The Daily Dish

Valuing Your Equity Stake in the Federal Government

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Eakinomics: Valuing Your Equity Stake in the Federal Government

The old joke is that the federal government has become a large financial institution with side businesses in national defense and poverty programs — think of the myriad financial products it offers: health insurance, flood insurance, mortgage insurance, student loans, small business loans, crop insurance, and more. Viewed from that perspective, the taxpayers are the equity investors in this large financial institution. How should they think about the risks of this investment? The Congressional Budget Office (CBO) put out a nice reminder this past week entitled "Fair-Value Estimates of the Cost of Federal Credit Programs in 2019" that contained the following summary:

> Using FCRA [Federal Credit Reform Act] procedures, CBO estimates that new loans and loan guarantees issued in 2019 would result in savings of $37.4 billion. But using fair-value procedures, CBO estimates that those loans and guarantees would have a lifetime *cost* of $37.9 billion. More than 80 percent of the difference between those amounts comes from three sources:
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> - The guarantees that Fannie Mae and Freddie Mac will make in 2019, analyzed on a FCRA basis, are projected to save the federal government about $23.5 billion. under fair-value accounting, however, the guarantees would cost about $2.5 billion.
> - The Department of Education's student loan programs are projected to save $4.1 billion on a FCRA basis but to cost $16.1 billion on a fair-value basis.
> - The Department of Housing and Urban Development's (HUD's) loan and loan guarantee programs are projected to save $9.5 billion on a FCRA basis but to cost $7.1 billion on a fair-value basis.

In short, looked at in one way (FCRA) the financial institution's 2019 book of business made $37.4 billion, while looked at another (fair-value) it *lost* $37.9 billion. What is going on?

When the CBO (or the Office of Management and Budget, OMB) looks at a loan, insurance product, loan guarantee or other financial transaction it follows a simple procedure: (a) it looks over the entire lifetime of the transaction, (b) it calculates the year-by-year outflows from the Treasury, (c) it calculates the year-by-year inflows of payments to the Treasury, and (d) it calculates the net cash amount in the present that has the same lifetime value as owning (b) and (c). (This is known as the "present" value of the those cash flows.) CBO is saying that the FCRA approach indicates that owning the cash flows is the same as having $37.4 billion in your pocket — a good thing — and the fair-value approach indicates that it is the same as owing $37.9 billion — a bad thing.

The essential thing to notice is that the two approaches use *exactly the same* year-by-year cash flows in and out of the Treasury. There is no disagreement about the performance of the financial product. They differ only in

how they treat the risk in the environment surrounding the transaction. The FCRA approach ignores those risks — recessions, recoveries, market booms, market busts, etc. It treats a dollar taken from the private sector in good times the same as a dollar taken in bad times, and a dollar paid out in good times the same as a dollar in bad times. But in bad times, cash is dear and payments made are more costly and cash received more valuable than when the economy is flush. The fair-value approach incorporates this market risk into its valuation of the programs.

Looked at from this perspective, the federal government is involved in activities — especially in housing and education — that might look good on average (FCRA), but when they go bad, they go really bad at the worst time (fair-value). The failure to anticipate and prepare for this risk is exactly why Fannie Mae and Freddie Mac are in conservatorship and the remaining loan programs are on dicey financial footing. It is important information for taxpayers because they may be uncomfortable with holding those risks, which would mean that it makes sense to reform the loan and guarantee programs.