

## LOANS AND LOAN GUARANTEES\*

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Mr. Apgar is the most senior of some 3,400 officials who work for the Federal Housing Administration, which is a part of the U.S. Department of Housing and Urban Development (HUD). Other people staff the housing finance agencies that help to fund homes on behalf of state and some of the larger local governments in the United States. All of these people work through private lenders that originate, service and otherwise administer this little-understood tool of government action. The FHA alone currently has over \$ 400 billion dollars of mortgage insurance -- a form of federal loan guarantee -- outstanding for single-family homes in the United States today.

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This chapter introduces the reader to loans and loan guarantees, the two major forms of government credit program. FHA single-family mortgage insurance, a loan guarantee program, is the largest credit program of the U.S. government.

## I. Defining the Tool

### **Defining Features**

The government provides credit through loans or loan guarantees as a way to encourage funding for borrowers or activities that are considered important, either politically or economically.

*The direct loan:* The government makes a direct loan when it borrows from the Treasury to lend money directly to borrowers. After making the loans, the government then services the loan, i.e., collects scheduled repayments from the borrowers, and forecloses or otherwise attempts to collect on the loan if a borrower cannot make scheduled payments.

*The loan guarantee:* When the government guarantees a loan, a private lender, such as a commercial bank or mortgage lender, makes the loan to the borrower. The government enters into a contractual agreement to make full or partial payment to the lender in case the borrower defaults upon the guaranteed loan. The private lender originates the loan, secures the government guarantee, and services the loan according to government regulations or minimum standards.

### **Relation to Key Tool Features**

Loans and loan guarantees differ in the extent to which they embody some of the key features in terms of which tools can be compared: (1) coerciveness, (2) directness, (3) automaticity, and (4) visibility.

*Coerciveness:* The first element, coerciveness, highlights an important feature of federal credit programs: there is a dichotomy between the extension of credit to a borrower and the effort to collect on loans and avoid defaults. When the government provides direct loans or loan guarantees, all parties to the transaction welcome this action. Sometimes a borrower may object to the amount of paperwork and personal disclosure that is required, but this would seem to be the limit of coerciveness in the origination of the loan.

By contrast, the effort to assure timely and full repayment of federal credit can involve sanctions that the government or its agents must apply. For a direct loan program, the government may apply sanctions, such as an offset against an income tax refund, against a defaulted borrower. Or the government may suspend a school from eligibility to participate in both the federal direct and guaranteed student loan programs.

For a guaranteed loan program, the government may apply sanctions against lenders who fail to underwrite or service loans properly. Or, if a lender makes a claim against a federal guarantee and puts the defaulted loan back to the government, then the government may apply sanctions directly against the borrower. In terms of a comparison with other tools of government, federal credit programs today can be considered to involve a medium amount of coerciveness to repay loans, depending upon the particular loan program.

*Directness:* The direct loan and the guaranteed loan differ from one another in the extent to which they use third parties to make loans, service them, and collect on defaults. As tools of government, direct loans tend to be more "direct" than guaranteed loans.

Thus, under the Rural Housing direct loan program, the U.S. Department of Agriculture extends federal credit through local offices and services those loans through a centralized automated servicing center located in St. Louis, Missouri. If a rural borrower defaults on a direct loan, first the servicing center and then the local office will attempt to work with the borrower to reinstate timely loan payments. If this is not a promising alternative, the local office will attempt to mitigate loss on the loan and ultimately may institute foreclosure proceedings on the borrower's home.

By contrast, a guaranteed loan program such as the Section 7(a) business loan program of the U.S. Small Business Administration operates largely through private lenders. In the SBA preferred lenders program, the SBA authorizes the private lender to attach a government guarantee to a specified volume of business loans that conform to SBA eligibility requirements. The private lender originates the small business loan, applies the federal guarantee, and services the loan according to SBA standards. If a borrower becomes delinquent, the lender works to bring the loan current and, if unsuccessful, attempts to mitigate the loss and ultimately to foreclose if necessary. The lender then makes a claim on the SBA guarantee for the lender's fraction of the loss on the defaulted loan.

While guaranteed loan programs rely upon lenders as intermediaries, some direct loan programs may use other kinds of intermediaries. For example, the Federal Direct Student Loan program of the U.S. Department of Education uses schools to originate loans for their students. The department recognizes that servicing is best done through experienced private sector contractors, rather than by officials of the department, and has hired a large contractor to service its direct student loans. If loans become delinquent, the department uses contractors to collect upon the loans and to mitigate losses.

One sign of the greater directness of direct loans, compared to loan guarantees, is the quality of information available to the federal credit agency. Government managers tend to have much more complete and timely information about direct loans than about loan guarantees. For guaranteed loan programs, important financial information resides with the private lender that made the loan; lenders often do not transmit this information to the government unless a loan becomes troubled and the lender is preparing to file a claim on the government guarantee. The availability of high quality information is critical for both direct loan and loan guarantee programs if government is to protect its financial position and assure that the program carries out its mission.

Thus, in terms of directness, guaranteed loan programs are "low" on the dimension of directness. By contrast, direct loan programs range between "high" on directness (e.g. the rural housing loan program) and "medium" (the direct student loan program).

*Automaticity:* The third tool feature is "automaticity," i.e., the extent to which the tool requires its own administrative structure. On this dimension, loan guarantees tend to be more automatic than direct loans, in the sense that government can use an existing private financial services system to provide guaranteed loans to borrowers. By contrast, as in the case of direct loan programs of the U.S. Department of Agriculture, the government may need to create a delivery system to originate and service its direct loans.

The element of automaticity shows why credit, including both direct loans and loan guarantees, can be tricky for government to provide effectively. Automaticity also shows the tension in credit programs between the initial provision of credit to borrowers, which can be very automatic, and the much greater effort that may be required to collect on loans once they have been made or guaranteed.

With respect to loan origination, guaranteed loans rank high in automaticity; many direct loan programs rank low. By contrast, the collecting on loans and avoidance of defaults on direct loans or loan guarantees is far less automatic, and can involve considerable effort for a federal credit agency. Given the substantial effort that the federal government has had to make in recent years to collect on defaulted direct and guaranteed loans, credit programs are justifiably scored as "low" on the dimension of automaticity in this respect.

*Visibility:* Prior to the 1990 Credit Reform Act, federal direct loan programs were highly visible in the budget, but loan guarantees were virtually invisible. The government budget treated direct loans as if they were cash outlays

with the full loan amount recorded as an expenditure in the year that the loan was disbursed. The government then treated loan repayments as budget receipts in the year that the government received them. By contrast, loan guarantees were not treated as outlays when they were issued; rather, they showed up in the budget only in cases of default when the government actually paid off a lender. This disparate budget treatment created a clear budgetary advantage for loan guarantees over direct loan programs.

The Credit Reform Act of 1990 changed this situation considerably and made both direct loans and loan guarantees highly visible in the budget process of the U.S. government. A major purpose of credit reform was to place credit programs on a comparable footing with other government programs. Credit budgeting requires a calculation of the so-called credit subsidy, i.e., the budgetary outlays that will be required to fund new loans or loan guarantees that the government provides each fiscal year.

Credit reform recognizes that a loan's true cost is not captured by its cash flows in any one year; the true cost is the net value of its cash flows to the government over the life of the loan. This value is the loan's "subsidy cost", which is the net present value of a loan's expected cash inflows and outflows over the life of the loan. Budgeting for loan programs with this present value-based accounting system represented a significant departure for the otherwise cash-based Federal budget.

To budget under credit reform, a government agency estimates the cash flows it will pay out or receive over the life of all direct loans or loan guarantees

that it originates in a given budget year. The agency then discounts these to provide a single estimate of all future cashflows. Major elements of this calculation include the present value of (1) the cost of estimated future loan defaults or claims against a government loan guarantee, and (2) any preferential interest rates on the loans. These costs are offset by up-front or periodic fees that the program may charge.

For example, if the estimated present value of a direct loan's cash outflows equals \$100 and the present value of its inflows equals \$90, its subsidy cost is \$10 and its subsidy rate is 10 percent. If an agency proposed to make \$2,000 of these loans, it would seek an appropriation of 10 percent of the desired face value, or \$200. The credit subsidy does not include the costs of administering a credit program; those costs are budgeted separately each year.<sup>1</sup>

Credit reform has meant that credit programs today have visibility in the U.S. government budget comparable to other tools such as direct government and tax expenditures. The annual budget request for each federal credit agency includes an estimate of the funds that will be required to cover the credit subsidy for new loans provided or guaranteed for the next fiscal year under each of the agency's separate credit programs.

One interesting contrast exists between government credit programs and insurance programs. Although both of these tools of government may involve the provision of financial support to individuals or companies, credit reform has increased the visibility of credit programs, while insurance programs remain largely beyond the purview of federal budget decisions.

## **Design Features and Major Variants**

A well-designed government credit program will balance the tension between doing good (i.e., serving worthy constituencies) and doing well (i.e., assuring that loans are rigorously underwritten and originated, serviced, and foreclosed upon). Many important design features relate to this issue.

*Defining eligible borrowers:* The most critical element in effective design of a credit program relates to appropriate targeting: The loan or guarantee is most beneficial economically if it is directed at borrowers in a band between those who are not creditworthy enough to be able to handle their government loan, and those who are so creditworthy as to have full access to private loans without needing a government subsidy. A failure to target credit properly can cause harm either from denial of credit to creditworthy borrowers or from the provision of too much credit to people who can't handle it.

A notable example comes from the Federal Housing Administration. For many years, into the 1960s, FHA applied financially conservative underwriting standards and applied outright forms of redlining, i.e., denial of access to credit, to groups of eligible borrowers in center cities.<sup>2</sup> Then in the mid-1960s FHA reversed course and began to insure large numbers of financially unsound center city mortgages that soon defaulted and contributed to "widespread speculation, default and foreclosure, the abandonment of homes, and the spread of neighborhood blight..."<sup>3</sup> It took many years for FHA to develop underwriting criteria that reflect an appropriate balance of objectives in targeting the program.

*Determining the amount of subsidy to provide: Government credit*

programs vary widely in the amount of subsidy that they provide to borrowers. Government provides credit subsidies in various forms: by paying for below-market interest rates, or grace periods before the borrower must begin making interest payments, or by charging lower fees than are needed to keep the program financially self-sustaining. High-subsidy federal programs tend to be direct loans rather than loan guarantees. High-subsidy direct loan programs include those of the Department of Agriculture: Farm Service Agency, Rural Development, Rural Housing, and Public Law 480, plus programs of the US Agency for International Development and the Export-Import Bank of the United States (ExIm Bank). Subgroups of these programs, including those that serve particular types of borrowers with large subsidies, may involve higher subsidies than the overall programs.

When the subsidy rates on such programs, or program subgroups, run over 30 percent, one finds that a large part of the credit program in fact is a grant that is provided through the program subsidy. Indeed, credit programs are attractive tools for policymakers who want to serve constituents that may not be considered eligible for outright grants. Extension of credit can be justified on grounds that the loan will be repaid on a businesslike basis. In fact, low quality of information for many federal credit programs can make it hard to determine the actual extent to which they contain a subsidy.

One type of subsidized credit program deserves special mention. This is the state or local loan program that funds itself through the issuance of tax exempt

bonds. The federal government, through a multibillion-dollar tax expenditure, helps to reduce the borrowing costs of state housing finance agencies, or other finance authorities. These authorities, in turn, may pass on some of their funding advantage to help borrowers obtain credit on subsidized terms. Some state student loan agencies report that they may use some of their subsidy to help provide financial counseling or special servicing to assist less advantaged borrowers to repay their student loans.

The Credit Reform Act of 1990 plays a major role in directing the attention of policymakers to the amount of subsidy that a program provides. In the 1970's and early 1980s, for example, the Congress did not need to budget for loan guarantee programs, even if they included some significant chance of default. In those years, the federal government extended credit to failing companies including Lockheed Aircraft and Chrysler, and to New York City.<sup>4</sup> Such programs would be harder to enact today because lawmakers would need to obtain an estimate of the credit subsidy involved and then find appropriated funds to pay for the estimated subsidy.

*Deciding whether loans will be backed by collateral:* If loans are intended to help a borrower to purchase or refinance real property, they generally will be secured loans. Secured loan programs include the residential loan programs of the FHA, VA, Rural Housing Service, and SBA, for example. By contrast, a consumer-type loan such as a student loan tends not to be backed by collateral.

For a lender in the private sector, loan collateral is a valuable way to reduce financial risk. For some government loan programs, the issue can be more

difficult. The government may find that foreclosure, for example on a farmer's property or on the home of someone who recently obtained an SBA disaster home loan, sometimes carries unacceptable political costs even when the borrower is in complete default on the loan. The preferred design option is to avoid requiring collateral unless the ability to foreclose or to encourage a pre-foreclosure sale actually can help to improve the government's financial position.

*Risk-sharing arrangements with lenders or other private parties:*

Government can share the risk of default with private parties such as lenders or, in the case of student loans, participating schools. Government can share risk by guaranteeing only a portion of a loan. Risk sharing is an important way to augment government credit management with the services of private parties who share the risk of financial loss and therefore may have an incentive to manage the risk to assure timely repayment of the loan. Through risk sharing, the private lender or other private party can gain a stake in managing the origination and servicing of loans as if their own money were at stake. If lenders have little or no stake in the financial risk of government loans, then their incentives can become distorted.<sup>5</sup>

It may be difficult to calibrate an appropriate amount of risk sharing for some programs. OMB Circular A-129, in its standards for proposed new credit programs, attempts to address this issue. The circular states that, "Private lenders who extend Government guaranteed credit [should] bear at least 20 percent of the loss from any default."<sup>6</sup> However, for some programs, a 20 percent risk share may be outweighed by the returns to lenders from the program so that a year or so after

origination they no longer have a significant financial stake in the loans that they hold and service. On the other hand, a 20 percent risk share may be enough to deter lenders from making some loans, especially to borrowers who are perceived as being insufficiently creditworthy.

The guaranteed student loan program currently requires lenders to share five percent of the financial risk; program supporters fear that any greater amount of risk sharing might deter lenders from originating loans to some disadvantaged students, especially those who attend vocational schools, who may be considered to be most in need of financial assistance. The government of Canada has adopted such an approach. Instead of providing an open-ended entitlement to student loans, as in the United States, the Canadian government pays lenders five-percent on each loan that they make, to cover the cost of future defaults. If the lenders keep defaults below this amount, they benefit; if defaults are higher, the lender bears the additional costs.<sup>7</sup>

Direct loan programs also can use risk sharing as a means of improving the alignment of incentives between a loan program and the private firms who may help to service the loans. State finance agencies, for example, may pay servicers each month a percentage of the money (i.e., the cash flows) that they collect from borrowers in repayments. The servicer thus has an incentive to service loans well so that the stream of repayments, and the associated servicing income, remains at high levels.

*Loan terms:* Loan terms include elements such as the fees and interest rates associated with loans, the size of loans, and their maturities and conditions

of default. All of these factors tend to vary across federal loan programs; the federal government has not yet standardized the definition of conditions for a loan default, for example.

Some of the most successful federal programs have involved extensions of credit for new types of loans. FHA single-family mortgage insurance involved the creation of the thirty-year self-amortizing mortgage to allow borrowers to obtain long-term funding for their homes. The 30-year FHA mortgage replaced the earlier form of financing through a balloon mortgage that the homeowner was required to refinance every few years. The successful experience of FHA mortgage insurance over several decades permitted the development of a private mortgage insurance industry to take similar kinds of risks with thirty-year level-payment mortgages. The Export-Import Bank similarly tends to lead the private market by providing longer term financing for exports to particular countries.

*Addressing elements of financial risk:* There are a number of ways to address financial risks in a credit program, and these will vary according to the particular type of loan or borrower. For example, limiting the maximum loan-to-value requirements can help to assure that borrowers have a significant equity stake in their homes and thus that they will make every effort to pay their mortgage loans on time.

With its emphasis upon up front disclosure of the likely costs of credit, the Credit Reform Act has increased the financial accountability of credit programs. The new budget treatment has created an incentive for policymakers to avoid program elements that could cause high default rates. The government has

become more successful at imposing limits upon the financial risks posed by lenders and other program intermediaries, notably schools in the student loan programs.

## II. Patterns of Tool Use

### U.S. National Government

The U.S. government extends credit for a broad range of purposes, from overseas activities to the needs of people caught in a disaster. The federal government today has over \$200 billion of direct loans and almost a trillion dollars of loan guarantees outstanding. Outstanding federal direct loans and guarantees amount to about ten percent of the total indebtedness of U.S. households and nonfinancial businesses.

Volume of loans and guarantees: Table 1 below lists the major credit programs of the U.S. government and the volume of credit outstanding for each. As noted there, the largest programs provide credit for housing (FHA, VA, and rural housing), education (direct and guaranteed student loans), and agriculture (Farm Service Agency and rural programs), plus a variety of business purposes (SBA and some export programs).

**Table 1**  
**Federal Credit Programs**  
(Outstanding loans and loan guarantees, in billions of dollars)

Program	Outstanding 1999
<b>DIRECT LOANS</b>	
Federal Student Loan Programs	65
Farm Service Agency (Excl. CCC), Rural Development, Rural Housing	45
Rural Electrification Admin and Rural Telephone Bank	29
Housing and Urban Development	14
Agency For International Development	11
Public Law 480	11
Export-Import Bank	12
Commodity Credit Corporation	7
Federal Communications Commission	8
Disaster Assistance	7
Other Direct Loans	22
<i>Subtotal: Direct Loans</i>	234
<b>LOAN GUARANTEES</b>	
FHA Mutual Mortgage Insurance Fund	411
VA Mortgage	221
Federal Family Education Loan Program	127
FHA General/Special Risk Insurance Fund	93
Small Business	39
Export-Import Bank	25
International Assistance	19
Farm Service Agency and Rural Housing	17
Other Loan Guarantees	23
<i>Subtotal: Loan Guarantees</i>	976
<b>TOTAL FEDERAL CREDIT</b>	1,210

SOURCE: Office of Management and Budget, Executive Office of the President, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2001*, Table 8-1, p. 208 (February 2000).

Figure 1, below, shows the volume of federal direct loans and loan guarantees outstanding in recent decades. Over the past 20-30 years the volume of federal loan guarantees has grown significantly, while the volume of direct loans outstanding has remained at a more constant level.

**Figure 1**

**Face Value of Federal Credit Outstanding**

**[INSERT FIGURE 1 HERE]**

Source: *Budget of the United States Government, Fiscal Year 2001, Analytical Perspectives*, Chapter 8, "Underwriting Federal Credit and Insurance," p. 207, Chart 8-1

Historical overview: The practice of extending credit for public purposes has a long history in the United States, dating back to the seventeenth century and the New England colonies.<sup>8</sup> After the establishment of the United States, state and local governments, and eventually the federal government, extended loans to support a number of infrastructure improvements such as canals and railroads.<sup>9</sup>

With the entry of the United States into World War I, the government created the War Finance Corporation (WFC), a wholly owned government corporation. By war's end, the WFC had lent money to support a wide variety of enterprises, including public utilities, power plants, mining and chemical firms, and railroads. During the economic downturn of 1920-22, the Congress transformed the WFC into a peacetime emergency finance corporation authorized to make loans to support exporters and individuals in the depressed agricultural sector. The government had established the WFC to be a temporary measure and wound up the WFC by 1929.<sup>10</sup>

In 1932 the government established a new Reconstruction Finance Corporation based upon the successful model of the WFC. From 1932 through the end of World War II, the RFC disbursed more than \$2.7 billion in direct loans, including loans to financial institutions, mortgage loans and loans for agriculture, railroads, mining, exports and other businesses, as well as \$ 1.2 billion for stock subscriptions in banks, insurance companies and other financial institutions.<sup>11</sup>

With the failure of thousands of banks, savings and loan institutions, and other private sources of credit, the Roosevelt Administration also created many other new credit programs. These included the single-family mortgage insurance

program of the Federal Housing Administration (FHA), a variety of federal agencies to provide credit to agriculture and rural communities, and to businesses. Many of today's federal credit programs, including those of the FHA, SBA, and the Export-Import Bank of the United States, trace back to this period.

Many of these programs were remarkably successful. They helped provide funds to banks and borrowers that found themselves in temporary straits because of the Great Depression, and generally helped to revive confidence in the financial markets by placing the financial strength of the federal government behind otherwise illiquid private obligations.

Over the past 20-30 years the volume of federal loan guarantees has grown significantly, while the volume of direct loans outstanding has remained at a more constant level. First, starting in the late 1960s, the government greatly expanded federal credit programs. The federal government responded to urban unrest with new FHA mortgage insurance programs, both for single-family homes and for apartment buildings. Many of these programs involved heavily subsidized interest rates as a way of helping to lower housing costs for low-income homebuyers and renters. The government also created the guaranteed student loan program in 1965 and greatly expanded its coverage in subsequent years.

Credit programs of the Farmers Home Administration (the FmHA, now succeeded by the Rural Services Agency) multiplied sixfold in outstanding volume between 1973 and 1984, to \$ 61 billion. This resulted from more generous loan terms and also from an expansion of types of loan program that the agency offered. In good part, the expansion of FmHA programs after 1981 represented a

way for the government to bail out private lenders, including rural banks and the Farm Credit System, that were hard hit by an agricultural downturn.

Starting with the Reagan Administration, the federal government made a serious effort to curtail domestic budget resources. For federal credit programs, budget constraints caused a shift in the form of the federal program, from direct loans to loan guarantees, rather than a constriction in the actual volume of credit outstanding.

This was possible because of the distorted budget treatment of direct and guaranteed loans before credit reform. The volume of outstanding loan guarantees rose while the volume of direct loans declined. The volume of outstanding loan guarantees continued to increase even after the Credit Reform Act was implemented, and this too reflects the effects of budget scoring rules. Congressional policymakers discovered that they could reduce the subsidy component of a direct loan or loan guarantee program and use the savings to provide a greater volume of loans for constituents.

#### U.S. State and Local Governments

By contrast to the virtually unlimited credit capacity of the federal government, state and local governments have much less financial capacity to issue debt obligations or to pledge their credit to issue loan guarantees. Unlike the federal government, states and localities are generally limited by their constitutions from engaging in deficit spending; this limits state and local governments in the amount of credit that they can extend on the basis of the strength of their governmental credit.

Bond issues back the most common forms of state credit programs. The federal government may provide some support to this form of credit program by providing a subsidy through a federal tax exemption for debt obligations issued by state or local governments or their instrumentalities. State and local authorities include power authorities, development finance authorities, housing finance agencies, student loan finance agencies and health care facilities authorities, for example.<sup>12</sup>

One interesting state lending vehicle is the state bond bank. By pooling the credit standing of participating local governments, plus some form of credit enhancement that the state government might provide, the bond bank permits localities to borrow at lower cost or on more favorable terms than they could otherwise. At least seventeen states now have some bond bank programs to help serve their localities.

Another type of credit program is the state revolving loan fund. Revolving loan funds provide credit to businesses or localities to help finance long-term economic development or environmental projects such as local wastewater or drinking water facilities. A revolving fund begins with seed capital, usually a federal grant or long-term loan, and lends money for designated public purposes on favorable financial terms. As borrowers repay their loans, they replenish the revolving fund so that loans can be provided to new borrowers or to fund new activities.<sup>13</sup>

## International Experience

Many national governments outside the United States provide credit for a variety of public purposes. German state (i.e., "Land") governments own so-called Landesbanken, that are authorized to fund a variety of activities, including providing real estate, trade, and commercial loans. In housing, the Japanese government plays a major role in funding home mortgages, through the wholly owned Government Housing Loan Corporation (GHLC). The GHLC provides perhaps forty percent of the country's mortgage credit, in the form of heavily subsidized loans, which in the late 1990s offered borrowers mortgage interest rates around 3 percent. In 1999, the GHLC had about 7.2 trillion Yen (\$ 50 billion) of home loans outstanding.<sup>14</sup>

The French government also has had a tradition of providing subsidized credit for income-eligible homeowners. However, the French have been turning away from government provision of mortgage credit. The French had used a quasi-governmental mortgage bank, the Credit Foncier de France, as its instrument for providing mortgage credit.<sup>15</sup> In 1998 the French government bailed out the Credit Foncier de France and took steps to create the legal framework for a system of private mortgage credit banks that would be authorized to issue mortgage-backed bonds to fund mortgages.

In the area of nationwide credit support for student loans, the government of the United Kingdom utilizes the Student Loans Company Ltd., a nonprofit adjunct to the UK Department for Education and Employment, to extend credit to students. The UK provides a system of income-contingent repayment on student

loans. Students defer making loan payments while they are in school, and then make their loan repayments through the UK Inland Revenue, the tax authority. By contrast, a recent survey of developing countries conducted for the International Finance Corporation found that, with a handful of exceptions, "there were no government student loan companies, and banks were not generally in the habit of lending to students either..."<sup>16</sup>

Developing countries do, however, provide government loans either directly or through state-owned banks to support favored sectors of the economy and especially state-owned enterprises. Many times these countries have been harmed when their loan programs turned into open-ended subsidies for money-losing enterprises. The net result, most notably in China, has been that a government directs massive amounts of valuable resources into activities that can prove to be immensely wasteful.<sup>17</sup> In many countries, government loan managers lack an incentive to recognize defaults and losses on loans, especially to powerful economic institutions and firms managed by influential political figures.

Credit programs also have a long history internationally. Already at the time of King George III, the British government enacted legislation to provide loans for infrastructure improvements, to relieve economic distress of private firms, and to support public and private organizations that were expected to provide expanded job opportunities to the unemployed. Special acts of Parliament in 1784 and 1799 authorized government loans to fund the completion of projects by two local canal companies, and subsequent acts expanded this practice of offering government loans.<sup>18</sup>

One interesting and multifaceted model comes from post-World War II Germany. In 1948, the new West German government and West German state (i.e., "Land") governments established the Kreditanstalt fuer Wiederaufbau (KfW, literally, the "Reconstruction Finance Corporation"). KfW's first task was to provide credit and equity financing in support of the reconstruction of the postwar West German economy. Although unrecognized in current KfW literature, it would seem as if the model of the U.S. Reconstruction Finance Corporation may have played a role in the design of KfW.

KfW accomplished its task of financing West German reconstruction and then turned to new financing activities on behalf of the German government. KfW today helps to provide project financing for the energy, steel and coal sectors and infrastructure investments, and to provide loans and equity investments for small and medium-sized businesses. Similar to the role of ExIm Bank in the United States, KfW also provides financing for German exports and the European aircraft industry (Airbus). The government corporation seeks to make a profit, but not to maximize profits each year on its operations.

### III. Basic Mechanics

The basic mechanics of a federal direct loan and a guaranteed loan, respectively, involve a series of steps, from development of the loan program to final repayment or collection on a loan, and the writing off of losses.

#### *Start-up*

All government loan programs involve a preliminary phase of developing regulations, contractual agreements, and loan documents that reflect the provisions of the law that authorizes the program. Both direct and guaranteed loan programs require that forms and procedures be developed to screen borrowers according to the statutory standards for eligibility in the program. For a loan guarantee program, the program agency also must establish procedures for certifying and decertifying lenders as to eligibility to participate in the program. Other certifications also may be needed. For example, the Department of Education must determine the eligibility of schools to participate in student assistance programs, including loans.

### *Marketing*

Especially at the beginning of a loan or guarantee program the government may need to help develop a market for the program. Lenders or other institutions such as schools, and also borrowers must be persuaded to participate. The Small Business Administration, for example, continues to concern itself with ways to increase lender participation in SBA programs. Private lenders can play a major role in helping to advertise the availability of government guaranteed loan programs to eligible borrowers.

Market development was a major issue for federally guaranteed student loans. The Congress enacted the student loan program in the late 1960s to provide a 100 percent guarantee against risk of default. However, most banks found these loans small and expensive to service. Thus, for many years lenders remained reluctant to participate heavily in the guaranteed student loan program.

Eventually, some of the larger private lenders and state governments created specialized student loan businesses to purchase the loans from the originating banks. These specialized student loan businesses began to realize economies of scale from holding and servicing student loans that were unprofitable for lenders that held only small numbers of loans. At that point the program was ready to take off.

### *Origination*

Origination is the process of actually extending a loan. It involves a contractual agreement between the lender and the borrower as to the terms of the loan. Origination requires underwriting the loan, i.e., determining whether the borrower is capable of repaying the loan in a timely manner and assessing the value of any collateral used to secure the loan. For example, federal business loans and home loans tend to require a lien against the borrower's property as collateral.

If a loan is a federal direct loan, the originator may be a federal agency, such as the SBA when it provides direct loans to disaster victims, or an intermediary such as a school that originates student loans. If a loan is federally guaranteed, a private lender will originate the loan pursuant to a contractual agreement with a federal agency to guarantee repayment of the loan by the borrower. Lenders that originate federally guaranteed loans include commercial banks, savings and loan institutions, and also other types of lenders such as mortgage bankers for FHA insured mortgages and VA and RHS guaranteed home loans, or finance companies for some business loans.

The process of loan origination highlights important operational differences between direct loans and loan guarantees. In a direct loan program, government officials maintain control over the process of determining borrower eligibility and deciding whether to make the loan. By contrast, for guaranteed loans government delegates much of the control over origination to the lender and the lender decides whether or not to make a particular government-guaranteed loan.

This creates an opening for the problem that economists call “moral hazard.” The government’s guarantee distorts the usual economic behavior of a private lender. Enough fee and interest income may accrue from a guaranteed loan in the first year or two that the lender becomes indifferent to the risk of later default. By originating loans that defaulted in high numbers, some lenders, notably in the failed FHA programs of the late 1960s, cumulatively caused the government billions of dollars of taxpayer losses, plunged borrowers into debt and bankruptcy, and harmed the very communities that the programs were intended to help.

Many government loan guarantee programs try to address problems of moral hazard by monitoring the default rates of loans that lenders originate for government programs. New credit scoring systems also may prove helpful in measuring lender performance.<sup>19</sup>

### *Disbursement*

Disbursement is the actual transfer of funds from the government or the lender, as the case may be, to the borrower. Disbursement on a residential

mortgage loan tends to occur all at once, at settlement when the borrower purchases or refinances the home. Disbursement on other types of loan may occur in stages. For instance, students may receive disbursements of student loan funds at the beginning of each semester.

### *Servicing*

Once the loan is disbursed, the borrower has the money and must begin to repay the loan according to its terms. During this phase, the loan must be serviced. Servicing is the process of (1) arranging to receive timely payments from the borrower, and (2) receiving and accounting for the funds as borrowers remit them. Some loans provide for a grace period before repayment is due. Students do not begin repayment of their U.S. government loans until six months after graduation, for example.

Lenders service the government guaranteed loans that they hold, and government agencies are responsible for servicing direct loans. Given the pressure to downsize government and the growth of new servicing technologies that increase efficiencies and economies of scale, federal agencies increasingly contract with private firms to service their direct loans. Loan asset sales also can help to outsource the servicing function for federal direct loans and nonperforming guaranteed loans that the government has acquired from lenders.

If a borrower is late in making a scheduled payment, the loan becomes delinquent. If the borrower does not come back into current payment status, there comes a point, defined differently for different federal credit programs, when the borrower is deemed to be in default on the loan agreement. Delinquencies and

defaults require action, in the collections stage of the credit cycle, to reinstate the borrower into current status, to work out or restructure the loan, or to pursue other remedies, such as foreclosure.

In servicing, loan guarantee programs again tend to manifest the problem of moral hazard: because the government guarantees some or all of the loan, the lender tends to be less careful in servicing a government-guaranteed loan than in managing its own unguaranteed loans. The problem of moral hazard also can arise for direct loans if government contracts out the servicing: unless the servicing contract is performance-based, so that the contractor has a financial stake in servicing each loan well, government may find that the contractor has little incentive to do an effective job.

Some federal loans, notably student loans, are backed only by the borrower's contractual obligation to repay the loan. Other loans, such as FHA or VA mortgage loans, are backed by collateral. In other words, they are secured loans. If the borrower defaults on the loan, the government or its agent or the lender, as the case may be, has the legal right to seize the property that is the loan collateral and sell it to help reduce the amount that is lost on the default.

#### *Loan Sales and Securitization*

Especially with new technologies that create economies of scale in loan management, lenders have an incentive to package their loans and sell them, either to larger institutions or in so-called securitization transactions. Government often has created special institutions to provide so-called secondary market

services, i.e., to purchase loans from lenders or otherwise provide funding for the loans that they originate.

Ginnie Mae, the Government National Mortgage Association, is a major secondary market institution that helps lenders to securitize government-guaranteed home mortgages. In a Ginnie Mae securitization, a lender originates or otherwise assembles a large number of government-guaranteed loans (i.e., FHA or VA or rural housing loans), places them in a trust structure, and issues mortgage-backed securities that allow investors to buy a share in the cashflows from the mortgages in the trust. Ginnie Mae facilitates this process by providing a guarantee to holders of the mortgage-backed securities that they will receive timely payment of the principal and interest due each month on the mortgages. Because Ginnie Mae guarantees these mortgage-backed securities with the full-faith-and-credit of the U.S. government, investors eagerly purchase such securities. Without the Ginnie Mae guarantee, lenders would not find as ready a market for their mortgages.

Government has also encouraged development of other secondary market institutions to support guaranteed loan programs. In the student loan market, for example, state agencies or nonprofit organizations may issue bonds, often tax-exempt, to fund pools of student loans that they purchase from the originating lenders. Other major secondary market institutions are government-sponsored enterprises, discussed in another chapter.

#### *Government Loan Asset Sales*

The U.S. government increasingly uses loan asset sales as a way to receive value from loans that it holds, including direct loans and defaulted guaranteed loans that it has repurchased from lenders. The UK Student Loans Company also has conducted sizeable sales of direct loans from its portfolio.

Building upon the largely successful asset sales experience of the Resolution Trust Corporation (RTC) in the late 1980s and early 1990s, the Department of Housing and Urban Development sold billions of dollars of nonperforming loans that it had been unable to collect on.<sup>20</sup> The Small Business Administration also has begun a series of loan asset sales as a way to reduce the workload burdens on the staff of that downsized agency. Federal experience from several agencies indicates that government can structure incentives so that the private sector will collect on nonperforming loans without treating the borrowers unfairly.

#### *Prepayment, Repayment, or Collection*

When a borrower repays the loan, the loan process is formally at an end. Prepayments occur when the borrower pays ahead of time, for example because of a desire to refinance a home. If a borrower fails to make timely payment, the government or private lender, as the case may be, makes efforts to collect on the loan.

The federal government may use its own staff to collect on direct loans or else will contract with private firms to collect from borrowers. The U.S. Department of Education, for example, has created an especially sophisticated

relationship with contractor collection companies to obtain high performance both in collecting on delinquent or defaulted loans and in fair treatment of borrowers.

In some cases, a federal government agency also is responsible for collecting on defaulted guaranteed loans. Until recently, for example, lenders that participate in the SBA Section 7(a) business loan program were permitted to put their defaulted federally guaranteed loans back to the SBA for collection and workout. Increasingly, the federal government requires lenders to deal with the defaulted guaranteed loans that they hold. In such cases, the lender may close out the loan, for example through foreclosure or a forced sale on the home or business property that a borrower has pledged as collateral for the loan. The lender then collects from the federal government the amount of the federal guarantee on that loan that could not be recovered from the borrower.

A number of federal programs, such as the HUD multifamily mortgage insurance program, have found that their delinquent or defaulted borrowers will remain current on all private obligations; they stiff only Uncle Sam.<sup>21</sup> Increasingly, government credit agencies are trying to deal with this problem. Through the application of laws such as the Debt Collection Improvements Act of 1996, the federal government has begun to exert considerable effort to collect on the debts of individual borrowers who have defaulted on their federal direct or guaranteed loans.

Federal agencies apply a number of techniques to induce defaulted borrowers to make good on their obligations. A number of federal credit agencies have joined in a cooperative arrangement, known as CAIVRS, or the Credit Alert

Interactive Voice Response System, to help screen applicants for new federal loans. The originators of federal direct and guaranteed loans run a computer search of the borrower against the database of past defaulted borrowers; CAIVRS signals if there is a match, so that the borrower is requested to repay the past obligation before becoming eligible for new federal credit.

Other tools include a federal income tax offset that allows federal credit agencies to attach income tax refunds of a defaulted borrower and offset the proceeds against the borrower's outstanding credit obligation to the federal government. Agencies such as the ExIm Bank and U.S. Agency for International Development also may benefit from the sovereign power of the U.S. government, to the extent that foreign governments are reluctant to default on their loans to the U.S. government for fear of being denied access to aid or credit in the future.

#### *Write-Off and Recognition of Losses*

When a loan is uncollectable and the government or its agent has no further remedies available to help mitigate the loss, then the loan must be written off. This is a process of explicit accounting for the fact that, unlike a performing loan, the written-off loan has no further value. Loans become uncollectable for a variety of reasons, including the bankruptcy of a borrower or a policy decision, such as the recent international agreement to write off uncollectable debt owed by the poorest third-world countries.

It can be very hard for a government agency to write off its losses from uncollectable loans. There is no incentive for a government official to take the formal accounting step and recognize the financial loss. In some programs serious

disincentives may exist, for example if field offices maintain their staffing levels by alleging that staff are needed to manage large numbers of troubled loans. In that context, a pattern of prompt write-offs of uncollectable loans could result in pressure to downsize.

The inability to recognize losses is yet another example of the precept that bad news travels slowly. Government agencies will correct this problem only when they develop accounts that are based upon accurate monitoring of the cashflows to and from all loans and loan guarantees.

At some point, the failure to recognize financial losses can become catastrophic. The Chinese government has experienced the costs of postponing the recognition of losses until they become intolerably large. China has been reluctant to close down state-owned enterprises that are in default on immense debts. The enterprises have used their lease on life to make large-scale mistakes, such as massive overproduction of unsalable goods and services, whose costs will burden the Chinese economy for years to come.<sup>22</sup>

#### IV. Tool Selection

##### **Rationale for Credit Programs**

As a general rule, government credit programs seek to provide credit to borrowers who somehow are considered to lack access to private loans on reasonable terms. The Office of Management and Budget (OMB) has published Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*, suggesting three reasons why a government credit program may be proposed to supplement and subsidize private sources of financing:

- To correct a capital market imperfection;
- To subsidize borrowers or other beneficiaries; and/or
- To encourage certain activities.<sup>23</sup>

*Market imperfections:* Credit programs are most effective when they overcome what economists call a market imperfection. A market imperfection can be defined in practical terms as some flaw in the market that deprives creditworthy borrowers of access to credit on appropriate terms. When a government program overcomes the imperfection, the program can provide loans to creditworthy borrowers without running the risk of intolerable levels of defaults.

When private credit markets are in disarray, most notably during the Great Depression, federal credit programs can serve a large number of potentially creditworthy borrowers who are not well served by private lenders. In good times, market imperfections are harder to find. Many market imperfections were caused by restrictive legislation that, for example, confined banks and other lenders in the geographic markets that they could serve. Today, the Congress has undone many of those laws and thereby removed the market impediments.

Other examples of credit market imperfections include discrimination, e.g., in the residential mortgage market. In 1998, 12 percent of FHA loans for home purchases went to African American homebuyers, and 13 percent to Hispanic homebuyers. This was over three times the proportion of such borrowers served by non-government loans. FHA also served a significantly larger proportion of low and moderate-income people and neighborhoods than did the

non-government loan.<sup>24</sup> Also, in the federal direct and guaranteed student loan programs, the government is providing credit to student borrowers who may not yet have established enough evidence of creditworthiness to be able to qualify for private credit on comparable terms.

If there is no market imperfection, the government program may have difficulty trying to serve enough creditworthy borrowers that have not already been served by private lenders. The remaining borrowers in a program as a group may not be sufficiently creditworthy to avoid significant risk of default. Also, if borrowers are considered to be financially disadvantaged, the government may be reluctant to impose fees upon their loans to compensate for the amount of financial risk that is involved. The result is likely to be a potentially high level of subsidy that is required to support such a program.

*Providing a subsidy:* Government may decide to target credit on preferential terms to borrowers or activities that are considered to merit a subsidy, even if no market imperfection may be apparent. The Export-Import Bank of the United States (ExIm Bank), for example, may provide loans on subsidized terms to help offset the prospect that foreign governments will subsidize their own companies in export markets and thereby deprive United States firms of sales in those markets. If other countries distort competition by subsidizing their exports, then the U. S. is ready to provide its own countervailing support.

With some exceptions, it is not clear that government makes a wise decision when it ties a subsidy to the extension of credit. The financial markets today are unbundling financial services because of the greater efficiency that can

come from applying each type of service to its own best purposes. Similarly, the government needs to recognize that the person or firm or other entity that needs access to credit may not need access to a subsidy, and vice-versa. In particular, if people or firms are not creditworthy, they may need grant-type assistance or special counseling or other subsidies, but they will not be promising candidates for a loan.

*Government credit as a pioneer:* Government often functions best as a pioneer in the credit markets. The FHA pioneered the thirty-year level payment mortgage; over time, private mortgage insurers followed FHA's lead and offered similar products. By extending credit to disadvantaged but creditworthy borrowers, possibly accompanied by some form of financial counseling, the government also can show private lenders that those borrowers are profitable credit risks.

The Micro and Small Enterprise Development program of the U.S. Agency for International Development is attempting to create such a demonstration effect in developing countries. By sharing risk with local lenders, the program seeks to expand the access to credit of creditworthy but neglected groups such as women entrepreneurs. These are ideal types of credit programs so long as government is willing to pay the price of success and eventually turn over a large number of its creditworthy constituent borrowers to the private sector.

### **Political Considerations**

*Developing a constituency:* Although there are counterexamples, credit programs can be hard to start and hard to end. The issue is one of

constituency; in the beginning of a program, constituencies may not welcome a federal program that might disrupt their current way of doing business. Yet, once a program matures it tends to have developed a determined constituency whose well being may be threatened by termination or even by reforms.

Some constituencies may be small; it is their influence that counts. Elisabeth Rhyne conducted interviews in the early 1980s with respect to SBA business loans and found that, "All of the interviewees placed the [congressional small business] committees first, the banks second, and small business third in level of commitment to the program."<sup>25</sup>

As Rhyne concluded, "It is my hypothesis that one of the reasons that [the SBA business loan program] continues to survive is that it meets certain needs of the Congressmen and Senators on the House and Senate Small Business Committees who oversee the programs."<sup>26</sup>

*The choice between direct loans and loan guarantees:* The choice between direct loans and loan guarantees involves political considerations. Private financial institutions are a powerful constituency that favors loan guarantees because of the fees and interest income that a lender can earn from a federally guaranteed loan and the way that a lender can use the federal loan to nurture a borrower relationship (e.g. of a student who later may take out a consumer loan or home mortgage from the bank). Lenders have welcomed the increase in volume of outstanding federal loan guarantees and also, for some programs, may welcome the growth in borrowing at less subsidized interest rates. By contrast, lenders tend

to view direct loans, except to the least creditworthy borrowers, as a competitive threat from the federal government.

*Constituencies as a source of inertia:* Lenders not only can provide a strong base of support for a program; they also may become a powerful source of inertia to maintain the features of a loan guarantee program in familiar ways. In one of its early efforts to address problems of high defaults in the guaranteed student loan program, the Department of Education developed regulations to set minimum standards of performance for lenders that service federal student loans. For years, lenders objected to these rules, known as the due diligence regulations, largely because they set formalistic standards that differed significantly from the performance-based approaches that banks took in servicing their own nonfederal loans.

Today the department is trying to free itself from these rules because of the need to reduce defaults through higher quality servicing based upon performance and measurable outcomes. Now that participating lenders have developed the requisite data processing systems to conform to the due diligence regulations, many of them resist the idea that the department again will change the rules.

*Program expansion:* Once a program constituency emerges, the Congress may enact laws to permit an expansion in the outstanding loan volume. Often the Congress will expand a targeted program to include groups of borrowers, who may be quite different from those that the program originally served. In the student loan program, the Congress relaxed earlier limitations and permitted

students to take out federal loans even if they could not show financial need. This expanded the program to serve middle class borrowers, and not merely those most in need.

The government expanded FHA single-family and multifamily mortgage programs in the 1960s to serve central cities. In that case, FHA programs already served the middle class and suburban areas; it was only afterwards that the Congress enacted subsidized programs such as the Section 235 homeownership and Section 236 rental housing programs to make housing available to low-income renters and homebuyers. Those programs combined FHA mortgage insurance with substantial interest rate subsidies that were intended to make the housing more affordable.

*Credit budget politics:* The Credit Reform Act of 1990 has created a budget framework that affects many legislative decisions about credit programs. Perhaps most important, credit reform subjects virtually all credit programs, including guarantees as well as direct loans, to annual budget constraints. When faced with budget constraints, the Congress often decides to reduce the amount of subsidy that a loan program provides, so that a fixed amount of appropriated funds can serve more constituents.

The Congress has a variety of options in this regard. For example, in 1992, the Congress enacted legislation to permit students to take out unsubsidized student loans, regardless of their financial need. While the government makes the interest payments for students in school under the subsidized student loan program, the student must make those interest payments for the unsubsidized

loans. More recently, the Congressional Budget Office (CBO) suggested that the terms of SBA business loans might be adjusted to eliminate the amount of federal subsidy involved. The CBO suggested that the Congress could achieve this by increasing the amount of risk sharing with private lenders and by increasing the loan-related fees that borrowers would pay the government for their SBA loans.

## V.

### Management Challenges and Potential Responses

The most critical elements in effective management of a credit program relate to the mandate, capacity, and accountability of the agency or department that is responsible for administering the program. A critical problem that many programs face is the erosion of creditworthy borrowers through a process of adverse selection. Consider each of these four factors in turn.

*Balancing Risks and Mission:* In program management too, the basic challenge for a credit program is to maintain balance between doing good and doing well, i.e., between extending credit to those creditworthy borrowers who need it and assuring that the program does not incur unacceptable losses. Some credit programs have mastered this tension between program goals and financial soundness; others have foundered because of their incapacity to deal with it.

An agency that does not actively manage the tension can face mounting difficulties. The problem with credit programs is that financially imprudent lending tends to become apparent only after a period of years; this gives an unwary agency considerable time to expand the volume of unsound loans or loan guarantees outstanding, so that accumulated losses can become substantial.

Achieving a proper balance may require an agency to try to manage its political environment. Credit programs often involve powerful constituencies that have interests that conflict with the management of a program in a cost-effective manner. Thus, the Congress is eager to provide funds so that the SBA can provide credit to victims of disaster; but the Congress seems less willing to appropriate funds to help the SBA to improve its ability to service those loans properly.

The Congress also may be reluctant to provide an agency with the resources or mandate to foreclose upon influential borrowers or to supervise lenders effectively, or to take other steps that protect the agency's financial position. This was especially true in earlier years. The 1970s and 1980s saw the publication of numerous reports and disclosures about high levels of defaults in many federal programs. Following the publicity surrounding the damage caused by such defaults, and especially since the enactment of the Credit Reform Act of 1990 and the need to budget and account for loan defaults, the Congress has provided federal credit agencies with increased program authority to reduce the volume of loans that lenders or others originate to borrowers with a high likelihood of defaulting.

Programs that the government manages through wholly owned government corporations tend to be especially capable of striking a good balance between doing well and doing good. As discussed in the chapter on government corporations and government sponsored enterprises, government corporations are supposed to be financially self-sustaining (except to the extent that the Congress from time to time may appropriate funds to subsidize uneconomic activities).

Similarly, some state finance authorities, and especially some that are structured to be nonprofit corporations, may achieve a workable balance between their activities and their available resources.

*Capacity:* A second management challenge relates to the availability of staff and systems to manage credit programs. A credit program requires staff and information-based systems to monitor the default rates of government-guaranteed loans originated or serviced by participating lenders, for example, and to apply appropriate corrective measures to deal with poor performers.

Many federal agencies are feeling the effects of years of hiring freezes and mandatory staff reductions. The U.S. General Accounting Office reported in 1993 that Ginnie Mae had only about 70 staff to oversee hundreds of billions of dollars of mortgage-backed securities, and urged that OMB and HUD, the department in which Ginnie Mae resides, take steps to grant Ginnie Mae a modest staff increase. By 1999, the volume of outstanding Ginnie Mae securities had risen to \$ 540 billion, while staffing had dropped to 56 people. Thanks to the robust U.S. economy in the six years following the GAO report, Ginnie Mae was able to get by with its diminished staffing capacity. The paradox is that policymakers undoubtedly will allocate more resources to the agency if it suffers a spate of issuer defaults, as happened in the late 1980s just before Ginnie Mae received its last boost in staffing.

Capacity also includes staff quality and training. Past hiring freezes mean that many federal agencies lack the necessary infusion of young professional talent who can help to apply new technologies and work processes to the

administration of credit programs. Also, skilled financial and technical professionals find ample opportunities in today's prosperous private credit markets, and public service has lost some of its luster.

These problems of capacity, subsumed under the term "hollow government," have significant implications for the design and management of federal credit programs. On the one hand, if agencies are short of in-house staff, then they must privatize many functions, just to obtain the needed personnel. On the other hand, government cannot run services with contractors alone; government also needs capacity to assure that the relationship between the agency and its contractors is properly structured and managed. When a contractor fails, as happened to the Department of Education in the student loan consolidation program, it is the department that takes the heat.

Effective agency leadership can help to resolve such issues. The Rural Housing Service of the Department of Agriculture, for example, engaged in a multiyear program to centralize servicing of rural housing direct loans in St. Louis, to add new technological capability to field offices to help with loan origination and servicing, and to relocate and downsize staff to accommodate the changes. The Rural Housing Service obtained a multiyear commitment from the Office of Management and Budget of the funds needed for the new technology and staff training. All parties lived up to their commitments, and the new office is now operating on the basis of state-of-the-art servicing technologies.

Capacity also affects the ability of government to hold third parties accountable for their performance. The final stages of the credit cycle, to the

extent that they involve defaults and the need to work out troubled loans can be very expensive and difficult for the government to resolve. In part, the problem may involve a politically powerful constituency that resists a federal agency's enforcement of its rights under a loan agreement. Federal credit agencies such as HUD have increasingly used asset sales as a way to reduce the immense burden upon staff that can result from a backlog of troubled loans.

*Keeping Third Parties Accountable:* To carry our credit programs through third parties, government must assure that its financial partners remain accountable for achieving program goals. After taking losses in many programs, the federal government is devoting increased resources to monitoring the performance of lenders who originate and service guaranteed loans. For federal single-family housing programs, Ginnie Mae has been a leader in developing lender-monitoring systems, both for its own use and for use of the Veterans Administration (VA) home loan program.

In the late 1980s a number of issuers of mortgage-backed securities defaulted on their obligations so that Ginnie Mae took billions of dollars of losses from its guarantees. The agency moved promptly to build a management information system, to track issuers of its mortgage-backed securities and the lenders who originated the mortgages in those pools. Ginnie Mae uses an automated financial data system to monitor delinquency and default rates of issuers and originators and mortgage pools that fall outside of expected parameters. Ginnie Mae officials believe that the system, now known as GPADS (the Government Portfolio Database Analysis System), has been extremely cost-

effective. The payoff is measured in terms of the government's capacity to act before rather than after loan origination and servicing practices create unacceptable financial losses.

The effectiveness of such monitoring systems can depend upon the legal authority that the Congress has made available to an agency that seeks to apply sanctions or to take other actions with respect to a third party whose actions are associated with high levels of defaulted loans. For the Department of Education, the Congress has provided authority to take action against schools that participate in the federal direct or guaranteed student loan program and whose students default in high numbers on their federal loans.

Thanks to new legislation that permits easier enforcement than in earlier years, the Department of Education has been able to report substantial progress in reducing default rates of schools that participate in the federal guaranteed student loan program. Using the particular definition in the law that permits the department to terminate schools with unacceptable default rates, overall defaults dropped from 21.4 percent on loans going into repayment in FY 1989 to 9.4 percent on loans going into repayment in FY 1996. This is a reduction of more than 50 percent.

Despite their increased attention to accountability, government credit agencies may neglect one important source of market discipline: they tend not to report their delinquent or defaulted business borrowers to private credit bureaus. Sometimes this reluctance comes at the behest of a congressional committee. The problem has been partially cured in the Debt Collection Improvements Act of

1996 and the statutory requirement that the status of defaulted individual (but not business) borrowers be reported to credit bureaus.

Federal credit agencies need the capacity to obtain accurate financial information and act promptly in response. Perhaps the greatest problem of accountability for federal credit programs relates to the unreliability of many data sources, especially for guaranteed loan programs. The good news for credit programs is that new management information systems permit increasing accuracy in credit administration and the generation of program information. Moreover, federal credit agencies have shown an increasing ability to learn from one another's promising practices.<sup>27</sup>

Under leadership from the Deputy Director for Management of OMB and a special Senior Advisor for Federal Credit and Cash Management, federal credit agencies are cooperating in a Federal Credit Policy Working Group that allows managers to exchange information in a supportive environment. Federal housing credit agencies, for example, are cooperating to create a joint federal housing data warehouse. Other federal agencies, including HUD and SBA, with support from the Federal Deposit Insurance Corporation, are sharing knowledge about the proper way to design and manage loan asset sales programs.

*Adverse Selection:* The problem of adverse selection relates to the ability of private firms such as lenders or mortgage insurers to keep the most profitable loans and to direct less profitable -- and generally less creditworthy -- borrowers to apply for government direct or guaranteed loans.

Federal credit programs contain structural elements that foster adverse selection. First, many credit programs by their terms offer credit only to those borrowers who have been turned down for similar credit by the private market. Second, government credit often is priced at a standard price, regardless of the creditworthiness of the borrower. This creates an incentive for private firms to offer a better price to more creditworthy borrowers than these borrowers can obtain from the government. As more creditworthy borrowers leave government programs, those programs find themselves with a higher proportion of less creditworthy borrowers than before.

An actuarial study of the FHA single-family program has pointed out that private lenders are applying new scoring-based technologies to find creditworthy borrowers. This could cause increased adverse selection: "That is, without modifying its underwriting rules, FHA might end up with lower average quality loans."<sup>28</sup>

The problem of adverse selection was difficult for FHA even before the application of those new technologies. In 1986, FHA mortgages were 1.9 times more likely than conventional mortgages to become 90 days past due. By mid-1998, the ratio had jumped to 4.4 times higher for FHA compared to conventional mortgages. Credit quality of VA mortgages compared to conventional mortgages also declined by similar amounts.

One can expect the application of scoring-based technologies to affect the credit quality of loans made or guaranteed by other government programs as well. Business loan programs of the SBA and some rural loan programs would seem to

be good candidates for increased adverse selection, as the private sector increases the application of scoring-based systems to serve creditworthy borrowers who otherwise would apply for government loans.<sup>29</sup>

At some point, to diminish the potential impact of adverse selection, policymakers may want to explore options for changing the form of some credit programs. One idea along these lines was contained in OMB's FY1996 passback concerning the FHA single-family mortgage insurance program. OMB proposed that FHA replace its traditional single-family mortgage insurance with a program of credit enhancements. In other words, FHA would provide grant funds to compensate private lenders for the additional default risk on the low-downpayment mortgages that FHA traditionally has supported.<sup>30</sup>

This proposal met with opposition from the mortgage banking industry, that includes many lenders that now have specialized in making FHA and VA loans under the current loan guarantee structure, and the idea was not included in the final version of the Administration's FY 1996 budget. Nonetheless it provides a useful model of how the transformation of a tool, here from a loan guarantee to a grant, can improve the ability of government to manage and budget for credit programs in today's environment. The proposal's demise also provides an illustration of the fact that stakeholder issues may prevent policymakers from adapting programs until the status quo for some of them becomes untenable.

## VI. Overall Assessment

### *Effectiveness and manageability*

Government has found it hard to manage many direct loan and loan guarantee programs. Constant changes in the credit markets have made it difficult for programs to maintain their balance between the mandate to provide credit to intended constituencies and the need to protect their programs against unacceptable levels of default and financial loss.

At the same time, new technologies, and especially the application of flexible data management systems, promise to make credit programs much easier to manage than ever before. The new systems will permit loan administration to occur on almost a real-time basis. Electronic data interchange between lenders and federal guarantee programs, and between government loan officers and centralized loan administration centers, promises to improve the manageability of many programs. Customer service also will increase, as round-the-clock toll free (800) numbers substitute for face-to-face meetings between borrowers and the people who service their loans.

The open question for many credit programs is whether stakeholders, including federal employees as well as private third parties, are willing to negotiate constructive outcomes so that credit agencies have the mandate and capacity to run their programs well. In the early 1990s, the Clinton Administration proposed to transform the FHA into a more efficient government corporation called the Federal Housing Corporation.<sup>31</sup> This proposal met with opposition from private mortgage insurance companies, who often view the government as a taxpayer-subsidized competitor, and who did not favor any increase in the effectiveness of that competitor. The rapid demise of that idea stands as a warning

that negotiations to increase the capacity of federal credit agencies often may not be easy. Internationally, the experience of many countries, especially but not solely in the developing world, has been that they may lack the institutional capacity or the mandate to require repayment of loans that governments make to politically powerful people or institutions.

Direct loan programs and loan guarantee programs both stand to benefit from new technologies and potential increases in management capability. Both types of program also need to work with stakeholders to assure positive outcomes.

In some respects, it may be easier to build consensus around effective management of direct loan programs than for loan guarantee programs. In contrast to loan guarantees, direct loans do not involve lenders who may believe that they have a stake in resisting overly effective supervision of performance. On the other hand, direct loan programs such as SBA disaster loans and direct student loans may involve other stakeholder concerns that must be negotiated.

### *Efficiency*

Government credit programs, especially after the Great Depression, had considerable scope for improving the efficiency of economic markets. Some credit programs, such as those that help to demonstrate the creditworthiness of some borrowers who have been neglected by the private markets, continue to play such a role. Yet, dramatic increases in efficiency of private financial markets have rendered some programs obsolete. When the markets work well, government has less to contribute. This again is true both for direct loans and loan guarantees.

There is another problem with government credit: it encourages indebtedness. In other words, by easing access to mortgage credit, a federal program encourages not merely housing, but also the indebtedness that is fundamental to the tool. There is reason to believe, for example, that federal school loans have helped to facilitate the massive increase in debt that many of today's students must bear.

### *Equity*

Almost by its nature, credit is an inequitable tool. Consider vertical equity first, i.e., equity across income classes. The most creditworthy borrowers -- who tend least to need many types of credit -- are the most attractive candidates to receive loans. The private sector has become quite adept at serving creditworthy borrowers. This means that many of the people whom the private sector deems not to be creditworthy in fact may be people who cannot repay their loans and who therefore are unsuitable recipients of significant amounts of government credit. Government is limited to serving a sometimes narrow band of borrowers who do not receive appropriate access to private credit, but who are likely to be able to repay their government loans.

Thus, a report of the Economic Research Service of the U.S. Department of Agriculture warns that high debt loads can limit the utility of federal credit as a way to encourage beginning farmers to purchase commercial farms.<sup>32</sup> Helen Dunlap, then HUD Deputy Assistant Secretary for Multifamily Housing, has made a similar point about the need for government to provide what she calls

"equity," i.e., carefully structured investments, to support rental housing for poor people, and not merely large amounts of federal credit.<sup>33</sup>

The General Accounting Office published a study, albeit on the basis of limited data, that reported that grant assistance was effective at reducing the college dropout rate of minority students and low-income students; assistance through federal student loans, by contrast, had no appreciable effect on dropout rates.<sup>34</sup> Whether or not a larger study would support this conclusion, the point remains: credit is not a remedy for the financial problems of those poor or otherwise disadvantaged people who have difficulty repaying their loans.

The experience of other countries in student loan programs bears out the problem of targeting credit in an equitable manner. In developing countries, issues of targeting include the problem of providing a government subsidy to members of a country's elite that do not need it, as well as the opposite problem, of imposing such stringent economic requirements that the most needy students do not qualify.<sup>35</sup>

In the United States, it is the middle class that seems to have been the largest beneficiary of credit programs, to finance suburban homes and student loans, for example. There appears to be a stratification of some loan markets. With exceptions, the private sector serves the most creditworthy borrowers, often without government assistance. Loan guarantee programs provide loans or serve borrowers with somewhat less credit strength, and direct loan programs, for example for rural borrowers or disaster loans, tend to make loans that are of lower credit strength than guaranteed loans.

Horizontal equity raises the question of whether similar people or firms receive similar benefit from a program. For some programs, it would seem that some well-situated firms have tended to benefit disproportionately from particular agricultural or business loan programs. The ExIm Bank, for example, is working hard to expand its service to other firms so that it can offset its image as "Boeing's Bank."

Where the private market continues to exhibit shortcomings, federal credit programs can play a significant role. The home mortgage market of the U.S., for example, continues to exhibit some discrimination, with respect to race and neighborhood. Here, FHA, VA, and the Rural Housing Service all help to improve horizontal equity, by serving greater proportions of racial minorities and disadvantaged communities than are served by lenders through conventional (i.e., non-government guaranteed) loans.

### *Legitimacy*

Policymakers tend to favor credit programs over other tools such as grants because of the expectation that the recipients will repay their government loans. This gives government credit the attractive appearance of a businesslike activity.

When particular credit programs develop a substantial constituency, they can become very popular. For example, the single-family home loan programs of the FHA and VA are considered to have helped to finance the American Dream in the suburbs after World War II.

Such success stories are harder to find today. Ginnie Mae, one of the most successful federal financial guarantee programs, is virtually ignored today, by the

Congress and the media, and even by some parts of the mortgage industry that it has supported for many decades. In recent years, even well managed credit programs such as those of the ExIm Bank and OPIC have had their legitimacy questioned, with charges that they represent "corporate welfare." Their very success suggests to some commentators, notably at think tanks with a conservative orientation, that their credit functions are best served by the private credit markets, without government intervention.

Perhaps the most popular federal credit programs today are the SBA disaster home loan and disaster business loan programs. In some sense, these programs are reminiscent of the Great Depression: they serve people and firms who previously were creditworthy but who have suddenly come upon hardship. In terms of legitimacy in the Congress and among the public, these would seem to be credit "worthy" people, in the sense of the legitimacy of their claim to receive government credit assistance.

When credit programs fail, they cause substantial defaults that hurt borrowers and that taxpayers must pay for. The Congress and the media are quick to pounce on such shortcomings. In 1970, for example, the House Banking Committee held an investigation and charged that the FHA "may be well on its way toward insuring itself into a national housing scandal."<sup>36</sup>

Shortly thereafter, the government first suspended and then terminated many of the criticized programs. Too often, housing credit programs seem to undergo cycles of enthusiasm as lenders and borrowers try out new programs, followed by disillusionment when they fail. On all of these issues of legitimacy,

the particular context and performance of a credit program appear to be more significant than whether it provides direct loans or loan guarantees.

## VII. Future Directions

Lester Salamon has written of tools of government that, "the key is to fit the tool to the nature of the task."<sup>37</sup> In the United States in today's economy, the available tasks for government credit are more diminished than ever before. This makes credit a tricky tool to apply, at least in this country.

Design of a high quality credit program requires attention both to the quality of the institution that administers the program and also the financial soundness of the program itself. Perhaps most important, a well designed credit agency or program, such as the War Finance Corporation after World War I or a number of New Deal programs, will benefit from an exit strategy so that the program might end on a note of success rather than failure.

Despite some shortcomings in design and management of credit programs, they remain the source of over a trillion dollars of credit for people, firms and other entities in the United States. The essential task for policymakers and program stakeholders today is to improve the design and management of credit programs and institutions and learn from past experience so that they can avoid incurring the kinds of substantial public costs that have toppled some programs in the past. When policymakers focus upon this tool, they need to understand its particular demands and characteristics as a way to assure that credit programs continue to provide their public benefits for many years to come.

## Suggestions for Further Reading

### Federal Budget Documents on Loans and Loan Guarantees:

Office of Management and Budget (for the current Fiscal Year), **Budget of the United States Government, [Fiscal Year]: Analytical Perspectives**, Chapter 8, "Underwriting Federal Credit and Insurance." A copy of the Analytical Perspectives for FY 2001, including the credit and insurance chapter, is available at <http://www.access.gpo.gov/usbudget/fy2001/pdf/spec.pdf>

Office of Management and Budget (for the current Fiscal Year), **Budget of the United States Government, [Fiscal Year]: Credit Supplement**. A copy of the Credit Supplement for FY 2001 is available at <http://www.access.gpo.gov/usbudget/fy2001/pdf/credit.pdf>

### Other Federal publications:

Federal Credit Policy Working Group, Office of Management and Budget, **Federal Credit Reform Tutorial**. A copy of this introduction to credit reform for credit managers, including case studies and an interactive teaching tool, is available at <http://www.financenet.gov/financenet/fed/fcpwg/fcpwgtutorial>

Financial Management Service, U.S. Department of the Treasury, October 1-3, 1996, **Workshop on Promising Practices: Transcribed Proceedings**. Transcripts of the three-day workshop are available at <http://www.financenet.gov/financenet/fed/fcpwg/reports.htm>.

U.S. Small Business Administration, **Asset Sales Source Book for Contractors and Investors**, February 1999. A copy of this guide to SBA loan and loan guarantee programs, including laws, regulations, and form agreements, is available at <http://www.sba.gov/assets/sourcebook.pdf>

### Academic studies:

Stanton, Thomas H., "Improving the Design and Administration of Federal Credit Programs," **The Financier: Analyses of Capital and Money Market Transactions**, Vol. 3, No. 2, May 1996, pp. 7-21. A copy of this article is available at <http://www.the-financier.com/finance/form.htm>

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Office of Management and Budget, Executive Office of the President. "FY 1996 Passback: Department of Housing and Urban Development." Washington, DC, November 21, 1994

Office of Management and Budget, Executive Office of the President. *Policies for Federal Credit Programs and Non-Tax Receivables*. Circular A-129. Washington, DC, 1993

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## ENDNOTES

- <sup>1</sup> See, "Primer on Credit Reform," published by the Federal Credit Policy Working Group, Office of Management and Budget, **Federal Credit Reform Tutorial**, at <http://www.financenet.gov/financenet/fed/fcpwg/fcpwgtutorial>
- <sup>2</sup> Calvin Bradford, "Financing Home Ownership: The Federal Role in Neighborhood Decline." *Urban Affairs Quarterly*. Vol. 14, No. 3, March 1979, pp. 313-335.
- <sup>3</sup> Hilbert Fefferman, "The Redlining of Neighborhoods By Mortgage Lending Institutions and What Can Be Done About It." *Redlining: A Special Report by FNMA*. Washington, DC: Federal National Mortgage Association, 1976, pp. 25-40 at p. 27). Failed loan programs for farmers and some students show a similar effect of harming the borrowers that were the nominal beneficiaries of the credit program. See examples in Thomas H. Stanton, "Improving the Design and Administration of Federal Credit Programs," *The Financier: Analyses of Capital and Money market Transactions*, Vol. 3, No. 2, May 1996, pp. 7-21
- <sup>4</sup> U.S. General Accounting Office, *Guidelines for Rescuing Large Failing Firms and Municipalities*, GAO/GGD-84-34, March 29, 1984.
- <sup>5</sup> As one study observes: "Although the [guaranteed student loan] program makes heavy use of the nation's private credit system, the private banks in the program act not as sellers in a market system but as administrative agents in a centralized bureaucracy." Michael S. McPherson and Morton Owen Schapiro, *Keeping College Affordable*. Washington, DC: Brookings Institution, 1991, pp. 159-60. Since that statement was written, the student loan program has increased risk sharing with lenders, but only modestly.
- <sup>6</sup> Office of Management and Budget, Executive Office of the President. *Policies for Federal Credit Programs and Non-Tax Receivables*. Circular A-129. Washington, DC, 1993, p. 30.
- <sup>7</sup> Personal communication from Arthur Hauptman, consultant to the World Bank, May 2000.
- <sup>8</sup> Roy A. Foulke, *The Sinews of American Commerce*. New York: Dun & Bradstreet, Inc., 1941, p. 57.
- <sup>9</sup> Carter Goodrich, *Government Promotion of American Canals and Railroads 1800-1890*. New York: Columbia University, 1960, p. 13; Foulke, pp. 211-212.
- <sup>10</sup> Woodbury Willoughby, *The Capital Issues Committee and War Finance Corporation*. Baltimore: Johns Hopkins, 1934, p. 48; James Stuart Olson, *Herbert Hoover and the Reconstruction Finance Corporation 1931-1933*. Ames, IA: Iowa State University, 1977, p. 12.
- <sup>11</sup> R.J. Saulnier, Harold G. Halcrow, and Neil H. Jacoby, *Federal Lending and Loan Insurance*. Princeton: Princeton University Press, 1958, pp. 14-15, 58.
- <sup>12</sup> Jerry Mitchell, *The American Experiment With Government Corporations*. Armonk, NY: M.E. Sharpe, Inc., 1999, p. 17; Donald Axelrod, *Shadow Government: The Hidden World of Public Authorities*. New York: Wiley, 1992.
- <sup>13</sup> James J. Mikesell and George B. Wallace. *Are Revolving Loan Funds A Better Way to Finance Rural Development?* Economic Research Service, U.S. Department of Agriculture. Agriculture Information Bulletin No. 724-05, October 1996; and John Petersen, *A Primer on State Bond Banks in the United States*.

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*First Conference on Capital Market Development at the Subnational Level: Local Strategies to Access Financial Markets*. Santander, Spain, October 15, 1998.

<sup>14</sup> Government Housing Loan Corporation website at [http://www.mof.go.jp/zaito/zaito99/kikan99\\_e/kikan99\\_10\\_e.htm](http://www.mof.go.jp/zaito/zaito99/kikan99_e/kikan99_10_e.htm)

<sup>15</sup> Douglas B. Diamond, Jr., and Michael J. Lea, *Housing Finance in Developed Countries: An International Comparison of Efficiency*. Special Issue, *Journal of Housing Research*. Vol. 3, No. 1, 1992.

<sup>16</sup> James Tooley, *The Global Education Industry: Lessons from Private Education in Developing Countries*. Washington, DC: International Finance Corporation, 1999, p. 111.

<sup>17</sup> See, Nicholas Lardy, *China's Unfinished Economic Revolution*. Washington, DC: Brookings Institution, 1998

<sup>18</sup> George Heberton Evans, Jr., *British Corporation Finance 1775-1850: A Study of Preference Shares*. Baltimore: Johns Hopkins, 1936

<sup>19</sup> Thomas H. Stanton, "Credit Scoring and Loan Scoring: Tools for Improved Management of Federal Credit Programs." Arlington, VA: PricewaterhouseCoopers Endowment, 1999.

<sup>20</sup> Financial Management Service, U.S. Department of the Treasury, October 1-3, 1996, **Workshop on Promising Practices: Transcribed Proceedings**, p. IX-1. Transcripts of the three-day workshop are available at <http://www.financenet.gov/financenet/fed/fcpwg/reports.htm>; Thomas H. Stanton, "Managing Federal Credit Programs in the Information Age: Opportunities and Risks," *The Financier: Analyses of Capital and Money Market Transactions*, Vol. 5, Nos. 2&3, Summer/Autumn 1998, pp. 24-39

<sup>21</sup> Financial Management Service, *Ibid.*, 1996, p. IX-4.

<sup>22</sup> Lardy, 1998.

<sup>23</sup> Office of Management and Budget, 1993 p. 29

<sup>24</sup> *Inside Mortgage Finance*, "HMDA Data Show Denial Rates Edged Lower for All Racial Groups in Soaring Mortgage Market of 1998," August 6, 1999. Because of variations in the quality of reporting, HMDA data (required to be reported under the Home Mortgage Disclosure Act) can be taken only as rough approximations of the underlying statistics.

<sup>25</sup> Elisabeth Holmes Rhyne, *Small Business, Banks, and SBA Loan Guarantees*. New York: Quorum, 1986, p. 26.

<sup>26</sup> *Ibid*, p. 25

<sup>27</sup> Financial Management Service, U.S. Department of the Treasury, October 1-3, 1996

<sup>28</sup> Price Waterhouse. *An Actuarial Review for Fiscal Year 1997 of the Federal Housing Administration's Mutual Mortgage Insurance Fund: Final Report*. Washington, DC, February 19, 1998, at p. 7.

<sup>29</sup> See, generally, Stanton, 1999.

<sup>30</sup> Office of Management and Budget, Executive Office of the President. "FY 1996 Passback: Department of Housing and Urban Development." Washington, DC, November 21, 1994, pp. 21-22.

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<sup>31</sup> See, Kerry D. Vandell, "FHA Restructuring Proposals: Alternatives and Implications," *Housing Policy Debate*, Vol. 6, No. 2, 1995, pp. 291-393, for an excellent discussion of this and other proposals for increasing the capacity of FHA.

<sup>32</sup> Charles Dodson, "Is More Credit the Best Way to Assist Beginning Low-Equity Farmers ?" Economic Research Service, U.S. Department of Agriculture. Agriculture Information Bulletin No. 724-04. August 1996

<sup>33</sup> Financial Management Service, 1996, p. IX-20.

<sup>34</sup> U.S. General Accounting Office. *Higher Education: Restructuring Student Aid Could Reduce Low-Income Student Dropout Rate*. GAO/HEHS 95-48. Washington, DC, March 1995

<sup>35</sup> Jamil Salmi, *Student Loans in an International Perspective: The World Bank Experience*. draft working paper, Washington, DC: World Bank, 1999

<sup>36</sup> Quoted U.S. Department of Housing and Urban Development. *Housing in the Seventies*. Report of the National Housing Policy Review, Washington, DC: GPO, 1974, p. 83.

<sup>37</sup> Lester M. Salamon, Editor, with Michael S. Lund, *Beyond Privatization: The Tools of Government Action*. Washington, DC: Urban Institute, 1989, p. 18.