a number of important benefits if the federal loan portfolio were sold without government guarantees. These include: 1) revealing the actual federal subsidy for loan programs; 2) reducing the deficit; and 3) encouraging privatization. By selling the loans to private financial institutions without any government guarantee, the discount on the price needed to find a buyer would reflect the subsidy currently associated with the loan portfolio. The American people would then learn the true cost of federal loan programs.

Government loan asset sales would help to reduce the deficit. The Congressional Budget Office (CBO) estimates that the sale of the entire government loan portfolio on a "nonrecourse" basis (that is,

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1. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1987, p. F-3.

2. United States General Accounting Office, Debt Collection, Information on the Amount of Debts Owed the Federal Government, December, 1985.

3. Office of Management and Budget, Special Analyses, Budget of the United States Government, Fiscal Year 1987, p. F-38.

without a guarantee to cover default) would produce a one-time net cash inflow to Treasury of about $95 billion.[4] This cash injection also would reduce future interest expenditures needed to finance the deficit. At current interest rates, this savings for next year alone would be approximately $7 billion. The deficit reduction potential of loan sales has not been lost on Congress. The recent Budget Reconciliation Act calls for the raising of $4.3 billion through loan sales. The Higher Education Act plans on raising an additional $580 million through the sale of college housing loans. Congress should build on this base next year and enact legislation to sell all newly originated loans to the private sector.

Even a small loan sale program could give an enormous boost to the Reagan privatization strategy. Privatization of federal assets tends to be seen purely in budget terms as a stop-gap method of raising cash to meet deficit reduction targets. This is certainly a benefit of privatization. Yet the sale of assets would make sound economic sense even if the federal government were enjoying a healthy budget surplus. When assets are owned by the government they tend invariably to be managed inefficiently, with decisions unduly influenced by political and bureaucratic factors. Transferring assets to the private sector leads to more businesslike management and greater efficiency, benefiting the entire economy.

The privatization of various federal assets raises various issues and affects different political constituencies.[5] But among these assets, the most easily salable appear to be Uncle Sam's extensive financial assets. Loan portfolio management is routine in the private sector. And because privatization would pose no threat to the existing beneficiaries of government loans, there is no strong lobby opposed to at least limited sales. That is why Congress has found privatization attractive in this case, while it has bitterly opposed other privatization initiatives, such as the sale of the Power Marketing Administrations. Once the program is launched, and financial institutions have invested in the expertise necessary to handle such assets, there will be every incentive to press for further loan sales.[6] In this way a powerful constituency could emerge to give political momentum to asset privatization, benefiting the taxpayer and bringing greater efficiency to the economy.

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4. Congressional Budget Office, New Approaches to the Budgetary Treatment of Federal Credit Assistance, March 1984, p. 66.

5. See Stuart M. Butler, Privatizing Federal Spending (New York: Universe Books, 1985).

6. See Robert M. Garsson, "Sifting through Uncle Sam's Loan Portfolio," American Banker, October 9, 1986.

WHY SELLING ASSETS MAKES SENSE

The sale of federal assets curiously is attacked by some lawmakers as a "smoke and mirrors" device to give the impression that something is being done about the deficit. These critics maintain that privatization merely converts a valuable, income-generating asset into immediate cash, cutting this year's deficit while adding to future problems, and having no net impact on the economy. This argument overlooks the relationship between ownership and efficiency.

In the first place, it is often sensible to sell an asset when there is a financial crisis, even though it may mean the loss of future income. As any successful businessman knows, it is necessary sometimes for a firm to sell assets to allow the company to weather a short-term financial storm. The alternative might be serious, long-term financial problems or even bankruptcy. The same is true of government.

Faced with a timetable for deficit reduction, Congress must take action to eliminate red ink. Without asset sales, it will have to make deeper and more rapid cuts in many programs. But the revenue from sales would allow the targets to be reached with smaller immediate cuts: like a prudent business, Congress could buy itself time to reorganize programs to accommodate future spending reductions more easily. Thus the temporary relief afforded by asset sales has the important benefit of giving Congress the leeway to reduce the scale of government with less disruption for those currently served by the programs. Furthermore, by reducing the federal deficit, asset sales provide additional savings because of the reduced interest expenditures required for financing the deficit.

The second beneficial aspect of asset sales has nothing to do with the deficit issue. The fact is that public sector managers face very different incentives from those in the private sector, simply because Congress is the ultimate owner. The managers of Conrail or Amtrak, for instance, know that their budget depends on their ability to please distinct political constituencies. Therefore, decisions to retain unprofitable station stops are influenced heavily by local political factors. Similarly, a manager in the Forest Service has no particular incentive to ensure that timber sales are operated profitably--or even in the best interests of timberlands. Timber sales revenue goes to the Treasury, not the Forest Service, while new access roads to allow cutting means a higher Forest Service budget. So the Service permits overcutting in areas where the practice actually leads to losses and even damage to the environment. These perverse incentives, which pervade federally owned assets, breed inefficiency, often significantly reducing the value of government assets--in some cases turning them into liabilities.

This built-in incentive for inefficiency means that, by selling an asset, the government can realize far more from private buyers than the "present," or capital, value of the potential income of the asset if it were to remain in government hands. The reason for this is that a private buyer, free of the bureaucratic and political problems that constrain the public sector manager, knows that he can earn more with the asset, and thus will pay more than it is worth to the government. Indeed, even a loss-making asset in government hands may be turned into hard cash in some cases. For instance, federal loans that have gone into default may still have some value if a private entity believes it could collect on the loan when the government has failed to. In this way the taxpayer gains, and so does the economy, because the asset is used more efficiently.

Selling the loan portfolio and other federal assets is thus far more than a mere accounting change, as critics of privatization allege: it gives a boost to the economy while gaining valuable maneuvering time for orderly program restructuring.

CURRENT CREDIT PRACTICE

The federal budget is a triumph of creative accounting that prevents the American people from determining the real cost of some government actions. A budget should make it possible for lawmakers and their constituents to compare the cost of providing assistance through an outright grant with that of providing the same assistance through a subsidized credit transaction.[7] The federal budget, however, does not permit these cost appraisals to be made, because grants and credit programs do not have a common "cost denominator."

The budget misstates credit costs by recording loan disbursements as current year costs, and repayments from current and previously made loans as current year cost offsets. The budget records zero cost for guarantees until a cash payment is required by a default. Only then is it treated as an actual cost item. Such cost measures imply that the value of resources consumed by a loan is the same for a grant of $1 million as for a $1 million guaranteed loan advanced at 5 percent interest. Federal grants and loans are treated as equal, which they are not. According to the Congressional Budget Office (CBO), this measure of cost (referred to as "net cash outflow") understates the real cost of federal credit by about $20 billion annually.

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7. Marvin Phaup, "Accounting for Federal Credit: A Better Way", Public Budgeting and Finance, Autumn 1985, p. 29.

TABLE 1
U.S. GOVERNMENT LOANS OUTSTANDING
(Billions of Dollars, September 30, 1985)

Agency	Outstanding
Funds Appropriated to the President:	
Economic support fund	6.2
Foreign military sales	19.1
Guarantee reserve fund	1.2
Agency for International Development	12.1
Defense	1.3
Agriculture:	
Farmers Home Administration	65.0
Commodity Credit Corporation	15.1
Rural Electrification Administration	37.0
Export Credits	10.0
Education:	
Guarantees of SLMA obligations	5.0
Guaranteed student loans	3.2
National direct student loans	5.1
College housing loans	2.3
Higher education	0.4
Housing:	
Low-rent public housing	16.8
Housing for elderly or handicapped	5.7
GNMA, FHA	5.8
Other	1.0
Transportation	1.6
Veterans Administration	2.7
Export-Import Bank	16.9
Deposit Insurance Agencies (FDIC, FSLIC)	5.6
Small Business Administration	9.4
Other	8.4
TOTAL	257.4

Source: Office of Management and Budget.

HOW LOAN SALES WOULD REFORM THE BUDGET

To determine the true subsidy of government direct loans, the CBO has suggested that the federal credit agencies sell their loans to private investors on a nonrecourse basis. This means that the buyer assumes all risk of default. The difference between the face amount of the loan and its market price would reveal the risk and subsidy involved. For example, a 25-year government loan of $100,000 at 2 percent might, after discounting for risk of default and below market interest rate, have a value of only $65,000 to private investors. In such a case, the government subsidy would be worth $35,000 or 35 percent of the loan's face amount. The CBO's proposed "Market Plan" would mean that federal loan-making agencies, such as the Farmers Home Administration (FmHA) and the Small Business Administration (SBA), would sell loans they had originated, and buyers would then reinsure the loans with private suppliers.

Because of the below market terms on government direct loans, their delinquency history, risk of default, and unclear forbearance rules, the market sale price would be less than the funds advanced.[8] Furthermore, because of the "time value" of money (a dollar received today is worth more than a dollar to be received at some time in the future) and the below market interest rates of the loan, the market value of various loans would be substantially lower than their nominal value. Agencies would show this difference--a market measure of the subsidy involved--in their budgets. The taxpayer and government would not be cheated out of any future income by selling the loans, in that future loan repayments are actually accelerated forward at any appropriately discounted rate.

Loan sales would not change credit eligibility for beneficiaries, since agencies would continue to select credit recipients on set repayment rules. Farmers and students would not lose their loans, or have the terms changed, when the loans were sold to the private sector. The loans would simply be administered more efficiently, and the subsidy made explicit by use of the private financial markets to determine the degree of taxpayer support. And the Treasury would receive revenue equal to the true value of the loans.

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8. Forbearance refers to the amount of time a creditor is willing to extend to a borrower for late payments.

STRUCTURING LOAN SALES

Several plans have been suggested for selling federal loans. Among them:

- The Reagan Administration's FY 1987 proposal for a pilot program to sell $4.4 billion (book value) of loans on a nonrecourse basis to the private sector;
- Senate legislation (S.2137), co-sponsored by Daniel Patrick Moynihan (D-NY) and Frank Lautenberg (D-NJ), to establish a pilot program to sell $30 billion of Farmers Home Administration loans on an "overcollateralized" basis over three years;
- Legislation (S.2142, H.R.1216), introduced by Senator Paul Trible (R-VA) and Representative Willis Gradison (R-OH), under which the government would sell newly originated loans, without a federal guarantee, to the highest bidder in a competitive auction. The Office of Management and Budget has recently established guidelines for the sale of loan assets, which closely parallel those set forward in the Trible-Gradison bill, except that they would permit competitively negotiated sales as well as auctions.

All these proposals have merit, for they would have the effect of moving the loans off the government's books. But there are shortcomings with some of the suggestions. Example: even though its backers claim that overcollateralization is not a federal guarantee, it is roughly equivalent. Overcollateralization means that the federal government would designate a pool of loans from its portfolio to serve as collateral for the loans sold under the Moynihan-Lautenberg plan. Loans designated as collateral would then be available for exchange by the investor in the event that any loans purchased under the pilot program became delinquent. At the time of substitution, all future cash proceeds for the delinquent loan, including interest and principal repayment, would revert to the federal government, while the proceeds of the substituted loan became that of the investor. Overcollateralization thus removes the burden of risk and collection from the investor, since he could dip into a pool of loans to replace any that turn sour. This defeats the primary purpose of loan sales--to impose discipline on the federal credit process and to identify subsidy costs.

A pilot program to sell existing loans, such as that championed by the Administration and included in the recently approved Budget Reconciliation Act, provides a virtually risk-free test of a general program. Yet a pilot program is unlikely to arouse as much interest among major investors as would a larger, permanent program. The

uncertainty surrounding the pilot program will tend to depress the market price of the loans sold. Congress thus must recognize that the results of a pilot program, although a useful test of privatization, will understate the potential of a large-scale sale of loan assets.[9]

The best general approach may be for Congress to agree next year to sell all newly originated loans, which usually total about $40 billion each year. This would constitute a sufficiently large asset sale to attract heavy investor interest.

ENHANCING THE QUALITY OF THE LOANS

For loan asset sales to achieve maximum taxpayer benefits, the quality of the loans must be enhanced to increase investor interest. Enhancing loan quality involves:

Standardization: The contract terms and documentation of new loans should be standardized. This would reduce uncertainty among potential private investors. Program beneficiaries and the taxpayer, moreover, would be given a clearer picture of the true value of the benefits involved.

Some portions of the existing portfolio, such as the Rural Development Insurance Fund, are standardized and highly marketable, but the sale of most of the existing portfolio would be complicated by the lack of contract uniformity. This adds further weight to the idea of selling newly originated loans as a first step, since they can be provided with standard contracts. To restructure existing loan contracts, future sale legislation should establish a commission to develop guidelines. Its members could include representatives from federal credit agencies, private banks, and the Office of Management and Budget.

Package size: Loans should be sold in packages large enough to interest large institutions, create a strong secondary market, and reduce the high overhead associated with sales of individual loans. Loans with similar terms and characteristics should be pooled to form marketable packages. The Office of Management and Budget recommends a $100 million threshold for such packages.

Insurance: Just as municipal bonds are sold with and without insurance for the timely receipt of interest and principal, federal government loans could be sold with the cost of insurance borne by the

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9. Testimony by Miner H. Warner, Vice President and Manager of the Government Finance Group, Salomon Brothers, Inc., before the Senate Governmental Affairs Committee, May 13, 1986.

investor. Existing federal guarantees could be reinsured with private insurance companies and the premiums charged to the appropriate agency account. In this way the risk would be quantified and made explicit in the budget of the agency.

Private insurance could be available even for a large volume of sales. Private mortgage insurance is a mature and well-seasoned industry carrying more than $22 billion of insurance.[10] Private debt insurance is also commonplace. Such insurance would upgrade the credit ratings of the debt issue, reducing the total debt service cost to the borrower and enhancing the market price of the asset.[11]

Service Contracts: All loans need to be "serviced," that is, payment records must be kept. Loan servicers are usually financial institutions that also originate loans. Such firms would act as trustee, collector, and paying agent, enforce investor's remedies, as well as advance payments that are delinquent. Federal loans could be sold with or without contracts to provide such services and priced accordingly.

An Efficient Secondary Market: To ensure the continued success of loan asset sales after the initial start-up phase, steps need to be taken to spur secondary markets. These are financial markets in which loans can be resold, much like the secondary markets in mortgages. Thus after a loan is originated and sold, the new owner will be able to sell the loan to an investor--who may in turn sell it to another party.

Secondary markets already exist for some government-sponsored loans. Typical of these is the market for Small Business Administration (SBA)-guaranteed loans. With SBA approval, 90 percent of a small business loan may be guaranteed, and the originator of the loan then can sell the guaranteed portion of the loan to an investor.[12] With strong participation by banks and other financial institutions in loan asset sales, secondary markets should soon evolve. In fact, loan sales may herald the emergence of a major new product area for capital markets. To publicize the financial and investment potential of federal loan sales, and thus maximize sales revenue for the government, it is essential that the agencies

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10. For a discussion of the private mortgage insurance industry, see Stephen Moore, "How Congress Can Defuse the Federal Housing Administration Time Bomb," Heritage Foundation Backgrounder No. 528, July 29, 1986.

11. Lynn Brenner, "Commercial Loan Guarantees," American Banker, March 14, 1986, p. 6.

12. For a more extensive discussion of the secondary market for SBA loans, see the Comptroller General, SBA's 7(a) Loan Guarantee Program: An Assessment of Its Role in the Financial Market, United States General Accounting Office, April 25, 1983.

originating the loans work closely with the financial institutions that possess the experience and resources to develop a strong secondary market.

CONCLUSION

A successful privatization program is essential if the Reagan Administration is to reach its goal of a smaller deficit through a reduction in the scale and scope of government. Unlike traditional budget cutting, where goods and services are simply withdrawn from beneficiaries, thus arousing voter anger, privatization allows services to continue "under new management" with budget savings achieved through greater efficiency. This is why loan asset sales make good political as well as economic sense.

Loan sales are a routine aspect of modern financial management in the private sector. Yet despite the efforts of the last three Administrations, federal credit programs continue to be managed inadequately, thanks to anachronistic accounting methods, defective monitoring, dilatory collections, and almost nonexistent controls. These problems are systemic; they arise from the fact that the government owns the loan portfolio. They can be solved only through the incentives that accompany a transfer to private ownership.

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