Research

The Advantage of Fair-Value Accounting

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Fair-value accounting is a term that describes a method of bookkeeping used by the Congressional Budget Office (CBO) to estimate the future budget impacts of proposed legislation or policy. CBO has said on numerous occasions that fair-value accounting provides a more comprehensive measure of federal costs as it takes into account market risk when estimating the future cost of federal credit programs. So it seems natural everyone would welcome fair-value accounting regardless of political affiliation.

As with most things in Washington, however, it's not that simple. Even though CBO has lauded the benefit of using fair-value accounting practices, federal law requires CBO to use a different method established by the Federal Credit Reform Act (FCRA). Costs to the federal government measured under FCRA are "calculated on a net present value[1] basis, excluding administrative costs and any incidental effects on governmental receipts or outlays."[2]

Accounting Errors

Federal law effectively limits the estimation of a future cost of any credit program to the budget equivalent of a snapshot – economic considerations at the time of the estimate are presumed to be true for the life of the loan, even when everyone knows that's impossible. While it may have been an accurate estimate once, it's not accurate forever.

The federal budget parallel is that the original estimated cost of a loan could be off — sometimes by a lot. When the projected cost of a federal loan program doesn't match the projected cash flows associated with that particular asset, the Department of the Treasury has to make up the difference. This is referred to in budget terms as a credit reestimate. Sometimes those reestimated amounts indicate small savings; sometimes they amount to

huge costs. The larger the loan program, the larger the potential error, as the reestimated subsidy rates apply to the loan program's annual volume. In other words, an error rate of 10 percent on a $5 million annual loan program is less significant than an error rate of 0.75 percent on a $1 billion loan program.

As the federal government lends billions of dollars every year, having an accurate estimation of the costs of those loans would help the Treasury accurately predict how much it will need to borrow in the future to offset the gap in cash flows precipitated by those loans. Interest rates, borrower behavior, and a number of other factors can impact the accuracy of the initial snapshot made under FCRA standards.

A quick look at some of the existing federal direct loan or guaranteed loan programs shows a reasonably wide variance in program costs relative to original estimates. Some programs show additional costs, while others show savings, but no program costs have consistently been accurately estimated.

Table 1: Lifetime Reestimates for Select Federal Credit Programs[3]

(Direct loan programs are in standard font; *guaranteed loan programs are in italics,* savings relative to original estimates are noted with parentheses)

Department and Program	Lifetime Reestimates	Lifetime Disbursements
Department of Agriculture		
Agricultural Credit Insurance Fund	($1 billion)	$25 billion
Rural Housing Service	$278,000	$37 billion
Rural Utilities Service	$264 million	$82 billion
Agricultural Credit Insurance Fund	*($2.2 billion)*	*$100 billion*
Rural Housing Service	*$2,522,000*	*$129 billion*
Rural Utilities Service	*($2.4 million)*	*$388 million*
Department of Commerce	($68 million)	$814 million
Department of Education		
Federal Direct Student Loans	$10,963,000	$762 billion

Department of Housing and Urban Development		
Mutual Mortgage Insurance Program	*$77,717,000*	*$2.773 trillion*

Under FCRA estimates, the federal direct student loan program has cost the Treasury (and taxpayers) almost $11 billion since its inception. Not inconsequential, but just a fraction of the nearly $78 billion error on federal housing guaranteed loan programs.

All told, every credit program estimated by FCRA has been inaccurately forecast, which isn't surprising, as no on can accurately predict the future. The headline isn't that the forecasts are wrong; the real story is how often FCRA underestimates the true cost of federal credit programs. The following chart shows the frequency with which FCRA rules underestimate selected federal loan programs and the associated costs resulting from the error.

Chart 1: Error Rates Resulting in Higher Cost Reesimates to the Federal Government

While FCRA has improved the federal government's ability to account for credit programs compared to the cash flow accounting in use for the majority of federal programs, it's far from perfect. Examining only a handful of the largest federal credit programs shows that since implementing FCRA accounting methods, the federal government has had to come up with roughly $90 billion to offset underestimated costs of credit programs. Those are costs that hit the Treasury, and when those costs are higher than anticipated, it forces the Treasury to borrow money from the public (or China) to cover the gap.

Alternatives

Twenty-four years after FCRA's inception, it's clear that federal accounting standards could be improved. Replacement legislation to develop more accurate data on historical performance and prospective risk of direct loan and loan guarantee programs recently passed the U.S. House of Representatives with bipartisan support. Applying fair value accounting to the government's lending and guarantee programs is an important step to take at this time and will provide a more accurate picture of the cost and risk to taxpayers.

Why is this important for Higher Education?

Over the next ten years, the federal government expects to originate over $1.37 trillion in new student loans. The gap between the FCRA and FVA estimates on those loans is $223 billion. Under the CBO's FCRA-based projections, we're supposed to see a net gain for the government of $135 billion. However, that same CBO report using FVA tells us that what we will get instead is a loss of $88 billion.[4]

What seems evident, is that the 2009 switch to direct student lending, made attractive by using FCRA standards that promised substantial savings has not only failed to produce the anticipated savings, it has cost taxpayers billions of dollars and shifted billions more onto the federal balance sheet, forcing the Department of Treasury to borrow money to keep the program afloat.

Changes to the current federal accounting standards would more accurately reflect the cost of the Federal Direct Student Loan program and possibly open the door to the use of the vast private capital markets willing to lend to students. Tapping into those markets would shift costs away from the federal government and generate real savings in the federal budget. It's also possible costs of private loans would be cheaper for students in the end.

As AAF has proposed, to evaluate this potential solution, Congress should develop a pilot program to determine if it is economically beneficial to utilize private capital in the long-term funding of Federal Direct Student Loans. A simple pilot program would provide all of the data necessary to make an informed policy decision.

Conclusion

The time to improve federal budgeting and accounting practices is long overdue. Requiring the executive branch and Congress to adopt 'fair value' accounting principles will go a long way providing these assurances. This could pave the way for federal student aid reforms that tap private sector funding and shift costs away from the federal government.

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[1] Net Present Value (NPV) is a way of comparing the value of money now with the value of money in the future. A dollar today is worth more than a dollar in the future, because inflation erodes the buying power of the future money, while money available today can be invested and grow.