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THE SIX TRILLION DOLLAR DEBT ICEBERG A REVIEW OF THE GOVERNMENT'S RISK EXPOSURE

INTRODUCTION

In a congressional floor speech last spring decrying the cost of the savings and loan (S&L) bailout, now estimated at between $150 billion and $300 billion, Representative Major Owens, the New York Democrat, declared that he believed there had never been a single item in peacetime that cost the government so much money. Owens raised an intriguing question, and research into federal budget history reveals that he was right. Only World War II cost more than the S&L bailout, at least in nominal dollars. But an examination of the finances of other government-backed agencies indicates that the bailout may be just the tip of a fiscal iceberg about to strike the American taxpayer. The total financial obligation of agencies underwritten by the federal government is now some $5.8 trillion -- and much of that obligation is in bad shape.

The S&L disaster represents an staggering breakdown of government, and the hidden costs to Americans likely will turn out to be several times the amount that the hapless taxpayer is scheduled to pay directly in extra taxes. It will take years to unravel what really happened and why. But one thing is clear: the government's mega-billion dollar commitment to guarantee the deposits of the savings and loans insured by the Federal Savings and Loan Insurance Corporation (FSLIC) was grossly mismanaged. This and the perverse incentives offered by the insurance program led to the wholesale looting of hundreds of thrift institutions.

Worsening Daily. As the S&L bailout legislation went through Congress, most lawmakers tried to convince Americans that the crisis was just an isolated incident, however costly, and that the vast bulk of the government credit programs are well-managed and pose little risk to the taxpayer. While

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taxpayers may wish for this to be so, a cursory examination of the federal government's vast credit empire actually reveals repeated instances of huge financial risks that are worsening by the day. In fact, the $958.9 billion in S&L deposits insured by the FSLIC at the end of 1989 represents just a small fraction of the financial liabilities the federal government has assumed through its many direct lending, loan guarantee, and insurance programs. The $4.2 billion loss at the Federal Housing Administration revealed in May 1989 in a General Accounting Office (GAO) audit and the Office of Management and Budget's (OMB) projection that the losses continue, are just among the latest hint of a vast liability that could land in the lap of taxpayers. The government's total risk exposure of nearly $6 trillion dollars is more than twice the national debt held by the public and more than five times the annual federal budget.

Comprehensive Effort Needed. A number of these programs already are encountering serious financial problems. Others could join them over the next year, depending upon how the economy performs. Like the FSLIC, some of these programs require immediate attention to stanch enormous losses and limit potential future claims on the taxpayer. Unfortunately, no such comprehensive effort is under way in Congress or the White House. Worse still, to the extent that credit-related legislation is being considered by Congress, some of it would make the situation even worse.

Because the potential costs of ignoring these problems are so huge, it is essential that steps be undertaken immediately to place the government's vast array of financial activities on a sound basis. This requires enactment of an Omnibus Credit Solvency Act that would fundamentally restructure these many programs to reduce the taxpayers' exposure to costly program failures. Such an act would improve underwriting standards and financial controls, tighten management, and eliminate or reform the most costly programs.

THE RISKS FACED BY TAXPAYERS

The $6 trillion risk exposure is spread among deposit insurance programs, loan and pension guarantees, direct loans, other forms of insurance, and the debt of the five multi-billion dollar government-sponsored enterprises.

1) Deposit Insurance

In addition to the $958.9 billion in savings and loan deposits insured by the FSLIC, another $1.806 trillion of deposits at commercial banks and savings banks are insured by the Federal Deposit Insurance Corporation (FDIC). In addition, approximately $161 billion in credit union deposits are insured by the National Credit Union Administration. Total deposit guarantees amounted to $2.9 trillion in 1989.

2) Loans and Guarantees

The federal government stands behind nearly half a billion dollars in guaranteed Veteran's Administration (VA) and Federal Housing Administra-

tion (FHA) mortgages, $48 billion in guaranteed student loans, and a host of other guarantees ranging from rural electrification to ship building loans, and from small business disaster loans to loans for building plants to convert grain to ethanol. Altogether, the contingent liability associated with the government's loan and deposit guarantees total approximately $3.5 trillion at the end of fiscal 1988. Other insurance programs, such as flood insurance, add about another half-trillion dollars to this liability.

3) Pension Programs

Added to these loan and insurance risks are 105,000 single-employer pension plans, and 2,300 multi-employer pension plans protected by the federal government's Pension Benefit Guaranty Corporation. The government's potential obligation for these pension programs is estimated at $819 billion for 1989.

4) Direct Loan Programs

The government also acts as a financial institution, extending loans to eligible borrowers. Major direct loan programs include the Export-Import Bank, the Small Business Administration, College Housing, and the Rural Telephone Bank. The portfolio of outstanding loans held by the federal government as of the end of fiscal 1989 amounted to $207 billion.

5) Government-Sponsored Enterprises

The government has created a number of "off-budget" enterprises and is responsible for their finances. These government-sponsored enterprises (GSEs) technically are private organizations, but in practice are treated and act as extensions of the federal government. Several of these enterprises add to the real estate exposure due the troubled mortgage insurance schemes. One of the GSEs, the Federal National Mortgage Association (FNMA), for instance, held $110 billion in mortgage loans and guaranteed another $208 billion in outstanding mortgage-backed securities at the end of 1989. Its companion, the Federal Home Loan Mortgage Corporation (FHLMC), holds few mortgages but guarantees $257 billion in mortgage-backed securities. Collectively, the five government-sponsored enterprises had an outstanding debt obligation of $763 billion at the end of 1989,[1] and they are the fastest growing source of federal credit exposure.

Although these privately-owned but government-sponsored enterprises maintain the fiction that they are independent of government and thus pose no liability to the taxpayer if they fail, recent experience suggests that the government will in fact bail them out to maintain their solvency during periods of adversity. The fiction of independence, for instance, did not

1 These GSEs are the Student Loan Marketing Association, the Federal National Mortgage Association, the Farm Credit System, the Federal Home Loan Bank System, and the Federal Home Loan Mortgage Corporation.

prevent the 1987 bailout of the "independent" Farm Credit Administration, with an estimated final cost of between $2 billion and $3 billion.

THE RISING TIDE OF RISK EXPOSURE

As the $958.9 billion pool of insured savings and loan deposits has unraveled, Americans have become painfully aware of the risks associated with such programs, and the enormous potential cost of mismanagement and failure to correct emerging problems. Yet the FSLIC is by no means the only federal credit program confronted with staggering losses. Default rates in many of the government direct loan and loan guarantee programs are rising at an alarming rate and could lead to huge losses which will have to be met by the taxpayer. The FDIC and the FHA posted their first-ever losses in 1988 and repeated that performance in 1989. With the residential and commercial real estate markets still weak, this trend could continue through 1990.

Many of the government-sponsored enterprises and insurance programs, moreover, have inadequate net worth and reserves to support the risks to which they are exposed. The FHA, for example, has seen the level of claims against its shrinking reserves rise nearly three-fold over the last three years. Further, half of the farm loans made by the Farmers Home Administration are in default, and half of these defaulted loans have been in that condition for more than three years. Yet even that dismal performance appears almost praiseworthy when compared to the 100 percent default rate experienced by the Economic Development Administration's loan guarantees for the steel industry and the equally disastrous performance of the ethanol production loan guarantees issued by the Departments of Agriculture and Interior.

Has Congress learned any lessons from these and the many other troubled loan programs? The answer appears to be, it seems, "no," judging from recent legislative initiatives. Indeed, some proposed congressional legislation actually would aggravate the problem. Example: Some in Congress would expand FHA exposure to markets already served by the private sector and on terms leading to a greater likelihood of default. And although the Bush Administration has proposed many valuable reforms in its 1991 budget to reduce the total risk to the taxpayer, much more needs to be done.

WHAT NEEDS TO BE DONE

The savings and loan fiasco could be just the beginning of a costly stream of financial disasters that will end up in the lap of the American taxpayer. Urgent action must be taken to reduce the potential price tag. Fortunately, it is not too late to avoid several potential collapses. But a comprehensive legislative package is needed soon. The appendix to this paper details the principal federal financial programs and lays out a reform strategy for groups of similar programs that should be included in an Omnibus Credit Solvency Act. Among its necessary provisions:

♦ **Establish premium incentives and operational practices to encourage both government providers and private sector users to act in a fiscally prudent fashion and to rebuild reserves.**

Many of the credit programs most in trouble cannot help but lose money because of poorly conceived, yet congressionally required, underwriting standards that actually forbid federal program managers from rejecting poor credit risks. Indeed, some programs, such as the Farmers Home Administration, are designed specifically to serve poor credit risks. For the same reason, many of the programs cannot charge premiums that correspond to likely (or actual) losses, and so are required to run at a deficit, such as the Pension Benefit Guarantee Corporation or the Federal Housing Administration.

♦ **Eliminate costly programs that have outlived their usefulness, such as many of those created during the Depression of the 1930s.**

Another source of the problem is the continued operation of programs that have long since outlived their usefulness and now expose the government and the taxpayer to needless risk. Many of the Depression-era programs – created to meet a national emergency – long ago have completed their job and should be retired gracefully. The Rural Electrification Administration, which met its goal in the mid-1950s, nonetheless continues to expand at ever-rising costs. Thus an omnibus bill should provide for a thorough review of the need of each program and an assessment of the potential for private sector alternatives.

The review also should consider the extent to which federal credit programs and government-sponsored enterprises have come to dominate and monopolize certain segments of the economy. The U.S. has a long tradition of concern over excessive concentration of market power, and several of the GSEs now dominate the market in degrees of concentration seldom seen in the private market. Government intrusion into the housing finance market, for instance, is very extensive. This exposes the taxpayers to risk and discourages private entities from offering the same service; this concentration in the mortgage market, for example, was a contributor to the weakening of the S&L industry. An omnibus credit bill thus should consider ways in which this responsibility and risk can be decentralized and returned to the private sector where it belongs.

♦ **Establish uniform accounting and financial controls that would quickly and accurately reveal program losses.**

Also exacerbating the structural weakness of these programs are a series of management, information, and control problems that make it difficult or impossible to properly supervise these programs. As the GAO audits have revealed, many of these programs have primitive accounting systems that hide more than they reveal. Moreover, standards of accounting between agencies also differ, making it difficult to make comparisons between programs. Any omnibus credit reform bill thus should include the requirement that accounting and financial control systems be overhauled and standardized. It should also include the requirement for accurate quarterly reporting so that

public officials can have timely and understandable information on program status.

CONCLUSION

The vast system of federal credit programs, with their $5.8 trillion in outstanding obligations, is in serious trouble. It costs the taxpayers billions of dollars a year in bailouts, defaults, and unneeded subsidies. Beyond these direct costs to American taxpayers is a host of indirect costs due to the disruption they cause to U.S. financial markets and the country's ability to deploy its capital resources in an efficient and productive fashion.

Facing the Fact. This national embarrassment and potential catastrophe must be brought under control as swiftly as possible through an Omnibus Credit Reform Bill that makes fundamental changes in the way these programs are structured and operated. Many of the reforms that should be contained in such a measure already have the support of the Administration and in Congress. Unfortunately, the reform approach to this date has been piecemeal, and thus misses the opportunity to achieve comprehensive reform, dealing with problems before they worsen. Congress must at last face up to the fact that the savings and loan crisis, and the other emerging problems associated with federal credit and guarantee programs, are not isolated and unconnected. Rather, they indicate systemic flaws. The solution is system-wide reform.

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APPENDIX

THE FEDERAL GOVERNMENT'S CREDIT OBLIGATIONS

GROUP I: THE HOUSING CREDIT PROGRAMS

Despite the prevailing popular view that the 1980s was a decade of government retrenchment, there was in fact a rapid growth of government credit programs, often at the expense of private financial institutions unable to compete with generous government subsidies. Indeed, one factor in the S&L collapse was aggressive government mortgage lending activity that depressed the earnings generated from traditional savings and loan lending activities. In the residential housing mortgage market, for example, expanding government programs led to the effective "federalization" of much of the nation's housing finance market, and to the assumption of multi-billion dollar liabilities by the taxpayer. Federal and federally-sponsored mortgage credit support accounted for just 17 percent of outstanding mortgages in 1980, but by the end of 1989, 41 percent of outstanding home mortgages had been guaranteed by federal agencies or securitized by GSEs as the Federal National Mortgage Association, the Federal Housing Administration, the Government National Mortgage Association, and the Federal Home Loan Mortgage Association widened their activities and displaced private providers of mortgage credit and insurance. There has been similar growth in the agriculture sector, with a vast array of subsidized federal credit support programs for farmers adding momentum to the agriculture debt crisis that first emerged in the middle of the decade.

What is ironic about this rapid growth in credit programs during the economically buoyant 1980s is that the vast majority of the programs were created during the Great Depression to help revive a struggling economy. But credit programs were not dissolved once the apparent need for them had passed. Instead, in predictable bureaucratic fashion, their missions simply were redefined and they continued to grow well beyond the scope and purpose envisioned by their founders.

1) The Federal Housing Administration

The Program. The Federal Housing Administration (FHA) was created in 1934 to revive the badly battered residential housing market by insuring a new type of residential mortgage instrument: the long-term, fixed rate, level payment, fully amortized mortgage. The goal of injecting new life into the housing market largely was fulfilled in the early postwar era, when private lending institutions returned in force to the housing finance market. In the early 1970s, the need for a government-operated mortgage insurance enterprise was further diminished when a private mortgage insurance in-

dustry emerged and offered lenders and borrowers essentially the same services as government and at competitive fees.

The Problem. Despite the shrinking need for a government mortgage insurance industry, the FHA has attempted to remain in operation by redefining its mission and expanding its activities into risky ventures that serve little or no public purpose yet expose the taxpayer to ever-growing potential losses. Thanks to a policy of lax underwriting standards, low downpayments and excessive risk-taking, as well as weakening regional real estate markets, the FHA now is confronted with the very real prospect of financial insolvency.

Rapid increases in claims filed by lenders against the FHA insurance fund have jumped. Since 1987, the cost associated with the acquisition of property and the assignment of mortgages has risen from $4.3 billion to an estimated $6.9 billion in 1990. Delinquencies of more than sixty days accounted for 6 percent of FHA mortgages in early 1989, compared with 5 percent in the third quarter of 1988 and just 2 percent in 1979. In early 1990 the delinquency rate has been running at 3.3 percent, but because revenues from new insurance premiums are expected to decline with the current slowdown in the real estate market, the FHA's losses could rise at an accelerating rate. The agency is estimated to lose $99 million a month in 1990

Considerable light has been shed recently on the FHA's troubles by a GAO audit which found that FHA's equity, essentially its reserves against losses, had declined to a negative $2.9 billion in support of $303 billion of insurance-in-force at the end of 1988.[2] Since the agency's financial condition has been deteriorating, it is quite possible that even these tiny reserves and equity have been completely wiped out, leaving the taxpayer liable to cover all future net losses.[3] In his June 9, 1990, testimony to the Senate Banking Committee, Housing and Urban Development Secretary Jack Kemp told members that years of neglect and mismanagement have rendered FHA ill equipped to fulfill its mission of promoting homeownership. Kemp noted the rapid financial deterioration of the FHA's Mutual Mortgage Insurance Fund, the major program for insuring mortgages on single family dwellings. He stated that under the existing program's arrangements each year's new business will lose money for FHA at a rate of $200 million, and this ultimately will wipe out the fund's net worth unless major reforms are made.

2 "1988 Financial Audit: Federal Housing Adninistration," Testimony of Charles A. Bowsher, Comptroller General of the United States before the Housing and Urban Affairs Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, September 27, 1989, p. 1.

3 For further details on FHA's financial status see Ronald Utt, S. 565: Pushing the Federal Housing Administration Toward Insolvency," Heritage Foundation *Issue Bulletin* No. 148, June 12, 1989.

What Needs to be Done

First and foremost, congressional efforts to reduce FHA's required downpayment should be rejected. Study after study demonstrates that loan losses rise as downpayments are lowered. Congress and the Administration should work to construct a package of legislative reforms that would restore permanent financial solvency to the FHA program. Among the steps, first suggested by The Heritage Foundation in 1986, needed to bring the FHA's finances under control:[4]

◆ Restrict FHA insurance to first time buyers with modest incomes.

◆ Require a minimum downpayment of no less than 5 percent of the cost of the property.

◆ Hold mortgage insurance limits at their present level of $101,250, as recommended by Secretary Kemp.

◆ End the practice of allowing borrowers to finance their closing costs.

◆ Increase FHA reserves to 4 percent of FHA's contingent liabilities by way of increased premiums, higher coinsurance, and better underwriting standards. Charge higher premiums for riskier mortgages.

Last year, in response to the GAO's audit report, HUD proposed a series of important interim reforms that Congress adopted. Kemp recently unveiled a package of sensible reforms to reduce the risk associated with low downpayments and achieve a comprehensive overhaul of the program.

2) The Veterans Administration

The Program. In 1948 the Veterans Administration (VA), now the Department of Veterans Affairs, launched a mortgage guarantee program designed to help eligible veterans to become homeowners. While the FHA insures 100 percent of a mortgage only up to a certain dollar limit and requires a minimum downpayment of between 3 percent to 5 percent, a VA mortgage has no upper dollar limit. VA guarantees only the first 40 percent of principal up to a maximum of $36,000 for loans up to $144,000. For loans that exceed $144,000, VA will pay 25 percent of the loan up to $46,000. VA loans require no downpayment. The VA mortgages do experience higher default rates than the FHA because of the lack of a downpayment requirement,[5] but the government's financial exposure actually is less than with the FHA because the risk is shared with the lender.

The Problem. Like the FHA, mortgages insured by the VA are experiencing much higher default rates and losses than anticipated. In many cases, the

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4 Stephen Moore, "How to Defuse the Federal Housing Administration Time Bomb," Heritage Foundation *Backgrounder* No. 528, July 29, 1986.

5 See Utt, *op. cit.* for an explanation of the relationship between downpayments and the risk of default.

losses exceed the government's guarantee, causing losses to the private lender – or to the Government National Mortgage Association (GNMA) which adds its own guarantee on top of VA's when the VA loans are "securitized" through the GNMA program, which provides 100 percent guarantees on its VA/FHA-backed securities.

Between 1981 and 1987, VA foreclosure actions increased by 215 percent. Over the same period, losses rose from $51 million to $615 million, but by 1990 the annual loss is expected to rise to $792 million. It is expected that VA mortgages written in 1990 eventually will experience a 10.4 percent foreclosure rate. In the past, VA often would cover all the loss on a defaulted mortgage – even that portion which exceeded its legal obligation. However, Congress in 1984 enacted legislation prohibiting the agency from paying out more than its legal obligation.

What Needs to be Done

Because the program was established to reward veterans for their service, and was not meant to be financially self-sufficient, a reform of the program should aim at bringing the taxpayer liability under control, not at an eventual elimination of taxpayer exposure. To accomplish this a package of reforms should:

♦ Undertake a thorough review of the VA's underwriting standards to determine whether too many risky borrowers are using the program. The program was never meant to be a blanket entitlement for all veterans – only those who could demonstrate an ability to repay the loan were deemed qualified for a VA guaranteed mortgage.

♦ Adopt the Bush Administration's most recent reform proposals that would require veterans to make a small downpayment of 4 percent of the amount of the loan above $25,000; charge a 1.75 percent loan fee; and, increase risk sharing with lenders.

3) The Federal National Mortgage Association

The Program. The Federal National Mortgage Association (FNMA), known as "Fannie Mae," is a privately-owned, government-sponsored enterprise (GSE), chartered and organized by the FHA in 1938 to provide secondary market support for the newly-devised FHA mortgages. In 1968 the FNMA was split into the newly-created Government National Mortgage (GNMA), or "Ginnie Mae," which took over those FNMA housing assistance programs that were largely targeted to moderate- and low-income households, and a new FNMA, which held onto to the profitable business of borrowing in capital markets to buy residential mortgages. The new FNMA became privately owned – its shares trade on the New York Stock Exchange – but retained several important links to the government including a line of credit with the U.S. Treasury, debt that is eligible for purchase by the Federal Reserve, and an exemption from registration with the Securities and Exchange Commission. Investors take these privileges to mean that the government will bail out FNMA if required. As a result, FNMA debt carries interest

rates just slightly higher than U.S. Treasury securities, and well below those available to its private sector counterparts. FNMA also issues mortgage-backed securities, which are sold to investors and secured by residential mortgages.

The Problem. By practicing a "savings and loan" investment strategy of borrowing short term to fund long-term investments in residential mortgages, FNMA is vulnerable to any rise in interest rates which would increase its borrowing costs and thus squeeze profits and reserves. The degree of risk facing FNMA is underscored by a report from the Department of Housing and Urban Development, which notes that the rise in interest rates between 1978 and 1981 reduced the FNMA's mark-to-market net worth from negative $387 million to a staggering negative $11 billion.[6] During this same period the FNMA also faced a growing default problem. The subsequent decline in interest rates and a massive expansion in its investment program helped reverse the deterioration through much of the 1980s. But by the end of 1987 the market value of its reserves still had risen to only $1.6 billion to support a portfolio of $97 billion of mortgages and $140 billion in mortgage-backed security guarantees.[7] According to the Bush Administration's FY 1991 Budget, "At the end of 1988 each held [FNMA and FHMLC] capital equal to less than 1.5 percent of assets including mortgage-backed securities.... With such a small margin, the taxpayers are more at risk."[8]

Recognizing the potential for trouble, HUD conducted a thorough investigation of the FNMA and released its report in January, 1989. The report concludes that FNMA's extensive operations "...creates serious risks to FNMA and...creates substantial risks of disruption to the housing market and possible calls for help from the Federal Government."[9] While the FNMA has made some progress in better matching the maturities of its assets and liabilities, it is still vulnerable to interest rate swings and its net worth is well below the level required of savings and loans under the 1989 bailout legislation. Compounding this is the potential risk associated with holding a portfolio of only one kind of asset – residential mortgages.

Even more disturbing is that while the FNMA continues to operate under conditions of a limited cushion of reserves, it does so as an increasingly important participant in the nation's residential mortgage market. In part, the growing federalization of the mortgage market, noted earlier, is due to the rapid growth of FNMA activities in the 1980s. Approximately 90 percent of all originated mortgages are eligible for support from the FNMA or its sister in-

6 *1987 Report to Congress on the Federal National Mortgage Association* (Office of Policy Development and Research, U.S. Department of Housing and Urban Development), unpublished draft dated January 19, 1989.
7 *Ibid.*
8 *Budget of the United States Government; Fiscal Year 1991* (Washington, D.C.: U.S. Government Printing Office, 1990), p. 236.
9 *Ibid.*, Chapter 1, p. 4.

stitution, the Federal Home Loan Mortgage Corporation (FHLMC). In 1986, these two institutions purchased loans equal to 82 percent of this eligible amount.[10] At the same time, virtually all of the FHA and VA loans originated that year were repackaged into GNMA's pass-through securities, which are 100 percent guaranteed by the government.

Given this commanding presence in the U.S. residential mortgage market – a presence that will increase because of the declining role of the savings and loan industry – any financial problems at the FNMA or its companion institutions could have devastating implications for the American housing market and the financial system, as well as for the hapless taxpayer who would no doubt be called upon to bail out the agencies.

What Needs to be Done

To avoid this, major reforms are needed to diminish the risk of insolvency. In particular, the FNMA's reserves need to be built up quickly. Studies for HUD by Standard and Poors, and Shearson Lehman, suggest that a capitalization level of about 5 percent of the FNMA's mortgage portfolio (compared with today's level of below 2 percent) and capitalization of 2 percent of its mortgage-backed securities obligation, would be appropriate for the risk assumed and would also allow the FNMA to become truly independent of the implicit government support that it now receives.[11]

According to the HUD report submitted to the OMB in the last days of the Reagan Administration, to achieve this ratio of reserves to liabilities, the FNMA should:

♦ Wind down its mortgage portfolio at a rate matching the maturation of its debt obligations. This would have the added benefit of beginning the process of defederalizing the mortgage market, permitting private lenders and secondary market participants to enter the market and compete with the FNMA.

♦ Cease payment of dividends to shareholders, so that all earnings can be applied to reserve accumulation.

♦ Increase fees to those mortgage originators (and borrowers) who utilize and benefit from FNMA support. President Bush's 1991 budget proposes a variation on this, recommending that fees be charged on all new debt and securities issued by the FNMA and the FHLMC.

Recently, the FNMA has acknowledged the existence of the problems and has begun to take significant actions. On May 8, 1990, the FNMA announced that it planned to set aside at least $2 billion over the next two years against

10 *Ibid.*, Chapter 4, p. 14.
11 *Ibid.*, Chapter 3, p. 8.

possible losses in its mortgage portfolio. Its chairman stated that it planned to spend most of its profits in this year and the next to meet this goal.[12]

4) The Government National Mortgage Association

The Program. The GNMA was created in 1988 to conduct activities previously carried out by the FNMA. Much of the agency's original low-income support activity has since been wound down to minimal levels, and the GNMA's major function today is to guarantee the payment of principal and interest on what are called GNMA mortgage-backed, pass-through securities. These securities were developed in the late 1960s as a way of tapping the capital markets for funds for housing. The idea was that those investors and institutions not willing to invest in residential mortgages would be willing to invest in government guaranteed securities collateralized by pools of residential mortgages that also were guaranteed by the government.

Only FHA-insured and VA-guaranteed mortgages can be used to back GNMA pass-through securities. Although the GNMA charges a nominal fee to those entities that issue the securities, it has been assumed that the organization is exposed to little risk because of the additional guarantee on the underlying collateral. By the end of fiscal 1990, the outstanding volume of GNMA-guaranteed securities is expected to reach $390 billion.

The Problem. The presumption of safety is now being questioned as past HUD management scandals continue to unfold. For one thing, the financial collapse of one GNMA security issuer revealed that the company had been skimming off borrower prepayments and not passing them through to the holders of the GNMA securities. The GNMA estimates that the losses associated with this issuer alone could cost GNMA as much as $125 million. Rising defaults in VA mortgages lead to another source of loss for GNMA. Whereas FHA insures 100 percent of the value of its mortgages, VA guarantees only 40 percent of the mortgage, up to a maximum amount of $36,000. Losses beyond this level must be born by the lender or mortgage holder – or ultimately by the GNMA when VA loans are used to back GNMA pass-through securities. Because of the rise in VA defaults, and a steady increase in losses exceeding the VA obligation, GNMA is facing heavy losses. With more than 10 percent of the VA mortgages written this year expected to go into foreclosure, the potential GNMA liability could be as high as $2 billion or more, an amount that exceeds the GNMA reserve fund of $1.7 billion.[13]

What Needs to be Done

To rectify these problems and avoid future losses, the GNMA should:

12 *Washington Post*, May 9, 1990, p. F1

13 "Rising VA Mortgage Losses Spell Trouble at Other Agency," *The New York Times*, June 29, 1989, p. 1.

♦ Review the capital standards required of its issuers and determine whether they should be raised as a result of the greater rate of mortgage defaults.

♦ Audit randomly chosen pass-through security issuers to determine that the existing standards are being met.

♦ Disqualify immediately those unable to meet the revised standards.

♦ Raise the guarantee fee, now set at only 6 basis points, to at least the 10 basis points recommended in Ronald Reagan's fiscal 1988 budget. As that budget noted, "This fee is closer to that charged other issuers of mortgage-backed securities and is part of a coordinated effort to increase opportunities for private sector activity in the secondary mortgage market for home mortgages."[14] Although Congress did not enact this proposal, Bush has included it in his 1991 budget.

5) The Federal Home Loan Operations

The Program. The government is even more deeply involved in mortgage finance, thanks to two other government-sponsored enterprises – the Federal Home Loan Bank System (FHLBS) and the Federal Home Loan Mortgage Corporation (FHLMC). The FHLBS was created in 1932 to provide a central credit facility for savings and loan institutions and to supervise and regulate the industry. As of the end of 1989, its outstanding loans were $151.1 billion, most of which were in the form of loans to savings and loan institutions. Although the FHLBS is better capitalized than some other government enterprises, the vast majority of its loans are concentrated entirely within the troubled savings and loan industry.

The Problem. The FHLMC was created in 1970 to stimulate the flow of capital into the housing market by establishing an active secondary market for conventional mortgages. While in some respects the corporation can be viewed as the conventional mortgage companion to the FNMA, it differs from the FNMA by largely relying on packaging its mortgages into a form of pass-through security and then reselling these securities in the open market. By securitizing the mortgages, much in the way that the GNMA does with FHA/VA mortgages, the FHLMC aims to attract additional funds to housing. As of the end of 1989, the FHLMC had $257 billion of these securities outstanding, and it is anticipated that this amount will increase by about $40 billion to $50 billion per year.[15]

14 *The Budget of the United States Government, Fiscal Year 1988* (Washington, D.C.: U.S. Government Printing Office, 1988), pp. 5-61.
15 1991 Budget, p. A-140.

What Needs to Be Done

The FHLMC is in better financial condition than FNMA and its interest rate risk exposure is manageable by virtue of its limited portfolio of mortgages held for investment. It is, nevertheless, concentrated in one asset and, by virtue of its implicit government support, has a competitive advantage over its private sector competitors. One way to diminish the latter advantage would be to require it to pay a fee to the government on all securities it issues to the private market, as proposed by the Bush Administration.

GROUP II: AGRICULTURE CREDIT PROGRAMS

The agriculture sector of the U.S. economy also enjoys substantial federal credit support. As in many of the other federal credit programs, the government greatly expanded its agriculture finance business during the Depression, although the first major programs were created in 1917. Because a disproportionate share of the bank failures during the Depression were concentrated in rural banks, many farmers were left without any source of credit to finance spring plantings, storage, and general improvements. The federal government stepped into this gap with several programs and institutions to help get the farm economy back on its feet.

When the Depression ended, these programs did not wither away — they were expanded and new ones were added. By 1985, the federal government accounted for more than half of the farm sector's real estate debt and more than a third of the other agriculture-related debt.

But for many farmers, it was too much of a good thing. The generous lending policies of the federal government promoted an unsustainable rate of increase in the price of farm land during the 1970s and early 1980s and induced many farmers to take on more debt than they could ever hope to service or pay back unless land and crop prices continued to escalate. But land and crop prices fell in the 1980s. The end result was a collapse of the agriculture economy that ruined the lives of thousands of farmers, bankrupted hundreds of rural banks and other businesses, and cost the taxpayers billions of dollars.

1) The Farmers Home Administration

The Program. The Farmers Home Administration (FmHA), created in 1948, has as its chief objective the provision of temporary credit to farmers whose financial situations prevent them from obtaining credit elsewhere at affordable rates and terms. The FmHA operates two major programs: one makes loans to farmers to finance farm ownership and other agriculture-related credit needs, while the other provides mortgage credit to assist farmers and other residents of rural areas to buy their own homes. Unlike the FHA and VA, which insure or guarantee loans made by private lenders at interest rates approximating the market rate of interest, the FmHA makes loans directly to the borrower, at subsidized interest rates, with funds provided by the U.S. Treasury.

The Problem. A 1988 General Accounting Office (GAO) study has discovered serious deficiencies in the FmHA loan program. The report notes that whereas the outstanding volume of FmHA loans increased by 400 percent between 1976 and 1987, the amount of delinquent payments over that period increased by a staggering 4,300 percent, from $164 million to about $7 billion. Of the $26.2 billion of loans outstanding at the end of 1987, some $12.8 billion was in default. A disturbing $6.7 billion of this amount had been in default for more than three years.[16] The resulting losses are expected to be significantly more than this. According to the report:

> Although implementing regulations have not been finalized, FmHA has estimated that approximately 16,200 of its farm borrowers will be eligible for the loan write-down, with about $2.1 billion of debt being written off as a loss. In addition, loan losses from other borrowers who will be unable to show repayment of debt even after write-down are estimated at about $6.7 billion. As a result, FmHA estimates total potential losses to be about $8.7 billion by fiscal year 1990.[17]

As a result of these and other losses, the FmHA agriculture credit revolving fund is estimated to have a *negative* net worth of $28 billion.[18] Unfortunately, this is not the only taxpayer cost of the program. The same GAO report estimates that FmHA agriculture borrowers received interest rate subsidies valued at between $612 million to $1.6 billion over and above the direct costs associated with the high rate of defaults.

The situation in the FmHA housing loan program is marginally better than the farm program, but still substantially worse than any of the government's other housing programs. At the end of fiscal 1988, the FmHA had $26.9 billion in loans outstanding to finance homeownership and housing rental programs in rural areas. Section 502 of the 1949 Housing Act created the FmHA's largest subsidy program to finance the purchase of single family homes at deeply subsidized interest rates. Under the 502 program eligible households with incomes below 80 percent of the median area income may borrow from the FmHA to purchase a home. The risk associated with these loans is particularly high, since no downpayment is required and borrowers must demonstrate that they cannot get credit from another source. Loans typically are written for 33 years, although they may be as long as 38. The interest

16 "Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit," U.S. General Accounting Office, GAO/RCED-89-3, November 1988, p. 9.

17 *Ibid.*, p. 36.

18 1991 Budget, p. 240.

rate on the loan is subsidized through an interest "credit." This reduces the effective interest rate to as low as 1 percent. According to one sample survey, the average effective interest rate on outstanding FmHA home loans is 3.4 percent,[19] leading to an estimated subsidy cost of $98 million dollars for just those loans that will be made in fiscal 1990.[20]

What Needs to be Done

The high costs of this program suggest that homeownership programs are an inappropriate and costly method of assisting low-income rural residents. Thus no new FmHA loans should be originated and the existing portfolio should be allowed to wind down through repayments and loan amortization. In non-rural areas, such households are assisted through vouchers, rental certificates, and other forms of low-income rental assistance. Vouchers are a proven, cost-effective method of providing housing assistance to the poor, and the Reagan Administration proposed that a voucher program be substituted for the direct loan programs that have pushed too many of rural Americans deeply into debt, ruining their credit rating and costing the taxpayer billions. Regrettably, Congress has ignored this request and legislation to reauthorize the existing loan program is now before both the House and the Senate. The Bush Administration, by contrast, recommends vouchers as a substitute for many of the rural housing loan programs. This recommendation should be supported.

2) The Rural Electrification Administration

The Program. The Rural Electrification Administration (REA) was created in 1935 to provide loans and loan guarantees to rural cooperatives for the purpose of providing electrical service to farms. At that time only 12 percent of the farms had electricity. But by 1964, some 98.1 percent of farms had service. Nonetheless, the program has continued to grow, despite the fact that its Depression-era mission was largely accomplished a quarter of a century ago.

The REA offers two types of credit assistance to eligible borrowers: 100 percent government-guaranteed loans and direct loans with 5 percent interest rates. Guaranteed loans are provided to eligible cooperatives by the Federal Financing Bank (FFB), which is part of the U.S. Treasury, or from private lenders with the REA guaranteeing the full payment of principal and interest. The direct loans are made by the REA to eligible electric cooperatives at a 5 percent interest rate, which is well below that on the guaranteed loans or on the loans a co-op's for-profit competitors must pay in private capital markets. As of the end of 1987, the latest year for which accurate figures are available from OMB documents, there were $22.6 billion in outstanding

19 "A Home of Our Own: The Costs and Benefits of the Rural Homeownership Program," A Publication of the Housing Assistance Council, 1988, p. 39.
20 OMB, Special Analysis F, 1990, p. F-42.

guaranteed loans, most of which were held by the FFB. There were another $13.1 billion in direct loans held by the REA.

The Problem. In 1988, a special report prepared by the Reagan Administration estimated the cumulative cost of subsidies at about $18 billion between 1973 and 1986. In addition to this costly subsidy, REA loans have experienced a relatively high default rate. Of the more than $20 billion in guaranteed loans outstanding, between $8 billion and $9 billion have gone into default.

Beyond the usual problems associated with the bad credit risks typical of federal credit programs, the REA confronts a special challenge in the form of a required 1993 repayment of an interest-free loan from the U.S. Treasury. The REA revolving loan is drifting toward insolvency because of the sharply mounting costs of the deeply subsidized 2 percent and 5 percent loans. Without substantial reforms, and with this interest-free loan coming due, a major taxpayer bailout will be needed to allow REA to continue operations. This year, Congress has appropriated approximately $320 million to cover loan payment defaults.

What Needs to Be Done

Recognizing that the program has long since achieved its goals and that the continued federal assistance is both costly and unjustified, the Reagan Administration proposed reducing the level of taxpayer support by replacing the direct REA loans and the 100 percent guaranteed FFB loans with 70 percent and 80 percent guaranteed loans from private sector lenders.[21] The Bush Administration resubmitted the proposal, proposing 70 percent and 90 percent guarantees. Congress should enact legislation to accomplish these reforms, including other steps that ultimately make the co-ops entirely reliant on private sector sources of credit.

3)The Farm Credit System

The Program. The Farm Credit System (FCS) has its origins in the Farm Loan Act of 1916, and took on its current form in 1933. The FCS was substantially reorganized in 1987 in response to rising loan losses and the threat of insolvency. Until then it had comprised four major entities: the Farm Credit Administration (a federal agency) and three separate privately-owned but government-sponsored enterprises – Banks for Cooperatives, Federal Intermediate Credit Banks, and Federal Land Banks.

The Problem. Although they are privately-owned GSEs, government sponsorship bestowed significant benefits upon the three farm lending institutions within the Farm Credit System. As is generally the case with GSE's, FCS was provided with a line of credit at the Treasury, made exempt from federal, state and local taxes, made eligible for Federal Reserve open market pur-

21 *Ibid*, p. F-19.

chases, given equal standing with Treasury debt as qualified investments for banks, made exempt from Securities and Exchange Commission registration, and could be treated as collateral for public deposits. With these advantages, the banks of the FCS were able to offer below-market rates to their borrowers and attract business away from their private sector competitors. Thanks to the privileged and subsidized position of the banks, outstanding farm real estate loans held by federal land banks increased by a staggering 588 percent between 1970 and 1983, compared with only 272 percent for all farm real estate loans.

This surge in lending by the land banks displaced billions of dollars of privately-available credit and exposed the federal government to enormous risk. When crop prices fell in the early 1980s, so did farm incomes and the value of farm land, the collateral securing the land banks' loans. Losses began to mount at many of the Systems' banks, and a poorly conceived bailout in 1985 failed to stem the red ink. When the FCS lost $1.9 billion in 1986, emergency bailout legislation was prepared and signed into law in early 1988. A recent estimate places the total taxpayer cost of the bailout at about $2.9 billion.[22]

Although the bailout resolved the short-run problem facing the FCS by injecting substantial amounts of cash into the system, the structural "reforms" included in the measure could further weaken the agriculture credit market, exposing farmers, government, and taxpayers to even greater risks in the future. This is because the bailout legislation increased the government's explicit liability for the new loans extended to the system and created a new federal enterprise that requires the federal government to guarantee the payment of principal and interest on new loans extended to farmers by private lenders.

The 1988 legislation also created two new government-sponsored enterprises that will increase the federal government's involvement in agriculture lending and thus expose the taxpayer to larger losses. These institutions are the Farm Credit Assistance Financial Corporation (FAC) and the Federal Agriculture Mortgage Corporation (FAMC or "Farmer Mac").

The FAC will provide the financing mechanism through which the FCS can receive capital beyond what it can borrow on its own – particularly for those FCS institutions whose loss-ridden loan portfolios preclude them from borrowing in private capital markets. Obligations issued by the FAC will carry the guarantee of the federal government, and the U.S. Treasury will pay all or part of the interest cost on most of FAC's debt for the next ten years. For those System lenders not eligible for FAC loans because they maintained their financial integrity during the recent period of adversity, the Act will reward them by creating the Farm Credit System Insurance Corporation, a federal agency that will insure all of their debt obligations. Thus with one pro-

22 *Ibid*, p. F-23 to F-27.

gram or the other, the federal government can now guarantee explicitly all obligations issued by the many lending institutions that comprise the Farm Credit System.

As disturbing as this extension of coverage may be, the FAMC poses an even larger potential risk to the government, the farmer, and the taxpayer. The FAMC was established to guarantee the timely repayment of principal and interest on pools of farm mortgages and certain rural housing loans originated by the FCS banks, commercial banks, savings and loans, and insurance companies. But this will encourage private lenders to make more farm mortgage loans at lower credit standards, since the risk can be transferred to the taxpayer. The bailout legislation makes it possible for the vast majority of loans extended to farmers, regardless of source, to be insured or guaranteed by the federal government.

Although future risks pervade the new program, the agriculture credit system has improved markedly over the past few years. Farm debt has declined 30 percent since 1983, largely as a consequence of write-offs, and agriculture sector debt-to-equity ratios have declined from 31 percent in 1985 to 22 percent today.

What Needs to be Done

With the agriculture debt situation of the recent past now largely resolved, efforts should be undertaken to diminish gradually the federal role and to encourage more private sector involvement. The 1987 bailout should be viewed as a short-term expedient and the institutions it created should be reduced in scope or transferred to the private sector.

4) The Federal Crop Insurance Program

The Program. There are several other, smaller farm credit and insurance programs that also suffer from relatively high loss rates. For example, the federal crop insurance program (FCIC) was created in 1980 to allow farmers to insure their crops against a variety of natural hazards such as drought and hail.

The Problem. The FCIC is heavily subsidized with losses and administrative costs consistently exceeding income. Yet farmer participation has never exceeded 30 percent, in large part because Congress has always showed a willingness to bail out farmers regardless of whether they have made the effort to obtain insurance against such losses. In 1989 the insurance in force was $13 billion and this year's loss is expected to be as high as $250 million.

What Needs to be Done

Congress should either substantially reform the program so that premium income matches expected losses, or terminate the program and rely on the existing discretionary authority to compensate farmers for losses experienced as a consequence of natural disasters.

GROUP III: OTHER MAJOR INSURANCE AND GUARANTEE PROGRAMS

When large segments of the banking industry began to fail during the Great Depression, thousands of depositors lost their life's savings and credit became unavailable in many communities. Confronted with the risk that depositors throughout the country would panic and withdraw their funds from all banks and thrifts, thereby jeopardizing the entire financial system, the government responded by creating a system to provide federal insurance to depositors to eliminate the threat of a nationwide run on the banks.

As long as the insured institutions were confined to a narrow range of investments offering limited risk, the system worked reasonably well and all losses were more than covered by the insurance premiums paid by the depository institutions. However, when the deregulation process gave banks and S&Ls more freedom to choose their investments, the continued existence of federal deposit insurance encouraged the unscrupulous or incompetent managers to take irresponsible risks with the knowledge that the government would pick up the pieces and cover the losses. This asymmetry of responsibility was one of the key reasons for the S&L debacle.

1) The Federal Deposit Insurance Corporation

The Program. In an effort to stabilize America's financial system during the Depression and restore confidence in depository institutions, Congress enacted the Banking Act of 1933. Among its many provisions, the Act created the Federal Deposit Insurance Corporation (FDIC) to insure, up to a specified limit (now $100,000 per depositor), deposits held at commercial banks. In 1935, similar coverage was extended to deposits at the savings and loan associations by the creation of the Federal Savings and Loan Insurance Corporation (FSLIC). The National Credit Union Administration (NCUA) also was created to insure deposits at federally-insured credit unions.

As of the end of 1989, these three federal agencies had insured a total of nearly $2.9 trillion of deposits, with $1,806 billion of this amount at commercial banks covered by the FDIC, $958.9 billion at savings and loans covered by the FSLIC, and $161 billion at credit unions and insured by NCUA. The financial institutions pay the appropriate insuring agency a flat-rate fee representing a percentage of their deposits.

The Problem. Confidence in the federal deposit insurance system was shaken when the extensive failures in the savings and loan industry vastly exceeded the reserves of the FSLIC, causing it to seek huge infusions of cash from the U.S. Treasury, the remaining S&Ls, and the taxpayer. Between now

and 1999, the total cost of the bailout is estimated to fall somewhere in the range of $150 billion to $300 billion.[23]

Although the commercial banking system had at first managed to escape the problems confronting its sister industry, solvency problems are beginning to emerge and there is growing concern regarding the ability of the FDIC to fulfill its obligations during a sustained period of financial stress.

Although the number of problem banks dropped to 1,394 in 1988 from a peak of 1,575 in 1987, the 200 banks failing that year and the 22 that required financial assistance cost the FDIC $7.3 billion, leading to the first-ever loss experienced by the agency. Another 206 banks failed in 1989, costing the FDIC $4.1 billion. The FDIC's reserves fell from $18.3 billion in 1987 to $16.3 billion at the end of 1988 and to $14.3 billion by 1989. Reporting on its most recent audit of the FDIC, the GAO concludes that "[T]he ratio of the FDIC's insurance fund balance to insured deposits declined to the lowest level ever, estimated by the Corporation to be 0.83 percent."[24]

Recent reports by the GAO and the Office of Management and Budget (OMB) offer only qualified support for the view that the worst is behind the FDIC. In its April 1989 audit, the GAO notes that "The Corporation anticipates it will have net income in 1989. However, a downturn in the Northeast or Southeast or increasing interest rates could result in additional insurance costs to the Corporation." Although the GAO was accurate in its predictions, in the next paragraph the GAO notes that "In spite of the significant number of bank failures and the potentially adverse conditions which could affect the Corporation, we believe that it has sufficient funds to handle current and short-term identifiable needs."[25] Earlier in 1989, OMB had also expressed a cautious view, when it noted in the President's 1990 Budget that, "U.S. banks recorded healthy profits in 1988, after a year of extraordinary losses. Nevertheless, concerns remain. Increased levels of nonperforming bank assets in 1988 represent a potential future danger sign. In addition, the FDIC has become increasingly concerned as banks and other institutions appear to be increasing their concentration in high-yield, high-risk "junk" bonds...."[26]

Two reports by private analysts, however, express a less optimistic view than either of these two government agencies. The "Shadow Financial Regulatory Committee," an unofficial group of leading banking experts from business and academia, concluded in a late 1988 report that "...if the FDIC

23 R. Dan Brumbaugh, Jr., Andrew S. Carron, and Robert E. Litan, "Cleaning Up the Depository Institutions Mess," *Brookings Papers on Economic Activity* I:1989, p. 261.

24 "Financial Audit: Federal Deposit Insurance Corporation's 1988 and 1987 Financial Statements," General Accounting Office, GAO/AFMD-89-63, April 1989, p. 6.

25 *Ibid.*, p. 7.

26 *Special Analysis, Budget of the United States Government, Fiscal Year 1990* (Washington, D.C.:U.S. Government Printing Office, January 1989), p. F-35.

were to experience losses that would not be unreasonable to anticipate in view of its recent loss experience and problem bank estimates, the FDIC's reserve balance would be exhausted at present."[27] Using historic failure rates for both problem and nonproblem banks, and relating these rates to the volume of bank assets at risk and the likely resolution costs, the Shadow Committee estimates the total of FDIC "booked" and "unbooked" losses at $21.3 billion, an amount exceeding current FDIC reserves.

Even more pessimistic than the Shadow Committee is "Cleaning Up the Deposit Mess," a 1989 report by three private sector economists. The economists question the view that the worst is behind the FDIC, contending that "Given the large number and asset size of weak banks, the extent to which GAAP accounting techniques (Generally Accepted Accounting Principles) hide market value losses, and the potential for rapid asset deterioration, it is possible that losses in the commercial banking industry could eclipse those of the thrift industry, especially if the economy enters a recession before the weak capitalization of many banks is corrected."[28]

The authors' conclusion is based on an analysis of the banking industry's balance sheet and their argument that many banks are very thinly capitalized, having actual reserves below 3 percent of assets. They note that in addition to the approximately 400 banks closed in 1987 and 1988, another 28 large banks with $22.5 billion in assets were still open and insolvent in late 1988, and a further 48 banks holding $43 billion in assets had capital ratios below 3 percent under GAAP.

Although the potential risk is considerable, any effort to estimate likely losses and costs are highly speculative and depend heavily upon the projected economic outlook over the next several years. Nonetheless, the risk is there and much of it follows directly from fundamental flaws in the way the government operates the deposit insurance system. Reviews of the issue by Heritage Foundation analysts[29] conclude that the problem stems from the fact that depository institutions, particularly the poorly supervised thrifts, have been able to engage in reckless business activities because the federal deposit insurance system takes no account of the riskiness of an institution's investments when setting premiums. In fact, because institutions making riskier investments generally offer higher deposit rates, depositors actually are encouraged to keep their money in them because they are secure in the knowledge that the government will bail them out if the institution fails. Indeed, this perverse incentive is one of the chief reasons why the cost of the S&L bailout grew so rapidly between 1987 and 1989.

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27 "Statement of the Shadow Financial Regulatory Committee on the Need to Estimate the True Economic Condition of the FDIC," Statement No. 36, December 5, 1988, p. 1.

28 Brumbaugh, *op. cit.*, p. 250.

29 James L. Gattuso and Dana Joel, "Only Structural Reform Can Solve the Long-Term Savings and Loan Crisis," Heritage Foundation *Backgrounder Update* No. 92, January 27, 1989. See also Bert Ely, "Confronting the Savings and Loan Industry Crisis," Heritage Foundation *Issue Bulletin* No. 126, August 13, 1986.

What Needs to be Done

Several important reforms have been proposed to reduce the taxpayers' exposure to deposit insurance risks.

Under one plan, deposit insurance premium rates would rise with the degree of risk associated with the loans and investments in an institution's portfolio. This would force institutions undertaking riskier investments to pay much higher insurance rates than those pursuing more conservative investment strategies. This would provide better protection for taxpayers and discourage reckless investment.

Another alternative proposes that the amount of deposit insurance available per depositor should be limited to something much less than $100,000. This would improve the current system both by diminishing the outstanding liability assumed by the government and by forcing larger individual depositors to pay more attention to the soundness of the institution where they keep their money, just as investors consider the quality of a mutual fund or individual stock when making an investment. For most Americans with only a few thousand dollars in bank deposits, there would be no change: they would be fully insured and would not have to worry about the quality of the management of their local bank. But even larger depositors would not have to check out each institution.

It would be unreasonable to expect a typical bank depositor to make independent judgments about his or her commercial bank. But in practice rating services such as Standard and Poors, and Moodys would do the work for each depositor in much the way they assess the risk associated with marketable debt instruments. Thus, depositors could select among triple A or double B banks much as they choose that combination of risk and reward most suitable for other investments.

A third alternative would place a much greater reliance on the resources of the banking system through a system of "cross-guarantees." Under this plan, the combined reserves of the banking system would serve as the first line of defense against the failure of any individual bank. FDIC insurance would serve as a back-up in the unlikely event that a credit crisis exhausted the reserves of the banking system.[30]

Although each of these plans could improve the system, the cross-guarantee proposal holds the greatest promise because it would greatly diminish the role of the federal government and create a powerful set of incentives to induce the banking system to move quickly against those banks whose inept lending practices jeopardize the collective resources of the system.

30 Bert Ely, *Making Deposit Insurance Safe Through 100% Cross-Guarantees* (Washington, D.C.: National Chamber Foundation, May 1990).

2) The Guaranteed Student Loan Program

The Program. The Guaranteed Student Loan Program (GSL), now referred to in statute as the Stafford Student Loan Program, was created in 1965 to provide financial assistance for students seeking higher education. Students qualify for GSLs if they are enrolled at least half time in an eligible institution of higher education or a vocational school. Undergraduates may borrow up to $2,625 in their first two years of schools. Providing they have completed two years, they may borrow up to $4,000 for each succeeding year. But the maximum amount they may borrow for undergraduate education is $17,250. The actual loans are made by private lenders – mostly depository institutions – at interest rates subsidized by the federal government. The $12.6 billion in new GSLs expected to be granted in 1990 are projected to entail an interest rate subsidy of just over $3.7 billion over the life of the loans.

The Problem. By the early 1980s, the deep interest rate subsidy and the absence of any household income limits on eligibility made GSLs the most attractive method of financing a college education or vocational training. In 1980 the dollar volume of new student loans granted was equivalent to more than half the amount of tuition received by all colleges and universities.[31] Some income constraints have since been imposed and the new loan volume is now below 40 percent of total tuition revenues. Currently, there is $48 billion in outstanding GSLs.

The chief problem now confronting the program is an excessive default rate. Loan losses have been rising sharply in recent years. Realized losses reached $1.4 billion in 1988, soared to $1.9 billion for 1989 and losses are expected to exceed $2 billion in 1990.

There are a variety of reasons for this sharp increase. One is the advent of "fly-by-night" vocational schools that induce unsuspecting individuals to sign up for instructional programs of dubious value and excessive tuition costs by emphasizing that costs will be covered by the GSL program. Upon graduation, if they make it that far, many of these poorly-trained students often fail to find adequately-paid employment and default on their loans. At one technical school in Baltimore, Maryland, the default rate was a staggering 83 percent on the outstanding loans of its students. The former students of many community colleges experience default rates in excess of 50 percent. The for-profit trade schools have average default rates of 40 percent, compared with 9 percent at four-year institutions.[32]

What Needs to be Done

In response to the problem, the U.S. Department of Education released new regulations last year designed to force reforms at those schools with the highest default rates. These schools will be required to reduce their student

31 *Statistical Abstract*, Tables No. 257 and No. 259, p. 153 and 154.
32 "A Governmental 'F' Awaits Schools Lax on Student Loan Defaults," *The Washington Post*, June 2, 1989.

default rate gradually over several years or face restrictions on the availability of GSL loans to finance tuition.

This is an inadequate response to the problem; institutions with dismal records will continue to receive federal credit support while still providing an inadequate education to young Americans. Many of these schools are nothing more than taxpayer-financed scams that prey on the disadvantaged, leaving them with a poor education and thousands of dollars in debt.

To cut the default rate, save the taxpayer more than a billion dollars, and limit the harm to future students, the Department of Education should modify its existing regulations to require all schools with default rates in excess of 30 percent to post a bond equal to the dollar volume of defaulted loans in excess of the 30 percent cutoff. Without the bond, these schools would be ineligible to participate in the GSL program. As the school's default rate declined, portions of the bond would be returned to the school. But if there were to be no progress, the bond would be used to cover defaults in excess of the cutoff, and additional bonding would be required to maintain eligibility for GSLs. This potentially costly requirement quickly would force the sham schools out of business. Over time, the 30 percent rate could be reduced to 15 percent, ensuring that the schools that remain in operation are those with a demonstrably positive effect on the careers of their students.

3) The Pension Benefit Guarantee Corporation

The Program. The Pension Benefit Guaranty Corporation (PBGC) was established in 1974 under Title IV of the Employee Retirement Income Security Act (ERISA), to protect workers' pension plans when private pension trusts are terminated without sufficient assets to meet their commitments. The insurance program is funded by premiums paid by the defined benefit pension plans covered by the program. The PBGC's liability reached $820 million in 1989.

The Problem. Initially it was believed that a premium of $1.00 per participant per year would be sufficient to provide the revenue needed to build reserves and cover PBGC losses. This turned out to be wildly optimistic, and in 1986 the premium was hiked sharply to $8.50 per participant. But even this was insufficient, and the premium was raised yet again in 1987. Single-employer plans now can face premiums ranging from $8.50 to $16.00 but a variable charge of up to $34 per participant can be levied depending upon a plan's unfunded vested benefits.

This change in premium structure is an important precedent for federal insurance programs, because it marks the introduction of a risk-based premium structure in which higher risk participants have to pay higher premiums in order to remain eligible. This could have significant benefits if applied to other programs such as the federal deposit insurance systems.

Despite this important reform, and a June 18 ruling by the Supreme Court giving the PBGC the power to force certain employers to take back the responsibility for their troubled pension programs, the corporation still is in

trouble, and the taxpayer exposed to potentially huge bailout costs. By 1989 the cumulative PBGC deficit had risen to between $3 billion and $4 billion, although that is not reflected it its published reports.[33] Even more troubling is information contained in a 1989 report of the Inspector General at the Department of Labor.[34] According to this report, a series of administrative, management and supervisory failings on the part of Department's bureau has seriously jeopardized the well-being of the many pension plans for which the government has ultimate responsibility. The Inspector General made a series of recommendations for better reporting and greater reliance on independent public auditors to maintain close surveillance over the plans. In that report, the Inspector General stated that "... the burden of insuring and protecting failed benefit plans will fall upon all taxpayers, not just the plan beneficiaries and parties, since the PBGC in the final insurer of these plan assets. Unless steps are taken now, today's S&L bailouts may become tomorrow's ERISA nightmare."[35] These remarks were prophetic. In recent testimony to Congress, the PBGC's Executive Director stated that the insurance fund's deficit could rise to $8 billion in the near future as a result of looming corporate bankruptcies.[36]

What Needs to be Done

The Department of Labor should be instructed to hire an independent consultant to measure the risks and to determine whether the existing premium and supervisory system are sufficient to keep these risks at a minimum. Until such time as this comprehensive review is completed, the PBGC should follow the advice of the Department of Labor's Inspector General by establishing better and more comprehensive auditing procedures. The Inspector General recommends that this task be contracted out to experienced, independent audit firms. In addition, Congress should give the PBGC more flexibility in setting its premiums so that revenues cover losses and expenses on a sustained basis.

33 The PBGC reported a cumulative deficit of $1.781 billion in 1986 but then reduced it to $1.480 billion in 1987 based on the attempt to shift the LTV pension obligation back to the company. LTV is a steel producer that filed for bankruptcy several years ago. LTV has refused to accept the obligation. The issue has gone to court twice and the PBGC has lost on both occasions. Unfunded liabilities of $2.2 billion is at stake and if the PBGC losses on appeal this amount would be added back to the accumulated deficit.

34 *Semiannual Report, Office of Inspector General, U.S. Department of Labor*: October 1, 1988 - March 31, 1989 (Washington, D.C., 1989).

35 *Ibid.*, p. 3.

36 Frank Swaboda, "Pension Fund Called Vulnerable," *The Washington Post*, June 14, 1990.

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33. [illegible] ... the amount would be added back to the accumulation ... [illegible]
34. *Semiannual Report, Office of Inspector General, U.S. Department of Labor, October 1, 1988 - March 31, 1989* (Washington, D.C., 1989).
35. *Ibid.*, p. 2.
36. Frank Swoboda, "Pension Fund Called Vulnerable," *The Washington Post*, June 14, 1992.