

7. CREDIT AND INSURANCE

Federal credit programs offer direct loans and loan guarantees for a wide range of activities, primarily housing, education, business and community development, and exports. At the end of 2004, there were \$219 billion in Federal direct loans outstanding and \$1,231 billion in loan guarantees. Through its insurance programs, the Federal Government insures bank, thrift, and credit union deposits, guarantees private defined-benefit pensions, and insures against other risks such as natural disasters, all up to certain limits.

The Federal Government also enhances credit availability for targeted sectors indirectly through Government-Sponsored Enterprises (GSEs)—privately owned companies and cooperatives that operate under Federal charters. GSEs increase liquidity by guaranteeing and securitizing loans, as well as by providing direct loans. In return for serving social purposes, GSEs enjoy many privileges which differ across GSEs. In general, GSEs can borrow from Treasury in amounts ranging up to \$4 billion at Treasury's discretion, GSEs' corporate earnings are exempt from State and local income taxation, GSE securities are exempt from SEC registration, and banks and thrifts are allowed to hold GSE securities in unlimited amounts and use them to collateralize public deposits. These privileges leave many people with the impression that GSE securities are risk-free. GSEs, however, are not part of the Federal Government, and their securities are not federally guaranteed. By law, GSE securities carry a disclaimer of any U.S. obligation.

This chapter discusses the roles and risks of these diverse programs in the context of evolving financial markets and assesses their effectiveness and efficiency.

- The first section analyzes the roles of Federal credit and insurance programs. Federal programs play useful roles when market imperfections prevent the private market from efficiently providing credit and insurance. Financial evolution has partly corrected many imperfections and generally weakened the justification for Federal intervention. The roles of Federal programs, however, may still be critical in some areas.
- The second section examines how credit and insurance programs were gauged by the Program Assessment Rating Tool (PART) and discusses special features of credit programs that may need to be considered in interpreting and refining this tool.
- The third section discusses Federal credit programs and GSEs in four sectors: housing, education, business and community development, and exports. The discussions focus on program objectives, recent developments, performance, and future plans for each program.
- The final section reviews Federal deposit insurance, pension guarantees, disaster insurance, and insurance against terrorism and other security-related risks in a context similar to that for credit programs.

I. FEDERAL PROGRAMS IN CHANGING FINANCIAL MARKETS

The Federal Role

In most cases, private lending and insurance companies efficiently meet societal demands by allocating resources to the most productive uses. Market imperfections, however, can cause inadequate provision of credit or insurance in some sectors. Federal credit and insurance programs improve economic efficiency if they effectively fill the gaps created by market imperfections. On the other hand, Federal credit and insurance programs that have little to do with correcting market imperfections may be ineffective, or can even be counter-productive; they may simply do what the private sector would have done in their absence, or interfere with what the private sector would have done better. Federal credit and insurance programs also help disadvantaged groups. This role alone, however, may not be enough to justify credit and insurance programs. For the purpose of helping disadvantaged groups, direct subsidies are generally more effective and less distortionary.

Market imperfections that can justify Federal intervention include insufficient information, limited ability to secure resources, imperfect competition, and externalities.

Insufficient Information. Financial intermediaries promote economic growth by allocating credit to the most productive uses. This critical function, however, may not be performed effectively when there is little objective information about borrowers. Some groups of borrowers, such as start-up businesses, start-up farmers, and students, have limited incomes and credit histories. Many creditworthy borrowers belonging to these groups may fail to obtain credit or be forced to pay excessively high interest. Government intervention, such as loan guarantees, can reduce this inefficiency by enabling these borrowers to obtain credit more easily and cheaply and also by providing opportunities for lenders to learn more about those borrowers.

Limited Ability to Secure Resources. The ability of private entities to absorb losses is more limited than

that of the Federal Government, which has general taxing authority. For some events potentially involving a very large loss concentrated in a short time period, therefore, Government insurance commanding more resources can be more credible and effective. Such events include massive bank failures and some natural and man-made disasters that can threaten the solvency of private insurers. Private entities also face some liquidity constraints. Small lenders operating in a local market, for example, may have limited access to capital and occasionally be forced to pass up good lending opportunities.

Imperfect competition. Competition is imperfect in some markets because of barriers to entry, economies of scale, and foreign government intervention. If the lack of competition forces some borrowers to pay excessively high interest on loans, Government credit programs aiming to increase the availability of credit and lower the borrowing cost in those markets may improve economic efficiency.

Externalities. Decisions at the individual level are not socially optimal when individuals do not capture the full benefit (positive externalities) or bear the full cost (negative externalities) of their activities. Examples of positive and negative externalities are education and pollution. The general public benefits from the high productivity and good citizenship of a well-educated person and suffers from pollution. Without Government intervention, people will engage less than socially optimal in activities that generate positive externalities and more in activities that generate negative externalities. Federal programs can address externalities by influencing individuals' incentives.

Effects of Changing Financial Markets

Financial markets have become much more efficient, thanks to technological advances and financial services deregulation. By facilitating the gathering and processing of information and lowering transaction costs, technological advances have significantly contributed to improving the screening of credit and insurance applicants, enhancing liquidity, refining risk management, and spurring competition. Deregulation, represented by the Riegle-Neal Interstate Banking and Branching Act of 1997 and the Financial Services Modernization Act of 1999, has increased competition and prompted consolidation by removing geographic and industry barriers.

These changes have reduced market imperfections, and hence weakened the role of Federal credit and insurance programs. The private market now has more information and better technology to process it, has better means to secure resources, and is more competitive. As a result, the private market is more willing and able to serve the populations traditionally targeted by Federal programs. The benefits of technological advances and deregulation, however, have been uneven across sectors and populations. To remain effective, therefore, Federal credit and insurance programs need to focus more narrowly on those sectors that have been

less affected by financial evolution and those populations that still have difficulty in obtaining credit from private lenders. The Federal Government also needs to pay more attention to new challenges introduced by financial evolution and other economic developments. Even those changes that are beneficial overall often bring new risks and challenges.

The Federal role of alleviating the information problem is generally not as important as it once was. Nowadays, lenders and insurers have easy access to large databases, powerful computing devices, and sophisticated analytical models. This advancement in communication and information processing technology enables lenders to evaluate the risk of borrowers more objectively and accurately. As a result, creditworthy borrowers are less likely to be turned down, while high-risk borrowers are less likely to be approved for credit. The improvement, however, may be uneven across sectors. The prevalence of credit scoring (an automated process that converts relevant borrower characteristics into a numerical score indicating creditworthiness) is a good sign that the information problem is not serious. Credit scoring is widely applied to home mortgages and consumer loans, but for small business loans and agricultural loans, its application is largely limited to small loans. Credit scoring is still difficult to apply to some borrowers with unique characteristics that are difficult to standardize.

Financial evolution has also alleviated resource constraints faced by private entities. Advanced financial instruments have enabled lenders and insurers to manage risks more effectively and secure needed funds more easily. Thus, it is less likely that a large potential loss discourages an insurer from offering an actuarially fair contract or that the lack of liquid funds prevents a lender from lending to creditworthy borrowers. Financial derivatives, such as options, swaps, and futures, have improved the market's ability to manage and share various types of risk such as price risk, interest rate risk, credit risk, and even catastrophe-related risk. An insurer can distribute the risk of a natural or man-made catastrophe among a large number of investors through catastrophe-related derivatives. The extent of risk sharing in this way, however, is still limited because of the small size of the market for those products. Securitization (pooling a certain type of asset and selling shares of the asset pool to investors) facilitates fund raising and risk management. By securitizing loans, even a lender with limited access to capital can make a large amount of loans while limiting its exposure to credit and interest risk.

Imperfect competition is much less likely in general, thanks to financial deregulation and improved communication technology. Financial deregulation removed geographic and industry barriers to competition. As a result, major financial holding companies offer both banking and insurance products nationwide. Internet-based financial services have lowered the cost of financial transactions and reduced the importance of physical location. These developments have been particularly

more beneficial to small and geographically isolated customers, as lower transaction costs make it easier to offer good prices to small customers. In addition, there are more financing alternatives for both commercial and individual borrowers that used to rely heavily on banks. Many commercial firms borrow directly in capital markets, bypassing financial intermediaries; the use of commercial paper (short-term financing instruments issued by corporations) has been particularly notable. Venture capital has become a much more important financing source for small businesses. Finance companies have gained market shares both in business and consumer financing.

Problems related to externalities may persist because the price mechanisms that drive the private market ignore the value of externalities. Externalities, however, are a general market failure, rather than a financial market failure. Thus, credit and insurance programs are not necessarily the best means to address externalities, and their effectiveness should be compared with other forms of Government intervention, such as tax incentives and grants. In particular, if a credit program was initially intended to address multiple problems including externalities, and those other problems have been alleviated, then there may be a better way to address the remaining externalities.

Overall, the financial market has become more efficient and safer. Financial evolution and other economic

developments, however, are often accompanied by new risks. In addition, security-related risks unexpectedly emerged in recent years, prompting Government intervention. Federal agencies need to be vigilant to identify and manage new risks to the Budget. For example, financial derivatives enable their users either to decrease or to increase risk exposure. If some beneficiaries of Federal programs use financial derivatives to take more risk, the costs of Federal programs, especially insurance programs, can rise sharply. The sheer size of some financial institutions has also created a new risk. While well-diversified institutions are generally safer, even a single failure of a large private institution or a GSE, such as Fannie Mae, Freddie Mac, and Federal Home Loan Banks could shake the entire financial market. A more visible risk today is the Pension Benefit Guaranty Corporation (PBGC) of the Department of Labor. PBGC is facing serious financial challenges due to unfavorable economic conditions in recent years and to flaws in program structure.

The September 11 attacks have increased security-related risks. The Federal Government had to intervene, due to the reluctance of private insurers to offer sufficient coverage. Managing insurance programs covering security-related risks is challenging because security-related events, such as terrorism and war, are highly uncertain in terms of both the frequency of occurrence and the magnitude of potential loss.

II. PERFORMANCE OF CREDIT AND INSURANCE PROGRAMS

The Program Assessment Rating Tool (PART) produces an assessment of the performance of federal programs designed to be consistent across programs. This section analyzes the PART score for credit and insurance programs as a group to identify the strengths and weaknesses of credit and insurance programs.

PART Scores

The PART classifies performance into four categories (program purpose and design, strategic planning, program management, and program results) and assigns a numerical score (0 to 100 percent) to each category. The overall rating (effective, moderately effective, adequate, ineffective, or results not demonstrated) is determined based on the numerical scores and some other factors.

There are 23 credit programs (defined as those involving repayment obligations) and 3 insurance programs among 607 programs that have been rated by the PART. For the group as a whole, credit and insurance programs have fairly similar PART scores to those for other programs (see Table "Summary of PART Scores"). When appropriately weighted, higher scores for credit and insurance programs in two categories are roughly offset by lower scores in the other two categories. The overall ratings for credit and insurance programs, however, are more clustered around the middle; the rating of "adequate" is much more common for credit and insurance programs (48 percent, compared with 25 percent for other programs), while the ratings of "effective" (4 percent, compared with 15 percent for other programs) and "results not demonstrated"

SUMMARY OF PART SCORES

	Purpose and Design	Strategic Planning	Program Management	Program Results
Credit and Insurance Programs				
Average	0.773	0.681	0.853	0.541
Standard Deviation	0.207	0.222	0.215	0.165
Other Programs (all others excluding credit and insurance programs)				
Average	0.865	0.723	0.805	0.463
Standard Deviation	0.185	0.246	0.185	0.269

(15 percent, compared with 30 percent for other programs) are rarer. The clustering around the middle suggests that most credit and insurance programs make useful contributions, but need to improve their effectiveness.

Across categories, credit and insurance programs show some similarities to other types of programs. For most programs that have been rated by the PART, the scores are relatively high for program purpose and design and for program management, while the scores are low for program results. This general pattern holds for credit and insurance programs. Relative to other programs, however, credit and insurance programs scored low in program purpose and design and high in program results.

The PART indicates that most credit and insurance programs have clear purposes. Many credit and insurance programs, however, fail to score high in program design. Some are duplicative of other federal programs or private sources, and some have flawed designs limiting their effectiveness and efficiency. Flawed designs are generally correctable. If some programs have become redundant or duplicative of the private sector's activities due to financial evolution, however, those programs need to be reviewed carefully. They may need to be refocused on activities that have been affected less by financial evolution, or to be discontinued.

In the program management category, while most credit and insurance programs are strong in basic financial and accounting practices, such as spending funds for intended purposes, some programs show weaknesses in more sophisticated financial management, such as cost control. Overall, credit and insurance programs are somewhat better in financial management than other programs. Given that these programs deal with highly complex financial problems, however, credit and insurance programs may still need to make significant improvements and show superior performance in financial management.

Program results, the most important category of performance, are a weak area for credit and insurance programs, as well as for some other programs assessed by the PART. A particularly troubling indication from detailed analyses is that many credit and insurance programs show deficiencies in program effectiveness and achieving results. Based on this finding, the managers of credit and insurance programs need to place much more emphasis on results-driven management.

Common Features

Credit programs share many features that distinguish them from other programs. For example, the cost is uncertain because of various risks, such as default risk, prepayment risk, and interest rate risk. Most credit programs are also intended to address imperfections in financial markets. These common features are discussed in relation to the four areas of the PART. Although this section focuses on credit programs, much of the discussion also applies to insurance programs. For example, the cost is uncertain for insurance pro-

grams, too, because insured events occur unexpectedly. Financial market imperfections are also the main justification for insurance programs. Understanding common features should help to interpret PART results and to devise adequate steps to improve performance.

Program purpose and design. Program purposes vary widely across credit programs. They include increasing homeownership, increasing the number of college graduates, promoting entrepreneurship, and promoting exports. The private market serves some of these distinctive purposes better now than it did in the past. Thus, changes in financial markets may have significantly affected the usefulness of some credit programs. Examining the effect of financial evolution may be a critical part of achieving effective reforms.

Credit programs share many critical elements of design. They try to correct imperfections in financial markets by making credit available to those borrowers who would not be able to obtain credit at reasonable cost without government assistance. To target the right borrowers, the program design needs to take into account various factors, such as borrowers' incentives, accessibility, the state of financial markets, and general economic conditions. Credit programs also need to deal with many complexities, such as screening borrowers, servicing loans, and collecting defaulted loans. Given these complexities, most credit programs may benefit from the private sector's expertise. To be effective, however, partnership with the private sector should be designed such that the private partner's profit is closely tied to its contribution to increasing the program's effectiveness and efficiency. Private lenders are generally better at screening borrowers, but their incentive to screen borrowers effectively evaporates if the Government provides a 100-percent loan guarantee.

Strategic planning. Credit programs operate in rapidly changing financial markets. Thus, an important aspect of strategic planning for credit programs is to adapt to changes in financial markets. To achieve maximum efficiency, program managers need to adapt their programs quickly to new developments. For example, private lenders are more willing to serve many customers to whom they did not want to lend in the past. Thus, some Federal credit programs may find themselves serving a narrower pool of riskier customers and need to adjust their policies and cost estimates accordingly. Quickly adopting new technologies is also important, because financial institutions are increasingly applying advanced technologies to risk management. Falling behind, Federal credit and insurance programs can be left with much riskier customers as private entities attract better-risk customers away from Federal programs.

Program management. Credit programs face some unique challenges. To assess how credit programs manage the challenges, the PART adds two extra items for credit programs; one item addresses managing risks and the other addresses estimating the program's cost and risk. Credit programs share similar risks as does the lending business. To manage those risks effectively,

program managers need to monitor the credit quality of loans and practice tight financial management. For credit programs, accurately estimating the program cost is a critical element of effective management. The cashflow is uncertain for credit programs; some loans default, while some others are prepaid. Thus, the program cost must be estimated based on the expected default, prepayment, and recovery rates. An inaccurate estimation would result in inadequate budgeting and incorrect program evaluation.

Some other management issues are more important, though not unique, for credit programs than they are for other programs. Data collection, for example, is critical for effective risk management and accurate cost estimation. Effective risk management requires accurate and timely information on loan performance. The key ingredients of predicting loan performance are loan performance histories and detailed data on borrower and lender characteristics.

Program Results. The main difficulty in evaluating program performance is measuring the net outcome of the program (improvement in the intended outcome net of what would have occurred in the absence of the program). Suppose that an education program is intended to increase the number of college graduates. Although it is straightforward to measure the number of college graduates who were assisted by the program, it is difficult to tell how many of those would not have obtained a college degree without the program's assist-

ance. Credit programs face an additional difficulty of estimating the program cost accurately. In evaluating programs, the outcome must be weighed against the cost. In the above example, the ultimate measure of effectiveness is not the net number of college graduates produced by the program but the net number per Federal dollar spent on the program. Thus, an inaccurate cost estimation would lead to incorrect program evaluation; an underestimation (overestimation) of the cost would make the program appear unduly effective (ineffective). Results for credit programs need to be interpreted in conjunction with the accuracy of cost estimation.

The net outcome of a credit program can change quickly because it depends on the state of financial markets, which are very dynamic. The net outcome can decrease, as private entities become more willing to serve those customers whom they were reluctant to serve in the past, or it can increase if financial markets fail to function smoothly due to some temporary disturbances. Thus, the effect of financial evolution needs to be analyzed carefully. A sub-par performance by a credit program could be related to financial market developments; the program might have failed to adapt to rapid changes in financial markets, or its function might have become obsolete due to financial evolution. The program should be restructured in the former case, and discontinued in the latter case.

PART Cross-Cut for Credit Programs

As one of the world's largest lenders, with a portfolio of nearly \$1.5 trillion in direct loans and loan guarantees, the Federal Government has a great interest in efficient risk management. This need is even stronger when considered in the context of the Government's target borrower population: those whose risk profiles prevent them from obtaining private credit on reasonable terms. Given the higher default probability and the substantial portfolio size, lax management can result in a large increase in the cost to the Government. Thus, the Government must adopt effective risk management techniques to keep defaults in check and increase recoveries when defaults do occur.

At the same time, the Government must ensure that it is effectively serving its intended borrowers. A number of credit program PART scores indicate that many agencies lack the data, processes, or overall understanding of the credit lifecycle (origination, loan servicing/lender monitoring, liquidation, and debt collection) to achieve these dual, and occasionally conflicting, goals.

Over the next year, OMB will conduct a PART cross-cut examining the major credit agencies' programs. This effort will be supported by a Credit Council comprised of OMB and agency representatives. The Council will identify agency and private sector best practices that can be implemented across the major credit agencies, leading to higher program and management efficiencies, budgetary savings, and improved PART scores.

III. CREDIT IN FOUR SECTORS

Housing Credit Programs and GSEs

The Federal Government makes direct loans, provides loan guarantees, and enhances liquidity in the housing market to promote homeownership among low- and moderate-income people and to help finance rental

housing for low-income people. While direct loans are largely limited to low-income borrowers, loan guarantees are offered to a much larger segment of the population, including moderate-income borrowers. Increased liquidity achieved through GSEs benefits virtually all borrowers in the housing market.

Federal Housing Administration

In June 2002, the President issued America's Homeownership Challenge to increase first-time minority homeowners by 5.5 million through 2010. During the first two and a quarter years since the goal was announced, over 1.9 million minority families have become homeowners. HUD's Federal Housing Administration (FHA) accounted for over 400,000 of these first-time minority homebuyers through its insurance funds, mainly the Mutual Mortgage Insurance Fund. FHA mortgage insurance provides access to homeownership for people who lack the traditional financial resources or credit history to qualify for a home mortgage in the conventional marketplace. In 2004, FHA insured \$107 billion in mortgages for almost 900 thousand households. Over 70 percent of these were people buying their first homes, many of whom were minorities.

For 2006, FHA is proposing two new mortgage programs that reduce the biggest barriers to homeownership—the down payment and impaired credit. The Zero Down mortgage allows first-time buyers with a strong credit record to finance 100 percent of the purchase price and closing costs. For borrowers with limited or weak credit histories, Payment Incentives initially charges a higher insurance premium, but reduces the borrower's premiums once they have established a history of regular payments, thereby demonstrating their creditworthiness.

The program was evaluated under the PART. The assessment found that the program is meeting its statutory objective to serve underserved borrowers while maintaining an adequate capital reserve. In 2004, 73 percent of FHA-insured loans were to first-time homeowners, and 37 percent were to minority homebuyers. However, the program lacks quantifiable annual and long-term performance goals which measure FHA's ability to achieve its statutory mission. In addition, the program's credit model does not accurately predict losses to the insurance fund, nor can FHA demonstrate its ability to reduce fraud in the program.

In response to these findings, in 2006 FHA will establish performance goals for the percentage of FHA Single Family endorsements for first-time and minority homeowners, and performance goals for fraud detection and prevention. FHA will also continue development of a credit model that more accurately and reliably predicts claims costs.

VA Housing Program

The Department of Veterans Affairs (VA) assists veterans, members of the Selected Reserve, and active duty personnel to purchase homes as recognition of their service to the Nation. The program substitutes the Federal guarantee for the borrower's down payment. In 2004, VA provided \$35 billion in guarantees to assist 270,571 borrowers.

Since the main purpose of this program is to help veterans, lending terms are more favorable than loans without a VA guarantee. In particular, VA guarantees

zero down payment loans. VA provided 109,493 zero down payment loans in 2004.

To help veterans retain their homes and avoid the expense and damage to their credit resulting from foreclosure, VA plans aggressive intervention to reduce the likelihood of foreclosures when loans are referred to VA after missing three payments. VA was successful in 44 percent of its 2004 interventions, and its goal is to achieve at least a 47 percent success rate in 2006.

Rural Housing Service

The U.S. Department of Agriculture's Rural Housing Service (RHS) offers direct and guaranteed loans and grants to help very low- to moderate-income rural residents buy and maintain adequate, affordable housing. The single family guaranteed loan program guarantees up to 90 percent of a private loan for low- to moderate-income (115 percent of median income or less) rural residents. The programs' emphasis is on reducing the number of rural residents living in substandard housing. In 2004, over \$4.5 billion in assistance was provided by RHS for homeownership loans and loan guarantees; \$3.23 billion of guarantees went to 34,800 households, of which 30 percent went to very low- and low-income families (with income 80 percent or less than median area income).

For the section 502 guaranteed loan program, the 2005 appropriation bill increased the guarantee fee on new loans to 2.0 percent. This was coupled with language that would allow the guarantee fee to be financed as part of the loan. The ability to finance the guarantee fee is more in line with the housing industry, including HUD and VA, and will allow more lower-income rural Americans to realize the dream of home ownership. The guarantee fee for refinance loans remains 0.5 percent. The guarantee fees are expected to remain at the same rate in 2006. Funding in 2006 stands at \$3 billion for purchase loans, and \$225 million for refinance loans.

RHS programs differ from other Federal housing loan guarantee programs. RHS programs are means-tested and more accessible to low-income, rural residents. In addition, the RHS section 502 direct loans offer extraordinary assistance to lower-income homeowners by reducing the interest rate down to as low as 1 percent for such borrowers. The section 502 direct program helps the "on the cusp" borrower obtain a mortgage, and requires graduation to private credit as the borrower's income and equity in their home increases over time. The interest rate depends on the borrower's income. Each loan is reviewed annually to determine the interest rate that should be charged on the loan in that year based on the borrower's projected annual income. The direct program cost is balanced between interest subsidy and defaults. For 2006, RHS expects to provide \$1.0 billion in loans with a subsidy cost of 11.39 percent.

RHS also offers multifamily rental housing loans, and loans and grants for farm labor housing. Direct loans are provided to private, public, and non-profit borrowers

to construct, rehabilitate, and repair multi-family rental housing for very low- and low-income residents, either through general occupancy properties or elderly and handicapped housing. To help achieve affordable rents, the interest rate is subsidized to a level between 1 and 2 percent. Many very low- and low-income residents' rents are further reduced to 30 percent of their adjusted income through rental assistance grants. During 2006, \$641 million for Section 521 rental assistance will be directed primarily to continue existing commitments.

RHS recently received a contracted study that addressed the preservation issues surrounding the over 40-year old program. A long-term initiative has been shaped to address the revitalization of the 17,400-property portfolio. During 2006, \$214 million will be directed to begin the revitalization initiative, primarily to transition existing residents in properties leaving the program. The \$27 million loan program level for the direct rural rental housing will be used to address repair and rehabilitation needs of preservation worthy properties. Additionally, the farm labor housing combined grant and loan level will provide \$56 million in 2006 for new construction as well as repair and rehabilitation. RHS also guarantees multifamily rental housing loans. RHS expects to be able to guarantee \$200 million in loans for 2006, which is double the amount from 2005.

Housing GSEs

Fannie Mae and Freddie Mac were chartered by Congress to increase the liquidity of mortgages and to promote access to mortgage credit for groups that historically have been underserved by private markets. Fannie Mae and Freddie Mac do not participate directly in the origination of mortgages. They carry out their chartered mission primarily by purchasing residential mortgages or guaranteeing mortgage-backed securities (MBS) consisting of residential mortgages. The guaranteed MBS are held by investors, mortgage lenders, and increasingly by Fannie Mae and Freddie Mac themselves. Fannie Mae and Freddie Mac finance their acquisition of loans and MBS assets by issuing debt; both also charge fees to mortgage originators who exchange a pool of loans for MBS issued and guaranteed by one of the enterprises.

As Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac have a unique status among private financial institutions. They are publicly held companies but were granted certain privileges to facilitate their chartered mission, including exemption from most state and local taxes and registration requirements with the Securities and Exchange Commission (SEC). Also, their debt and MBS may be held without limit by federally chartered depository institutions.

Regulatory oversight of Fannie Mae and Freddie Mac is shared among multiple agencies across the Government. The Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency in the Depart-

ment of Housing and Urban Development (HUD), is the primary safety and soundness regulator of Fannie Mae and Freddie Mac. HUD is responsible for the establishment and enforcement of affordable housing goals for the enterprises, ensuring their compliance with fair housing laws and their charters, and reviewing new activities and programs in consultation with OFHEO. The Treasury Department has discretionary authority to approve or disapprove the issuance of the GSEs' debt, and the SEC now regulates Fannie Mae under the Securities Exchange Act of 1934. Freddie Mac has not yet registered under the 1934 Act, but has publicly committed to do so when able.

The Federal Home Loan Bank System (FHLBS) was established by Congress to provide liquidity to home mortgage lenders who are members of the individual Banks. The System comprises 12 separate, regional Federal Home Loan Banks (FHLBs, or Banks), each of which is a member-owned cooperative. The Banks issue debt for which the Banks are jointly and severally liable, and use the proceeds principally to make advances (secured loans) to their members. Member institutions primarily secure advances with residential mortgages and other housing-related assets. Like Fannie Mae and Freddie Mac, the Banks have been granted special privileges as part of their Government charter, including exemption of their corporate earnings from Federal income tax and from State and local taxes. In addition, the Secretary of the Treasury has authority to purchase up to \$4 billion of these entities' debt securities. In recent years, some FHLBs have begun to purchase mortgages from their members. At the end of 2003, the 12 FHLBs held about \$115 billion of mortgages, equivalent to 7 percent of the combined total of \$1.5 trillion held by Fannie Mae and Freddie Mac. In addition, as of 2003, the FHLBs held about \$774 billion in debt, while Fannie Mae held \$976 billion, and Freddie Mac held \$757 billion.

The Federal Housing Finance Board (FHFB) regulates the mission and the safety and soundness of the FHLBs. As it does with respect to Fannie Mae and Freddie Mac, the Treasury Department has discretionary authority over the issuance of FHLB debt. The FHFB recently required that the FHLBs register with the SEC, and registration is expected for most if not all of the FHLBs later this year.

GSE Borrowing Advantage

Their unique status enables all three housing GSEs to borrow at rates lower than investors would ordinarily accept, theoretically to pay higher prices to originating lenders for mortgages, and in the case of the FHLBs to make low-cost advances to member institutions. Although the prospectus for each GSE security clearly states that it is not backed by the U.S. Government, the misperception exists among many investors that the Government backs the GSEs. In 2004 the Congressional Budget Office estimated the implicit Federal subsidy to the three housing GSEs was \$23 billion during the previous year. A Federal Reserve study suggests

that over one-half of the implicit subsidy to Fannie Mae and Freddie Mac accrues to the GSEs' shareholders.

Risk

As with all financial institutions, risk is inherent in the way the housing GSEs conduct their business. By assuming and managing some of the risks arising from mortgage lending, the GSEs generate some benefits for consumers and significant profits for their owners. However, the mix of benefits and risks varies depending on how the GSEs conduct their businesses.

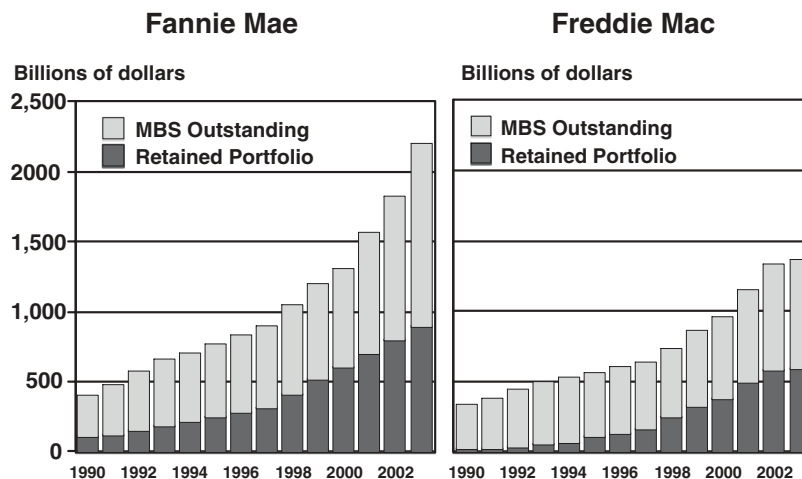
Credit Risk. By issuing and guaranteeing securities based on pools of mortgages they purchase from lenders, Fannie Mae and Freddie Mac assume some portion of credit risk, which enhances liquidity to the mortgage market and thereby reduces the cost of credit to borrowers. Fannie Mae and Freddie Mac control their credit risk by using underwriting standards to evaluate the mortgages they purchase for securitization. Their risk is further limited by statutory provisions that require private mortgage insurance or equivalent protection on high loan-to-value ratio mortgages. Credit losses for the enterprises, as a percentage of the face value of mortgages they purchased, averaged 5.4 basis points for a fifteen-year period ending in 2002 and have been declining. Viewed in isolation, Fannie Mae and Freddie Mac's assumption of credit risk arising from guarantees of MBS held by other investors benefits the market and homebuyers while incurring a risk that is easily managed and well-understood.

Interest Rate Risk. A more challenging form of risk arises from the effect that interest rate movements can have on portfolios of mortgages and mortgage-backed

securities. Interest rate risk arises from the changing market values of the GSEs' interest-sensitive assets and liabilities. Interest rate movements can cause the interest margins between their mortgage and other assets and their liabilities to grow or shrink, potentially changing the mark-to-market value of their equity capital and estimated future earnings dramatically in a short period. Historically, the FHLBs assumed interest rate risk by issuing debt and using the proceeds to make loans, often of comparable maturities, to member institutions to support their mortgage lending and other investments; this risk is somewhat mitigated since they often require prepayment penalties on advances to member institutions. Much more recently, however, some of the Banks have created mortgage purchase programs that assume interest rate risk for pools of mortgages.

Fannie Mae, and more recently Freddie Mac, have built large portfolios of mortgages and repurchased MBS. However, by choosing to borrow substantially in order to build large retained portfolios of mortgages and mortgage-backed securities, they assume a different, more challenging set of risks and increase the complexity of their operations. Their ability to repurchase large volumes of their own MBS is driven by their ability to finance these mortgages with lower-cost debt than other investors, thanks to market misperceptions of a unique status for the enterprises that allow them to borrow at lower rates. Federal Reserve economists have found no evidence that these repurchases provide any additional benefit to borrowers. They clearly provide an opportunity for the GSEs to increase their earnings, however.

**Chart 7-1. Total Mortgages,
1990-2003**



At the end of 2003, Fannie Mae's retained portfolio as a percentage of its MBS outstanding (held by others) was 69.4 percent, or almost \$900 billion; Freddie Mac's retained portfolio as a percentage of MBS outstanding was 78.1 percent, or over \$600 billion. In periods of declining interest rates, mortgage refinancings increase, so higher-yielding mortgages prepay, exposing holders of these mortgages or securities based on them to the risk of having to reinvest these funds at lower rates. As Federal Reserve Chairman Greenspan has noted, Fannie Mae and Freddie Mac have chosen not to offset the interest rate risk arising from their portfolio operations by increasing capital but to attempt to manage that risk by issuing callable debt and by purchasing derivative financial instruments, such as interest rate swaps and options on swaps. For example, they might hedge fixed-rate mortgages, which drop in value when interest rates increase, using derivative instruments that increase in value under the same scenario. The techniques necessary to manage interest rate risk and its potential effect on earnings are complex, and their management becomes increasingly difficult with increases in the size and complexity of the portfolio to be managed. Chairman Greenspan has also noted that the sophistication of the operations required to hedge prepayment risk with little capital places an enormous burden on these institutions.

Like other financial institutions, the housing GSEs attempt to limit their interest rate exposure and the effect of interest rate movements on their earnings. Chairman Greenspan has suggested statutory limits on the dollar amount of the debt held by Fannie Mae and Freddie Mac relative to the dollar amounts of mortgages securitized and held by other investors, and limiting the ability of the FHLBs to hold mortgages and mortgage-backed securities directly, as additional ways to manage the interest rate risk of the GSEs.

Operations risk. Recent events reinforced concerns over the risks posed by the GSEs and their existing regulatory framework. These events have illustrated how the burden of managing interest rate risk mixed with management deficiencies can lead to operational failings. In 2003, Freddie Mac reported that it had understated its earnings by \$5 billion over three years, and eventually acknowledged substantial issues with accounting, management practices, and internal controls. OFHEO subsequently assessed substantial financial penalties on the company, and its senior management was replaced. A year-long investigation into the accounting, internal controls, and management practices at Fannie Mae by OFHEO led to findings of inappropriate accounting procedures and practices, internal control deficiencies, and questionable management oversight. The SEC concurred in the finding of inappropriate accounting practices and directed that Fannie restate its earnings for 2001–2004. These findings led Fannie Mae to replace its Chairman and CEO, and its CFO. The Enterprise estimated it would be forced to recognize \$9 billion in losses, reducing its capital below the regulatory minimum requirement. During the

same period, two of the twelve FHLBs entered into written agreements with FHFB that required review of operational practices and controls, announcing that their accounting practices needed revision and, in one instance, that earnings required restatement.

These developments now reveal some of the ways that the assumption of large-scale interest rate risk complicates the operational challenges facing the GSEs. The techniques necessary to manage interest rate risk and its potential effect on earnings are complex, and their management becomes increasingly difficult with increases in the size and complexity of the portfolio to be managed. While other large financial institutions may face similar challenges, the management of interest rate risk and operations risk is a particular challenge for the GSEs, given their size, regulatory structure, and the lack of full market discipline.

The rules governing accounting for derivatives likewise are complex. Interpreting and applying the accounting rules have posed challenges to companies that use derivatives. Out of concern that firms were using inconsistent methods to account for the use of derivatives to hedge interest rate risk and the potential that their use could obscure a company's true position or misrepresent earnings, in 1998 the Financial Accounting Standards Board (FASB) promulgated the rule known as FAS 133; it became effective in 2000. In part, this rule requires companies, with narrow exceptions, to reflect on their balance sheets the amount that derivatives rise or fall in value, even if derivatives contracts are still open and gains or losses are not yet locked in.

In 2004, OFHEO found, and the SEC concurred, that Fannie did not adequately document its hedges and routinely violated FAS 133 in a number of ways. For example, Fannie Mae, in its treatment of hedges when it changed financial strategies and, with no new testing or proof of effectiveness, took derivatives that were initially paired with one liability, and paired them with another. The SEC also found that Fannie Mae failed to comply in material respects with FAS 133. At OFHEO's behest, Fannie Mae agreed to cease all hedge accounting that did not conform with FAS 133 by the first quarter of CY 2005, and to ensure going forward that all hedge accounting complies with this requirement. Fannie Mae has already stated that this correction will reduce its capital and its earnings by \$9 billion from 2001 through mid-2004. This leaves Fannie Mae below the minimum regulatory capital requirement and subjects it to further regulatory actions. This follows upon the events of 2003, when Freddie Mac discovered substantial accounting and internal control issues, including issues with the application of FAS 133, leading to replacement of senior management and restatement of its financial statements over the 2000–2003 time-frame. The SEC and the Department of Justice have continued to investigate both Fannie Mae and Freddie Mac.

During the same period, the FHFB announced a written agreement with the FHLB of Chicago which re-

sulted in a review of the Bank's accounting practices, changes to certain accounting methods under FAS 133, and subsequently, a delay in the Bank's issuance of its third quarter 2004 financial statements.

The failure of Fannie Mae and Freddie Mac and, to a lesser extent, the FHLBs to account for the use of derivatives and hedges consistent with Generally Accepted Accounting Principles (GAAP) prompted their regulators to investigate for the presence of control deficiencies and weaknesses in corporate governance, which they have identified. Fannie Mae and Freddie Mac were cited within a nine-month period for serious and systemic operational control deficiencies that contributed in part to the need for massive earnings restatements. The cited deficiencies included management cultures that stressed earnings stability at the expense of other considerations, ineffective processes for developing accounting policies, and absence of independent internal controls for review of certain transactions. These developments highlight the risks inherent in the GSEs' operations, risks that because of their size and relationships with other institutions could have far-reaching effects should one of them falter.

Systemic Risk. The risks undertaken by the GSEs, if not properly managed, may pose a threat to their solvency. Under some circumstances, they also may threaten the stability or solvency of other financial institutions and the economy. Current Federal law explicitly exempts the securities of the GSEs from the statutory limitation on commercial banks' investment in the "investment securities" of individual firms. In a February 2003 study conducted by OFHEO utilizing FDIC data, over 2,000 commercial banks held at least 51 percent of their capital in the form of debt issued by Fannie Mae; and almost 1,000 commercial banks held at least 51 percent of their capital in the form of debt issued by Freddie Mac.

Should a financial crisis affecting the GSEs and other financial actors develop, the market's misperception of Government backing of GSE securities could affect its course and resolution. A September 2004 Federal Reserve Bank of Atlanta study indicated concern that severe stress to one of the GSEs might contribute to weakness in other financial institutions that hold significant GSE obligations, especially if the path to resolution of the crisis and the potential for Government intervention are misunderstood.

The potential for systemic risk arising from the GSEs' size and their central role in mortgage markets combined with the difficulty of managing the risks inherent in a large mortgage portfolio raise fundamental questions about the value they add through their support for mortgage lending and reduced costs to borrowers relative to the risks their current operations pose. Some research by Federal Reserve economists suggests that GSE securitization activities have a relatively small effect on mortgage interest rates—just a few dollars a month on an average mortgage—and that their practice of holding mortgages in portfolio has almost no effect on mortgage costs. Instead of being leaders in increas-

ing historically underserved groups' access to credit, the GSEs have actually trailed the market averages in a number of dimensions. The Administration has sought to narrow the gap by lessening the risks posed by the GSEs and increasing the benefits they offer to the public.

Enhancing Safety and Soundness

Events of the past year reinforced concerns over the risks posed by the GSEs and highlighted the need for meaningful GSE reform. A strengthened regulator would have the in-house expertise to monitor accounting methodology and to detect any problems, as well as the authority and expertise to monitor regulatory standards for the development and implementation of systems and controls. A strong regulator would also hold the authority to place a failing entity into receivership similar to that held by the other financial safety and soundness regulators.

The Administration intends that any proposed new regulatory framework for the GSEs follows the principles for regulation of financial institutions established by the international Basel Committee, principles accepted throughout the world as requirements for first-class regulation. As described in the President's FY 2005 Budget, these principles involve increasing market discipline, strengthening supervision, and ensuring appropriate capital requirements.

Market Discipline. Chief among the factors that guide a company in its decision-making is the discipline imposed by the market. Investors can discipline the GSEs to the extent that they have adequate information about their risks and financial condition. Current market discipline is hindered by a misperception that the Federal Government would back GSE securities in the event of a GSE default, and because GSE investors do not enjoy the same level of disclosure, or oversight of disclosures, as investors in other public companies. Ironically, at the times when investors would most benefit from detailed information about the enterprises' finances, they are left without adequate information for months or years.

The Administration in 2002 called upon the three housing GSEs to register voluntarily their equity securities under the 1934 Securities Exchange Act. In June 2004, the FHFB adopted a final rule that will require each FHLB to register a class of its stock by June 30, 2005, leading to improved disclosures. Fannie Mae voluntarily registered and began filing disclosures with the SEC in 2003. However, because of its recent accounting problems, Fannie Mae is no longer able to provide these disclosures. Freddie Mac does not anticipate being in compliance with SEC standards before the second quarter of 2006. Since the GSEs are not subject to the same market discipline as other public companies, market discipline by itself is not always sufficient to ensure safety and soundness.

Supervision. An effective financial regulator must possess authorities commensurate with its responsibilities and capabilities. The Administration determined

that the safety and soundness regulators of the housing GSEs lack sufficient powers and stature to meet their responsibilities. The President's 2005 Budget reflected, therefore, that both OFHEO, regulator of Fannie Mae and Freddie Mac, and the FHFB, regulator of the FHLBS, should be replaced with a new, consolidated regulatory regime, empowered with expanded enforcement authority, receivership authority, and access to its funding independent of the annual appropriations process.

A new regulator, like other Federal regulators of financial institutions, must have full authority together with accountability for the prudential supervision of the enterprises, which includes the authority to approve new activities of the enterprises. It would have authority to review their ongoing business activities and reject new ones if they would be inconsistent with their charter or prudential operations or incompatible with the public interest. HUD would continue to be consulted on new activities in order to ensure that the GSEs are in compliance with their charters and that the GSEs carry out their public mission.

Currently, the means by which the failure of a GSE could be resolved differs between Fannie Mae and Freddie Mac, on the one hand, and the FHLBs, on the other. In the case of a failed FHLB, the FHFB has power to liquidate such institution, subject to certain limitations relating to the whole number of Banks in the system. OFHEO, on the other hand, lacks the power to place an entity into bankruptcy or receivership.

The Federal banking regulators have broad powers to place a failed institution into receivership, and to conduct the orderly wind-down of a failed bank in such a way that systemic disruption is minimized. Giving such uniform powers to a Federal regulator of GSEs could likewise help prevent dislocation in financial markets in the event of the insolvency of such an institution. Further, such powers would address any misperception that the GSEs are backed by the Government. By providing clarity to the markets that the GSEs (and their creditors) are subject to the same business risks as are other corporate entities, an even greater level of market discipline might be brought to bear on the GSEs' operations. In general, this type of market discipline has proven very effective in ensuring that businesses operate in a prudential, and safe and sound manner.

Capital requirements. Because neither investors nor regulators can predict all possible errors by a company or unexpected economic changes, requirements that ensure that the GSEs hold capital adequate to cushion such shocks are essential. Capital requirements must be set with an eye to both known risks and unknown or unquantifiable risks. Losses from unknown risks can well exceed losses from measured risks, as shown by the rapid depletion of capital in 1998 for the highly leveraged hedge fund, Long-Term Capital Management. For this reason, it is essential that the new regulator of the housing GSEs have unambiguous authority to

adjust both risk-based and minimum capital requirements.

Affordable Housing Mission

One of the public purposes of the GSEs is to promote access to mortgage credit for low- and moderate income families. By law, HUD establishes annual affordable housing goals for Fannie Mae and Freddie Mac. In 2004, HUD established the affordable housing goals for Fannie Mae and Freddie Mac for 2005 through 2008. The low and moderate income goal will increase from 50 percent (of the minimum share of housing units financed by a GSE's mortgage purchases in a particular year) in 2004 to 56 percent by 2008; the underserved areas goal will increase from 36 percent in 2004 to 39 percent by 2008; and the special affordable housing goal will increase from 20 percent in 2004 to 27 percent by 2008.

The table below shows how Fannie Mae and Freddie Mac have trailed the marketplace in lending to first-time minority homebuyers in the 2001–2003 timeframe. It is likely that, as a result of these new, higher goals, they will need to improve their efforts to reach out to low-income and minority first-time homebuyers.

PERCENTAGE OF FANNIE MAE AND FREDDIE MAC LOANS TO FIRST-TIME MINORITY HOMEBUYERS COMPARED TO THE FULL MARKETPLACE, 2001–2003 AVERAGES¹

	Fannie Mac	Freddie Mac	Both GSEs	Full Market ²
All Race/Ethnicity Groups	25.7%	26.1%	25.9%	39.1%
African American and Hispanic	4.7%	3.5%	4.2%	9.0%
All Minorities	7.5%	6.1%	6.9%	12.3%

Source: Department of Housing and Urban Development.

¹ The first-time homebuyer definition for the market analysis is homebuyers who have never owned a home. The definition for the GSEs is purchasers who have not owned a home within the past three years. The percentages show first-time homebuyer mortgages by race/ethnicity category as a share of all home purchase mortgages purchased by the GSE or originated in the market.

² "Market" means conventional, conforming home purchase loans.

With their growth as a share of the mortgage marketplace, Fannie Mae and Freddie Mac have faced increased market competition in the acquisition of mortgages and MBS; the increase in affordable housing goals and subgoals may mean that Fannie Mae and Freddie Mac must be more innovative or aggressive in purchasing loans that meet the goals classifications. They can do this in part by using a larger portion of the subsidy they enjoy as a result of their Government ties to support purchases of goals-qualifying loans.

Part of the Administration's proposal for a strengthened regulatory framework would provide HUD with the authority to penalize Fannie Mae and Freddie Mac if they fail to reach the affordable housing goals. Current law does not permit the Secretary of HUD to impose timely and appropriate penalties for a GSE's failure to reach a goal.

The FHLBs address their affordable housing obligations in a different fashion. For instance, by statute,

each FHLB is assessed ten percent of its net income for support of affordable housing. This assessment enables each FHLB member to provide subsidized and other low-cost funding to create affordable rental and homeownership opportunities, and support for commercial and economic development activities that benefit low- and moderate-income neighborhoods.

With their large subsidy, and with their substantial market share, the GSEs should lead the market in creating homeownership opportunities for less advantaged Americans. However, HUD has conducted analyses showing that private lenders operating without the benefits and subsidies enjoyed by the GSEs contribute more to affordable housing than do Fannie Mae and Freddie Mac. One purpose of a stronger regulatory approach is to ensure that all three housing GSEs fulfill their charter obligations.

Education Credit Programs and GSEs

The Federal Government guarantees loans through intermediary agencies and makes direct loans to students to encourage post-secondary education. The Student Loan Marketing Association (Sallie Mae), created in 1972 as a GSE to develop the secondary market for guaranteed student loans, has now been privatized.

Student Loans

The Department of Education helps finance student loans through two major programs: the Federal Family Education Loan (FFEL) program and the William D. Ford Federal Direct Student Loan (Direct Loan) program. Eligible institutions of higher education may participate in one or both programs. Loans are available to students regardless of income. However, borrowers with low family incomes are eligible for loans with additional interest subsidies. For low-income borrowers, the Federal Government subsidizes loan interest costs while borrowers are in school, during a six-month grace period after graduation, and during certain deferment periods.

In 2006, over 9 million borrowers will receive over 15.1 million loans totaling over \$95 billion. Of this amount, more than \$62 billion is for new loans, and the remainder reflects the consolidation of existing loans. Loan levels have risen dramatically over the past 10 years as a result of rising educational costs and an increase in eligible borrowers.

The FFEL program provides loans through an administrative structure involving over 3,500 lenders, 35 State and private guaranty agencies, roughly 50 participants in the secondary market, and approximately 6,000 participating schools. Under FFEL, banks and other eligible lenders loan private capital to students and parents, guaranty agencies insure the loans, and the Federal Government reinsures the loans against borrower default. In 2006, FFEL lenders will make over 11.5 million loans totaling over \$72 billion in principal, roughly a third of which involve consolidations of existing loans. Lenders bear two percent of the default risk, and the Federal Government is responsible for the re-

mainder. The Department also makes administrative payments to guaranty agencies and, at certain times, pays interest subsidies on behalf of borrowers to lenders.

The William D. Ford Direct Student Loan program was authorized by the Student Loan Reform Act of 1993. Under the Direct Loan program, the Federal Government provides loan capital directly to more than 1,100 schools, which then disburse loan funds to students. In 2006, the Direct Loan program will generate almost 3.6 million loans with a total value of nearly \$23 billion, including over \$7 billion in consolidations of existing loans. The program offers a variety of flexible repayment plans including income-contingent repayment, under which annual repayment amounts vary based on the income of the borrower and payments can be made over 25 years with any residual balances forgiven.

The Administration is strongly committed to the lender-based FFEL program and expects it to continue as the primary source of loans to students in the years ahead. In addition, the Administration will continue to maintain a DL program to ensure that no eligible student is denied access to student loans in the event a student or school cannot find a suitable lender.

However, problems in the structures of the current student loan programs prevent them from meeting current policy and program objectives. Specifically, the Federal Government assumes almost all of the risk for the loans, while federal subsidies to intermediaries lenders and guaranty agencies are set high enough to allow the less efficient ones to generate a profit. These problems lead to unnecessary costs for taxpayers and prevent the program from achieving the efficiencies the market is designed to provide.

The 2006 Budget proposes a package of reforms to both the FFEL and DL loan programs to achieve significant cost savings and improve effectiveness. These reforms will link subsidy payments for lenders and guaranty agencies more closely to their costs and will modify interest rates for borrowers who are no longer in school and have just consolidated their loans. The Budget achieves \$34 billion in savings over ten years by cutting unnecessary subsidies and payments to lenders, state guaranty agencies, and loan consolidators, and by placing a larger share of the loan risks on lenders. These savings will be used to increase the Pell Grant maximum award, pay off the current \$4 billion Pell shortfall, and improve benefits to students in school by increasing loan limits for first year students and extending the current favorable interest rate framework.

Sallie Mae

The Student Loan Marketing Association (Sallie Mae) was created as a shareholder-owned government sponsored enterprise (GSE) by the Education Amendments of 1972 to expand funds available for student loans by providing liquidity to lenders engaged in the Federal Family Education Loan Program (FFELP), formerly the

guaranteed student loan program (GSLP). Sallie Mae was reorganized in 1997 pursuant to the authority granted by the Student Loan Marketing Association Reorganization Act of 1996. Under the Reorganization Act, the GSE became a wholly owned subsidiary of SLM Corporation and was required to be wound down and liquidated by January 30, 2008. On June 30, 2004, the SLM Corporation first purchased FFELP student loans through non-GSE affiliates and, as a result, the GSE was required by statute to terminate purchases of FFELP student loans. Accordingly, the GSE is no longer a source of liquidity for SLM Corporation for the purchase of student loans, and the GSE-related financing activities have primarily been limited to refinancing the remainder of its assets through non-GSE sources. As of September 2004, the Company had substantially completed the wind-down of the GSE and, on November 1, 2004, SLM Corporation sent notices to the Secretary of Education and the Secretary of the Treasury that it intended to wind-down and dissolve the GSE on December 31, 2004 or as soon as practicable thereafter, three years in advance of the statutory deadline. The dissolution was completed on December 29, 2004.

All GSE debt that remains outstanding upon completion of these wind-down activities will be defeased through the creation of a fully collateralized trust. The collateral, consisting of cash and financial instruments backed by the full faith and credit of the U.S. government, will generate cash flows that provide for the interest and principal obligations of the defeased debt.

Business and Rural Development Credit Programs and GSEs

The Federal Government guarantees small business loans to promote entrepreneurship. The Government also offers direct loans and loan guarantees to farmers who may have difficulty obtaining credit elsewhere and to rural communities that need to develop and maintain infrastructure. Two GSEs, the Farm Credit System and the Federal Agricultural Mortgage Corporation, increase liquidity in the agricultural lending market.

Small Business Administration

The Small Business Administration (SBA) helps entrepreneurs start, sustain, and grow small businesses. As a “gap lender” SBA works to supplement market lending and provide access to credit where private lenders are reluctant to do so without a Government guarantee. Additionally, SBA assists home- and business-owners cover the uninsured costs of recovery from disasters.

The 2006 Budget requests \$307 million, including administrative funds, for SBA to leverage more than \$25 billion in financing for small businesses and disaster victims. The 7(a) General Business Loan program will support \$16.5 billion in guaranteed loans while the 504 Certified Development Company program will support \$5.5 billion in guaranteed loans. SBA will supplement the capital of Small Business Investment Companies

(SBICs) with \$3 billion in long-term loans for venture capital investments in small businesses.

To continue to serve the needs of small businesses, SBA will focus program management in three areas:

1) Targeting economic assistance to the neediest small businesses

SBA seeks to target assistance more effectively to credit-worthy borrowers who would not be well-served by the commercial markets in the absence of a Government guarantee to cover defaults. SBA is actively encouraging financial institutions to increase lending to start-up firms, low-income entrepreneurs, and borrowers in search of financing below \$150,000. Preliminary evidence shows that SBA’s outreach for the 7(a) program has been successful. Average loan size has decreased from \$258,000 in 2000 to \$167,000 in 2004, while the number of small businesses served has grown from 43,748 to 81,133 during the same time period.

2) Improving program and risk management

Improving management by measuring and mitigating risks in SBA’s \$57 billion business loan portfolio is one of the agency’s greatest challenges. As the agency delegates more responsibility to the private sector to administer SBA guaranteed loans, oversight functions become increasingly important. SBA established the Office of Lender Oversight, which is responsible for evaluating individual SBA lenders. This office has made progress in employing a variety of analytical techniques to ensure sound financial management by SBA and to hold lending partners accountable for performance. These techniques include financial performance analysis, industry concentration analysis, portfolio performance analysis, selected credit reviews, and credit scoring to compare lenders’ performance. The oversight program is also developing on-site safety and soundness examinations and off-site monitoring of SBLCs and compliance reviews of SBA lenders. In addition, the office will develop incentives for lenders to minimize defaults and to adopt sound performance measures.

Improving risk management also means improving SBA’s ability to estimate more accurately the cost of subsidizing small businesses. During 2003 and 2004, SBA followed through on its commitment to improve its accuracy in estimating the cost of its major credit programs by developing loan-level credit and reestimate models for the Section 504, Disaster, 7(a), and Secondary Market Guarantee programs. The 2006 Budget reflects net upward reestimates of the lifetime expected taxpayer costs for outstanding loans—of \$408 million for the 7(a) program, \$123 million for the Section 504 program, \$267 million for Disaster Loans, and \$922 million for SBIC Participating Securities. A net downward reestimate of \$60 million is also reflected for the SBIC Debentures program. The 2006 upward trend in reestimates generally reflects technical corrections to credit subsidy models (e.g., the 7(a) subsidy model failed to account for purchased interest on defaulted loans), higher interest rates and the agency’s shift from

the traditional approach (based on historical account activity) to the balances approach for performing reestimates. In adopting the balances approach, SBA uncovered that its historical records did not reconcile to the credit programs' asset and liability balances currently recorded with Treasury. SBA is working to improve its financial record keeping to mitigate future accounting discrepancies.

Total budgetary cost increases over the past 3 years totaled \$4.0 billion (\$3.1 billion in reestimates and \$0.9 billion for interest on the reestimates) for existing SBA-guaranteed loans and \$1.7 billion (\$1.1 billion for reestimates and the remainder for interest on reestimates) for existing direct loans. While most of these budgetary cost increases related to the weak performance of the SBIC Participating Securities program and Disaster Loan asset sales, the agency's two largest business programs also generated significant budgetary cost increases for taxpayers. Over the three-year period, the net budgetary cost increase was \$636 million for outstanding 7(a) guarantees (\$330 million in reestimates) and \$180 million (\$87 million in reestimates) for outstanding Section 504 guarantees.

The 2006 Budget supports \$3 billion in guaranteed venture capital investments for small businesses through the SBIC Debentures program, which provides credit financing to small business investment companies. However, the 2006 budget does not support new guaranteed investments for the Participating Securities program. Over ten years of operations, the Participating Securities program has realized and projected losses of approximately \$2.2 billion out of \$6.2 billion in disbursements. These losses reflect a structurally flawed program in which the Federal Government contributes up to two-thirds of investment capital but only receives up to ten percent of profits. Further, as the Program Assessment Rating Tool (PART) analysis revealed, SBICs do not have incentives to repay capital expeditiously, extending the Government's risk exposure. Rather than make new investments through this program, SBA will continue to improve efforts to monitor and mitigate risk in approximately \$9 billion in commitments in the program's portfolio. The program had already ceased making new guaranteed investments on October 1, 2004 because sufficient borrower fees to cover the program's costs were not enacted.

3) Operating more efficiently

To operate more efficiently, SBA is piloting an automated loan origination system for the Disaster Loan program. As a result, loan-processing costs, times, and errors will decrease, while Government responsiveness to the needs of disaster victims will increase. SBA is also transforming the way that staff perform loan management functions in both the 7(a) and 504 programs. In 2004, SBA implemented new procedures for Section 504 loan processing. Results have been positive with the average loan processing time reduced from four weeks to only a few days. In 2005, SBA will streamline its 7(a) loan origination functions. Similarly, SBA is

also centralizing its loan liquidation functions for the Section 504 program and requiring intermediaries to assume increased liquidation responsibilities.

USDA Rural Infrastructure and Business Development Programs

USDA provides grants, loans, and loan guarantees to communities for constructing facilities such as health-care clinics, day-care centers, and water and wastewater systems. Direct loans are available at lower interest rates for the poorest communities. These programs have very low default rates. The cost associated with them is due primarily to subsidized interest rates that are below the prevailing Treasury rates.

The program level for the Water and Wastewater (W&W) treatment facility loan and grant program in the 2006 President's Budget is \$1.5 billion. These funds are available to communities of 10,000 or fewer residents. The program finances W&W facilities through direct or guaranteed loans and grants. Applicant communities must be unable to finance their needs through their own resources or with commercial credit. Priority is given based on their median household income, poverty levels, and size of service population as determined by USDA. The community typically receives a grant/loan combination. The grant is usually for 35–45 percent of the project cost (it can be up to 75 percent). Loans are for 40 years with interest rates based on a three-tiered structure (poverty, intermediate, and market) depending on community income. The community facility programs are targeted to rural communities with fewer than 20,000 residents and have a program level of \$527 million in 2006. USDA also provides grants, direct loans, and loan guarantees to assist rural businesses, including cooperatives, to increase employment and diversify the rural economy. In 2006, USDA proposes to provide \$899 million in loan guarantees to rural businesses (these loans serve communities of 50,000 or less).

USDA also provides loans through the Intermediary Relending Program (IRP), which provides loan funds at a 1 percent interest rate to an intermediary such as a State or local government agency that, in turn, provides funds for economic and community development projects in rural areas. In 2006, USDA expects to retain or create over 74,784 jobs through its business programs, which will be achieved primarily through the Business and Industry guarantee and the IRP loan programs.

Electric and Telecommunications Loans

USDA's Rural Utilities Service (RUS) programs provide loans for rural electrification, telecommunications, distance learning, telemedicine, and broadband, and also provide grants for distance learning and telemedicine. See the Budget Appendix for more information on these programs.

Providing funding and services to needy areas is of concern to USDA. Many rural cooperatives provide service to areas where there are high poverty rates. Based on PART findings, USDA is reviewing its current

method of issuing telecommunications loans, “first in; first out”, to determine if it allows for adequate support for areas with the highest priority needs. In addition, to ensure the electric and telecommunications programs’ focus on rural areas, USDA will require recertification of rural status for each electric and telecommunications borrower on the first loan request received in or after FY 2006 and on the first loan request received after each subsequent Census. Legislation will be sought to allow for the rescission of loans that are more than ten years old.

The Budget includes \$2.5 billion in direct electric loans, \$670 million in direct telecommunications loans, \$359 million in broadband loans and \$25 million in DLT grants. The budget proposes blocking the mandatory broadband funding and providing discretionary funding. The demand for loans to rural electric cooperatives has been increasing and is expected to increase further as borrowers replace many of the 40-year-old electric plants. RUS electric borrowers are expected to upgrade 225 rural electric systems, which will benefit over 3.4 million customers. The telecommunications borrowers are expected to fund over 50 telecommunication systems for advanced telecommunications services, which will provide broadband and high-speed Internet access and benefit over 300 thousand rural customers. DLT grants are expected to support the provision of distance learning facilities to 150 schools, libraries, and rural education centers and also to provide telemedicine equipment to 150 rural health care providers, benefiting millions of residents in rural America.

The Administration proposes to establish the process and terms to implement a dissolution of the Rural Telephone Bank (RTB). Dissolution will allow the RTB to close as the demand for loans has been fulfilled through other sources. In addition, the stock holders will obtain a cash payout for their stock while removing this cumbersome program from the Government. This proposal avoids the privatization of a bank that will either fail or need continued Government support to remain in operation.

Loans to Farmers

The Farm Service Agency (FSA) assists low-income family farmers in starting and maintaining viable farming operations. Emphasis is placed on aiding beginning and socially disadvantaged farmers. FSA offers operating loans and ownership loans, both of which may be either direct or guaranteed loans. Operating loans provide credit to farmers and ranchers for annual production expenses and purchases of livestock, machinery, and equipment. Farm ownership loans assist producers in acquiring and developing their farming or ranching operations. As a condition of eligibility for direct loans, borrowers must be unable to obtain private credit at reasonable rates and terms. As FSA is the “lender of last resort,” default rates on FSA direct loans are generally higher than those on private-sector loans. However, in recent years the loss rate has decreased to 3.6 percent in 2004, compared to 4.7 percent in 2003.

FSA guaranteed farm loans are made to more credit-worthy borrowers who have access to private credit markets. Because the private loan originators must retain 10 percent of the risk, they exercise care in examining the repayment ability of borrowers. As a result, losses on guaranteed farm loans remain low with default rates of 0.69 percent in 2004, as compared to 0.71 percent in 2003. The subsidy rates for these programs have been fluctuating over the past several years. These fluctuations are mainly due to the interest component of the subsidy rate.

In 2004, FSA provided loans and loan guarantees to approximately 26,000 family farmers totaling \$3.1 billion. The number of loans provided by these programs has fluctuated over the past several years. The average size for farm ownership loans has been increasing. The majority of assistance provided in the operating loan program is to existing FSA farm borrowers. In the farm ownership program, new customers receive the bulk of the benefits furnished. The demand for FSA direct and guaranteed loans continues to be high due to crop/livestock price decreases and some regional production problems. In 2006, USDA’s FSA proposes to make \$3.8 billion in direct and guaranteed loans through discretionary programs.

A PART evaluation conducted in 2004 showed that the FSA’s direct loan program functions well in general. To improve program effectiveness further, FSA is conducting an in-depth review of its direct and guaranteed loan portfolios to assess program performance, including the effectiveness of targeted assistance and the ability of borrowers to graduate to private credit. The results of this review will assist FSA in improving the delivery of its services and the economic viability of farmers and ranchers.

The Farm Credit System and Farmer Mac

The Farm Credit System (FCS or System) and the Federal Agricultural Mortgage Corporation (FarmerMac) are Government-Sponsored Enterprises (GSEs) that enhance credit availability for the agricultural sector. The FCS provides production, equipment, and mortgage lending to farmers and ranchers, aquatic producers, their cooperatives, related businesses, and rural homeowners, while Farmer Mac provides a secondary market for agricultural real estate and rural housing mortgages.

The Farm Credit System

During 2004, the financial condition of the System’s banks and associations continued a 15-year trend of improving financial health and performance. As of September 30, 2004, capital increased 11.1 percent for the year and stood at \$18.0 billion. These capital numbers exclude \$2.1 billion of restricted capital held by the Farm Credit System Insurance Corporation (FCSIC). Loan volume has increased since 1989 to \$94.9 billion in September 2004. The rate of asset growth for the preceding three-year period (2001-2003) has been averaging 7.4 percent. However, the rate of capital accumulation has been greater, resulting in total capital (in-

cluding restricted capital) equaling 16.2 percent of total assets at year-end 2003, compared to 15.3 percent at year-end 2000. Nonperforming loans decreased significantly to 0.88 percent of total loans in September 2004, compared to 1.38 percent in September 2003. Competitive pressures, higher balances of lower yielding investments, and a low interest rate environment have narrowed the FCS's year-to-date net interest margin to 2.52 percent for September 2004 from 2.62 percent in 2003. The current interest rate environment and strong competition in the lending markets are likely to continue placing pressure on the net interest margin. Consolidation continues to affect the structure of the FCS. In January 1995, there were nine banks and 232 associations; by September 2004, there were five banks and 97 associations.

The FCSIC ensures the timely payment of principal and interest on FCS obligations. FCSIC manages the Insurance Fund which supplements the System's capital and supports the joint and several liability of the System banks. On September 30, 2004 the Insurance Fund's net assets totaled \$1.9 billion, of which \$40 million was allocated to the Allocated Insurance Reserve Accounts (AIRAs) held for the System banks and the Financial Assistance Corporation's stockholders. Not including the AIRAs, the Insurance Fund was at 2.01 percent of adjusted insured debt obligations of the System banks, slightly above the statutory minimum of 2 percent.

Improvement in the FCS's financial condition is also reflected in the examinations by the Farm Credit Administration (FCA), its regulator. Each of the System institutions is rated under the FCA Financial Institution Rating System (FIRS) for capital, asset quality, management, earnings, liquidity, and sensitivity. At the beginning of 1995, 197 institutions carried the best FIRS ratings of 1 or 2, 36 were rated 3, one institution was rated 4, no institutions were rated 5, and 26 institutions were under enforcement action. In September 2004, all 102 banks and associations had ratings of 1 or 2, and no institution was under an enforcement action.

Over the past 12 months, the System's loans outstanding have grown by \$3.6 billion, or 3.9 percent, while over the past five years they have grown \$25.2 billion, or 36.2 percent. The volume of lending secured by farmland increased 51.5 percent, while farm-operating loans have increased 34.7 percent since 1999. Agricultural producers represented the largest borrower group, with \$76.9 billion including loans to rural homeowners and leases, or 81.1 percent of the dollar amount of loans outstanding. International loans (export financing) represent 3.0 percent of the System's loan portfolio. Loans to young, beginning, and small farmers and ranchers represented 12.9, 18.7, and 31.8 percent, respectively, of the total dollar volume outstanding in 2003, which is slightly higher than in 2002. These percentages cannot be summed given significant overlap in these categories. Providing credit and related services to young, beginning, and small farmers and ranch-

ers is a legislated mandate and a high priority for the System.

The System, while continuing to record strong earnings and capital growth, remains exposed to a variety of risks, including concentration risk, possible changes to government programs, the volatility of agricultural exports and commodity prices, animal and plant diseases, and concerns about future off-farm employment prospects, given the trends in job outsourcing and global competition.

Farmer Mac

Farmer Mac was established in 1987 to facilitate a secondary market for farm real estate and rural housing loans. Since the Agricultural Credit Act of 1987, there have been several amendments to Farmer Mac's chartering statute. Perhaps the most significant amending legislation for Farmer Mac was the Farm Credit System Reform Act of 1996 that transformed Farmer Mac from a guarantor of securities backed by loan pools into a direct purchaser of mortgages, enabling it to form pools to securitize. The 1996 Act increased Farmer Mac's ability to provide liquidity to agricultural mortgage lenders. Since the passage of the 1996 Act, Farmer Mac's program activities and business have increased significantly.

Farmer Mac continues to meet core capital and regulatory risk-based capital requirements. Farmer Mac's total program activity (loans purchased and guaranteed, and AgVantage bonds purchased) as of September 30, 2004, totaled \$5.5 billion. That volume represents 1.8 percent reduction from program activity at September 30, 2003. Of total program activity, \$2.2 billion were on-balance sheet loans and agricultural mortgage-backed securities and \$3.3 billion were off-balance sheet obligations. Total assets were \$3.8 billion at the close of the calendar third quarter, with non-program investments accounting for \$1.4 billion of those assets. Farmer Mac's net income to common stockholders for the first three quarters of 2004 was \$18.4 million, a decrease of \$1.74 million, or 8.7 percent from the same period in 2003.

International Credit Programs

Seven Federal agencies—the Department of Agriculture (USDA), the Department of Defense, the Department of State, the Department of the Treasury, the Agency for International Development (USAID), the Export-Import Bank, and the Overseas Private Investment Corporation (OPIC)—provide direct loans, loan guarantees, and insurance to a variety of foreign private and sovereign borrowers. These programs are intended to level the playing field for U.S. exporters, deliver robust support for U.S. manufactured goods, stabilize international financial markets, and promote sustainable development.

Leveling the Playing Field

Federal export credit programs counter subsidies that foreign governments, largely in Europe and Japan, provide their exporters, usually through export credit agen-

cies (ECAs). The U.S. Government has worked since the 1970's to constrain official credit support through a multilateral agreement in the Organization for Economic Cooperation and Development (OECD). This agreement has significantly constrained direct interest rate subsidies and tied-aid grants. Further negotiations resulted in a multilateral agreement that standardized the fees for sovereign lending across all ECAs beginning in April 1999. Fees for non-sovereign lending, however, continue to vary widely across ECAs and markets, thereby providing implicit subsidies.

The Export-Import Bank attempts to strategically "level the playing field" and to fill gaps in the availability of private export credit. The Export-Import Bank provides export credits, in the form of direct loans or loan guarantees, to U.S. exporters who meet basic eligibility criteria and who request the Bank's assistance. USDA's "GSM" programs similarly help to level the playing field. Like programs of other agricultural exporting nations, GSM programs guarantee payment from countries and entities that want to import U.S. agricultural products but cannot easily obtain credit. The U.S. has been negotiating in the OECD the terms of agricultural export financing, the outcome of which could affect the GSM programs.

Stabilizing International Financial Markets

In today's global economy, the health and prosperity of the American economy depend importantly on the stability of the global financial system and the economic health of our major trading partners. The United States can contribute to orderly exchange arrangements and a stable system of exchange rates by providing resources on a multilateral basis through the IMF (discussed in other sections of the Budget), and through financial support provided by the Exchange Stabilization Fund (ESF).

The ESF may provide "bridge loans" to other countries in times of short-term liquidity problems and financial crises. In the past, "bridge loans" from ESF provided dollars to a country over a short period before the disbursement of an IMF loan to the country. Also, a package of up to \$20 billion of medium-term ESF financial support was made available to Mexico during its crisis in 1995. Such support was essential in helping to stabilize Mexican and global financial markets. Mexico paid back its borrowings under this package ahead of schedule in 1997, and the United States earned almost \$600 million more in interest than it would have without the lending. There was zero subsidy cost for the United States as defined under credit reform, as the medium-term credit carried interest rates reflecting an appropriate country risk premium.

The United States also expressed a willingness to provide ESF support in response to the financial crises affecting some countries such as South Korea in 1997 and Brazil in 1998. It did not prove necessary to provide an ESF credit facility for Korea, but the United States agreed to guarantee through the ESF up to \$5 billion of a \$13.2 billion Bank for International Settlements (BIS) credit facility for Brazil.

In the event, the ESF guaranteed \$3.3 billion in BIS credits to Brazil and earned \$140.3 million in commissions. Such support helped to provide the international confidence needed by these countries to begin the stabilization process.

Using Credit to Promote Sustainable Development

Credit is an important tool in U.S. bilateral assistance to promote sustainable development. USAID's Development Credit Authority (DCA) allows USAID to use a variety of credit tools to support its development activities abroad. This unit encompasses newer DCA activities, such as municipal bond guarantees for local governments in developing countries, as well as USAID's traditional microenterprise and urban environmental credit programs. DCA provides non-sovereign loans and loan guarantees in targeted cases where credit serves more effectively than traditional grant mechanisms to achieve sustainable development. DCA is intended to mobilize host country private capital to finance sustainable development in line with USAID's strategic objectives. Through the use of partial loan guarantees and risk sharing with the private sector, DCA stimulates private-sector lending for financially viable development projects, thereby leveraging host-country capital and strengthening sub-national capital markets in the developing world. While there is clear demand for DCA's facilities in some emerging economies, the utilization rate for these facilities is still very low.

OPIC also supports a mix of development, employment, and export goals by promoting U.S. direct investment in developing countries. OPIC pursues these goals through political risk insurance, direct loans, and guarantee products, which provide finance, as well as associated skills and technology transfers. These programs are intended to create more efficient financial markets, eventually encouraging the private sector to supplant OPIC finance in developing countries. OPIC has also created a number of investment funds that provide equity to local companies with strong development potential.

Ongoing Coordination

International credit programs are coordinated through two groups to ensure consistency in policy design and credit implementation. The Trade Promotion Coordinating Committee (TPCC) works within the Administration to develop a National Export Strategy to make the delivery of trade promotion support more effective and convenient for U.S. exporters.

The Interagency Country Risk Assessment System (ICRAS) standardizes the way in which agencies budget for the cost associated with the risk of international lending. The cost of lending by the agencies is governed by proprietary U.S. government ratings, which correspond to a set of default estimates over a given maturity. The methodology establishes assumptions about default risks in international lending using averages

of international sovereign bond market data. The strength of this method is its link to the market and an annual update that adjusts the default estimates to reflect the most recent risks observed in the market.

For 2006, OMB updated the default estimates using the default estimate methodology introduced in FY 2003 and the most recent market data. The 2003 default estimate methodology implemented a significant revision that uses more sophisticated financial analyses and comprehensive market data, and better isolates the expected cost of default implicit in interest rates charged by private investors to sovereign borrowers. All else being equal, this change expands the level of international lending an agency can support with a given appropriation. For example, the Export-Import Bank will be able to provide generally higher lending levels using lower appropriations in 2006.

Adapting to Changing Market Conditions

Overall, officially supported finance and transfers account for a tiny fraction of international capital flows. Furthermore, the private sector is continuously adapting its size and role in emerging markets finance to

changing market conditions. In response, the Administration is working to adapt international lending at Export-Import Bank and OPIC to dynamic private sector finance. The Export-Import Bank, for example, is developing a sharper focus on lending that would otherwise not occur without Federal assistance. Measures under development include reducing risks, collecting fees from program users, and improving the focus on exporters who truly cannot access private export finance.

OPIC in the past has focused relatively narrowly on providing financing and insurance services to large U.S. companies investing abroad. As a result, OPIC did not devote significant resources to its mission of promoting development through mobilizing private capital. In 2003, OPIC implemented new development performance measures and goals that reflect the mandate to revitalize its core development mission.

These changes at the Export-Import Bank and at OPIC will place more emphasis on correcting market imperfections as the private sector's ability to bear emerging market risks becomes larger, more sophisticated, and more efficient.

IV. INSURANCE PROGRAMS

Deposit Insurance

Federal deposit insurance promotes stability in the U.S. financial system. Prior to the establishment of Federal deposit insurance, failures of some depository institutions often caused depositors to lose confidence in the banking system and rush to withdraw deposits. Such sudden withdrawals caused serious disruption to the economy. In 1933, in the midst of the Depression, the system of Federal deposit insurance was established to protect small depositors and prevent bank failures from causing widespread disruption in financial markets. The federal deposit insurance system came under serious strain in the late 1980s and early 1990s when over 2,500 banks and thrifts failed. The Federal Government responded with a series of reforms designed to improve the safety and soundness of the banking system. These reforms, combined with more favorable economic conditions, helped to restore the health of depository institutions and the deposit insurance system.

The Federal Deposit Insurance Corporation (FDIC) insures deposits in banks and savings associations (thrifts) through separate insurance funds: the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The National Credit Union Administration (NCUA) administers the insurance fund for most credit unions (certain credit unions are privately insured and not covered by the fund). FDIC and NCUA insure deposits up to \$100,000 per account. FDIC insures \$3.6 trillion of deposits at 7,660 commercial banks and 1,365 savings institutions. NCUA insures about 9,113 credit unions with \$495 billion in insured shares.

Current Industry and Insurance Fund Conditions

The bank industry continues to earn record profits. In the quarter ending September 30, 2004, banks reported record-high earnings for the sixth time in the last seven quarters. In fiscal year 2004, industry net income totaled \$122 billion, an increase of 7 percent over fiscal year 2003. The quality of loans continues to improve as net charge-offs fell to a four-year low. Despite the improving trends, some risks remain. Rising interest rates, for example, might cause stresses in certain real-estate markets and strains on banks in some regions.

Only four BIF members and one SAIF member with a combined \$175 million dollars in assets failed during fiscal year 2004. In comparison, in the last five years, assets associated with BIF failures have averaged \$857 million per year, while failures associated with SAIF averaged \$455 million. At the height of the banking crisis in 1989, failed assets rose to over \$150 billion in one year. The FDIC currently classifies 95 institutions with \$25 billion in assets as "problem institutions," compared to 116 institutions with \$30 billion in assets a year ago.

In fiscal year 2004, the reserve ratio (ratio of insurance reserves to insured deposits) of BIF stayed above the 1.25-percent statutory target. As of September 30, 2004, BIF had estimated reserves of \$34 billion, or 1.32 percent of insured deposits. Factors that helped BIF stay above the statutory target in fiscal year 2004 include fewer bank failures, slow growth of insured deposits, and increases in unrealized gains on securities available for sale. The SAIF reserve ratio also remained above the designated reserve ratio throughout the year.

As of September 30, 2004, SAIF had reserves of \$12.5 billion, or 1.33 percent of insured deposits. Through June 30, 2005, the FDIC will continue to maintain deposit insurance premiums in a range from zero for the healthiest institutions to 27 cents per \$100 of assessable deposits for the riskiest institutions. In May, the FDIC will set assessment rates for July through December of this year. Due to the strong financial condition of the industry and the insurance funds, less than 10 percent of banks and thrifts paid insurance premiums in 2004.

During 2004, 22 Federally insured credit unions with \$120 million in assets failed (including assisted mergers). In comparison, in 2003, 8 Federally insured credit unions with \$25 million in assets failed. The National Credit Union Share Insurance Fund (NCUSIF) ended fiscal year 2004 with assets of \$6.3 billion and an equity ratio of 1.28 percent, below the NCUA-set target ratio of 1.30 percent. Each insured credit union is required to deposit and maintain an amount equal to 1 percent of its member share accounts in the fund. Premiums were waived during 2004 because the ratio stayed above 1.25 percent. As the Fund's equity ratio did not exceed 1.30 percent, NCUA did not provide a dividend to credit unions in fiscal year 2004.

The Federal banking regulators (the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve) are planning a rulemaking that would implement the new Basel Capital Accord (Basel II). The original Basel Capital Accord is an international agreement establishing a uniform capital standard across nations. It adopted a risk-based capital requirement that applies differing risk weights to a few broad categories of assets. Basel II proposes several ways to improve the risk-based capital requirement, including refining risk categories and applying sophisticated models calculating the risk of various assets. U.S. regulators are considering implementing the model-based capital requirement for the largest banks (about 20) that have complex financial structures and expertise to apply sophisticated models. The new capital requirement would be a major change because those banks hold the overwhelming majority of U.S. banking assets.

As a result of consolidation, fewer large banks control an increasingly substantial share of banking assets. Thus, the failure of even one of these large institutions could strain the insurance fund. Banks are increasingly using sophisticated financial instruments such as asset-backed securities and financial derivatives, which could have unforeseen effects on risk levels. Whether or not these new instruments add to risk, they do complicate the work of regulators who must gauge each institution's financial health and the potential for deposit insurance losses that a troubled institution may represent.

Federal Deposit Insurance Reform

While the deposit insurance system is in good condition, the Administration supports reforms to make improvements in the operation and fairness of the deposit insurance system for banks and thrifts. In 2003, the Treasury Department and federal banking regulatory agencies submitted to Congress a proposal that would accomplish this objective. Specifically, the proposal would merge the BIF and the SAIF. A single merged fund would be stronger and better diversified than either fund alone and would prevent the possibility that institutions posing similar risks would again pay significantly different premiums for the same product. Under the current system, the FDIC is required to maintain a ratio of insurance fund reserves to total insured deposits of 1.25 percent. If insurance fund reserves fall below the 1.25 ratio, the FDIC must charge either sufficient premiums to restore the reserve ratio to 1.25 percent within one year, or no less than 23 basis points if the reserve ratio remains below 1.25 percent for more than one year. The Administration's proposal would give the FDIC authority to adjust the ratio periodically within prescribed upper and lower bounds and greater discretion in determining how quickly it restores the ratio to target levels. This flexibility would help reduce potential pro-cyclical effects by stabilizing industry costs over time and avoiding sharp premium increases when the economy may be under stress. Finally, the FDIC has been prohibited since 1996 from charging premiums to "well-capitalized" and well-run institutions as long as insurance fund reserves equal or exceed 1.25 percent of insured deposits. Therefore, less than 10 percent of banks and thrifts pay insurance premiums, allowing a large number of financial institutions to increase their insured deposits rapidly without any contribution to the insurance fund. The Administration proposal would repeal this prohibition to ensure that institutions with rapidly increasing insured deposits or greater risks appropriately compensate the insurance fund.

Pension Guarantees

The Pension Benefit Guaranty Corporation (PBGC) insures most defined-benefit pension plans sponsored by private employers. PBGC pays the benefits guaranteed by law when a company with an underfunded pension plan becomes insolvent. PBGC's exposure to claims relates to the underfunding of pension plans, that is, to any amount by which vested future benefits exceed plan assets. In the near term, its loss exposure results from financially distressed firms with underfunded plans. In the longer term, additional loss exposure results from the possibility that currently healthy firms become distressed and currently well-funded plans become underfunded due to inadequate contributions or poor investment results.

PBGC monitors troubled companies with underfunded plans and acts, in bankruptcies, to protect its beneficiaries and the future of the program. Such pro-

tections include, where necessary, initiating plan termination. Under its Early Warning Program, PBGC negotiates settlements with companies that reduce losses in the event the plan terminates.

PBGC's single-employer program suffered record annual losses from underfunded plan terminations in 2001 through 2004. As a result of these record losses, the program's deficit at FY 2004 year-end stood at \$23.3 billion, compared to \$11.2 billion a year earlier and a \$9.7 billion surplus at FY 2000 year-end. Large underfunded terminations include: in FY 2002, LTV, a steel company, with a claim of nearly \$2 billion, which was PBGC's largest to date; in FY 2003, Bethlehem Steel, with a claim of about \$3.6 billion, National Steel, and US Airways' Pilots Plan; and in FY 2004, Kaiser Aluminum's Salaried Plan, Pillowtex, and Weirton Steel. More important in FY 2004 than claims for completed terminations was the increase in claims for "probable" terminations to \$16.9 billion from \$5.2 billion in FY 2003.

Additional risk and exposure may remain for the future because of economic uncertainties and significant underfunding in single-employer pension plans, which exceed an estimated \$450 billion at fiscal year-end, compared to \$350 billion at the end of FY 2003 and \$50 billion at the end of December 2000. PBGC's exposure to "reasonably possible" terminations, the amount of unfunded vested benefits in pension plans sponsored by companies at greater risk of default, stood at \$96 billion at the end of December 2003, up from \$82 billion a year earlier.

The smaller multiemployer program guarantees pension benefits of certain unionized plans offered by several employers in an industry. It ended 2003 with its first deficit in over 20 years, of about \$261 million. The deficit fell to \$236 million in 2004. However, estimated underfunding in multiemployer plans approximated \$150 billion at year-end, up from over \$100 billion at the end of FY 2003.

With assets of \$39 billion, the agency can meet its obligations for a number of years into the future, but, with \$62 billion of liabilities in the single-employer program, it is clear that the financial integrity of the federal pension insurance program is at risk.

Looking to the long term, to avoid benefit reductions, strengthen PBGC, and help stabilize the defined-benefit pension system, the 2006 Budget proposes legislative reforms to:

- Require employers to fully fund their plans by making up their funding shortfall over a reasonable period of time and give companies added flexibility to contribute more in good economic times.
- Require that funding be based on a more accurate measure of liabilities and establish appropriate funding targets based on a plan's risk of termination.
- Update the variable-rate premium to reflect the new funding targets and provide for the PBGC Board to reexamine it periodically to cover the

cost of expected claims and to improve PBGC's financial position; and adjust the flat-rate premium to reflect the growth in worker wages.

- Require employers to forego benefit increases if the sponsor is financially weak or has a significantly underfunded pension plan.
- Require plans to provide timely information on the true financial health of pension plans to workers and make such information publicly available to other stakeholders.

The Administration's comprehensive reforms will strengthen funding for workers' defined-benefit pensions; provide more accurate information about pension liabilities and plan underfunding; and ensure PBGC's continued ability to safeguard pension benefits for 44 million Americans.

Disaster Insurance

Flood Insurance

The Federal Government provides flood insurance through the National Flood Insurance Program (NFIP), which is administered by the Emergency Preparedness and Response Directorate of the Department of Homeland Security (DHS). Flood insurance is available to homeowners and businesses in communities that have adopted and enforced appropriate flood plain management measures. Coverage is limited to buildings and their contents. By 2005, the program is projected to have approximately 4.9 million policies from more than 19,000 communities with \$828 billion of insurance in force.

Prior to the creation of the program in 1968, many factors made it cost prohibitive for private insurance companies alone to make affordable flood insurance available. In response, the NFIP was established to make insurance coverage widely available. The NFIP requires building standards and other mitigation efforts to reduce losses, and operates a flood hazard mapping program to quantify the geographic risk of flooding. These efforts have made substantial progress.

The number of policies in the program has grown significantly over time. The number of enrolled policies grew from 2.4 to 4.3 million between 1990 and 2002, and by about 85,000 policies in 2004, bringing the policy total to 4.5 million. DHS is using three strategies to increase the number of flood insurance policies in force: lender compliance, program simplification, and expanded marketing. DHS is educating financial regulators about the mandatory flood insurance requirement for properties that are located in flood plains and have mortgages from federally regulated lenders. The NFIP also has a multi-pronged strategy for reducing future flood damage. The NFIP offers mitigation insurance to allow flood victims to rebuild to code, thereby reducing future flood damage costs. Further, through the Community Rating System, DHS adjusts premium rates to encourage community and State mitigation activities beyond those required by the NFIP.

Despite these efforts, the program faces financial challenges. The program's financing account, which is a cash fund, has sometimes had expenses greater than its revenue, preventing it from building sufficient long-term reserves. This is mostly because a large portion of the policyholders pay subsidized premiums. DHS charges subsidized premiums for properties built before a community adopted the NFIP building standards. Properties built subsequently are charged actuarially fair rates. The creators of the NFIP assumed that eventually the NFIP would become self-sustaining as older properties left the program. The share of subsidized properties in the program has fallen, but remains substantial; it was 70 percent in 1978 and is 28 percent today.

Until the mid-1980s, Congress appropriated funds periodically to support subsidized premiums. However, the program has not received appropriations since 1986. During the 1990s, FEMA, which is now part of DHS, relied on Treasury borrowing to help finance its loss expenses (the NFIP may borrow up to \$1.5 billion). As of October 31, 2002, the NFIP had repaid all of its outstanding debt.

Although the program is generally well run, it receives some criticism about the low participation rate and the inclusion of subsidized properties, especially those that are repetitively flooded. The program has identified approximately 11,000 properties for mitigation action. To the extent they are available; funds will come from the Hazard Mitigation Grant Program, the Predisaster Mitigation Grant Program, and the Flood Mitigation Grant Program. The Flood Insurance Reform Act of 2004 defines the criteria that qualify these repetitively-damaged properties for special mitigation. The legislation also extended the NFIP's authority through September 30, 2008. An additional problem is the fairly low participation rate. Currently, less than half of the eligible properties in identified flood plains participate in this program. In comparison, the participation rate for private wind and hurricane insurance is nearly 90 percent in at-risk areas. Given that flood damage causes roughly \$6 billion in property damage annually, DHS is in the process of evaluating its incentive structure to attract more participation in the program, while not encouraging misuse of the program.

Crop Insurance

Subsidized Federal crop insurance administered by USDA's Risk Management Agency (RMA) plays an important role in assisting farmers to manage yield and revenue shortfalls due to bad weather or other natural disasters. RMA continues to evaluate and, provide new products so that the Government can further reduce the need for ad-hoc disaster assistance payments to the agriculture community in bad years.

The USDA crop insurance program is a cooperative effort between the Federal Government and the private insurance industry. Private insurance companies sell and service crop insurance policies. These companies rely on reinsurance provided by the Federal Govern-

ment and also by the commercial reinsurance market to manage their individual risk portfolio. The Federal Government reimburses private companies for the administrative expenses associated with providing crop insurance and reinsures the private companies for excess insurance losses on all policies. The Federal Government also subsidizes premiums for farmers. The Agricultural Risk Protection Act of 2000 (ARPA) increased premium subsidy levels to encourage farmers to purchase higher and more effective levels of coverage.

RMA renegotiated the Standard Reinsurance Agreement (SRA) in 2004. The SRA contains the operational and financial risk sharing terms between the Federal Government and the private companies. The ARPA allowed these terms to be renegotiated once between the 2001 and 2005 reinsurance years. RMA utilized this opportunity to strengthen the document to address such issues as company oversight and quality control. As a result of these negotiations, company administrative expense reimbursements were reduced by approximately 3 percent, and a 5 percent net book quota share was introduced to better balance profit potential between the companies and the Federal Government. The new SRA is expected to generate annual program cost savings of approximately \$36 million.

In addition to these changes, the 2006 Budget includes a legislative proposal that would require any farmer that receives a Federal commodity payment for his/her crop to buy crop insurance at a minimum coverage level of 50/100. This proposal is intended to ensure farmers have adequate protection in the event of a natural disaster without resorting to ad hoc disaster assistance. Additionally, the Administration's proposal will lower the imputed premium on Catastrophic Crop Insurance (CAT) by 25 percent and charge an administrative fee on CAT equal to the greater of \$100 or 25 percent of the (restated) imputed CAT premium, subject to a maximum fee of \$5,000. The proposal will also reduce premium subsidies by 5 percentage points on policies with a coverage level of 70 percent or below (75 percent for Group Risk Protection (GRP)) and by 2 percentage point on policies with a coverage level of 75 percent or above (80 percent for GRP). Plus the proposal reduces the A&O reimbursement on all buy-up coverage by 2 percentage points and increases the net book quota share to 22 percent, but provides a ceding commission to the companies of 2 percent. These changes are expected to be in effect in 2007 and will save \$140 million a year.

There are various types of insurance programs. The most basic type of coverage is CAT, which compensates the farmer for losses in excess of 50 percent of the individual's average yield at 55 percent of the expected market price. The CAT premium is entirely subsidized, and farmers pay only an administrative fee. Commercial insurance companies deliver the product to the producer in all states. Additional coverage is available to producers who wish to insure crops above the CAT coverage level. Premium rates for additional coverage depend on the level of coverage selected and vary from

crop to crop and county to county. The additional levels of insurance coverage are more attractive to farmers due to availability of optional units, other policy provisions not available with CAT coverage, and the ability to obtain a level of protection that permits them to use crop insurance as loan collateral and to achieve greater financial security. Private companies sell and service the catastrophic portion of the crop insurance program, and also provide higher levels of coverage, which are also federally subsidized. Approximately 82 percent of eligible acres participated in one or more crop insurance programs in 2004.

For producers purchasing the additional levels of insurance, there are a wide range of yield- and revenue-based insurance products available through the Federal crop insurance program. Revenue insurance programs protect against loss of revenue stemming from low prices, poor yields, or a combination of both. These programs extend traditional multi-peril crop insurance protection by adding price variability to production history. Indemnities are due when any combination of yield and price results in revenue that is less than the revenue guarantee. The price component common to these plans uses the commodity futures market for price discovery. Revenue products have gained wide acceptance among producers and have played an integral role in providing more effective risk management options for the nation's agricultural producers. In crop year 2004, these revenue products accounted for over 52 percent of all policies earning premium, 59 percent of net insured acres, and 55 percent of total program liability.

USDA also continues to expand coverage. In 2004, a sugar beet stage removal pilot program was introduced. In addition, approval was given to a pilot program of crop insurance for Silage Sorghum in two states and to make Adjusted Gross Revenue-Lite available in five additional states, both effective for the 2005 crop year. USDA also expanded the availability of the Livestock Risk Protection plan of insurance to additional states and for additional types of livestock. Further, RMA has issued 4 contracts for development of new risk management tools for pasture, rangeland and forage. ARPA directed FCIC to establish the development of a pasture, rangeland and forage program as one of its highest research and development priorities. RMA continues to pursue a number of avenues to increase program participation among underserved states and commodities.

For more information and additional crop insurance program details, please reference RMA's web site: (www.rma.usda.gov).

Insurance against Security-Related Risks

The Federal Government offers terrorism risk insurance and Airline War Risk Insurance on a temporary basis, and has created the smallpox injury compensation program. After the September 11 attacks, private insurers became reluctant to insure against security-related risks such as terrorism and war. Those events are so uncertain in terms of both the frequency of occur-

rence and the magnitude of potential loss that private insurers have difficulty estimating the expected loss. Furthermore, terrorism can produce a large loss that could wipe out private insurers' capital. These uncertainties make the private sector reluctant to provide security-related insurance. Thus, it is necessary for the smooth functioning of our economy that the Federal Government insure against some security-related risks until the private sector learns enough to be comfortable about estimating those risks.

Terrorism Risk Insurance

On November 26, 2002, President Bush signed into law the Terrorism Risk Insurance Act of 2002. The Act was designed to address disruptions in economic activity caused by the withdrawal of many insurance companies from the marketplace for terrorism risk insurance in the aftermath of the terrorist attacks of September 11, 2001. Their withdrawal in the face of great uncertainty as to their risk exposure to future terrorist attacks led to a moratorium in construction projects, increased business costs for the insurance that was available, and substantial shifting of risk from reinsurers to primary insurers, and from insurers to policyholders (e.g., investors, businesses, and property owners). Ultimately, these costs were borne by American workers and communities through decreased development and economic activity.

The Act established a temporary Federal program that provides for a system of shared public and private compensation for insured commercial property and casualty losses arising from acts of terrorism. The program is administered by the Treasury Department and is scheduled to sunset on December 31, 2005.

Under the Act, insurance companies included under the program must make available to their policyholders during the first two years of the program coverage for losses from acts of terrorism (as defined by the Act), and Treasury was required to determine whether to extend this requirement into the third and final year of the program. On June 18, 2004, the Secretary of the Treasury announced his decision to extend the "make available" requirement through the third and final year. The Act also requires as a condition for Federal payment that insurance companies disclose to policyholders the premium charged for terrorism risk insurance and the Federal share of compensation under the program.

In the event of a terrorist attack on private businesses and others covered by this program, insurance companies will cover 100 percent of the insured losses up to each insurance company's deductible as specified in the Act. Insured losses above that amount would then be shared between the insurance company and the Treasury, with Treasury covering 90 percent of the losses above the insurance company's deductible. However, neither the Treasury nor any insurer would be liable for any amount exceeding the statutory annual cap of \$100 billion in aggregate insured losses. At that point, the Act explains that Congress will determine

the procedures and source of any further payments. The Act also provides authority for the Treasury to recoup Federal payments via surcharges on policyholders. Certain recoupment is mandatory, based on insurance marketplace aggregate annual retention amounts specified in the enabling statute. In other circumstances, the Act authorizes optional recoupment.

Treasury has created a separate Terrorism Risk Insurance Program office to implement the Act, which has included setting up an infrastructure to handle potential claims under the Act. In order to be ready to make payments under the Act, Treasury has: 1) finalized all of the regulations necessary for the submission and payment of potential claims under the Act; 2) contracted with a claims management contractor and an auditor to assist with the processing and verification of potential claims; and 3) established a web-based claims facility. The Act also requires Treasury to conduct a study on the effectiveness of the program and to report the results to the Congress by June 30, 2005. Treasury has been conducting a comprehensive survey of insurers, reinsurers, and policyholders as part of that study.

Airline War Risk Insurance

After the September 11, 2001 attacks, private insurers cancelled third-party liability war risk coverage for airlines and dramatically increased the cost of other war risk insurance. In response, the Department of Transportation (DOT) provided a short-term reimbursement to airlines for the increased cost of aviation hull and passenger liability war risk insurance under the authority provided in P.L. 107-42. Due to the extended disruption in the marketplace, DOT also offered airlines third-party liability war risk insurance coverage at subsidized rates to replace coverage initially withdrawn by private insurers. Under Presidential Determination No. 01-29, the President delegated the authority to extend the duration of aviation insurance to the Secretary of Transportation. Starting in 2001, insurance coverage was initially provided in 60-day increments, but Presidential Determination Nos. 2004-9 and 2005-15 subsequently extended the allowable period of insurance up to one year.

The Homeland Security Act of 2002 included airline war risk insurance legislation. This law mandated an extended term for third-party war risk coverage and expanded the scope of coverage to include war risk hull, passenger and crew, and property liability insurance. Under the law, the Secretary of Transportation was directed to extend insurance policies until August 31,

2003. In addition, the law also limited the total premium for the three types of insurance to twice the premium rate charged for the third-party liability insurance as of June 19, 2002. The 2003 Department of Defense supplemental appropriation (P.L. 108-11), the Century of Aviation Reauthorization Act (P.L. 108-176, Vision 100), and the Consolidated Appropriations Act of 2005 (P.L. 108-447) ultimately extended the mandatory provision of insurance through August 31, 2005. Consequently, in December 2004, the President issued Presidential Determination 2005-15, authorizing the continued provision of insurance now in force through August 31, 2005, and the DOT issued policies to conform to that date. The basic authority of the insurance program extends through March 30, 2008.

Currently 75 air carriers are insured by DOT. Coverage for individual carriers ranges from \$80 million to \$4 billion per carrier with the median insurance coverage at approximately \$1.8 billion per occurrence. Premiums collected by the Government are deposited into the Aviation Insurance Revolving Fund. In 2004, the fund collected approximately \$180 million in premiums for insurance provided by DOT. In 2005, it is anticipated that \$109 million in premiums will be collected by DOT for the provision of insurance. At the end of 2004, the balance of the Aviation Insurance Revolving Fund available for future claim payments was \$401 million. The Federal Government would pay any claims by the airlines that exceed the balance in the aviation insurance revolving fund.

Smallpox Injury Compensation

The Administration has taken steps to insure the immediate mobilization of emergency response personnel in the event of a smallpox attack. The Smallpox Injury Compensation Program, set up under the Smallpox Emergency Personnel Protection Act of 2003, encourages vaccination of designated emergency personnel by providing benefits and/or compensation to certain persons harmed as a direct result of receiving smallpox countermeasures, including the smallpox vaccine. Only persons receiving the smallpox vaccine under the Department of Health and Human Services Declaration Regarding the Administration of Smallpox Countermeasures are eligible for benefits. Also, the Homeland Security Act of 2002 provided medical liability protection to doctors, drug manufacturers, and hospitals that administer smallpox vaccine and other countermeasures during an emergency declaration.

Chart 7-2. Face Value of Federal Credit Outstanding

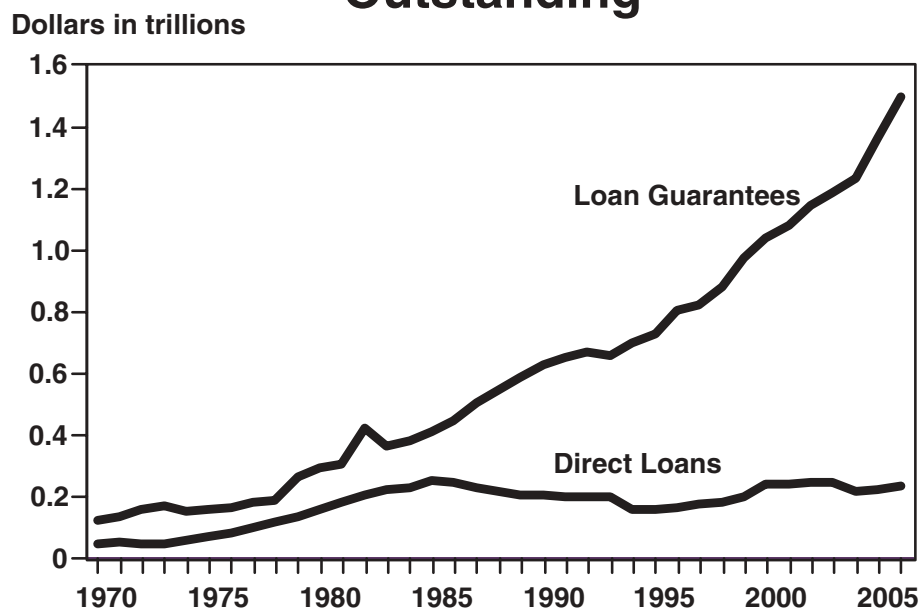


Table 7-1. ESTIMATED FUTURE COST OF OUTSTANDING FEDERAL CREDIT PROGRAMS

(in billions of dollars)

Program	Outstanding 2003	Estimated Future Costs of 2003 Outstanding ¹	Outstanding 2004	Estimated Future Costs of 2004 Outstanding ¹
Direct Loans: ²				
Federal Student Loan Programs	102	10	107	8
Farm Service Agency (excl. CCC), Rural Development, Rural Housing	44	11	43	10
Rural Utilities Service and Rural Telephone Bank	32	3	32	3
Housing and Urban Development	13	3	13	3
Agency for International Development	9	4	8	3
Public Law 480	11	7	9	5
Export-Import Bank	11	4	11	5
Commodity Credit Corporation	7	3	7	3
Federal Communications Commission	5	1	4	4
Disaster Assistance	3	1	3	1
Other Direct Loan Programs	12	.....	13	2
Total Direct Loans	249	47	250	47
Guaranteed Loans: ²				
FHA Mutual Mortgage Insurance Fund	407	2	384	1
VA Mortgage	323	5	351	4
Federal Family Education Loan Program	213	15	245	23
FHA General/Special Risk Insurance Fund	89	4	91	4
Government National Mortgage Association (GNMA) ³ .....	.....	*	.....	*
Small Business	53	2	57	2
Export-Import Bank	34	3	36	2
International Assistance	19	2	21	2
Farm Service Agency and Rural Housing	24	1	24	1
Commodity Credit Corporation	4	*	4	*
Air Transportation Stabilization Program	2	1	2	1
Other Guaranteed Loan Programs	16	1	17	3
Total Guaranteed Loans	1,184	36	1,232	43
Total Federal Credit	1,907	83	1,935	90

* \$500 million or less.

¹ Direct loan future costs are the financing account allowance for subsidy cost and the liquidating account allowance for estimated uncollectible principal and interest. Loan guarantee future costs are estimated liabilities for loan guaranties.² Excludes loans and guarantees by deposit insurance agencies and programs not included under credit reform, such as CCC commodity price supports. Defaulted guaranteed loans which become loans receivable are accounted for as direct loans.³ GNMA outstandings are excluded from the totals because they are secondary guarantees on loans guaranteed by FHA, VA and RHS.

Table 7-2. REESTIMATES OF CREDIT SUBSIDIES ON LOANS DISBURSED BETWEEN 1992-2004 ¹—Continued

(Budget authority and outlays, in millions of dollars)

Program	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Agriculture resource conservation demonstration project								2		1	-1	*
Commodity Credit Corporation export guarantees	3	103	-426	343				-1,410		-13	-230	-205
Rural development insurance fund	49			-3								
Rural housing insurance fund	2	10	7	-10		109		152	-56	32	50	
Rural community advancement program ²				-10		41		63	17	91	15	
Commerce:												
Fisheries finance					-2			-3	-1	3	*	1
Emergency steel guaranteed loans										50	*	3
Emergency oil and gas guaranteed loans								*	*	*	*	*
Defense:												
Military housing improvement fund											-3	-1
Defense export loan guarantee												-5
Education:												
Federal family education loan program: ³												
Volume reestimate			535	99		-13	-60	-42		277		-420
Other technical reestimate	97	421	60			-140	667	-3,484		-2,483	-3,278	1,321
Health and Human Services:												
Health center loan guarantees							3		*	*		1
Health education assistance loans										-5	-37	-33
Housing and Urban Development:												
Indian housing loan guarantee								-6	*	-1	*	-4
Title VI Indian guarantees										-1	1	4
Community development loan guarantees											19	-10
FHA-mutual mortgage insurance				-340		3,789		2,413	-1,308	1,100	5,947	1,980
FHA-general and special risk	-175		-110	-25	743	79		-217	-403	77	352	507
Interior:												
Bureau of Indian Affairs guaranteed loans				31				-14	-1	-2	-2	*
Transportation:												
Maritime guaranteed loans (title XI)						-71	30	-15	187	27	-16	4
Minority business resource center									1		*	*
Treasury:												
Air transportation stabilization program										113	-199	292
Veterans Affairs:												
Veterans housing benefit fund program	-447	167	334	-706	38	492	229	-770	-163	-184	-1,515	-462
International Assistance Programs:												
U.S. Agency for International Development:												
Development credit authority									-1		1	-3
Micro and small enterprise development											2	-2
Urban and environmental credit	-2	-1	-7		-14				-4	-15	48	-2
Loan Guarantees to Israel											-76	-111
Overseas Private Investment Corporation:												
OPIC guaranteed loans									5	77	60	-213
Small Business Administration:												
Business loans			257	-16	-279	-545	-235	-528	-226	304	1,750	1,034
Other Independent Agencies:												
Export-Import Bank guarantees	-11	-59	13				-191	-1,520	-417	-2,042	-1,133	-655
Total	-616	995	727	-832	5,642	4,518	-3,641	-6,427	-1,832	-142	3,469	5,349

* \$500,000 or less.

¹Excludes interest on reestimates. Additional information on credit reform subsidy rates is contained in the Federal Credit Supplement.²Includes rural water and waste disposal, rural community facilities, and rural business and industry programs.³Volume reestimates in mandatory loan guarantee programs represent a change in volume of loans disbursed in the prior years. These estimates are the result of guarantee programs where data from loan issuers on actual disbursements of loans are not received until after the close of the fiscal year.

Table 7-3. DIRECT LOAN SUBSIDY RATES, BUDGET AUTHORITY, AND LOAN LEVELS, 2004-2006

(in millions of dollars)

Agency and Program	2004 Actual			2005 Enacted			2006 Proposed		
	Subsidy rate ¹	Subsidy budget authority	Loan levels	Subsidy rate ¹	Subsidy budget authority	Loan levels	Subsidy rate ¹	Subsidy budget authority	Loan levels
Agriculture:									
Agricultural credit insurance fund	13.32	117	881	7.40	70	955	7.14	67	937
Farm storage facility loans	1.22	1	63	-2.44	-2	83	-1.34	-1	67
Rural community advancement program	1.88	27	1,395	7.50	107	1,425	6.09	79	1,300
Rural electrification and telecommunications loans	-1.60	-70	4,345	-1.28	-44	3,440	-0.18	-6	3,189
Rural telephone bank	-4.32	-7	170	-1.83	-3	175			
Distance learning, telemedicine, and broadband program	2.09	13	633	2.07	13	596	2.68	8	328
Farm labor	42.73	15	36	47.06	18	38	44.59	19	42
Rural housing insurance fund	12.25	185	1,509	14.68	193	1,314	12.55	136	1,085
Rural development loan fund	43.27	17	40	46.38	16	34	43.02	15	34
Rural economic development loans	18.76	3	15	18.79	5	25	19.97	5	25
Public law 480 title I	58.08	23	39	55.98	27	48	55.40	24	43
Commerce:									
Fisheries finance	-6.31	-4	64	-6.01	-11	185	-5.02	-2	24
Defense—Military:									
Defense family housing improvement fund	33.73	56	166	33.95	71	209	25.34	145	572
Education:									
College housing and academic facilities loans			55			70			50
Loans for short-term training							-1.56	-1	85
Federal direct student loan program	-0.61	-135	21,979	-0.53	-131	24,480	-3.51	-861	24,530
Homeland Security:									
Disaster assistance direct loans				-2.60	-1	25	-0.19		25
Housing and Urban Development:									
FHA-mutual mortgage insurance						50			50
FHA-general and special risk			50			50			50
State:									
Repatriation loans	70.75	1	1	69.73	1	1	64.99	1	1
Loan for renovation of UN Headquarters				0.47	6	1,200			
Transportation:									
Federal-aid highways				5.94	142	2,400	6.18	149	2,400
Railroad rehabilitation and improvement program			263			250			
Treasury:									
Community development financial institutions fund	34.37	2	5	36.52	2	5			
Veterans Affairs:									
Vocational rehabilitation and employment administration	1.33		3	1.14		4	1.59		4
Housing	0.83	1	127	-2.71	-25	941	-2.61	-44	1,696
International Assistance Programs:									
Debt restructuring		28			338				
Overseas Private Investment Corporation	3.03	6	198	10.67	19	178	10.27	19	185
Small Business Administration:									
Disaster loans	11.72	79	668	12.86	514	3,982	14.64	83	810
Business loans	9.55	2	23	10.25	1	10			
Export-Import Bank of the United States:									
Export-Import Bank loans	11.40	22	193	34.00	17	50	34.00	17	50
Total	N/A	382	32,921	N/A	1,343	42,223	N/A	-148	37,582

N/A = Not applicable.

¹ Additional information on credit subsidy rates is contained in the Federal Credit Supplement.

Table 7-4. LOAN GUARANTEE SUBSIDY RATES, BUDGET AUTHORITY, AND LOAN LEVELS, 2004-2006

(in millions of dollars)

Agency and Program	2004 Actual			2005 Enacted			2006 Proposed		
	Subsidy rate ¹	Subsidy budget authority	Loan levels	Subsidy rate ¹	Subsidy budget authority	Loan levels	Subsidy rate ¹	Subsidy budget authority	Loan levels
Agriculture:									
Agricultural credit insurance fund	3.10	75	2,402	2.91	80	2,763	2.66	76	2,866
Commodity Credit Corporation export loans	10.58	457	4,318	6.83	309	4,528	8.93	393	4,396
Rural community advancement program	3.75	46	1,217	3.36	29	885	3.74	44	1,184
Rural electrification and telecommunications loans				0.01		1,100			
Distance learning, telemedicine, and broadband program							3.82	1	30
Rural housing insurance fund	1.68	54	3,333	1.09	37	3,381	1.33	52	3,881
Rural business investment				8.05		60			
Renewable energy				1.87	11	615	1.75	5	286
Defense—Military:									
Arms initiative	3.00		4	4.10	1	28	20.00	1	5
Education:									
Loans for short-term training							5.71	11	198
Federal family education loans	11.40	9,602	84,219	11.96	10,111	84,548	8.22	6,556	79,754
Health and Human Services:									
Health education assistance loans	16.48	25	46						
Health resources and services	12.58	2	13	5.35	1	17	5.40	1	17
Housing and Urban Development:									
Indian housing loan guarantee fund	2.73	5	197	2.58	5	145	2.42	3	99
Native Hawaiian Housing Loan Guarantee Fund	2.73	1	40	2.58	1	37	2.42	1	35
Native American housing block grant	10.56	2	17	10.32	2	18	12.26	5	38
Community development loan guarantees	2.30	6	287	2.30	6	275			
FHA-mutual mortgage insurance	-2.47	-2,660	107,699	-1.82	-2,121	185,000	-1.70 ²	-1,867	185,000
FHA-general and special risk	-1.00	-276	29,000	-0.51	-180	35,000	-0.98	-341	35,000
Interior:									
Indian guaranteed loans	6.13	5	84	6.76	5	85	4.75	6	119
Transportation:									
Minority business resource center program	2.53		8	2.08		18	1.85	1	18
Federal-aid highways				4.68	9	200	3.67	7	200
Maritime guaranteed loan (title XI)	7.65	13	174	27.54	39	140			
Treasury:									
Air transportation stabilization program	-8.93	-3	30						
Veterans Affairs:									
Housing	0.54	200	35,613	-0.28	-125	44,206	-0.22	-105	47,208
International Assistance Programs:									
Loan guarantees to Israel			1,750			3,000			2,360
Microenterprise and small enterprise development		1							
Development credit authority	3.11	10	351	4.31	21	487	3.90	21	539
Overseas Private Investment Corporation	0.27	-96	1,647	-3.42	-45	1,300	-4.38	-62	1,400
Small Business Administration:									
General business loans	0.38	91	23,972			34,253			37,000
Export-Import Bank of the United States:									
Export-Import Bank loans	1.88	172	13,128	2.80	288	13,761	2.91	291	13,761
Presidio Trust:									
Presidio Trust				0.08		20	0.08		50
Total	N/A	7,732	309,549	N/A	8,484	415,870	N/A	5,100	415,444
ADDENDUM: SECONDARY GUARANTEED LOAN COMMITMENT LIMITATIONS									
GNMA:									
Guarantees of mortgage-backed securities	-0.27	-405	146,066	-0.23	-368	200,000	-0.23	-368	200,000

N/A = Not applicable.

¹ Additional information on credit subsidy rates is contained in the Federal Credit Supplement.² Rate includes effects of legislative proposals. For more details, see the Federal Credit Supplement.

Table 7-5. SUMMARY OF FEDERAL DIRECT LOANS AND LOAN GUARANTEES

(In billions of dollars)

	Actual								Estimate	
	1997	1998	1999	2000	2002	2002	2003	2004	2005	2006
Direct Loans:										
Obligations	33.6	28.8	38.4	37.1	39.1	43.7	45.4	42.0	56.0	47.6
Disbursements	32.2	28.7	37.7	35.5	37.1	39.6	39.7	38.7	47.9	44.2
New subsidy budget authority ¹	*	-0.8	1.6	-0.4	0.3	*	0.7	0.4	1.3	-0.1
Reestimated subsidy budget authority ² .....	.....	7.3	1.0	-4.4	-1.8	0.5	2.9	2.6	4	.....
Total subsidy budget authority	2.4	6.5	2.6	-4.8	-1.5	0.5	3.5	3.0	5.1	-0.1
Loan Guarantees:										
Commitments	282.3	348.4	415.9	298.1	418.0	482.6	561.8	450.2	494.4	489.1
Lender disbursements	254.7	337.9	388.2	286.3	366.7	446.2	247.2	429.0	468.0	459.0
New subsidy budget authority ¹	*	3.3	*	3.6	2.3	2.9	3.8	7.3	8.1	4.7
Reestimated subsidy budget authority ² .....	.....	-0.7	4.3	0.3	-7.1	-2.4	-3.5	2.0	2.9	.....
Total subsidy budget authority	3.6	2.6	4.3	3.9	-4.8	0.5	0.3	9.3	11.0	4.7

* \$500 million or less.

¹ Prior to 1998 new and reestimated subsidy budget authority were not reported separately.² Includes interest on reestimate.

Table 7-6. DIRECT LOAN WRITE-OFFS AND GUARANTEED LOAN TERMINATIONS FOR DEFAULTS

Agency and Program	In millions of dollars			As a percentage of outstanding loans ¹		
	2004 actual	2005 estimate	2006 estimate	2004 actual	2005 estimate	2006 estimate
DIRECT LOAN WRITEOFFS						
Agriculture:						
Agricultural credit insurance fund	147	129	126	1.69	1.59	1.65
Commodity Credit Corporation fund	18	.....	.....	0.16	.....	.....
Rural community advancement program	13	11	14	0.16	0.12	0.14
Rural telephone bank .....	.....	3	3	.....	0.30	0.31
Rural development insurance fund	2	1	1	0.08	0.04	0.05
Rural housing insurance fund	121	126	121	0.44	0.47	0.46
P.L.480	934	.....	.....	9.11	.....	.....
Debt reduction (P.L.480)	154	11	.....	22.48	1.85	.....
Commerce:						
Economic development revolving fund	2	1	1	8.33	7.14	10.00
Education:						
Student financial assistance	6	7	7	1.84	2.16	2.16
Perkins loan assets .....	.....	.....	51	.....	.....	.....
Federal direct student loan program	256	350	396	0.24	0.31	0.39
Homeland Security:						
Disaster assistance direct loan program	13	127	.....	9.09	81.93	.....
Housing and Urban Development:						
Revolving fund (liquidating programs) .....	.....	1	1	.....	16.66	25.00
Guarantees of mortgage-backed securities	99	30	28	79.83	50.84	45.16
Interior:						
Indian direct loan	11	2	2	22.44	6.25	7.69
Labor:						
Pension Benefit Guaranty Corporation	10	31	90	100	100	100
Transportation:						
Railroad rehabilitation and improvement	2	4	6	0.54	0.65	1.03
Treasury:						
Community development financial institutions fund .....	.....	1	.....	.....	1.58	.....
Veterans Affairs:						
Veterans housing benefit program	13	8	8	0.72	0.39	0.28
International Assistance Programs:						
Military debt reduction .....	.....	11	.....	.....	4.34	.....
Debt reduction (AID)	8	7	.....	3.37	0.93	.....
Overseas Private Investment Corporation .....	.....	8	8	.....	1.40	1.34
Small Business Administration:						
Disaster loans	53	44	61	1.53	0.73	0.89
Business loans	6	9	6	1.80	3.22	2.69
Other Independent Agencies:						
Export-Import Bank	27	67	71	0.24	0.65	0.76
Debt reduction (ExIm Bank)	5	121	.....	0.45	11.04	.....
Spectrum auction program	50	.....	3,422	0.97	.....	88.76
Tennessee Valley Authority .....	.....	1	.....	.....	1.40	.....
Total, direct loan writeoffs	1,950	1,111	4,423	0.65	0.28	1.49
GUARANTEED LOAN TERMINATIONS FOR DEFAULT						
Agriculture:						
Agricultural credit insurance fund	94	83	83	0.74	0.63	0.63
Commodity Credit Corporation export loans	130	160	160	1.97	1.83	1.82
Rural community advancement program	119	147	174	2.16	2.94	3.57
Rural electrification and telecommunications loans .....	.....	6	6	.....	0.38	0.39
Rural housing insurance fund	122	134	146	0.72	0.80	0.86
Commerce:						
Emergency steel guaranteed loan program .....	.....	12	8	.....	7.69	6.89

Table 7-6. DIRECT LOAN WRITE-OFFS AND GUARANTEED LOAN TERMINATIONS FOR DEFAULTS—Continued

Agency and Program	In millions of dollars			As a percentage of outstanding loans ¹		
	2004 actual	2005 estimate	2006 estimate	2004 actual	2005 estimate	2006 estimate
Defense—Military:						
Family housing improvement fund		4	4		1.65	1.70
Education:						
Federal family education loan	3,679	4,992	5,837	1.28	1.55	1.67
Health and Human Services:						
Health education assistance loans	58	41	40	2.32	1.69	1.69
Housing and Urban Development:						
Indian housing loan guarantee		1	4		0.67	2.48
Title VI Indian Federal guarantees program		1	2		1.06	1.85
FHA—Mutual mortgage insurance	7,390	6,056	5,484	1.43	1.21	1.01
FHA—General and special risk	1,790	2,052	1,731	1.57	1.84	1.50
Guarantees of mortgage-backed securities	260	70	600	0.04	0.01	0.09
Interior:						
Indian guaranteed loan	1	1	1	0.26	0.24	0.23
Transportation:						
Maritime guaranteed loan (Title XI)		50	35		1.41	1.06
Treasury:						
Air transportation stabilization program		923	8		54.19	1.19
Veterans Affairs:						
Veterans housing benefit program	1,374	2,763	2,816	0.38	0.69	0.64
International Assistance Programs:						
Foreign military financing		3	10		0.09	0.38
Micro and small enterprise development	3	1	1	6.00	1.31	2.00
Urban and environmental credit program	34	22	26	1.78	1.19	1.52
Development credit authority		2	3		0.87	0.90
Overseas Private Investment Corporation	78	57	58	1.77	1.43	1.39
Small Business Administration:						
General business loans	1,378	1,308	1,272	2.04	1.66	1.43
Pollution control equipment		1			16.66	
Other Independent Agencies:						
Export-Import Bank	360	440	494	0.81	0.93	0.99
Total, guaranteed loan terminations for default	16,870	19,330	19,003	0.80	0.89	0.82
Total, direct loan writeoffs and guaranteed loan terminations	18,820	20,441	23,426	0.79	0.83	0.89
ADDENDUM: WRITEOFFS OF DEFAULTED GUARANTEED LOANS THAT RESULT IN LOANS RECEIVABLE						
Agriculture:						
Agricultural credit insurance fund		1	1		5.88	5.88
Education:						
Federal family education loan	286	259	233	1.38	1.19	1.02
Health and Human Services:						
Health education assistance loans	24	24	24	2.54	2.56	2.59
Housing and Urban Development:						
FHA—Mutual mortgage insurance	1			0.10		
FHA—General and special risk	310	383	6	7.01	7.56	0.10
Interior:						
Indian guaranteed loan	10	1	1	40.00	7.14	9.09
Treasury:						
Air transportation stabilization program			617			66.27
Veterans Affairs:						
Veterans housing benefit program	83	120	148	5.87	6.14	6.26

Table 7-6. DIRECT LOAN WRITE-OFFS AND GUARANTEED LOAN TERMINATIONS FOR DEFAULTS—Continued

Agency and Program	In millions of dollars			As a percentage of outstanding loans ¹		
	2004 actual	2005 estimate	2006 estimate	2004 actual	2005 estimate	2006 estimate
International Assistance Programs:						
Overseas Private Investment Corporation .....	.....	29	3	.....	12.18	1.18
Small Business Administration:						
General business loans	249	262	280	7.51	6.30	5.90
Total, writeoffs of loans receivable	963	1,079	1,313	2.42	2.46	2.75

¹ For direct loans and loan guarantees, outstanding loans equal start-of-year outstanding balance plus new disbursements. For loans receivable, outstanding loans equal start-of-year outstanding balance plus terminations for default resulting in loans receivable.

Table 7-7. APPROPRIATIONS ACTS LIMITATIONS ON CREDIT LOAN LEVELS ¹

(in millions of dollars)

Agency and Program	2004 Enacted	2005 Enacted	2006 Proposed
DIRECT LOAN OBLIGATIONS			
Agriculture:			
P.L. 480 direct credit	39	48	43
Commerce:			
Fisheries finance	64	185	24
Education:			
Historically black college and university capital financing	229	229	162
Loans for short-term training			85
Homeland Security:			
Disaster Assistance Direct Loan Financing Account	25	25	25
Housing and Urban Development:			
FHA-general and special risk	50	50	50
FHA-mutual mortgage insurance	50	50	50
State:			
Repatriation loans	1	1	1
Loan for renovation of UN Headquarters		1,200	
Transportation:			
Transportation infrastructure finance and innovation program	2,200	2,200	2,200
Transportation infrastructure finance and innovation program line of credit	200	200	200
Treasury:			
Community development financial institutions fund	11	11	
Veterans Affairs:			
Native American and transitional housing		50	30
Vocational rehabilitation	3	4	4
International Assistance Programs:			
Military debt reduction	31		
Small Business Administration:			
Business loans	23	10	
Total, limitations on direct loan obligations	2,926	4,263	2,874
LOAN GUARANTEE COMMITMENTS			
Agriculture:			
Agricultural credit insurance fund	2,402	2,763	2,866
Rural business investment program guarantee		60	
Defense—Military:			
Arms initiative	4	28	5
Education:			
Loans for short-term training			198
Health and Human Services:			
Health education assistance loans	150		
Housing and Urban Development:			
Indian housing loan guarantee fund	197	145	99
Title VI Indian Federal guarantees	17	18	38
Native Hawaiian Housing Loan Guarantee Fund	40	37	35
Community development loan guarantees	275	275	
FHA-general and special risk	29,000	35,000	35,000
FHA-mutual mortgage insurance	185,000	185,000	185,000
Interior:			
Indian loans	84	85	119
Transportation:			
Minority business resource center	18	18	18
Transportation infrastructure finance and innovation program loan guarantee	200	200	200
Maritime guaranteed loan (title XI)	174	140	
International Assistance Programs:			
Loan guarantees to Israel	3,000	3,000	
Development credit authority			700

Table 7-7. APPROPRIATIONS ACTS LIMITATIONS ON CREDIT LOAN LEVELS¹—Continued
(in millions of dollars)

Agency and Program	2004 Enacted	2005 Enacted	2006 Proposed
Small Business Administration:			
General business loans	23,972	34,253	37,000
Total, limitations on loan guarantee commitments	244,533	261,022	261,278
ADDENDUM: SECONDARY GUARANTEED LOAN COMMITMENT LIMITATIONS			
Housing and Urban Development:			
Guarantees of mortgage-backed securities	200,000	200,000	200,000
Total, limitations on secondary guaranteed loan commitments	200,000	200,000	200,000

¹ Data represents loan level limitations enacted or proposed to be enacted in appropriation acts. For information on actual and estimated loan levels supportable by new subsidy budget authority requested, see Tables 7-3 and 7-4.

Table 7–8. FACE VALUE OF GOVERNMENT-SPONSORED ENTERPRISE LENDING ¹

(In billions of dollars)

	Outstanding	
	2003	2004
Government Sponsored Enterprises		
Fannie Mae ²	N/A	N/A
Freddie Mac ³	1,393	N/A
Federal Home Loan Banks ⁴	N/A	N/A
Sallie Mae ⁵ .....	.....	.....
Farm Credit System	86	87
Total	N/A	N/A

N/A = Not available.

¹ Net of purchases of federally guaranteed loans.² Financial data for Fannie Mae is not presented here because Fannie Mae announced in December 2004 that it would have to restate financial results for fiscal years 2001–2004.³ 2003 figure derived from Freddie Mac 2003 Annual Report. While financial data for 2003 is presented here, Freddie Mac announced on November 1, 2004 that it would report full-year audited results for 2004 by March 31, 2005.⁴ Financial data for the Federal Home Loan Banks are not presented here because the Federal Home Loan Banks announced through their Office of Finance in December 2004 that the consolidated financial statements of the Federal Home Loan Banks for 2002 and 2003, and the first two quarters of 2004 will need to be restated.⁵ The face value and Federal costs of Federal Family Education Loans in the Student Loan Marketing Association's portfolio are included in the totals for that program under guaranteed loans in table 7–1.

Table 7-9 LENDING AND BORROWING BY GOVERNMENT-SPONSORED ENTERPRISES (GSEs)

(In millions of dollars)

Enterprise	2004
LENDING	
Student Loan Marketing Association	
<i>Net change</i>	-27,787
Outstandings	136
Federal National Mortgage Association: ¹	
Portfolio programs:	
<i>Net change</i>	N/A
Outstandings	N/A
Mortgage-backed securities:	
<i>Net change</i>	N/A
Outstandings	N/A
Federal Home Loan Mortgage Corporation: ²	
Portfolio programs:	
<i>Net change</i>	N/A
Outstandings	N/A
Mortgage-backed securities:	
<i>Net change</i>	N/A
Outstandings	N/A
Farm Credit System:	
Agricultural credit bank:	
<i>Net change</i>	(193)
Outstandings	23,270
Farm credit banks:	
<i>Net change</i>	2,409
Outstandings	60,762
Federal Agricultural Mortgage Corporation:	
<i>Net change</i>	(451)
Outstandings	5,549
Federal Home Loan Banks: ³	
<i>Net change</i>	N/A
Outstandings	N/A
Less guaranteed loans purchased by:	
Student Loan Marketing Association:	
<i>Net change</i>	(27,787)
Outstandings	136
Federal National Mortgage Association: ¹	
<i>Net change</i>	N/A
Outstandings	N/A
Other:	
<i>Net change</i> ⁴	N/A
Outstandings ⁴	N/A
BORROWING	
Student Loan Marketing Association:	
<i>Net Change</i>	(24,763)
Outstandings	2,058
Federal National Mortgage Association: ¹	
Portfolio programs:	
<i>Net Change</i>	N/A
Outstandings	N/A
Mortgage-backed securities:	
<i>Net Change</i>	N/A
Outstandings	N/A
Federal Home Loan Mortgage Corporation: ²	
Portfolio programs:	
<i>Net Change</i>	N/A
Outstandings	N/A
Mortgage-backed securities:	
<i>Net Change</i>	N/A
Outstandings	N/A
Farm Credit System:	
Agricultural credit bank:	
<i>Net Change</i>	175

Table 7–9 LENDING AND BORROWING BY GOVERNMENT-SPONSORED ENTERPRISES (GSEs)—Continued

(In millions of dollars)

Enterprise	2004
Outstandings	26,626
Farm credit banks:	
<i>Net Change</i>	3,763
Outstandings	71,812
Federal Agricultural Mortgage Corporation:	
<i>Net Change</i>	(414)
Outstandings	3,424
Federal Home Loan Banks: ³	
<i>Net Change</i>	N/A
Outstandings	N/A
DEDUCTIONS	
Less borrowing from other GSEs: ⁴	
<i>Net Change</i>	N/A
Outstandings	N/A
Less purchase of Federal debt securities: ⁴	
<i>Net Change</i>	N/A
Outstandings	N/A
Less borrowing to purchase loans guaranteed by:	
Student Loan Marketing Association:	
<i>Net Change</i>	(27,787)
Outstandings	136
Federal National Mortgage Association: ¹	
<i>Net Change</i>	N/A
Outstandings	N/A
Other: ⁴	
<i>Net Change</i>	N/A
Outstandings	N/A

N/A = Not available.

The estimates of borrowing and lending were developed by the GSEs based on certain assumptions that are subject to periodic review and revision and do not represent official GSE forecasts of future activity, nor are they reviewed by the President. The data for all years include programs of mortgage-backed securities. In cases where a GSE owns securities issued by the same GSE, including mortgage-backed securities, the borrowing and lending data for that GSE are adjusted to remove double-counting.

¹ Financial data for Fannie Mae is not presented here because Fannie Mae announced in December 2004 that it would have to restate financial results for fiscal years 2001–2004.

² Financial data for Freddie Mac is not presented here because Freddie Mac announced on November 1, 2004 that it would report full-year audited results for 2004 by March 31, 2005.

³ Financial data for the Federal Home Loan Banks are not presented here because the Federal Home Loan Banks announced through their Office of Finance in December 2004 that the consolidated financial statements of the Federal Home Loan Banks for 2002 and 2003, and the first two quarters of 2004 will need to be restated.

⁴ Totals and subtotals have not been calculated because a substantial portion of the total is subject to the above-described restatements.