7. CREDIT AND INSURANCE

Federal credit programs offer direct loans and loan guarantees to support a wide range of activities, primarily housing, education, business and community development, and exports. At the end of 2005, there were $247 billion in Federal direct loans outstanding and $1,084 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.

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 that 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 their securities are risk-free. GSEs, however, are not part of the Federal Government, and GSE securities are not federally guaranteed. By law, GSE securities carry a disclaimer of any U.S. obligation.

This chapter discusses the roles of these diverse programs and assesses their effectiveness and efficiency.

- The first section analyzes the roles of Federal credit and insurance programs. Federal programs can 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. 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 interprets the PART results.
- The third section discusses individual credit programs and GSEs classified into four sectors: housing, education, business and community development, and exports. The discussion focuses on program objectives, recent developments, performance, and future plans for each program.
- In a similar format, the final section reviews Federal deposit insurance, pension guarantees, disaster insurance, and insurance against terrorism and other security-related risks.

I. FEDERAL PROGRAMS IN CHANGING FINANCIAL MARKETS

The Federal Role

In most cases, private lending and insurance companies efficiently meet economic 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.

Relevant market imperfections include insufficient information, limited ability to secure resources, imperfect competition, and externalities. The presence of a market imperfection suggests a possibility that a well-designed Government program can improve on the market outcome, although it does not necessarily mean that Government intervention is desirable. Addressing a market imperfection is a complex and difficult task.

Insufficient Information. Financial intermediaries may fail to allocate credit to the most deserving borrowers if there is little objective information about borrowers. Some groups of borrowers, such as start-up businesses and start-up farmers, 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. For very irregular events, such as natural and man-made disasters, there may not be sufficient information to estimate the probability and magnitude of the loss. This pricing difficulty may prevent insurers from covering those risks at reasonable premiums.

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.

Imperfect Competition. Competition can be imperfect in some markets because of barriers to entry or economies of scale. Imperfect competition may result in higher prices of credit and insurance in those markets.

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.

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; it has better means to secure resources; and it is more competitive. As a result, the private market is more willing and able to serve a portion of the population 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 or insurance 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. Credit scoring (an automated process that converts relevant borrower characteristics into a numerical score indicating creditworthiness), for example, is considered as a breakthrough in borrower screening. While credit scoring is widely applied to home mortgages and consumer loans, it is applied to a limited extent for small business loans and agricultural loans due to the difficulty of standardizing unique characteristics of small businesses and farmers. With technological advances, such as computer simulation, pricing catastrophe risks has become easier, but it remains much more difficult than pricing more regular events such as automobile accidents. It is still difficult for insurers to estimate the probability of a major natural disaster occuring. The difficulty may be greater for man-made disasters that lack scientific bases.

Financial evolution has also alleviated resource constraints faced by private entities. Advanced financial instruments have enabled 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. 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.

Imperfect competition, one possible motivation for Government intervention, is much less likely in general, thanks to financial deregulation and improved communication and financing 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. 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, small lenders with limited access to capital can more effectively compete with large ones. 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, there may be a better way to address 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. 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 posed by the Pension Benefit Guaranty Corporation (PBGC) of the Department of Labor. PBGC is facing serious financial challenges due to unfavorable developments in recent years and to flaws in program structure that the Administration has proposed to remedy.

Security-related risks heightened after the September 11th attacks also pose a challenge. Insurance programs covering security-related risks, such as terrorism and war, are difficult to manage because those events 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) is a performance evaluation tool designed to be consistent across Federal 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 evaluates programs in four areas (program purpose and design, strategic planning, program management, and program results) and assigns a numerical score (0 to 100) to each category. The overall rating (effective, moderately effective, adequate, ineffective, or results not demonstrated) is determined based on the numerical scores and the availability of reliable data.

There are 30 credit programs (defined as those involving repayment obligations) and 5 insurance programs among 795 programs that have been rated by the PART. When appropriately weighted, the overall average score for credit and insurance programs is similar to that for other programs (see Table "Summary of PART Scores"). The ratings for credit and insurance programs, however, are more clustered around the middle. Most credit and insurance programs (77 percent, compared with 55 percent for other programs) are rated "adequate" or "moderately effective," while only 2 programs (6 percent, compared with 16 percent for other programs) are rated "effective." These results suggest that most credit and insurance programs meet basic standards, but need to improve.

Looking across evaluation criteria, for both credit and insurance programs and other programs, the scores are high in program purpose and design and in program management, while low in program results. Relative to other programs, however, credit and insurance programs scored low in program purpose and design and high in program results.

SUMMARY OF PART SCORES

	Purpose and Design	Strategic Planning	Program Management	Program Results
Credit and Insurance Programs				
Average	77.1	69.4	84.8	53.0
Standard Deviation	20.4	23.6	19.6	18.1
All Others Excluding Credit and Insurance Programs				
Average	86.3	73.4	81.4	47.1
Standard Deviation	19.3	25.2	18.0	26.6

The PART indicates that most credit and insurance programs have clear purposes (not necessarily economically justifiable purposes) and address specific needs. 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, such as inadequate incentive structures, limiting their effectiveness and efficiency.

Regarding strategic planning, credit and insurance programs show strengths in accomplishing short-term goals. Weaknesses are found in pursuing long-term performance goals, conducting stringent performance evaluation, and tying budgets to performance outcomes. Many programs, however, have taken meaningful steps to correct their strategic planning deficiencies.

In the program management category, credit and insurance programs are strong in basic financial and accounting practices, such as spending funds for intended purposes, and in collaborating with related programs. However, some programs show weaknesses in more sophisticated financial management, such as evaluating risks—a critical skill for the effective management of credit and insurance programs.

Program results, the most important category of performance, are a weak area for credit and insurance programs despite a higher average score than that of other programs. In particular, many credit and insurance programs lack objectives evidences of program effectiveness and achieving results. This finding points to a strong need for results-driven management.

Common Features

There are some key features that distinguish credit and insurance programs from other programs. Credit and insurance programs are intended to address imperfections in financial markets. They also face various risks, such as uncertain default rates and erratic claim rates. Understanding common features in relation to the PART should help to interpret PART results and to devise adequate steps to improve performance.

Program Purpose and Design. The most important role of credit and insurance programs is to serve those target populations that are not effectively served by the private sector. Financial markets, however, have been evolving to serve those populations better. Thus, to refocus programs appropriately, it is important to examine the effect of financial evolution.

Lending and insurance are complex businesses involving screening applicants, financing, servicing, and monitoring. Given these complexities, the Government can significantly benefit from partnership with the private sector that combines the Government's and private entities' strengths. It takes a careful program design to realize the potential benefit from such partnership. In particular, the private partner's profit should be closely tied to its contribution to the program's effectiveness and efficiency. Without proper incentives, private entities do not perform as intended. For example, private lenders are generally better at screening borrowers, but they may not screen borrowers effectively if the Government provides a 100-percent loan guarantee.

Strategic Planning. Financial markets change rapidly, and credit and insurance programs need to adapt to new developments quickly. For example, adopting new technologies is important. Private lenders are increasingly applying advanced technologies to credit evaluation. Falling behind, Federal credit programs can be left with much riskier borrowers as private entities attract better-risk borrowers away from Federal programs.

Program Management. Risk management is a critical element of credit and insurance programs. The cashflow is uncertain both for credit and insurance programs. The default rate and the claim rate can turn out to be significantly different than expected. Credit programs also face prepayment and interest rate risks. These risks must be carefully managed to ensure that the program cost stays within a reasonable range. Effective risk management requires that program managers thoroughly understand the characteristics of beneficiaries and vigilantly monitor new developments. Given these needs for accurate and timely information, collecting and processing data may be more important for credit and insurance programs than for most other programs.

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 assistance. Credit and insurance 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 and insurance programs need to be interpreted in conjunction with the accuracy of cost estimation.

The net outcome of a credit or an insurance 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

President's Management Agenda Program Initiative: Improved Credit Management

As one of the world's largest lenders, with a portfolio of more than $1.3 trillion in outstanding 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, while still controlling administrative costs.

At the same time, the Government must ensure that it is effectively serving its intended borrowers. While these primary goals may occasionally conflict, agencies can achieve both in large part through effective risk identification, careful portfolio monitoring through information reporting, and tracking administrative costs through the credit lifecycle.

The five major credit agencies (the Departments of Agriculture, Education, Housing and Urban Development, Veterans Affairs, and the Small Business Administration) and Treasury will be included in a new President's Management Agenda initiative to improve credit program management. Agencies will be rated on their performance in the areas of loan origination, servicing and portfolio monitoring, and liquidation/debt collection. This effort will be supported by a Credit Council comprised of the Office of Management and Budget 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.

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.

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 mortgage borrowers in general.

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, nearly 2.5 million minority families have become homeowners. The Department of Housing and Urban Development's (HUD's) Federal Housing Administration (FHA) helped almost 450,000 of these first-time minority homebuyers through its loan insurance funds, mainly the Mutual Mortgage Insurance (MMI) Fund. FHA mortgage insurance guarantees mortgage loans that provide 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, 77.5 percent of FHA-insured loans were to first-time homeowners, and 35.0 percent were to minority homebuyers. In 2005, FHA insured almost $58 billion in purchase and refinance mortgages for more than 478,000 households. Nearly 80 percent of these homebuyers were buying their first homes, almost 100,000 were minorities.

While FHA has been a primary mortgage source for first-time and minority buyers since the 1930s, its loan volume has fallen precipitously in the past three years. This is due in part to lower interest rates that have made uninsured mortgages affordable for more families. Moreover, private lenders—aided by automated underwriting tools that allow them to measure risks more accurately—have expanded lending to people who previously would have had no option but FHA—those with few resources to pay for downpayments and/or weaker credit histories than the private sector considered safe. The development of new products and underwriting approaches has allowed private lenders to offer loans to more homebuyers. While this is a positive development when the private sector is offering favorable terms, some borrowers either end up paying too much or receiving unfair terms.

As private lenders have expanded their underwriting to cover more and more buyers, changes have taken place in the composition of FHA's business. First, the percentage of FHA-insured mortgages with initial loan-to-value (LTV) ratios of 95 percent or higher has increased substantially, from 38.6 percent in 1995 to 80.7 percent in 2005. Second, the percentage of FHA loans with downpayment assistance from seller-finance non-profit organizations has grown rapidly, from 0.3 percent in 1998 to 31 percent in 2005. Recent studies show that these loans are riskier than those made to borrowers who received downpayment assistance from other sources. In FY 2005, FHA's cumulative default claim rate for its core business is projected to have risen from approximately 8 percent to 10 percent

The FHA single-family mortgage program was assessed in 2005 using the PART rating tool. The assessment found that the program was meeting its statutory objective to serve underserved borrowers while maintaining an adequate capital reserve. However, the program lacked quantifiable annual and long-term performance goals that would measure FHA's ability to achieve its statutory mission. In addition, both the PART assessment and subsequent GAO and IG reports noted that the program's credit model does not accurately predict losses to the insurance fund, and that despite FHA efforts to deter fraud in the program, it has not demonstrated that these steps have reduced such fraud.

In response to these findings, in 2006 FHA will measure its performance against goals, such as the percentage of FHA Single Family loans for first-time and minority homeowners, and performance goals for fraud detection and prevention. While FHA has taken steps to improve the accuracy of its annual actuarial review claim and prepayment estimates, it will continue to develop a credit model that more accurately and reliably predicts claims costs.

Proposals for Program Reform

In order to enable FHA to fulfill its mission in today's changing marketplace, the Administration will introduce legislation that will give FHA the ability to respond to current challenges to homeownership among its traditional target borrowers: low and moderate-income first-time homebuyers. FHA has already taken steps, within its current authority, to streamline its paperwork requirements and remove impediments to its use by lenders and buyers. However, these additional tools will enable it to expand homeownership opportunities to its target borrowers on an actuarially sound basis.

To remove two large barriers to homeownership—lack of savings for a downpayment and impaired credit—the Administration proposes two new FHA mortgage products. The Zero Downpayment mortgage will allow first-time buyers with a strong credit record to finance 100 percent of the home purchase price and closing costs. For borrowers with limited or weak credit histories, a second program, Payment Incentives, will initially charge a higher insurance premium and reduce premiums after a period of on-time payments.

FHA's current nearly flat premium, or fee, structure—charging uniform premiums regardless of the borrower's risk of default as indicated by the percentage of downpayment to the loan amount or borrower credit quality—means that loans to creditworthy borrowers subsidize loans to less creditworthy borrowers. The former may be paying proportionately too much premium, while the latter are paying too little.

For 2007, FHA is proposing to introduce tiered risk-based pricing as a way to more fairly price its guarantee to individual borrowers, and at the same time eliminate the incentive for higher risk borrowers to use FHA because they are undercharged. FHA will base each borrower's mortgage insurance premiums upon the risk that the borrower poses to the FHA mortgage insurance fund. FHA proposes to base its mortgage insurance premiums upon a borrower's consumer credit score from Fair, Isaac, and Company (FICO), amount of downpayment, and source of downpayment (the borrower's own resources, relatives, employer, non-profit organization or public agency). Mortgage insurance premiums will be based on FHA's historical experience with similar borrowers. This change will decrease premiums for many of FHA's traditional borrowers, thereby increasing their access to homeownership.

This price structure has many advantages. First, unlike the subprime market, FHA would price a borrower's risk via the mortgage insurance premium, not in the interest rate. With mortgage insurance, borrowers would pay a market rate of interest, and, as a result, would pay lower monthly payments and lower total costs than they would if they paid a higher mortgage interest rate throughout the life of the loan. Second, using this pricing structure, FHA would promote price transparency. Each borrower would know why they are paying the premium that they are being charged and would know how to lower their borrowing costs—i.e., by raising their FICO score or their downpayment, both matters under their control. Third, using risk-based pricing, FHA could annually review the performance of its programs in conjunction with the preparation of its credit subsidy estimates and could adjust its premiums as necessary to assure the financial soundness of the MMI Fund.

A reformed FHA will adhere to sound management practices that include a new framework of standards and incentives tied to principles of good credit program management. At least annually, FHA will determine the volume and credit subsidy of each product it guarantees. These estimates will determine whether the credit subsidy rate will meet the target credit subsidy rate, and whether policy steps are required to ensure that it does.

To ensure transparency, FHA proposes to run the MMI Fund so that it maintains a target weighted-average credit subsidy rate. To determine the target subsidy rate, FHA will perform probabilistic or scenario analyses to ensure that the reestimated subsidy rate will not exceed an agreed upon upward bound.

The proposed reforms will enable FHA to better meet its objective of serving first-time and low-income home buyers by managing its risks more effectively.

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 2005, VA provided $23 billion in guarantees to assist 149,399 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 84,208 zero down payment loans in 2005.

To help veterans retain their homes and avoid the expense and damage to their credit resulting from foreclosure, VA intervenes aggressively to reduce the likelihood of foreclosures when loans are referred to VA after missing three payments. VA's successful actions resulted in 48.4 percent of such delinquent loans avoiding foreclosure in 2005.

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 2005, nearly $4.2 billion in assistance was provided by RHS for homeownership loans and loan guarantees; $3.05 billion of guarantees went to 31,700 households, of which 30 percent went to very low and low-income families (with income 80 percent or less than median area income).

For 2007, RHS will increase the guarantee fee on new 502 guaranteed loans to 3 percent from 2 percent. This allows the loans to be less costly for the Government without a significant additional burden to the borrowers, given that they can finance the fee as part of the loan. This will be coupled with language that will ensure that the RHS guarantee is the only Federal home loan product for which the borrower qualifies. This will ensure that the RHS home loan guarantee program is not redundant with similar home loan guarantee programs at HUD or VA. The guarantee fee for refinance loans remains 0.5 percent. Funding in 2007 is requested at $3.5 billion for purchase loans and $99 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 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 requires graduation to private credit as the borrower's income and equity in their home increase 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 2007, RHS expects to provide $1.2 billion in loans with a subsidy rate of 10.03 percent.

RHS offers multifamily housing loans and guarantees to provide rural rental housing, including farm labor housing. Direct loans are provided to construct, rehabilitate, and repair multi-family rural rental housing for very low- and low-income, elderly or handicapped residents as well as migrant farm laborers. To help achieve affordable rents, the interest rate is subsidized to 1 percent. Many very low- and low-income residents' rents are further reduced to 30 percent of their adjusted income through rental assistance grants. For 2007, the request for rental assistance grants is for two-year contracts, down from four years, with a total finding level of $486 million. A two year contract term allows the multifamily housing direct loan program to operate efficiently. Of the total amount requested, $4 million is expected to be used to replenish funds spent for rental assistance for those affected by Hurricane Katrina.

RHS will continue to propose funding and legislative changes to address the preservation issues surrounding the over 40-year old program. A long-term initiative has been developed to revitalize the 17,000-property portfolio. During 2007, $74 million will be directed to the revitalization initiative, primarily to move existing residents in properties leaving the program. No funds are requested for the direct rural rental housing program because fixing the current portfolio is the first priority. The farm labor housing combined grant and loan level will provide $55 million in 2007 for new construction as well as repair and rehabilitation. RHS also guarantees multifamily rental housing loans. RHS expects to be able to guarantee $198 million in loans for 2007.

Government-Sponsored Enterprises in the Housing Market

Between the years 1932–1970, Congress chartered three companies to support the national housing market. These Government-sponsored enterprises ("GSEs") are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. (The Federal Home Loan Bank System is comprised of 12 individual banks with shared liabilities.) Together the three enterprises currently support, in one form or another, nearly one-half of all residential mortgages outstanding in the U.S. today. These enterprises are not part of the Federal Government, nor are they fully private. The companies were chartered by Congress with a public mission, and endowed with certain benefits that give them competitive advantages when compared with fully private companies.

The Administration continues to propose broad reform of the supervisory system that oversees Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The Administration's reform would establish a new safety and soundness regulator for the housing GSEs with powers comparable to other world-class financial regulators. Comparable authorities include the ability to put a GSE into receivership should it fail, flexible authority to set appropriate capital standards, and ability to mitigate the risks the enterprises currently pose to the financial system and economy.

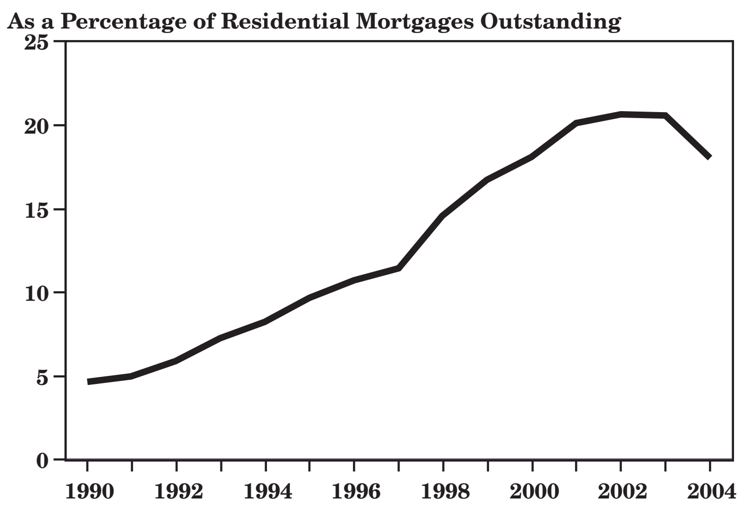
Systemic Risk. Systemic risk is the risk that a failure in one part of the economy could lead to additional failures in other parts of the economy—the risk that a small problem could multiply to a point where it could jeopardize the country's economic well-being. The particular systemic risk posed by the GSEs is the risk that a miscalculation, failure of controls, or other unexpected event at one company could unsettle not only the mortgage markets but other vital parts of the economy. To understand this risk, one must understand the interdependencies among the GSEs and other market participants in the financial system. While the interrelationships of the modern financial system permit highly efficient management and dispersion of risk, these interdependencies, if not disciplined by the regulatory and market environment, may allow a failure in one place to immediately disrupt many other sectors.

The GSEs are among the largest borrowers in the world. Lenders invest in GSE debt securities, and the value of their investment depends on the timely return of their money plus interest. The investors in GSE debt include thousands of banks, thousands of institutional investors such as insurance companies, pension funds, and foreign governments, and millions of individuals through mutual funds and 401k investments. Based on the prices paid by these investors, they act as if there is a legal requirement that the Federal Government guarantees GSE debt. In fact, there is no such guarantee or Federal backing. This perception by investors is reinforced by private ratings agencies in their guidance to investors. For example, recent guidance noted with regard to Fannie Mae and Freddie Mac, "the firms' strategic importance to the US mortgage finance market and global capital markets implies a strong degree of Government support that underpins Moody's Aaa senior unsecured ratings of both housing GSEs."

The market's perception of GSE debt gives the GSEs a competitive advantage over other companies in the housing market, and leads to reduced market discipline. Because investors act as if there is a legal requirement for the Federal Government to back GSE debt, investors on average lend their money to the GSEs at interest rates up to 40 basis points less ($400 less per year for every $100,000 borrowed) than investors lending money to similarly rated, yet fully private, companies. In addition, investors do not demand the same financial disclosures as for fully private companies. Most of the GSEs either have failed to register their securities, or have suspended filing financial statements, with the Securities and Exchange Commission. Yet there has been no significant impact on the pricing of GSE debt securities. This lack of market discipline facilitates the growth of the GSE asset portfolios, thereby increasing systemic risk.

GSE Asset Portfolios. Two of the housing GSEs—Fannie Mae and Freddie Mac—have used their funding advantage to amass large asset portfolios. Together these portfolios are funded by $1.7 trillion in debt. From 1990 through 2004, the GSEs' competitive funding advantage enabled them to build portfolios of mortgage assets at a rate far exceeding the growth of the overall mortgage market, as shown in the graph. In 1990, the GSEs held less than five percent of outstanding mortgages in their asset portfolios. In 2004, they held 18 percent.

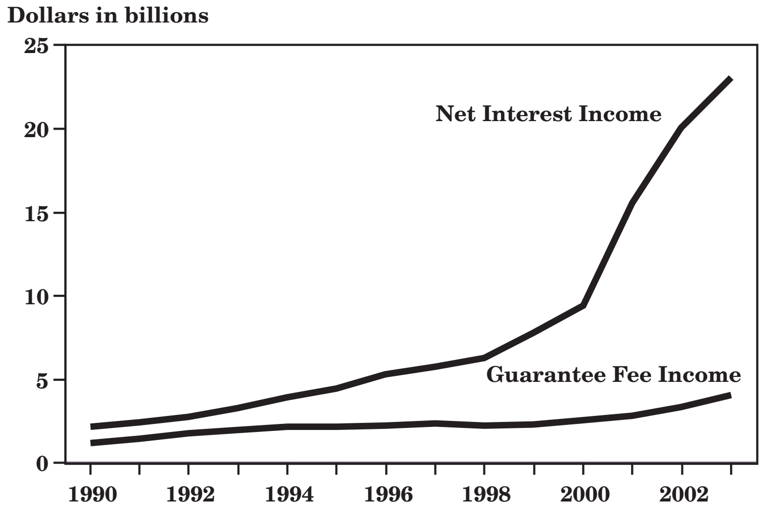
Chart 7-1. Fannie Mae and Freddie Mac Growth of GSE Asset Portfolios



Source: Office of Federal Housing Enterprise Oversight.

In the last decade, the principal source of income for Fannie Mae and Freddie Mac has been net interest on their portfolios. From the 1970s to the early-1990s, Freddie Mac engaged principally in the business of guaranteeing mortgage-backed securities (MBS) for purchase by others, with only a limited mortgage asset portfolio. Although Fannie Mae has always had a mortgage asset portfolio, it was much smaller prior to the last decade. In 2003, the GSEs' income from the MBS guarantee-business represented less than 18 percent of the interest income earned on the asset portfolios. (Income data for Fannie Mae is not available for 2004 due to the pending re-audit and restatement of Fannie Mae's financial statements.)

Chart 7-2. Fannie Mae and Freddie Mac Combined Income



Source: Office of Federal Housing Enterprise Oversight.

The Federal Home Loan Banks have not to date grown mortgage asset portfolios as large as Fannie Mae or Freddie Mac, but the income generated by the mortgage portfolios of the Federal Home Loan Banks has grown since the mid-1990s. Their principal business remains lending to regulated depository institutions and insurance companies engaged in residential mortgage finance. These loans, called advances, are on favorable terms because like Fannie Mae and Freddie Mac, the Federal Home Loan Banks borrow at lower costs than otherwise comparable financial institutions. The Federal Home Loan Banks' advance business carries interest-rate risk, and the Banks must manage this risk.

Thin Capital Cushions. Systemic risk is exacerbated because the GSEs are not required to hold cushions of capital comparable to the capital requirements levied on other large financial institutions.

The three GSEs hold about one-half the capital held by similar, yet fully private, financial institutions. By law, Fannie Mae and Freddie Mac are permitted to borrow $97.50 for every $100 of the asset portfolio, because their capital requirement is only 2.5 percent for these assets. The Federal Home Loan Banks are required to hold about a 4 percent capital cushion, slightly better but still less than that required for commercial banks. Commercial banks must hold a 5 percent capital cushion to be classified as well-capitalized, and generally need additional capital to meet their risk-based capital requirements. In contrast, the risk-based capital requirements for the GSEs have not required additional capital above their minimum capital requirements. These low capital requirements combined with the funding advantage described above have enabled Fannie Mae and Freddie Mac to amass asset portfolios without raising as much capital as other financial institutions, contributing to the GSEs' rate of growth. It also gives them a smaller capital cushion against unexpected changes in the economic environment.

Although the GSEs' mortgage investments are of relatively low default risk, other types of risk in the GSEs' asset portfolios are substantial. Mortgage portfolios carry considerable interest-rate risk, partly because of the prepayment risk caused by the refinance option available on most mortgages that allows homeowners to prepay their mortgages at any time to take advantage of lower interest rates. This risk can be mitigated—for example, through purchase of interest-rate hedges—but the GSEs protect themselves against only some of the interest rate risk of their portfolios. Moreover, hedges are imperfect. Hedging misjudgments would occur even if the GSEs' policy were to fully hedge the portfolio because predicting interest-rate movements and mortgage refinancing activity is difficult. As

GSE asset portfolios have grown in size, the GSEs' participation in the market for hedging instruments has become dominant enough to cause interest rate spikes in the event that a GSE needs to make large and sudden adjustments to its hedging position.

Systemic risk also is exacerbated because financial institutions that lend money to the GSEs may treat these investments favorably. Contrary to their other investments, banks are required to hold only a small amount of capital against the risk of decline in value or failure of the GSE investment. As noted by one rating agency in its guidance to investors, the GSEs have a competitive advantage because financial institutions have virtually no investment limits for GSE debt. Research shows that more than 60 percent of institutions in the banking industry hold as assets GSE debt in excess of half of their equity capital.

Other large financial institutions have more diversified investments, carry less debt relative to their assets, and are subject to disclosure of their business and operations with the Securities and Exchange Commission. In contrast, the GSEs' asset portfolios are highly leveraged, bear significant interest-rate risk, and have a dominant presence in the markets to hedge these risks. These factors, combined with a lack of limits on institutions lending to the GSEs, help explain the systemic risk posed by the GSEs.

GSE Asset Portfolios in the Marketplace. As demonstrated above, the asset portfolios are profit-makers for Fannie Mae and Freddie Mac. In addition, the GSEs claim that their asset portfolios are necessary to maintain a liquid market for their securities and mortgage investments in general. But the market for mortgage-backed securities is robust and liquid, with $250 billion traded daily. The GSEs also claim that their asset portfolios can protect the market in the event of a decline by providing an injection of liquidity. Although the GSEs could use their funding advantage to help limit a market decline by purchasing MBS, it is not necessary for the GSEs to hold an asset portfolio of such investments prior to the decline to provide this liquidity.

The GSEs also claim that by issuing debt to purchase their own mortgage-backed securities, they are attracting foreign investment in the US mortgage market that could not otherwise be gained. But there exists a healthy and growing appetite of foreign investors for mortgage-backed securities, as well as a sophisticated marketplace able to transform mortgage-backed securities into the appealing features of debt securities. In addition, the large amounts of GSE debt may compete to some degree with US Treasury securities, which has the potential to raise the cost of Federal borrowing.

Finally, Fannie Mae and Freddie Mac claim that their asset portfolios expand opportunities for, and lower the cost of, lending to groups traditionally underserved by the private market. These include minority and low-income borrowers. HUD sets annual goals for the GSEs' purchases of mortgages to underserved groups. Meeting HUD's goals, however, does not require the GSEs to hold these mortgages as assets. Most of these mortgages could be securitized and sold to investors, contributing to the expansion of affordable housing as well as any mortgages held by the GSEs.

Mitigating Systemic Risk. The Budget proposes a new strengthened GSE regulator as an independent agency. This proposal and others currently before Congress include differing provisions with respect to the power of a new regulator to require the GSEs to limit the size of their asset portfolios, and to specify under what conditions the regulator should require such a limitation.

Mitigating systemic risk requires taking action before a crisis occurs. Thus a new GSE regulator that is limited in its powers cannot properly mitigate systemic risk. When limited to consideration of the safety and soundness risk of a particular enterprise, for example, the regulator may not fully consider potential consequences to others in the mortgage markets and the larger economy. A world-class regulator for the GSEs must be equipped with the power to limit the systemic risk posed by a GSE before any safety and soundness event at a particular GSE occurs.

Congress can ensure that the GSE asset portfolios do not place the US financial system at risk by instructing a new GSE regulator that asset portfolios are a significant source of systemic risk, and should be limited by the GSE regulator accordingly. This does not mean reducing the size of the mortgage market. The GSEs could still guarantee mortgage-backed securities for sale to other investors. The mortgage market will grow whether mortgages are owned by investors or by the GSEs.

A new regulator with appropriate powers would reduce systemic risk by requiring the GSEs over time to dispose of certain assets, leaving only those that provide a specific public benefit, such as a pipeline for mortgage securitization and affordable housing mortgages not suitable for securitization. These public benefit assets characterize only a small percentage of GSE assets, and thus would decrease the size of the asset portfolios and effectively mitigate the systemic risk posed by the GSEs to the US economy.

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, was privatized in 2004.

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.

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. Lenders bear two percent of the default risk, and the Federal Government is responsible for the remainder. 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. 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.

Last year, the Administration worked to improve the way the loan programs operate by eliminating unnecessary subsidies, expanding risk-sharing to reduce costs, and improving the financial stability of the guaranty agency system. In response, Congress passed reconciliation legislation which will reduce excess subsidies in FFEL and help make both the Direct Loan and FFEL programs more effective. The reforms include a reduction in the percentage of Federal guarantee provided against default in recognition of the strong repayment record for student loans today and an elimination of unnecessary and costly loan subsidy provisions that allowed some loan holders to have exorbitant financial returns on loans funded through tax-exempt securities.

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, as well as renters, cover the uninsured costs of recovery from disasters.

The 2007 Budget requests $436 million, including administrative funds, for SBA to leverage more than $28 billion in financing for small businesses and disaster victims. The 7(a) General Business Loan program will support $17.5 billion in guaranteed loans while the 504 Certified Development Company program will support $7.5 billion in guaranteed loans for fixed-asset financing. SBA will supplement the capital of Small Business Investment Companies (SBICs) with $3 billion in long-term, guaranteed loans for venture capital investments in small businesses. At the end of 2005, the outstanding balance of business loans totaled $63 billion.

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. SBA's outreach for the 7(a) program has been successful. Average loan size has decreased from $232,000 in 2001 to $160,000 in 2005, while the number of small businesses served has grown from 43,000 to 89,000 during the same time period.

Improving management by measuring and mitigating risks in SBA's $63 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. In the past few years, SBA established the Office of Lender Oversight, which is responsible for evaluating individual SBA lenders. This office employs a variety of analytical techniques to ensure sound financial management by SBA and to hold lending partners accountable for performance. These techniques include portfolio performance analysis, selected credit reviews, credit scoring to compare lenders' performance, and industry concentration analysis. The oversight program is also developing on-site safety and soundness examinations and off-site monitoring of Small Business Lending Companies and compliance reviews of SBA lenders.

To operate more efficiently, SBA has implemented an automated loan origination system for the Disaster Loan program. The system eliminates the paper intensive processes that had been used for decades by the Office of Disaster Assistance. Savings are projected at approximately $5 million per year under the new system. 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 streamlined its 7(a) guarantee processing function. Similarly, SBA has also centralized its loan liquidation functions for guaranteed programs resulting in a 78 percent reduction in related administrative costs. These efforts have allowed the agency to reduce staffing levels while improving customer service.

The 2007 Budget proposes to continue providing preferential loan terms to victims of disasters. However, in order to contain the escalating costs of the loans while matching borrowers' assistance needs, the Budget proposes to adopt graduated interest rates for the Disaster Loan program. During the first five years after a disaster, interest rates will remain deeply subsidized, as they are currently structured, although interest rate caps would be eliminated. Thereafter, rates would graduate to those of comparable-maturity Treasury instruments. This structure would continue to provide borrowers with deep interest subsidies when they need them most—immediately after a disaster—and after five years the subsidies would be reduced for the remainder of the loan period.

In addition, the 2007 Budget builds upon the success of eliminating credit subsidy requirements for the 7(a) loan program by proposing that borrowers cover the costs of administering Federal guarantees on business loans greater than $1 million. This will make these loans self-financing and reduce the need for taxpayer support by about $7 million.

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 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 2007 President's Budget is $1.4 billion. These funds are available to communities of 10,000 or fewer residents. 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. Communities typically receive a grant/loan combination. The grant may be up to 75 percent of project costs; however, many projects are viable with 70 percent or more of the projects costs financed with a loan. The 2007 Budget reflects a significant change in the method for determining the interest rate charged on such loans, from a three-tiered structure (poverty, intermediate, and market) depending on community income to an interest rate that is 60 percent of the market rate not to exceed 5 percent. This change is expected to substantially reduce the loan repayment costs for most communities, at a lower loan to grant ratio. The community facility program is targeted to rural communities with fewer than 20,000 residents. It will have a program level of $522 million in 2007.

USDA also provides grants, direct loans, and loan guarantees to assist rural businesses, including cooperatives, and to increase employment and diversify the rural economy. In 2006, USDA proposes to provide almost $1 billion in loan guarantees to rural businesses that serve communities of 50,000 or less. USDA also provides rural business 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. Overall, USDA expects to retain or create over 73,000 jobs through its business programs in 2007, 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 (DLT).

The Budget includes $3.8 billion in direct electric loans, $690 million in direct telecommunications loans, $356 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.

The Rural Telephone Bank is in the process of dissolving. All stock will be redeemed during 2006 and no new loans will be provided. Loans approved in prior years, but not disbursed will still be available for borrowers at modified terms to reflect the bank's dissolution.

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 3.1 percent in 2005, compared to 3.4 percent in 2004. FSA-guaranteed farm loans are made to more creditworthy 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 0.45 percent in 2005, as compared to 0.69 percent in 2004. 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 2005, FSA provided loans and loan guarantees to approximately 26,000 family farmers totaling $3 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 low crop/livestock prices and some regional production problems. In 2007, FSA proposes to make $3.4 billion in direct and guaranteed loans through discretionary programs. In addition, FSA proposes to increase fees on many of its guaranteed loan programs to reduce the cost of the program and bring the fees in line with other Federal guaranteed loan programs.

To improve program effectiveness further, FSA conducted in 2005 an in-depth review of its direct 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. Contingent on availability of adequate resources in 2006, FSA will conduct a similar study of its guaranteed loan program.

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

The financial condition of the System's banks and associations has continued to improve. The ratio of capital to assets increased to 17.1 percent at year-end 2004 from an already high level of 16.1 percent at year-end 2001. As of September 30, capital consisted of $2 billion in restricted capital held by the Farm Credit System Insurance Corporation (FCSIC) and $20.7 billion of unrestricted capital—a record level. Nonperforming loans decreased, and earnings increased, although rising short-term interest rates moderately squeezed interest margins. The examinations by the Farm Credit Administration (FCA), the FAC's Federal regulator, also show the strong financial condition of FCS institutions. As of September 2005, all FCA institutions had one of the top two examination ratings (1 or 2 in a 1–5 scale). Assets grew at a brisk pace (over 7 percent annual rate) in recent years, while the number of FCS institutions decreased due to consolidation. In September 2002, there were seven banks and 104 associations; by September 2005, there were five banks and 96 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 the joint and several liability of the System banks. On September 30, 2005, the assets in the Insurance Fund totaled $2.029 billion. Of that amount, $40 million was allocated to the Allocated Insurance Reserve Accounts (AIRAs). On September 20, 2005, the Insurance Fund as a percentage of adjusted insured debt was 1.87 percent in the unallocated Insurance Fund and 1.91 percent including the AIRAs. This was below the Secure Base target of 2 percent. During 2005, growth in System debt has outpaced the capitalization of the Insurance Fund that occurs through investment earnings and the accrual of premiums. In addition, the Insurance Fund paid out $231 million toward the retirement of the remaining Financial Assistance Corporation (FAC) bonds. On June 10, 2005, the FAC repaid its remaining debt obligations of $325 million and also repaid all interest advanced by the U.S. Treasury ($440 million).

Over the past 12 months, the System's loans outstanding have grown by $8.3 billion, or 8.8 percent, while over the past three years they have grown $15.3 billion, or 17.4 percent. As required by law, all borrowers are also stockholder owners of System banks and associations. As of September 30, 2005, the System has more than 461,000 stockholders. Loans to young, beginning, and small farmers and ranchers represented 12.7, 19.1, and 31.0 percent, respectively, of the total dollar volume of farm loans outstanding at the end of 2004. The percentage of loans to beginning farmers increased in 2004, while loans to young and small farmers were slightly lower. Young, beginning, and small farmers are not mutually exclusive groups, and thus, cannot be added across categories. Providing credit and related services to young, beginning, and small farmers and ranchers 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 associated with the agricultural sector, including concentration risk, changes in real estate values, weather-related catastrophes, possible changes to government programs, volatile commodity prices, animal and plant diseases, and uncertain prospects of off-farm employment.

Farmer Mac

Farmer Mac was established in 1987 to facilitate a secondary market for farm real estate and rural housing loans. The Farm Credit System Reform Act of 1996 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. This change increased Farmer Mac's ability to provide liquidity to agricultural mortgage lenders. Since then, 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, AgVantage bond assets, and real estate owned) as of September 30, 2005, totaled $5.1 billion. That volume represents a decrease of 7.5 percent from program activity at September 30, 2004. Farmer Mac attributes the decline to ample liquidity among rural lenders and the generally strong financial position of farmers currently. Of total program activity, $2.1 billion were on-balance sheet loans and agricultural mortgage-backed securities, and $3.0 billion were off-balance sheet obligations. Total assets were $4.3 billion at the close of the third quarter, with nonprogram investments accounting for $2.0 billion of those assets. Farmer Mac's net income for first three quarters of 2005 was $22.4 million, an increase of $2.4 million or 11.6 percent over the same period in 2004.

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 agencies (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 "level the playing field" strategically 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. A loan or credit may not be made for more than 6 months in any 12-month period unless the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months.

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 2007, 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 2007.

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.

While the deposit insurance system for banks and thrifts today is generally sound and well managed, inherent weaknesses in the system prompted the President to propose reforms, including the establishment of a new combined, stronger Federal Deposit Insurance Corporation (FDIC) insurance fund and increased flexibilities for the FDIC regarding fund levels and the authority to charge premiums. These new authorities would allow the FDIC to better manage the fund and help avoid strain on financial institutions by stabilizing industry costs over time instead of having a potential for sharp premium increases when the economy may be under stress. Many of these reforms, including the merger of the insurance funds, were included in the Deficit Reduction Act of 2005, which the Budget assumes will be enacted before publication.

The FDIC insures deposits in banks and savings associations (thrifts). The National Credit Union Administration (NCUA) insures deposits (shares) in most credit unions (certain credit unions are privately insured). FDIC and NCUA insure deposits up to $100,000 per account. Under the Deficit Reduction Act of 2005, the deposit insurance ceiling will be changed for various accounts, including an increase for retirement accounts of up to $250,000. Beginning in 2010, and every five years thereafter, FDIC and NCUA will have the authority to increase deposit insurance coverage limits for non-retirement accounts based on inflation if the Boards determine prudent. As of September 30, 2005, FDIC insured $3.8 trillion of deposits at 8,867 commercial banks and thrifts and NCUA insured $515 billion of deposits (shares) at 8,795 credit unions.

Current Industry and Insurance Fund Conditions

For the quarter ending September 30, 2005, insured banks and thrifts continued to report record-high earnings, outpacing the previous quarter's net earnings by $1.4 billion. In the year ending September 30, 2005, industry net income totaled $134 billion—a nine percent increase over the $123 billion income reported for the previous year. 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 those regions.

In 2005, no banks or thrifts failed. In comparison, during the previous year, five banks and thrifts, with combined assets of $175 million dollars, failed. As of September 30, 2005, the FDIC classified 68 institutions with $21 billion in assets as "problem institutions," compared to 95 institutions with $25 billion in assets one year earlier.

Under the Deficit Reduction Act, the FDIC's Bank Insurance Fund (BIF) and its Savings Association Insurance Fund (SAIF) will be merged into the near Deposit Insurance Fund (DIF). At the end of September 2005, the SAIF reserve ratio (ratio of insurance reserves to insured deposits) stood at 1.30 percent—well above the statutory target of 1.25 percent. However, a surge in insured deposits reduced the reserve ratio of BIF to 1.25 percent as of September 2005, when the latest statistics are available. While this just meets the statutory target, it raises the likelihood that all BIF-insured institutions could be assessed premiums in 2006 because of the requirement to maintain the reserve ratio at the statutory target. Under the Deficit Reduction Act, the FDIC will have more flexibility as to when it can charge premiums. Under the Act, the FDIC is authorized to charge risk-based premiums on any member institution to manage fund reserves and can set the reserve ratio at the beginning of each year within a range between 1.15 and 1.50 percent of estimated insured deposits. When an insurance fund is expected to remain above the statutory target, the FDIC is authorized to charge deposit insurance premiums only on institutions that are not well capitalized or well managed, with a maximum premium of 27 cents per $100 of assessable deposits for the riskiest institutions. Due to the strong financial condition of the industry, less than 10 percent of banks and thrifts paid insurance premiums in 2004.

During 2005, 13 Federally-insured credit unions with $148 million in assets failed (including assisted mergers). In comparison, during 2004, 22 Federally-insured credit unions with $120 million in assets failed. The National Credit Union Share Insurance Fund (NCUSIF) ended fiscal year 2005 with assets of $6.3 billion and an equity ratio of 1.27 percent, below the NCUA-set target ratio of 1.30 percent. Each insured credit union is required to deposit and maintain an amount in the NCUSIF equal to one percent of its member share accounts in the fund. The insurance premium charge was waived again during 2005 because the ratio stayed above 1.25 percent. NCUA is required to assess a premium if the ratio falls below 1.20 percent and is authorized to do so if the ratio falls below 1.25 percent.

The Federal banking regulators (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) continue to work on a rulemaking that would implement the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II). The original Basel Capital Accord (Basel I) is an international agreement establishing a uniform capital standard across nations. It adopted a risk-based capital requirement that applies a few risk weights to broad categories of assets. The Federal banking regulators issued capital rules based on Basel I in 1989. Basel II would improve the risk-based capital requirement in several ways, including refining risk categories. U.S. regulators are considering requiring the largest banks that have complex financial structures and expertise to use an internal ratings-based approach to calculate credit risk capital requirements, and an advanced measurement approach to calculate operational risk capital requirements. The rule, if adopted, would apply to banks that hold the overwhelming majority of U.S. banking assets. The regulators are using Quantitative Impact Study 4 data recently obtained from banks likely to be covered by the rule to help develop the rulemaking, including the implementation schedule and transition provisions.

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 meets the legal criteria to transfer its obligations to the pension insurance program. PBGC's claims exposure is the amount by which qualified benefits exceed assets in insured plans. In the near term, the risk of loss stems from financially distressed firms with underfunded plans. In the longer term, loss exposure results from the possibility that currently healthy firms become distressed and currently well-funded plans become underfunded due to inadequate contributions, poor investment results, or increased liabilities.

Losses to the PBGC and benefit losses to workers and retirees are exacerbated by structural flaws in the statutory plan funding requirements and in the design of the insurance program. The pension system is replete with moral hazards that allow the buildup of unfunded pension promises even in plans with weak sponsors, where the risk of plan termination is high. At the same time, PBGC lacks the standard insurance industry safeguards against moral hazards—such as underwriting standards and risk-based premiums.

PBGC monitors troubled companies with underfunded plans and acts to protect the interests of the pension insurance program's stakeholders where possible. Such protections include initiating termination of an underfunded plan in appropriate circumstances. Under its Early Warning Program, PBGC works with companies to strengthen plan funding or otherwise protect the insurance program against avoidable losses. However, PBGC's authority to prevent undue risks to the insurance program is limited.

The combination of the flawed design of the pension insurance system and adverse economic conditions has resulted in PBGC's single-employer program incurring substantial losses from underfunded plan terminations in 2001 through 2005. The table below shows the ten largest plan termination losses to date. As a result of these losses, the program's deficit at 2005 year-end stood at $22.8 billion,[1] compared to a $9.7 billion surplus at 2000 year-end.

LARGEST 10 CLAIMS AGAINST THE PBGC'S SINGLE-EMPLOYER PROGRAM, 1975–2005

Top 10 Firms	Fiscal Years of Plan Terminations	Claims (by firm)	Percent of Total Claims (1975–2005)
1. United Airlines	2005	$7,093,803,951	22.7%
2. Bethlehem Steel	2003	3,654,380,116	11.5%
3. US Airways	2003, 2005	2,861,901,511	9.0%
4. LTV Steel*	2002, 2003, 2004	1,959,679,993	6.2%
5. National Steel	2003	1,161,019,567	3.7%
6. Pan American Air	1991, 1992	841,082,434	2.7%
7. Weirton Steel	2004	690,181,783	2.2%
8. Trans World Airlines	2001	668,377,105	2.1%
9. Kemper Insurance	2005	566,128,387	1.8%
10. Kaiser Aluminum	2004	565,812,015	1.8%
Top 10 Total	....	20,062,366,861	63.3%
All Other Total	....	11,646,148,178	36.7%
TOTAL	....	**$31,708,515,039**	**100.0%**

Sources: PBGC Fiscal Year Closing File (9/30/05), PBGC Case Administration System and PBGC Participant System (PRISM).

Due to rounding, percentages may not add up to 100 percent.

Data in this table have been calculated on a firm basis and include all plans of each firm.

Values and distributions are subject to change as PBGC completes its reviews and establishes termination dates.

* Does not include 1986 termination of a Republic Steel plan sponsored by LTV.

Additional risk exposure remains for the future because of economic uncertainties and significant underfunding in single-employer pension plans, which, on a termination basis, exceeded $450 billion at the end of 2005, the same as a year earlier but now concentrated among larger plans. This exposure is higher than the $350 billion at the end of 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, was $108 billion at September 30, 2005. The comparable estimates for 2004 and 2003 were $96 billion and $82 billion, respectively. Several large companies in the airline and automotive industries recently filed for bankruptcy with a potential exposure to PBGC in the billions of dollars.

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 stood at $335 million at the end of 2005, up from $236 million in 2004. Estimated underfunding in multiemployer plans approximated over $200 billion at year-end, up from over $150 billion and $100 billion in 2004 and 2003, respectively.

The agency has sufficient liquidity to meet its obligations for a number of years; however, neither the single-employer nor multiemployer program has the resources to satisfy fully the agency's long-term obligations to plan participants. As of September 30, 2005, the PBGC's single-employer and multiemployer programs together had assets of $57.6 billion to cover liabilities of $80.7 billion, a shortfall of $23.1 billion.

In February 2005 the Administration proposed comprehensive reforms to strengthen funding for workers' defined-benefit pensions; provide more accurate infor-

[1] The 2005 year-end single-employer program deficit of $22.8 billion was less than the $23.3 billion deficit at the end of 2004 because increased losses from new claims were offset by new premiums, favorable liability revaluations due to increasing interest rates, and investment returns. There is no assurance that these results will continue.

mation about pension liabilities and plan underfunding; and enable PBGC to meet its obligations to participants in terminated pension plans. The reforms would:

- 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 re-examine 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 forgo 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.

In late December 2005, the Senate approved a conference report on budget reconciliation that contains a premium increase for both the single-employer and multiemployer insurance programs; House action on the conference report is expected early in 2006. In addition, comprehensive pension bills (S. 1783 passed by the Senate on November 16, 2005, and H.R. 2830 passed by the House on December 15, 2005) are expected to be considered by a Conference Committee early in 2006. The Administration is evaluating the bills in light of its pension reform goals and is committed to pension reform that would strengthen funding requirements and restore PBGC to solvency.

Disaster Insurance

Flood Insurance

The Federal Government provides flood insurance through the National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency 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. In January 2006, the program had 4.7 million policies in more than 20,100 communities with $811 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 affordable 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.

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 floodplains and have mortgages from federally regulated lenders. These strategies have resulted in policy growth of 5 percent in the last 12 months.

DHS also has a multi-pronged strategy for reducing future flood damage. The NFIP offers flood mitigation assistance grants to assist flood victims to rebuild to current building codes including base flood elevations, thereby reducing future flood damage costs. In addition, two newly enacted grant programs will help reduce the number of repetitive loss properties through acquisition, relocation, or elevation, not only helping owners of high-risk property, but reducing a disproportionate drain on the National Flood Insurance Fund. As the new repetitive loss grants are implemented, FEMA will work to ensure that all of the flood mitigation grant programs are closely integrated, resulting in better coordination and communication with State and local governments. Further, through the Community Rating System, DHS adjusts premium rates to encourage community and State mitigation activities beyond those required by the NFIP. These efforts, in addition to the minimum NFIP requirements for floodplain management, save the country well over $1 billion annually in avoided flood damages.

The program's reserve account, which is a cash fund, has sometimes had expenses greater than its revenue. The program's goal of providing affordable insurance does not permit the accumulation of large cash reserves. Currently, structures built prior to flood mapping and NFIP floodplain management requirements pay less than fully actuarial rates. These structures make up less than 25 percent of the total 4.7 million policies in force.

Mostly because of the four major hurricanes in 2004, the NFIP handled 74,000 claims nationwide, resulting in payments totaling more than $2 billon, the highest loss year since the program began in 1968. All but $300 million of these payments were made with the reserve in the fund. However, this record loss year was surpassed in 2005 by a factor of more than 10 because of hurricanes Katrina, Rita, and Wilma. These three storms are expected to result in over 200,000 claims with an estimated payment totaling more than $23 billion. As a result, the Administration and Congress have worked to increase the borrowing authority to make certain that all claims could be paid.

The Administration is also working with Congress to improve the NFIP based on the following principles: protecting the NFIP's integrity by covering existing commitments; phasing out subsidized premiums in order to charge fair and actuarially sound premiums; increasing program participation incentives and improving enforcement of mandatory participation in the program; increasing risk awareness by educating property owners; and reducing future risks by implementing and enhancing mitigation measures. The catastrophic nature of the 2005 hurricane season has also triggered an examination of the program, and the Administration is working with Congress to reform the program to further mitigate the impact of flood damages and losses.

Crop Insurance

Subsidized Federal crop insurance administered by USDA's Risk Management Agency (RMA) assists farmers in managing 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 Government 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.

The 2007 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 points on policies with a coverage level of 75 percent or above (80 percent for GRP). In addition, the proposal reduces the Administrative and Operating 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 2008 and will save $140 million a year. This proposal was also included in the 2006 Budget.

In addition, the 2007 Budget includes a proposal to implement a participation fee in the Federal crop insurance program. The proposed participation fee would initially be used to fund modernization of the existing information technology (IT) system and would supplement the annual appropriation provided by Congress. Subsequently, the fee would be shifted to maintenance and would be expected to reduce the annual appropriation. The participation fee would be charged to insurance companies participating in the Federal crop insurance program; based on a rate of about one-half cent per dollar of premium sold, the fee is expected to be sufficient to generate about $15 million annually beginning in 2008. The existing IT system is nearing the end of its useful life and recent years have seen increases in "down-time" resulting from system failures. Over the years, numerous changes have occurred in the Federal crop insurance program; including, the development of revenue and livestock insurance which have greatly expanded the program and taxed the IT system due to new requirements, such as daily pricing, which were not envisioned when the existing IT system was designed. These new requirements contribute to increased maintenance costs and limit RMA's ability to comply with Congressional mandates pertaining to data reconciliation with the Farm Service Agency. The participation fee will alleviate these problems.

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. 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. For the ten principal crops, which account for about 80 percent of total liability, over 75 percent of eligible acres participated in the crop insurance program.

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 2005, revenue products accounted for about 54 percent of policies earning premium, 52 percent of net insured acres, and 62 percent of total program liability.

USDA also continues to expand coverage. In 2005, a sugar beet stage removal pilot and a Silage Sorghum pilot were introduced. In addition, RMA made Adjusted Gross Revenue-Lite available in five additional States, and expanded Livestock Risk Protection. RMA also submitted two new risk management tools for pasture, rangeland and forage protection for consideration. It is expected in 2006 that the Livestock Gross Margin pilot program will be expanded to include cattle. RMA is also making substantial improvements to the Florida Fruit Tree pilot program to enhance coverage and make it more effective for loss due to hurricane. RMA also expanded the Group Risk Income Protection plans for cotton, wheat and grain sorghum for the 2006 crop year. RMA continues to pursue a number of avenues to increase program participation among underserved States and commodities by working on declining yield issues and looking at discount programs for good experienced producers who pose less risk.

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

Insurance Against Security-Related 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 on many new construction projects, increasing business costs for the insurance that was available, and substantially shifting 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, three-year Federal program that provided a system of shared public and private compensation for insured commercial property and casualty losses arising from acts of terrorism (as defined by the Act). Under the Act, insurance companies included in the program were required to make available to their policyholders coverage for losses from acts of terrorism. In the event of a terrorist attack on private businesses and others covered by this program, the Federal Government would cover 90 percent of the insured losses above each insurance company's deductible (as specified in the Act). The Act also provided authority for the Department of the Treasury to recoup Federal payments via surcharges on policyholders.

The Act required the Department of the Treasury to conduct a study on the effectiveness of the program and to report the results to Congress by June 30, 2005. Treasury found that the Act had achieved its goals of supporting the insurance industry during a transitional period and had stabilized the private insurance market. Extending the Act in its then-current form was likely to hinder further development of the terrorism risk insurance market by crowding out innovation and capacity building. As a result, the Administration sought significant reforms to the program.

In December 2005, Congress extended the program for two years, through December 31, 2007, and the President signed it into law. The 2005 Act continues to require insurance company participants to make available terrorism risk insurance through the fifth and final year. But, the 2005 Act significantly reduces taxpayers' exposure by excluding certain lines of insurance from Federal coverage: Commercial automobile, burglary and theft, surety, professional liability, and farm owners multiple peril are removed from the program altogether. In addition, the 2005 Act increases insurers' deductibles from 15 percent of direct earned premiums for calendar year 2005 to 17.5 percent in 2006 and 20 percent in 2007. The extension also decreases the Federal co-payment for insured losses above the insurers' deductibles from 90 percent of insured losses in calendar year 2005 and 2006 to 85 percent of insured losses in 2007.

Finally, the new legislation increases the trigger amount for Federal payments, currently at $5 million in aggregate insured losses from an act of terrorism. After March 31, 2006, no Treasury payments can be made unless the aggregate industry insured losses exceed $50 million in calendar year 2006 or $100 million in calendar year 2007. Neither the Department of the Treasury nor any insurer will be liable for any amount exceeding the statutory annual cap of $100 billion in aggregate insured losses. Above that amount, the Act states that Congress will determine the procedures that would govern any further payments.

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 one-time 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. DOT also offered airlines short duration third-party liability war risk insurance at subsidized rates because coverage was initially withdrawn by private insurers followed by a period of marketplace disruption. Currently, aviation war risk insurance coverage is generally available from private insurers, albeit at significantly higher costs. However, commercial insurance coverage for occurrences involving weapons of mass destruction is now being withdrawn from the market. Because of this program, airlines receive financial protection from war risk occurrences and are able to meet conditions imposed by aircraft liens and leases.

The Homeland Security Act of 2002 (HSA) included airline war risk insurance legislation. The HSA and subsequent authorization and appropriation acts directed the continuation of third party liability war risk insurance policies in effect on June 19, 2002 through August 31, 2006 at the premium rate in effect on June 19, 2002. The Secretary is authorized to limit the third party liability of air carriers and aircraft and aircraft engine manufacturers to $100 million, when the Secretary certifies that the loss is from an act of terrorism. The acts further required the scope of insurance coverage to include war risk hull loss and passenger and crew liability at a total policy premium not to exceed twice that charged for third party liability. Consequently, the President has issued several Presidential Determinations, the most recent on December 22, 2005, authorizing the continued provision of aviation war risk insurance through August 31, 2006 and the DOT has issued policies to conform to HSA requirements.

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 FY 2005, the fund earned approximately $164 million in premiums for insurance provided by DOT, and it is anticipated that $144 million in premiums will also be earned in FY 2006. No claims have been paid by the program since its expansion in 2001. At the end of 2005, the balance of the Aviation Insurance Revolving Fund available for payment of future claims was $568 million. The balance in the fund is sufficient to pay small claims, but would be inadequate to meet the coverage limits of the largest policies in force ($4 billion) or a series of large claims. The Federal Government would pay any claims by the airlines that exceed the balance in the aviation insurance revolving fund. The Administration does not support a straight extension of this program, which crowds out private sector mechanisms for managing risk. Looking forward, the Administration is committed to working with Congress to ensure that air carriers more equitably share in the risks associated with this program.

Chart 7-3. Face Value of Federal Credit Outstanding

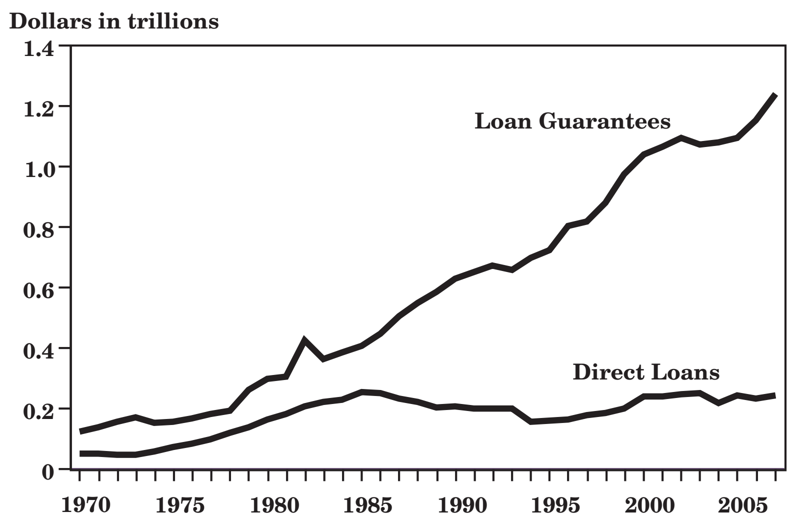


Table 7–1. ESTIMATED FUTURE COST OF OUTSTANDING FEDERAL CREDIT PROGRAMS

(In billions of dollars)

Program	Outstanding 2004	Estimated Future Costs of 2004 Outstanding [1]	Outstanding 2005	Estimated Future Costs of 2005 Outstanding [1]
Direct Loans: [2]				
Federal Student Loans	107	8	113	11
Farm Service Agency (excl. CCC), Rural Development, Rural Housing	43	10	43	9
Rural Utilities Service and Rural Telephone Bank	32	3	34	2
Housing and Urban Development	13	2	12	2
Export-Import Bank	12	5	10	5
Public Law 480	9	5	9	4
Agency for International Development	8	3	8	3
Commodity Credit Corporation	7	3	3	1
Federal Communications Commission	4	4	*	*
Disaster Assistance	3	1	4	1
VA Mortgage	2	*	1	*
Other Direct Loan Programs	13	2	11	3
Total Direct Loans	251	46	247	41
Guaranteed Loans: [2]				
FHA Mutual Mortgage Insurance Fund	384	1	336	2
VA Mortgage	351	4	206	3
Federal Family Education Loan Program	245	23	289	31
FHA General/Special Risk Insurance Fund	91	4	90	3
Small Business	57	2	73	2
Export-Import Bank	36	2	36	2
International Assistance	21	2	22	2
Farm Service Agency (excl. CCC), Rural Development, Rural Housing	29	1	30	1
Commodity Credit Corporation	4	*	2	*
Maritime Administration	3	*	3	*
Air Transportation Stabilization Program	2	1	1	1
Government National Mortgage Association (GNMA) [3]	....	*	....	*
Other Guaranteed Loan Programs	8	3	8	1
Total Guaranteed Loans	1,231	43	1,096	48
Total Federal Credit	**1,482**	**89**	**1,343**	**89**

* $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 guarantees.

[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 data 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 1992–2005 [1]

(Budget authority and outlays, in millions of dollars)

Program	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
DIRECT LOANS:												
Agriculture:												
Agriculture credit insurance fund	28	2	–31	23	....	331	–656	921	10	–701	–147	–2
Farm storage facility loans	....	....	....	....	....	....	....	–1	–7	–8	7	–1
Apple loans	....	....	....	....	....	....	....	–2	1	....	*	*
Emergency boll weevil loan	....	....	....	....	....	....	....	....	1	*	*	3
Agricultural conservation	....	....	....	....	....	....	....	....	....	....	....	....
Distance learning and telemedicine	....	....	....	....	....	....	....	1	–1	–1	1	....
Rural electrification and telecommunications loans	61	–37	84	....	–39	....	–17	–42	101	265	143	....
Rural telephone bank	....	....	10	....	–9	....	–1	....	–3	–7	–6	....
Rural housing insurance fund	152	46	–73	....	71	....	19	–29	–435	–64	–200	....
Rural economic development loans	....	....	1	....	–1	*	....	–1	–1	....	–2	....
Rural development loan program	1	....	....	....	–6	....	....	–1	–3	....	–3	....
Rural community advancement program [2]	....	....	8	....	5	....	37	3	–1	–84	–34	....
P.L. 480	....	–37	–1	....	....	....	–23	65	–348	33	–43	–239
P.L. 480 Title I food for progress credits	84	–38	....	....	....	....	....	....	–112	–44	....	....
Commerce:												
Fisheries finance	....	....	....	....	....	....	–19	–1	–3	....	1	–14
Defense:												
Military housing improvement fund	....	....	....	....	....	....	....	....	....	....	*	–4
Education:												
Federal direct student loan program: [3]												
Volume reestimate	....	....	....	....	22	....	–6	....	43	....	....	....
Other technical reestimate	....	3	–83	172	–383	–2,158	560	....	3,678	1,999	855	2,827
College housing and academic facilities loans	....	....	....	....	....	....	–1	....	....	....	....	....
Homeland Security:												
Disaster assistance	....	....	....	....	....	47	36	–7	–6	*	4	*
Interior:												
Bureau of Reclamation loans	....	....	....	....	....	3	3	–9	–14	....	17	1
Bureau of Indian Affairs direct loans	....	....	....	....	1	5	–1	–1	2	*	*	*
Assistance to American Samoa	....	....	....	....	....	....	....	....	....	*	*	2
State												
Repatriation loans	....	....	....	....	....	....	....	....	....	....	....	–3
Transportation:												
High priority corridor loans	....	....	....	–3	....	....	....	....	....	....	....	....
Alameda corridor loan	....	....	....	....	....	–58	....	....	....	–12	....	....
Transportation infrastructure finance and innovation	....	....	....	....	....	....	18	....	....	....	3	–11
Railroad rehabilitation and improvement program	....	....	....	....	....	....	....	....	....	–5	–14	–11
Treasury:												
Community development financial institutions fund	....	....	....	....	....	1	....	....	*	–1	*	–1
Veterans Affairs:												
Veterans housing benefit program fund	30	76	–72	465	–111	–52	–107	–697	17	–178	987	–47
Native American veteran housing	....	....	....	....	....	....	....	....	–3	*	*	*
Vocational Rehabilitation Loans	....	....	....	....	....	....	....	....	*	*	*	–1
Environmental Protection Agency:												
Abatement, control and compliance	....	....	....	....	....	....	3	–1	*	–3	*	*
International Assistance Programs:												
Foreign military financing	....	....	13	4	1	152	–166	119	–397	–64	–41	–7
U.S. Agency for International Development:												
Micro and small enterprise development	....	....	....	....	....	....	....	*	....	*	....	....
Overseas Private Investment Corporation:												
OPIC direct loans	....	....	....	....	....	....	....	....	–4	–21	3	–7
Debt reduction	....	....	....	....	....	36	–4	....	*	–47	–104	54
Small Business Administration:												
Business loans	....	....	....	....	....	....	1	–2	1	25	....	–16
Disaster loans	....	....	....	–193	246	–398	–282	–14	266	589	196	61
Other Independent Agencies:												
Export-Import Bank direct loans	–16	37	....	....	....	–177	157	117	–640	–305	111	–257
Federal Communications Commission	....	....	....	4,592	980	–1,501	–804	92	346	380	732	–24
LOAN GUARANTEES:												
Agriculture:												
Agriculture credit insurance fund	14	12	–51	96	....	–31	205	40	–36	–33	–22	–162

Table 7–2. REESTIMATES OF CREDIT SUBSIDIES ON LOANS DISBURSED BETWEEN 1992–2005 [1]—Continued

(Budget authority and outlays, in millions of dollars)

Program	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Agriculture resource conservation demonstration	....	....	....	....	....	....	2	....	1	–1	*	*
Commodity Credit Corporation export guarantees	103	–426	343	....	....	....	–1,410	....	–13	–230	–205	–366
Rural development insurance fund	....	....	–3	....	....	....	....	....	....	....	....	....
Rural housing insurance fund	10	7	–10	....	109	....	152	–56	32	50	66	....
Rural community advancement program	....	....	–10	....	41	....	63	17	91	15	29	....
Commerce:												
Fisheries finance	....	....	....	–2	....	....	–3	–1	3	*	1	*
Emergency steel guaranteed loans	....	....	....	....	....	....	....	....	50	*	3	–75
Emergency oil and gas guaranteed loans	....	....	....	....	....	....	*	*	*	*	*	–1
Defense:												
Military housing improvement fund	....	....	....	....	....	....	....	....	....	–3	–1	–3
Defense export loan guarantee	....	....	....	....	....	....	....	....	....	....	–5	....
Education:												
Federal family education loan program: [3]												
Volume reestimate	....	535	99	....	–13	–60	–42	....	277	....	....	....
Other technical reestimate	421	60	....	....	–140	667	–3,484	....	–2,483	–3,278	1,348	6,837
Health and Human Services:												
Heath center loan guarantees	....	....	....	....	....	3	....	*	*	....	1	*
Health education assistance loans	....	....	....	....	....	....	....	....	–5	–37	–33	–18
Housing and Urban Development:												
Indian housing loan guarantee	....	....	....	....	....	....	–6	*	–1	*	–3	–1
Title VI Indian guarantees	....	....	....	....	....	....	....	....	–1	1	4	*
Community development loan guarantees	....	....	....	....	....	....	....	....	....	19	–10	–2
FHA-mutual mortgage insurance	....	....	–340	....	3,789	....	2,413	–1,308	1,100	5,947	1,979	2,842
FHA-general and special risk	....	–110	–25	743	79	....	–217	–403	77	352	507	238
Interior:												
Bureau of Indian Affairs guaranteed loans	....	....	31	....	....	....	–14	–1	–2	–2	*	15
Transportation:												
Maritime guaranteed loans (title XI)	....	....	....	....	–71	30	–15	187	27	–16	4	–76
Minority business resource center	....	....	....	....	....	....	....	1	....	*	*	....
Treasury:												
Air transportation stabilization program	....	....	....	....	....	....	....	....	113	–199	292	–109
Veterans Affairs:												
Veterans housing benefit fund program	167	334	–706	38	492	229	–770	–163	–184	–1,515	–462	–843
International Assistance Programs:												
U.S. Agency for International Development:												
Development credit authority	....	....	....	....	....	....	....	–1	....	1	–3	–2
Micro and small enterprise development	....	....	....	....	....	....	....	....	....	2	–2	–3
Urban and environmental credit	–1	–7	....	–14	....	....	....	–4	–15	48	–2	–5
Assistance to the new independent states of the former Soviet Union	....	....	....	....	....	....	....	–34	....	....	....	....
Loan Guarantees to Israel	....	....	....	....	....	....	....	....	....	–76	–111	188
Loan Guarantees to Egpyt	....	....	....	....	....	....	....	....	....	....	....	7
Overseas Private Investment Corporation:												
OPIC guaranteed loans	....	....	....	....	....	....	....	5	77	60	–212	–21
Small Business Administration:												
Business loans	....	257	–16	–279	–545	–235	–528	–226	304	1,750	1,034	–390
Other Independent Agencies:												
Export-Import Bank guarantees	–59	13	....	....	....	–191	–1,520	–417	–2,042	–1,133	–655	–1,164
Total	995	727	–832	5,642	4,518	–3,641	–6,427	–1,854	–142	3,468	6,008	9,189

* Less than $500,000.

[1] Excludes interest on reestimates. Additional information on credit reform subsidy rates is contained in the Federal Credit Supplement.

[2] Includes rural water and waste disposal, rural community facilities, and rural business and industry programs.

[3] Volume reestimates in mandatory programs represent a change in volume of loans disbursed in the prior years.

Table 7–3. DIRECT LOAN SUBSIDY RATES, BUDGET AUTHORITY, AND LOAN LEVELS, 2005–2007

(In millions of dollars)

Agency and Program	2005 Actual			2006 Enacted			2007 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	7.38	69	935	6.42	67	1,052	9.50	95	1,008
Farm storage facility loans	–1.43	–1	72	–0.84	–1	67	0.25	....	74
Rural community advancement program	6.81	113	1,650	6.09	78	1,287	14.28	184	1,287
Rural electrification and telecommunications loans	–0.96	–47	4,837	–0.51	–31	6,028	–0.81	–36	4,528
Rural telephone bank	–1.83	–3	175	....	....	....	....	....	....
Distance learning, telemedicine, and broadband program	2.11	2	114	2.42	29	1,219	2.90	9	327
Rural housing assistance grants	46.76	3	6	46.76	3	6	47.82	....	....
Farm labor	47.06	16	33	44.59	17	38	47.95	20	42
Rural housing insurance fund	14.70	191	1,288	14.46	215	1,515	10.45	136	1,294
Rural development loan fund	46.38	16	34	43.02	15	34	44.07	15	34
Rural economic development loans	18.79	5	25	19.97	5	25	21.84	8	35
Public law 480 title I direct credit and food for progress	57.55	17	30	54.14	16	30	....	....	....
Commerce:									
Fisheries finance	–9.52	–9	91	–2.60	–5	158	–8.08	....	5
Defense—Military:									
Defense family housing improvement fund	19.23	40	208	25.34	150	592	28.40	215	757
Education:									
College housing and academic facilities loans	....	....	39	....	....	56	....	....	56
Federal direct student loan program	3.32	1,071	31,857	2.05	599	29,221	0.16	41	24,807
Homeland Security:									
Disaster assistance direct loan	....	....	....	73.17	750	1,025	1.18	....	25
Housing and Urban Development:									
FHA-mutual mortgage insurance	....	....	5	....	....	50	....	....	50
State:									
Repatriation loans	69.73	1	1	64.99	1	1	60.14	1	1
Contributions to international organizations	....	....	....	0.47	6	1,200	....	....	....
Transportation:									
Federal-aid highways	13.04	18	138	6.18	149	2,400	5.05	121	2,400
Railroad rehabilitation and improvement program	....	....	130	....	....	200	....	....	....
Treasury:									
Community development financial institutions fund	36.52	2	7	37.47	3	7	....	....	....
Veterans Affairs:									
Housing loans	–2.57	–5	165	5.08	19	384	2.93	17	605
Vocational rehabilitation program	1.14	....	3	1.59	....	3	2.00	....	4
International Assistance Programs:									
Debt restructuring	....	435	....	....	64	....	....	183	....
Overseas Private Investment Corporation	6.56	22	335	10.27	15	146	4.28	15	350
Small Business Administration:									
Disaster loans	12.86	163	1,271	14.64	671	4,587	13.18	118	900
Business loans	10.25	2	18	7.17	1	20	....	....	....
Export-Import Bank of the United States:									
Export-Import Bank loans	....	....	....	34.00	17	50	34.00	17	50
Total	**N/A**	**2,121**	**43,467**	**N/A**	**2,853**	**51,401**	**N/A**	**1,159**	**38,639**

[1] Additional information on credit subsidy rates is contained in the Federal Credit Supplement.
N/A = Not applicable.

Table 7–4. LOAN GUARANTEE SUBSIDY RATES, BUDGET AUTHORITY, AND LOAN LEVELS, 2005–2007

(in millions of dollars)

Agency and Program	2005 Actual			2006 Enacted			2007 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	3.27	72	2,195	2.68	77	2,880	1.10	27	2,498
Commodity Credit Corporation export loans	5.07	152	3,001	4.13	128	3,107	3.61	115	3,167
Rural community advancement program	3.91	34	876	3.77	44	1,200	3.94	50	1,273
Rural electrification and telecommunications loans	....	....	....	0.09	....	99	....	....	....
Distance learning, telemedicine, and broadband program	....	....	....	....	....	....	4.63	1	30
Rural housing insurance fund	1.14	36	3,142	1.21	62	5,137	0.61	23	3,762
Rural business investment	....	....	....	7.72	5	65	....	....	....
Renewable energy	5.73	1	10	6.45	11	177	6.49	2	35
Defense—Military:									
Defense family housing improvement fund	6.06	10	165	....	....	....	....	....	....
Education:									
Federal family education loan	11.09	11,130	100,405	9.87	9,839	99,649	7.27	6,125	84,287
Health and Human Services:									
Health resources and services	5.35	1	17	3.50	1	15	....	....	....
Housing and Urban Development:									
Indian housing loan guarantee fund	2.58	3	103	2.42	2	116	2.35	6	251
Native Hawaiian housing loan guarantees	2.58	....	2	2.42	1	36	2.35	1	43
Native American housing	10.32	1	4	12.26	1	10	11.99	2	15
Community development loan guarantees	2.30	8	337	2.20	6	276	....	....	....
FHA-mutual mortgage insurance	–1.80	–1,044	58,017	–1.70	–839	[2] 48,594	–0.96	–845	[2] 86,039
FHA-general and special risk	–0.85	–169	19,652	–1.65	–282	[2] 17,165	–3.38	–247	[2] 7,370
Interior:									
Indian guaranteed loan	6.76	5	85	4.75	5	112	6.45	5	87
Transportation:									
Minority business resource center program	2.08	....	7	1.85	....	18	1.82	....	18
Federal-aid highways	....	....	....	3.67	7	200	3.90	8	200
Maritime guaranteed loans (Title XI)	27.54	38	140	7.64	5	65	....	....	....
Veterans Affairs:									
Housing loans	–0.32	–74	22,544	–0.32	–116	36,110	–0.30	–114	37,681
International Assistance Programs:									
Loan guarantees to Israel	....	....	750	....	....	1,000	....	....	1,000
Loan guarantees to Egypt	....	....	1,250	....	....	....	....	....	....
Development credit authority	5.09	10	199	3.90	10	257	5.49	13	238
Overseas Private Investment Corporation	–3.13	–53	1,694	–6.28	–64	1,025	–1.88	–30	1,600
Small Business Administration:									
General business loans	0.01	3	19,939	....	....	27,500	....	....	28,000
Export-Import Bank of the United States:									
Export-Import Bank loans	1.09	152	13,936	1.76	243	13,828	0.25	44	17,477
Presidio Trust:									
Presidio Trust	....	....	....	....	....	....	0.32	....	20
Total	**N/A**	**10,316**	**248,470**	**N/A**	**9,146**	**258,641**	**N/A**	**5,186**	**275,091**
ADDENDUM: SECONDARY GUARANTEED LOAN COMMITMENTS									
GNMA:									
Guarantees of mortgage-backed securities loan guarantee	–0.23	–218	112,519	–0.23	–205	[2] 89,000	–0.27	–235	[2] 86,000
SBA:									
Secondary market guarantee	....	....	10,000	....	....	12,000	....	....	12,000
Total, secondary guaranteed loan commitments	**N/A**	**–218**	**122,519**	**N/A**	**–205**	**101,000**	**N/A**	**–235**	**98,000**

[1] Additional information on credit subsidy rates is contained in the Federal Credit Supplement.
[2] Loan levels do not include standby commitment authority.
N/A = Not applicable.

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

(In billions of dollars)

	Actual								Estimate	
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Direct Loans:										
Obligations	28.8	38.4	37.1	39.1	43.7	45.4	42.0	56.3	62.6	49.1
Disbursements	28.7	37.7	35.5	37.1	39.6	39.7	38.7	50.6	54.6	45.6
New subsidy budget authority	–0.8	1.6	–0.4	0.3	*	0.7	0.4	2.1	2.9	1.2
Reestimated subsidy budget authority [1]	7.3	1.0	–4.4	–1.8	0.5	2.9	2.6	3.8	3.3	....
Total subsidy budget authority	6.5	2.6	–4.8	–1.5	0.5	3.5	3.0	6.0	6.1	1.2
Loan guarantees:										
Commitments [2]	218.4	252.4	192.6	256.4	303.7	345.9	300.6	248.5	258.3	234.6
Lender disbursements [2]	199.5	224.7	180.8	212.9	271.4	331.3	279.9	221.6	240.6	245.7
New subsidy budget authority	3.3	*	3.6	2.3	2.9	3.8	7.3	10.1	8.9	5.0
Reestimated subsidy budget authority [1]	–0.7	4.3	0.3	–7.1	–2.4	–3.5	2.0	3.5	6.9	....
Total subsidy budget authority	2.6	4.3	3.9	–4.8	0.5	0.3	9.3	13.6	15.8	5.0

* Less than $50 million.
[1] Includes interest on reestimate.
[2] To avoid double-counting, totals exclude GNMA secondary guarantees of loans that are guaranteed by FHA, VA, and RHS, and SBA's guarantee of 7(a) loans sold in the secondary market.

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]		
	2005 actual	2006 estimate	2007 estimate	2005 actual	2006 estimate	2007 estimate
DIRECT LOAN WRITEOFFS						
Agriculture:						
Agricultural credit insurance fund	132	135	135	1.84	2.04	2.16
Commodity Credit Corporation fund	24	....	....	1.15	....	....
Rural community advancement program	4	4	4	0.05	0.04	0.04
Rural development insurance fund	3	1	1	0.14	0.05	0.05
Rural housing insurance fund	90	113	108	0.35	0.45	0.44
P.L.480	61	189	....	0.69	2.30	....
Debt reduction (P.L.480)	4	....	....	0.76	....	....
Commerce:						
Economic development revolving fund	1	1	1	7.14	10.00	16.66
Education:						
Student financial assistance	6	6	6	1.85	1.85	1.85
Homeland Security:						
Disaster Assistant Direct Loan Program Account	127	....	....	97.69	....	....
Housing and Urban Development:						
Revolving fund (liquidating programs)	....	1	1	....	16.66	25.00
Guarantees of mortgage-backed securities	....	36	27	....	65.45	48.21
Interior:						
Indian direct loan	4	2	1	18.18	11.76	7.14
Labor:						
Pension benefit guaranty corporation fund	31	87	93	....	....	....
Veterans Affairs:						
Veterans housing benefit program	10	7	7	0.90	0.69	0.52
International Assistance Programs:						
Military debt reduction	7	....	....	2.76	....	....
Overseas Private Investment Corporation	....	8	8	....	1.29	1.08
Small Business Administration:						
Disaster loans	51	63	60	1.66	1.72	0.91
Business loans	....	4	2	....	2.18	1.22
Other Independent Agencies:						
Export-Import Bank	102	33	36	1.02	0.36	0.45
Debt reduction (ExIm Bank)	38	20	....	3.46	1.89	....
Spectrum auction program	3,346	....	418	77.56	....	96.53
Tennessee Valley Authority fund	1	1	1	1.88	2.08	1.85
Total, direct loan writeoffs	4,042	711	909	1.84	0.32	0.38
GUARANTEED LOAN TERMINATIONS FOR DEFAULT						
Agriculture:						
Agricultural credit insurance fund	61	58	58	0.58	0.56	0.54
Commodity Credit Corporation export loans	190	163	181	4.53	6.62	6.02
Rural community advancement program	87	101	117	1.86	2.14	2.30
Rural electrification and telecommunications loans	....	3	3	....	0.66	0.56
Rural housing insurance fund	260	275	280	1.87	1.87	1.69
Defense—Military:						
Procurement of ammunition, Army	....	8	....	....	30.76	....
Family housing improvement fund	....	5	6	....	1.23	1.50
Education:						
Federal family education loan	4,724	5,527	6,320	1.92	1.91	1.88
Health and Human Services:						
Health education assistance loans	23	29	26	0.95	1.69	1.82
Housing and Urban Development:						
Indian housing loan guarantee	....	4	4	....	2.08	2.00
Title VI Indian Federal guarantees program	....	1	2	....	1.25	2.38
FHA—Mutual mortgage insurance	6,757	6,463	6,639	1.76	1.92	1.98
FHA—General and special risk	1,408	2,394	1,138	1.55	2.66	1.27
Interior:						
Indian guaranteed loan	3	1	1	0.89	0.31	0.30

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]		
	2005 actual	2006 estimate	2007 estimate	2005 actual	2006 estimate	2007 estimate
Transportation:						
Maritime guaranteed loan (Title XI)	....	35	35	....	1.12	1.15
Treasury:						
Air transportation stabilization program	125	9	....	7.33	0.94	....
Veterans Affairs:						
Veterans housing benefit program	1,076	2,628	2,515	0.30	1.27	1.22
International Assistance Programs:						
Micro and small enterprise development	1	1	1	1.31	7.14	9.09
Urban and environmental credit program	33	21	29	1.79	1.27	1.87
Development credit authority	....	1	2	....	0.59	0.72
Overseas Private Investment Corporation	38	45	45	0.98	1.25	1.25
Small Business Administration:						
General business loans	1,551	1,903	2,102	2.69	2.59	2.53
Pollution control equipment	....	1	....	....	25.00	....
Other Independent Agencies:						
Export-Import Bank	182	211	253	0.50	0.58	0.64
Total, guaranteed loan terminations for default	16,519	19,887	19,757	0.98	1.31	1.27
Total, direct loan writeoffs and guaranteed loan terminations	20,561	20,598	20,666	1.08	1.19	1.15
ADDENDUM: WRITEOFFS OF DEFAULTED GUARANTEED LOANS THAT RESULT IN LOANS RECEIVABLE						
Agriculture:						
Agricultural credit insurance fund	3	1	1	7.69	2.85	2.85
Commerce:						
Federal ship financing fund	1	....	....	4.17	....	....
Education:						
Federal family education loan	863	1,006	1,071	4.02	4.52	4.72
Housing and Urban Development:						
FHA—Mutual mortgage insurance	....	10	1	....	1.84	1.72
FHA—General and special risk	226	8	6	4.80	0.13	0.08
Interior:						
Indian guaranteed loan	4	2	2	25.00	15.38	18.18
Treasury:						
Air transportation stabilization program	....	102	....	....	76.11	....
International Assistance Programs:						
Overseas Private Investment Corporation	84	4	3	38.35	2.56	1.47
Small Business Administration:						
Business loans	221	276	276	5.02	4.47	3.74
Pollution control equipment	29	....	....	59.18	....	....
Other Independent Agencies:						
Export-Import Bank	51	....	....	25.37	....	....
Total, writeoffs of loans receivable	1,482	1,409	1,360	3.64	3.53	3.22

[1] For direct loans and loan guarantees, outstanding loans equal the 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	2005 Actual	2006 Actual	2007 Estimate
DIRECT LOAN OBLIGATIONS			
Agriculture:			
Agricultural credit insurance fund	1,112	953	930
P.L. 480 direct credit	30	30	....
Commerce:			
Fisheries finance	91	64	5
Education:			
Historically black college and university capital financing	193	222	170
Homeland Security:			
Disaster assistance direct loans	25	1,025	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	....
Treasury:			
Community development financial institutions fund	11	11	....
Veterans Affairs:			
Native American loans	50	30	30
Vocational rehabilitation	3	3	4
Small Business Administration:			
Business loans	18	20	....
Total, limitations on direct loan obligations	1,634	3,659	1,265
LOAN GUARANTEE COMMITMENTS			
Agriculture:			
Agricultural credit insurance fund	2,201	2,797	2,498
Housing and Urban Development:			
Indian housing loan guarantee fund	145	99	104
Title VI Indian federal guarantees	18	18	15
Native Hawaiian housing loan guaranteed	37	35	35
Community development loan guarantees	275	138	....
FHA-general and special risk	35,000	35,000	35,000
FHA-mutual mortgage insurance	185,000	185,000	185,000
Interior:			
Indian loans	85	112	87
Transportation:			
Minority business resource center	18	18	18
Maritime guaranteed loan (Title XI)	140	65	....
Veterans Affairs:			
Housing loans	....	1	....
International Assistance Programs:			
Loan guarantees to Israel	3,000	....	....
Development credit authority	....	700	700
Loan guarantees to Egypt	2,000	....	....
Small Business Administration:			
General business loans	19,939	27,500	28,000
Total, limitations on loan guarantee commitments	247,858	251,483	251,457
ADDENDUM: SECONDARY GUARANTEED LOAN COMMITMENT LIMITATIONS			
Housing and Urban Development:			
Guarantees of mortgage-backed securities	200,000	200,000	100,000
Small Business Administration:			
Secondary market guarantee	10,000	12,000	12,000
Total, limitations on secondary guaranteed loan commitments	210,000	212,000	112,000

[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 LENDING [1]

(In billions of dollars)

	Outstanding	
	2004	2005
Government Sponsored Enterprises		
Fannie Mae [2]	N/A	N/A
Freddie Mac [3]	1,481	N/A
Federal Home Loan Banks [4]	N/A	N/A
Farm Credit System	87	92
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 2001–2004. The restatement is not likely to be completed prior to the second half of calendar year 2006.

[3] While financial data for 2004 is presented here, Freddie Mac announced on November 8, 2005 that it would reduce net income for the first half of calendar year 2005 and expects to release full-year 2005 results by March 2006.

[4] Financial data for the Federal Home Loan Banks are not presented here because following discussions with the Securities and Exchange Commission, six of the twelve Federal Home Loan Banks have announced their intent to restate their 2001–2004 financial statements.

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

(In millions of dollars)

Enterprise	2005
LENDING [1]	
Federal National Mortgage Association: [2]	
Portfolio programs:	
Net change	N/A
Outstandings	N/A
Mortgage-backed securities:	
Net change	N/A
Outstandings	N/A
Federal Home Loan Mortgage Corporation: [3]	
Portfolio programs:	
Net change	N/A
Outstandings	N/A
Mortgage-backed securities:	
Net change	N/A
Outstandings	N/A
Farm Credit System:	
Agricultural credit bank:	
Net change	1,853
Outstandings	25,121
Farm credit banks:	
Net change	6,039
Outstandings	66,802
Federal Agricultural Mortgage Corporation:	
Net change	–423
Outstandings	5,126
Federal Home Loan Banks: [4]	
Net change	N/A
Outstandings	N/A
Less guaranteed loans purchased by:	
Federal National Mortgage Association: [2]	
Net change	N/A
Outstandings	N/A
Other: [4]	
Net change	N/A
Outstandings	N/A
BORROWING [1]	
Federal National Mortgage Association: [2]	
Portfolio programs:	
Net change	N/A
Outstandings	N/A
Mortgage-backed securities:	
Net change	N/A
Outstandings	N/A
Federal Home Loan Mortgage Corporation: [3]	
Portfolio programs:	
Net change	N/A
Outstandings	N/A
Mortgage-backed securities:	
Net change	N/A
Outstandings	N/A
Farm Credit System:	
Agricultural credit bank:	
Net change	1,840
Outstandings	28,466
Farm credit banks:	
Net change	9,549
Outstandings	81,361
Federal Agricultural Mortgage Corporation:	
Net change	504
Outstandings	3,928
Federal Home Loan Banks: [4]	
Net change	N/A

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

(In millions of dollars)

Enterprise	2005
Outstandings	N/A
DEDUCTIONS [1]	
Less borrowing from other GSEs: [5]	
Net change	N/A
Outstandings	N/A
Less purchase of Federal debt securities: [5]	
Net change	N/A
Outstandings	N/A
Federal National Mortgage Association: [2]	
Net change	N/A
Outstandings	N/A
Other: [5]	
Net change	N/A
Outstandings	N/A

N/A = Not available.

[1] 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.

[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 2001–2004. The restatement is not likely to be completed prior to the second half of calendar year 2006.

[3] Freddie Mac announced on November 8, 2005 that it would reduce net income for the first half of calendar year 2005 and expects to release full-year 2005 results by March 2006.

[4] Financial data for the Federal Home Loan Banks are not presented here because following discussions with the Securities and Exchange Commission, six of the twelve Federal Home Loan Banks have announced their intent to restate their 2001–2004 financial statements.

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