CHAPTER II. THE FEDERAL FINANCING BANK: A TREASURY TOOL FOR ORDERLY MARKETING OF FEDERAL SECURITIES

This chapter describes the practices of financing activity in the government securities market that gave rise in the early 1970s to the need for a central financing authority. It then discusses the FFB's establishment and operations.

TAPPING THE SECURITIES MARKET FOR FINANCING

Since World War II, the federal government has provided some goods or services indirectly or through third parties. By using grants-in-aid, tax expenditures, direct loans, loan guarantees, and regulations, federal agencies have been able to encourage or give incentives to state and local governments, individuals, or private enterprises to undertake activities that the agencies might otherwise have provided directly to the beneficiaries. 1/ Third-party provision of services also has sometimes taken the form of independent public and quasi-public entities designed to operate on a businesslike basis. For instance, the Export-Import Bank was established to lend money to promote exports of American products, and the Student Loan Marketing Association (SLMA) was designed to promote the flow of credit into loans for students.

One consequence of this trend to indirect or third-party provision of government services was an increase in the 1960s and early 1970s in the number of federal agencies issuing or guaranteeing securities offered in the government securities market. As part of its policy of encouraging third-party delivery of services, the federal government created new financing mechanisms that allowed agencies or nonfederal entities to tap the government securities market to finance federally sponsored activity. These new mechanisms took three different forms.

1/ Lester Salamon has called this indirect provision of services "third-party government." See Lester M. Salamon, "The Rise of Third-Party Government," The Washington Post, June 29, 1980.

New Financing Mechanisms

Debt Issued by Federal Agencies. To encourage the provision of services to the public on a businesslike basis, the Congress authorized several agencies--notably the Export-Import Bank, the Tennessee Valley Authority (TVA), and the Postal Service--to sell their own bonds in order to finance their operations. 2/ These agency debt securities were generally backed by the full faith and credit of the federal government and, thus, had the same backing as the Treasury's own debt securities. 3/ Agencies sometimes marketed their debt directly; in other cases, they used the services of an underwriter.

Sales of Loans from Agency Portfolios. By selling loans from their portfolios to third-party investors, federal agencies could generate new capital for further loans. These sales were known as loan asset sales. As a result, the role of the federal lending agency became much like that of a broker: arranging loans and providing for their private financing. In addition to mobilizing private capital for public purposes, such sales had the advantage of lowering the selling agency's net outlays because the sales are treated in the agency's budget in the same way as repayments on a loan--that is, as offsetting receipts.

Originally agencies sold individual loans to private investors. Later, however, some agencies pooled together a large number of small loans and sold shares of ownership in such loan pools. These shares, called participation certificates or certificates of beneficial ownership (CBOs), were more attractive to investors, especially institutional investors. They could be sold in units of a million dollars or more. Furthermore, because the issuing agency made up the difference between market rates and the return on below-market-rate federal loans, they could be sold at attractive prices and yields. Finally, the issuing

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2/ This authority, technically known as authority to spend agency debt receipts, is one of two forms of borrowing authority (the other being authority to borrow from the Treasury, known as authority to spend public debt receipts).

3/ In some cases, however, the federal government's backing is only implicit. For example, TVA's debt is not explicitly backed by the full faith and credit of the government; instead, it is backed by the revenue from TVA's sales of electric power.

agencies fully guaranteed the interest and principal due on such certificates. These features of CBOs made them easy to sell in the government securities market.

Guaranteed Securities. Since the 1930s, loan guarantees have provided incentives to lending institutions to make home mortgages. In the 1960s and early 1970s, the federal government began using loan guarantees to make credit available for other publicly desired purposes. In particular, loan guarantees were used to allocate credit to large, discrete ventures, such as financing the construction of an ocean vessel. Because of their larger size and longer terms, banks or other lending institutions were often hesitant to originate such guaranteed loans. It was found, however, that borrowers with 100 percent federal guarantees could sell bonds or notes in the government securities market like Treasury bonds or notes. Thus, through 100 percent guarantees, federal agencies could help nonfederal borrowers tap the government securities market for financing.

Crowding in the Government Securities Market

In addition to the Treasury's own marketing of bills, notes, and bonds, by 1973 as many as 18 different agencies or programs were offering financial instruments in the government securities market: either their own debt securities, securities backed by direct loans from their own holdings, or securities issued by private concerns that they had guaranteed. 4/ On average, some type of federally assisted financing was being offered in the market three out of every five business days.

This proliferation of marketable federal securities strained the capacity of the securities markets. As one observer noted:

> What's happening is that the new agencies are crowding the financing calendar with issues whose purposes, credit terms, guarantees, sinking fund provisions, and the like, cannot be readily understood or appraised by investors. Many of these

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4/ Statement by Paul A. Volcker, Under Secretary for Monetary Affairs, Department of the Treasury, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 15.

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> new issues are of such small size that broad ownership appeal and distribution is not being accomplished. 5/

Because of their small size and the lack of broad ownership, many of the new types of issues cost their agencies more money:

> Whenever you have small issues and few owners, you have an imperfect market. Imperfect markets mean there is a wide spread between the bid price and the asked price. Imperfect markets also cost borrowers more interest. 6/

The market for these securities contrasted markedly with the market for Treasury securities which, with their large unit sizes and broad distribution of ownership, operates very efficiently and at lower costs. It is possible, for example, to trade Treasury bills on which the difference between the bid and asked prices of $1 million or more of bills may be only $50.

The results of the proliferation of agencies tapping the securities market for financing were higher costs. First, the agencies had to pay higher interest rates in order to sell their securities, thus increasing their interest costs. Second, the agencies had higher administrative costs because they had to maintain a financing staff to market the securities. And third, when an agency used an underwriter to market an offering, it paid underwriting fees.

THE SOLUTION: A CENTRAL FINANCING AUTHORITY

The Treasury Department, with its responsibility for the efficient and economical management of the federal government's debt, viewed the overcrowding in the government securities market--with the resulting higher financing costs for agencies--as a debt

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5/ Statement of Robert H. Bethke, Vice Chairman, U.S. Government and Federal Agencies Committee, Securities Industry Association, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 49.

6/ Statement by Robert H. Bethke in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 51.

management problem. Although federal agency debt issues, loan asset or CBO sales, and guaranteed securities usually had the same full-faith-and-credit backing as the Treasury's own debt issues, they were being charged higher interest rates than Treasury issues of comparable maturity.

To remedy this problem, the Nixon Administration proposed and the Congress--with some amendments--passed the Federal Financing Bank Act of 1973 (Public Law 93-224). The act established a bank within the Treasury Department to be a central financing agent for marketable securities issued or guaranteed by federal agencies. The bank would be off-budget; that is, its receipts and disbursements would not be included in the totals of the unified budget. 7/

When the bank was established, it was presumed that it would buy securities from agencies or guaranteed borrowers, financing its purchases by issuing its own debt. This would reduce the number of issuers of marketable federal securities to two: the Treasury and the FFB. It was further presumed that the market, with fewer types of securities to contend with, would purchase the FFB's debt at rates comparable to those of the Treasury's own debt. Thus, it would be possible for the FFB to finance agency debt, loan asset sales, and guaranteed securities at near-Treasury interest rates, saving the agencies, their guaranteed borrowers, and the federal government millions of dollars in interest costs. Witnesses testifying before the Ways and Means Committee on the Administration's proposal estimated that securities financed through the FFB would bear interest at rates about one-half of one percentage point below those on separately financed agency issues. 8/ Estimates of the annual volume of new FFB purchases ranged from $4 billion to $7 billion, implying annual interest savings over the term of those obligations of between $20 million and $35 million.

7/ The bank's budgetary treatment and the rationale for placing it off-budget are described in the next chapter.

8/ See the statement by Paul A. Volcker, Under Secretary for Monetary Affairs, Department of the Treasury, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 93:1 (1973), p. 20. Also see the statement by Robert H. Bethke, Securities Industry Association, in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 52.

THE FFB IN OPERATION: A TOOL OF DEBT MANAGEMENT

The Federal Financing Bank began operating in May 1974. In seven years it has become well-established as a tool of debt management. The number of entrants in the government securities markets has been reduced dramatically, and the bank's operations save the federal government millions of dollars in interest costs annually. The following sections describe the bank's levels of activity and its financing.

Levels of Activity

Since 1974 the FFB has become an important source of financing for marketable securities issued or guaranteed by federal agencies. As seen in Figure 1, the FFB's portfolio has grown rapidly and steadily since its inception. Its outstanding holdings totaled $107.3 billion at the end of fiscal year 1981 and are expected to continue increasing during fiscal year 1982.

FFB activity levels have been greater than was anticipated during the Congressional hearings on the proposals to establish the bank. Treasury Under Secretary Volcker estimated that during its first two years the bank would purchase about $15 billion of agency securities, or $6 to $7 billion annually. 9/ As Figure 1 illustrates, however, net new lending fluctuated between $9 billion and $12 billion during the bank's first four years (fiscal years 1975 to 1978). Since 1978 net lending has climbed steadily, reaching $24.8 billion in fiscal year 1981, or twice the 1978 level.

In terms of the categories of FFB activity, purchases of loan assets from agencies have predominated, accounting for 48.3 percent of the FFB's total holdings at the end of fiscal year 1981. Direct loans to borrowers holding agency guarantees accounted for 28.6 percent of all holdings, followed by purchases of agency debt (23.2 percent). The following sections briefly describe the levels of activity for each type of activity.

Loan Assets. The FFB has become the primary purchaser of loan assets sold by federal agencies. In 1975, its first full year of operation, the FFB purchased 63.8 percent of all loan

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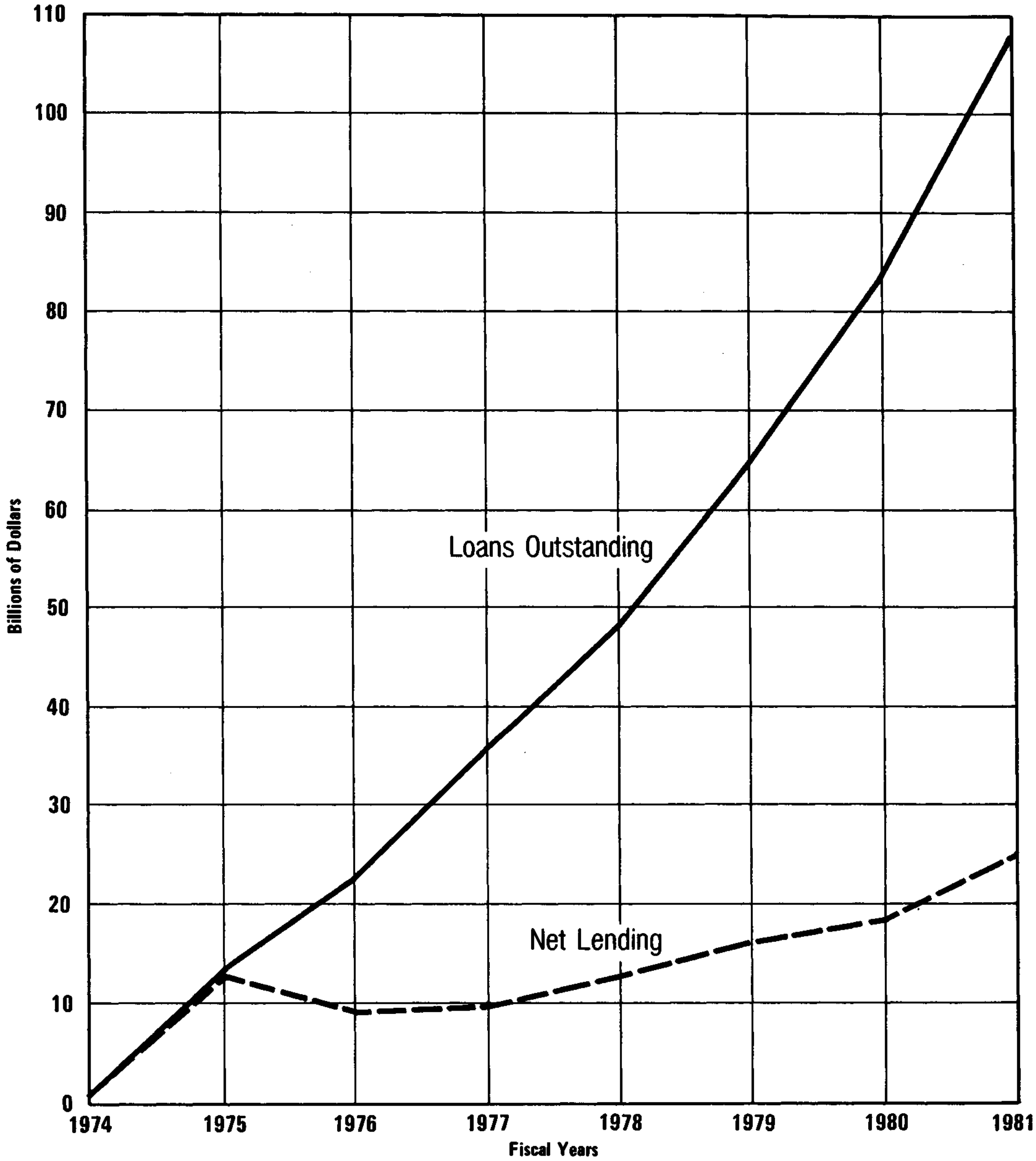
9/ Volcker in Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 28.

Figure 1.

Net Lending and Loans Outstanding of the Federal Financing Bank, Fiscal Years 1974-1981



SOURCES: *Budget of the United States Government,* Fiscal Years 1976-1982, Special Analyses on Credit; and Department of the Treasury, FFB News, September 1981 Report (October 26, 1981).

assets offered for sale by federal agencies. By 1980 the FFB's share had increased to 92 percent, or $12.1 billion of the $13.2 billion of assets offered for sale. 10/ The Farmers Home Administration (FmHA) has been the principal seller of loan assets to the FFB. As seen in Table 1, FFB holdings of FmHA CBOs totaled $48.8 billion by the end of fiscal year 1981, or 94 percent of the bank's loan asset holdings. This pattern is expected to continue in 1982.

TABLE 1. FFB HOLDINGS OF OUTSTANDING LOAN ASSETS, FISCAL YEARS 1980-1982 (In billions of dollars)

Agency	1980	1981	1982 a/
Farmers Home Administration	38.0	48.8	54.1
Rural Electrification Administration	1.9	2.6	3.0
All Other Agencies	0.5	0.4	0.6
Total, Loan Asset Holdings	40.4	51.8	57.7

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981); and estimates based on Mid-Session Review of the Budget, July 1981.

a/ Estimates.

Direct Loans to Guaranteed Borrowers. Instead of issuing securities to be bought by investors in the government securities market, borrowers with a guarantee from a federal agency may have the FFB purchase the entire security issue. Thus, the FFB, in effect, makes a direct loan to that borrower. At the end of fiscal

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10/ The bulk of loan assets not sold to the FFB consist of home mortgages sold by the Government National Mortgage Association in the secondary mortgage markets.

year 1981, the FFB's holdings of this type of loans totaled $30.6 billion. In terms of dollar volume, the two largest categories of borrowers were rural electric cooperatives under guarantees by the Rural Electrification Administration (REA) and foreign countries purchasing U.S.-made military equipment under guarantees by the Department of Defense (DoD). These two categories of borrowers accounted for $21.5 billion of the loans outstanding at the end of 1981, or 70 percent of the total (see Table 2). Rapid growth in FFB direct loans is expected to continue: at the end of fiscal year 1982 loans outstanding are estimated to total $41.5 billion, nearly twice the volume at the close of 1980.

Agency Debt. Since its inception in 1974, the FFB has been the sole financing agent for nearly all new issues of agency debt. At the close of fiscal year 1981, its holding of agency debt approached $24.9 billion, up 18 percent over the previous year (see Table 3). During 1981 the FFB advanced $2.3 billion to the Export-Import Bank and $2.0 billion to the TVA, on a net basis. The U.S. Railway Association and the Postal Service both reduced their outstanding loan balances owed to FFB during 1981.

Financing

To finance its purchases of agency debt and loan assets and its direct loans to guaranteed borrowers, the FFB may either sell its own securities directly to the public or it may borrow from the Treasury. Although, according to the bank's charter, the FFB may borrow only $15 billion from the public at any time, it may, with the Secretary's approval, borrow without limits from the Treasury. Originally, it was thought that the FFB would borrow from the Treasury on an interim basis, repaying these borrowings periodically through the sale of its own securities in the market. It was assumed that the bank's securities would pay the same low interest rates paid by the Treasury on its own obligations.

This did not turn out to be the case. In July 1974, the bank auctioned its own bills for the first time. As these issues subsequently were traded in the market, they began to trade at rates above those on Treasury securities with comparable maturities. Unhappy with this turn of events, the Treasury officials who manage the FFB's operations decided that thereafter the FFB would borrow exclusively from the Treasury.

Typically, to arrange financing for an agency, the FFB allows the agency to specify the terms of the loan with respect to amount,

TABLE 2. OUTSTANDING FFB LOANS TO GUARANTEED BORROWERS, FISCAL YEARS 1980-1982 (In billions of dollars)

Agency and Borrower	1980	1981	1982 a/
REA Guaranteed Loans to Rural Electric Cooperatives	8.4	12.3	16.5
DoD Guaranteed Loans for Foreign Military Sales	7.2	9.1	11.1
Department of Education Guaranteed Loans to Student Loan Marketing Association	2.3	4.3	5.3
HUD Guaranteed Loans to Low-Rent Public Housing	0.1	0.9	3.5
TVA Guaranteed Loans to Seven States Energy Corporation	0.7	0.9	1.2
Other	2.8	3.1	3.9
Total, Loans Outstanding	21.5	30.6	41.5

SOURCES: Budget of the United States Government, Fiscal Year 1982, Special Analysis on Credit; Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981); and estimates based on Mid-Session Review of the Budget, July 1981.

a/ Estimates.

maturity, and payment dates. The FFB then borrows the necessary funds from the Treasury Department, paying interest rates that the Treasury would have to pay to borrow the funds in the market. The FFB then executes the loan to the agency, charging it one-eighth of a percentage point more than the rate it is paying to the Treasury.

TABLE 3. FFB HOLDINGS OF OUTSTANDING AGENCY DEBT, FISCAL YEARS 1979-1981 (In billions of dollars)

Agency	1979	1980	1981
Export-Import Bank	8.0	10.1	12.4
Tennessee Valley Authority	7.1	8.9	10.9
National Credit Union Association	--	0.1	0.1
U.S. Railway Association	0.4	0.5	0.2
Postal Service	1.6	1.5	1.3
Total, Debt Holdings	17.1	21.1	24.9

SOURCES: Budget of the United States Government, Fiscal Years 1981 and 1982, Special Analyses on Credit; and Department of the Treasury, Federal Financing Bank News, September 1981 Report (October 26, 1981).

The difference is used to cover the FFB's administrative costs and possible contingencies and to pay dividends to the Treasury. Risk is not a factor in these pricing decisions; the determining factor is the Treasury's current cost of money.

Explaining FFB's Growth

Two factors may explain why the FFB's activity levels have outstripped initial expectations. First, the bank buys everything that is offered to it. It does not exercise any discretion--as long as a security is guaranteed or sold by an agency, the FFB will buy it. This method of operating is intentional. Treasury officials maintain that the bank is merely a financing authoricy, not a program agency, and should, therefore, make no judgments about projects presented to it.

Second, since the FFB borrows all its funds from the Treasury, it has practically unlimited available funds. This has enabled the FFB to increase greatly the scope of its operations without having to seek Congressional approval for increases in borrowing authority. For example, at the end of fiscal year 1981, all but $10,000 of the FFB's total holdings of $107.3 billion of agency debt, loan assets, and direct loans to guaranteed borrowers had been financed by borrowing from the Treasury. This is over seven times what the FFB could have financed if it had been limited to its initial $15 billion of authority to borrow from the public.

CHAPTER III. BUDGETARY TREATMENT OF FFB'S ACTIVITIES

FFB purchases of certificates of beneficial ownership (CBOs) and FFB direct loans to borrowers with federal guarantees cause the annual total of direct lending recorded in the unified budget to be understated. To understand why this occurs, it is first necessary to understand the principles governing the budgetary treatment of federal credit transactions, the first topic discussed in this chapter.

BUDGETARY TREATMENT OF FEDERAL CREDIT TRANSACTIONS: A PRIMER

Although they are all credit transactions, borrowing, lending, and guaranteeing of loans by federal agencies are treated very differently in the budget process. Borrowing, as a means of financing, does not affect either the borrowing agency's outlays or those of the budget's totals. Lending by an agency, on the other hand, is considered a federal activity, and, as such, is counted in the budget. Loan guarantees represent only contingent liabilities of the federal government, and have been defined in law as non-budgetary transactions. The following sections explain the resulting differences in the budgetary treatment of these three credit activities.

Borrowing by a Federal Agency: A Means of Financing

Some federal agencies have specific authority granted by the Congress to borrow funds, either from another agency, the Treasury, or a nonfederal lender, as a means of financing their prescribed activities. A typical sequence of transactions runs as follows: the agency sells its bond or note, recording the funds it receives from the sale as an increase in its fund balance, with a corresponding increase in its liabilities. Only when it disburses the funds for one of its program activities does the agency record outlays. When the bond or note comes due, the agency repays the lender (that is, the security holder) and records a decrease in its fund balance and a corresponding decrease in its liabilities. Thus, the agency's outlay totals, and total budget outlays as well, are unaffected by the borrowing transactions. Because the borrowing is only a means of financing other direct federal activity, the borrowed funds are not counted as receipts, nor are the funds repaid recorded as outlays.

If the lender is another federal agency, it too records no outlays for the borrowing transaction. Instead, it records the extension of the loan as a decrease in its fund balance and an increase in its assets. When the loan is repaid, the lending agency's fund balance increases while its assets decrease. 1/

The exclusion of the flows of loan principal and repayments from agency outlays and receipts mirrors the treatment of borrowing by Treasury to finance the deficit. Treasury borrowing is not counted as receipts to the government; otherwise the budget would always be balanced. Nor are Treasury repayments on federal borrowing considered outlays. 2/ Instead, both Treasury and agency borrowing are considered a means of financing.

Lending by a Federal Agency: Program Activity

Lending by a federal agency to a nonfederal borrower constitutes program activity, rather than a means of financing. Federal agencies make loans to spur certain types of economic activity or to assist particular borrowers to undertake specific transactions. Because the loan is disbursed to an entity outside the federal budget, the disbursement of the loan principal is recorded as an outlay on the lending agency's books. When the loan is repaid, the payments of loan principal are counted as

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1/ This discussion refers only to the extension and repayment of loan principal. Interest paid by a borrowing agency to a lender, whether another agency or a nonfederal entity, is recorded as an outlay. If the lender is a federal agency, it records the interest as an offsetting receipt, or negative outlay; thus, the unified budget outlay total remains unchanged. If the lender is outside the federal government, total budget outlays increase by the amount of the interest payment. In any case, these interest flows are small, compared to the flows of loan principal, and the discussion in this paper of the budgetary effects of lending and borrowing does not consider them.

2/ The sizable payments of interest on the federal debt ($82.6 billion in 1981) are recorded as outlays in function 900.

offsetting receipts, or negative outlays. If a loan is repaid in the same year that it is extended, the agency's books show no outlay effect for the year. If the term of the loan is longer than one year, then the agency records outlays in the year in which the loan is disbursed, increasing total budget outlays as well as the agency's total outlays. In succeeding years, as principal payments are received, the agency's budget records negative outlays, and the unified budget's outlay total decreases. At the end of the loan's term, if the loan is fully repaid, the final budgetary cost to the federal government is zero.

Federal Loan Guarantees

When an agency pledges to repay the principal and interest due on a loan in the event of a default, it removes or lowers the lender's risk in making that loan. The result is an allocation of credit to the borrower by the lender, who, in the absence of the guarantee, might have denied the loan, or have offered it only at very high interest rates. Because the federal government's liability is contingent--only if the borrower defaults does the government have to repay the loan--a loan guarantee is not considered a budgetary transaction. The Congressional Budget Act of 1974 specifically excludes loan guarantees from the definition of budget authority or spending authority. The guaranteeing agency's budget total and the unified budget totals do not reflect either the extension of a guarantee when a loan is made, or its cancellation once the loan is repaid. Outlays are recorded only if, and when, the government must pay a claim on a defaulted loan.

An Anomaly: Sales of CBOs

The current budgetary treatment of the sales of certificates of beneficial ownership by the Farmers Home Administration (FmHA) and the Rural Electrification Administration (REA) is an anomaly. According to accepted budgetary principles, CBO sales should be treated in the budget as agency borrowing; special provisions of law, however, state that CBO sales are to be treated as asset sales. This special treatment does not affect the manner in which the programs operate; it does, however, greatly affect the size of the programs as they appear in the budget.

Sales of CBOs: Loan Assets or Borrowing? As noted in Chapter II, some federal lending agencies have sold loan assets--individual notes or pools of loans, first called participation certificates and later certificates of beneficial ownership--from their loan portfolios in order to recover the loan capital without having to wait for the loans to mature and be repaid. These loan asset sales are treated in the budget as repayments--that is, by selling the loan the agency gets back its loan principal, as if the loan were repaid. Thus, an agency can make a loan during a fiscal year, which would increase its outlays, but by selling the loan (at par) in that same year, offset those outlays, resulting in net outlays of zero for the year.

An outright sale of a loan asset by a federal agency results in the transfer of the loan note to the purchaser, along with the responsibilities for servicing the loan and the risk of default. After the sale, payments of interest and principal go directly to the purchaser rather than the federal agency, which is relieved of any liability or risk.

Few, if any, federal loan assets are sold under the exacting conditions of an "outright" sale, however. Most sales take the form of participation certificates or certificates of beneficial ownership. These differ markedly from the outright sale of a loan asset. First, the selling agency fully guarantees the certificate with respect to the timely payment of principal and interest; thus, the buyer assumes no risk. Second, the loans backing a CBO or participation certificate are not transferred to the buyer, nor does the buyer assume any responsibilities for servicing the loans. These remain with the originating agency, and the borrowers make payments to the agency, which in turn makes payments to the purchaser of the CBO.

The use of the term "loan asset sales" for these transactions is, thus, a misnomer. The agencies are not selling loans; in fact, they are selling guaranteed securities that only incidentally represent a pool of loans. As such, sales of CBOs are identical to agency borrowing, not asset sales.

One of the recommendations of the President's Commission on Budget Concepts in its 1967 report was that sales of participation certificates be treated as agency borrowing. 3/ In the fiscal year

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3/ The Commission's Report stated:

> In one sense, the sales of shares in a pool of loans is but a short, logical step beyond the sale of the asset itself; but this is a critical step . . . .

1969 budget, many participation certificates were reclassified as agency debt. Agencies began, however, to search for means of circumventing the Commission's recommendation. They tried to develop new instruments--the sale of block notes, certificates of beneficial indebtedness, and certificates of beneficial ownership--that would be easy to use but still be treated as an asset sale. 4/ In 1973, the Congress enacted special provisions that permit the Farmers Home Administration and the Rural Electrification Administration to count the sales of certificates of beneficial ownership as asset sales. The laws simply overrode the principle established by the Commission on Budget Concepts. 5/

Consequence of Anomalous Treatment of CBOs. As a consequence of the anomalous treatment of CBO sales, the level of direct federal lending for any fiscal year is understated, as is the budget deficit. In comparison with agencies unable to take advantage of these techniques, FmHA and REA, through their CBO

> The Commission is firm in its conviction, therefore, that participation certificates, regardless of their advantages or disadvantages on other scores, represent a means of financing the budget deficit rather than an offset to expenditures in determining the amount of the deficit to be financed.

See the Report of the President's Commission on Budget Concepts (Washington, D.C.: GPO, October 1967), pp. 54-55.

4/ See Congressional Budget Office, "Loan Asset Sales: Current Budgetary Treatment and Alternatives," Loan Guarantees: Current Concerns and Alternatives for Control--A Compilation of Staff Working Papers, Chapter III--Sales of Loan Assets: Controversy and Problems (January 1979).

5/ The relevant statutory language states:

> Any sale . . . of notes or of beneficial ownership therein shall be treated as a sale of assets for the purpose of the Budget and Accounting Act, 1921 . . .

See Title II, Public Law 93-135 and Section 304, Rural Electrification Act of 1936, as amended by Section 2, Public Law 93-32.

sales, are able to record lower outlay totals for the same volume of new lending, because they, in effect, can transfer the outlays outside the budget to the purchasers of the CBOs. 6/

BUDGETARY TREATMENT OF FFB FINANCING

After its establishment, the FFB became the primary financing agent for agency debt, CBO sales, and fully guaranteed securities that had previously been sold in the government securities market. Although, strictly speaking, FFB financing of these federal credit activities has not changed the interactions of the transactions with the unified budget, it has increased their visibility. Thus, a growing number of policymakers are now aware of the understatement of direct lending levels resulting from the anomalous budgetary treatment of CBO sales and the conversion of loan guarantees into off-budget direct loans by the FFB.

FFB's Budgetary Status

One of the basic premises underlying the establishment of the FFB was that it should not affect the treatment in the unified budget of the activities it financed. To accomplish this, the bank was established as an off-budget entity. Section 11(c) of the Federal Financing Bank Act of 1973 states:

> Nothing herein shall affect the budget status of the federal agencies selling obligations to the Bank . . . or the method of budget accounting for their transactions. The receipts and disbursements of the Bank in discharge of its functions shall not be included in the totals of the budget of the United States Government and shall be exempt from any general limitation imposed by statute on expenditures and net lending (budget outlays) of the United States.

6/ In REA's case, the Rural Electrification and Telephone Revolving Fund (RETRF) is already off-budget. So the effect of the sales of CBOs is to transfer outlays from the off-budget RETRF to the FFB.

During the hearings on the FFB proposal, Treasury Under Secretary Volcker explained:

> The Federal Financing Bank is not a device to remove programs from the federal budget; nor is it a device to bring programs back into the budget. The Bank would in no way affect the existing budget treatment of federal credit programs. If a program is now financed outside of the budget, the treatment would continue. If a program is now financed in the budget, that treatment would continue. The Bank is intended to improve the financing of all federal agencies' borrowing activities, regardless of their budgetary treatment. 7/

Budgetary Consequences of FFB Activities

Agency Debt. Agency borrowing from the FFB has no impact on the unified budget totals, just as agency borrowing from any lender has no impact. The FFB functions in this case as an invisible financing agency.

Loan Asset Sales. Prior to the FFB's establishment, when FmHA or REA sold a CBO to a nonfederal investor, the special provisions of law governing the treatment of CBO sales effectively hid the transaction in an invisible "netherworld" outside the federal government instead of recording it as an agency outlay in the budget. The outlay was, in effect, absorbed by the investor purchasing the CBO.

When the FFB purchases a CBO, the effect on the unified budget remains the same. The understatement of direct lending, and of unified budget outlays that results, however, becomes more visible. Instead of the outlays being incurred by a nonfederal invisible investor, they are incurred by a more visible, but off-budget, entity of the federal government.

Direct Loans to Guaranteed Borrowers. When the FFB buys a fully guaranteed security that a nonfederal issuer would have otherwise sold in the government securities market, it in effect makes a direct loan to that nonfederal issuer. The effect on the

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7/ Federal Financing Bank Act, Hearings before the House Committee on Ways and Means, 92:2 (1972), p. 20.

unified budget remains the same--that is, the loan guarantee issued by the federal agency does not affect unified budget outlays whether the guaranteed loan is financed in the securities market or by the off-budget FFB. FFB origination of the loan, however, increases the visibility of an inconsistency in budgetary treatment: outlays are incurred by the off-budget FFB for a direct loan initiated and guaranteed by an on-budget agency.

Consider the following two examples. The Export-Import Bank (Eximbank) has the authority to borrow to finance direct loans to promote exports of American goods. Eximbank may borrow from the FFB, by selling a bond to it, and then use the funds to make a direct loan to the national airline of a foreign country to assist it to buy a U.S.-built commercial jetliner. The loan from the FFB to Eximbank is treated as a means of financing, and has no effects on the unified budget. The direct loan by Eximbank to the foreign airline, however, is recorded as an outlay in the Eximbank budget and in the unified budget totals.

Contrast that transaction to the following one. The Department of Defense issues a guarantee to the same foreign government for a loan to finance the purchase by that nation's armed forces of U.S.-made military equipment. The loan is financed by the FFB. In this case no outlays are recorded in the unified budget, although the transaction was initiated by the Defense Department. Instead, the outlays are recorded by the off-budget FFB.

The characteristics of the two transactions are identical, save in one respect. The source of the funds is the same: the FFB borrows from the Treasury which borrows in the government securities market. The action taken is a direct loan to a borrower outside the federal government. The only difference is who incurs the outlays. In the first case, they are absorbed by the on-budget Eximbank; thus, they are included in total budget outlays and the deficit. In the second case, they are absorbed by the FFB and contribute to the off-budget deficit.

Is the FFB Neutral with Respect to Budgetary Transactions?

The FFB's charter was specifically designed so that the effect on the unified budget would be the same with FFB financing of agency debt, CBO sales, and guaranteed securities as it had been when individual agencies sold these instruments in the government securities market. In fact, the FFB is not neutral in all of its budgetary transactions. It is neutral with respect to agency debt.

Strictly speaking, it is neutral with respect to CBO sales; it does, however, make more visible the understatement of direct lending that results from the anomalous budgetary treatment of CBOs sold by FmHA and REA. But it is not neutral in its handling of direct loans to guaranteed borrowers. Instead, it converts a loan guarantee into an off-budget direct loan.