I

Background

Government credit programs are intended to meet various social and economic objectives. By providing more favorable terms than are available from private lenders, credit programs assist borrowers, including some who could not obtain funds otherwise. To overcome the private lender perception that particular credit investments are unnecessary, two explanations are usually given in the defense of these programs. First, a market imperfection, such as bias or lack of information, may prevent normal, profitable market transactions from occurring between lenders and borrowers. Second, lenders may withhold credit when the payoffs of such an investment are judged to be below a normal market return. Credit programs are developed to address perceived market failures which affect the availability of capital in markets where some public interest is at stake.

One way government can try to protect the public interest, through the promotion of desired activities in areas such as housing, education, agriculture, exports, regional development and industry, is to increase the credit available to finance those activities. Government uses many tools to do this, including loan guarantees and direct loans. Guaranteed loans have taken on an increasingly important role as a policy tool, replacing direct intervention as the government's preferred method of involvement in markets.

Guarantee programs are generally intended to facilitate the investment of private capital in a market. A loan guarantee guarantees a lender that, should a borrower default, the government will repay the amount guaranteed, subject to the terms and conditions of an agreement. Because the guarantee reduces the lender's risk, the borrower should be able to obtain funds at a lower interest rate, or negotiate a loan that might otherwise be unobtainable. By providing access to capital on favorable terms, the government, in effect, provides a subsidy.

The guarantee is intended to reduce costs or to channel more credit toward favored activities. The availability of additional credit is intended to give borrowers both the means and the incentive for activities that will achieve the government's desired program objectives.

The prototype loan guarantee in the United States is the Federal Housing Administration (FHA) mortgage insurance program, created by the National Housing Act of 1934, to restore stability to housing markets badly shaken by the volatility of the Great Depression. In the mid-1940s, the Veterans Administration also began to insure home mortgages and by 1950, 97% of new federal loan guarantees went to housing-related loans. In the 1950s, loan guarantees were introduced into agriculture and rural development, domestic business assistance, and export assistance. They were extended to foreign investment, international aid, education, and health policy in the 1960s, and in the 1970s began to be used for energy development, transportation, and the fiscal relief of local governments. By the 1980s, the federal government operated guarantees for a wide range of societal purposes and a diverse clientele. There are now 12 federal departments or agencies that operate loan guarantee programs in the United States. The uses of the loan guarantee tool in the United States now range from the Department of Agriculture's guarantees of farm operation and operating loans, farm housing, and farm business and industry loans, to the Department of Health and Human Service's guarantees to health maintenance organizations for expanding health care delivery. The borrowers served include homeowners, farmers, students, small businesses, foreign exporters, public utilities, shipbuilders, railroads, and state, local, and foreign governments.

A. Credit Reform

The primary political appeal of loan guarantees to governments is their apparent lack of cost. Loan guarantees do not involve immediate cash spending by the government. For this reason, they can be a more attractive tool to the government than direct loans or grants, particularly in periods of fiscal restraint. In theory loan guarantees require less of a budget outlay. However, they can generate sizable financial obligations and significantly affect the government's fiscal framework. An understanding of the magnitude and nature of these risks is critical to the management of and the policy decision making for public financial guarantee programs.

The Federal Credit Reform Act of 1990 was passed by the United States Congress in recognition of the fact that there are costs associated with guarantee programs. The act required new accounting procedures to capture these costs by mandating that the estimated cost arising from the direct and guaranteed loans of a program be calculated on a net present value basis, excluding administrative costs. For most programs, direct loan obligations and loan guarantee commitments cannot be made unless appropriations for the cost have been provided in advance through annual appropriations acts. In addition, annual limitations on the amount of obligations and commitments may be enacted as part of the appropriation language.

Credit reform was necessary in the United States because the previous accounting methods were based on current cash flows, and hence did not reveal the true costs of credit activities, such as the subsidized costs over the life of the loan, at the time they were undertaken. Prior to the enactment of the Federal Credit Reform Act, loan guarantees did not require advance appropriations, and had no impact on the budget until a default occurred. Payments which resulted from defaults on a guaranteed loan were simply treated as budgetary outlays when they were actually made.

Credit reform expands the existing information on cash flows from direct loan obligations and loan guarantees to identify the net present value of the subsidy costs of these transactions. This new procedure attempts to recognize the costs of providing credit at the time the costs are incurred. This treatment insulates both budget outlays and the deficit from the effects of government financing of the nonsubsidized part of credit transactions. As a result, credit reform makes comparable the net costs of credit and noncredit activity.

While the Canadian federal programs are not affected by the Credit Reform Act, Canadian officials have also recently adjusted the procedure by which they record the obligations incurred when loans are guaranteed. In 1992, the Auditor General of Canada released a report which recommended that the federal government account for loan guarantee costs by establishing reserves. At that time, the government did not recognize any of the loan guarantee costs for which the government could be held liable until it was forced to honor the guarantees. The Canadian government has updated its policy since the release of the Auditor's report and it now includes the accrued costs of loan guarantees in the government's financial statements.

B. Conclusion

The use of guaranteed loans as government policy tools is not without controversy. Proponents of their use argue that they serve a necessary function by providing funds in market areas in which social benefits exceed social costs, but in which private lenders are unable or unwilling to provide capital. However, critics argue that guarantees interfere with the market and do not increase the credit supplied for a particular public purpose, but merely subsidize lenders for loans they would have extended anyway. In addition, critics claim that guarantees underwrite inefficient activities and "crowd out" other, more productive borrowers, thus decreasing national productivity and increasing the probability of unintended effects. Clearly, a better understanding of the costs and risks associated with each individual program is essential to the effectiveness of loan guarantees. When effectively designed and adapted to problems that are appropriately defined and understood, loan guarantees can be a workable, effective policy tool.