S. HRG. 114–83

THE ECONOMIC EXPOSURE OF FEDERAL CREDIT PROGRAMS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

JUNE 17, 2015

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PUBLISHING OFFICE

95–375 WASHINGTON : 2015

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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WEDNESDAY, JUNE 17, 2015

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Dan Coats, Chairman, and Mike Lee, presiding.

Representatives present: Schweikert, Grothman, Carolyn B. Maloney of New York, Delaney, Adams, and Beyer.

Senators present: Coats, Lee, Cotton, Sasse, Klobuchar, and Heinrich.

Staff present: Connie Foster, Harry Gural, Colleen Healy, David Logan, Viraj Mirani, Barry Nolan, Leslie Phillips, Sue Sweet, Jim Whitney, and Phoebe Wong.

OPENING STATEMENT OF HON. DANIEL COATS, CHAIRMAN, A U.S. SENATOR FROM INDIANA

Chairman Coats. The Committee will come to order.

The Committee today will examine the economic exposure of Federal credit programs. I would like to thank our witnesses for being here. We will be introducing them shortly.

As I begin, I want to thank Senator Mike Lee for agreeing to spearhead this program. He helped with us in terms of putting all this together and inviting the witnesses. He will be here very shortly.

I have a conflict and have to be on the Senate floor. I apologize to the witnesses and my Committee members here that I have to do this, but I will put it in the capable hands of Senator Lee to conduct this hearing.

He has played a leading role in raising attention to this issue. As I have indicated, he and his staff have helped us in putting together the hearing, including identifying some of our witnesses.

Today we will examine why accounting for our federal assets matters, and why inaccurate monitoring can bring economic harm to borrowers who pay higher interest rates to cover the defaults of others, private lenders who are frozen out of the markets they seek to serve, and taxpayers who may be exposed to unqualified losses.

During my prior service in the Senate, I was one of the nay votes for the Omnibus Budget Reconciliation Act of 1990. Twenty-five years later, I never imagined that I would be chairing a hearing to debate the impact of accounting rules passed back then.

This situation reminds me of an old Yogi Berra quote, "The future ain't what it used to be." The 1990 Reconciliation law included the Federal Credit Reform Act, accounting rules crafted in reaction to the rocky credit history of the 1980s.

The Resolution Trust Corporation held the assets of failed savings and loans and put the Federal Government in the loan-workout business. Sadly, fraudulent student loans made during the decade, that decade, led to a 20 percent student-loan default rate and a loss equal to almost 10 percent of outstanding loans.

Cash accounting for all these asset changes within a budget year presented a volatile picture of the Federal budget that properly represented spending trends. Since then, the Federal Government has followed the rules of FCRA, recording an annual present-value adjusted, quote, "subsidy cost" to account for losses it may incur in the future charged against loans it has made directly, as well as guarantees it provided for loans made by others.

It took 10 years to refine the complicated net present value calculations used for FCRA, but by 2002 government accountants calculated that the federal portfolio of $1.3 to $1.4 trillion in loans and guarantees generated annual subsidy costs in the range of $5 to $12 billion.

This brings us to the financial crisis of 2008 which ballooned the government's loan assets. FCRA's accounting rules converted loan subsidy costs into deficit reducers. Since 2008, government accountants have booked nearly $200 billion in annual subsidy gains while the amount of federal loans and guarantees has more than doubled.

As a result, it is clear that the more credit market exposure the government takes on, the more that expectations of future revenue rise under the current accounting rules without equal accounting for higher risk.

At the end of September 2014, loans made or fully guaranteed by the Federal Government totaled over $2.9 trillion. This includes $1.1 trillion in student loans. The Federal Reserve reported that nonmortgage consumer debt totaled $3.3 trillion as of September 30, 2014, giving the Federal Government a one-third share of the U.S. consumer loan market.

Add that to the 70 percent of the mortgage market that the Federal Government holds through direct loan guarantees and Fannie Mae and Freddie Mac, and the Federal Government is the largest consumer lender in the country.

A lot has changed in those 25 years. So today we must ask ourselves: Do accounting rules passed 25 years ago reflect the complexity of today's financial world?

I would now like to recognize Ranking Member Maloney for her opening statement, and just before I do I want to hand over this gavel. When I first got a gavel in my hand I thought, wow, I can get something done here.

So, Mike, be careful. Don't take us past the jurisdiction of the Committee. It would be tempting, but I am putting this in very capable hands. And thank you for heading up this hearing. But first, let us hear from Senator—I mean, Congresswoman Maloney.

And then after you give your opening statement I would ask you to introduce the witnesses and take care of the hearing.

Senator Lee [presiding]. Right.

[The prepared statement of Chairman Coats appears in the Submissions for the Record on page 28.]

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, RANKING MEMBER, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Maloney. Thank you so much, Chairman Coats, for holding this hearing. And I thank all of our panelists for being here today.

In this morning's hearing we will compare two systems for budgeting federal credit programs. The first, the Federal Credit Reform Act of 1990—so-called FCRA—was signed into law by George H. W. Bush in 1990. It has proven a reliable tool for budgeting federal credit programs.

The second, so-called "Fair Value Accounting," is a program supported by some of my colleagues in the Republican Party that will make federal credit programs seem more expensive. If implemented, this system will necessitate cutting loan programs, or raising interest rates. In my mind, there is nothing fair about "Fair Value Accounting."

At its root, today's hearing is about two vastly different philosophical approaches to government. My Republican friends believe that the Federal Government, in this case federal lending programs, should operate just like the private sector. But the Federal Government is not the private sector. The principal motivation of the private sector is to maximize profit.

The principal role of government is to provide services that the private sector cannot or will not provide. These differences are especially clear in federal lending programs.

Private institutions make loans that they think will be the most profitable. But the United States Government sees things differently.

For example, it lends to a group of individuals with little or no income and no credit history. They are known as "college students." And there are more than 20 million of them in the United States today.

The vast majority of student loans are issued or guaranteed by the Federal Government. Why does the government take on this risk? Because it helps millions of Americans go to college who might otherwise not be able to afford to go.

It also benefits the rest of us by creating a more educated workforce. A better workforce will make our country more competitive, and will make our economy stronger and our country stronger. This is a social good not recognized by private lenders.

I want to turn to the specific question of how we measure the cost of Federal Government loan programs. How these programs are accounted for and how their budget impact is assessed will affect the broader deficit outlook in choices we make as policymakers.

The current procedure under the Federal Credit Reform Act appropriately calculates the lifetime costs of federal credit programs, reflecting both the risk of default and the government's cost of borrowing.

FCRA has been very accurate. OMB found that in the more than 20 years that FCRA has been in place, the initial cost estimates of all credit programs differed from their actual costs by less than one percent of their face value. As they say: If it ain't broke, don't fix it.

But today we are apparently trying to fix a system that already works very well. It is part of a broader ideological initiative. In tax policy Republicans are trying to change the rules of the game by instituting so-called "dynamic scoring." This would make tax cuts seem less expensive than they really are.

In federal credit policy, Republicans are trying to change the rules of the game using an accounting system that will make programs like student loans look more expensive. The result of this so-called fair value accounting will be cuts in federal loan programs. For example, less money available for students at higher interest rates.

Under fair value accounting, the cost of federal credit programs, which are funded by the purchase of low-interest Treasury Securities, would be evaluated as if they were forced to borrow with an additional risk premium demanded by the private sector.

As the Center on Budget and Policy Priorities put it, fair value budgeting requires that the budget, quote, "reflect amounts that the Treasury would never actually pay anyone," end quote. It will make federal lending programs appear more costly than they really are.

Millions of Americans have something to lose if proponents of this accounting system have their way. I regret that we don't have any of their representatives on the panel today. However, Chairman Coats and I have received letters from a number of organizations that strongly oppose the fair value accounting system. I have a stack of them here (indicating), and I have a letter with me right now from the National Education Association which states, and I quote:

"NEA opposes the use of fair value accounting in federal credit programs, especially student loan programs, because it would artificially raise their costs and make them appear to be more expensive to the Federal Government than they really are." End quote.

I ask unanimous consent to place this letter into the record.

Senator Lee. Without objection.

[The letter appears in the Submissions for the Record on page 29.]

A letter from the National Association of Home Builders states, and I quote, "Fair value accounting would artificially raise the rates on home loans." And I would also like to enter that letter into the record.

[The letter appears in the Submissions for the Record on page 31.]

Other organizations also oppose using fair value accounting for budgeting purposes: The National Association of Realtors, the National Association of Independent Colleges and Universities, The Retired Enlisted Association, The National Rural Electric Cooperative Association, The Student Aid Alliance, The National Multifamily Housing Council, and many, many others, and I would like to place these letters that I just mentioned into the record.

[The letters appear in the Submissions for the Record on page 34.]

Representative Maloney. In conclusion, I ask that we listen to both sides of the debate today, but that ultimately we not let ideology trump reality. Fair value budgeting would distort the budget process, undercut federal credit programs, and ultimately deprive millions of Americans of the financial support that they need to get an education, buy a home, or start or operate a small business.

I look forward to our discussion today, and I thank each of the witnesses for appearing before the Committee. And I yield back. Thank you.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 51.]

OPENING STATEMENT OF HON. MIKE LEE, A U.S. SENATOR FROM UTAH

Senator Lee. Thank you, Representative Maloney, and the documents you have submitted will be submitted into the record, without objection.

I want to thank Chairman Coats for calling this hearing, and also for his insightful remarks, and for the remarks that we have heard so far from Representative Maloney.

From the early days of our Republic, we have had an ongoing debate about the role to be played by the Federal Government within the credit market. The provision of credit to the states and its assumption by the newly formed Federal Government was a topic of great debate and discussion during the drafting of the Constitution in 1787 and during the early Congresses formed pursuant to that document.

Provision of credit by the Federal Government has a somewhat more recent history. As Mr. Elliott, who is one of our witnesses today, noted in his book “Uncle Sam In Pinstripes,” the provision of federal credit began in the way we are discussing today in the early part of the 20th Century. It began with farm programs under President Theodore Roosevelt.

These programs have ballooned over the past century. Today we frequently hear about $18 trillion in total outstanding public debt. It is far less common to hear about the $3 trillion in Federal Government loan exposure that Journalist Michael Grunwald identified earlier this year.

This federal credit system has grown over the years at times responding to perceived political needs, and at other times responding to political pressure from special interests, natural mission creep, and bureaucratic ambitions.

This has left us with a system that no one would design. We have a housing finance system that leans almost entirely on federal backstops in the FHA and VA.

We have a student loan program administered almost entirely by the Federal Government, a program that notably took considerable writedowns over recent weeks.

We have the Export-Import Bank that was founded before exporters could easily fly across the ocean to visit customers, and now exists largely to facilitate deals between large corporations and large banks, while leaving the taxpayer on the hook.

From TARP to farm programs, the Federal Credit System is hard to think of as a system at all, except for one feature. If things go wrong, the Federal Government is on the hook. If things go wrong, the taxpayer ends up with the bill.

It is critically important that Congress debate the wisdom of such a system's existence at all, including the Constitutional and prudential justifications for the provision of federal credit.

Today we look to start that debate by discussing something much simpler than this larger discussion. Namely, we are looking to find valid means to analyze costs, compare management structures, and establish a general rubric to make apples-to-apples comparisons.

We hope to be able to both compare different credit programs against each other, and compare credit programs relative to spending, tax, or regulatory programs designed to accomplish similar goals.

Getting on the same page on these questions will be a key step in the process of reforming these programs.

So I thank the Chairman again for this opportunity and I look forward to the testimony that we are going to hear from each of our witnesses.

And with that, I would like to introduce our witnesses before we hear from them. We will start on this end of the table and then move over.

Dr. Douglas Holtz-Eakin is the President of the American Action Forum, and most recently was a commissioner on the Congressionally chartered Financial Crisis Inquiry Commission. During 2001 to 2002, he was the Chief Economist of the President's Council of Economic Advisers. From 2003 to 2005, Dr. Holtz-Eakin was the sixth director of the Congressional Budget Office. From 2007 to 2008, he was Director of Domestic and Economic Policy for the John McCain Presidential Campaign. And following the 2008 election, Dr. Holtz-Eakin was the President of DHE Consulting. Dr. Holtz-Eakin received his B.A. from Denison University, and his Ph.D. from Princeton University.

Jason Delisle is the Director of the Federal Education Budget Project, which is part of the Educational Policy Program at New America. Mr. Delisle is a leading expert on the federal student loan program, and federal financing for higher education. Before joining New America in 2007, Mr. Delisle was a senior analyst on the Republican staff of the United States Senate Budget Committee. Prior to that position, he served as a legislative aide in the office of Representative Thomas Petri. Mr. Delisle holds a Masters Degree in Public Policy from George Washington University, and a Bachelor's Degree from Lawrence University in Appleton, Wisconsin.

Douglas Elliott, a Fellow in Economic Studies at the Brookings Institution, is a member of the Initiative on Business and Public Policy. A financial institutions investment banker for two decades, principally at J.P.Morgan, he was the founder and principal researcher for the Center on Federal Financial Institutions, a think tank devoted to the analysis of federal lending and insurance activities. He recently wrote the book, "Uncle Sam In Pinstripes," evaluating the U.S. federal credit programs, the only comprehensive review of the Federal Government's credit activities to be written in the last quarter century. Mr. Elliott graduated from Harvard College magna cum laude with an A.B. in Sociology in 1981, and in 1984 he graduated from Duke University with an M.A. in Computer Science.

Last but not least, Paul Van de Water is a Senior Fellow at the Center on Budget and Policy Priorities where he specializes in Medicare, Social Security, and health coverage issues. He is also Director of the Center's Policy Futures Initiative. Previously he was Vice President for Health Policy at the National Academy of Social Insurance. Van de Water worked for over 18 years at the Congressional Budget Office. From 1994 to 1999, he was Assistant Director for Budget Analysis.

So with that, why don't we hear from the witnesses. Let's hear from all of you. If you can try to keep your remarks within about five minutes, then we will proceed to questions from there. And we will start with you, Dr. Holtz-Eakin.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, Ph.D., PRESIDENT, AMERICAN ACTION FORUM, WASHINGTON, DC

Dr. Holtz-Eakin. Thank you, Senator Lee, Ranking Member Maloney, and Members of the Committee, for the chance to be here today.

As has been emphasized in your remarks and Chairman Coats' remarks before that, there is an enormous commitment of taxpayer resources to federal loans and loan guarantees. If you look at the tables put out most recently by the Office of Management and Budget, there are $3.3 trillion since 2014 in such loans and loan guarantees outstanding. And in light of the magnitude of this commitment of resources, I applaud the Committee for looking into this. I think it is an extremely important topic to understand.

I will be brief. I will just make three basic points.

Point number one is that the 1990 Federal Credit Reform Act was actually an enormous step forward in that it leveled the playing field between direct federal lending and the guarantee of private loans by the Federal Government. Both have the same economic function; they provide the same credit flow to the ultimate consumer; and they are both backed by the taxpayer and are a commitment of the taxpayers' resources.

However, having said that, the Federal Credit Reform Act does have a glaring hole. If you look in the OMB tables, those $3.3 trillion in loans and loan guarantees are assumed to make a profit, a profit, of $22.3 billion, and not be perceived as a cost to the taxpayer.

That is counter to anyone's intuition and reveals the flaw with the Federal Credit Reform Act, which is it omits an important source of risk—the market risks that are associated with credit activities.

That omission of market risk causes FCRA to underestimate the true cost of credit evaluated in that fashion. And it is important when Congress is making decisions to not only have a firm handle on the benefits of credit programs, but also their actual cost to the taxpayers with all kinds of risks involved.

The big difference between FCRA and fair value accounting is fair value accounting incorporates this market risk. It recognizes that as the economy fluctuates there is a tendency for loan failures to bunch during downturns, and that risk should be involved in the calculation of potential losses and any credit activity.

It also recognizes that the taxpayer has to come up with the money to cover those losses at a time when money is especially valuable. During downturns, Americans are less affluent and they do not want to have to cover these losses. So fair value accounting gets that into the mix.

The second reason it is pretty obvious that something needs to be done is it should not be the case that if you take a loan in the private sector and simply drag it across the line between the private sector and government, it should somehow become more valuable or less risky instantaneously because of the label on it. And that is exactly what happens under FCRA.

And indeed we have seen examples of this in recent legislation where we have used a government takeover of a private loan portfolio to finance government activities. That is a pure budget gimmick and one of the main reasons I think it is important to examine fair value accounting.

And the third point is that fair value accounting is not some untested theoretical proposition. When I was the Director of the Congressional Budget Office, we undertook numerous studies of what important federal backstops would look like under fair value accounting. We looked at the Pension Guaranty Corporation. We looked at the Student Loan Program. We looked at the then-Chrysler bailout from the 1980s. We looked at the guarantees for Air West during 2001–2002. We looked at Fannie Mae and Freddie Mac. And in each case, you would see a clear pattern: things that looked like they were profitable with the government became a cost to the taxpayer; things that were costly to the taxpayer were underestimated and needed to be revised upward.

Since then, we have actually seen fair value accounting, both in resources given to the Housing GSEs, Fannie Mae and Freddie Mac, and for accounting for the TARP program and the budgeting of that intervention.

So this is not something that is untested. This is not something that could not be done, and doing it would give a fair presentation of the commitment of taxpayer backstop to the credit programs, and I would encourage the Congress to move forward with it.

Thank you.

[The prepared statement of Dr. Douglas Holtz-Eakin appears in the Submissions for the Record on page 53.]

Senator Lee. Mr. Delisle.

STATEMENT OF MR. JASON DELISLE, DIRECTOR, FEDERAL EDUCATION BUDGET PROJECT, NEW AMERICA, WASHINGTON, DC

Mr. Delisle. Thank you, Senator Lee, Ranking Member Maloney, and Members of the Committee. I am glad to have the opportunity to testify about the cost of federal credit programs and the Federal Student Loan Program in particular.

The Federal Government's direct loan program plays a vital role in our postsecondary education system and our national economy. It guarantees access to credit at favorable terms for millions of

Americans who pursue credentials that range from short-term certificates to graduate professional degrees.

And despite the recent backlash against student debt, a government loan is a perfectly logical tool to support postsecondary education. Loans allow students to move some of the future earnings that they would gain from an education to the present, and to finance the education itself.

Moreover, a robust private market for student lending is unlikely to develop because of information asymmetries and poor economies of scale. And a private market would likely make credit most readily available to those who need it least. It would also restrict credit availability in times of economic stress, the point at which demand for higher education surges.

So while the case for a government student loan program is strong, so too is the case for knowing what it costs. One point helps make that clear.

The student loan program is quickly set to become the largest government loan program. With $1.2 trillion in debt outstanding, it is on the verge of eclipsing mortgage guarantees made through the Federal Housing Administration.

Yet despite the need for reliable information about what this program costs, Congress has actually prevented the nonpartisan Congressional Budget Office from doing just that. As a result, we have the highly unusual situation of the Congress asking CBO to provide it with the best estimate of what the budget agency believes the program costs, while dictating what information the CBO must use to construct its estimate.

In the early 1990s, Congress made important changes to the way federal loan programs are treated in the budget with the enactment of the Federal Credit Reform Act, or FCRA. That law put federal loan programs on an accrual basis and was a big improvement over measuring loans on a cash-in/cash-out basis.

But what lawmakers also included was a provision in the law that systematically understates the cost of government loan programs. And I am using the words of the Congressional Budget Office there.

They mandated that budget analysts, including the CBO, discount risky cash flows associated with a loan at a risk-free rate—the interest rates on U.S. Treasury securities. Thus, the average expected cash flows for government loans are treated as if they were financially indistinguishable from those of the U.S. Treasury with the same expected performance.

The CBO has argued that that approach does not provide a comprehensive measure of what federal credit programs actually cost the government. Indeed, FCRA suggests that the government can earn a profit on student loans even though it provides them at terms much more generous than taxpayers would offer voluntarily.

FCRA's risk-free discounting can also make it appear, albeit erroneously, that when the government purchases loans at market prices it immediately records a financial gain. Worse still, the riskier the loan that the government buys, the larger the immediate financial gain.

The Center on Budget and Policy Priorities warned in 2005 that those dubious results created a, quote, "supposed free lunch," unquote. And in response argued fervently that expected returns on risky assets must be risk-adjusted, citing the CBO and many economists.

But as I am sure you will hear today, the CBBP now says that view was, quote, "mistaken." The economists at the CBBP cited in 2005, including the CBO, have not, however, changed their position.

A better accounting approach, one endorsed by the Congressional Budget Office and many financial economists, would discount loan cash flows using a market-based rate, one that is higher than a U.S. Treasury rate. That approach incorporates a cost for bearing market risk, also called "fair value accounting."

So at first glance, the support for fair value accounting would suggest that Congress should amend FCRA and require that budget estimates for loan programs use a market-based discount rate. But I would recommend a different approach.

Requiring that cost estimates use a specific type of discount rate, a U.S. Treasury rate, or a market-based rate for that matter, is a highly unusual intrusion on the discretion Congress affords the CBO.

When the CBO develops estimates for other federal programs like the Pell Grant Program, Congress does not require it to assume a certain rate of inflation or student enrollment growth; the CBO uses whatever it believes is most appropriate.

In that regard, Congress should simply amend the language of FCRA to give budget agencies the freedom to use the discount rate they deem will result in the best estimate. This will surely result in fair value accounting because the CBO already supports that. And that is a great result because it will be an accounting decision that is free of Congressional and partisan interference.

That concludes my testimony today. I look forward to questions that you may have.

[The prepared statement of Mr. Jason Delisle appears in the Submissions for the Record on page 60.]

Senator Lee. Thank you, sir. Mr. Elliott.

STATEMENT OF MR. DOUGLAS ELLIOTT, FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. Elliott. Thank you, Senator. And thank you all for the opportunity to testify today on an area of great interest to me.

Senator Lee was kind enough to describe my background. I founded the Center on Federal Financial Institutions and worked at it as a volunteer for three years because I do believe that this is a very important and underlooked area, and he was kind enough to mention my book as well.

Given the political nature of so much of the discussion, let me note that I am as close to a political neutral as you will find on this topic. I do not belong to a political party. I have served in no administration. And I am a moderate on the political spectrum. So you can factor that in as you listen to me.

In my book I made a number of recommendations for improving the effectiveness and efficiency of the federal credit program. I would like to repeat a few of them here.

Specifically, we should target borrowers more carefully, take more account of the relative risks of different loans, use the same budget rules for all federal credit programs, use risk-based discount rates for federal budget purposes, formalize the process of initiating new federal credit programs, create a federal bank to administer all of these programs, focus more on optimizing the allocation of money between these various programs, spread best practices across the programs more effectively, and improve the compensation and training of federal financial workers.

Now given your interests and the time constraints, I will focus on risk-based discount rates.

Accounting systems such as the federal budget are tools that should be designed to meet specific needs and should differ depending on those needs. There is not a "right" moral answer. These are tools.

Our current budget approach for federal credit programs ignores the variability of potential results. Given how strongly the budget numbers drive decision making, we are effectively acting as if Congress and the taxpayers do not care about risk—which I do not believe to be the case. Instead, I believe subsidy costs in the federal budget should reflect this uncertainty for several reasons, which mostly come down to how they are likely to change the decision making.

First, it is important that federal credit programs be structured to minimize risks where possible, while still achieving the overall objectives. This is less likely to happen when the budget numbers that drive them ignore risk.

Second, the benefit to borrowers of government loans is higher for risky loans, since these would be priced higher by the private lenders but are not usually priced higher by the government. Ignoring that risk for federal budgeting has distorting effects on the choices that Members of Congress make. In particular, there will be a tendency to direct scarce federal dollars to sectors where there is more uncertainty in the outcomes since those borrowers will find the federal loans more valuable. They will lobby harder for them, and they are more likely to apply for and to accept such loans, choosing them over private alternatives.

Third, risk-based pricing, one of my other recommendations, is considerably more likely to be implemented if the budget appropriately reflects risk as a cost. The situation today in which a loan with a wide range of potential outcomes is treated as costing the same as a relatively certain loan discourages political decisions that take account of such risk.

Now there are reasonable counterarguments to moving to risk-based discount rates, although I do not personally find them compelling. The principal one is that the U.S. Government can spread any unexpected losses over a very wide tax base and many years of time, and therefore does not need to worry about the variability of outcomes. However, the way in which federal credit losses are ultimately offset is by increasing taxes or decreasing federal expenditures. And it seems very unlikely—sorry, it seems very likely that taxpayers would prefer less risk of a big tax increase to more risk of one, even if the latter were offset by a potential on the other side for unusually good performance and future tax reductions.

This is especially likely since, as Douglas referred to, credit losses are concentrated in those years when the economy is particularly bad and taxpayers are unlikely to feel capable of comfortably bearing the resulting tax increases.

There are also various technical arguments about maintaining the consistency of federal credit programs with other programs, and of dealing with swings in estimated costs. These are reasonable concerns, but they are outweighed by the fact that Congress uses the initial subsidy estimates as by far the most important figure on which to make decisions. As long as these are the critical numbers, I believe it is important to incorporate risk appropriately into them in order to improve the quality of decisions. Thank you very much for your time and consideration.

[The prepared statement of Mr. Douglas Elliott appears in the Submissions for the Record on page 71.]

Senator Lee. Thank you, Mr. Elliott. Mr. Van de Water.

STATEMENT OF PAUL VAN de WATER, SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Dr. Van de Water. Senator Lee, Ranking Member Maloney, Members of the Committee, thank you for the opportunity to appear here today. The current method of accounting for federal credit programs, as you have heard, fully records on a present-value basis all of the cash flows into and out of the Treasury. And that fully reflects the risk of default.

In contrast, fair value accounting would add an extra amount to the budgetary cost based on the fact that loan assets are less valuable to the private sector than to the government for several reasons: Businesses must make a profit. They cannot put themselves at the head of the line when collecting a debt. They borrow at higher interest rates than the government. And private-sector investors are risk-averse. That is, they dislike losses, in this case higher than expected loan defaults, more than they like equally likely gains, lower defaults. But none of those factors that affect private-sector lenders represents an actual cost that the government incurs when it makes loans. Fair value accounting is misguided for four reasons.

First of all, the budget should reflect only the Federal Government's actual income and outgo, that is, funds that the Treasury actually receives or disburses. Including in the budget a cost for risk that the government does not actually pay would overstate spending, deficits, and debt, making the federal budget a less accurate depiction of the Nation's fiscal position.

Second, fair value accounting would treat different federal programs inconsistently because it would not impose a risk version penalty on noncredit programs, many of which have costs that are at least as uncertain and variable as those of credit programs. Regardless of one's position on whether a particular credit program is worthwhile or not, the budget should put credit programs and other programs on a level playing field. Fair value accounting would tilt the playing field against credit programs, thereby distorting the process of setting priorities.

Third, even if one thought that the Federal Government should be risk averse on behalf of its citizens, as advocates contend, fair value accounting presents an incomplete and misleading picture of federal credit programs. Federal loan programs do not necessarily increase financial risks for U.S. citizens overall. If the cost of a loan program turns out to be higher than originally estimated, taxpayers will indeed eventually have to cover the higher costs. But students, farmers, homeowners, or other borrowers will have received more help. Fair value accounting considers only the first half of this equation.

Fourth and finally, cost estimates by themselves are not designed to assess whether a federal program is worthwhile, and they should not be expected to do so. Deciding whether a federal program or project is worth undertaking or expanding entails evaluating many factors in addition to its cost to the government, and risk is indeed one of those.

Doug Elliott suggested that leaving risk out of a cost estimate suggests that the government does not care about risk. I would have to disagree with my friend Doug on that topic. There are a lot of things that get left out of cost estimates that are extremely important. As an example, building a bridge in a lightly populated area is likely to be less valuable and may not be worth doing compared to resurfacing a heavily traveled highway in the Northeast corridor. A bill's cost estimate is never going to reflect all of these different factors, and trying to do so is a vain effort.

My conclusion is the same as that of former CBO Director Robert Reischauer who says that fair value accounting, quote, "represents a misguided attempt to mold budget accounting to facilitate a cost/benefit analysis with the result that neither the budget nor the cost/benefit analysis would serve their intended purposes well." Thank you.

[The prepared statement of Dr. Paul Van De Water appears in the Submissions for the Record on page 82.]

Senator Lee. Thank you very much. Thanks to each of you for your testimony.

Well it seems to me that if we are using accounting methods that do not accurately reflect reality, then the fundamental problem here is that we are lying to ourselves. We are fooling ourselves. And we are fooling ourselves with regard to a very large sum of money.

Dr. Holtz-Eakin, are we making these decisions under flawed accounting rules without a good idea of the relevant tradeoffs? That is, if we are analyzing these incorrectly, do we really have the ability accurately to ascertain whether some other program, or no action at all, might be preferable?

Dr. Holtz-Eakin. I do not believe so. I think that, you know, fair value accounting would affect a lot of different aspects of the operation of the government. It would affect the analysis of new programs. It would affect the re-estimates that occur each year. It would affect the balance sheet presentation. But the most important thing it would affect would be the decision making by the Congress about the relative costs of programs.

Now the Congress has the right to determine the value of programs. That is what it does. But it should be presented with an accurate measure of the costs so that they can make good decisions, and they are not right now.

Senator Lee. And if we are not doing that, then we are fooling ourselves. We are not getting accurate information, or we are presented information saying this is worth it, this is making money, when in fact it is not; we are not making logical decisions.

Dr. Holtz-Eakin. I think the most important point that Dr. Delisle made was that the Congress has precluded the CBO or anyone else from giving a fair representation of the expected cost of the programs. That is not in your interest.

Senator Lee. And, Mr. Delisle, we are not really talking here about changing programs; we are talking about analyzing them accurately? Is that correct?

Mr. Delisle. Right. So we are talking about the cost, and usually in these debates we hear a lot about the benefits of the programs. Fair value is completely agnostic to the benefits of the program. You can have a government program that costs money and provides benefits to people. I think that fact is actually quite intuitive.

It is credit reform that flips that upside down and suggests that you can provide benefits to people and also earn a net return, which does not really make much sense.

Senator Lee. And I would ask both of you, what are the risks to the taxpayer when we pretend that programs raise money for the government while CBO finds that they lose money under fair value? What kind of risk does that present?

Dr. Holtz-Eakin. There are hypothetical answers to that, but I will give you a real one. We did an estimate of the taxpayer cost of the implicit subsidy in guarantee to Fannie Mae and Freddie Mac. We did it back in 2003 or 2004, when I was CBO Director. That number was about $20 billion a year, or $200 billion.

It was painfully close to what the taxpayer ultimately had to shell out in the crisis for the housing GSEs. That is the risk you run. You will not budget for real costs that will happen in very bad moments.

Mr. Delisle. Well I would—the sort of, the flaws in the Federal Credit Reform Act actually make the entire world of finance appear as a gigantic arbitrage opportunity for the Federal Government. To show you how distorting that is, you have heard that Greece has a bit of a debt problem. And the market is charging them quite a high interest rate on their bonds. Under FCRA, if the Federal Government purchased Greece's debt, it would book an immediate profit.

I cannot imagine many members of the Committee suggesting that that looks right to them.

Senator Lee. Maybe we should look into that, though?

[Laughter.]

Mr. Elliott, on the net, examining all federal programs in the aggregate, and all costs and benefits of these programs, does the academic literature indicate that during normal economic times that federal credit programs are net negative, or a net positive, for the economy?

Mr. Elliott. We do not know, is the short answer. One reason we do not know is there are many judgment calls that have to be made.

I think there are certain programs—student loan programs, for example—where it is very clear that there is a market imperfection that really cannot be solved other than by having a very significant federal role.

In programs like that there is no question in my mind that, at least properly run, provide a significant economic benefit. Many of the other programs, it's harder to say. In many ways they are more redistributional than anything else. It is choosing which segments of the population to help, and Congress many have valid reasons for helping them, or they may not.

Senator Lee. Thank you. Okay, I see my time has expired. Ranking Member Maloney.

Representative Maloney. Thank you.

Mr. Van de Water, changing to fair value budgeting would have far-reaching consequences for students, and Veterans, and home buyers, and small businesses who benefit from our various federal credit programs. Fair value budgeting would not actually make federal credit programs more costly, but it would certainly make them all appear more costly than they really are.

It would do this by assuming banks and governments are somehow alike, and assigning to government credit programs the same costs of lending as those faced in the private sector.

So would increased phantom costs resulting from fair value accounting be passed along to borrowers in the form of higher interest rates and fees?

Dr. Van de Water. We can only speculate as to what the result would be, but certainly by increasing the cost of credit programs relative to those of noncredit programs, it would change the incentives, exactly as Doug Elliott has just said, in a way that would make it highly likely that the Congress would either reduce the scope of the lending programs, or change the terms—that is, increase the interest rates, charge higher origination fees, whatever, in ways to make the programs less generous.

So I think it is clear that changing the accounting method would be likely to have real impacts on borrowers.

Representative Maloney. As the cost of these federal credit programs appear to increase, would the federal deficit also increase?

Dr. Van de Water. That is one of the complications that this introduces. The problem, as I see it, with fair value accounting is that it introduces a cost in the budget which is not actually a cash-dollar cost that the government ever incurs.

The good thing about our current accounting system is that we actually have a benchmark at the end of the day for figuring out whether things actually worked out the way we estimated. Namely, we can observe the cash flows.

But if one starts adding a cost—in this case a cost for risk—which is not a cash cost, we lose that ability to track the budget to what actually happens.

And the proposals for fair value accounting, depending on the proposal, make various adjustments to make sure the books balance in the end even when you have added this imaginary cost.

Representative Maloney. And would higher apparent costs for federal credit programs disadvantage them relative to other federal programs? And if so, how?

Dr. Van de Water. That is exactly right. As the other witnesses have indicated, the essence of fair value accounting is to add to the estimated cost of federal credit programs an additional item, a risk premium, a risk penalty, to reflect the fact that there is uncertainty in what the disbursements of the credit programs will actually be.

But the same thing is true for many, many other federal spending programs as well. In advance, we do not know exactly what they are going to cost, and we do not know precisely in what years they will be incurred.

So by adding a risk penalty for credit programs but not for other federal programs, we are thereby putting the credit programs at a disadvantage.

Representative Maloney. Thank you.

Mr. Delisle, there are more than 20 million college students now in the United States, and many of them rely on student loans provided by or guaranteed by the Federal Government.

Fair value accounting would likely mean that student loan programs will shrink and/or that interest rates will go up. How would you defend fair value accounting to a large meeting of college students?

Mr. Delisle. Well, I would say, like I said at the beginning of my testimony, there is a strong rationale for having a federal student loan program. And it is important to provide subsidized credit to them. I am a hundred percent for that.

But what the program costs should be agnostic to what we think the benefits are. Right? Cost/benefit analysis is two parts. You have got to get the costs right, and you have got to get the benefits right. They are two different things.

Representative Maloney. And Mr. Elliott, we have received—I went through a whole stack of letters from organizations, stakeholders in our country that were basically opposing fair value accounting. To name a few: the National Education Association, the National Association of Home Builders. The Retired Enlisted Association, The National Rural Electric Cooperative Association, The Student Aid Alliance. Many other very active associations, including the National Association of Realtors, have gone on record against fair value.

And if you were advising a Member of Congress on this issue, how would you recommend that he or she explain the issue to these organizations?

Mr. Elliott. I think I would argue along the same lines that Jason just did, which is essentially we want Congress to be making decisions based on the best possible cost numbers, the best possible benefit numbers.

I am not at all surprised that a set of borrowers basically would prefer us to use lower discount rates on the theory that that will not give us any incentive to increase the rates. So there is nothing we can say to them that will change their position.

Representative Maloney. Well my time has expired.

Senator Lee. Okay. Next we will recognize Mr. Delaney; then after Mr. Delaney, Mr. Schweikert, and then we will proceed from there.

Representative Delaney. Thank you. I want to thank all the witnesses for being here today and sharing their testimony.

Mr. Elliott, you mentioned a concept that I thought was very interesting, which is creating a bank within the government and consolidating all the lending activities out of that bank, which I would love to follow up with you more on that. That seems to be a pretty interesting idea. You could have consolidated accounting, and credit, and portfolio management, and all those kinds of things, and it would make these programs inherently less sloppy, right, because there would be more rigor around how they are managed.

From an accounting standpoint, if that bank had its assets effectively mark-to-market, which is in some ways what this does, would you suggest that its liabilities also be mark-to-market? Because my experience with financial institutions, if you mark one side of the balance sheet you have to mark the other side, as well.

How should we think about—a lot of this discussion is about marking the assets to market to provide greater transparency. Are they priced right? How do they compare to the market? Et cetera. Would we then also have to mark the liabilities to market?

Mr. Elliott. So two parts. First, thank you for your positive comments about the idea of a single federal credit bank. I do think there are—there is great potential there for improved efficiency, which——

Representative Delaney. Right. And we will follow up on that later.

Mr. Elliott. In terms of the question, what the Federal Credit Reform Act does is it looks at both the positive and negative cash flows out from this point in time forward.

Representative Delaney. Yes.

Mr. Elliott. All those, whether positive or negative, at any point are discounted back at the same discount rate.

Representative Delaney. Right.

Mr. Elliott. So your question then would have to be, to get to what you are calling the liability side, is we would have to decide how were we funding those.

Representative Delaney. Yes.

Mr. Elliott. Which we do not do in the budget. We do not say this part is from borrowing; that is from a three-year borrowing; that is from a seven-year borrowing——

Representative Delaney. But you could, right? If you ran it as a bank, you could basically have a relationship with the Treasury Department and issue different series of notes to the Treasury that they would buy. And you would have a whole liability stack.

Mr. Elliott. You know, it is an interesting point and not one I have seriously considered, to be honest, because it is not—it is so far different from how we budget now I have just not given it thought.

Representative Delaney. Because I just think when we talk about mark-to-market accounting, which is basically where we are going in this discussion, it is like people talk about that with banks all the time. They say the banks should mark your assets to market, which most banks do not mark their loans to market.

But in reality, they then should mark their liabilities to market, right? And banks have much better liabilities than nonbanks do. So those liabilities would mark up, and you would mark the assets down, and you would kind of end up in the same place.

So I think it is important if we think about mark-to-market accounting for the assets that we also have to have some framework for thinking about it for the liabilities so that you do not overcorrect so much. Because in fact the government borrows at a much better rate than your average AAA borrower.

And so in fact the government's liabilities are worth more, right? So just when you would mark these assets down, you would be marking the liabilities up.

But I think there might be a better way to get at some of the issues that I agree with you on as to whether we are pricing these things right, whether we really understand the cost. And Mr. Holtz-Eakin, or Dr. Holtz-Eakin, maybe you could comment on this.

I have talked about a proposal where, rather than changing the accounting we simply require the government on a regular basis to sell off 10 percent of all its exposure in all these credit programs. Right? So you take all the credit programs, Ex-Im, housing programs, things we do for small businesses, go down the list and say on some regular basis you have to sell off 10 percent of your exposure to the market.

And then we see how the market prices it, right? And that to me—because using accounting to figure out if things are priced right is theoretical and it is based on assumptions, and people can always play with assumptions. But when you actually have to sell a piece to the market, you are actually getting real transparency. And that information in some programs should maybe dictate how they are priced, but other programs we just should know it.

We should say, hey, we are making loans to startup energy companies that would sell it for 20 cents on the dollar. That is a huge subsidy. Should we be using that money elsewhere?

Would you comment on that proposal?

Dr. Holtz-Eakin. I think that is quite useful. In terms of the two things that are going to be affected, the first is, as you mentioned, the mark-to-market on the balance sheet. I am actually less concerned about that.

Representative Delaney. Yes.

Dr. Holtz-Eakin. I am much more concerned about the income statement, making sure we get that cost right.

Representative Delaney. Yes.

Dr. Holtz-Eakin. One of the practical difficulties people always ask is, how do I get the right market risk to do the discounting?

Representative Delaney. If you sell a piece, you know.

Dr. Holtz-Eakin. This gives you some information.

Representative Delaney. Right.

Dr. Holtz-Eakin. And I think it is something that is worth exploring.

Representative Delaney. I talked to the chairman of the Financial Services Committee, House Chairman Hensarling, about this, because there is a big debate with Ex-Im right now. Folks at Ex-Im say they're priced to the market.

Dr. Holtz-Eakin. Right.

Representative Delaney. All these other people come in and say they're undercutting the market. My point is, well we should just make them sell off part of their balance sheet every year and then we will know. Right? If people pay par, they are pricing it right. If they pay at a big discount, then there is a big subsidy. And then we can decide, are we okay with that?

Dr. Holtz-Eakin. Right. And you are going to get a maturity strip——

Representative Delaney. Right.

Dr. Holtz-Eakin [continuing]. So you can get the estimates right.

Representative Delaney. You would have to do it in a logical way. So that is something I also think should be put on the table in this discussion as you all think about this.

Thank you.

Senator Lee. Okay. We are now going to go to Senator Klobuchar, and then to Mr. Schweikert.

Senator Klobuchar. Thank you, Congressman. I appreciate it.

Thank you to all our witnesses. It is great to see some of you back—Dr. Holtz-Eakin—and to be back here at the Joint Economic Committee on this important hearing.

I thought I would start out with veterans' housing. Since 2001, the VA has helped 3.75 million Veterans buy their own homes.

Mr. Van de Water, how would changing to the fair value or added-cost accounting method affect the VA's Home Loan Program, in your view?

Dr. Van de Water. Senator, the general effect of fair value accounting is to increase the estimated cost of credit programs compared to the way that cost is recorded under the current accounting mechanism.

And while we cannot be sure exactly how Congress would respond to that change with regard to any particular program, including veterans, I think it is highly likely that if the program were to appear more expensive that it would fare less well in the annual competition for resources, and therefore, it is likely, although not entirely certain, that the Veterans Housing Programs would become smaller, or that the loan terms would be changed in a way to reduce the subsidies for borrowers.

Senator Klobuchar. Okay. Thank you. Mr. Elliott, Minnesota cares a lot about infrastructure. We are the State that had that bridge collapse six blocks from my house, killing 13 people. And as you know, we have some issues with infrastructure, everything from bridges, roads, rail, and I am a fan of doing something about it, and I support a lot of the work that Congressman Delaney and others have been doing in this area.

How would switching from the current financing system using the 30-year Treasury rate with credit premium to the fair value or added-cost accounting affect investment in infrastructure, in your view? Are there other funding mechanisms that we should examine?

Mr. Elliott. Currently, in my view, we understate the cost of all the programs, and therefore Congress would be looking at higher costs to do the same thing using the current approach. As would Paul, I cannot say what Congress might then choose to do in terms of that. Presumably higher costs might make them do less, but who knows.

In terms of other ways of doing it, there are of course things like public-private partnerships, but I honestly will confess I am not an expert on those.

Senator Klobuchar. Perhaps, Mr. Delaney, you could ask him. No, there's a lot—Senator Warner will actually be putting our bill out today, a bipartisan bill similar to some of the work that Congressman Delaney has done. And so that is part of the answer, but clearly not the only answer.

I just wanted to end on the Ex-Im Bank. We have 170 Minnesota businesses that have been helped by the Ex-Im Bank just in one year alone. I visit all 87 counties in my State every year, and I often visit these small businesses. The topic usually isn't even Ex-Im, but then I find out that they are exporting. We are such a big export State, we have 17 Fortune 500 companies, and it has spawned a lot of the smaller companies that export. But they literally have no expert on Kazakhstan or something, and they use the Ex-Im Bank to help them, and help them with financing.

Mr. Van de Water, does the current system under the Fair Credit Reporting Act of 1990 reflect the costs of the Ex-Im Bank to the taxpayers? And how would the funds returned to the American taxpayer be accounted for under the new rules?

Dr. Van de Water. Yes, Senator. The current accounting mechanism fully reflects all of the cash that goes into or out of the Treasury. So in that sense, the current accounting mechanism does reflect the full cost of the Export-Import Bank and other credit programs.

The difference is that fair value accounting would add to that cost, to the recorded cost, an additional sum to reflect risk, which is not an actual cash cost to the Treasury or to taxpayers.

Senator Klobuchar. Okay. Does anyone want to add anything, or disagree?

Mr. Elliott. If I could just add one thing, briefly.

Senator Klobuchar. Yes.

Mr. Elliott. One of the issues we sometimes lose sight of is both potential approaches are simply ways of trying to summarize a long series of future cash outflows and inflows. The human mind is not capable of dealing with it, if we were to tell you it was X amount this year, X amount this year, you could not usefully do that.

So we have to bring it to a value in today's dollars. These are both reasonable ways of doing it, but what we are arguing about is what would be the effects of doing it one way or another in terms of how you would make your decisions.

Senator Klobuchar. Right. Okay. Well I will just make one last shameless pitch for the Ex-Im Bank, which is not the subject of this hearing but, as has been pointed out, could be affected by the way we do accounting and may affect taxpayers and those involved. And that is that we have 80 developed nations across the world that have similar financing authorities, and we would be the only one that didn't.

We have China having major financing opportunities for their businesses, and I just hope we find a way in the next few weeks not to shut the Ex-Im Bank down. You are nodding your head, Dr. Holtz-Eakin. Do you agree with me?

Dr. Holtz-Eakin. Perhaps to the chagrin of my fellow conservatives, I am compelled by a theoretical argument that it shouldn't exist. I think if you look at the data, you can make the case that Ex-Im should be reformed in some fairly dramatic ways; that its exposure cap might actually be restricted until we saw the moment where actual exporters could not get financing, and then we would know we need it. But I don't know how you can decide in the absence of that evidence that it shouldn't be around.

Senator Klobuchar. Very good. That's a perfect end to my questions. Thank you everyone.

Senator Lee. Okay. Congressman Schweikert, and then we will go to Congressman Beyer.

Representative Schweikert. Thank you, Senator Lee.

First off, Mr. Delaney, thank you. That is actually a creative idea. You know, part of the discussion here for many of us who are sort of fixated on sort of price theory is what's the actual pricing of the value of both the credit risk, the programmatic risk, and how do you discover that? To the Democrat witness, all those years in those finance classes, I need to go back and get my money back from those professors because I have now heard things I have never heard before.

One of my personal fixations here, Mr. Chairman and Dr. Holtz-Eakin, I would love—because I think you have actually written parts about this—is what is the actual value of credit programs? And how do you actually value the risk profile of them?

Because we seem to have a setup today with the massive amounts of—most Americans have no concept the amount the Federal Government is on the hook for. I mean, what was it, the Politico article last year, or several months ago, "The Real Bank of America" was in the trillions, and trillions, and trillions, and trillions, and trillions of dollars that we were on the hook for.

You would do more than just the fair value accounting. Wouldn't you ultimately try to develop a risk pricing model for these programs? How would you go about doing that?

Dr. Holtz-Eakin. So a couple of things. First, I would echo what my friend, Mr. Delisle, says again and again, which is be very clear about what is a cost and what is a benefit. So when you say what is the value of a credit program, that sounds like the benefit to those who are served by it. There may be some empirical evidence, but that is also a judgment call in the end of the policymakers.

If you are going to measure costs, step number two is to first of all quantify all the costs that are actually present in the economic environment. And in this instance, for credit programs it is out there in markets. We can find out. We can do price discovery the way Mr. Delaney suggests, or use other techniques, but, you know, take comprehensive measures——

Representative Schweikert. If——

Dr. Holtz-Eakin. Let me finish with one more thing, because this is the important point. And the point that Mr. Van de Water made earlier was, look, other programs have costs as well. Social Security has some risks. Medicare has some risk. We are not quantifying that.

That actually makes the major point, which is: You cannot pretend the Federal Government is a riskless entity. All it does is transmit the risk in the economic environment through it back to the taxpayers who are subject to those risks to begin with.

So measure them comprehensively. Trace them back to the taxpayer, because that is ultimately who is going to pay.

Representative Schweikert. You may have actually nailed it. Forgive me if I mispronounce. Is it Deso?

Mr. Delisle. De-lyle.

Representative Schweikert. Delisle. I would not have even gotten close.

Mr. Delisle. That's all right.

Representative Schweikert. All right. So a bifurcation of this argument is in some ways that I almost am hearing that I don't want to know the real pricing because it may take away my policy optionality over here because we might not do this.

How do I mentally get my fellow Members of Congress to sort of bifurcate this thing? We need to know the real cost of what we are doing, and then on this side deal with the policy side of it? Because when many of us start to really dig into the unfunded liabilities, it is stunning. We are seeing some in academia saying we are well over a couple hundred trillion in the 75-year window of unfunded liabilities. Yet, if you were to share that with fellow Members of Congress they would just stare at you.

How do we do that education?

Mr. Delisle. You do it exactly the same way you do it for every other federal program, which is, you say to the nonpartisan Congressional Budget Office: Do your best. Tell me what you think it costs. But don't tell me what you think we should do after you've given us that information; we will handle that.

Loans are different because it is the only place that I know of where Congress has told the CBO to use a certain set of assumptions in its estimate. So the CBO can't do that. And that is why we are here today.

If there were no provision requiring the CBO to use a certain kind of discount rate in its estimate, we would not be here. Mr. Schweikert. So, Doctor——

Dr. Holtz-Eakin. If I could add something, there is another big difference between these credit programs and those other, quote, "unfunded liabilities."

Credit programs are a contract. You have to honor it. Once that loan is issued, that is a loan contract and the taxpayer is on the hook.

The so-called, quote, "unfunded liabilities" are not liabilities; they are programmatic decisions made by Congress and can be changed. There is settled law on that fact. And the term "unfunded" I dislike intensely because it suggests the only need is to fund them, and there is not enough taxes out there to do that.

So this is about the decision making for the structure of those programs.

Representative Schweikert. Well the simple reality—I have been here five years, and I think I have never been able to have a rational vote on mandatory spending. And in four years, 76 percent of all of our spending will be programmatic.

So it is the clash of math and policy, and it is collapsing very fast around us.

With that, Mr. Chairman, I will yield back.

Senator Lee. Mr. Beyer.

Representative Beyer. Thank you, Senator.

Mr. Elliott, if the current FCRA regulation takes the present value of the long-term cash flow out and the long-term cash flow in, doesn't this already reflect the likelihood of default of some of these loans? And doesn't this methodology then already build the risk into the portfolio?

On top of that, how do you—how do you answer the objection over the past two decades that FCRA has proven to be extremely accurate in projecting the actual cash flow of all these federal credit loan programs?

Mr. Elliott. There is a confusion with the term "risk." If you mean "risk" the potential for losing, the expectation of losing money—that is, some loans will not pay you back— FCRA does a good job of taking that into account.

What we are talking about here is, when you enter into a program some of them—there is a high likelihood you will end up where you expect to be. And there are other programs with a much wider range of possibilities.

And so the question is: Do you as a Member of Congress want a budget number to reflect the difference between very certain results and very uncertain results? Or do you not?

Representative Beyer. It seems to me that one of the issues here is that we are trying to compare the Federal Government's credit to that of a major financial institution, a bank, a profit-making institution. And clearly we are involved in this as a federal government because we are making loans that banks would not make—student loans being the best example.

And we are doing that because we have a larger social purpose.

So, Dr. Van de Water sort of reminds me of the asymmetric warfare, that fair value takes societal costs but not societal benefits. It is like the dynamic scoring, which my dear friend Congressman Delaney has written about very well in various op eds in The Post, that dynamic scoring takes in all the benefits of a tax cut but absolutely none of the benefits of investing in education, and health care, and housing, and the like.

I got an e-mail from the University of Virginia that asked: Would a move to fair value accounting capture both the values of pursuing higher education and the monetary and nonmonetary positive externalities of having a highly educated populace that has access to federal student loans?

Dr. Van de Water. Well the answer to that is, of course not. And we wouldn't expect that a federal budget cost estimate would include things like that because many of those things are benefits to the individual students. They are extremely important benefits. Some of them have carryover benefits for the economy as a whole.

But that is a perfect example, that there are a lot of costs and benefits that are never going to show up in a cost estimate that are essential for the Congress to evaluate in deciding whether to go ahead with a program, or to expand it. But for accounting, I have been arguing that we should retain as a benchmark cash actually going into and out of the government.

And you should not expect a cost estimate to contain anything beyond that.

Representative Beyer. And my suggestion is, when you have risk, things that cannot be assessed down the line, that can also be offset by the societal benefits that we are also choosing not to mention.

Dr. Van de Water. Exactly. Because while a loan program, a student loan program, for example, increases risks for taxpayers, it is reducing the risks for the student borrowers. And at the same time, if the defaults turn out to be higher than expected, it means, as I said in my testimony, that taxpayers will be bearing a higher cost, but it also means that the student borrowers will be receiving a higher benefit.

Those are both very important facts, but neither one of them belongs in the cost estimate, in my view.

Representative Beyer. Thank you. Mr. Delisle, one slightly tongue-in-cheek question, which is: Why would we ever buy Greek debt? And then the more serious one is:

Given that we don't have a profit motive as the government in our federal credit, the market risk premium represents an opportunity cost that is not tied to cash flow. Doesn't the cash flow make much more sense than an opportunity cost that may never be realized? Especially when the historical data suggests that in fact we are doing just fine?

Mr. Delisle. Do you believe that the average expected cash flow, as CBO estimates it from a student loan, is guaranteed to occur exactly the way they project it to occur? If so, FCRA is your model.

If you do not think average expected cash flows are guaranteed to occur the way they are estimated, then fair value is your model.

In terms of why would we ever buy Greek debt? FCRA tells you there is absolutely no budget reason not to do so.

Representative Beyer. Except that we have the larger social purposes. We have put these things in place because we are trying to build a better America, a better economy. I am not sure that buying Greek debt is on that list.

Mr. Delisle. But it does not cost you anything. FCRA says you make money doing it, immediately. So why wouldn't you do it, if you make money and you help out—you solve a financial crisis. There is no budgetary reason not to do it. But I am very delighted that you are having problems with sort of the notion that there is no budget reason not to do that.

But I should say, on the issue of measuring the benefits, you are holding fair value accounting to a higher standard than all the other ways we do cost estimates. None of them—not cash accounting, not FCRA—none of them factor in the benefits.

When you do the estimate for a highway project, it does not include the value of the benefits. None of the approaches do. So this isn't a flaw with fair value. You are simply asking more of fair value than you are asking of any of the other accounting methods.

Representative Beyer. Thank you. Mr. Chairman, thank you.

Senator Lee. Senator Cotton.

Senator Cotton. Thank you. I apologize if we've been over this ground. I am just coming from presiding over the Senate.

I would like to start, Dr. Holtz-Eakin, with you. Could you outline any real challenges or risks to simply using fair value accounting as one source of knowledge, even if it is not mandated for use, even if it is not something that we put in the statute but it is something that informs our policy judgments?

Dr. Holtz-Eakin. I see no downside to that. Indeed, some of that happens now. We have seen CBO put out estimates of the budgetary impact of various credit programs under both FCRA accounting and what they would look like under fair value, so that Congress has some notion—the Ex-Im Bank being a notable example.

Senator Cotton. Okay. Tell you what, why don't we just go down the panel and hear responses to that.

Mr. Delisle. I'm sorry? The question again was?

Senator Cotton. So is there any risk or drawback of using fair value accounting as at least one source of information to inform policy judgments, even if we don't amend FCRA and make that the method of accounting?

Mr. Delisle. Well I think that the risks in using fair value are the same as they are in using other accounting methods; that, you know, the information you know today ends up not being perfect, and so something changes in the future to make your original estimate different, or off. Those exist in all the forms.

I should point out though that there has been some conversation about how the Federal Government is different from private entities. I think that that is a perfectly valid argument if the Federal Government had its own money. It doesn't have its own money. It has our money, and it has to use our value for the price of risk. That's only fair. And where do we go to assess our collective value for risk? We look at the market prices. Because you have a massive voting system on what something is worth, and I think that is the appropriate place to go to figure out what these loans actually cost.

Senator Cotton. Could I ask you to say more about the conversation you cited about the differences between the Federal Government and businesses? I hear that, and I hear my thinking that says, yes, the Federal Government is different. It is not a for-profit enterprise. Therefore, it makes decisions not based on market or financial signals, but on political decisions oftentimes. And frequently, whereas market-based institutions pick winners and losers which is in the nature of a capitalist society, the government tends to pick losers. Because if they were winners, they would have gotten financing in the private marketplace.

So could you say a little bit more about that?

Mr. Delisle. So my first response is, nonprofit credit unions are nonprofit. They also can borrow at a very low rate because they have a government guarantee on their deposits. Even they don't make loans at terms as generous as the Federal Government because they don't think it is worth it. So there is clearly something more going on than your profit motive. I also think that, you know, the same could be true for pension funds, right? Pensions funds are nonprofit. But they assign a value to assets at the market price. And I think that is the fairest value, regardless of your intentions and your motivations.

Senator Cotton. All right. Mr. Elliott, any real risk of at least using fair value accounting as a way to inform our decision making?

Mr. Elliott. I think it would be a step forward, very clearly. The one risk is, there is an argument that having two sets of numbers makes it a little harder for people to— there is a danger of talking past each other. But I would still rather have the extra information.

Senator Cotton. Okay.

Dr. Van de Water. I see no objection to providing additional information of that sort.

Senator Cotton. It sort of sounds like we are all in agreement, it is worthwhile and should inform our policymaking.

Okay. Thank you all. Thank you.

Senator Lee. I want to thank our Committee members, and I want to thank our witnesses especially for coming and providing the insightful testimony.

Your testimony has been very helpful. The hearing record will remain open for three business days for those members who may wish to submit questions for the record.

We will be adjourned.

(Whereupon, at 11:20 a.m., Wednesday, June 17, 2015, the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. DAN COATS, CHAIRMAN, JOINT ECONOMIC COMMITTEE

The committee will come to order.

The committee today will examine the economic exposure of federal credit programs. I'd like to thank our witnesses for being here.

Today, we will examine why accounting for our federal assets matters, and why inaccurate monitoring could bring harm to:

- Borrowers who pay higher interest rates to cover the defaults of others;
- Private lenders who are frozen out of markets they seek to serve; and,
- Taxpayers, who may be exposed to unquantified losses.

During my prior service in the Senate, I was one of the "Nay" votes for the Omnibus Budget Reconciliation Act of 1990. Twenty-five years later, I never imagined that I would be chairing a hearing to debate the impact of accounting rules passed back then. This situation reminds me of an old Yogi Berra quote, "The future ain't what it used to be."

The 1990 reconciliation law included the Federal Credit Reform Act, accounting rules crafted in reaction to the rocky credit history of the 1980s. The Resolution Trust Corporation held the assets of failed savings & loans and put the federal government in the "loan workout" business. Sadly, fraudulent student loans made during the decade led to a 20% student loan default rate and a loss equal to almost 10% of outstanding loans. Cash accounting for all these asset changes within a budget year presented a volatile picture of the federal budget that properly represents spending trends.

Since then, the federal government has followed the rules of FCRA, recording an annual present-value adjusted "subsidy cost" to account for losses it may incur in the future charged against loans it has made directly, as well as guarantees it provided for loans made by others. It took 10 years to refine the complicated net present value calculations used for FCRA, but by 2002, government accountants calculated that the federal portfolio of $1.3–1.4 trillion in loans and guarantees generated annual subsidy costs in the range of $5 to $12 billion, no small chunk of change.

This brings us to the financial crisis of 2008, which ballooned the government's loan assets. FCRA's accounting rules converted loan subsidy costs into deficit reducers. Since 2008, government accountants have booked nearly $200 billion in annual subsidy gains while the amount of federal loans and guarantees has more than doubled. As a result, it is clear that the more credit market exposure the government takes on, the more that expectations of future revenue rise under current accounting rules, without equal accounting for higher risk.

At the end of September 2014, loans made or fully guaranteed by the federal government totaled over $2.9 trillion. This includes $1.1 trillion in student loans. Additionally, the Federal Reserve reported that nonmortgage consumer debt totaled $3.3 trillion as of September 30, 2014, giving the federal government a one-third share of the U.S. consumer loan market.

Add to that the 70 percent of the mortgage market that the federal government holds through direct loans, guarantees, and Fannie Mae and Freddie Mac, and the federal government is the largest consumer lender in the United States.

A lot has changed in twenty-five years. So today, we must ask ourselves, do accounting rules passed twenty-five years ago reflect the complexity of today's financial world?

I'd now like to recognize Ranking Member Maloney for her opening statement.

NEA NATIONAL EDUCATION ASSOCIATION nea.org
Great Public Schools for Every Student

1201 16th St., N.W. | Washington, DC 20036 | Phone: (202) 833-4000

Lily Eskelsen García
President

Rebecca S. Pringle
Vice President

Princess R. Moss
Secretary-Treasurer

John C. Stocks
Executive Director

June 16, 2015

The Honorable Carolyn B. Maloney
U.S. House of Representatives
2308 Rayburn House Office Building
Washington, DC 20515-3212

Dear Representative Maloney:

On behalf of the three million members of the National Education Association and the students they serve, we would like to submit for the record our views on fair value accounting in connection with the June 17 hearing, "The Economic Exposure of Federal Credit Programs."

NEA opposes the use of fair value accounting in federal credit programs, especially student loan programs, because it would artificially raise their costs and make them appear to be more expensive to the federal government than they really are. That, in turn, would distort taxing and spending decisions, and could lead to cuts in those programs. Specifically, the Congressional Budget Office estimates that a significant portion of the additional annual cost would occur in discretionary programs. As a result, annual appropriations bills would be "scored" as multiple billions more costly than they really are, further squeezing the limited funds available for investments in education, our nation's infrastructure, and high-value research and development.

Incorporating a non-budgetary cost such as "market risk" into official cost estimates would also discourage students from pursuing public service careers like teaching. NEA member Latechia Mitchell, a second-grade teacher in Maryland, took out loans for $60,000 to get the master's degree she needed to teach. "I am not sure if I had known how difficult it would be to pay back my loans on a public school teacher's salary, I would have still chosen this career," she said at a congressional forum on student loan debt earlier this year.

NEA member Brittany Jones told the Senate Budget Committee that to fulfill her dream of becoming a teacher, she took out $70,000 in loans she will be repaying for the next 25 years. "I've seen my friends and classmates turn away from a career in teaching because they can't afford the education they need," she said.

Current estimates of federal loans and loan guarantees already take into account the chance that a borrower will default, pay early or late, and that a dollar repaid tomorrow is not the same as a dollar repaid today. They also predict true fiscal effects with a high degree of accuracy. Since 1992, the initial cost estimates of all credit programs have differed from their actual cost by less than 1 percent of the face value of all loans and guarantees, according to the Office of Management and Budget.

While market risk may capture certain costs not reflected in current estimates, those costs are fundamentally different from budget costs—and therefore should not be included. Many aspects of the federal budget are subject to market risk, including tax receipts and Social Security obligations. Applying fair value methods only to credit programs would make it impossible to compare different parts of the budget on an apples-to-apples basis.

We thank you for the opportunity to submit these comments.

Sincerely,

Mary Kusler

Mary Kusler
Director of Government Relations

NAHB

National Association of Home Builders

1201 15th Street NW
Washington, DC 20005

T 800 368 5242
F 202 266 8400

www.nahb.org

Government Affairs

James W. Tobin III
Senior Vice President & Chief Lobbyist

June 16, 2015

The Honorable Dan Coats	The Honorable Carolyn Maloney
Chairman	Ranking Member
Joint Economic Committee	Joint Economic Committee
1632 Longworth House Office Building	2308 Rayburn House Office Building
Washington, DC 20515	Washington, DC 20515

Dear Chairman Coats and Ranking Member Maloney:

On behalf of the 140,000 members of the National Association of Home Builders (NAHB), I am writing to express our strong concern regarding the use of "fair value accounting" for federal credit programs. As the Joint Economic Committee hears testimony on this issue, NAHB would like to draw attention to how altering the budget rules for important loan programs would negatively impact key housing programs, including those operated by the Federal Housing Administration, the Rural Housing Service, and the Veterans Administration.

NAHB believes that utilizing "fair value accounting" for government loan programs would artificially increase the projected cost of such loans compared to the established accrual accounting method determined by the 1990 Federal Credit Reform Act (FCRA). Such a change in accounting methods would require additional funds to be committed, or higher costs for borrowers, in response to a theoretical accounting method that is inappropriate for federal budget purposes.

Most federal budgeting analyses for tax and spending programs use a non-discounted cash basis method. While subject to certain limitations, the benefit of this approach is that it allows an apples-to-apples comparison of fiscal policies with respect to impacts on the federal deficit.

A notable exception to this set of scorekeeping conventions are loan programs examined under the rules established by the 1990 Federal Credit Reform Act. Under the FCRA method, loan programs are scored on an accrual basis, meaning that the discounted lifetime costs of the policy are accounted for during the fiscal year in which the loan is made. The changes made by FCRA were intended to allow a reasonable comparison of loan and loan guarantee programs with other tax and spending policies, including contrasting loan programs, which would be repaid, with grant programs that were not associated with future revenues.

Under the FCRA rules, the subsidy cost of the policy is determined by discounting the forecasted future cash flows (including amounts disbursed, principal and interest payments, as well as fees and net losses from defaults). The present value of these future flows is scored as a single, lump sum number for the time period in which the loan is originated. The present value is dependent on the discount rate used. The FCRA system employs interest rates for comparable U.S. Treasury securities to discount the future flows. Such a method accurately reflects the true cost of funds for the U.S. government, which is an appropriate method of discounting. Higher discount rates are more likely to show net costs for the federal budget.

As the Congressional Budget Office has detailed, the fair value accounting method would use a different method of discounting.[1] Under this version of accrual based scorekeeping, private market-based debt rates are used. Because these rates are based on the risk tolerance and perspectives of private investors, they reflect the additional compensation required by risk averse investors to invest in private loans. As a result, under the fair value accounting method, a larger discount rate is employed, which reduces the future value of the cash flow associated with the loan, thereby increasing the cost of the program on a scorekeeping basis.

Proponents of fair value accounting claim that this method is the more appropriate measure of risk associated with these loan programs. However, this is not correct. The FCRA accrual method currently incorporates a forecast of future losses that are expected due to loan default. The difference between the scoring methods is in fact primarily reflected in the discount rate used to create the estimates. Risk averse private investors discount future cash flows more than the federal government, which is why such investors require market risk premiums for debt. Clearly, the market for Treasury securities does not require such premiums.

When determining the correct approach for federal budgeting purposes, it is important to keep in mind the objective of scorekeeping. An analogy to tax policy is helpful in this regard. The Joint Committee on Taxation (JCT) produces two widely used sets of tax estimates.[2] The first are revenue estimates that report the year-by-year impacts on the federal deficit that result from proposed changes in tax law. Revenue estimates incorporate micro-behavior, while holding Gross Domestic Product constant. They are useful for making an apples-to-apples comparison of the revenue cost of various tax proposals. The second major form of estimates are tax expenditure estimates. Tax expenditures hold micro-behavior constant, so each analysis reflects the foregone tax revenues (roughly, the expected tax benefit) that are due to established tax policies, such as deductions, credits, exclusions and deferrals.[3]

While the analogy is not perfect, the FCRA and fair value accrual methods are linked to different analytical purposes. The FCRA, which uses the appropriate non-risk averse cost of borrowing for the federal budget, is a measure of the discounted, expected future costs of various programs. The fair value accounting, which imposes a discount rate appropriate for private investors on the federal government, measures the subsidy value of the program (roughly its benefit). Returning to the tax analogy, it is important to note that it is revenue estimates which are used for budget-making purposes, not tax expenditure numbers, which serve more as a supplemental analytical tool. NAHB argues that, similarly, it is the FCRA accrual method which uses – for federal budget purposes – the discount rate that is appropriate to the federal budget. The fair value method is not the appropriate method for estimating the discounted cash flow of federal programs because it uses discount rates required by risk-averse private investors, which the federal government is not. Thus, the fair value accounting method stands more akin to tax expenditure estimates, which are an analytical measure of benefit and not budget cost.

Beyond the scorekeeping flaws that fair value accounting would create, this analytical method would create a disconnect between the forecasted discounted costs and the intended policy objectives of these programs. Loan guarantees, such as those provided by the Federal Housing Administration (FHA), are critical countercyclical economic policies that ensure that credit is available to prospective homebuyers when other sources cease to exist during an economic

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[1] Fair-Value Estimates of the Costs of Selected Federal Credit Programs for 2015-2024. Congressional Budget Office, May 2014.

[2] The most recent JCT tax expenditure report: "Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018". August 8, 2014. JCX-97-14. https://www.jct.gov/publications.html?func=startdown&id=4664

[3] For more on the theory and practice concerning tax expenditure estimation, see: "Reconsidering Tax Expenditure Estimation". Roseanne Altshuler and Robert Dietz. 2011. *National Tax Journal* 64(2) 459-490

crisis. For example, consider the share of new home sales financed by FHA-backed mortgages prior to and during the Great Recession. From 2002 to the end of 2007, the average quarterly market share for FHA-backed mortgage for sales of newly built homes was 6.36% according to data from the Census Bureau and NAHB analysis.[4] In contrast, during and after the Great Recession, private sources of mortgage financing receded, thus increasing the importance of the FHA program. Between 2008 and the end of 2013, the market share for new home sales backed by FHA-insured mortgages more than tripled, totaling 20% of all new home sales.

Increasing the cost of these important counter-cyclical finance programs would be harmful for the economy. Adding additional hypothetical costs by imposing private market risk expectations on Federal government programs could result in program cuts for policies that are the most important when the economy needs them the most. Utilizing fair value accounting for scorekeeping purposes would thus move away from measuring the present value cost of various programs to measuring a benefit concept that is taken from the perspective of risk averse market participants, which the Federal government is not.

Thank you for considering our views.

Sincerely,

James W. Tobin III

[4] "Increase for New Home Sales Financed by FHA-Backed Mortgages" NAHB Economics Eye on Housing post. April 23, 2015. Robert Dietz. http://eyeonhousing.org/2015/04/increase-for-new-home-sales-financed-by-fha-backed-mortgages/

NCSHA

June 16, 2015

The Honorable Daniel Coats
Chairman
U.S. Congress Joint Economic Committee
493 Russell Senate Office Building
Washington, DC 20510-1405

The Honorable Carolyn Maloney
Ranking Member
U.S. Congress Joint Economic Committee
2308 Rayburn House Office Building
Washington, DC 20515-3212

Dear Chairman Coats and Ranking Member Maloney:

As you undertake the Committee's June 17 hearing on *The Economic Exposure of Federal Credit Programs*, the National Council of State Housing Agencies (NCSHA) would like to express our deep concern about the potential impact of proposals to shift the accounting methods for federal loan and guarantee programs from the scorekeeping methodology enacted as part of the Federal Credit Reform Act of 1990 (FCRA) to "fair value" accounting. As we stated in the March 17, 2015 joint letter on this issue to the House and Senate Budget Committees, which we understand has been submitted to you separately, we are concerned that this change could add "phantom" costs to federal loan and guarantee programs and have a significant negative impact on the federal appropriations process for them and other federal programs.

NCSHA's members are the Housing Finance Agencies (HFAs) of the 50 states, the District of Columbia, New York City, Puerto Rico, and the U.S. Virgin Islands. HFAs administer a wide range of affordable housing and community development programs, including HOME, Section 8, homelessness assistance, down payment assistance, state housing trust funds, tax-exempt Housing Bonds, and the Low Income Housing Tax Credit (Housing Credit). HFAs also commonly use programs administered by the Federal Housing Administration (FHA) and the U.S. Department of Agriculture's Rural Housing Service (RHS) to support their affordable housing activities.

HFAs effectively employ these resources to advance their common public-purpose mission of providing affordable housing to the people of their jurisdictions who need it. HFAs have established a multi-decade record of safe and sound lending that has made it possible for millions of people of modest means to purchase their first homes or access affordable rental housing.

Federal loan and guarantee programs—including programs administered by FHA, RHS, and the U.S. Department of Veterans Affairs (VA)—have long played a critical role in the provision of affordable housing. Programs at these agencies insure both single-family and multifamily loans for qualified buyers who would be unable to achieve financing without the guarantee provided by these programs. In doing so, they allow for private sector investment in these loans, create market liquidity, and improve the lives of those who otherwise would likely not be able to purchase a home or find affordable rental housing.

If Congress were to adopt fair value accounting methodology, federal housing loan programs, including those administered by FHA, RHS, and VA, would appear on paper to cost more than they do in actuality. Unlike the current FCRA system, which bases cost estimates on the actual cost of administering the programs, fair value accounting would apply a private market discount rate to these programs, distorting their actual costs to the federal taxpayer and on paper adding significantly to the federal deficit – even though these costs are not actually incurred.

To cover these phantom costs, these housing programs would either be forced raise premiums to the extent where they would become prohibitively more expensive, or Congress would need to significantly increase appropriations to cover these fictitious cost estimates. For example, FHA raises approximately $4.4 billion in revenue annually, much of which is used to support programs funded by the Transportation, Housing and Urban Development, and Related Agencies (THUD) annual appropriations bills. According to Congressional Budget Office cost estimates under the fair value accounting methodology, FHA instead would require an appropriation of $3.5 billion, creating an $8 billion hole in the THUD budget. This would be extremely problematic not only for FHA but also for the many other programs in the THUD bill that are offset by FHA receipts.

We hope you will look closely at the potential impact fair value accounting will have on these and other federal loan and guarantee programs. It appears likely that fair value accounting will lead to phantom costs in programs that provide vital services to our communities. Additionally, we believe that fair value accounting would make the federal budget a less accurate representation of government spending.

Thank you for considering our views on this important matter. Please feel free to reach out to me with any questions you might have.

Sincerely,

Garth B. Rieman

Garth B. Rieman
Director of Housing Advocacy and Strategic Initiatives

NLHA

NATIONAL
LEASED HOUSING
ASSOCIATION

June 15, 2015

The Honorable Daniel Ray Coats
Chairman
Joint Economic Committee
SD-G01 Dirksen Senate Office Bldg
Washington, DC 20510

The Honorable Carolyn B. Maloney
House Ranking Member
Joint Economic Committee
2308 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Coats and Ranking Member Maloney:

The National Leased Housing Association appreciates that the Joint Economic Committee is holding a hearing on Federal Credit programs. These programs are important to our membership organizations which develop, administer or manage affordable multifamily rental housing.

As you know, in 1990 Congress changed the accounting rules for federal credit programs to ensure that accurate federal costs were represented and to allow comparisons between federal programs. The "Federal Credit Reform Act (FCRA)" amended the prior cash basis scoring to more accurately reflect the costs to the Treasury of Federal Credit programs by adopting an accrual accounting approach and including such factors as expected losses, late payments, etc.

We are concerned about recent proposals to shift federal credit programs' accounting to a Fair Value Accounting methodology. On its face, such a methodology may sound reasonable, but it does not reflect reality. Fair value is calculated using a market interest rate even though federal programs borrow at lower Treasury rates. Federal loan and loan guarantee programs were developed to provide citizens access to credit in adverse markets where the private sector is not operating.

Moving to a fair value model will distort the actual costs of these programs and add significantly to the federal deficit – yet such costs are actually NOT being incurred. In other words, the fair value methodology would require additional appropriations to offset the phantom costs.

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As pointed out by the National Association of Realtors in its statement, "the impact on the Appropriations process if fair value estimates are used would be severe. For example, using fair value for FHA would hurt many programs under the Transportation-HUD appropriations bill. The Congressional Budget Office (CBO) estimates that, instead of raising $4.4 billion in revenue which is currently used to fund many other parts of the T-HUD budget, FHA would require an appropriation of $3.5 billion, and provide no offsets for the rest of the T-HUD Budget. If fair value accounting is adopted, federal housing loan programs such as FHA, the VA home loan guarantee and rural housing loans would either become significantly more expensive for borrowers, or would require increased appropriations of billions of dollars to cover costs that only exist on paper."

We believe that the Federal budget will be a less accurate reflection of actual government spending should Congress agree to shift to a Fair Value accounting methodology. NLHA urges the rejection of any proposals to mandate fair value accounting.

Sincerely,

Denise B. Muha

Denise B. Muha
Executive Director

NMHC NATIONAL MULTIFAMILY HOUSING COUNCIL

NAA NATIONAL APARTMENT ASSOCIATION

June 17, 2015

The Honorable Daniel Coats
Chairman
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Amy Klobuchar
Ranking Member
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Kevin Brady
Vice Chairman
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Carolyn Maloney
Ranking Member
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Coats, Ranking Member Klobuchar, Vice Chairman Brady and Ranking Member Maloney:

On behalf of the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA), we are writing to thank you for holding a hearing on "The Economic Exposure of Federal Credit Programs" and to urge you to oppose measures mandating the concept of Fair Value Accounting.

We appreciate the opportunity to share the views of the apartment industry on federal credit programs, especially the proposal that would shift the accounting methods for federal loan and guarantee programs to Fair Value Accounting from the "Federal Credit Reform Act of 1990." A change that could add phantom costs onto housing programs and have a negative impact on the appropriations process.

For more than 20 years, NMHC and NAA have partnered in a joint legislative program to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of more than 170 state and local affiliates, NAA is comprised of over 67,000 members representing more than 7.6 million apartment homes throughout the United States and Canada. The combined spending by the apartment industry and its 36 million residents contributed$1.3 trillion to the U.S. economy and supported 12.3 million jobs in 2013.

NMHC/NAA Joint Legislative Program

1850 M Street, NW, Suite 540, Washington, DC 20036
202 974 2300 Office | www.nmhc.org

While fair value seems like a reasonable measure of the cost of a federal program – it does not reflect reality and would negatively impact our industry's ability to meet the nation's housing needs. Federal credit programs like the Federal Housing Administration (FHA) multifamily housing loan program have been a cornerstone for the construction and permanent financing and refinancing of apartments. After the 2008 financial collapse, they became a vital source of construction capital for apartments and now currently account for 9 percent of the total outstanding multifamily mortgage debt. Between 1990 and 2014, they accounted for 10.9 percent of the total net increase in mortgage debt.

Should Fair Value Accounting be adopted, FHA loans would need to be made either significantly more expensive to borrowers or provide increased appropriation to cover the costs that only appear on paper. This would be unfortunate, as FHA is a material and important source of capital for underserved segments of the rental market.

On behalf of the NMHC and NAA we urge you to oppose the concept of Fair Value Accounting and respectfully request that this letter, and the attached coalition letter we submitted in March to the Budget Committee, be included in the record for the Committee's hearing on June 17.

We look forward to working with you to create a housing system that ensures our continued ability to meet the housing needs of today's 37 million Americans building their lives in apartments.

Sincerely,

Douglas M. Bibby
President
National Multifamily Housing Council

Douglas S. Culkin, CAE
President
National Apartment Association

National Rural Electric
Cooperative Association
A Touchstone Energy Cooperative

Statement of the National Rural Electric Association Submitted to:

The United State Congress Joint Economic Committee

Hearing Titled:

The Economic Exposure of Federal Credit Programs

June 16, 2015

On behalf of the over 900 electric cooperatives that provide power to 42 million consumer-owners in 47 states, NRECA expresses concern over using fair value estimates of cost for federal loan programs, especially the U.S. Rural Utilities Service Electric Loan Program on which two thirds of America's electric cooperatives depend.

If adopted, fair-value accounting would needlessly drive up the cost of capital for electric cooperatives that borrow funds through the USDA's Rural Utilities Service (RUS) electric loan program. Over the last 10 years (from 2005-2014), there were 1,376 RUS electric loans approved. This loan volume totaled $42.2 billion to 588 different rural electric borrowers. The total net benefit to the federal government (the annual negative subsidy) was $1.4 billion. These funds were used to build, maintain and improve infrastructure, keeping electricity affordable and reliable. Enacting this policy change would require the government to use subjective accounting to determine the cost of federal loan programs to the government. That shift ignores electric cooperatives' outstanding record of repaying RUS loans in full and on time.

Fair value accounting will have a negative effect on the rural economy of America since fewer loan dollars will be available to electric cooperatives to build, maintain and improve the infrastructure needed to keep electricity safe, affordable and reliable. And that means higher electric bills for electric cooperative consumer members in rural America as co-ops meet their financial needs with more expensive capital from other sources.

Fair-value accounting does not change the fundamentals of how any particular loan program would work, nor will it improve program performance. It simply increases the price tag. Using fair value estimates will make the RUS program more expensive on paper from a budget scorekeeping perspective, even though that is contrary to rural electric cooperatives' outstanding record of repaying RUS loans in full and on time.

The ensuing fiscal pressure would almost certainly crowd-out even the most successful federal loan programs like the RUS electric loan program by making it appear more expensive on paper, reducing the loan level that the appropriators can authorize with the same level of available funding. This arbitrary change will raise electricity rates unnecessarily and that means higher electric bills for electric cooperative consumer members across America.

4301 Wilson Blvd. • Arlington, VA 22203-1860 • tel: 703.907.5500 • www.nreca.coop

This move towards Fair Value Accounting appears to be an effort to solve problems with other troubled loan programs and not the RUS electric loan program. If that is true, we encourage Congress to reform those programs rather than impose fair value accounting on all federal loan programs. That would be much more effective than implementing this change costing the American public more to deliver the same program and calling it reform.

Please stand with the 900 electric co-ops nationwide and oppose using fair value accounting. Instead we urge you to recognize the success of one of the most successful federal loan programs ever, the RUS electric loan program. Before making the change to fair value accounting, we welcome the opportunity to discuss the issue and its impact on one of the most successful federal loan programs ever.

If adopted, fair value accounting will have a chilling, negative effect on the economy of this nation, particularly in rural America. It would be wise to look before we leap into this change.

Thank you for the opportunity to submit this statement for the record.

Contact: Abbie Laugtug, NRECA 703-907- 5822 abbie.laugtug@nreca.coop

June 16, 2015

The Honorable Dan Coats
Chairman
Joint Economic Committee
493 Russell Office Bldg
Washington, D.C. 20510

The Honorable Carolyn B. Maloney
Ranking Member
Joint Economic Committee
2308 Rayburn House Office Building
Washington, DC 20515

Senator Coats and Congresswoman Maloney:

The undersigned organizations submit this letter, which was sent to the Budget Committees regarding Fair Value Accounting.

American Council on Education
Community Home Lenders Association
Council for Affordable and Rural Housing
Institute of Real Estate Management
National Affordable Housing Management Association
National Apartment Association
National Association of Home Builders
National Association of Independent Colleges and Universities
National Association of REALTORS®
National Council of State Housing Agencies
National Housing Trust
National Leased Housing Association
National Multifamily Housing Council
Stewards of Affordable Housing for the Future
Student Aid Alliance

March 17, 2015

The Honorable Mike Enzi	The Honorable Bernie Sanders
Chairman	Ranking Member
U.S. Senate Committee on the Budget	U.S. Senate Committee on the Budget
379A Russell Senate Office Building	332 Dirksen Senate Office Building
Washington, DC 20510	Washington, D.C. 20510

Dear Chairman Enzi and Ranking Member Sanders:

This week the Budget Committees will markup the FY16 budget resolutions. One proposal being considered would shift the accounting methods for federal loan and guarantee programs to fair value accounting from the Federal Credit Reform Act of 1990 (FCRA). This change could add phantom costs onto these programs, and have a significant impact on the Appropriations process.

While fair value seems like a reasonable measure of the cost of a federal program – it does not reflect reality. Fair value accounting places a private market value on programs run by the federal government. Federal loan and loan guarantee programs are fundamentally different than their private sector counterparts. They were not created to be profit-making and are required to function under all market conditions unlike for-profit programs which tend to exit the market in adverse economic conditions. In many cases, these programs were actually created to fill market gaps in which the private sector did not operate. Using a private market discount rate would distort the actual costs of these programs to the federal taxpayer and add significantly to the federal deficit – even though these costs are not incurred.

Of the more than 100 credit programs in the federal budget, more than 44 of these programs are cost neutral or make money for the government as currently scored. But, under fair value accounting, more than 75% of these programs would appear to cost money – mandating policy changes or additional appropriations to offset these phantom costs. [1]

These programs fall across all areas of government: small business loans, veterans' housing loans, rural utility loans, FHA loan guarantees, transportation and infrastructure loans, student loans, and agriculture loans. These programs would now need to be made either significantly more expensive to borrowers, or given an increased appropriation - billions of dollars – to cover costs that only appear on paper.

The below signed organizations strongly urge you to oppose the inclusion of any language mandating fair value accounting in the FY16 budget resolution. Adding a placeholder for inapplicable and imaginary private sector costs that the government does not incur simply complicates the appropriations process and makes the budget a less accurate reflection of actual government spending.

Sincerely,

American Council on Education
Community Home Lenders Association
Council for Affordable and Rural Housing
Institute of Real Estate Management
National Affordable Housing Management Association

[1] Derived from CBO, *Fair Value Estimates of the Cost of Federal Credit Programs in 2013,* June 27, 2012, Supplemental Spreadsheet at http:www.cbo.gov/publication/43352

National Apartment Association
National Association of Home Builders
National Association of Independent Colleges and Universities
National Association of REALTORS®
National Council of State Housing Agencies
National Housing Trust
National Leased Housing Association
National Multifamily Housing Council
Stewards of Affordable Housing for the Future
Student Aid Alliance

cc: The Honorable Thad Cochran, Chairman, Senate Committee on Appropriations
The Honorable Barbara A. Mikulski, Vice Chairwoman, Senate Committee on Appropriations

The Retired Enlisted Association
WASHINGTON OFFICE
1001 N. Fairfax Street, Suite 102
Alexandria, Virginia 22314
Telephone: (703) 684-1981
Fax: (703) 548-4876
Email: treadmin@treadc.org

FOUNDED 1963
CHARTERED BY CONGRESS

June 16th, 2015

The Honorable Daniel Coats
Chairman Joint Economic Comm
G-01 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Carolyn Maloney
Ranking Member Joint Economic Comm
G-01 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Coats and Ranking Member Maloney,

I am writing on behalf of The Retired Enlisted Association concerning the proposal before your Joint Economic Committee to adopt a"fair value " accounting method when analyzing federal credit programs.

Several of those programs, such as veterans' home loans, Small Business loans, student loans are of great importance to America's veterans. We believe that the "fair value" accounting would damage these programs by overstating their true costs to the government.

Unlike the private sector the federal government is not focused on making a profit. Indeed, many of these programs were created to fill gaps in the private markets and provide benefits for veterans who have served our country at their peril and are now reentering the civilian world.

We urge you not to adopt the "fair value" method. We thank you for your attention to our concerns

Sincerely,

Deirdre Parke Holleman

Deirdre Parke Holleman
Executive Director Washington Office

* * * UNITED WE STAND * * *

Student Aid Alliance

June 15, 2015

Senator Daniel Coats
Chairman
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

Representative Carolyn Maloney
Ranking Member
Joint Economic Committee
G-01 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Coats and Ranking Member Maloney:

On behalf of the over eighty member organizations and institutions of the Student Aid Alliance, which represents students, college presidents, and other educators who support federal student aid, we write to express our strong concern with the use of so-called "fair-value" estimates for federal credit programs. As the Joint Economic Committee explores this issue, we would like to highlight the significant damage a move to this scoring method would have for the federal student loan programs.

We believe that policy decisions should be made based on the real impact to the Treasury of those decisions. "Fair-value" estimates depend on the inclusion of phantom costs to the scoring of federal credit programs, creating the illusion of deficits without any corresponding impact on the Treasury. Far from better-informing the annual budget and appropriations process, the production of fair-value scores would greatly complicate the process and reduce transparency and comparability.

The implications for student loans of such an approach are significant, and dangerous. CBO estimates that shifting from the current, accurate method to "fair-value" scoring would show an increased deficit of $223 billion over ten years, with no changes to the underlying programs. As Congress considers reauthorization of the Higher Education Act, the use of these erroneous, phantom costs will inevitably force policy choices that will be detrimental to students.

We urge you to support America's students by supporting accuracy and transparency in budget scoring, and rejecting the gimmicks inherent in the "fair-value" methodology.

Sincerely,

Molly Corbett Broad
Co-Chairman

David Warren
Co-Chairman

Student Aid Alliance

2015 Members

AACRAO: American Association of Collegiate Registrars and Admissions Officers
ACT, Inc.
American Association of Colleges for Teacher Education
American Association of Colleges of Nursing
American Association of Colleges of Osteopathic Medicine
American Association of Colleges of Pharmacy
American Association of Community Colleges
American Association of State Colleges and Universities
American Association of University Professors
American College Personnel Association
American Council on Education
American Dental Education Association
American Federation of Teachers
American Indian Higher Education Consortium
American Society for Engineering Education
American Student Association of Community Colleges
APPA
Association of American Law Schools
Association of American Universities
Association of American Veterinarian Medical Colleges
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Public and Land-grant Universities
Association of Research Libraries
Association of Schools of Allied Health Professionals
Boston University
Clemson University
Coalition of Higher Education Assistance Organization
Columbia University
Consortium of Christian Colleges and Universities
Consortium of Universities of the Washington Metropolitan Area
Council for Higher Education Accreditation
Council for Opportunity in Education
Council of Graduate Schools
Council of Independent Colleges
Duke University
EDUCAUSE
Georgetown University
Harvard University
Massachusetts Institute of Technology
Michigan State University
National Association for College Admission Counseling
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of College Stores
National Association of Graduate and Professional Students
National Association of Independent Colleges and Universities
National Association of State Student Grant and Aid Programs
National Association of Student Financial Aid Administrators
National Association of Student Personnel Administrators
National College Access Network
National Council for Community and Education Partnerships
National Council of Higher Education Loan Resources
National Council of Research Administrators
National Direct Student Loan Coalition
National Education Association
Rutgers, The State University of New Jersey
The California State University
The College Board
The Fashion Institute of Design & Merchandising
The Hispanic Association of Colleges and Universities
The National Collegiate Athletic Association
The Ohio State University
UNCF
United States Student Association
University Continuing Education Association
University of California
University of Maryland System
University of Massachusetts
University of Michigan
University of Rochester
University of Southern California
University of Washington
US Public Interest Research Group
Utah Valley State College
Vanderbilt University
Women's College Coalition
Work Colleges Coalition

YOUNGINVINCIBLES

June 16, 2015

The Honorable Dan Coats
Chairman
Joint Economic Committee
Washington, DC 20510

The Honorable Carolyn B. Maloney
Ranking Member
Joint Economic Committee
Washington, DC 20510

Dear Chairman Coats and Ranking Member Maloney:

Please see the following statement regarding "fair value accounting":

FOR IMMEDIATE RELEASE
June 16, 2015

Contact: Sarah Lovenheim, sarah.lovenheim@younginvincibles.org

(WASHINGTON) — Ahead of a Joint Economic Committee hearing on so-called "fair-value accounting," slated for June 17, Young Invincibles' Policy Director Jennifer Wang released the following statement:

"So-called "fair-value accounting" is far from fair: it's an accounting gimmick that makes student loans appear more expensive for the federal government than they actually are. 'Fair value accounting' prices in risks that do not exist, obscuring the fact that the government makes billions of dollars from the student loan program. Adding phantom costs to federal financial aid is a distraction from discussing increasing investments in higher education and if it moves forward, young people could end up paying the price."

For more background on how "fair-value accounting" would hurt students, please reference this [illegible].

We appreciate your consideration of this important issue.

Sincerely,

Young Invincibles

PREPARED STATEMENT OF HON. CAROLYN B. MALONEY, RANKING MEMBER, JOINT ECONOMIC COMMITTEE

Thank you Chairman Coats for holding today's hearing.

In this morning's hearing, we will compare two systems for budgeting federal credit programs.

The first, the Federal Credit Reform Act of 1990 (FCRA), was signed into law by George H.W. Bush in 1990. It has proven a reliable tool for budgeting federal credit programs.

The second, so-called "fair value" accounting, is a program supported by some of my colleagues in the Republican Party that will make federal credit programs seem more expensive. If implemented, this system will necessitate cutting loan programs or raising interest rates.

In my mind, there is nothing fair about "fair value" accounting.

At its root, today's hearing is about two vastly different philosophical approaches to government.

My Republican friends believe that the federal government—in this case federal lending programs—should operate just like the private sector.

But the federal government is not the private sector.

The principal motivation of the private sector is to maximize profit.

The principal goal of government is to provide services that the private sector cannot or will not provide.

These differences are especially clear in federal lending programs. Private institutions make loans that they think will be the most profitable.

But the United States government sees thing differently.

For example, it lends to a group of individuals with little or no income and no credit history. They are known as "college students," and there are more than 20 million of them in the United States today. The vast majority of student loans are issued by or guaranteed by the government.

Why does the government take on this risk? Because it helps millions of Americans go to college who might otherwise not be able to afford to go. It also benefits the rest of us by creating a more educated workforce. A better workforce will make our country more competitive and our economy stronger.

This is a social good not recognized by private lenders.

I want to turn to the specific question of how we measure the costs of federal government loan programs.

How these programs are accounted for—and how their budget impact is assessed—will affect the broader deficit outlook and choices we make as policymakers.

The current procedure under the Federal Credit Reform Act appropriately calculates the lifetime cost of federal credit programs reflecting both the risk of default and the government's cost of borrowing.

FCRA has been very accurate. OMB found that since in the more than 20 years FCRA has been in place, the initial cost estimates of all credit programs differed from their actual cost by less than one percent.

As they say—if it ain't broke, don't fix it.

But today we're apparently trying to "fix" a system that already works well.

It is part of a broader ideological initiative.

In tax policy, Republicans are trying to change the rules of the game by instituting so-called "dynamic scoring." This would make tax cuts seem less expensive than they really are.

In federal credit policy, Republicans are trying to change the rules of the game using an accounting system that will make programs like student loans look more expensive.

The result of this so-called "fair value" accounting will be cuts in federal loans programs—for example, less money available for students at higher rates.

Under "fair value" accounting, the cost of federal credit programs, which are funded by the purchase of low-interest Treasury securities, would be evaluated as if these governments were forced to borrow with an additional "risk premium" demanded by the private market.

As the Center on Budget and Policy Priorities put it, fair value budgeting requires that the budget "reflect amounts that the Treasury would never actually pay anyone."

It will make federal lending programs appear more costly than they really are.

Millions of Americans have something to lose if proponents of this accounting system have their way. I regret that we don't have any of their representatives on this panel today.

However, Chairman Coats and I have received letters from a number of organizations strongly opposed to "fair value" accounting.

A letter from the National Education Association states that, quote: "NEA opposes the use of fair value accounting in federal credit programs, especially student loan programs, because it would artificially raise their costs and make them appear to be more expensive to the federal government than they really are."

I ask unanimous consent to enter this letter into the record.

A letter from the National Association of Homebuilders states that "fair value accounting" would artificially raise the rates on home loans. I also would like to enter that letter into the record.

Other noted organizations also oppose using "fair value accounting" for budgeting purposes:

- The National Association of Realtors
- The National Association of Independent Colleges and Universities
- The Retired Enlisted Association
- The National Rural Electric Cooperative Association
- The Student Aid Alliance
- The National Multifamily Housing Council
- And many others . . .

I would like to place letters from several of these organizations into the record.

In conclusion, I ask that we listen to both sides of the debate today—but that, ultimately, we not let ideology trump reality.

Fair value budgeting would distort the budget process, undercut federal credit programs, and, ultimately, deprive millions of Americans of the financial support they need to get an education, buy a home, or start or operate a small business.

I look forward to our discussion this morning and thank each of the witnesses for appearing before the Committee.

FCRA vs. Fair Value Accounting:
A Comparison and Recommendation

United States Congress

Joint Economic Committee

Douglas Holtz-Eakin, President*

American Action Forum

June 17, 2015

*The views expressed here are my own and not those of the American Action Forum. I thank Gordon Gray, Chad Miller, Meghan Milloy, and Andy Winkler for their assistance in preparing for this testimony.

Chairman Coats, Ranking Member Maloney, and Members of the Committee, thank you for the opportunity to speak with you today. In this testimony, I'd like to make three basic points that support incorporating Fair Value Accounting into the federal budget process:

1. The Federal Credit Reform Act (FCRA) was needed to place the cash flows for economically equivalent activities on a level budgetary playing field, but has proven to underestimate the ultimate taxpayer cost of credit activities.
2. Fair Value Accounting (FVA) provides a more comprehensive measure of the cost of federal credit programs by better accounting for risk.
3. FVA already has been used successfully as the standard for budgetary treatment for TARP and for federal assistance to Fannie Mae and Freddie Mac.

Let me address each in turn.

Creating a Level Budgetary Playing Field

The Federal Credit Reform Act (FCRA) was passed in 1990 to ensure that the federal budget more accurately reflected the taxpayer costs for both federal direct loans and federally guaranteed loans, and did so in a comparable fashion. These two activities have the same economic purpose: provide credit using the taxpayer as a guarantee of repayment. But in the absence of FCRA they appear quite differently on the federal budget.

On the one hand are direct loans: loans made directly from the federal government to the borrower in which the federal government makes one large payment for the total amount of the loan and then, over the course of the next several years, receives incremental payments from the borrower for the principal amount and the interest of that loan. If the borrower fails to repay, the taxpayer picks up the shortfall. Before FCRA, accounting for a direct loan showed the full amount of the loan as an outlay in the year that it was disbursed, recorded principal and interest as receipts in the year received, and had no explicit recognition of the probability of failure to repay in full.

On the other hand are federally guaranteed loans: loans made to the borrower by a private lender in which repayment is guaranteed by the full faith and credit of the federal government. Repayment of those loans is made directly to the lender, but the government receives various fees at the time of application and/or throughout the repayment period. However, if the borrower defaults on the loan, the federal government is liable for the amount of the percentage of the loan that it guaranteed. Unlike direct loans, before FCRA, federally-guaranteed loans showed a budgetary "profit" at the time of approval since the government received the guarantee fee yet owed no money unless the borrower ended up defaulting down the road.

After FCRA, however, direct and guaranteed loans were accounted for in the same way: a single lump sum of the estimate of the net present value of receipts and outlays (excluding administrative costs and any incidental effects on government receipts or outlays). In this way, any taxpayer subsidy is identified in the budget (the present value of receipts is smaller than the present value of outlays) and is directly comparable between loans and guarantees.

FCRA Underestimates Taxpayer Costs

FCRA mandated the computation of subsidy rates in credit programs. In a CBO letter to then Ranking Member Judd Gregg of the Senate Budget Committee[1] the process is described: "FCRA facilitates the comparison of the budgetary effects of direct loans and loan guarantees by converting the net outlays for each program into a single lump-sum estimate of net costs (that is, the discounted present value of all cash flows). Those cash flows are discounted using the government's costs of borrowing – that is, the interest rates it pays on Treasury securities of comparable maturities. The resulting subsidy estimate is recorded in the federal budget in the year of a loan's disbursement. Subsidies computed under FCRA do not include the government's costs for administering the loans; those administrative costs are recorded separately, on a cash basis."

Unfortunately, the FCRA approach has systematically underestimated costs. As pointed out in a recent study conducted by the American Action Forum[2], the budget estimates required under FCRA are fundamentally uncertain due to market changes and economic fluctuations. In those circumstances, one would expect that some estimates would turn out to be too high, while others would be too low. Instead, a quick look at some existing federal direct or guaranteed loan programs shows both a wide variance in revised estimates of program costs (compared to their original estimates) and a bias toward revising the costs upward.

Table 1: Lifetime Re-estimates for Select Federal Credit Programs[3]

(Direct loan programs are in standard font; *guaranteed loan programs are in italics,* savings relative to original estimates are noted with parentheses)

Under FCRA estimates, the federal direct student loan program has cost the Treasury (and

Department and Program	Lifetime Re-estimates	Lifetime Disbursements
Department of Agriculture		
Agricultural Credit Insurance Fund	($1 billion)	$25 billion
Rural Housing Service	$278,000	$37 billion
Rural Utilities Service	$264 million	$82 billion
Agricultural Credit Insurance Fund	*($2.2 billion)*	*$100 billion*
Rural Housing Service	*$2,522,000*	*$129 billion*
Rural Utilities Service	*($2.4 million)*	*$388 million*
Department of Commerce	($68 million)	$814 million
Department of Education		
Federal Direct Student Loans	$10,963,000	$762 billion
Department of Housing and Urban Development		
Mutual Mortgage Insurance Program	*$77,717,000*	*$2.773 trillion*

taxpayers) almost $11 billion since its inception. While not inconsequential, this is but a fraction of the nearly $78 billion re-estimate on federal housing guaranteed loan programs.

While FCRA has improved the federal government's ability to account for credit programs compared to the cash flow accounting in use for the majority of federal programs, it is far from perfect. Examining only a handful of the largest federal credit programs shows that since implementing FCRA accounting methods, the federal government has had to come up with roughly $90 billion to offset underestimated costs of credit programs. Those are costs that are ultimately born by the taxpayer.

The bias stems from omitting a source of risk: market risk. An alternative would base the budget cost of federal credit programs on an estimate of the market value of the federal government's obligations, an estimate that accounts for market risk and includes administrative costs associated with originating, servicing, and collecting the loan.

Fair Value Accounting is A More Comprehensive Measure of the Cost of Federal Credit Programs

This approach is commonly referred to as Fair Value Accounting. Per a 2014 CBO study on fair value estimates of the cost of federal credit programs[4], "[m]arket risk is the component of financial risk that remains even after investors have diversified their portfolios as much as possible; it arises from shifts in macroeconomic conditions, such as productivity and employment, and from changes in expectations about future macroeconomic conditions. The government is exposed to market risk when the economy is weak because borrowers default on their debt obligations more frequently and recoveries from borrowers are rare. When the government extends credit, the associated market risk of those obligations is effectively passed along to taxpayers, who, as investors, would view that risk as having a cost. Therefore, the fair-value approach offers a more comprehensive estimate of federal costs."

Such a significant reform to budget procedures should not be undertaken lightly. However, my views are informed by the fact that, during my tenure as Director, the Congressional Budget Office undertook a number of studies of the implications of accounting fully for economic risks in the budgetary treatment of financial commitments such as the credit programs being discussed today. In example after example (pension guarantees; deposit insurance; flood insurance; student loans; and assistance for Chrysler and America West Airlines) it becomes clear that an incomplete assessment of risks leads to misleading budget presentations and may engender poor policy decisions. Fair value accounting would be a significant step toward improving this informational deficit.

My views are echoed by a wide array of budget experts. In addition to a March 2010 CBO report that discussed the use of FVA for federal student loan programs and stated that budget rules do "not include the costs to taxpayers that stem from certain risks involved in lending," the Pew-Peterson Commission on Budget Reform proposed "fair-value accounting" for credit programs and the President's National Commission on Fiscal Responsibility and Reform advocated for reform of budget concepts that would more accurately reflect costs. It is clear from many studies, reports, and varying points of view, that FVA is a better, more comprehensive, and more accurate measure of the cost of federal credit programs.

<u>Fair Value Accounting Already has Been Used Successfully in TARP and Fannie/Freddie</u>

In closing, I would like to draw your attention to two recent instances in which FVA has been widely used and accepted. First, in a 2009 study, commissioned by chair of the independent Congressional Oversight Panel Elizabeth Warren, FVA was successfully used to show that the total market value of TARP assets was $176 billion - $78 billion lower than what the government had paid. In dismissing the methods used by former Treasury Secretary Henry M. Paulson and advocating for the FVA study on the matter, Warren said, "Despite the assurances of then-Secretary Paulson, who said that the transactions were at par – that is for every $100 injected into the banks the taxpayer received stocks and warrants from the banks worth about $100 – the valuation study concludes that Treasury paid substantially more for the assets it purchased under the TARP than their then-current market value." In doing so, Warren further dismissed the administration's official FCRA estimate which stated that the assets were, at the time of purchase, valued at $12.6 billion more than taxpayers paid – an estimate that failed to include the cost of market risk.

Finally, in a 2011 report, CBO stated that the real cost of the federal government guaranteeing Fannie Mae and Freddie Mac is $317 billion, more than double the $130 billion claimed by the Obama Administration using cash payment accounting methods. Specifically, the report explained that CBO considered the mortgages guaranteed by Fannie and Freddie as new guarantee obligations of the federal government, and "[f]or those guarantees, CBO's projections of budget outlays equal the estimated federal subsidies inherent in the commitments at the time they are made." This was a sharp contrast to OMB's treatment of Fannie and Freddie as nongovernmental entities and its limited reporting of only the net cash payments provided by Treasury to Fannie and Freddie. Since then, the CBO estimates have been used as the standard, and OMB's FCRA estimates have been widely disregarded.

Thank you. I look forward to answering your questions.

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[1] https://www.cbo.gov/sites/default/files/gregg_studentloans__09-07-27.pdf
[2] http://americanactionforum.org/research/the-advantage-of-fair-value-accounting
[3] Electronic versions of The 2015 *Federal Credit Supplement* in both PDF and Excel formats are available at http://www.whitehouse.gov/omb/budget/Supplemental. Tables 7 and 8 provide information on the lifetime reestimates of direct loan and loan guarantee cohorts 1992 through 2013 by agency, bureau, program, and risk category. The tables show the following for each cohort: the original subsidy rate at the point of obligation or commitment; the current reestimated subsidy rate; the change in subsidy rates due to interest and technical updates; dollar reestimates for the current year; net lifetime reestimate data; and lifetime disbursements through September 30, 2013. Some cohorts displayed in the 2015 *Supplement* have closed—there are no outstanding direct or guaranteed loans in the cohort and no further activity is expected. These cohorts are identified with a footnote and will not be displayed in future *Federal Credit Supplement* volumes.
[4] http://www.cbo.gov/sites/default/files/45383-FairValue.pdf

NEW AMERICA

Testimony of Jason Delisle
Director, Federal Education Budget Project

Before the Joint Economic Committee of the U.S. Congress
Hearing Topic: "The Economic Exposure of Federal Credit Programs"

June 17, 2015

Chairman Coats, Ranking Member Maloney, and members of the committee, thank you for the opportunity to testify about the costs of federal credit programs and the federal student loan program in particular.

In the early 1990s, Congress made important changes to the way federal loan programs are treated in the budget with the enactment of the Federal Credit Reform Act (FCRA).[1] Leading up to the enactment of that law, most budget experts and economists agreed that existing budget practices, which treated loans on a cash-in cash-out basis, made it difficult to discern what federal loan programs cost taxpayers.[2] That approach also had the distorting effect of making direct federal loans appear as grants in the year they were issued and making a government guarantee of the same loans appears free. FCRA corrected those flaws by putting federal loans on an accrual basis so that the budget measures and states their cost on a present value basis. The budget now reflects the lifetime cost of the loan as a lump sum in the year it is made.

For all the benefits of the FCRA approach over what it replaced, it still fails to provide lawmakers and the public with an accurate measure of the obligations taxpayers face through government credit programs. That is because lawmakers included a provision in the original law that systematically understates the cost of government loan programs. As the nonpartisan Congressional Budget Office explains, "FCRA-based cost estimates, however, do not provide a comprehensive measure of what federal credit programs actually cost the government and, by extension, taxpayers."[3] As I will discuss later in my testimony, that less-than-comprehensive measure of costs creates unusually perverse incentives for policymakers.

Switching to an accrual accounting approach is undoubtedly better. The issue is how the law instructs budget agencies to carry out that approach. Specifically, budget analysts must estimate the cost of loan programs using a discount rate -- the rate at which future cash flows are converted to a present value -- that reflects the interest rates on U.S. Treasury securities of comparable maturities. Thus, the law requires that risky cash flows be discounted at a risk-free rate. The expected average cash flows for a federal loan portfolio are treated as if they were financially indistinguishable from the cash flows of a U.S. Treasury security with the same expected performance.

Of course, the average expected cash flows from a government loan, such as those made to college students, are riskier than a U.S. Treasury bond with the same expected performance. A better approach then, one endorsed by the Congressional Budget Office (CBO) and many academic economists, including those at the U.S. Federal Reserve, is to discount the cash flows using a market-based rate because it incorporates the cost of bearing market risk, also called "fair-value" accounting.[4] I will point the members of the committee to several sources that explain that method further and show why it is the right approach for measuring the cost of government loan programs.[5] I devote the remainder of my testimony to discussing the effects of both FCRA and fair-value accounting (FVA) on the federal student loan program.

The Federal Student Loan Program

The federal student loan program is the second largest government credit program. Only the mortgage programs under the Federal Housing Administration are larger, although not by much, and some sources show that student loans may have actually eclipsed those programs in size. The student loan program issues over $100 billion annually in new loans, and outstanding balances total $1.2 trillion.[6] [7] The program has grown rapidly in recent years, with outstanding balances now almost three times higher than ten years ago. Prior to 2010, the program issued loans both directly and as federal guarantees under the Federal Family Education Loan program. Since then, all new loans have been issued as direct loans.

The tables below provide information about the status of the loan portfolio and how it has changed over time. Data prior to 2013 is very limited, as the U.S. Department of Education only recently began providing information about the loan portfolio.[8]

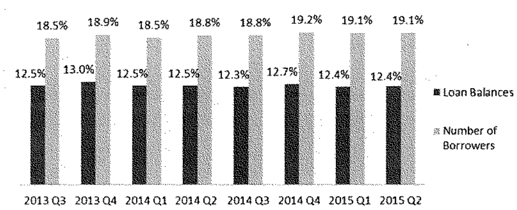
Federal Student Loan Portfolio Status By Year

	2006		2013 (Q3)		2015 (Q1)	
	$ Billions	Share	$ Billions	Share	$ Billions	Share
In-School/Grace	86	19.5%	193	19.3%	190	16.9%
Repayment	229	51.9%	494	49.4%	601	53.6%
Deferment	49	11.0%	122	12.2%	130	11.6%
Forbearance	39	8.8%	91	9.1%	127	11.3%
Default	39	8.8%	89	8.9%	108	9.6%
Other	0	0%	10	1%	11	1%
Total*	441	100%	999	100%	1,122	100%

Sources: New America; For outstanding loan value in 2006, President's Fiscal Year 2008 Budget Request, Analytical Perspectives; For portfolio by repayment status in 2006, "Guaranteed vs. Direct Lending: The Case of Student Loans" in Measuring and Managing Federal Financial Risk http://www.nber.org/chapters/c3038.pdf; For portfolio by repayment status in 2013 and 2015, U.S. Department of Education, Office of Federal Student Aid, "Federal Student Loan Portfolio" https://studentaid.ed.gov/about/data-center/student/portfolio.

*Share may not add to 100% due to rounding.

Federal Student Loan Portfolio Defaults as Share of Loans Due*

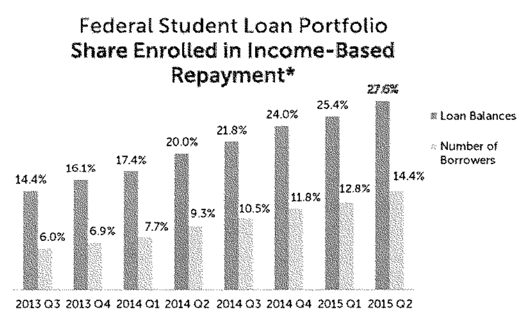


*Loans due includes loans that have entered repayment and the borrower is either making payments, enrolled in unemployment/hardship deferment or forbearance, or in default. Loans in school (including deferment) or grace period are not included.

Source: US Department of Education; New America

There are two sets of features in the federal loan program that are important to any discussion about program costs. First, federal student loans are made on what is effectively a no-questions-asked basis. That is, there are virtually no underwriting criteria, which stands in contrast to private loans as well as other federal loan programs. Most institutions of higher education can receive the loans, and students are eligible regardless of their credit histories, current or potential earnings, or choice of educational program from a sub-baccalaureate certificate, to a four-year degree, all the way to a master's or professional degree.

The second set of features important to the discussion is the repayment terms. They are far more generous to the borrower than what a private lender would offer. They include not only a below-market interest rate (4.29 percent fixed for loans issued in the 2015-2016 school year) but nearly a dozen repayment options. Borrowers can opt to extend the terms on their loans to up to 30 years without an increase in the interest rate, and they can use an income-based repayment option that lets the loan negatively amortize and offers loan forgiveness after 10 or 20 years of repayment. Borrowers can also put their loans into forbearance with as little as a phone call, and the Direct Loan program does not charge penalties for late payments until the loan is nearly a year past due (i.e. in default). Forbearances and deferments for unemployment and economic hardship now total 18 percent of loan balances that have come due and 14 percent of borrowers whose loans have come due.[9] Enrollment in income-based repayment plans is also growing rapidly.



*For Direct Loan portfolio only; excludes loans in the FFEL program. Includes loans repaid in the Income-Based Repayment plan and the Pay As You Earn plan. Calculated as a share of the $552 billion Direct Loans in repayment.

Source: US Department of Education; New America

Cost of Federal Student Loans Repaid in Income-Based Repayment & Pay As You Earn Plans Under FCRA (Loans Issued in 2014)					
	Subsidy Rate	**Admin Costs[1]**	**Subsidy + Admin**	**Volume (Billions)**	**Present Value Lifetime Cost (Billions)**
Subsidized Stafford	14.6%	1.7%	16.3%	$3.8	$0.6
Unsubsidized Stafford	14.2%	1.7%	15.9%	$11.8	$1.9
Parent and Grad PLUS	7.5%	1.7%	9.2%	$3.0	$0.3
Consolidation	32.5%	0.4%	32.9%	$25.1	$8.3
Total	24.3%	0.9%	25.3%	$43.7	**$11.0**

Source: New America using President's FY16 Budget Request Appendix

1. Reflects average administrative costs for all repayment plans. Figures for Income-Based plans are not provided and are likely significantly higher than the average.

I list these features because they help to illustrate that students and borrowers receive substantial benefits through the federal student loan program — which is what policymakers intended. The program is meant to make subsidized credit available to students with few restrictions on who may receive a loan to ensure broad access to a postsecondary education. Intuitively, when the federal government provides subsidies to the beneficiaries of programs, those subsidies impose a cost on taxpayers. But because of the flaws in FCRA, the budget shows just the opposite. The federal student loan program as a whole appears to earn a net return for the government.

Student Loan Cost Estimates: FCRA vs Fair Value

According to the latest estimates under FCRA, federal student loans issued over the coming 11 years will earn $6.5 billion per year. That figure reflects the CBO's March 2015 baseline estimates and administrative costs reported in the president's budget request.[10] [11] However, the CBO reports that under fair-value accounting (FVA) the cost estimate changes from a projected gain to a projected loss. After adding administrative costs, a CBO estimate published last year shows that the federal student loan program is projected to *cost* $10.5 billion per year.[12] Note that because both FVA and FCRA are accrual accounting methods, those costs reflect the *lifetime* costs of the loans issued in each year in the forecast. That is different from the 10-year cost estimates that Congress is used to, which reflect outlays in only those years. FVA and FCRA reflect all of the cash flows from loans issued in a given year, whether those cash flows occur within or outside a 10-year budget window.

The difference between the FCRA and FVA estimates is solely the result of using a risk-free discount rate in FCRA and adding a risk premium to that rate for FVA. The risk premium the CBO has historically used ranges from 3.5 percentage points to 2.4 percentage points added to a U.S. Treasury interest rate, depending on the student loan type.[13] Contrary to what some believe about the difference between the estimates, both FCRA and FVA use the same estimates of how much money the government should expect to be repaid and when, taking into account default risk and interest rates. The FVA method does not assume a higher average default rate. Rather, the risk premium reflects that loan performance might be worse than average during times of economic weakness.

The difference in costs between the two accounting measures is larger for the student loan program than for any other federal credit program. That is likely because the market risk that taxpayers bear in the federal student loan program is higher than for other programs. Indeed, the loans are unsecured and made without regard to creditworthiness, which is not the case for other large programs like mortgage guarantees. That is one of the more distorting effects of FCRA. Because FCRA excludes a cost for market risk, the more a loan is affected by market risk, the more FCRA understates its cost and the larger the difference will be under FVA. Thus, as the riskiness of the loan increases so do the apparent gains to the government under FCRA.

All other entities, including the same taxpayers whose money the government uses to make loans, know that the higher potential payoff that comes from taking more financial risk is zero-sum, not a free lunch as FCRA would make it appear. It is another way of saying expected returns must be "risk-adjusted" and explains why people invest in bonds rather than stocks much of the time — bonds have a lower rate of return but they are safer.

Critics of FVA Once Supported It

Economists at the Center on Budget and Policy Priorities who are outspoken critics of FVA actually made that same argument to show that the higher projected returns that investing Social Security funds in the stock market appears to produce net to zero after accounting for the additional risk of owning those assets.[14] Jason Furman, the current chairman of the president's Council of Economic Advisers, wrote a paper in 2005 for the Center on Budget and Policy Priorities that was devoted almost entirely to debunking the higher-return claim made by Social Security privatization supporters. In the paper, Furman appealed to the CBO and its argument for risk-adjusting costs using fair-value methods. Failure to do so, Furman argued, would make it appear that investing in riskier assets produced a "free lunch." The Center on Budget and Policy Priorities and Jason Furman now believe their earlier view was "mistaken" and that the CBO is and was wrong in supporting FVA.[15 16]

How FVA Affects the Current Student Loan Program

Both the FVA and FCRA estimates discussed so far are baseline estimates. They are projections for the cost of the federal student loan program in its current form. The program is treated as direct spending (i.e. mandatory spending) in the budget and will continue to exist in its current form until Congress changes it through legislation. Therefore, the CBO projects what the program is likely to cost over the next 10 years, absent a change in the law. Changes to the programs are "scored" against this current-law baseline.

The concept of a baseline projection with respect to the FCRA-FVA debate and student loan costs has led to some confusion. Reporters and student aid advocates have warned that because the FVA estimate shows that the student loan program operates at a cost, the program would face cuts or Congress would have to act to cut the program if FVA became the official accounting method. On the contrary, the student loan program is already in law, and changing accounting rules to FVA would not automatically affect the student loan program nor would it trigger offsetting spending cuts elsewhere in the budget. That the loan program operates at a cost under FVA shows that the loan program provides subsidies to student borrowers, which is what a government loan program is supposed to do. Adopting FVA does not force policymakers to take any action to change the student loan program. In fairness, FVA would show that the budget deficit is larger than currently stated, which could encourage lawmakers to make spending cuts, which may or may not include the student loan program.

Differences between FVA and FCRA have also caused confusion with respect to proposals to reduce interest rates on federal student loans. Because the cost estimates for the loan program in current law switch from gains to losses under FVA, some observers seem unclear about whether FVA has the same effect on proposals to change current law and cut interest rates. In fact, under both accounting methods, the proposals would be scored by CBO as a cost and an increase in the budget deficit. If under the current-law baseline estimates the federal loan portfolio is expected to generate a certain amount of interest, then reducing that future interest must be a cost under either accounting method.

That said, FVA would actually show that cutting interest rates results in a *smaller cost* than under FCRA. That is because cutting interest rates produces a loss of expected interest income in future years. FVA discounts those future losses at a higher rate, making them smaller, resulting in less of a loss than if the same change is estimated using the lower, risk-free discount rates under FCRA.[17]

How FVA Affects Proposals for New Loan Programs

The flaws in FCRA and a switch to FVA are likely to affect policy decisions the most in cases where lawmakers increase or reduce the amount students can borrow and in proposals to purchase private student loans.

First, consider the case of loan limits. The federal student loan program limits the amount undergraduates can borrow annually and in aggregate. A dependent undergraduate student in her first year of study can borrow only $5,500. Because estimates under FCRA show that federal student loans that will be made under the existing law earn a positive return, legislation to raise the loan limits will appear to increase those gains. Allowing students greater access to subsidized credit looks as if it reduces the budget deficit under FCRA. Under FVA, such proposals generally have the opposite effect. They increase government costs.

The Obama administration's proposal for a new Perkins Loan program is a prime example of those effects. The Perkins Loan program currently operates alongside the government's much larger Direct Loan program, and the administration would replace it by letting students take out more Stafford Loans under the Direct Loan program ($5,500 more each year per student), totaling $8.5 billion annually.[18] The president has included the proposal in his annual budget request many times. The administration and the CBO estimate that this proposal earns around $400 million per year under FCRA. The Obama administration proposes to use those earnings to offset new spending on the Pell Grant program for undergraduate students. The CBO has occasionally provided a fair-value estimate for this proposal, estimating that it would actually cost about $600 million per year.

Obama Administration Perkins Loan Proposal*
Fair-Value and Federal Credit Reform Act Estimates
($ millions)

	2013	2014	2015	2016	2017	10-Year
Perkins Loan Proposal, FCRA	-315	-760	-765	-625	-505	**-4,300**
Perkins Loan Proposal, Fair-Value	110	345	520	630	750	**6,450**

Source: Congressional Budget Office, 2012

*Negative figures reflect gains; postive reflect cost

The president's proposal to replace the Perkins Loan program is somewhat paradoxical due to the flaws in FCRA. Allowing students to borrow more federal loans appears to pay for offering many of the same students more grant aid. It is one government program subsidizing another government program and almost suggests that students are paying for their own grants.

FCRA distorts incentives federal policymakers face in another way. As the CBO explains, "purchases of loans at market prices appear to make money for the government..."[19] The government appears to create

value simply by holding a private asset on its books at market value. Proposals that involve the government purchasing private students loans illustrate this effect.
During the recent economic recession, Senator Sherrod Brown proposed that the federal government purchase private student loans, convert them to federal loans, and then reduce borrowers' interest rates. The government would pay the lenders the full outstanding balance on the loans. Borrowers would receive new, better terms and repay the remainder of their loans to the Department of Education. The CBO was required under FCRA to show that this transaction would result in an immediate $9.2 billion gain to the government. For a more recent proposal of this nature, the Bank on Students Emergency Loan Refinancing Act of 2014, sponsored by Senator Elizabeth Warren, the CBO again estimated a slightly lower net gain for the government of $5.0 billion.[20]

Note that borrowers would pay *less* interest to the government than they would pay to private lenders under these proposals. Even so, under FCRA, billions in new funds for the government would appear as soon as the transaction was made — funds that under federal budgeting rules could be used to offset new spending or tax cuts all in the first year that the policy was in place. The CBO provided a fair-value estimate for the debt swap proposal in 2009 showing that the proposal would cost $700 million.[21]

Fair-Value is About Cost, Not Benefits

Discussions about FVA often lead to debates about the merits of the student loan program. That FVA shows student loans impose a cost on taxpayers can be misunderstood as a normative assessment. Arguments in favor of FVA are seen as arguments against the government making loans. Conversely, advocates have made arguments about the need for a robust student loan program and why the government ought to provide loans to students as a case against the government adopting FVA.[22] But FVA is concerned only with the cost of the program, not its benefits. FVA itself is agnostic about the benefits of a loan program, just as cash accounting does not take into consideration the economic and societal benefits of the Pell Grant program or any other government program.

The merits of the student loan program and the merits of accounting rules should be judged separately. Judging the two together simply does not make sense and is a rhetorical tactic likely meant to appeal to broad support for the federal student loan program to distract from the underlying accounting issue. The following passage from an opinion piece in *U.S. News* from earlier this year that argues against the government adopting FVA is typical. Its author clearly aims to make the case for FCRA over FVA by making a case for the student loan program itself.

> *Young people everywhere are still struggling to recover from the recession. While unemployment numbers have dropped nationwide, millions of young people are still bearing the brunt of joblessness five years since the recession ended. Of the young people who have been fortunate*

> *enough to find jobs, many work in sectors where the median wages are declining. That's why higher education and college affordability are paramount. By 2020, 65 percent of jobs nationwide will require education beyond high school, a goal that the U.S. will fail to reach if Congress does not seize the moment to invest in higher education.*[23]

Of course, none of those arguments are any less compelling under FVA or FCRA. Nor do they have anything to do with the issue at the heart of the FVA-FCRA debate.

Recommendation: Amend FCRA But Do Not Mandate FVA

While it would seem obvious to recommend that Congress change FCRA and require that budget estimates use a market-based discount rate, Congress should not take that approach. Mandating a specific type of discount rate is what created the problems with FCRA in the first place. This is an unusual intrusion on the discretion Congress affords the CBO, given its mandate to provide lawmakers with what it deems the best estimate of the cost of a policy. When the CBO develops estimates for other federal programs, like the Pell Grant program, Congress does not require it to assume a certain rate of inflation or growth in student enrollment. The CBO uses what it believes is the most appropriate set of assumptions.

In that regard, Congress should simply amend the language of FCRA to give budget agencies the freedom to use the discount rate they deem will result in the best estimate. Given the widespread view among financial economists and budget experts, including those at the CBO, that the appropriate discount rate is one that reflects the riskiness of the loan that the government makes, the end result will surely be fair-value accounting. But it will be an accounting decision that is free of congressional — and partisan — interference. That is the ideal type of accounting.

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Douglas J. Elliott
June 11, 2015

Evaluating Federal Credit Programs
Testimony Before the Joint Economic Committee of Congress

My name is Douglas Elliott and I am a Fellow at the Brookings Institution. I am speaking today in my personal capacity; the views expressed here are my own and should not be attributed to the staff, officers or trustees of the Brookings Institution.

Thank you for the opportunity to testify today on the important topic of the federal credit programs, which now represent over $10 trillion of loans and guarantees to the private sector, but have received too little attention. I have tried to help remedy this over the years. In 2003, I founded the Center On Federal Financial Institutions, a non-partisan think tank devoted to analyzing the federal credit and insurance programs, which I ran for three years. (Douglas Holtz-Eakin was a board member, along with a number of other distinguished experts from both parties.) In 2011, I wrote a comprehensive book on the federal credit programs called "Uncle Sam in Pinstripes: Evaluating US Federal Credit Programs", the first book of its nature in 25 years, since a previous Brookings publication by Barry Bosworth and co-authors.

Given the political nature of so much of the discussion, let me note that I am as close to a neutral expert as you will find in this area. I do not belong to a political party, have served in no administration, and am a moderate on the political spectrum. Further, my work in this area is as a technician. I do not intend to tell Congress which programs it should authorize or what their size should be; that is for you to decide by weighing the many trade-offs that exist. However, I do feel very strongly about ensuring you have the appropriate information to make those decisions and that the structure and operation of the programs maximizes their effectiveness and efficiency.

Well-designed federal credit programs are an appropriate response when there are imperfections in credit markets that cannot readily be solved in other ways. Lending to students is one of the clearest examples. Private lenders are simply unwilling to make very long-term, unsecured loans at any reasonable interest rate to individuals on the basis of their potential earnings capacity judged as of age 18. Yet we are clearly better off as a society if capable students are able to attend college even if their parents cannot, or will not, finance them. In this circumstance, it is difficult to see any alternative to a government program of loans, loan guarantees, or outright grants.

On the other hand, the government appropriately stays clear of most forms of business lending, where there are well-developed markets that function smoothly. The principal exception is for small business, where there is reason to believe that many worthy firms have trouble expanding because of difficulties in obtaining credit. This is a problem across the globe. I have been speaking with officials in Europe and China about the benefits of our Small Business Administration, which melds private sector credit underwriting with federal guarantees to increase credit availability and lower its cost. Not every aspect of our SBA program is right, but the general idea is an excellent one.

Note that I started this discussion with the phrase "well designed." Just because there is a good case for a federal credit program in an area does not mean that a *particular* program is worthwhile. Programs must be designed and operated so that the societal benefits outweigh the costs, which is not always the case in reality. Further, it would be good to increase benefits and reduce costs even for those programs that are already worthwhile.

In my book, I made a number of recommendations for improving the effectiveness and efficiency of the federal credit programs. I would like to repeat some of them here. Specifically, we should:

- Target borrowers more carefully.
- Take more account of the relative risks of different loans.
- Use the same budget rules for all federal credit programs.
- Use risk-based discount rates for federal budget purposes.
- Formalize the process of initiating new federal credit programs.
- Create a federal bank to administer all federal credit programs.
- Focus more on optimizing the allocation of money between programs.
- Spread best practices more effectively across the government.
- Improve the compensation and training of federal financial workers.

For this hearing, I understand the most interest may be in the point about risk-based discount rates, so let me expand at length upon that issue before reviewing the others.

Use Risk-Based Discount Rates for Federal Budget Purposes

Accounting systems, such as that used for the federal budget, are tools that should be designed to meet specific needs. The internal accounting systems used to make management decisions at companies, for example, often differ from those used for reporting to shareholders. Tax accounting rules, for their part, are designed to appropriately raise revenue and are not intended to be the same as managerial accounting methods or Generally Accepted Accounting Principles.

Our current budgeting approach for federal credit programs ignores the variability of potential results. A program that could with equal probability earn the government $110 or lose the government $100, is treated the same as a program that with certainty will earn the government $5, since on average they will yield the same result. (In the first case, half the time we make $10 more than we lose the other half of the time, for an average of $5 of profit.) Given how strongly the budget numbers drive decision-making, we are effectively acting as if Congress and the taxpayers do not care about risk.

The question of whether to use risk-based discount rates in the federal budget is a pragmatic one – will it help Congress and the Executive Branch to make better decisions? I think it would. Currently, taxpayers are effectively taking risk without charging for it, from a budget point of view. I believe subsidy costs in the federal budget should instead reflect this uncertainty, for several reasons.

Structuring programs to minimize risk. It is important that federal credit programs be structured to minimize risk, where possible, while still achieving the overall objectives. This is particularly crucial since there appears to be at least a modest bias in initial subsidy estimates to understate total costs. This bias is almost certainly worse in cases of highly uncertain outcomes, because of political pressure for relative optimism.

Recognizing risk. The benefit to borrowers of government loans as compared with loans on the private market is higher for risky loans, all else equal, since these would be priced higher by private lenders but are generally not priced by the government to reflect their risk. Ignoring this fact for federal budgetary purposes has distorting effects on the choices politicians make. In particular, there will be a tendency to direct scarce federal lending dollars to sectors where there is more uncertainty in the outcomes, since the borrowers will find the federal loans most valuable. They will lobby harder for them and are more likely to apply for such loans and to choose them over private alternatives.

Implementing risk-based pricing. Risk-based pricing, which is one of my other recommendations, is considerably more likely to be implemented if the budget appropriately reflects risk as a cost factor. The situation today, in which a loan with a wide range of potential outcomes is treated as costing the same as a relatively certain loan, discourages political decisions that take account of such risk.

There are reasonable counter-arguments to moving to risk-based discount rates, although I do not find them compelling. The principal one is that the US government can spread any unexpected losses over a wide tax base and many years of time and therefore does not need to worry about variability in outcomes. However, I buy the argument by Professor Deborah Lucas at MIT, and others. She maintains that taxpayers are the ultimate bearers of this risk, just as shareholders bear the risk at companies, and they are risk-averse. Shareholders certainly prefer more certain returns to riskier ones, and I would submit that taxpayers do as well. The way in which federal credit losses are ultimately offset is by increasing taxes or decreasing federal expenditures. It seems very likely that taxpayers would prefer *less* risk of a big tax increase to *more* risk of one, even if there is an offsetting potential on the other side for unusually good performance and future tax reductions. This is especially likely because there is a strong correlation across credit losses, so that losses are concentrated in a few years when the economy is particularly bad and taxpayers are unlikely to feel capable of comfortably bearing the resulting tax increases.

There are also technical arguments about maintaining the consistency of federal credit programs with other programs in the budget and of dealing with swings in estimated costs as interest rates move from year to year. These are reasonable concerns, but they are outweighed by the fact that Congress uses the *initial* subsidy estimates in the federal budget as by far the most important figures on which to make decisions about federal credit programs. As long as these are the critical numbers, I believe it is important to incorporate risk appropriately into them in order to improve the quality of decisions.

Let me now expand somewhat on the other recommendations:

Target Borrowers More Carefully

Federal credit programs are generally intended to spur greater investment, output, and employment in certain sectors. Unfortunately, a significant portion of the subsidies appear to be taken up by borrowers who would have performed the desired activities without any federal help. That is, many borrowers would have made the same total investment by obtaining funds through private channels or using more of their own assets. William Gale concludes that "credit subsidies cost the government in excess of

50 cents per dollar of *incremental* target-group investment."[1] Other researchers are unable to nail down the portion of borrowings that represents additional activity but conclude that it is only a fraction of the total borrowings supported by the government programs.

It is politically and bureaucratically easiest to continue providing funds for everyone who meets the group characteristics, is able to repay, and wishes to borrow. However, the cost to the taxpayer would be considerably lower if we could eliminate subsidies for at least a portion of those borrowers who would not change their investment behavior because of the federal aid or would do so only marginally. In many cases, this may involve a greater degree of means testing, such as in the area of student loans. A lower-income student is more likely to enroll in or continue to attend college as a direct result of loan availability than is a higher-income student who would attend regardless. Similarly, mortgage aid to a lower-income homebuyer is more likely to result in a new home purchase than is aid to a wealthy family. In the case of housing, more targeting would only partially counteract the greater benefit to wealthy individuals of the deductibility of mortgage interest.

Take More Account of the Relative Risk of Different Loans

A key societal role of financial institutions and markets is to direct resources from savers to investors. The economy performs best when the financial sector chooses the optimal set of projects to fund, based on the trade-off of risks and potential returns. The role of the federal credit programs is largely the same, although the allocation decisions are intended to reflect additional societal factors that are not easily encompassed by the markets, either because of market flaws or economic externalities.

Unfortunately, government programs find it difficult to do two key things that are critical to optimal resource allocation. First, the programs are generally required to provide credit to anyone who meets certain simple criteria, such as being a college student, or being a veteran and meeting some simple down payment and income tests for a mortgage. In contrast, private financial institutions in normal times require more detailed information to make credit judgments. Second, federal programs often have no variation in their loan pricing to reflect risk. If they do, it is usually quite simple, with two or three price levels depending on simple criteria. The loan pricing practices of private institutions are much more sensitive to the particular level of risk.

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[1]. Gale (1991, p. 134; emphasis in original).

It would be better if the government incorporated more underwriting and risk-based pricing into its credit programs. This would be fairer to the taxpayers and the various types of borrowers, since there would be lower loan default rates and a more even distribution of subsidies between borrowers representing different levels of risk. Default rates would decline because some weak borrowers would be turned down but also because risk-based pricing would encourage the more creditworthy borrowers to participate and discourage the worst risks from borrowing. (Using a single price for all potential borrowers creates a relative bargain for the riskiest borrowers.) A fairer distribution of subsidies would result because the gap between the private market rate and the federal rate would be more uniform, as federal pricing followed the private pattern more closely by adjusting for risk. (Everyone might still receive a significant subsidy, but there would be less variance in the subsidy.)

The big obstacle to credit underwriting is the difficulty in having a government employee exercise discretion in evaluating loan eligibility, since every such choice can produce a backlash from the borrower, with repercussions for the politicians and bureaucrats involved and, in the extreme, the threat of a lawsuit. However, information technology is now so advanced that it would be possible to have significantly more refined automatic criteria for turning down the worst risks and for deciding how much to vary the interest rate on the loan.

The obstacles are both harder and easier when the program is implemented as a guarantee program, as is true for small-business loans. Private lenders can exercise credit judgment using the best information available, eliminating the problem of discretion by government employees. However, it can be difficult to provide sufficient incentives to persuade those lenders to invest in the resources necessary to gather the information and make the credit decisions carefully. The Small Business Administration provides less than a 100 percent guarantee of loan repayment in order to encourage such credit underwriting. However, being shielded from, say, 80 percent of any loss commensurately reduces the economic incentive to underwrite, which can be a costly activity for small-business loans. To counteract this, the federal government has provided various incentives and disincentives in its guarantee programs. For example, student lenders with low default rates among their borrowers used to receive a higher guarantee percentage and some other advantages, before the abolition of the guarantee program. Those with the worst records were knocked out of the program over time.

There is considerably more room to design or expand mechanisms in both the direct and guaranteed loan programs to reflect the relative risk of various potential borrowers. For example, Congress should allow risk-based pricing more frequently, indeed it should push for it. As noted, advances in information technology provide a sounder and more consistent basis than previously existed to make distinctions among borrowers.

Use the Same Budget Rules for All Federal Credit Programs

Budgets assist in resource allocation decisions, such as determining which federal credit programs should be expanded and which contracted. This process is distorted, however, if budget calculations are made under different rules for different programs, as is the case today. The traditional credit programs are currently subject to the rules of the Federal Credit Reform Act, which broadly represent best practice in this area. However, the emergency programs under TARP used a variant of those rules with a different discount rate, an approach that the author believes is superior. The Fed programs, for their part, were under another set of rules, and the FDIC programs under yet another. It would be best to use the rules of the Federal Credit Reform Act, as amended for the TARP programs to include risk-based discount rates, for all federal credit programs. The consistency would remove a considerable temptation to house programs where they would appear cheapest on the federal budget, rather than where they would be administered best. In addition, the consistency would aid in allocating money between the programs.

Formalize the Process of Initiating New Credit Programs

It would be useful for Congress to impose on the executive branch and on itself the discipline of a formal proposal process for new credit programs. The Congressional Budget Office should review each proposal and comment on the consistency and achievability of the elements of the proposal.

Ideally, any proposal would be required to include the following elements:

- a statement of the purposes of the program, with prioritization among objectives if possible, including an explanation of any perceived market failures or externalities meriting federal intervention or a statement that the intent is redistributive
- a definition of the target groups to be aided
- an explanation of the mechanisms to be used
- a target initial subsidy level and explanation of how the level was arrived at

- if a new agency is proposed, an explanation of why an existing federal credit provider should not run the program

A strategic plan is not a panacea, and Congress could choose to pass legislation that only minimally met these proposal requirements. However, some of the worst potential problems could be weeded out by encouraging a reasonable explanation of the new program, its merits, how it would work, and what it would be likely to cost over time. A coherent and comprehensive explanation of the key points might also provide helpful guidance to the administrators of the new credit program going forward.

This reform would force a discipline on proposals that create a credit program only as a by-product of larger legislation. For example, the broadcasting spectrum auction that took place some years back ended up including a requirement that the government accept deferred payments from minority bidders, to encourage a more diverse range of bidders.[2] Unfortunately, this effectively meant that the government in a number of cases lent speculative investors the funds to make their bid, taking what was effectively equity risk, not credit risk. When the tech bubble burst before those investors could finance themselves, the government ended up taking large losses. It is likely that the mechanisms for this aspect of the spectrum auction would have been given considerably more thought if a formal process for credit program proposals had been in place.

The reform would also have pushed Congress and the administration toward a greater consistency across the federal credit programs. By highlighting comparisons between a new proposal and existing credit programs, the Congressional Budget Office review could encourage standardization in cases where there was not a strong reason to follow a different procedure.

Create a Federal Bank to Administer All Credit Programs

Cabinet departments, such as Agriculture or Education, have no comparative advantage in evaluating and administering credit programs and having the programs spread out among so many different entities loses many potential advantages of economies of scale and expertise. It would be better to bring all the credit programs under one roof. Admittedly, creating a federal bank would be a stretch politically, since moving existing programs means changing the relative power of different congressional committees and

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[2]. This was an auction where the winning bidders were given the right to broadcast on specific parts of the electronic spectrum, often for mobile phone or other wireless communication uses.

other groups. However, many commonalities across the federal credit programs could be handled more effectively by a centralized bank.

All of the direct loan programs have to perform the standard functions of

- informing prospective borrowers of the availability of credit and the terms on offer,
- evaluating loan applications,
- extending loans,
- collecting principal and interest payments,
- monitoring the financial health of borrowers, or at least their payment record,
- tracking collateral, for secured loans,
- intervening when borrowers run into trouble or fail to make required payments,
- managing and liquidating assets taken over as a result of defaults,
- monitoring potential fraudulent activity,
- performing strategic planning, and
- accounting for their present and future costs according to federal budget rules.

All guarantee programs have to ensure that the same steps are performed, although many of these would be delegated in the first instance to private lenders. In addition, the federal programs have to monitor their relationships with private lenders and the economic terms relevant to that relationship.

There could be significant efficiencies in standardizing the government's approach to these functions and having common administration of each step, to the extent possible. Having a common agency that performed all these functions would also enhance the ability to apply best practices. One way to reduce the political problems, although it would hardly eliminate them, would be to continue with separate agencies to provide high-level management of each program but to move many of the standard services to the Federal Bank as a kind of "back office", in industry parlance.

Focus More on Optimizing the Allocation of Money between Programs

Many federal credit programs are intended to serve the same broad purpose. For example, myriad programs were in place to deal with the credit crunch during the Great Recession, some administered through TARP and many at the Fed, as well as in other parts of the government. There does not appear to have been a systematic analytical approach to determining whether a dollar spent in one program would have more benefit than one spent in another. Similarly, the government has a host of housing-related programs, including Fannie Mae and Freddie Mac, the FHA, Ginnie Mae, housing loans at Department of Veterans Affairs, housing loans at the Department of Agriculture, and so on. They share the same underlying goal of making it easier for the middle and working classes to afford home ownership, yet there is little analysis done to determine which programs and subprograms across these agencies work most effectively. The allocation question ties into the related question of how budget costs should be calculated. The existence of differing methods across programs biases resource allocation in ways that create inefficiencies.

Implementation of the recommendation to create a single federal bank, would likely go a long way toward achieving such coordination. Failing that, the recommendation to force a formal proposal process, would to help to some degree. Perhaps beefing up the roles of the Congressional Budget Office and the Office of Management and Budget in reviewing the coordination of credit programs could assist further.

Spread Best Practices More Effectively Across the Government

Much of what each program does consists of basic banking activities. There are better and worse ways to do them in a federal government context. Unfortunately, little effort has been made to bring good ideas from one department to another or to spread the word of approaches that do not work. During the Clinton administration, the Office of Management and Budget created the Federal Credit Policy Working Group, which brought together representatives of the different programs to discuss common issues. The main focus at the time was implementation of the new Federal Credit Reform Act, but other issues were also hashed out. Perhaps there even needs to be a senior official with sole responsibility, and some authority, to coordinate at least the technical aspects of these programs.

A series of smaller steps could aid in emphasizing learning from other programs. For example, there could be special bonuses or other recognition for the five federal employees who have most effectively encouraged the spread of best practices. Encouraging movement of personnel across credit programs, perhaps tied to the enhanced training suggested below, would also help in this regard.

Improve the Compensation and Training of Federal Financial Workers

Many government departments face the problems of recruiting and retaining good workers in an environment in which the private sector can pay more. However, the disparity is far sharper in the financial area than in any other government activity, because of the generous sums paid by private sector financial firms for people with useful skills in this area. For this reason, the Federal Reserve and some of the regulatory bodies have the legal ability to pay more for certain positions than would be possible in other government departments. That flexibility should be extended to federal financial officials in the credit programs.

In addition, there ought to be an increased effort to improve the training of employees in these programs. To assist in this, it would be worthwhile to create a certification program for these employees that would be tied to higher pay and better career prospects.

Thank you for your time and consideration of my ideas. I will be happy to answer questions.

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June 17, 2015

Testimony of Paul N. Van de Water
Senior Fellow, Center on Budget and Policy Priorities
Before the Joint Economic Committee

Economic Exposure of Federal Credit Programs

Mr. Chairman, Vice Chairman Brady, Ranking Member Maloney, and members of the committee, I appreciate the invitation to appear before you today. My testimony will explain why so-called "fair-value accounting" would distort the budget by making federal credit programs appear more expensive than they really are.

The current method of accounting for federal credit programs fully records — on a present-value basis — all the cash flowing into and out of the Treasury.[1] That includes the risk of default — the likelihood that some direct loans will not be paid back in full or that a borrower will default on a loan that the federal government has guaranteed.

In contrast, fair-value accounting would add an *extra amount* to the budgetary cost, based on the fact that loan assets are less valuable to the private sector than to the government for several reasons: businesses must make a profit; they can't put themselves at the head of the line when collecting a debt; they borrow at higher interest rates; and private-sector investors are risk-averse — they dislike losses (in this case, higher-than-expected loan defaults) more than they like equal, and equally likely, gains (lower defaults). None of these factors represents an actual cost that the government incurs when it makes loans.

Fair-value accounting is misguided for four reasons.

First, the budget should reflect only the federal government's actual income and outgo — that is, funds that the Treasury actually receives or disburses. Including in the budget a *phantom cost* that the government *does not actually pay* would overstate spending, deficits, and debt, making the federal budget a less accurate depiction of the nation's fiscal position.

[1] Paul N. Van de Water and Joan Huffer, *House "Budget Transparency" Bill Would Make Budget More Opaque*, Center on Budget and Policy Priorities, June 18, 2013, http://www.cbpp.org/sites/default/files/atoms/files/6-18-13bud.pdf.

Second, fair-value accounting would treat different federal programs inconsistently, because it would not impose a risk-aversion penalty on non-credit programs, many of which have costs that are at least as uncertain and variable as those of credit programs.[2] Regardless of one's position on whether a particular credit program is worthwhile, the budget should put lending and other programs on a level playing field. Fair-value accounting would tilt the playing field against credit programs, thereby distorting the process of setting priorities.

Third, even if one thought that the federal government should be risk-averse on behalf of its citizens, as advocates contend, fair-value accounting presents an incomplete and misleading picture of federal credit programs. Federal loan programs do not increase financial risk for U.S. citizens overall. If the cost of a loan program turns out to be higher than originally estimated, taxpayers will eventually have to cover the higher costs — but students, farmers, homeowners, or other borrowers will have received more help. Fair-value accounting considers only the first half of this equation.

Fourth, cost estimates by themselves are not designed to assess whether a federal program is worthwhile — and should not be expected to do so. Deciding whether a federal program or project is worth undertaking entails evaluating many factors in addition to its cost to the government. Replacing a worn out and heavily travelled bridge might have substantial benefits, for example, while building one from nowhere to nowhere would be a waste of money. A bill's cost estimate will never reflect all of these factors, and trying to make it do so would be both vain and foolish.

My conclusion is the same as that of former Congressional Budget Office Director Robert Reischauer, who says that fair-value accounting "represents a misguided attempt to mold budget accounting to facilitate a cost-benefit analysis, with the result that neither the budget not the cost-benefit analysis would serve their intended purpose well."[3]

[2] David Kamin, "Risky Returns: Accounting for Risk in the Federal Budget," *Indiana Law Journal*, Spring 2013, pp. 723-72, http://ilj.law.indiana.edu/articles/14-Kamin.pdf.

[3] Robert D. Reischauer, Letter to Representative Chris Van Hollen, January 23, 2012; see Van de Water and Huffer.

Question for the Record submitted by The Honorable Mike Lee for Dr. Douglas Holtz-Eakin Joint Economic Committee hearing on "The Economic Exposure of Federal Credit Programs"

1. **We have seen heavy regulatory pressures on financial institutions in recent years, regulatory burdens which disproportionately impact small financial institutions, resulting in mergers driven by returns to scale on compliance, closures of small financial institutions, and diminished creation of new financial institutions. Do you think financial regulation is hampering the ability for the private sector to meet credit needs?**

Yes. The purpose of Dodd-Frank was partly to stem abuses and fix systemic weaknesses in the financial services sector, made apparent when the housing bubble burst and helped bring about the 2008 financial crisis. Yet many of the regulations promulgated under Dodd-Frank, intended to create a safer financial system, have had adverse effects, burdensome costs, and consequences beyond the financial services industry on small businesses and consumers. Banks of all sizes have reported increased costs to comply with Dodd-Frank, potentially driving up the cost of banking and lending for consumers. In its effort to make the financial system safer, Dodd-Frank has also restricted the availability of financial products and credit, particularly for low-income borrowers, young people, and minorities. Dodd-Frank has affected lending in a number of ways. Banks have faced numerous challenges including increased costs from compliance, increased costs raising capital standards, and regulatory uncertainty. With regard to home mortgages, lenders have been particularly conservative in part because of this uncertainty. Regulators have missed statutory deadlines and made repeated revisions to proposed rules. Lenders have therefore been forced to prepare for the strictest future standards fearing the forced buyback of loans, a problem with vast economic impacts.

There have been numerous studies attempting to shed light on this environment of tightened credit and other hidden costs associated with Dodd-Frank implementation. For example, a survey of small banks by the Mercatus Center at George Mason University showed that more than 80 percent of respondents reported compliance cost increases of more than 5 percent since the passage of Dodd-Frank in 2010. Increased compliance costs include the need for outside expertise, additional staff, and time spent on additional paperwork. In the survey, many small banks reported the need to trim back or eliminate some products and perks offered to customers, especially with regard to residential mortgages, home equity lines of credit, overdraft protection, and credit cards. Some have also argued that these increased costs have resulted in higher fees for consumers, a pickup in bank mergers and market consolidation, and a dearth of new bank charters, which is anti-competitive and may limit consumer choice.

Similarly, the results of a survey on lending from the American Bankers Association taken in early 2014 showed that two-thirds of respondents would restrict lending because of the ability-to-repay/qualified mortgage rule as defined by regulators with authority under Dodd-Frank. Furthermore, 80 percent of respondents expected new regulations to measurably reduce credit availability. Compliance costs and regulatory burdens were also the top concerns cited by survey respondents.

2. In a May 2014 study, the Congressional Budget Office found that the Export-Import Bank appeared to have a net subsidy of -$14 billion under FCRA rules, while it posted a net subsidy of $2 billion under Fair-Value Accounting. Setting aside questions of benefit, is a more accurate and appropriate cost assessment one performed under FCRA or one performed using fair value?

A more accurate and appropriate cost assessment is one performed using Fair Value Accounting. As I explained in my testimony before the committee, while FCRA was an enormous step forward in that it leveled the playing field between direct federal lending and the guarantee of private loans by the Federal Government, FCRA fails to take into account the market risk associated with credit activities. For example, according to the most recent tables from OMB, there are $3.3 trillion of taxpayer resources currently in federal loans and loan guarantees. Under FCRA, OMB assumes that these $3.3 trillion will generate a profit of $22.3 billion and cost taxpayers nothing. However, that is counter to anyone's intuition and reveals the flawed methodology inherent to FCRA that omits market risk and underestimates the true cost of credit evaluated in that way. On the other hand Fair Value Accounting incorporates this market risk and recognizes that, as the economy fluctuates, there is a tendency for loan failures to spike during downturns, and that risk should be involved in the calculation of potential losses and any credit activity. It also recognizes that the taxpayer has to come up with the money to cover those losses at a time when money is especially valuable. For all of these reasons, Fair Value is a more appropriate cost assessment for Ex-Im and other credit programs.

Douglas J. Elliott
June 25, 2015

Thank you, Senator, for your interest and the opportunity to respond. I have added my responses underneath the original questions.

Question for the Record submitted by The Honorable Mike Lee for Mr. Douglas Elliott Joint Economic Committee hearing on "The Economic Exposure of Federal Credit Programs"

1. While you were writing *Uncle Sam in Pinstripes*, you looked at federal credit programs across the spectrum. Were data on these programs collected and presented by the federal government in a coherent, or even comparable fashion? Were they collected in a way that would lend itself to comparison to say, spending programs or tax credits? What changes would you recommend for data collection on federal credit programs?

A. The Federal Credit Reform Act has done an excellent job of putting federal credit programs onto the budget in a way that captures the economics of these activities. It would be helpful to move to risk-based discount rates, as I discussed in my testimony, and it would be helpful to show the administrative expenses in a way that would allow them to be added to the other cash flows to produce a comprehensive total cost estimate. However, the FCRA does capture the most important aspects even as it is presented today. Further, the Executive Branch has done a good job of presenting useful supplementary information in the budget documents and the various annexes where federal credit programs are referenced. The big issue is that a number of federal credit activities are not covered by FCRA, such as all programs administered by the Federal Reserve and all of the activities of Fannie Mae and Freddie Mac. For those activities, different accounting rules are used from the FCRA rules and the information presented can be quite different as well. I believe it would be better to have one uniform set of accounting rules and at least an agreed minimum set of data to be reported for all programs where the federal government has significant credit risk to the private sector.

2. There seems to be a basic tradeoff that exists with federal credit programs- that in general, the more that federal government programs imitate the underwriting and credit issuing practices of the private sector, the weaker the subsidization of desired behavior becomes. Do you agree with this assessment in general, and are there any specific programs where this does not seem to be the case?

The answer to this question depends heavily on one's assumptions about the base case against which changes should be judged. For example, if one holds constant the assumed total budget subsidy for the program, then, by definition, the degree of subsidization will not be affected by the extent and form of the underwriting and credit practices. A different assumption would be that Congress would hold the authorized volume of lending constant for the program, rather than the subsidy amount, in which case it is probable that the total subsidy cost would decline if standards closer to those of the private market were used.

There are at least two reasons for this. First, if the federal government pays less attention to the relative degree of risk of different borrowers than the private sector does, then there may be a tendency for the riskiest borrowers to go for the public loans while less risky borrowers stay with the private sector. However, this effect may not occur if the subsidy for all qualifying borrowers is high enough that everyone would want to apply and would choose the public loan over the private one. Second, if government pricing, like private sector pricing, discourages the riskiest loans through higher pricing or refusal to lend, then some risky loan applicants will drop out because they are discouraged by the price or will be turned down. This would make the pool of actual loans less risky and therefore less costly on average to the government.

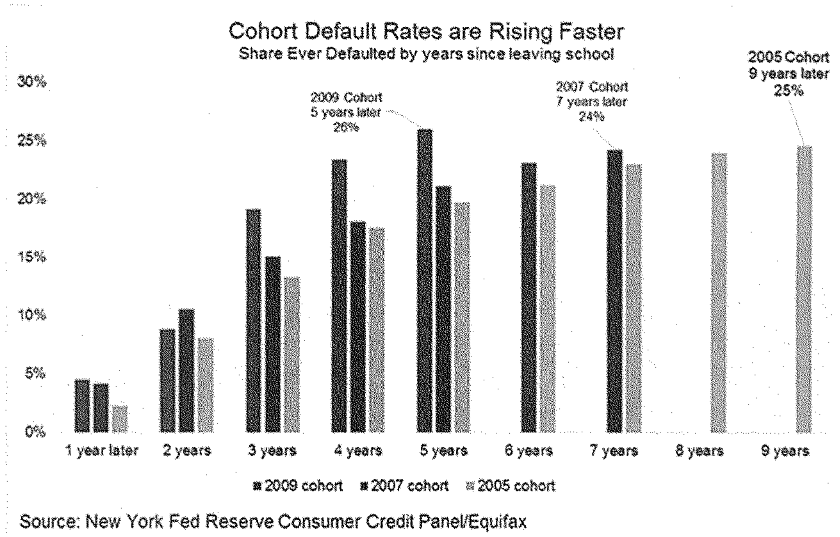
In general, I believe that it would be best if we could structure the programs so that we encourage loans where the total benefit to *society* exceeds the expected cost, just as private lenders encourage loans where the total benefit to the *lender* exceeds the expected cost (including profit margin). This means that the government would make some loans that the private sector would not and would charge less for other loans than the private sector would, since sometimes the additional societal benefits, such as from educating our youth, justify the government subsidy. However, there are still real advantages to differentiating among loans by level of risk and treating them on that basis, including risk-based pricing, even though non-market factors are considered. If two borrowers would produce the same societal benefits, but one is riskier, then the public would be best served by directing the funds to the less risky borrower. Thus, there are aspects of how the private sector provides credit that are applicable, with some modifications, as best practices for the public sector. Both the public and private lenders are in the business of allocating funds to the most worthy projects; the difference is that the public lenders should take account of larger societal benefits and not just the direct financial benefits for the lender.

Question for the Record submitted by The Honorable Bill Cassidy, M.D. for Dr. Douglas Holtz-Eakin Joint Economic Committee hearing on "The Economic Exposure of Federal Credit Programs"

Federal student loans are a tool for us to invest in our future, to enable young men and women to attend institutions of higher education. Normally, we would not make investments blindly, and consider various factors when making an investment.

According to the Federal Reserve Bank of St. Louis, student loans delinquency rate was actually 27.3 percent for all loans in repayment- and 55%, or $703 billion, of student loans that are in repayment. Effectively, $192 billion in federal student loans will be delinquent over the course of several months. Furthermore, the Department of Education reports that over 30% of direct loans are held by individuals facing partial financial hardship. The value of loans held by such individuals has increased by more than 80% since the middle of 2013.

We are in fact burdening these students, at a staggering cost to the taxpayer. Does it do somebody a favor to lend them money if they are at a high risk of default?



There is a role for the federal government in providing access to a post-secondary education. Increasing educational attainment has strong economic impacts that are apparent in the table (below) on wages and unemployment, for example.

Earnings and unemployment rates by educational attainment

Education attained	Unemployment rate in 2014 (Percent)	Median weekly earnings in 2014
Doctoral degree	2.1	$1,591
Professional degree	1.9	1,639
Master's degree	2.8	1,326
Bachelor's degree	3.5	1,101
Associate's degree	4.5	792
Some college, no degree	6.0	741
High school diploma	6.0	668
Less than a high school diploma	9.0	488
All workers	5.0	839

Note: Data are for persons age 25 and over. Earnings are for full-time wage and salary workers.
Source: Current Population Survey, U.S. Department of Labor, U.S. Bureau of Labor Statistics

That said, traditional rules for underwriting need not be ignored. A borrower should be in the right loan for the right institution. Borrowers with vastly different earning potential, or borrowers that fail to consider or simply overestimate the value of their education, and then compound their future financial difficulties by over borrowing, shouldn't expect equally favorable terms and conditions on loans. The one-size-fits all federal direct loan program does not provide the kind of economic scrutiny that traditional underwriting would provide, leading to poorer performance of loans and burdens on borrowers.

Questions for the Record submitted by Congresswoman Alma Adams, Ph.D. to

Dr. Paul N. Van de Water

Joint Economic Committee Hearing:

"The Economic Exposure of Federal Credit Programs"

1. There have been legislative proposals that change the method of scoring federal programs to that of Fair Value accounting. But unfortunately, those proposals do not take into account that accounting for the budget is different from that of a cost benefit analysis.

   Dr. Van de Water, can you please speak to the differences in budget scoring vs. a cost benefit analysis and how Fair Value Accounting should not be confused with that of budgeting which only takes into account cash flows? Can you also highlight the accuracy of Fair Value accounting versus that of our current method of accounting for federal credit programs?

   Answer: The budget should reflect the federal government's actual income and outgo — that is, funds that the Treasury actually receives or disburses. Including in the budget a risk-aversion penalty that the federal government does not actually pay, as fair-value accounting would do, would overstate spending, deficits, and debt, making the budget a less accurate picture of the nation's fiscal position. Considerations of risk properly belong in a cost-benefit analysis, along with other non-monetary costs and benefits of federal credit programs; they do not belong in the budget. Fair-value accounting confuses budgeting and cost-benefit analysis and serves neither purpose well.

   Both the current method of accounting for federal credit programs and fair-value accounting require the Congressional Budget Office and the Office of Management and Budget to estimate the future cost of direct loans and loan guarantees at the time they are issued. However, the current accounting method is ultimately more accurate because the estimates are adjusted to accord with actual Treasury cash flows, whereas fair-value estimates can never be compared with any observable outcomes. Fair-value accounting's risk-aversion penalty is an unobservable quantity, and there is no way to determine if a fair-value estimate is accurate, even after the fact.

2. Dr. Van de Water, can you also speak to the limitations that Fair Value Accounting will place on largely successful federal credit programs?

   Answer: Compared to the current accounting method, fair-value accounting would raise the estimated cost of federal credit programs and put them at a disadvantage in the budget process compared to non-credit programs. The likely result is that Congress would reduce the volume of federal direct and guaranteed lending or make loan terms less favorable for borrowers, for example, by raising interest rates or origination fees.

Douglas J. Elliott

June 26, 2015

Thank you for your interest, Congresswoman. I have included my response below, right after your question.

Questions for the Record submitted by Congresswoman Alma Adams, Ph.D. to

Mr. Douglas Elliott

Joint Economic Committee Hearing:

"The Economic Exposure of Federal Credit Programs"

1. Mr. Elliott, since Fair Value Accounting factors in additional costs, what impact would that have on borrowers looking for better rates in government loans than that of the private market? What is the chance the government raises interest rates as a result of this new scoring method?

Congress will make the decision about what rates should be charged for government loans, so it is impossible to say what the effect will be of better reflecting costs on the federal budget by using risk-based discount rates. There is no direct effect on pricing as a result of using different budget scoring. You, as a member of Congress, would be in a better position than I am to predict what that body will do.

Budgeting for Federal Credit Programs: The Case for Fair Value

Letter prepared for the record of the
U.S. Congress Joint Economic Committee Hearing of June 17, 2015

Deborah Lucas*

Sloan Distinguished Professor of Finance, MIT and
Director, MIT Center for Finance and Policy

*The views expressed are my own and not those of the MIT Center for Finance and Policy (CFP).

Dear Chairman Coats, Ranking Member Maloney, and Members of the Committee,

I appreciate this opportunity to offer my support for the adoption of Fair Value principles in accounting for Federal Credit Programs. This letter briefly reviews the economic and practical case for that recommendation, and responds to some of the criticisms that have been raised by opponents to that change. The discussion draws on my past work and practical experience with this issue, both through my academic research and during my time as Chief Economist and later as Assistant Director of the Financial Analysis Division at CBO.

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Background: The Goals of FCRA

Currently most federal credit activities are accounted for under the Federal Credit Reform Act of 1990 (FCRA). FCRA--which requires that the budget record the lifetime cost of federal direct loans and loan guarantees in the year the loans are disbursed--represents a significant improvement over the cash basis of accounting the preceded it. However, because of FCRA's requirement that lifetime costs be calculated using Treasury interest rates for discounting future projected cash flows, the subsidy costs recorded in the budget systematically understate the full cost of the government's credit commitments.[1]

As will be explained shortly, a move to fair value accounting would remedy that downward bias inherent in FCRA cost estimates. Most importantly, it would create a more level playing field between credit and non-credit programs, and it would remove the budgetary arbitrage that currently creates the appearance of phantom profits for some credit programs.

[1] The omission of essential administrative costs such as servicing and collection from FCRA estimates also contribute to the understatement of credit subsidies in the budget, and a comprehensive subsidy estimate should also include those costs. However, those administrative costs are accounted for on a cash basis elsewhere in the budget.

In evaluating whether a move to fair value accounting would be an improvement over current subsidy estimates, it is worthwhile to review the stated purposes of FCRA in section 501 of the Act:

> "The purposes of this title are to--
> § 501(1) **measure more accurately the costs** of Federal credit programs;
> § 501(2) **place the cost of credit programs on a budgetary basis equivalent to other Federal spending**;
> § 501(3) **encourage the delivery of benefits in the form most appropriate** to the needs of beneficiaries; and
> § 501(4) **improve the allocation of resources among credit programs and between credit and other spending programs**." *(emphasis added)*

As those purposes make clear, the passage of FCRA codified the primacy of accurate cost measurement over the tracking of cash flows for credit programs. The term "cost" means the economic value of resources committed to a federal activity or program. Although the cash expended often corresponds to economic cost that is not always the case. For a loan or loan guarantee, where the associated cash flows are uncertain and span many years, the associated cash flows affect cost, but do not directly correspond to it.

The distinction between cost and cash is important because some opponents of fair value emphasize that the budget should track cash flows, and that fair value estimates do not correspond directly to cash flows. However, largely because of the existing use of FCRA accounting for credit programs, the budget deficit currently does not measure the cash shortfall of the government or the year-to-year change in government debt. That is, the introduction of any type of accrual accounting into the budget, including FCRA accounting, puts a wedge between the reported budget deficit and cash because of the use of discounted cash flows. This can be seen clearly in CBO's debt and deficit projections. In 2014 for example, CBO reports that debt held by the public increased by $797 billion, whereas the reported deficit was $483 billion.

Neither FCRA nor fair value accounting tracks actual cash flows. Under either approach, a set of so-called "below-the-line accounts" are necessary to reconcile cash flows with reported deficits. Fortunately, straightforward methods are available to do that reconciliation. And cash flow information is readily obtainable from other sources, for instance in the Financial Statements prepared by Treasury. Hence I believe that the question of whether FCRA or fair value accounting comes closer to mimicking cash accounting is irrelevant to the choice between them.

The Logical Case for Adopting Fair Value

The above discussion underscores that the central question, which is what is the best way to measure the lifetime cost of federal direct loans and loan guarantees so as to meet the goals set out in FCRA?

In most respects FCRA and fair value accounting are closely related: Both aim to measure the lifetime cost of credit programs upfront, at the point in time when funds are committed to a cohort of borrowers and hence when the estimates are the most decision-relevant. And both involve projecting the same uncertain future cash flows (e.g., interest and principal payments net of default losses) and determining their equivalent value today or "present value."

The difference between FCRA and fair value is in how the present value of those future cash flows is determined: FCRA uses Treasury rates to discount risky future cash flows to the present, ignoring any cost of the associated risk (although expected losses are taken into account in projected cash flows). A fair value approach implicitly are explicitly uses market rates for discounting, and those market rates include a charge for risk. To determine the appropriate discount rates, a fair value approach relies on competitive market prices, or an approximation to competitive prices.

The logical case for fair value accounting has been written about extensively, and I will only summarize a few key ideas here.[2] The essence is that market prices, which aggregate the preferences for good and services across many individuals, are the best available measure of value and hence cost in market economies. Market prices reflect the real cost to investors of bearing risk that cannot be easily avoided by portfolio diversification, often referred to as market risk. The government can redistribute the market risk associated with its credit activities but cannot reduce or eliminate that risk. Ultimately the market risk must be passed through to taxpayers (and other government stakeholders), who are averse to bearing it. Hence the market risk that the government assumes represents a real cost to taxpayers, who are the *de facto* equity holders in all government credit activities.

A fair value approach, by including the cost of market risk, improves the comparability of the cost of credit programs with that of most other federal spending. That is because the cost of market risk is already reflected in the budgetary cost of most of the goods and services that the government purchases. That is true of both direct and indirect purchases. For example, if the government buys a vehicle, or if it makes a grant or transfer payment that is used by the recipient to buy the vehicle, the purchase price paid includes the cost of the market risk associated with producing and selling the vehicle. By the same reasoning, FCRA accounting makes credit

[2] See for example, "Fair-Value Accounting for Federal Credit Programs," CBO Issue Brief, March 2012; "Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024," CBO Report, May 2014; "Reforming Credit Reform," D. Lucas and M. Phaup, Public Budgeting and Finance, 2008; "Valuation of Government Policies and Projects," D. Lucas, Annual Review of Financial Economics, 2012; "Uncle Sam in Pinstripes," Douglas Elliott, The Brookings Institution; "Accounting for the Cost of Government Credit Assistance," Statement of the Financial Economics Roundtable, 2012.

programs appear to be systematically less expensive than other spending of equivalent economic cost because it neglects the cost of market risk.

The observation that the cost of market risk is reflected in the prices paid by the government for most goods and services and hence should be included for costing credit as well runs counter to an argument made by many opponents of fair value. They claim that a fair value approach would unfairly disadvantage credit programs relative to other forms of government assistance. To the contrary, a switch to fair value accounting would make the treatment of market risk more level between credit and most non-credit programs, and hence it would not unfairly disadvantage recipients of federal credit assistance.

Another objection raised by critics of fair value is that there may be many benefits to credit programs that are not measured, and it would be wrong to single out market risk as the one omission or externality that needs to be incorporated into budgetary costs. That line of reasoning seems to mischaracterize the budget process, and to confuse the measurement of costs with that of benefits. The budget is intended to provide a comprehensive measure of the cost of federal activities, and therefore should include the cost of market risk. However, as for other federal spending, the benefits of federal credit programs are decided through the political process; they are not quantified as part of the budget process.

The Practical Case for Adopting Fair Value

There are a number of compelling practical reasons to adopt a fair value approach to accounting for federal credit programs. In my view, these are the strongest arguments for a move to fair value because they suggest that the size of distortions under FCRA can be significant:

(1) Eliminate the "budgetary arbitrage" opportunities that exist under FCRA

Under FCRA, the government credits itself with making a profit on loans it makes at market prices. As Jason DeLisle describes in his testimony, that practice creates the possibility of a money machine. Taken to an extreme, the government could go from deficit to surplus by ramping up the scale of its lending operations and investing the money in risky loans paying market rates. That strategy has been used, albeit on a more modest scale, to create budgetary profits at times in the past. For example, Treasury credited itself with a negative subsidy rate (i.e., profit) in 2010 on $30 billion of MBS purchases from the GSEs that it purchased at market prices.

(2) Put credit and non-credit assistance on a more level playing field

Neglecting the cost of market risk lowers the perceived cost of credit assistance relative to that of economically equivalent grant or benefit payments, creating an incentive to over-rely on credit assistance. Recognizing the full cost of assistance encourages the delivery of benefits in the most appropriate form. An area where this is likely to be important is the funding for higher education, where one reason for the growing reliance on the federal student loan program relative to educational grants may be partly fueled by the overstated profitability under FCRA of the student loan programs.

(3) Make financial transactions at market prices budget-neutral

Under FCRA, federal purchases of financial assets at competitive market prices appear to make money, whereas selling assets at market prices appears to lose money. That distortion makes it difficult for managers of federal credit programs to efficiently manage their portfolios.

Where that distortion could become particularly important is in policy discussion about the implications of privatizing Fannie Mae and Freddie Mac. Under FCRA accounting liquidating their mortgage portfolios would appear costly to the government, whereas under fair value it would be neutral for the budget if the mortgages were sold through a competitive auction.

(4) Add transparency and discipline to the budget process

FCRA accounting is an invention of the federal government, it is not in use by other entities, private or public. That makes it relatively difficult for policymakers and the public to evaluate whether the estimates, which depend on many assumptions, are reasonable. By contrast, fair value accounting is increasingly required of private sector financial firms. To address those needs, the private sector has developed the capacity to make and audit such estimates, and there is an established set of standards that guide the estimation process. The plausibility of fair market estimates can also be assessed by comparison to market price data. This suggests that a move to fair value would improve the transparency and accuracy of budget estimates, even though initially the switch would require investments by the government in developing new procedures, training analysts, and educating users of those numbers.

I hope that these comments are helpful in your deliberations. Please feel free to contact me if I can provide any further information.

Sincerely,

Deborah Lucas