CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

December 5, 2008

Honorable Steny H. Hoyer
Majority Leader
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Leader:

This letter responds to your request for information about how alternative proposals to provide financial aid to the automobile industry would affect the federal budget. Specifically, you asked CBO to analyze the budgetary effects of two legislative proposals: S. 3715, the Auto Industry Emergency Bridge Loan Act, as introduced on November 20, 2008; and draft legislation released by the House Committee on Financial Services (and posted on that committee's Web site) on November 17, 2008.

Both proposals would authorize up to $25 billion in "bridge loans" to support ongoing operations of automobile manufacturers and component suppliers. Provisions related to the administration and financial terms of such loans are similar under the two proposals, but significant differences arise regarding their budgetary treatment and potential net impact on the federal budget. For each proposal, you asked CBO to discuss:

- How proposed bridge loans and repayments would be recorded in the federal budget;

- The amount of subsidy budget authority that would be necessary to fund the loans;

- The total amount of bridge loans that CBO estimates could be provided; and

- The estimated net impact on the deficit.

The table below summarizes key features, costs, and net budgetary impact of the two proposals you asked CBO to evaluate.

Legislative Proposal:	**S. 3715, as introduced**	**House Committee on Financial Services Draft Legislation (November 17, 2008)**
Budgetary Treatment	Federal Credit Reform Act	Troubled Assets Relief Program (TARP)
Estimated Subsidy Rate	100% of loan principal	70% of loan principal
Budget Authority Needed to Fully Fund $25 Billion in Bridge Loans	$25 billion	$17.5 billion
Budget Authority Available Under Proposal	$7.5 billion	$17.5 billion
Estimated Loan Level Under Proposal	$7.5 billion	$25 billion
Gross 10-Year Budget Cost	$7.5 billion	$17.5 billion
Offsets to Gross Cost	$7.5 billion from rescission of funds for DOE section 136 loans	$5 billion to $7.5 billion of estimated TARP outlays under current law
Net 10-Year Budget Cost	No net cost	$10 billion to $12.5 billion

S. 3715, the Auto Industry Emergency Bridge Loan Act

S. 3715 would rescind $7.5 billion of funds previously appropriated to the Department of Energy (DOE) to cover the cost of providing up to $25 billion in direct loans to automobile manufacturers and component suppliers pursuant to section 136 of the Energy Independence and Security Act of 2007 (EISA). (Those funds are available under current law to support loans for capital reinvestments in manufacturing facilities designed to produce vehicles with greater fuel efficiency and reduced emissions.) S. 3715 also would appropriate $7.5 billion to the Department of Commerce (DOC) to cover the cost of up to $25 billion in "bridge loans" to support ongoing operations of eligible automobile manufacturers and component suppliers. Under S. 3715, repayments of bridge loans would be available, without further Congressional action, to support new loans under section 136 of EISA.

Draft Legislation Posted by the House Committee on Financial Services

This legislation would require the Secretary of the Treasury to provide $25 billion in bridge loans to eligible automobile manufacturers and component suppliers. The loans would be administered under the Troubled Assets Relief Program (TARP), which authorizes the Secretary to purchase, insure, hold, and sell up to $700 billion in troubled financial instruments.

Budgetary Treatment

In general, federal budget activities are recorded on a cash basis, with a few significant exceptions. In particular, the Federal Credit Reform Act (FCRA) requires that the budgetary impact of federal credit programs be measured in terms of the net present value of estimated cash flows for direct loans or loan guarantees. That measure is known as the subsidy cost. Under FCRA, agencies must receive an appropriation equal to the estimated subsidy cost before making or guaranteeing loans. In the case of direct loans, FCRA further specifies that repayments of loans are unavailable for spending and that new loan obligations may be made only to the extent that new budget authority is provided in advance to cover anticipated credit subsidy costs. In other words, direct loan repayments are not available to "revolve" into new loans. Instead, such repayments are a means of financing the original loans, and the availability of repayments for that purpose is implicit in the usual subsidy calculation. The concept of revolving loan repayments into new loans, as proposed in S. 3715, is inconsistent with the budgetary accounting of FCRA.

Under FCRA, projected cash flows associated with direct loans or loan guarantees are discounted using the average interest rate on Treasury securities of similar maturity to the loan cash flows. A variation of that credit reform accounting was recently enacted in Public Law 110-343, the Emergency Economic Stabilization Act of 2008, which established TARP. That legislation requires that the federal subsidy cost of purchasing assets under TARP be recorded on the budget using procedures similar to those required by FCRA, but with an adjustment to account for the market risk associated with those assets. Public Law 110-343 provides an indefinite appropriation of whatever amounts are necessary to cover the estimated subsidy costs of purchasing financial assets under TARP. (The law authorizes the Secretary of the Treasury to purchase or insure assets and limits purchases outstanding at any one time to no more than $700 billion.)

Ordinarily, bridge loans to the automobile industry would be recorded on the federal budget consistent with the requirements of FCRA. Both of the proposals you asked about would depart from that treatment:

- S. 3715 would credit repayments of bridge loans to a separate fund that would be available, without further Congressional action, to support new loans authorized under section 136 of EISA. As explained below under "Subsidy Costs of Bridge Loans," CBO estimates that redirecting those payments to a purpose other than simply retiring the debt for the original loans would increase the estimated subsidy cost of the loans to 100 percent of the aggregate face value of the loans.

- Because, under the Committee on Financial Services proposal, the bridge loans to auto manufacturers would be administered through TARP, the cost of those loans would be calculated using the unique budgetary treatment that, by law, applies to activities conducted under that program.

Subsidy Costs of Bridge Loans

Estimated subsidy costs under both FCRA and TARP take into account the financial condition of borrowers and reflect factors such as default risk, anticipated recoveries in the case of a default, and statutorily specified terms and conditions of the loans. The estimated subsidy costs of TARP transactions are required to include an additional adjustment to reflect the market risk associated with the various types of financial assets acquired under the program. Accounting for such market risk means discounting future cash flows such as expected loan repayments at a higher rate than a Treasury rate. (Treasury borrowing from the public is often viewed as essentially "risk-less," and as a result, carries interest rates lower than those for private-sector borrowing.) Thus, under TARP, potential repayments would be credited with a lower present value, and the estimated subsidy costs that would be recorded in the federal budget for bridge loans would be larger than if those loans were administered outside of TARP. CBO believes that the TARP treatment —accounting for market risk—best represents the true economic costs of such loans.

The requirement in S. 3715 that would direct loan repayments to be used to make additional loans would raise the effective subsidy cost of the bridge loans made to automobile manufacturers to 100 percent. That result occurs because repayments would automatically revolve into new loans without subsequent appropriation of any additional funding to cover the subsidy costs of those new loans, as would normally be required under FCRA. By making new loans with the repayments of the initial loans, the government would essentially be spending those receipts. Under those conditions, CBO estimates that fully funding the proposed $25 billion in loans would require the appropriation of $25 billion in budget authority to cover the subsidy cost. However, S. 3715 would provide only $7.5 billion in total subsidy funding for all auto company loans.

In contrast, CBO estimates that the average subsidy rate for bridge loans to automakers under TARP, as specified in the draft legislation proposed by the Financial Services Committee, would be roughly 70 percent of the face value of loans and that funding $25 billion of bridge loans would incur a subsidy cost of $17.5 billion. The estimated subsidy rate of 70 percent reflects market risk, as required for TARP accounting. If those loans were made from authority other than TARP, CBO estimates the subsidy rate following standard credit reform accounting would be about 50 percent. The difference represents the absence of a market risk adjustment for discounting the cash flows.

These subsidy rates reflect a combination of interest rate and repayment terms, the risk that automakers will default on the loans, and the possibility of recoveries on defaulted loans.

Loan Levels

The total amount of loans that could be disbursed under each proposal would depend on the amount of subsidy budget authority that would be made available.

S. 3715 would appropriate $7.5 billion to cover the cost of bridge loans, but CBO estimates that bridge loans under that legislation would have a subsidy cost of 100 percent. At a result, we estimate that the funds provided would support loans totaling $7.5 billion—significantly less than the $25 billion authorized under the bill.

In contrast, the proposal from the House Financial Services Committee would require the Secretary of the Treasury to make up to $25 billion in bridge loans under TARP. The Secretary of the Treasury has an existing appropriation for whatever amounts are necessary to cover the subsidy costs of implementing TARP. Consequently, no further appropriation actions would be needed for bridge loans under this proposal. However, as described below, CBO estimates that enacting this legislation would lead to a net increase in the federal deficit because the cost of making bridge loans to the auto companies would likely be greater than the cost of other uses of the existing TARP authority.

Net Impact on the Deficit of Enacting S. 3715

The incremental cost of each proposal would be measured relative to current law. In the case of S. 3715, the appropriation of $7.5 billion for bridge loans would be offset by an equal rescission of funds previously appropriated for section 136 loans. Thus, CBO estimates that S. 3715 would provide no net increase in the funding levels—that is, no net change in budget authority. However, CBO anticipates that loans under section 136 of EISA will be disbursed gradually over the next several years. We estimate that the proposed bridge loans would be fully disbursed in 2009 and thus would result in a net increase in direct spending of about $7 billion this year. Under S. 3715, that increased spending would be offset by lower spending in later years, resulting in a net increase in outlays of $2.3 billion over the 2009-2013 period but no net change over the 2009-2018 period.

If S. 3715 were modified to remove the provision directing re-use of loan repayments for additional loans, the estimated subsidy rate would drop from 100 percent to about 50 percent, CBO estimates. In that case, the amount of initial bridge loans that could be supported with the $7.5 billion of subsidy authority would double to $15 billion under CBO's estimates. The estimated net effect on direct spending would be unchanged—an increase in outlays of $2.3 billion over the 2009-2013 period but no net change over 10 years. (Eliminating the repayment "revolving" provision would mean that any future loans under section 136 of EISA would require the Congress to appropriate new funds for the cost of those loans since S. 3715 would rescind the existing subsidy funding for such loans.)

Net Impact on the Deficit of Enacting the House Financial Services Committee's Proposal

CBO estimates that requiring the Secretary of the Treasury to devote $25 billion of TARP authority to bridge loans would likely result in a net increase in the federal deficit when compared with how that authority would be used under current law. CBO expects that the net budget cost of those loans would probably be higher than the cost of alternative uses of TARP funds, which would likely involve firms whose credit risks are lower than those of the automobile industry.

CBO estimates that the TARP subsidy rate for bridge loans to the automobile companies would be roughly 70 percent of their aggregate face value—reflecting the market risk adjustment required for TARP accounting. Thus, we estimate that funding $25 billion in such loans would cost $17.5 billion under the Financial Services Committee's draft legislation.

CBO further estimates that, under current law, the subsidy rate associated with using those funds to purchase troubled assets under TARP will probably average between 20 percent and 30 percent. As a result, we estimate that using $25 billion of TARP authority to acquire financial assets under current law will cost between $5 billion and $7.5 billion. Thus, the proposal to use those funds to provide bridge loans to automakers would increase costs above those anticipated under current law by $10 billion to $12.5 billion (the difference between the estimated range of current-law costs and the estimated $17.5 billion cost for $25 billion of auto company loans using TARP authority).

I hope this information is helpful. If you wish further details, we would be happy to provide them. CBO's staff contact is Megan Carroll.

Sincerely,

Robert A. Sunshine
Acting Director

cc: Honorable John A. Boehner
Republican Leader

Identical letters sent to the Honorable Barney Frank and the Honorable Carl Levin.