



Remarks by Governor Edward M. Gramlich

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Loan Guarantee Programs

In recent years the Congress has responded to industrial difficulties by enacting loan guarantee programs, first for steel and oil and gas, later for airlines and rural television services. Unlike programs passed two or three decades ago on behalf of the Lockheed and Chrysler corporations, these new programs are open to all qualifying companies within the specified industries. Companies can apply for a loan guarantee that covers most of the loan amount, usually in the range of 80 percent to 90 percent. In each of these four new programs, the Congress has created a board to judge the applications, and the boards have in turn hired a staff and outside consultants to analyze these applications and make recommendations on whether the specific applications should be approved. Because the programs involve credit markets, a Federal Reserve Board delegate has been appointed to the loan guarantee boards, and I have been that delegate for each of the four boards.

Though political motives undoubtedly are involved in the creation of loan guarantee programs, an economic rationale could be involved as well. Some social value, which private credit markets may undervalue, may exist in keeping alive particular firms or in financing particular services of ongoing firms. For example, a loan applicant might provide essential consumer services, add to competition in certain markets, or employ resources that would otherwise be unemployed in the short run. The supply of credit to an entire industry could at times be temporarily interrupted, through no fault of the industry, as is perceived to have happened for airlines after September 11, 2001. To the extent that keeping alive such services, firms, or firms in such industries has social value--a matter that many economists would view with pronounced skepticism--there could be a rationale for a loan guarantee program to facilitate the supply of the missing credit.

Merely stating these possible rationales suggests how difficult it might be to tailor a loan guarantee program to deal with them. Affirmative loan guarantee decisions should be justified either by nonmarket benefits for consumers or producers or by credit market disruptions. Ideally these benefits should outweigh taxpayers' opportunity cost of supplying the funds, called the net credit subsidy cost of the guarantee. Although the temptation will be there, decisions should not be made on the basis of political influence. Given these considerations, it makes sense to empower a board with the ability to sponsor the required analyses and with some insulation from the normal political lobbying process to judge the applications.

The Congress in fact did set up these programs and create these boards. We at the Fed did participate in their administration. This talk reports on these four boards, from a personal perspective. I stress that I am speaking for myself and not for congressional decisionmakers, other members of the loan guarantee boards, or the Federal Reserve Board.

Rationale

Economists have a long-standing aversion to intervening in private markets. Politicians sometimes evince just as long-standing a tendency to intervene. The two urges have been in conflict since the early days of government, in areas such as tax subsidies, tariffs, regulatory preferences, and public works spending.

Industrial loan guarantees represent a new battleground for such tensions. Economists on their own would rarely see value in such loan guarantee programs, or in industrial subsidies more generally. Politicians might prefer other forms of subsidy, but when industrial difficulties loom in their districts, loan guarantees represent a convenient device for giving aid while still limiting budgetary expenditures. This political reasoning may explain why the Congress has passed so many loan guarantee programs recently, though it cannot explain why loan guarantee programs were rare until recently.

A loan guarantee program has potential value if nonmarket benefits are generated by the firms or services kept alive by the guarantee-induced credit extensions. It is important to stress the nonmarket benefits because, presumably, private lenders and investors are already receiving the normal market benefits of credit transactions. These nonmarket benefits will result mainly from, or reside within, the firms or services kept alive by the loan guarantees. Other firms in the industry that do not get guarantees could only be affected indirectly, perhaps through a potential increase in competition. Taxpayers could incur costs for those firms that receive guarantees but later fail. All gains and losses should of course be tallied in a full accounting, but the focus on nonmarket benefits would involve mainly the firms kept alive by the credit subsidy.

A board set up to administer a guarantee program might be viewed as trying to find those applications with relatively high nonmarket benefits and relatively low credit-subsidy costs to taxpayers. The methodological approach for doing this is benefit-cost analysis. The board should try to approve applications with positive net social benefits--that is, where the nonmarket benefits of keeping a firm alive outweigh the required credit subsidy costs to taxpayers, along with any other administrative or other costs of the program.

As for the nonmarket benefits themselves, the following types of benefits have at least been invoked in congressional discussions of the recent loan guarantee programs:

- Essential consumer services. One example could involve essential air service, or added airline competition, to remote destinations, presumably what the Congress meant by asking the airlines board to consider a "safe, efficient, and viable" air transportation network. Another could involve selected consumer services provided by ongoing firms and financed by loan guarantees, a requirement of the rural television board.
- Geographical immobility of labor. Workers may find relocating away from depressed areas to be costly; and in some situations letting loan guarantee programs preserve some industrial jobs in these struggling areas could be cheaper in social terms. These requirements were not written into any of the loan guarantee programs, but substantial pressure is often put on loan guarantee boards to weigh such considerations.
- Temporary credit dislocations. When an industry suffers a serious unanticipated shock, such as the airline industry did after September 11, 2001, there could be temporary financial distortions. There may be cash losses from airline routes temporarily put out of service. Lenders and investors may temporarily find providing

credit too risky, even to firms that later prove viable. To implement this rationale, the Congress required the airlines board to find evidence of damage due to September 11 events before granting loan guarantees.

Mere mention of these possible benefits does not, of course, prove their existence. They will typically be very subjective, with some board members seeing nonmarket benefits for particular applicants and others not seeing them. But if board members agree that nonmarket benefits are not present, the board should have no economic reason to interfere with the normal functioning of private credit markets by approving a loan guarantee.

On the cost side, the board should try to measure the present-value cost to taxpayers, or net credit subsidy, of the loan guarantee applications. This net credit subsidy is the present-value cost of all expected credit losses less the present value of all collateral, loan fees, stock warrants, and other terms of the loan guarantee deal. In contrast to the subjective nonmarket benefits, the net credit subsidy is usually more easily estimated.

Loan guarantee applications usually involve significant risk--after all, the riskiness of the prospective loans is an important rationale for the loan guarantee program in the first place. Hence the analysis must be especially sensitive to risk. The applicants must submit valid business plans for the period of the guarantee, usually five to ten years. These business plans must be analyzed under a full range of alternative scenarios for input prices, output prices, currency exchange rates, interest rates, and output demands. Any collateral offered to creditors and to the board should be similarly valued, under a similar range of assumptions. Any stock warrants, or other equity participations, should be valued according to options-pricing formulas.

The legislation for each of the four boards has been written to make the guarantees partial, so that private creditors take on at least some nonguaranteed risk. Making the guarantees partial ensures that these private creditors will subject the application to their own credit analysis. In effect, the partial guarantee ensures that applications are examined with a second pair of eyes, giving the board an independent assessment of the economic viability of the loan application.

Exactly how high the net credit subsidy should be is, of course, debatable. Different board members have different tolerances for net credit subsidies. Since an application for loan guarantee has some transactions costs, and could carry some reputational damage, the boards I have served on have seen few loan applications with expected net credit subsidies near zero. Borrowers with no required credit subsidies should be able to draw private credit without any need for a federal guarantee. At the other extreme, as the net credit subsidy rises to, say, 30 percent of the loan amount or more, the implicit probability that the borrower will default gets very high. In this range, claiming a reasonable probability that the loan will be repaid, as is required by the loan guarantee regulations, is difficult. The boards I have served on have been reluctant to approve applications with a high default risk, even in cases with some potential nonmarket benefits.

The difficult cases have fallen between these two extremes--that is, applications involving low to moderate net credit subsidies and at least some potential nonmarket benefits. In these cases, the borrower would typically not qualify for private credit, but the net social benefits of the application may outweigh the net credit subsidy. These are the cases in which benefit-cost analysis becomes critical and on which the boards have focused their energies.

Results

Membership on the four loan guarantee boards has varied (see [table](#)). At this point, the board for rural television services is just getting started, and no applications have been submitted. The oil and gas board operated in 2000 and 2001 and is now closed down. The steel board operated for these same two years and was extended for another two by the Congress. The airline board officially stopped accepting applications at the end of June 2002, but some applications are still being revised and voted on, and other loans are still in the process of closing.

In aggregate, the four boards were authorized to guarantee up to nearly \$13 billion in loans--\$500 million for oil and gas, \$1 billion for steel and \$1.25 billion for rural television. The airlines guarantee law was written differently, with the amount of federal guarantees, not loans, limited to \$10 billion. While the three fully-operating loan guarantee boards--oil and gas, steel, and airlines--have approved nearly half the applications they received, for various reasons the dollar amount of guaranteed loans approved has been significantly less than was authorized. At this point, only about 15 percent of the amounts authorized in the three programs has actually been disbursed in the form of loan guarantees, to ten successful applicants. Counting repayment probabilities, anticipated fees, collateral value, and the option value of stock warrants, the *ex ante* present value of the implicit federal subsidy for the loans that have closed is less than \$400 million, though a few more loans and applications are still in the pipeline.

Reasons for the low participation differ by industry. With oil and gas, the statute limited the program to small borrowers, below the interest level of many banks. Moreover, lenders were required to make the application, on behalf of their borrowers. Then oil prices spiked in 2000, the year when applications were submitted, improving conditions in the industry and making credit more easily available. When this happened many lenders, and their borrowers, withdrew their applications. It made little sense for oil and gas lenders and borrowers to go through the federal procedures, not particularly onerous but not trivial either, to get an unnecessary guarantee. Hence only fifteen completed applications were received, six were approved, and only three small applications closed and were eventually funded. Less than 1 percent of the federal authorization was ultimately used.

The steel board also accepted applications in 2000, also from the lenders. In this case, eleven completed applications were received; these had the potential for using up most of the federal authorization. Of this total, seven were approved. But shortly after the bulk of the proposals were submitted, the U.S. economy entered a period in which overall output growth slackened and both energy prices and the exchange value of the dollar rose sharply. These factors made for very difficult circumstances for the steel industry. Many lenders, even those sponsoring applications that had been approved by the board, decided that they could not follow through and never closed on their loan applications--testimony to the importance of the second pair of eyes. In the end, only one application closed, covering 11 percent of the federal authorization. Unfortunately, this one successful applicant, Geneva Steel, later failed and was forced to liquidate its operations. At this point the federal government has paid the lender the guaranteed portion of the \$110 million Geneva Steel loan, but the government is still trying to sell Geneva's collateral assets to recover some of these funds. The estimated *ex post* loss on this loan is not included in the *ex ante* federal subsidy cost of \$400 million mentioned earlier, though the relevant *ex ante* amount was included.

At the close of 2001 the Congress extended the steel program for another two years, with the application period being extended another eighteen months. So far in this extension period, activity has been very slow, with just two new applications, both of which were approved, and one new closing. The new closing raises the total to 15 percent of the federal authorization, and this tally could go as high as 40 percent if the last approved application closes. More than thirty other steel companies have gone into bankruptcy proceedings over the last five years. If there are further steel applications--increasingly unlikely as the deadline approaches--they will probably be in connection with chapter 11 bankruptcy restructurings designed to make the steel firms viable.

The loan guarantee program for airlines is far and away the largest, and it has generated far and away the most publicity and controversy. The program was passed in response to the terrorist attacks of September 11, 2001, and the board was open for applications through the end of June 2002. With this program the applications were to be made by the airlines, not the lenders. Despite the enormous publicity surrounding the program, only sixteen domestic air carriers decided to apply; only three of the largest eight. There were rumors that the nonapplicants were dissuaded by the terms demanded by the loan guarantee board--high fees and stock warrants.

The applications had the potential for using up 36 percent of the federal authorization. At this point, seven applications have been approved with two more pending. Five loans have closed, using up 15 percent of the guarantee authorization. Of the large airlines, applications from America West and US Airways have been approved and have closed, but the application from United Airlines was not approved. United filed for chapter 11 shortly after its application was not approved, and it could revise its application as it emerges from bankruptcy.

The low participation rates have different rationales, but they probably all suggest a common message. When all is said and done, it turns out to be difficult to produce an application that appeals simultaneously to the borrower and to the lender and yet still satisfies the rigorous legislative requirements and the board's interpretation of these requirements. In the case of oil and gas, the borrowers generally decided that they were not interested--they could get credit on reasonable terms without any federal guarantee. For steel, generally the lenders lost interest, in many cases after the board had approved the application. For airlines, few of the large ones even applied.

Overall, slightly less than half of the completed applications received by the boards were approved, and 40 percent of those eventually closed. Hence there was proportionately more attrition *after* the board approval decision than before.

Lessons

This brief experience with loan guarantee boards suggests several important lessons:

- Loan guarantee programs cannot save failing industries. Enthusiastic proponents of loan guarantee programs seem to believe that improved access to credit markets is the cure for entrenched industrial problems. But often the lack of access to credit markets is itself caused by serious industrial difficulties. If the business plan of an applicant just cannot be made to show a profit under reasonable economic assumptions, private lenders are unlikely to be interested in making new loans. If the application involves a high net credit subsidy and a low prospect of repayment, the loan guarantee board is

unlikely to be interested in extending a guarantee. Hence, sensibly administered loan guarantee programs may not result in much lending activity, may not forestall many bankruptcies, and are unlikely to save sick firms or industries.

- Loan guarantee boards are not good vehicles for dealing with immediate emergencies. Loan guarantee boards have been given fiduciary constraints and must analyze proposals carefully. The thoroughness of the evaluations that loan guarantee boards and private lenders must undertake means that decisions cannot be made quickly. If an immediate emergency looms for an industry, loan guarantees are unlikely to be dispensed rapidly enough to deal with the emergency.
- Lower rhetoric about loan guarantee boards is in order. When the loan guarantees were first passed, many supporters viewed them as salvations for the industry, and many in the opposition felt that the future of market capitalism was gravely threatened. Neither stance is realistic. On the one side, as just mentioned, loan guarantees cannot be salvations if the underlying industry economics are not favorable. Credit access alone cannot cure many industrial difficulties, the second pair of eyes limits private lender participation, and the fiduciary requirements of the government are rigorous.

On the other side, fiduciary standards and other requirements of the loan guarantee boards do not seem to threaten market capitalism either. Some new lending activity has occurred, and some firms have been kept alive by the guarantees; but in general the number of firms kept alive is small compared with the number that have gone into bankruptcy proceedings without a guarantee. The normal market adjustment processes in the steel and airlines industries do not seem to have been impeded by loan guarantees, though these market adjustments may have been cushioned.

- Having independent boards is a sensible approach. The boards I have served on were insulated from the normal lobbying processes. This separation has kept the approval process on an analytical level. The boards have imposed reasonably arduous standards, but certainly not overly arduous standards, and have approved nearly half the total number of applications. More attrition occurred after the board approval process than before.

Of course the board can misuse benefit-cost analysis and mis-estimate critical values. But every decision I have participated in has been based on analytical considerations, and none has later been overturned politically.

Conclusion

How this overall experience should be assessed is still debatable. The loan guarantee approach might be described as middle-of-the-road--more intrusive than just relying on private lenders to allocate credit but less intrusive than giving industrial handouts or bailouts. The boards have been set up to contain political considerations, and they seem to have been reasonably successful in doing that. They have limited taxpayer costs. They have tried to make decisions on the basis of underlying economics, keeping nonmarket benefits firmly in mind.

The steel and airline boards have operated at a time of serious difficulties for their respective industries. The boards have not prevented a number of bankruptcy filings in these industries. They do not seem to have impeded normal market adjustment processes, but they may have cushioned these processes. Ten firms have been approved for loan guarantees, and nine of them are still operating. Whether these nine ultimately generate sufficient nonmarket benefits to compensate for their taxpayer costs remains to be seen.

Membership on Loan Guarantee Boards

Agency	Oil and Gas	Steel	Airlines	Rural Television
Federal Reserve	Chair	Chair	Chair	Member
Treasury	--	--	Member	Chair
Commerce	Member	Member	--	Member
Transportation	--	--	Member	--
Agriculture	--	--	--	Member
Securities & Exchange	Member	Member	--	--

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