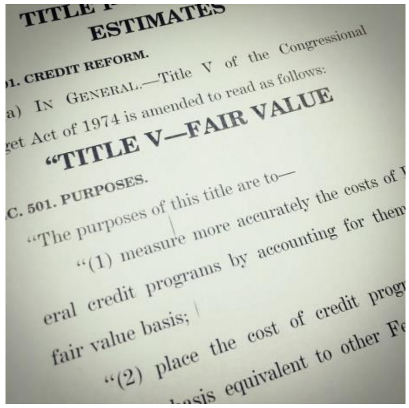

Fair Value in Federal Credit

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Executive Summary

For many years, the budgeting of Federal Credit programs has been governed by the Federal Credit Reform Act of 1990 (FCRA), whereas most private sector financial institutions have used fair value to report the value of their assets and liabilities. Recent initiatives may require the budgetary costs of Federal Credit programs to reflect the fair value of the related loans or loan guarantees.

These initiatives raise a number of questions regarding the implementation of fair value for estimating the cost of Federal programs. In this paper, we explore the implications of applying fair value accounting for the budgeting of Federal loan programs.

1. Valuation of Federal Credit

Under FCRA, loans and loan guarantees are valued at their net present value of future cash flows, and the most significant factors that affect a loan program's cost over time are interest rates and loan performance. Accordingly, changes in the market value of loans and loan liabilities from other market factors do not directly affect the budgetary cost of Federal loans and guarantees. In contrast, fair value requires that assets and liabilities be valued at the appropriate exchange price in an orderly market transaction and will incorporate these other factors. In general, private sector investments "available-for-sale" are valued using fair value, and investments intended to be held to maturity are valued at amortized cost.

For many private sector entities, market values for similar assets are widely available for implementing fair value accounting. However, because many Federal Credit programs exist to fill gaps in the private marketplace, identifying similar assets for valuation in the private market is challenging. Moreover, most Federal direct loans and loan guarantees are usually held on the Federal agency's balance sheet rather than sold in the marketplace. These unique characteristics mean that developing the budgetary cost using the fair value valuation may not be as simple as fair value valuation of private market assets. As a result, the estimated costs of these Federal programs may lack precision, leading to less reliability, consistency, and usefulness in the results for effective decision making purposes.

2. Implementation Effects and Challenges

Recent studies conducted by the Congressional Budget Office (CBO) have estimated that applying fair value to Federal lending is likely to increase program subsidy costs[1]. These increases in subsidy cost may pose challenges to Federal programs, potentially requiring changes in borrower terms.

Furthermore, the costs of Federal programs are likely to become more volatile as they incorporate the market value of assets and liabilities. Increased volatility from the implementation of fair value means that Federal agencies will need to operate programs in subsidy environments that may shift widely from year to year due to market fluctuations. This volatility may also make certain programs' costs less reliable and perhaps less useful than under the current methodology.

3. Financial Reporting Effects

Requirements to use fair value for budgeting for Federal lending are not binding for Federal financial statement valuation purposes. The application of different accounting standards may result in gaps between budgetary costs and those stated in agencies' financial statements.

[1] Likewise, many supporters of fair value for Federal lending hold that without fair value, costs are underestimated.

How are Federal Credit Program Costs Currently Determined?

The costs of Federal direct loan and loan guarantee programs are currently budgeted for pursuant to the Federal Credit Reform Act of 1990 (FCRA), as amended. This law was enacted to bring budget parity to Federal Credit programs, especially between loan guarantees (which may not require a cash outlay or inflow for many years) and direct loans (which have an up-front disbursement) by determining the net cost to the taxpayer at the time the loan or guarantee is approved.

The FCRA method uses the net present value of cash flows over the life of the loan or guarantee to estimate program costs. This method includes all observed and estimated future cash inflows and outflows (such as loan guarantee payments, principal and interest (net of defaults), recoveries, and prepayments) to the Federal Government associated with a loan or group of loans, over its lifetime. These cash flows are discounted at the approximate cost of Treasury borrowing over an equivalent maturity period, which is fixed once the loan is substantially disbursed.

The FCRA method of estimating subsidy cost is used across all Federal Credit programs, and is made consistent through the use of the same Treasury discount rate tables issued to agencies for use in their budget formulation and financial reporting processes. Program cost estimates are made and reevaluated across the life of the loans to ensure the program cost reflects ongoing program updates and developments in the borrower credit profile.

Fundamentally, FCRA relies on measuring cash outflows and inflows to measure and establish net cost. The tradable market value of the credit instrument does not drive or determine the cost under FCRA.

What is Fair Value and when is it Used?

Fair value is described as an entry or exit price, or the price at which a willing buyer and seller would agree to exchange an asset or liability in an orderly market. There are various techniques available to determine fair value depending on the availability of an independently determined price for such exchange.

Financial accounting standard setters are consistent in their requirements for the use of fair value. The International Public Sector Accounting Standards Board notes that market value "is particularly appropriate when…the asset is being held with a view to sale."

For general financial reporting purposes, state and local governments are required to value only their tradable investments at fair value. The fair value of other assets and liabilities are disclosed in the footnotes, but do not drive values reported in their principal financial statements.

Investments held by Federal agencies intended to be held to their maturity are valued at their amortized cost, while securities available for sale are valued at fair value.

When is Fair Value Accounting Appropriate?

The Federal Accounting Standards Advisory Board (FASAB) outlines a number of considerations related to the use of fair value accounting in Federal financial reporting. FASAB notes that Federal financial statements have traditionally followed a "mixed-attribute" model with assets such as property and equipment being valued at "initial amounts" (e.g. historical cost, as adjusted for depreciation, depletion, etc.), and others, such as loans and loan guarantees, reported at remeasured amounts.

Although the value of loans and loan guarantees are "remeasured" under FCRA, they are not reported at fair value. FASAB also notes fair value is only one of several potential measurement methods available for financial reporting (e.g. replacement cost, etc.), although it is an alternative to traditional cost-based accounting.

With respect to the specific use of fair value, FASAB notes:

> *When market values can be used, amounts that are remeasured at fair value generally are high in relevance, reliability, and understandability, and in their comparability to equivalent amounts reported by other entities and their contribution to timely reporting. When fair value must be estimated, the degree to which the qualitative characteristics are met vary depending on the availability of information about similar assets and liabilities and the degree of estimation required.*[2]

The use of remeasured amounts in financial reporting is perceived to be more meaningful in assessing an entity's financial position, service potential, and ability to meet obligations when due. Reporting the difference between the initial amount of an asset or liability and its remeasured value, or holding gains or losses, can help users in:

- Fulfilling financial reporting objectives by providing the information to various users on the economic results of decisions to hold rather than sell assets,
- Understanding the costs of programs and activities based on changing costs, and
- Assessing the efficiency and effectiveness of the management of the entity's assets and liabilities, including whether a change in financial position resulted from management's operating decisions or from changes in prices beyond management's control.

What Information Would Be Provided by Using Fair Value Accounting for Federal Credit Programs?

Using the fair value method for valuing the initial and remeasured amounts for Federal direct loans and loan guarantees would provide users with information related to several areas not considered in the current standards.

Current fixed discount rate environment: The current methodology for establishing the discount rate for Federal direct loans and loan guarantees under FCRA involves setting a fixed discount rate once a given cohort of loans is 90% disbursed, based on the average maturity of the cohort of loans. This approach assumes that Treasury actually borrows funds from the public in debt terms that match the portfolio. However, Treasury typically borrows debt with maturities unrelated to Federal lending. Valuing the Federal loan portfolio based on Treasury's average borrowing rate with the public would significantly change the value of existing loans as the borrowing rate changes over time.

Inherent uncertainty in the performance of an asset or liability: Many Federal Credit programs exist precisely because there is no market for the asset or liability due to the risk and uncertainty in the performance of a loan. Market valuations can be significantly affected by this uncertainty. For example, although current Federal standards may value a $1,000 mortgage loan, crop loan, or a business loan with the same expected terms and performance similarly, market values for each loan could differ due to the risk of deviations from those expectations.

[2] Statement of Federal Financial Accounting Concepts 7: *Measurement of the Elements of Accrual Based Financial Statements in Periods after Initial Recording,* paragraph 42

Differences in performance: Assets may produce different cash flows if held by the private market than if held by the Federal Government. A simple example of this difference is the ability of the Federal Government to collect on defaulted debts through the use of the Treasury Offset Program, which results in higher recoveries, and thus a higher valuation to the Federal Government than to a private market participant.

Supply and demand: Market values for a given asset can also vary depending on other macroeconomic factors. For example, the market prices for equivalent mortgage loans can vary as the availability of credit or regulatory requirements changes.

Incorporating the market value of these assets in connection with the budget process would likely introduce private sector volatility and market risk factors that would not impact the Federal Credit programs directly unless they intended to sell the loans or guarantees in an open market environment.

Fair Value Implementation and Likely Effects

The unique nature of different types of Federal direct loans and loan guarantees will make the determination of their true "market" values challenging. Commercial accounting standards require assets' and liabilities' fair values be classified into three different categories based on the reliability of the valuation techniques used:

- **Level One Inputs:** These inputs come from observable market data (market prices) in the market in which the asset or liability would be exchanged.
- **Level Two Inputs:** These inputs come from observable market data falling in markets where the asset is not traded, but markets that have similar characteristics or necessary data inputs for the development of reasonable fair value estimates.
- **Level Three Inputs:** These inputs are unobservable in markets. Such inputs could include required returns, inputs derived from an entity's proprietary data, reasonable estimates of exit prices, or other unobservable data.

Each Federal agency would be required to determine whether there are observable inputs that can be used in valuing the portfolio and then determine which valuation technique is appropriate based on the availability of those inputs. Although there may not be a readily available market price for many of the Federal Government's loans, there are tools available from various ratings and consulting firms than can be used to obtain reasonable market prices for these assets and liabilities that would likely meet the Level Two category.

If a Level Three approach to valuing a portfolio is required, the agency would need to document its assessment of how each valuation assumption would be affected by market participation (e.g. default rate, prepayment rate, recovery rates, discount rates, etc.). Different performance factors identified in similar assets or liabilities in the market place might be used as proxies to support management's informed opinion for selected assumptions, as is currently provided for in Federal accounting standards for loan programs.

Implementation Impacts on Federal Credit Programs

Using the current valuation method prescribed by FCRA, certain high-quality loans can have a valuation that exceeds the loan principal amount. Likewise, under FCRA, certain loan guarantees have liabilities that are less than the fees collected from the borrower, resulting in a net asset to the government. For these credit instruments, the interest rates and/or fees paid by the borrower to the Federal Government are more than sufficient to fund the loss reserve for that loan or guarantee, eliminating the need for appropriation to fund loss reserves.

Many of these programs have a long history of not requiring appropriations, and policymakers have never been required to fund the loss reserves of these programs using appropriations. These programs are referred to as “zero subsidy” or “negative subsidy” programs because their cost to the taxpayer is zero or even negative.

However, applying fair value valuation methods will likely reduce the value of direct loans and increase the value of loan guarantee liabilities. If policymakers are unwilling to make up the difference in cost by providing appropriations to keep these zero/negative subsidy programs, then the terms and conditions of the loan or guarantee will have to be less generous to the borrower to maintain the zero/negative cost and avoid the need for an appropriation of taxpayer funds. Below is a list of changes to terms and conditions that may be considered to maintain zero/negative subsidy in a fair value environment:

Direct Loans:

- Shorter maturities
- Higher borrower interest rates
- New/more fees charged to the borrower
- Tighter underwriting standards, leading to lower credit risk
- Stronger collateral provisions, leading to stronger recoveries in the event of default

Loan Guarantees:

- Shorter maturities
- Reduced risk share by Federal Government and more risk share by private lender
- New/more fees charged to the borrower
- Tighter underwriting standards required of lenders, leading to lower credit risk
- Stronger collateral provisions required of lenders, leading to stronger recoveries in the event of default

Implementation Impacts on Federal Budget Preparation Schedule

Implementation of fair value does not change the cyclical production schedule of either the President’s Budget or the agency’s financial statements. The audited financial statements will still be published annually by November 15th and the President’s Budget will still be delivered to the Congress by the first Monday in February.

If the President’s Budget were to reflect fair value accounting for the 2017 fiscal year (FY), the FY 2017 budget would be submitted to the Congress on February 1st, 2016. The timing of the budget preparation cycle would require Federal agencies to use fair value accounting to produce estimates in the fall of 2015.

Furthermore, credit valuations as of September 30th, 2015 may be required to reflect fair value principles and, if so, all existing credit valuations would need to be reestimated to reflect the change. Given fair value’s expected effect of a fall in valuations and an increase in loan guarantee liability, significant funding would be drawn under the “permanent and indefinite appropriation” provisions of FCRA during FY 2016. Additionally, estimates for future loan-making in FY 2017 would also forecast higher costs and/or less generous terms offered to borrowers.

To accommodate Office of Management and Budget (OMB) oversight and final preparation of the budget, this timing could cause an immediate and acute need for system-wide fair value valuations to be completed no later than fall 2015, assuming enactment in mid-FY 2015. Given that budget offices have little experience in developing fair value estimates, complying with this requirement could be challenging and perhaps unrealistic, especially for small and thinly staffed programs.

We note, however, that it is unlikely for similar changes in the preparation of financial statements to be implemented within the same timeframe. As a result, discrepancies between reported values in the President's Budget and agency financial statements are likely in the first years after enactment.

Financial Reporting under Fair Value

Accounting standards for direct loans and loan guarantees are prescribed by FASAB, but effectively follow the requirements of FCRA. So while currently there is consistency in how direct loans and loan guarantees are valued for budget and financial reporting purposes, there is no specific requirement for them to be consistent.

If the President's Budget used fair value to value the cost of loans and guarantees while the financial statement preparers continued to rely upon FCRA, the program cost recognized in the agency's Statement of Net Cost would theoretically be determined using the FCRA methodology, while the budgetary transactions and funding would be based on the fair value cost. The financial statements would then reflect an unfunded liability to (or receivable from) the Treasury General Fund that would not be the same as the amount of subsidy transferred in the subsequent year, as would be the case if the valuation methodologies are the same. The ongoing inconsistency between these approaches could eventually cause significant distortion in the financial statements and impact their usefulness.

Budgeted program cost rates approved by OMB are presented in the footnotes to the financial statements and the footnote disclosure could be readily expanded to present the cost rate based on current FCRA methodology, as well as the rates based on fair value calculations.

Based on FASAB's current Three-Year Plan[3], there is no intention to reexamine the value of fair value reporting for general purpose financial reporting purposes, but the topic would likely need to be reconsidered.

Preparing for Fair Value

Unless and until fair value for Federal Credit budgeting is required by law, extensive preparation by Federal agencies is unwarranted. However, prudent steps can be taken to prepare program and Office of the Chief Financial Officer (OCFO) staff and other stakeholders for fair value accounting if it becomes law. Below are some recommendations:

- Set periodic meetings for senior leaders to follow the legislation and monitor changing bill language. Federal Credit program leaders should be following fair value bills.
- Set meetings with auditors, and notify them that your agency is monitoring fair value bills and taking actions to prepare. Get feedback from your auditor about how to prepare. Your auditor may not be aware of the fair value bills. If not, make them aware as additional time for preparation is good for both the agency and the auditor.

[3] http://www.fasab.gov/pdffiles/annual_report_2012.pdf

- Identify which credit program expenses are "essential preservation expenses," as the fair value bills add these expenses to the valuation of Federal Credit. Segregating and identifying these expenses may be time-consuming and require recalibration of accounting data and systems. Advance planning could be helpful.
- Asset and liability valuation:
    - Assess the availability of data on comparable commercial market loans from orderly markets to value assets (direct loans) or liabilities (loan guarantees).
    - Determine the appropriate level of fair value data input available (Level 1, 2, or 3).
    - Estimate the fair value of a small subset of the loan portfolio according to the leveled approach discussed above.
    - Establish fair value estimates for selected assets/liabilities and compare to the FCRA-based value. The difference will be the estimated change in subsidy required for the portfolio.
- Use asset and liability valuation results to develop a reasonable preliminary estimate of the program portfolio (direct loan or loan guarantee) valuation reestimate.
- Consider providing further training for agency budget analysts.

Unanswered Questions and Outstanding Issues

The introduction of current fair value bills raises a host of questions related to the use of fair value accounting in the Federal Government. These unanswered questions and outstanding issues will need to be tackled in the event that fair value budgeting for Federal Credit is implemented. We anticipate further developments on the topic of fair value accounting for Federal Credit programs, as well as actions from OMB and FASAB to address some of these items.

1. **Has the cost/benefit of implementing fair value accounting for Federal Government been fully considered and documented? When would fair value information be useful?**

Providing fair value costs would give lawmakers information on what the private sector would require to issue a similar loan or guarantee, which could be useful in determining the extent to which the Federal Government competes with the private sector for similar loans. However, the willingness and capacity of the private market to provide similar services must be considered.

2. **Does this represent a significant change in the Federal Government's intention to hold its credit program assets to maturity?**

Consistent with how fair value is applied in the private sector, this change would seem appropriate if the intention of the Federal Government is to sell its loans and guarantees on the open market after they have been disbursed. But one of the primary reasons the Federal Government sponsors many of these programs is an unwillingness of the private sector to provide these loans and guarantees without a significant discount. Such costs would be recognized now under fair value even if the decision to sell these assets does not occur immediately, or ever.

While providing this information in supplemental tables in the President's Budget would benefit lawmakers in their resource allocation process, appropriating loan program costs based on this approach is inconsistent with current accounting practices.

3. **Is there an alternative method to calculate the cost of Federal Credit programs?**

Assuming the intention is to hold these assets to maturity, the current FCRA process uses a fixed discount rate set at 90% disbursement that does not reflect the Federal Government's current cost of borrowing. Using the current weighted average interest rate of all Treasury debt held by the public as the discount rate under the FCRA methodology would provide a more appropriate representation of the current cost of the Federal Government's capital needed to maintain these assets and liabilities on the balance sheet.

4. Will Federal agencies' financial statements be prepared using fair value accounting? What would this timing look like?

There is no guarantee that FASAB will adopt fair value accounting for Federal financial reporting if budgeting under fair value becomes law. If fair value is not adopted, this inconsistency would result in a mismatch between actual subsidy amounts transferred to and from the program and the costs of the program as calculated. Such inconsistency seems to contradict the objectives of Federal financial reporting.

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