



BUDGET BULLETIN

SENATE COMMITTEE ON THE BUDGET
CHAIRMAN MIKE ENZI | @BUDGETBULLETIN

114th Congress, 2nd Session: No. 17

September 15, 2016

Accounting for Federal Credit Programs

In This Issue:

FCRA vs. Fair-Value Accounting

Broad Budgetary Impacts

Case Study: Federal Student Lending

by Peter Warren, Director of Oversight and Senior Analyst

FCRA vs. Fair-Value Accounting

Accounting drives policy. In the private sector, accounting approaches used by public companies shape their quarterly earnings figures, influencing investor valuation as reflected in stock prices. Similarly, in the federal government, how spending and revenues are presented in the federal budget influences cost estimates (“scoring”), deficit projections, and ultimately policy decisions.

Federal credit programs – such as Federal Housing Administration home loan guarantees, direct student loans and loan guarantees, and Export-Import Bank loan guarantees – have long been used as a form of government subsidy, alongside grants and income-transfer programs.

Before 1990, the government presented virtually the entire federal budget, including credit programs, on a cash-flow (dollars entering and exiting the Treasury) basis. This method tended to skew decisions about use of government credit. The lifetime cost of most loans and loan guarantees was obscured, since cash-flow impacts beyond the budget window were omitted. In addition, a new federal loan guarantee initially appeared to be free, while the entire principal amount of a government-issued loan appeared as an expense in the year the loan was originated.

Eventually, these problems led Congress to overhaul the accounting rules for federal credit programs. As part of the Budget Enforcement Act of 1990, Congress added a new title to the Congressional Budget Act of 1974, title V, cited as The Federal Credit Reform Act of 1990 – commonly known as FCRA.

FCRA accounting is necessarily more complex than cash-flow accounting, since it requires in the year in which a federal direct loan is originated or a federal loan guarantee is made that the budget record the ultimate cost of that credit activity to the Treasury on a net-present-value basis. Thus, the entire projected lifetime cost of the credit is presented in year one, requiring an agency administering a credit program to estimate the final cost by projecting a myriad of future events, including interest rates and future-year repayments (and non-repayments) of loan principal and interest.

A trade-off with FCRA, then, is sacrificing the near-term certainty of cash-flow accounting in order to attain a more realistic, albeit imperfect, portrayal of the long-term cost of federal credit. In bringing forward the cost of long-term credit, FCRA requires a determination of the present value of projected Treasury cash flows, such as borrower repayments to the Treasury and Treasury payments to lenders for guaranteed loan defaults. On this point, the FCRA authors in Congress directed the scorekeepers at the Congressional Budget Office (CBO):

In estimating net present values, the discount rate shall be the average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made.

CBO and the Office of Management and Budget (OMB) interpret this FCRA language as requiring them to use Treasury borrowing rates as the government's discount rate (the valuation of future cash flows) in determining the cost of federal credit programs.

Since before FCRA's enactment, CBO officials and many economists have argued that the use of Treasury rates understates the cost of federal credit. A private lender's cost of credit rises based on the riskiness of the loans extended. Due to the uncertainty of repayment, the lender needs to set aside appropriate reserves and prepare for extraordinary default scenarios. That is why private lenders making loans to individuals or corporations with no credit history charge relatively higher interest rates than they would to individuals or entities with sterling credit. But under FCRA, the cost to the government of financing the credit is the same regardless of the riskiness of the loan.

CBO and other proponents of fair-value accounting – a market-based method – believe that the federal government cannot finance risky loans more cheaply than the private sector. The government can transfer the risk of higher-than-expected defaults to taxpayers, who would ultimately absorb the cost, but that is not the same as eliminating the risk. Thus, CBO argues that for budgetary accounting purposes the government's discount rate in extending risky credit should be considered to equal the existing market rate applicable to a private lender choosing to extend credit to the same parties on the same terms the government is offering.

CBO has argued for fair-value accounting for years. For instance, in its March 2012 issue brief titled "Fair Value Accounting for Federal Credit Programs," CBO asserts:

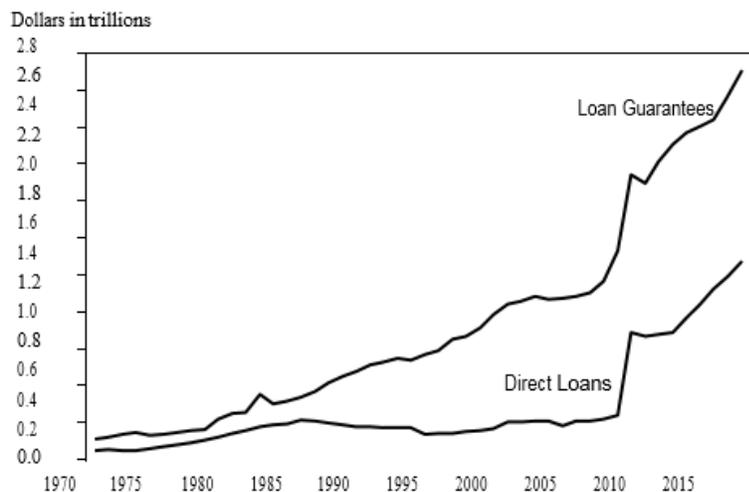
FCRA-based cost estimates... do not provide a comprehensive measure of what federal credit programs actually cost the government and, by extension, taxpayers.... because FCRA estimates use Treasury interest rates instead of market-based rates for discounting, FCRA estimates do not incorporate the cost of the market risk associated with the loans.... In the view of the Congressional Budget Office (CBO), adopting a fair-value approach would provide a more comprehensive way to measure the costs of federal credit programs and would permit more level comparisons between those costs and the costs of other forms of federal assistance...CBO's view is that the cost of risk is a real cost to the government that is relevant for budgeting as well as for cost-benefit analyses.

Broad Budgetary Impacts

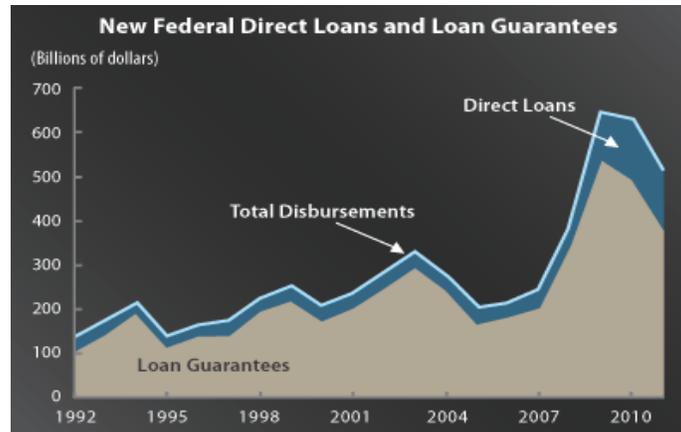
The impact on the broad budget of FCRA's requirement that scorekeepers use a risk-free discount rate to value federal credit activity is a function of two factors: the volume of federal credit extended and the riskiness of that credit.

Federal credit activity has increased dramatically in recent decades, as illustrated in Figure 1 below. At the close of fiscal year 2015, there was \$3.5 trillion in federal credit outstanding (\$2.3 trillion in guarantees and \$1.1 trillion in direct loans). A surge in credit activity during the recent fiscal crisis caused the extension of new credit to double between fiscal years 2008 and 2009, as shown in Figure 2 on page 4. Although new credit issuance has declined somewhat since, it remains far above pre-crisis levels, and outstanding volume of guarantees and direct loans continues to climb annually.

FIGURE 1:
Face Value of Federal
Credit Outstanding



Source: OMB, FY 17 Budget, Analytical Perspectives

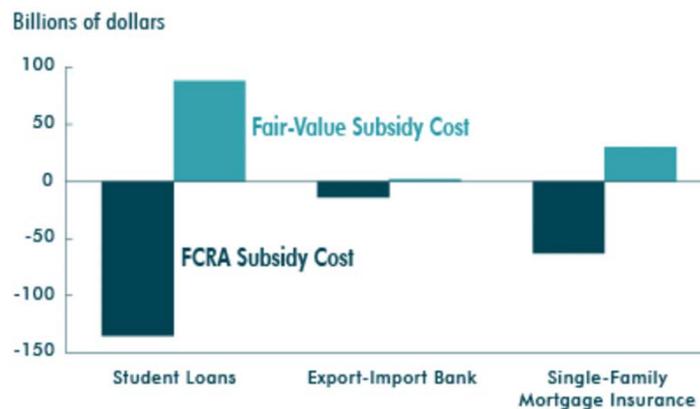
FIGURE 2:

Source: CBO website

A May 2014 CBO report finds that the budgetary impact of using a risk-free Treasury rate instead of a fair-value discount rate varies depending on the volume and risk level of specific federal credit programs. CBO assesses the budgetary cost over the 10-year budget window of three federal credit programs, including the two largest – FHA single-family mortgage insurance and direct student loans. While FCRA accounting (and thus the official CBO baseline) indicates these programs would save the federal government \$212 billion over the next decade, CBO’s substitution of a fair-value discount rate yields a collective \$120 billion cost over the same period – a difference of \$332 billion.

FIGURE 3:

Estimated Total Budgetary Costs of Selected Federal Credit Programs Under FCRA and the Fair-Value Approach, 2015 to 2024



Source: CBO website

Case Study: Federal Student Lending

The federal government began issuing guarantees on privately financed loans to college students under the Higher Education Act of 1965. A quarter-century later, FCRA's 1990 enactment made federal direct lending financially feasible. Consequently in 1992, the year in which the FCRA accounting rules took effect, the Treasury began lending directly to students on a pilot basis. The direct-lending program continued to expand, and in 2010 the government ended its pre-existing student loan guarantee program.

Since FCRA's enactment, student lending has grown as a share of the federal credit portfolio; currently, the government originates more than \$100 billion in direct student loans annually. According to the Government Accountability Office's *Financial Report of the United States FY 2015*, the more than \$1 trillion in federal student loan receivables now represents the government's largest asset, and 31 percent of all federal assets.

Significantly, CBO's 2014 report projects that federal student loans issued over the next decade will cost \$88 billion under fair value, compared with the \$135 billion savings assumed in the FCRA baseline – a \$223 billion discrepancy.

Two policy implications follow:

First, while FCRA accounting incentivizes the expansion of federal student lending by achieving budgetary savings, fair-value accounting would have the opposite effect, since the budgetary burden imposed by the program would need to be weighed against the benefits.

Second, within the sphere of federal student aid, a fair-value baseline would require policymakers to re-weight the cost and benefit of student loans against other forms of student aid, such as grants.

An illustration is the existing policy debate over whether to cap or eliminate Graduate student PLUS loans ("Grad PLUS"), which currently are not subject to an annual or aggregate limit. Uncapped federal borrowing has been linked to rising tuition costs. Under the current FCRA baseline, however, curbing Grad PLUS lending volume has a budgetary cost. Not so under fair value. The published March 2016 [CBO fair-value baseline for Grad PLUS](#) projects that the loan cohort issued in fiscal year 2017 will cost 8.4 cents per dollar loaned. This means that under fair value, a reduction of \$1 billion in Grad PLUS volume next year would save \$84 million dollars. Alternatively, it could serve as a budget-neutral offset for an \$84 million hike in Pell Grant aid.