

FOR RELEASE ON DELIVERY

Statement by

David M. Lilly  
Member, Board of Governors of the Federal Reserve System

Before the

Subcommittee on Economic Stabilization  
of the  
Committee on Banking, Finance and Urban Affairs  
of the  
United States House of Representatives

Wednesday, March 30, 1977

I appreciate the opportunity to appear before you this morning to discuss Federal Government loan guarantees. I would like to say at the outset, that I am not an expert on the wide range of specific guarantee programs. I intend, therefore, to focus my remarks on the general question of the economic implications of loan guarantees and the treatment of such guarantees in the budgetary process.

The volume of guaranteed loans has been rising rapidly in recent years, reflecting growth under longstanding programs as well as the introduction of additional programs established to foster a variety of new public policy objectives. Congress has also been deluged of late with proposals that would further expand existing guarantee programs or would involve the use of the Government's guarantee of loans for a number of new purposes, particularly in the energy field. These developments clearly point to the need for Congress to make a thorough assessment of the public policy implications of programs that utilize the Federal Government's credit standing and to improve procedures for evaluating and accounting for such programs.

As you noted in your letter, the character of the Government's loan guarantee activities has been changing. Old, well-established programs generally have involved the provision of a guarantee on relatively small loans in the agricultural, mortgage, or small business areas. Under these programs, risk has been spread among a large number

of borrowers and over a wide geographical area, and default rates have proven to be low and fairly predictable. In the case of FHA Section 203b insured mortgages, as an outstanding example, premiums charged for this insurance have more than covered all losses to date.

Most of these older programs were established to remedy imperfections thought to exist in the private credit markets that resulted in a smaller flow of credit into certain uses than seemed warranted by underlying economic circumstances. Such imperfections were attributed to lenders' inability to pool large amounts of risk, their lack of knowledge about the characteristics of borrowers, and/or their reluctance to innovate new lending terms. It was, in part, to acquaint lenders with new opportunities that these programs were administered in ways that involved the private sector in the origination, servicing and even coinsurance of loans. This strategy has often succeeded. In the home mortgage area, for example, an active and expanding private sector has increasingly assumed the risk taking functions originally performed by the Government.

Many of the loan guarantee programs established more recently have been quite different in nature. They have involved the use of the Government's guarantee of loans to underwrite spending that has been judged to yield desirable social objectives, but which may offer only indifferent prospects of being financially successful. Programs such as student loans and assistance for low and moderate income home buyers, for example, would appear to involve a sizable element of risk

to the Government and subsidy to the recipients, since the full repayment of these loans is recognized to be uncertain.

Other newly proposed programs would involve use of loan guarantees to aid in the financing of projects, particularly in the energy area, whose exceptionally large size relative to the borrowing unit virtually precludes private lenders from providing funds on an unassisted basis. Also, in some cases, there is considerable uncertainty as to the feasibility of the technology to be used or as to whether the economic conditions likely to prevail in the future will justify the undertaking. Thus, in these instances, the Government would incur a contingent liability whose size while unknown can be presumed to be quite large.

Moreover, even though such programs are to be authorized in the form of loan guarantees, private involvement in a large percentage of them is likely to be modest, because the Federal Financing Bank probably will originate, service, and hold the great bulk of these loans. As you know, since it began operating in 1974, the FFB has not only made direct loans to Government agencies, but has acquired a substantial volume of Government guaranteed loans as well. There is, in any case, little substantive difference between a direct loan and a guaranteed loan held by a private borrower in which risk of failure to repay is assumed by the U.S. Government. The FFB's acquisition of guaranteed loans further blurs this distinction, however, and in effect converts guaranteed loans into direct loans.

There are, however, clear advantages gained when the Federal Financing Bank acquires guaranteed loans. Such acquisitions serve to consolidate and bring order to the process of issuing Government guaranteed debt instruments. Potential disruptions to the functioning of securities markets that could be caused by numerous public sales of guaranteed security issues are thus avoided. In addition, the FFB loans funds which it has borrowed from the Treasury, and it is therefore able to hold the interest rates it charges to levels that are just above the rates the Treasury pays when it borrows in the market. Guaranteed loans, when placed in private hands, normally carry interest rates significantly higher than rates on Treasury securities of similar maturity, because such loans lack the liquidity of direct Treasury issues. The savings realized by what, in effect, amounts to the substitution of direct Treasury debt for guaranteed loans can accrue either to the borrower through lower interest charges, or to the taxpayer if a fee is levied on the guaranteed loan.

Concerns have been expressed in some quarters that the advantages offered by the FFB may be encouraging growth of guaranteed loans. In my view such concerns are perhaps misdirected. I would prefer to attribute the growth of such loans to the way they have been treated in the budgetary process. As you are well aware, the exclusion of loan guarantee programs from the regular appropriation process eases their initiation and impedes their subsequent control. The amount of guaranteed loans does not appear in functional categories of the budget, and some individual guarantee programs extend over many years, with little periodic zero base

review or control other than overall limits set by Congress. Moreover, new loan guarantee programs have little or no impact on current budgets. There is no formal mechanism in many programs for establishing reserves when loan guarantees are made in order to cover defaults that might occur while the loans are outstanding. Instead, losses on guaranteed loans are reflected in the budget at the time they occur.

Loan guarantee programs also impose other costs on the taxpayer. In some guarantee programs, such as guaranteed student loans, subsidies are provided explicitly to those receiving guarantees. In addition, there are programs in which the cost of processing loan applications and servicing loans are borne by the Government. Loan guarantees also tend to raise the amount of interest that must be paid on the national debt. This occurs because instruments bearing the full faith and credit guarantee of the Federal Government are viewed as close substitutes for direct Government debt by many investors, and the competition from such instruments might tend to increase the cost of the Treasury's own debt financing operations.

Loan guarantees also have other significant effects on the economy which are difficult to quantify and almost never find their way into budgetary discussions. These effects are the shifts in resource allocation patterns caused by the operation of loan guarantees. The principal reason for loan guarantees, of course, is to redistribute credit to favored sectors so as to stimulate production of particular types of goods or services. In the case of many programs, the credit provided finances activities that would not otherwise have been undertaken.

Many of the programs proposed for energy developments, for example, are of this latter type. In the case of other programs, guaranteed loans may not produce an equivalent increase in spending in the area because funds might be shifted by the borrower from one use to another or because credits obtained under a guarantee may simply replace borrowing that would have otherwise occurred. But even in these latter cases, it seems quite likely that the reduced cost of finance induces some additional outlays.

While loan guarantees generally result in a net increase in credit used to finance selected types of expenditures, it must be stressed that coincidentally the volume of funds available for loans to borrowers not favored by such programs tends to be diminished and the cost of these funds may be raised. As a result, the additional spending on projects backed by loan guarantees will be offset to some extent by reduced expenditures for other purposes.

To sum up then, loan guarantees, as well as other forms of Federal credit assistance, make funds available to finance certain types of spending that have been deemed through the legislative process to be of high social value. These funds are not provided without cost, however. Defaults on guaranteed loans result in a direct drain on the Treasury's tax revenues, and there are other types of attendant costs including the higher interest rates on Treasury debt caused by enlarging

the supply of securities carrying the full faith and credit of the Federal Government.

Recognition that loan guarantees are not costless or without side effects does not necessarily lead to the conclusion that such programs should be eliminated. But it does highlight the need for careful evaluation of the relationship between their benefits and costs. I do not believe this is being done adequately at present, since budgetary procedures do not establish for Congress a suitable framework for making such assessments.

While there is widespread agreement that reforms in the budget treatment of credit programs are desirable, there is little consensus on what a revised budget should contain. Some budget authorities have argued that all the credit activities of the Federal Government should be incorporated in the unified budget. Under this approach, outlays would include all loan contracts guaranteed by the Government and its agencies as well as all direct loans. The budget would then measure the increase in the actual and potential financial liability of the Government, thereby providing a comprehensive accounting of the Government's involvement in the credit markets.

An all inclusive budget would also focus attention on the total resource allocation effects of Government activity. Congressional Committees responsible for various functional areas of the budget would be better able



to consider Federal credit programs in tandem with taxation and expenditure programs. Thus, judgment on the advisability of adopting alternative approaches to achieving budgetary goals would be improved and a better understanding of the overall impact of the Government on the economy would be obtained.

An alternative approach to the budgetary treatment of credit activities would be one in which Federal credit extensions, whether involving direct loans or guaranteed loans, would be excluded from the unified budget and kept track of in a separate set of accounts. This approach has been recommended by analysts who emphasize the difference between outlays that involve the acquisition of financial assets, on the one hand, and purchases of goods and services or transfers of income on the other. In the former case, the Government receives a claim on a borrower as an offset to its provision of funds; in the latter it does not.

By affording similar status to direct and guaranteed loans and carrying them in a separate loan account, this approach would also highlight the Federal Government's impact on the credit allocation process. At the same time, the unified budget would conform more closely to a business firm's statement of income and expense. Loan transactions under this approach would not be reflected in the unified budget except to the extent that defaults and/or subsidies on these loans give rise to outlays. In a proper accounting scheme, of course, these types of costs should enter the budget on an accrual basis when the potential liability is incurred, rather than on a cash basis at the time of default. To implement this



procedure, Congress would have to estimate the potential for defaults on loans made in any year, and then appropriate sufficient funds to be held in a reserve account to cover the defaults as they occur.

Requiring current estimates of eventual costs to taxpayers might well produce a more careful appraisal of various Federal credit proposals. But the difficulties that would be encountered in making these estimates would be substantial, especially in the case of programs instituted or proposed more recently that involve large elements of unknown risk. Yet, it is clear that some estimates, however tenuous, would be preferable to current practice which in general ignores possible future costs of such programs.

The need to distinguish between Federal credit programs and other expenditures was recognized by the 1967 Presidential Commission on the Budget. Specifically, with respect to direct loans the Commission advised that while such transactions should be placed in the comprehensive budget, they should be set apart from other outlays. Such a different treatment was advised in order to permit the calculation of an expenditure account surplus or deficit and to facilitate analysis of the impact of direct loans. The Commission also recommended that subsidy elements in direct loans should be estimated and reflected in expenditure accounts.

With regard to the budgetary treatment of loan guarantees, the Commission offered no specific recommendations because it had not had time to study this question sufficiently. It indicated, however, that coordinated surveillance of direct and guaranteed loans was desirable

and that a summary should be prepared along with the budget, setting forth amounts of guaranteed and insured loans outstanding as well as direct loans.

In adopting the Unified Budget concept in 1968, the President accepted the Commission's recommendation to include direct loans in the budget. The recommendation to delineate between loan disbursements and other outlays was also adopted initially but this practice has been abandoned in recent budgets. Also, the recommendation for estimating subsidy elements was introduced in only a very few instances. Over the years, greater attention has been brought to bear on loan guarantees, as they have been reviewed in some detail -- along with direct loans -- in a chapter of the Special Analysis document that accompanies the budget. This approach, however, is obviously no substitute for one that would require consideration of Federal credit programs in the formal budget process, and it was disappointing that the Budget Control Act of 1974 did not mandate such treatment.

The problems of budgetary management of Federal credit programs under review by this Committee are obviously as complex as they are important. Careful study and deliberation will be required before a comprehensive budgetary system can be derived that will best serve the various needs of the Congress. I will not attempt to offer specific recommendations for a program that might best serve these objectives, but I would like to mention several points that I believe deserve careful consideration in your deliberations.

First, if it is decided to continue including the direct loans of government-owned agencies in the budget, it seems clear to me that all such loans should be so treated. In this regard, last year's Congressional decision to return the Export-Import Bank to the Budget was a salutary development. Similar treatment, I believe, should be considered for other agencies, including the Federal Financing Bank. There is no difference in substance between a direct Federal loan and a loan that is guaranteed by a Government agency and acquired by the FFB. If one type of loan is included, then so should the other.

A problem that could very well arise from including the FFB in the budget, however, is that its lending and investing operations could become an easy target for those wanting to make pseudo cuts in the budget. In that case, the financing of loans guaranteed by Federal agencies might tend to be shifted back to the piecemeal and costly approach that prevailed prior to the initiation of the FFB. Accordingly, any changes in the budgetary status of the FFB would have to be accompanied by other measures that prevent the loss of the cost saving benefits which are provided by the FFB. Perhaps, legislation could be enacted that would require agencies to place certain types of loan guarantees exclusively with the FFB. This point clearly would need detailed exploration.

Second, should the decision be made to continue to keep privately-held loan guarantees off the budget, it is imperative that

steps be taken to achieve more effective Congressional surveillance and control of these programs. At a minimum all such loans should be included on a separate line in the concurrent budget resolution. This highlighting of the total of Government-loan guarantees will provide both the Congress and the public with a more complete picture of the Government's involvement in the economy.

Congress should also establish rules requiring reconsideration of each loan guarantee program on a yearly basis. In carrying out this task, I would further advise the initiation of zero base budgeting; that is, Congress should ask whether a program continues to be necessary before it decides to continue and expand it.

Finally, Congress should require the formulation of estimates of the potential defaults on loans that have been guaranteed and should make provisions for these losses in the budget by setting up reserve accounts. Such reserves are not needed for direct loans or guaranteed loans held by Government agencies, if they are already reflected as outlays in the budget.

In concluding, I would like to say that we at the Board regard the passage of the Congressional Budget Act, and its implementation in the past two years, as a major advance in the interests of sound budget management. The reforms in the treatment of Federal credit programs and loan guarantee programs which may result from the efforts of this Committee would constitute an additional substantial step toward this important goal.