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Statement of the

Shadow Financial Regulatory Committee

on

Proper Financing of Private Party Securities Fully Guaranteed by the Federal Government

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Federally-guaranteed securities proliferated in the early 1970s when a number of federal agencies (e.g., Department of Ariculture, Defense, Housing and Urban Development, General Services Administration, Small Business Administration), in order to escape budget constraints on their lending programs to private parties, began to guarantee the loan obligation of such parties, rather than lend them money directly.[1]

Typically, these private party obligations, which carried the full faith and credit of the United States, were sold in cooperation with the agencies by underwriters in the public market at interest rates considerably higher than ordinary Treasury obligations, their credit equivalent.

In response to a mounting flood of this costly form of federal financing, the Congress in 1973 created the Federal Financing Bank (FFB) with the U.S. Treasury Department. In general,[2] all private party securities fully guaranteed by

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1 Federal government budget conventions require recording the entire amount of a government loan as a cash expenditure, or "outlay," of the current period. When loan repayments are made to the government in the future, they are recorded as "negative outlays" of that period. By contrast, loans guaranteed by the federal government do not give rise to "outlays" at all unless a payment is made under the guarantee. The Committee believes that the recording of the entire amount of a federal loan as an "outlay" is misleading, and that only the present value of the subsidy inherent in the loan, together with reserves from any losses expected, should be recorded as current expenditures. (The Committee recognizes that such a convention leads logically to the use of the type of structure for the federal budget sometimes referred to as a "capital budget." Thereunder, the principal amount of a loan would be recorded as an asset acquistion rather than a current expenditure.)

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2 Notably excepted, among others, were the fully government-guaranteed mortgage pool securities of the Government National Mortgage Association (Ginnie Mae).

the federal government were thereafter required to be sold to the FFB, which, in turn, would fund the securities through ordinary Treasury financing, thereby passing the benefit of Treasury's low cost borrowing to the private parties. For years, the FFB thus efficiently financed federal credit programs. The disbursements made by the FFB, however, were not recorded as budget outlays. This budget treatment was agreed to because it was effectively the same as had existed before the FFB, when such government-guaranteed obligations were sold in the open market; the political tradeoff for creation of the efficient FFB financing mechanism was its off-budget status. Thus, federal agencies through their private party loan guarantee programs were still able to channel substantial resources to their constituencies without increasing stated government expenditures.

In 1986, after thirteen years of off-budget treatment, the Gramm-Rudman Act mandated that the disbrusements of the FFB be recorded as budget outlays and charged to the agencies which fully guaranteed the private party securities funded by the FFB. Accordingly, federal government expenditures now include the very sizable agregated disbursements formerly made "invisible" through FFB off-budget Treatment.

Unfortunately, this change in accounting treatment has led recently to a return to pre-FFB open-market financing by federal agencies. Under the pressures of Gramm-Rudman, Congress, having put the FFB outlays on budget, is now ordering that the fully government-gauranteed loans of certain private parties by financed once again in the open market to keep them off-budget. Examples of measures along these lines enacted by the last Congress include legislation which:

* requires two billion dollars of fully government-guaranteed rural electric cooperative loans to be sold in the open market, rather than to the FFB.

* requires several hundred million of fully government-guaranteed small business investment company debentures to be sold in the open market, rather than to the FFB.

* requires approximately two billion dollars of fully government-guaranteed agricultural loans to be sold in the open market, rather than to the FFB.

Thus, to reduce the apparent deficit, sound federal financing policy is being sacrificed. (Ironically, the inefficiencies and increased costs of these financing programs will cause the true value of the deficit to become even greater.) When the Congress returns, it seems likely that there will be a renewal of these misguided efforts.

The Committee urges that all federal credit programs be funded through Treasury financing rather than through the inefficient method of open-market sales, as separate and distinct securities, of fully federally-guaranteed private party loans (or their inventive functional equivalents, such as pledgeable federal financing leases with private parties, federal agreements to buy back defaulted private party securities or to make up deficient private party debt service, and so forth).

In this spirit, we encourage Congress and the Administration to contest vigorously any future efforts to undermine this principle. In particular, the Committee objects to legislation of the kind passed in 1986 which mandates sale of fully federally-guaranteed private party obligations in the public market rather thn to the FFB. The FFB, or its equivalent, should be preserved in essentially its present character, with its use required for private party fully guaranteed obligations. Legislative "quick fix" attacks on the FFB concept under Gramm-Rudman pressures for deficit reduction will only add to the true cost of financing government programs.