



Budgeting for Federal Credit Programs: The Case for Fair Value

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Overview

- Background: Goals of FCRA
- Rationale for adoption of fair value estimates for credit scoring
 - The economic logic
 - The practical case
 - Avoiding “budgetary arbitrage” that creates the appearance of phantom profits
 - Creating a level playing field between credit support and other types of spending

Goals of FCRA

- The passage of FCRA codified the importance of accurate cost measurement over the tracking of cash flows for credit programs
 - Cash basis accounting makes costly guarantees look like money makers
 - Cash basis accounting makes profitable direct loans look like losers

Goals of FCRA

- SEC. 501. PURPOSES.
- 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.**

Under current law, budget deficits don't track gov't cash flows or net borrowing from the public

Table 1-3.

Federal Debt Projected in CBO's Baseline

Billions of Dollars

	Actual, 2014	2015	2016	2017	2018	2019	2020
Debt Held by the Public at the Beginning of the Year	11,983	12,779	13,359	13,905	14,466	15,068	15,782
Changes in Debt Held by the Public							
Deficit	483	468	467	489	540	652	739
Other means of financing	314	112	79	72	62	62	59
Total	797	580	546	561	602	714	798
Debt Held by the Public at the End of the Year	12,779	13,359	13,905	14,466	15,068	15,782	16,580

Implications

- The issue of how well cash flows are being tracked in the budget under FCRA vs. fair value is a red herring
 - The budget doesn't track cash flows now
 - Either under FCRA or fair value, cash flows from credit programs have to be reconciled with reported accruals in "below the line" accounts
 - Reconciling accruals and cash is fairly straightforward under both FCRA or fair value
 - Cash flows information is available in Treasury's Financial Statements and elsewhere
- **The real question: how best to measure the lifetime cost of federal direct loans and loan guarantees to achieve the goals set out in FCRA?**

FCRA vs. Fair Value

- **Both aim to measure the lifetime cost** of credit programs upfront, at the point in time when funds are committed for a cohort of borrowers
- **Both involve projecting net future cash flows** (e.g., interest and principal payments net of default losses) and determining their equivalent value today or “present value”
- The **difference is in how the present value is evaluated** of those future cash flows
- **FCRA uses Treasury rates** (which are the market price of safe cash flows) to discount risky future cash flows
- **A fair value approach uses market rates** that include a charge for risk for discounting
 - It aims to value claims using competitive market prices (or at an approximation to those prices)

The Logical Case for Adopting Fair Value

- **Market prices are the best available measure of cost in market economies**
 - Market prices include the cost to investors of bearing market risk
 - Market risk represents a true economic cost; the government can redistribute it but cannot make it go away
- **The cost of market risk is already reflected in the budget for most of the goods and services** that the government buys (directly or through cash grants)
- By neglecting the cost of market risk, **FCRA accounting makes credit programs appear to be systematically less expensive than other spending of equivalent economic cost**

Why the government's cost of capital exceeds its borrowing rate

- Example: The government makes a risky loan to finance an investment in new electrical generation.
 - Principal is \$100 million
 - Interest rate charged to borrower is 3%
 - Treasury borrowing rate is 2%
 - Maturity is 1 year

Why the government's cost of capital exceeds its borrowing rate

- Notional government balance sheet right after loan is made:

Assets	Liabilities
Risky loan \$100m	Government Debt \$100m

Why the government's cost of capital exceeds its borrowing rate

- Notional balance sheet at end of the year if the loan pays off in full:

Assets	Liabilities
Cash \$103m	Government Debt \$102m

"Profit" of \$1 million

Why the government's cost of capital exceeds its borrowing rate

- Notional balance sheet at end of the year if the **loan defaults and recovery is only \$80m:**

Assets	Liabilities
Cash \$80m	Government Debt \$102m Taxpayers -\$22m

- Government borrowing costs are only low because of taxpayer backing, they are unrelated to the risk of a particular investment.
- **Taxpayers and the public are *de facto* equity holders in government investments**—they absorb any gains or losses.
- Hence, the government's cost of capital is logically a weighted average of the cost of debt and equity (as for a private sector firm).

The Practical Case for Adopting Fair Value

- **Eliminates “budgetary arbitrage” opportunities** that exist under FCRA
 - Under FCRA, the government credits itself with making a profit on loans it makes at market prices
 - That creates a money machine: The government could go from deficit to surplus by ramping up the scale of its lending operations
 - E.g., Treasury credited itself with a negative subsidy rate (i.e., profit) in 2010 on \$30 billion of MBS purchases from the GSEs at market prices
 - Same logic makes investing social security surplus in the stock market a panacea

The Practical Case for Adopting Fair Value

- **Puts 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 it encourages the delivery of benefits in the most appropriate form
 - E.g., student loans vs. educational grants

The Practical Case for Adopting Fair Value

- **Makes financial transactions at market prices budget-neutral**
 - By contrast under FCRA, buying financial assets at competitive prices appears to make money, whereas selling them appears to lose money
 - Particularly important for policy discussion about implications of privatizing Fannie and Freddie

The Practical Case for Adopting Fair Value

- **Adds transparency and discipline to the budget process**
 - FCRA accounting is an invention of the government that is not used elsewhere
 - By contrast, fair value accounting is increasingly required of private sector financial firms
 - There is an established set of standards for making and auditing fair value estimates



Thank you!

Related articles

- “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