5-1-1989

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United States: Government Accountability Office (GAO)

United States General Accounting Office 138696

GAO Testimony

138696

For Release
on Delivery
Expected at
10:00 a.m.
Friday
May 19, 1989

The Budgetary Treatment of the Proposed Resolution Funding Corporation (REFCORP)

Statement of
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Before the
Task Force on Urgent Fiscal Issues
Committee on Budget
House of Representatives

045494 / 138696

GAO/T-AFMD-89-8

GAO Form 160 (12/87)

Mr. Chairman and Members of the Task Force:

I am pleased to appear before you today to present our view on whether the financing to resolve the current crisis in the savings and loan industry should be on or off-budget.

USE OF FEDERAL MONIES SHOULD BE ON-BUDGET

We have long taken the position that sound budgeting requires a comprehensive budget that includes the receipts and outlays of all federal government entities. The government did not have such a budget during many years of this century. Indeed, it has only been since 1969 that it has used a unified budget covering most federal activities.

This is not to say that there are no problems with the structure of the current unified budget. There are. This is why we proposed in our November 1988 transition reports changes in the budget's structure to unmask the effects of the trust fund surpluses, focus attention on the trade-off between current consumption and capital investment decisions, and highlight the activities of governmental business-type enterprises.

It is important to note, though, that our proposals are designed to reform the unified budget, make it more workable, and reduce pressures to remove federal activities from the budget. We are concerned about the growing number of proposals to establish off-budget entities to carry out governmental functions. These proposals, whose apparent purpose is usually to avoid the discipline required by constrained budget resources, are a serious threat to the integrity of the government's budget and financial management systems. If the proliferation of such entities continues, it will raise grave doubts about the credibility of the government's reports on its financial operations and condition, making it even more difficult for decisionmakers and the public to understand and deal meaningfully with the overriding problem of the budget deficit.

Let us now turn, Mr. Chairman, to the immediate question before us--the financing of the government's savings and loan resolution actions.

THE OFF-BUDGET REFCORP APPROACH

An important feature of the administration's proposed approach, reflected in recent weeks in H.R. 1278, "The Financial Institutions Reform, Recovery and Enforcement Act of 1989," is the creation of an off-budget, government-sponsored enterprise (GSE) to raise funds for a new on-budget federal corporation created by the same legislation, the Resolution Trust Corporation (RTC). The latter would be responsible for resolving currently insolvent savings and loan institutions and those which become insolvent during the 3 years after enactment of the legislation. The RTC would use funds provided by REFCORP.

REFCORP would fund the RTC by borrowing $50 billion in the securities market, through sales of 30-year REFCORP bonds, and then transferring the borrowed money to RTC by purchasing (using the borrowed funds) capital certificates of the RTC. The legislation would require savings and loan industry sources to provide about $5 billion to $6 billion to REFCORP by purchasing REFCORP nonvoting common stock. REFCORP would use this money to purchase 30-year, zero coupon Treasury bonds. Upon maturity, these bonds would provide REFCORP the $50 billion needed to pay off its debt principal.

Under the plan, no U.S. Treasury dollars would be needed to pay off the principal. Indeed, the legislation would stipulate that there is no federal government guarantee of REFCORP's repayment of this $50 billion. However, there would be a statutory requirement for the federal government to pay that portion of REFCORP's interest payments (on the $50 billion in borrowings) not covered by the proceeds from liquidating the assets of failed savings and loan institutions and from other industry amounts available to REFCORP.

Budgetary Implications of Establishing REFCORP as an Off-Budget Entity

Let me now turn to the budgetary implications of establishing REFCORP as an off-budget entity. The provisions of H.R. 1278 as reported out this week by the House Committee on Banking, Finance and Urban Affairs do not stipulate that REFCORP's receipts and outlays would be excluded from the government's totals. However, the administration's explanations of the bill clearly indicate that OMB would treat REFCORP like a GSE and, as such, exclude its amounts from the government's totals.

GSEs are entities chartered by the federal government to promote federal policy, but they are excluded from the budget's totals on the grounds that they are essentially privately owned and controlled. An example is the Federal National Mortgage Association ("Fannie Mae").

The budget advantage of classifying REFCORP as an off-budget GSE, and having it rather than the Treasury borrow the funds needed for savings and loan case resolutions, is that such an approach would minimize the short-term impact of resolution actions on the government's reported deficit. This, of course, would make it much easier for the government to meet or approach its Gramm-Rudman-Hollings deficit targets over the next few years.

Classifying REFCORP as an off-budget GSE would minimize the short-term deficit impact because REFCORP's $50 billion payment to the RTC would then be treated as private GSE money flowing from outside the government to a federal corporation. In other words, the money the government receives from REFCORP would be treated as a federal collection rather than a federal borrowing. Under established budgetary conventions, collections are offsets that reduce (by the amount of the collections) the budget's reported net outlays. On the other hand, amounts borrowed by the government are not counted as offsetting collections, and for good reason--to do so would permit the government to balance its books through borrowings.

GAO Concerns

We have two concerns about this off-budget approach. First, it is not the least costly approach. We and others have pointed out that this off-budget REFCORP approach would have the longer-term consequence of increasing Treasury's interest costs over those that Treasury would pay if it, rather than REFCORP, borrowed the funds and made them available for resolution actions. This is because REFCORP's borrowings would carry higher interest costs than Treasury's. According to the administration, REFCORP would have to pay 25 basis points more than Treasury would have to pay on 30-year bonds, adding $3.8 billion to

Treasury's interest costs over the life of the program. If REFCORP had to pay 30 basis points more, the added interest costs would be $4.5 billion, and there are other estimates of an even larger basis point spread and added interest costs.

Our second concern relates to the need to maintain budget discipline. If budget discipline is to be maintained, care should be taken to avoid creating new (off-budget) GSEs that, in reality, are more like federal agencies performing governmental functions. The label "GSE" should not be loosely given to justify off-budget approaches and make it appear that the government is staying within deficit targets.

This raises the question: Should REFCORP be considered a GSE? In our view, this question should be approached by looking at the ownership of REFCORP, and the substance of its transactions.

There are, indeed, certain private ownership features. REFCORP's three board members would come from a GSE--two presidents of Federal Home Loan Banks, and the director of the Banks' Office of Finance. Also, REFCORP would rely upon employees of the Federal Home Loan Banks for its staff support. REFCORP would have no staff of its own.

Furthermore, the capitalization of REFCORP would come from the nonvoting common stock purchases of the private Federal Home Loan Banks. REFCORP would pay off the principal on its 30-year debt using the proceeds of zero coupon bonds it purchased using industry funds, and there would be no federal guarantee of REFCORP's debt principal.

However, there also are governmental features. The federal government would probably exercise closer control over REFCORP than it does over most other GSEs. The authorizing legislation would narrowly circumscribe the permissible activities of REFCORP, and provide for close supervision of REFCORP by the RTC's Oversight Board. As we stated earlier, RTC would be established as a federal corporation. The proposed law states that REFCORP, ". . . shall be subject to such regulations, orders, and directions as the Oversight Board may prescribe." According to the draft legislation, the Oversight Board would make the decisions on the amounts, timing, and methods of REFCORP's financing, including the amount of REFCORP stock that the private Federal Home Loan Banks would have to purchase.

Finally, the federal government would assume a legal liability for part or all of REFCORP's interest costs. To the extent that REFCORP's interest costs are not covered by designated REFCORP income (asset liquidations and Federal Home Loan Bank funds), Treasury must make up the shortfall. Administration officials estimate that this would cost the

Treasury about $89 billion in interest outlays over the life of REFCORP's 30-year bonds.

When we consider on balance the various features of REFCORP, we are led to believe that REFCORP would more closely resemble a federal agency than a GSE.

This view is reinforced by the substance of REFCORP's transactions. REFCORP's relationship to the public would have a distinct governmental feature in its sole purpose and function--to borrow funds from the public and disburse those funds to a federal corporation, the RTC, for use in liquidating obligations of the federal government. Also, the funds REFCORP would receive from the savings and loan industry (to buy the zero coupons) would resemble tax revenues in their involuntary nature. The Federal Home Loan Banks would have little choice but to purchase REFCORP's stock, and the insured savings and loan institutions would have to pay their "assessments." We should add that these industry sources of REFCORP funds would have little or no expectation of ever getting their funds back: REFCORP is not designed to be a profit-making entity.

AN ON-BUDGET APPROACH

Such concerns have prompted some parties to propose funding the government's resolution actions through Treasury rather than through REFCORP borrowings. This is basically the approach adopted by the House Committee on Ways and Means in its mark-up of H.R. 1278. I should add, though, that such an on-budget Treasury-financed approach would increase the budget's reported deficit, because the government's large resolution outlays would not be offset by collections from a GSE. Administration officials have stated that this would cause concern in domestic and international financial circles. Others, however, have stated that the financial markets are already recognizing the fiscal implications of the current problem and would not be adversely affected by an on-budget approach. I am inclined to agree with this latter interpretation. I also note that you have scheduled other witnesses this morning who will address this issue.

Also, some point out that an on-budget approach would increase reported outlays beyond fiscal year 1989, for any resolution actions that could not be completed in 1989, and add to other difficulties of reaching the Gramm-Rudman-Hollings deficit targets. Actions would be needed to either raise the Gramm-Rudman-Hollings deficit targets, or exempt the resolution outlays from the calculation of the deficit. As I have stated in previous testimony, we think that the targets should be raised to accommodate any extra governmental spending to resolve the savings and loan industry crisis.

Ultimately, the question of whether Treasury or REFCORP borrowings are used will be a policy choice of the Congress and the President. And I would suggest that in making that choice, our elected officials consider carefully the added costs and the implications for budget discipline of establishing an off-budget REFCORP.

CONCLUDING REMARKS

In conclusion, Mr. Chairman, we believe that if REFCORP is used as part of the solution to the savings and loan crisis, it should be on-budget as a federal corporation. We have reached this conclusion after considering the ownership of REFCORP and the substance of its transactions. It is especially clear to us that the substance of REFCORP's activities is governmental--it is designed solely to raise funds for a federal corporation to satisfy federal obligations to the American public, and it relies upon tax-like collections from industry sources.

Thank you, Mr. Chairman. This concludes my prepared statement, and I would be glad to answer any questions you or members of the Task Force may have.