Statement of
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NOTICE
This statement is not available for public release until 10:00 a.m. (EDT), on Wednesday, June 17, 1987.

Mr. Chairman, I am pleased to have the opportunity to submit this statement on the Veterans Administration home loan guaranty program to this Committee. My statement will focus on four primary issues:

- The costs and budgetary treatment of the home loan guaranty program;

- The Administration's credit reform proposal;

- The proposed sales of vendee loans without recourse to the government; and

- The estimated cost of several legislative proposals that would affect the home loan guaranty program.

THE COSTS AND CURRENT BUDGETARY TREATMENT OF THE HOME LOAN GUARANTY PROGRAM

The Veterans Administration (VA) home loan guaranty program enables eligible veterans to obtain mortgage credit from private lenders on concessionary terms. The VA guarantees the lender against potential losses from borrower default up to the lesser of 60 percent of the mortgage amount or $27,500. The VA guaranty assures the lender of repayment, which the borrower's downpayment and payment of private mortgage insurance would provide on a conventional loan.

The VA charges veterans who receive a guaranteed home loan a one-time fee of 1 percent of loan principal, which may be financed. The Veterans Administration also sets a ceiling on the interest rates on guaranteed home loans that usually is about one-quarter to one-half of one percent below the rate on comparable private mortgages. VA-guaranteed mortgages are assumable by subsequent purchasers of the homes.

When a veteran defaults on a mortgage guaranteed by the VA, the Veterans Administration frequently pays the lender the remaining balance of the loan and acquires title to the property. To recover some of these default costs, the VA sells the properties. In approximately 60 percent of these home sales, the agency takes back a mortgage from the purchaser. The agency then sells the mortgage--a so-called "vendee loan"--to an investor. To date the VA has sold all vendee loans with recourse to the government--that is, with a promise to buy back or replace any loans that default. As under the home loan guaranty program, the VA does not require borrowers to make downpayments and charges them a one-time fee of 1 percent of loan principal.

Veterans who borrow under the home loan guaranty program and borrowers--veterans and others--who obtain a vendee loan from the VA receive substantial subsidies from the government. The principal source of

these subsidies is the VA's 1 percent guaranty fee, which covers only a fraction of the costs of acquiring, renovating, and selling properties when borrowers default. Private mortgage insurers would charge a substantially higher fee to provide the same coverage on zero downpayment conventional mortgage loans. The President's budget for fiscal year 1988 estimates the alternative private fee would equal 5.6 percent of loan principal on both home loan guaranty and vendee loans.

The lower interest rate that eligible veterans pay on home loan guaranty mortgages provides a second subsidy to these borrowers. This subsidy arises because VA-guaranteed home loans may be included in pools of federally guaranteed and insured mortgages used to collateralize mortgage-backed securities (MBSs) guaranteed by the Government National Mortgage Association (Ginnie Mae). Because they are federally guaranteed, Ginnie Mae MBSs are the cheapest way of financing mortgages, and most of the cost savings achieved are passed through to VA home loan and other federally guaranteed borrowers. It is important to recognize, however, that this second subsidy enjoyed by VA home loan guaranty borrowers is not provided by the VA home loan guaranty program itself and, therefore, should not be lumped together with the subsidy provided by the low origination fee the VA charges.

Estimated Subsidy Costs

The President's fiscal year 1988 budget estimates that each borrower receiving a VA-guaranteed home loan receives a subsidy equal to 6.4 percent of the principal amount of the loan. The Administration estimate incorrectly lumps together the effects of the low VA origination fee and Ginnie Mae MBS financing. While CBO believes the estimate may be too high, we have not done a reestimate. Based on the 6.4 percent figure, the Administration estimates that the $26.7 billion in new home loans the President's budget estimates will be guaranteed during fiscal year 1988 will provide borrowers subsidies of $1.7 billion. The President's budget estimates the subsidy on vendee loans also to be equal to 6.4 percent of loan principal. CBO believes this subsidy percentage may be too low, since vendee loans have much higher default rates than home loan guaranty mortgages, and private mortgage insurers probably would require a higher up-front premium than they would on home loan guaranty mortgages. Based on the 6.4 percent number, the Administration estimates the subsidies on the $746 million in vendee loans that the President's budget projects will be made in fiscal year 1988 will be $48 million.

The President has proposed legislation--introduced in the Senate as S. 920--that would lower the subsidies provided by VA home loan guarantees and vendee loans by increasing the up-front fee from one to 2.5 percent of

loan principal, and by eliminating the interest rate ceiling on home loan guaranty mortgages. The Administration estimates that these changes would reduce the estimated subsidies of VA home loan guarantees from $1.7 billion to $0.8 billion, and of vendee loans from $48 million to $19 million, in fiscal year 1988. CBO's estimate of the budgetary impact of S. 920 is discussed below.

In analyzing federal credit programs, one should note that the government provides a subsidy to a borrower only by incurring an equivalent loss. Thus, estimates of the subsidies provided by credit programs are also estimates of the subsidy costs of those activities--that is, estimates of the equivalent in today's dollars of the net losses in future years from the credit assistance. Subsidy cost is the best measure of the real costs to the government of credit assistance.

Deficiency of Current Budgetary Treatment

The current budgetary treatment of federal credit programs obscures the subsidy costs of VA home loan guarantees and vendee loans. This difficulty arises because cash-based accounting, designed to capture the cost of spending programs, is ill - suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

Under cash-based accounting, VA home loan guarantees do not result in outlays until defaults occur. The substantial delay between commitments and outlays for guarantees results in an understatement of the cost of new activity and of its effect on the budget deficit in the year in which the VA commits itself to these liabilities. Indeed, because cash-based accounting requires the VA to show guarantee fees as offsetting collections, which reduce outlays, new guarantees appear to lower government costs in the year when guarantee fees are collected.

Further, under cash-based accounting, when the VA exchanges an acquired property for a vendee loan mortgage, the transaction is scored as having no effect on outlays or the deficit. This treatment assumes that the loan the agency receives is equivalent in value to the home. As argued above, however, the VA actually suffers a loss on a vendee loan, because the current value of the principal and interest payments the borrower agrees to make on the mortgage, net of expected default and other costs to the VA, is less than the value of the property the agency gives up. Under cash-based accounting, there is no way of capturing this loss--the subsidy cost of the loan--up front, when the exchange occurs.

Finally, repayments and the proceeds of sales of vendee loans are scored as offsetting collections (reducing the deficit) when received, thereby making outlays a misleading indicator of current activity.

The unified budget combines in one account, the VA loan guarantee revolving fund, all the cash flows from the home loan guaranty program--fees on new guarantees; disbursements to acquire and improve properties and to repurchase vendee loans sold; and receipts from vendee loan sales. The President's January 1987 budget submission, which assumes enactment of the legislation proposed by the President, shows zero budget authority, and net outlays of negative $136 million, for the fund for fiscal year 1988. CBO's reestimate of the President's fiscal year 1988 budget shows zero budget authority and negative $340 million in outlays for the fund for the year. Neither set of estimates provides information on the subsidy costs of the program identified above, nor enables the Congress to identify or control those costs.

THE ADMINISTRATION'S CREDIT REFORM PROPOSAL

In March, the Administration proposed legislation--introduced in the Senate as S. 745--and amendments to the President's fiscal year 1988 budget that would report the subsidy costs of new credit activity in agency budget accounts. Under the proposal--known as credit reform--the VA would request annual appropriations equal to the amount of subsidy to be provided to borrowers receiving home loan guaranty mortgages and vendee loans during each fiscal year. The subsidy appropriations would be to a new budget account--a companion of the VA loan guarantee revolving fund--and

would involve budget authority and outlays in the same manner as direct spending programs.

When loans guaranteed under the home loan guaranty program were disbursed or properties exchanged for vendee loan mortgages, the VA would use these appropriations to pay the estimated subsidy costs of the transactions to a new central revolving fund in the Treasury. The central revolving fund would receive the transferred appropriations and guaranty fee payments, and would be responsible for future disbursements and collections associated with both forms of new credit activity. It would finance these outlays with subsidy payments from the VA, repayments, recoveries, loan sales, and borrowing from the Treasury.

Impact on the VA Home Loan Guaranty Program

Table 1 shows the impact of the Administration's credit reform proposal on the VA loan guaranty revolving fund. The figures are from the President's budget for fiscal year 1988 and reflect the legislation proposed by the President which would increase the upfront fee charged by the VA. A number of aspects of the table are noteworthy.

First, credit reform would require an appropriation to fund the subsidy costs of VA home loan guarantees and vendee loans in fiscal year 1988. The

figure shown in Table 1--$779.6 million--reflects the subsidy cost estimates in the President's budget discussed above. The requirement that funds be appropriated to cover the subsidy cost of these activities before loans can be made or guaranteed would enable the Congress to control those costs in advance.

TABLE 1. THE PRESIDENT'S FISCAL YEAR 1988 BUDGET FOR THE VA LOAN GUARANTY REVOLVING FUND (In millions of dollars; not Reestimated by CBO)

	Budget Authority	Outlays
Current Budgetary Treatment	0.0	-136.3
With Credit Reform:		
Subsidies appropriation	779.6	586.1
Loan guarantee revolving fund	403.3	262.2
Total	1,182.9	848.3
Treasury - credit revolving fund (LGRF portion)	0	-884.[a]
Totals	1,182.9	-36.3

Source: Office of Management and Budget

a. Reflects $100 million for purchase of reinsurance of $1.4 billion in new guaranteed home loans made in fiscal year 1988.

Second, the total amount of credit assistance provided under the VA home loan guaranty program would not change as a result of credit reform per se, which would make no substantive changes in the VA's credit programs. The Administration has stated that it does not intend for the appropriation of subsidies for VA home loan guarantees and vendee loans to limit eligible veterans' entitlements to credit assistance or otherwise to constrain program operations. Thus, the $779.6 million subsidy appropriation figure in Table 1 is only an indefinite amount corresponding to the Administration's estimates of what the subsidy costs of the program would be if S. 920 were enacted. If S. 920 did not become law and if credit reform were adopted, a higher subsidy appropriation for the VA home loan guaranty program would be necessary.

Third, credit reform would increase Veterans Administration outlays for guaranteed home loans and vendee loans--in the new subsidy account and the current loan guarantee revolving fund—by about $985 million in fiscal year 1988 (assuming the Administration's estimates and enactment of S. 920). This increase would occur as the income from new loan guaranty fees and sales of vendee loans was shifted to the new Treasury revolving fund. Assuming that S. 920 were enacted and the amounts of assistance provided and private market conditions remained unchanged, in about thirty years—when all VA home loans guaranteed or vendee loans made before credit

reform were paid off--the budgetary costs of the two programs would stabilize at about $780 million in appropriated budget authority and outlays each year (assuming the Administration's subsidy cost estimates). At that point, the VA's budget would show only the subsidy costs of home loan guarantees and vendee loans.

Fourth, the new Treasury central revolving fund would spend $100 million in fiscal year 1988 to reinsure $1.4 billion in new home loan guarantees issued in that year. The purchase of reinsurance would provide a market-based estimate of the subsidy costs of the home loan guaranty program, and the initial outlays would be offset by equivalent reductions in federal costs for purchases of defaulted loans and other default-related disbursements in future years.

CBO supports the credit reform proposed by the Administration as a substantial improvement in the budgetary treatment of the credit activities of the VA and other agencies, for three reasons:

- The information in the President's budget and Congressional budget resolutions does not measure adequately the costs of the VA's home loan guaranty and other credit programs and, thus, is a poor means of controlling those costs.

- Because subsidy cost estimates are comparable to the familiar appropriations of budget authority for most discretionary spending, the Congress can use them to weigh the impact of credit against other forms of federal assistance and against the ultimate tax burden they create.
- Credit reform offers the Congress a way of controlling credit program costs at the time decisions are made, through the appropriations process.

CBO also believes that, even if credit reform is not enacted, estimates of the subsidy costs of the VA's credit programs can help the Committee and the Congress evaluate different types of credit assistance provided by the agency and compare the costs of the VA's credit programs with the costs of other government programs.

PROPOSED SALES OF VA LOAN ASSETS WITHOUT RECOURSE TO THE GOVERNMENT

Before fiscal year 1987, the VA sold all vendee loans with recourse to the government--that is, with a promise to repurchase or replace a loan that defaulted with another mortgage of equal value. In April, the VA attempted to sell without recourse a portion of the vendee loans made during fiscal year 1987. Beginning in fiscal year 1988, all vendee loans will be sold on a

nonrecourse basis. The change is consistent with the **Administration's** decision to score all loan asset sales with recourse as borrowing, beginning in fiscal year 1988.

The VA has a significant portfolio of vendee loans that currently are delinquent, have a poor payment history, or may have poor documentation. As part of its new loan sales program, the Administration has proposed to achieve deficit reduction by having the VA sell this entire **portfolio--** estimated to be $900 **million--without** recourse. The loans would be sold in equal $300 million installments in each of fiscal years 1988, 1989, and 1990.

CBQ's Views on Loan Asset Sales

CBO's position on the merits of selling loan assets with or without recourse to the federal government **is** two-fold. First, we agree with the Administration that the sale of loan assets with recourse to the government, or with a federal guarantee, is a form of borrowing because the government has retained the risks inherent in the loans. In effect, the government has taken on an obligation to make good on any losses realized by the investor because of default. If loan assets were removed from the federal **government's** books by such "sales," the government would be left with unrecognized but potentially sizable liabilities. Further, from the investor's point of view, the purchase of loan assets with recourse is equivalent to the purchase of Treasury securities. Aside from the fact that they would be less

liquid, they are as good as Treasury securities because the investor assumes no credit risk.

In contrast, loan asset sales that are final and without any recourse to the government entail only an exchange of one asset--cash--for another—loans. The investor is entitled only to the stream of payments on the purchased assets and has no further claim on the federal government. All of the risk inherent in the assets has been transferred from the government to the investor. The proceeds of such sales are equivalent to early repayment of principal and are counted as offsetting collections under current cash-based budget accounting.

Second, CBO believes that reductions in the budget deficit, properly measured, should only reflect actions that actually improve the government's financial condition and, thus, lessen the need to reduce spending or increase tax revenues now or in the future. Since sales of VA vendee loan and other loan assets, with or without recourse to the government, do not improve the government's financial condition CBO believes they should not be considered to reduce the deficit. The cash the government receives in exchange for loan assets sold without recourse does indeed reduce the current cash deficit, federal borrowing, and future interest payments on the federal debt. Nonetheless, future deficits and borrowing will not be reduced because the interest and principal payments

will go to the loan asset holder, rather than the government, and these amounts are equivalent in present value terms to the proceeds of the sales. Moreover, agency loan sales do not reduce the government's demands on the credit markets--the Treasury borrows less, but the sales tap the same pool of saving. Thus, in CBO's view, loan sales--with or without recourse--are merely a more expensive form of borrowing than issuing Treasury debt, and should not be considered a form of deficit reduction because they do not improve the government's financial condition.

Loan asset sales without recourse, however, have the virtue of helping to measure the costs of VA vendee and other federal direct loans. The difference between the outstanding principal on a vendee loan sold by the VA without recourse and the proceeds of the sale--the discount from face value--is a measure of the subsidy cost of the loan: the value in today's dollars of amounts needed in the future to pay expenses arising from the loan.

The VA's Trial Nonrecourse Sale of Vendee Loans

As mentioned above, the VA will begin offering all vendee loans for sale without recourse to the government in October. In April, the VA conducted a trial nonrecourse sale of $84 million in vendee loans. The VA used a sealed bid auction, the method the agency uses to sell vendee loans with

recourse. The VA advertised the offering in the press one month in advance and sent offering circulars to prospective buyers.

The trial offering received a total of three bids. Two were speculative and offered less than 20 cents on the dollar for less than $1 million in mortgages on homes in only two states. The third offered 60 cents to 67 cents on the dollar for $8 million in loans in two states. Although the latter bid was close to the VA's pre-sale minimum price of 75 cents on the dollar, the agency chose not to renegotiate the bid because it was for only a small portion of the offering.

Consideration of the three types of investors who are likely to bid to purchase vendee loans suggests why the trial nonrecourse sale of vendee loans was not successful.

- If the loans are sold with recourse, mortgage banks will bid to buy them for pools to be financed with Ginnie Mae MBSs. These firms were not interested in the loans offered for sale without recourse in April because the mortgages could not be financed with Ginnie Mae MBSs.

- Savings and loans and commercial banks that purchase mortgages to hold them in portfolio may bid to purchase vendee loans sold

without recourse if those loans are collateralized by homes in their region, and they hope they can buy the mortgages at good prices. The three bids the VA received at the April trial auction were from this type of investor.

- Investment banking firms can package vendee loans sold without recourse into securities that will be attractive to large, institutional investors such as pension funds. If the VA had provided such firms enough time to evaluate the loans offered for sale, develop an appropriate form of securities, obtain investment-grade ratings, and arrange a group of underwriters to sell them, the trial nonrecourse sale could have succeeded.

Implications for Future Sales

The Congress should not interpret the results of the trial sale as indicating that future nonrecourse sales of vendee loans--or of any other federal loan assets--are doomed to failure. As noted above, such loans are potentially attractive to institutional investors, if packaged properly. Several government agencies, among them the Farmers Home Administration, have employed investment advisors to help them plan and, eventually, to execute successful nonrecourse loan asset sales. There is no reason to believe that

the VA's loans are less attractive. Of course, the VA will have to develop the marketability of their loans at some cost (or pay intermediaries a small percentage of sales proceeds for performing these services), but such investment should be cost-effective in the long run.

Many government analysts express the view that the bid prices on initial nonrecourse sales of loan assets will be cautiously low because of the absence of investor experience with high-risk federal loan assets. If the VA can assess and implement appropriate ways to package loans into securities, obtain investment-grade ratings, and identify potential investors, it can minimize any possible underbidding and maximize sales proceeds.

The portfolio loans held by the loan guaranty revolving fund which the Administration also proposes to sell beginning in fiscal year 1988 are rather different from the vendee loans the VA routinely offers for sale. The regularly sold loans are usually less than a year old, have no history of delinquency, and qualify for inclusion in pools financed with Ginnie Mae MBSs. On the other hand, many of the older portfolio loans are delinquent, have poor payment histories, or have incomplete loan documentation. These characteristics will lead investors to require substantially larger price discounts on these loans than on vendee loans (even those sold without recourse). Despite these differences, however, CBO believes that vendee loans that are not current can still be sold without recourse to the

government if sufficient efforts are made to package the loans into appropriate securities.

LEGISLATIVE PROPOSALS

At the **Committee's** request, CBO has analyzed S.9, the Service-Disabled **Veterans'** Benefits Improvement Act of 1987, and S. 920, which is the **Administration's** request for legislative changes in the home loan guaranty program.

S. 9

The Committee requested that CBO comment on two provisions of **S.9:** the increase in the maximum guaranty under the VA home loan program from $27,500 to $36,000, and the exemption of the loan guaranty program from sequestration under the Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 99-177).

An increase in the guaranty ceiling would have several effects. Because the increase would enable borrowers to obtain mortgages of up to $144,000 without a down payment (as opposed to the current maximum of $110,000), CBO assumes that the demand for loans would grow by 2.5 percent. Further, the increase in the guaranty ceiling would raise the VA's liability for default on the vast majority of mortgages guaranteed after

enactment. As can be seen in Table 2 below, in 1988 the higher loan demand would raise receipts from loan origination fees by $14 million. In later years, however, increased default costs would offset the higher fee receipts by a growing margin.

Exempting the loan guaranty revolving fund (LGRF) from sequestration would have no net impact on the federal budget, since S.9 would not change the deficit targets established by P.L. 99-177. In the loan guaranty program, the sequestration reductions are made in the amount of new loans that can be guaranteed during the year. This reduction in guaranty commitments decreases receipts from origination fees in the first year, but has little effect on that year's default costs. Thus, sequestration of the loan guaranty program results in an increase in the outlays of the revolving fund in the first year that is more than offset by outlay savings in the future.

TABLE 2. INCREASE THE MAXIMUM VA MORTGAGE GUARANTY FROM $27,500 to $36,000 (By fiscal years, in millions of dollars)

	1988	1989	1990	1991	1992
Budget Authority	-14	17	20	0	0
Estimated Outlays	-14	17	29	31	33

SOURCE: Congressional Budget Office.

In the CBO 1987 Annual Report (The Economic and Budget Outlook; Fiscal Years 1988-1992, January 1987), CBO projected that the 1988 sequestration might require across-the-board reductions in nondefense programs of 20 percent. This estimate, however, is subject to significant revision as the result of legislative actions, changes in the economic outlook, and other factors occurring before the sequestration report is prepared in August. For illustrative purposes only, the effects of a 20 percent sequestration on the LGRF in 1988 would be an increase in outlays of $50.5 million.

S.920

Only two provisions of S. 920 would have a significant budgetary impact. Section 3 would increase the origination fee on guaranteed and vendee loans from 1.0 percent of the loan principal to 2.5 percent. This proposal has been estimated to reduce LGRF outlays by $356 million in 1988 (see Table 3). Section 8 would reduce from 60 percent of acquisitions to 40 percent the ceiling on the use of VA financing (vendee loans) in the disposition of agency-owned real estate acquired through foreclosures. Since the alternatives to vendee financing--selling the properties outright for cash--would increase the initial collections of the revolving fund, LGRF outlays would be expected to fall by $55 million were this provision to be enacted.

The remaining provisions of S.920 would extend certain authorities in connection with the loan guaranty program, which are already assumed to be extended in the CBO baseline, and would make changes in administrative procedures that would not significantly affect program spending. Thus, they would have no significant cost impact.

TABLE 3. S.920, THE VETERANS' HOUSING AMENDMENTS ACT OF 1987. (By fiscal years, in millions of dollars)

	1987	1988	1989	1990	1991	1992
Section 3; Increase Origination Fee to 2.5%						
Budget Authority	-95	-190	-113	0	0	0
Estimated Outlays	-95	-356	-283	-269	-275	-326
Section 8; Lower ceiling on Vendee Loans						
Budget Authority	0	0	0	0	0	0
Estimated Outlays	0	-55	-32	-13	1	14
Total						
Budget Authority	-95	-190	-113	0	0	0
Estimated Outlays	-95	-411	-315	-282	-274	-312

SOURCE: Congressional Budget Office

CONCLUSION

In conclusion, CBO believes that the current budgetary treatment of the credit programs of the VA and other agencies presents a distorted picture of their true costs. Credit reform would significantly improve the budgetary treatment of the VA loan guarantee program by including estimates of the subsidy costs of new home loan guarantees and vendee loans in the budget. Finally, CBO believes that nonrecourse sales of vendee loans can provide market-based estimates of the subsidy costs of that form of credit assistance.