

# Federal Credit Programs

*Borrower Outcomes Matter More  
than Volume*

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## Summary

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- There are disturbing signs that the country is overly burdened with federal debt. The Department of Education projects that lifetime defaults on this year's set of loans to undergraduates will exceed 25 percent. Meanwhile, one in five disadvantaged FHA borrowers (with a FICO score of 620) defaults on his or her single-family mortgage loan. High default rates can harm many borrowers that a program is designed to help. Today's high volumes of federal credit raise the question whether, at least for some categories of borrower, perhaps too much credit is being extended.
- Despite such concerns, credit programs continue to grow in volume. Federal credit programs need to focus on outcomes so that they can strike a balance between providing credit for those who need it and not harming borrowers by burdening them with debt they cannot pay back. When properly targeted, credit programs provide many benefits, filling in where private lenders may not be serving the market well, overcoming discrimination, and conveying a subsidy for especially important classes of borrower (veterans) or public purposes (education). *It is time to change the focus from volume of credit an agency extends to the outcomes it achieves.*
- Defaults cause great harm to borrowers. Borrowers with student loans cannot avail themselves of bankruptcy protections that allow debtors to reduce their debts to manageable proportions. Bankruptcy laws also disadvantage individual mortgage borrowers by precluding writing down a mortgage when the home has lost value. Although credit can provide needed support for small businesses, students, and homebuyers, for example, while not overburdening these borrowers with too much debt, it can be hard for some programs to hit that "sweet spot." By focusing on their riskiest loans to measure borrower benefits and costs—and adjusting their standards up or down—credit program managers can help assure that the benefits to creditworthy borrowers outweigh the costs to those who default. (Some programs, most notably student loans, may not have authority to do this, except indirectly.)
- Ensuring that lenders and other program partners originate and service loans properly is one major factor in preventing unnecessary defaults. Laws, regulations, and operating procedures that set clear standards and permit application of a series of graduated sanctions for poor performers are also needed.
- Some programs collect and use data about borrower outcomes, but most do not. Good-quality information is necessary to help with design and management of federal credit programs. Combining this information with other datasets, such as at

Census or the IRS, can help to reveal outcomes, in terms such as income, wealth, children's education, of programs such as student loans, home mortgage loans, or small business loans. Some agencies may need added authority to be able to collect such outcome-related information.

- **Pricing credit according to risk and having lenders bear some of the default risk are additional reforms worth serious consideration.** Pricing credit according to risk could send a signal to less creditworthy borrowers about the need to save before they incur debt burdens that they may not be able to handle. The lower default rate of VA home loans compared to FHA-insured mortgages suggests the value of giving lenders "skin in the game" so that they—rather than primarily borrowers and taxpayers—bear greater costs of defaults. Counseling borrowers, both before they take on debt and in case they begin to become delinquent, can also help to avert defaults.
- **Many credit agencies find themselves in a squeeze between increasing volumes of credit they provide and seriously constrained administrative budgets.** Risk-based budgeting is a way for credit agencies to prioritize their resources to protect their core missions. Less important activities need to be pared back if necessary.
- **Budgets for administrative costs should be combined with credit subsidy amounts.** This would create an incentive for federal agencies to make cost-effective invest-

ments in staff, systems, and processes, if these could be offset by savings from lower defaults.

- **Credit programs need to place increased emphasis upon evaluation, experimentation and pilot programs.** Good evaluation can help policymakers and managers determine need and target programs to the most beneficial outcomes for taxpayers and borrowers. Although some increase in authority may be required, experiments and pilot programs are another way for credit agencies to focus their efforts on achieving the most beneficial results.
- **Treasury and OMB have important roles to play in assuring credit agencies have the authority needed to evaluate and manage their programs effectively.** Perhaps the most important value that Treasury and OMB can add to federal credit programs is to provide cross-cutting administrative guidance and support legislation that provides agencies authority to collect and evaluate outcome-related information, engage in experimentation and pilot programs, and improve oversight of lenders and other program partners. The Federal Credit Policy Council could also be strengthened as a forum for credit agencies to exchange information about promising practices.

*This report and working papers will be posted at [www.thomas-stanton.com](http://www.thomas-stanton.com).*

## Summary

# I. Introduction

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*Federal credit programs have grown to massive size. There are disturbing signs that some borrowers are becoming overly burdened with federal debt. Federal credit programs need to focus on outcomes so that they can strike a balance between providing credit for those who need it but not harming borrowers by burdening them with debt they cannot pay back.*

The federal government extends credit through loans and loan guarantees to help support important sectors of the economy. Among the largest federal credit programs are those serving homebuyers, students, and rural borrowers. Federal credit helps millions of people buy homes, often their first homes, fund their educations, and own their own farms. Communities benefit from federal loans for infrastructure or disaster recovery, and businesses—often small businesses—can

establish themselves and grow thanks to federal loan guarantees.

Yet there is cause for concern. Figure 1, below, shows a doubling of federal direct loans and loan guarantees, from \$ 1.5 trillion in 2007 to \$ 3.4 trillion today, or over \$ 10,000 for every man, woman, and child in America. The federal government extends this credit through over 100 different programs administered by some 20 different agencies.<sup>1</sup> There is a wide range of federal credit outstanding, in terms of purposes of each program and effects on borrowers. Today's high volumes of federal credit raise the question whether, at least for some categories of borrower, perhaps too much credit is being extended.<sup>2,3</sup>

This report looks across federal credit agencies and programs to assess strengths and limitations of credit as a policy tool, as well as

<sup>1</sup> As tabulated in the *Federal Credit Supplement to the Budget of the U.S. Government*, FY 2017. Government loan and loan guarantee programs are in addition to credit support provided through other mechanisms such as the tax exemption for state and local bonds and government backing of Government-Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac.

<sup>2</sup> This is not to downplay the importance of volume of federal credit in some circumstances. For instance, as discussed in Part II, after the financial crisis of 2008–09, and in the absence of stronger fiscal stimulus, federal credit programs played a valuable countercyclical role.

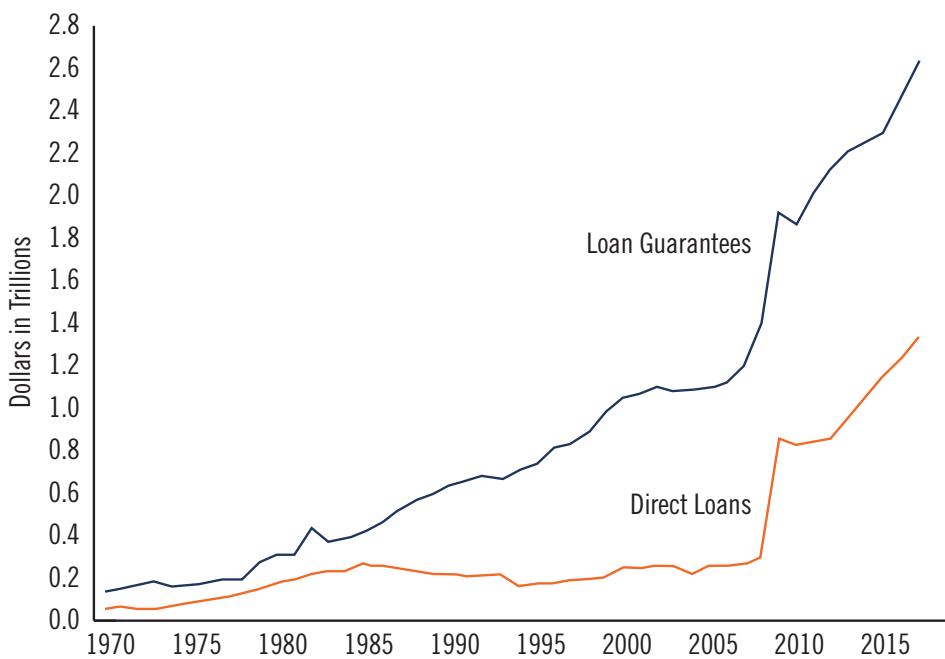
<sup>3</sup> By contrast to the expansion of individual indebtedness from federal programs, overall household indebtedness seems sustainable, especially at today's low interest rates. Household debt relative to gross domestic product peaked in early 2008 at nearly 100 percent and has since fallen steadily to just under 80 percent today. Even with the recent decline, however, total household debt remains at historically high levels.

promising practices and lessons learned that can help to inform policymakers, budget officials, and program managers. The conclusion of this report is easily summarized: federal credit programs need to focus on outcomes rather than outputs. Instead of measuring success by the volume of credit they provide, programs need to ask: how much did our work improve circumstances for our borrowers? Above all, programs need to avoid extending credit to borrowers who cannot handle their debt burdens; this requires attention to the benefits and costs of credit for the least credit-worthy borrowers that a program serves. These borrowers have the greatest likelihood of defaulting and suffering the harm that defaults can cause. While borrower defaults provide a useful proxy for assessing costs to program

borrowers, agencies also need improved access to outcome information, such as projected incomes of students who incur indebtedness to attend different kinds of educational institution and projected family health, education, and income of borrowers of differing creditworthiness who take out federally supported mortgages. Generating and applying such information may involve strengthening agency capacity to conduct program evaluations and cross-agency collaboration, such as between credit agencies and the Census Bureau.

The authors are grateful to the Laura and John Arnold Foundation, and our project officer Kathy Stack, for the generous grant provided to the American Society of Public Administration that allowed us to undertake

**Figure 1. Face Value of Federal Credit Outstanding**



*Source:* "Face Value of Federal Credit Outstanding," Chart 20-1 of the *Budget of the United States Government, FY 2017, Analytical Perspectives*, p. 329.

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the research for this report. In preparing this report the authors have:

1. Conducted over 40 interviews with federal credit managers, financial officers, and others with extensive knowledge of federal credit programs;
2. Reviewed literature and prepared background papers on the history, the economics, and the budget and federal credit programs;
3. Prepared an interim report; and
4. Convened a one-day roundtable meeting of selected credit program officials from nine different federal agencies and departments and two experts from the MIT Golub Center for Finance and Policy and our Arnold Foundation project officer. The roundtable and its robust discussion helped us to gain insight about the recommendations of our interim report and allowed for the exchange of promising practices among the participants.<sup>4</sup>

We are grateful to all of the people who kindly contributed their knowledge and insights in interviews, and who participated in the credit roundtable. We would like to express special thanks to Douglas Criscitello, Charles Tansey, Robert Van Order, and a reviewer of an earlier draft of the executive summary. While this report builds on their collective expertise, we hasten to add that we three authors are solely responsible for the information and recommendations that we present.

Several themes emerge from our research. Each relates to the importance of a programmatic emphasis on borrower outcomes:

1. Because defaults harm borrowers that credit programs seek to serve, agencies should focus on borrower outcomes rather than merely the volume of credit.
2. To be most effective, federal credit programs should focus on borrowers who (a) are not well served by the private credit market but (b) have the capacity or potential capacity to repay loans that they take out.
3. While loan defaults are a useful measure of borrower harm, agencies need to adopt more sophisticated approaches to evaluating both the benefits and costs of programs for particular kinds of borrowers that they serve.
4. Federal credit agencies need to innovate, both to keep up with technological and market developments, and to develop alternative ways to assist their constituencies.
5. Budget pressures increasingly deprive federal credit managers of sufficient resources to prudently manage the volume of credit. Focus on borrower outcomes rather than volume of credit can help to alleviate some of these pressures.

The larger political context of federal credit programs cannot be ignored. Implementation of federal credit programs relies heavily on private sector intermediaries, such as lenders

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<sup>4</sup> There is precedent for nonfederal forums to encourage the exchanging of promising practices; federal credit program conferences took place in 2006 and 2015, sponsored by Deloitte and PwC respectively.

## Introduction

in a guaranteed loan program, contractors in a direct loan program or specialized intermediaries such as schools in the student loan program. Sometimes, and especially when borrowers are relatively weak politically, these intermediaries and other special interests can wield more policy influence than the borrowers themselves. The result can be distortion of a program towards serving interests of intermediaries, even at a cost of serving interests of borrowers. This is part of the political process.<sup>5</sup> The problem becomes more acute, however, when it causes significant harm to beneficiaries that programs are supposed to help.

Emphasis on borrower outcomes can make a major difference in a program's benefit-cost equation. Especially important is the need to generate and publish information about outcomes. Whether or not policymakers ultimately make program adjustments, it is important that they support the ability of agencies to collect and inform decisions with data about outcomes. Sometimes influential stakeholders encourage legislation or other limitations on the ability of agencies to collect or publish data about outcomes that could help borrowers. Agencies may need support from Treasury and the Office of Management and Budget (OMB) to help overcome impediments to collecting useful data.

This final report is structured as follows: this section provides the introduction. Section II provides background on federal credit programs including purposes that credit programs serve most effectively and the need to strike a balance between extending too much and too little credit. Section III recommends ways of improving borrower outcomes, by targeting credit to the most useful purposes and protecting borrowers, especially the least creditworthy borrowers, from the harm that defaults can cause. Agencies need to adjust credit criteria to increase overall benefits to borrowers while reducing harm from taking on too much debt. Section IV discusses ways to improve program outcomes, including addressing constraints on administrative budgets that threaten the ability of agencies to manage increasing volumes of credit they are called upon to provide. Section V suggests ways that Treasury and the Office of Management and Budget can increase support of federal credit programs by promoting the sharing of promising practices, providing new opportunities for shared services, and helping, if necessary through the legislative process, to improve access to data, program evaluation, and program performance. Section VI specifies actions that individual credit agencies, Treasury, OMB, and stakeholders, can take. Section VII concludes.

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<sup>5</sup> Thus, Elizabeth Rhyne conducted a survey of supporters of the SBA's Section 7(a) business loan program for her doctoral dissertation at the Kennedy School of Government. She found that primary supporters of the program were the House and Senate Small Business Committees, followed by commercial banks that originated and serviced the SBA-guaranteed loans, with small business borrowers being a generally absent support group: "First, small business is not a well-directed political force. There are too many small businesses, with interests and political views too diverse...Second, to the extent that small business is an effective political force, it channels its energies largely towards ends other than support for SBA's credit programs." Elizabeth Holmes Rhyne, *Small Business, Banks, and SBA Loan Guarantees*, Quorum Books, 1988, pp. 21-22.

## Introduction

### *Federal Credit Programs: Borrower Outcomes Matter More than Volume*

This report is accompanied by background papers on three subjects: (1) Economics of Federal Credit Programs, (2) History of Federal Credit Programs, and (3) Credit Programs and the Federal Budget Process. These papers are available on request from the authors of this report.

#### **Introduction**

*Federal Credit Programs: Borrower Outcomes Matter More than Volume*

## II. Background: How Federal Credit Programs Work

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### A. Public purposes of federal credit programs

*When properly targeted, credit programs provide many benefits, filling in where private lenders may not be serving the market well, overcoming discrimination, and conveying benefits for especially important classes of borrower (veterans) or public purposes (education).*

Figure 2, below, from the federal budget for the 2017 fiscal year, summarizes the volume of credit outstanding in each major federal credit program in the 2015 fiscal year, the latest year for which complete information is available. The largest direct loan program is the Federal Direct Student Loan Program, and the largest loan guarantee program is Federal Housing Administration (FHA) mortgage insurance, which backs a variety of types of mortgage loans. Because student loans and FHA single-family mortgage insurance are by far the largest, many examples in this report draw upon experiences of those programs.

Federal credit programs generally serve at least one of four public policy purposes. Three relate to different types of market imperfections while the last arises in situations where

credit is a particularly advantageous public policy tool:

1. They address a particular market failure or gap, typically caused by asymmetries in information.
2. They improve resource allocation in the overall economy.
3. They help to overcome the effects of discrimination in the credit markets.
4. They provide a means to convey a subsidy to help achieve a particular public policy objective or assist a particular category of borrowers.

Individual federal credit programs can involve several purposes. Although they need not convey a subsidy to achieve one or more of the first three objectives, actual implementation of a program often involves subsidizing an activity as well as addressing a market imperfection. Consider each purpose in turn.

#### Addressing market gaps

The need for federal intervention in the credit markets is often justified on the basis that

**Figure 2. Outstanding Direct Loans and Loan Guarantees (*In billions of dollars*)**

Program	Outstanding FY 2015
<b>Direct Loans:<sup>1</sup></b>	
Federal Student Loans	839
Education Temporary Student Loan Purchase Authority	77
Rural Utilities Service and Rural Telephone Bank	52
Farm Service Agency, Rural Development, Rural Housing	55
Export-Import Bank	23
Advance Technology Vehicle Manufacturing, Title 17 Loans	16
Housing and Urban Development	19
State Housing Finance Authority Direct Loans	8
Transportation Infrastructure Finance and Innovation Act Loans	11
Disaster Assistance	6
International Assistance	3
Public Law 480	3
Troubled Asset Relief Program (TARP) <sup>2</sup>	1
Small Business Lending Fund (SBLF) <sup>2</sup>	2
Other direct loan programs <sup>2</sup>	29
<b>Total direct loans</b>	<b>1,145</b>
<b>Guaranteed Loans:<sup>1</sup></b>	
FHA Mutual Mortgage Insurance Fund	1,123
Department of Veterans Affairs (VA) Mortgages	462
Federal Student Loan Guarantees	220
FHA General and Special Risk Insurance Fund	149
Farm Service Agency, Rural Development, Rural Housing	134
Small Business Administration (SBA) Business Loan Guarantees <sup>3</sup>	106
Export-Import Bank	62
International Assistance	24
Commodity Credit Corporation Export Loan Guarantees	3
Title 17 Loan Guarantees	3
Government National Mortgage Association (GNMA) <sup>3</sup>	.....
Other guaranteed loan programs <sup>2</sup>	13
<b>Total guaranteed loans</b>	<b>2,300</b>
<b>Total Federal credit</b>	<b>3,445</b>

<sup>1</sup> Excludes loans and guarantees by deposit insurance agencies and programs not included under credit reform, such as Tennessee Valley Authority loan guarantees. Defaulted guaranteed loans that result in loans receivable are included in direct loan amounts.

<sup>2</sup> As authorized by the statute, table includes TARP and SBLF equity purchases, and International Monetary Fund (IMF) transactions resulting from the 2009 Supplemental Appropriations Act. IMF activity will no longer be reflected in this table as of the end of FY 2015.

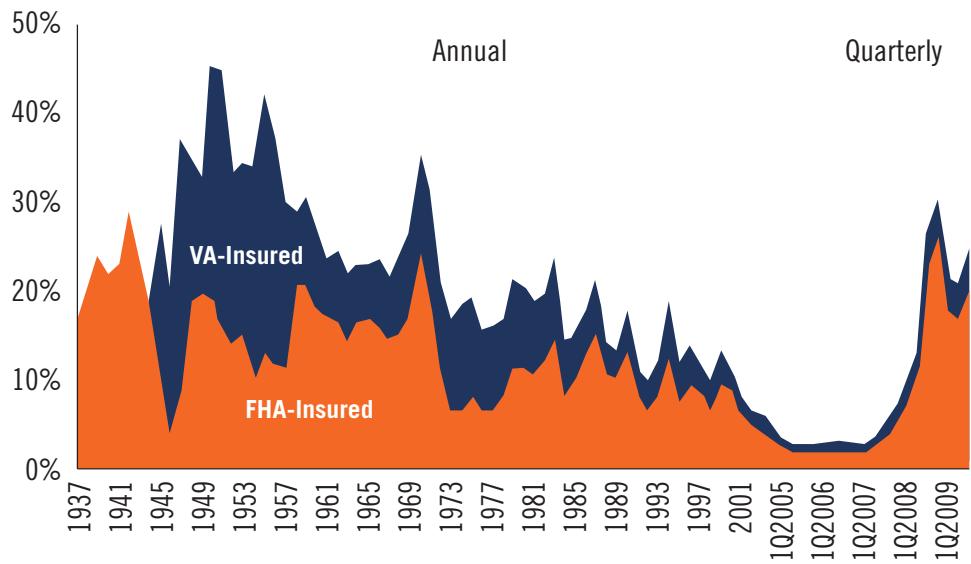
<sup>3</sup> To avoid double-counting, outstandings for GNMA and SBA secondary market guarantees, and TARP FHA Letter of Credit program are excluded from the totals.

**Source:** “Estimated Future Cost of Outstanding Direct Loans and Loan Guarantees,” Table 20-2 of the *Budget of the United States Government, FY 2017, Analytical Perspectives*, p. 330.

#### Background: How Federal Credit Programs Work

*Federal Credit Programs: Borrower Outcomes Matter More than Volume*

**Figure 3. Countercyclical Role of FHA**



**Note:** From U.S. Department of Housing and Urban Development (1935-1997), Freddie Mac, and Inside Mortgage Finance (1998-present), courtesy of Ed Golding.

**Source:** Robert Van Order and Anthony M. Yezer, "FHA: Recent History and Future Prospects," *Housing Policy Debate*, vol. 24, no. 3, pp. 644-650, at p. 645.

such markets are failing to perform a normal market function of supplying credit. One prominent example of such a situation arises when recessions or more severe economic contractions cause serious disruption in financial markets. During the Great Depression of the 1930s, for example, the Roosevelt Administration developed a combination of programs to help revive the mortgage market. The Federal Housing Administration's (FHA) single family mortgage insurance program was a prominent feature of this effort. Loss of confidence by private lenders meant that the private sector was failing to serve the credit needs of thousands of prospective homebuyers who in fact had the creditworthiness to repay mortgage loans. FHA stepped into the breach by providing federal mortgage insurance and thereby restoring lenders' confidence that they

could lend to creditworthy borrowers with the assurance of being repaid.

The FHA mortgage insurance program has continued to be an important element in the government's efforts to combat credit contractions since the 1930's. Figure 3, below, shows changes in FHA and VA market share of mortgage lending from the 1930s to the recent financial crisis. Of particular note is the way that FHA market share receded in the 2000s as the housing bubble inflated and private subprime mortgages took market share from FHA. When the bubble burst, FHA again increased market share to support the home mortgage market.

More generally a market gap or imperfection can arise when creditworthy borrowers cannot

obtain access to credit on terms consistent with their level of credit risk. Economists explain this type of market imperfection in terms of asymmetric information: borrowers may have more information about their ability and willingness to repay a loan than the lender is able to obtain or verify.<sup>6</sup> In such situations, government intervention to make or guarantee lending may lead to economic outcomes whose value to society as a whole exceeds the cost to taxpayers in supporting the credit.

One commonly cited example of this form of market failure or “credit gap” occurs in the case of small business lending. Banks may have difficulty assessing the riskiness of a loan to a small business or it may be too expensive to conduct such analyses relative to the size of the loan. Small, untried businesses may lack the financial track record needed to ensure their creditworthiness. By guaranteeing loans for a large number of small businesses each year, the Small Business Administration (SBA) can achieve economies of scale, meaning that fixed administrative costs of making small business loans are spread over a sufficient volume to minimize the cost per loan. This, in turn, leads to a total loan portfolio composed of loans that pay off with an average loss rate that is within an acceptable range and budget impact. Once a small business establishes its track record and creditworthiness with an SBA loan, it then can graduate to obtain loans from a commercial lender.

Another example relates to higher education. Private financial institutions have a demonstrated record of not being willing to lend to borrowers who lack a credit record or collateral that can be feasibly repossessed in the event of default. But that is precisely the situation that confronts a young student who, after years of advanced education and training and when he or she embarks on a career with good income prospects, may be quite able to repay a loan. Yet private lenders are unable to ascertain which students will prove to have such reassuring prospects. Of course, supporting college education loans can entail other public purposes as well, such as assuring a highly trained workforce and increasing our country’s overall standard of living.

Federal support for agriculture and rural loans was initially justified on the grounds that, especially in sparsely populated parts of rural America, there existed a scarcity of lenders. This problem, however, may have been exacerbated by state and federal laws that limited branch banking. The widespread uptake of information technology combined with changing banking laws appears to have largely eliminated this particular market gap.

### Improving resource allocation

Extension of credit can be an attractive means of addressing cases in which a market econ-

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<sup>6</sup> Lenders could charge higher interest rates to reflect their incomplete understanding of the relative risk of lending to a particular class of borrowers. But at such higher interest rates only the very riskiest borrowers may be willing to take out a loan. This, in turn, would cause lenders to raise rates even further. The end result is that there may be no interest rate at which lenders and a particular class of borrowers are willing to engage in a credit transaction, despite the fact that at least a portion of the borrowers in the market should be able to obtain financing if lenders had a full and accurate understanding of the likelihood of repayment.

omy fails to invest sufficient resources. In such cases the social benefit of allocating additional resources to an activity exceeds the cost to taxpayers. Typical examples are infrastructure, education and alternative energy technologies. These are not necessarily cases of pure public goods in which there is a socially desired product or service that the market does not provide because it cannot charge a price to individual consumers, that is, the “free rider” phenomenon. But there is an element of public good in the justification for these types of programs because, if left to the market, the socially optimal amount of spending or investment will not occur.

Public infrastructure investments such as limited access highways and bridges are often cited examples of using credit to correct this particular type of market failure. Although technology is making it increasingly feasible to impose tolls on infrastructure users, there may be considerable reluctance by private investors to undertake many infrastructure projects, especially those that would produce benefits, such as reduced congestion and travel times, throughout a region and not just for those using a particular road or bridge.

Similarly, investments in higher education may produce broad social improvements for society as a whole, not merely for those who pursue advanced education. Yet, left to the private market, the total amount of invest-

ment in higher education by our country’s citizens may be suboptimal not only because of the market gap issue discussed earlier, but also because society as a whole will benefit from an increasingly skilled workforce.

Investments in advanced research and technology present yet another example of a possible case of suboptimal investment by the private economy. For example, one program designed to overcome what policymakers believe is a market imperfection is the title XVII program of the US Department of Energy (DOE). The enabling legislation for this program, “Loan Guarantees for Projects That Employ Innovative Technologies,” supports the extension of credit for such purposes as alternative energy technologies that the private markets might not provide, while also containing provisions intended to help protect taxpayers from losses.<sup>7</sup> To carry out its demonstration mission, the program has begun to collect data on questions such as how the credit market has developed and whether the government has ceased to be the only source of funding for its projects.

It should be acknowledged that achieving this resource allocation improvement objective using a loan or loan guarantee program can be difficult. While the public objective is to improve resource allocation by supporting an increment of additional investment and spending, a large portion of the lending involved—and, usually, a subsidy as well—may

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<sup>7</sup> The intended demonstration nature of the program is seen in Section 1702(d) of the enabling legislation:  
“(1) IN GENERAL.—No guarantee shall be made unless the Secretary determines that there is reasonable prospect of repayment of the principal and interest on the obligation by the borrower.  
“(2) AMOUNT.—No guarantee shall be made unless the Secretary determines that the amount of the obligation (when combined with amounts available to the borrower from other sources) will be sufficient to carry out the project.”

simply go to supporting the level of activity that would have occurred even in the absence of the government program.

### Overcoming discrimination

The credit markets have had a checkered history with respect to discrimination, especially on racial or ethnic grounds. For decades, African American homebuyers had difficulty getting approved for mortgages because of racist practices in housing markets. Lenders would redline entire neighborhoods, especially in center cities, and refuse to make home loans in those areas.<sup>8</sup> Discrimination may continue, even in the absence of any discriminatory intent, once patterns become ingrained. In this case, simply banning discriminatory practices could potentially be less effective than overcoming redlining them through a government program.

Unfortunately, the government's track record in using federal lending to overcome discriminatory practices has been mixed. For many years, the FHA mortgage insurance program, for example, was administered in a manner that supported, rather than combatted, housing discrimination. In recent decades, however, FHA mortgage insurance has served to ensure loans will be made to minorities and in impoverished neighborhoods where conventional private lenders have been less willing to lend.

Similarly, SBA's 7(a) small business loan program and Section 504 commercial loan program have both made loans to minority and other disadvantaged borrowers at rates above those undertaken by comparable private sector lenders. SBA accomplishes its objectives of serving underserved markets and populations—including minority, veterans, and women—by making smaller loans and loans with lower fees than those typically made by the private sector.<sup>9</sup>

### Conveying subsidies for particular public purposes

A final purpose for which the federal government extends support for credit transactions is to convey a subsidy to promote a particular objective or aid a particular segment of the economy. The classic public purpose of this kind is homeownership. The government promotes homeownership because policymakers contend that owning a single-family home can have valuable social benefits:

“You want to reinforce family values in America, encourage two-parent households, get people to stay home? Make it easy for people to own their own homes and enjoy the rewards of family life and see their work rewarded. This is a big deal. This is about more than money and sticks and boards and windows. This is about the way we live as a people and what kind of society we’re going to have.”<sup>10</sup>

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<sup>8</sup> See background paper on “History of Federal Credit Programs” for further detail.

<sup>9</sup> Small Business Administration, *FY 2017 Congressional Budget Justification and FY 2015 Annual Performance Report*, pp. 94-102.

<sup>10</sup> President William J. Clinton, “Remarks on the National Homeownership Strategy,” June 5, 1995.

A particular argument for homeownership is that it represents a form of forced savings: While low-income borrowers would have a high propensity to spend on current needs, the single-family home is thought to provide one of the few avenues for them to build wealth.<sup>11</sup>

It should be noted that government support for homeownership through intervention in the credit markets extends beyond the FHA and VA mortgage guarantee programs. Generous tax benefits are provided for homeownership, and there are several small grant and direct subsidy programs as well. In addition, the federal government has used loan guarantees, deposit insurance, and support for large government-sponsored enterprises (GSEs) to assure the availability of 30-year fixed-rate mortgages in the United States. These mortgages are a particularly risky form of credit not found in most other countries and would likely not be widely available in the United States without government subsidies that are extended in several forms.

Another example of a credit purpose many contend is deserving comes from international trade. Thanks to trade agreements, countries are prohibited from providing many forms of direct subsidy for their exports. One form of subsidy that remains permitted is credit support. Thus, the Export-Import Bank of the United States (Ex-Im) helps to fund transactions that, while they could be funded with-

out government support, use federal credit to counter credit subsidies from other nations competing to supply products such as airplane fleets.

Both the Export-Import Bank and the SBA also support credit to borrowers or transactions that are too small for private-sector providers in the credit markets. In these cases policy makers have determined that government support for credit to small businesses and small exporters is desirable to overcome the limitations that private market lenders would otherwise impose.

Yet another class of borrower that policymakers consider especially deserving is the veteran population. The VA home loan program is designed to assist veterans by providing a guarantee on a home loan that allows a veteran to purchase a home without making a down payment. The belief is that veterans who have risked all in service to our country deserve to have a chance to establish themselves afterwards in a home. The VA loan benefit is part of a series of benefits that we provide to our veterans.

Similarly, many other federal loan and loan guarantee programs entail the provision of some degree of subsidy even if they at the same time are aimed at addressing or mitigating a particular form of market imperfection. As discussed later in this report, the federal

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<sup>11</sup> Christopher E. Herbert, Daniel T. McCue, and Rocio Sanchez-Moyano, "Is Homeownership Still an Effective Means of Building Wealth for Low-income and Minority Households? (Was it Ever?)", Chapter 2 in Eric S. Belsky, Christopher E. Herbert, and Jennifer H. Molinsky, *Homeownership Built to Last: Balancing Access, Affordability, and Risk after the Housing Crisis*, Brookings Institution Press, 2014. For a non-credit approach to wealth building, see, Department of Labor, Employee Benefits Security Administration, 29 CFR Part 2510, "Savings Arrangements Established by States for Non-Governmental Employees," *Federal Register*, Vol. 81, No. 168, August 30, 2016, pp. 59464-59477.

budget now provides at least some formal recognition of the subsidy, if any, involved in the operations of federal supported lending, thanks to the revision of the treatment of federal credit programs in the federal budget beginning in 1992. Nevertheless, even when a federal credit program is officially scored or recorded in the budget as not entailing any amount of subsidy, there may be reason to ask whether the program will cause losses for which federal taxpayers must provide public resources.<sup>12</sup>

### B. Striking a balance between extending too much and too little credit

*Credit can be hard to manage because, unlike other tools of government such as grants or tax expenditures, credit must be repaid. Defaults can cause great hardship for borrowers, their families, and their communities. There is a “sweet spot” where federal credit can provide needed support for small businesses, students, homebuyers, and other borrowers, while not overburdening them with too much debt. It can be hard for some programs to hit that “sweet spot.”*

As policymakers seek to address each of the public purposes discussed above, credit can be an unusually difficult tool of government to manage compared to other tools such as grants or tax expenditures.<sup>13</sup> In contrast to a grant, which is a one-way outlay of funds, credit is an outlay of funds that requires re-

payment. Repayment means that a credit program can appear to be less expensive in the public policy making process while providing the same initial amount of resources to the intended beneficiary. However, human nature being what it is, a credit program tends to find it much easier to lend money to a borrower than to collect the repayment. Too often policymakers encourage agencies to extend credit to people who—despite their great need, or perhaps because of it—are unlikely to be able to repay the loan. This can cause significant defaults and hardship for borrowers who succumb to the attraction of what looks like a solution to their problems.

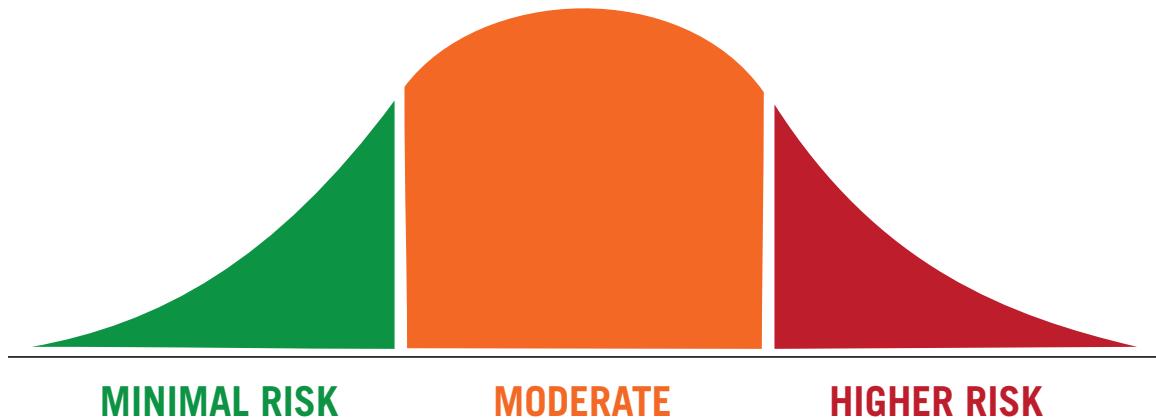
The middle section of Figure 4 below, illustrates the “sweet spot” for a federal credit program. Ideally government should lend to more risky borrowers than the private sector would serve on reasonable terms, but avoid supplying credit to borrowers who are unlikely to be able to repay their loans. The “sweet spot” also includes creditworthy smaller businesses who, especially since the tightening of private credit markets after the financial crisis, may not be well served because of the higher operating costs that private lenders face when lending to smaller rather than larger borrowers.

On the right side of the curve, a government credit program can cause harm by lending large amounts of money to people who cannot afford to pay it back. This occurred in substantial form in the late 1960s and early 1970s, when the FHA began lending exces-

<sup>12</sup> For further discussion, see the background paper on “Credit Programs and the Federal Budget Process.”

<sup>13</sup> Lester M. Salamon, ed., *The Tools of Government: A Guide to the New Governance*, Oxford University Press, 2002.

**Figure 4. Targeting Federal Credit**



*Source:* MIT Golub Center for Finance and Policy, "Mission & Metrics: Finance Training for Federal Credit Program Professionals," July 2016.

sive amounts of subsidized credit to households in center cities of the United States. The result was large-scale default by poor families who had never been counseled how to manage their meager finances, major cost to federal taxpayers, and devastation to American center cities.<sup>14</sup> The harm overlending causes to communities is a recurring issue, as happened again with an excessive supply of private credit in the financial crisis, leading to concentrations of foreclosed properties that undermined the quality of localities and

caught neighborhoods in a downward spiral of plummeting house prices.<sup>15</sup>

People who lack prospects of being creditworthy, such as prospective students in low-quality schools or disadvantaged homebuyers, too often find that their borrowing has led them to encumber their future incomes with debt from an inappropriate educational institution or home purchase. Such borrowers undergo additional harm if, after a default, they are foreclosed on or otherwise

<sup>14</sup> See, e.g., U.S. Department of Housing and Urban Development, *Housing in the Seventies: National Housing Policy Review*, 1974; Leonard Downie, Jr. *Mortgage on America*, Praeger Publishers, 1974; Brian D. Boyer, *Cities Destroyed for Cash: The FHA Scandal at HUD*, Follett Publishing, 1973; Calvin Bradford, "Financing Homeownership: The Federal Role in Neighborhood Decline," *Urban Affairs Quarterly*, March 1979, pp. 313-335.

<sup>15</sup> As the Consumer Financial Protection Bureau has found: "Many recent studies document the negative effect of a foreclosed property on the homeowners in its vicinity. There are several reasons for this effect. Among them are displacement of demand that otherwise would have increased the neighborhood prices, reduced valuations of future sales if the buyers and/or the appraisers are using the sold foreclosed property as a comparable, vandalism, and disinvestment. Using the data on house transactions in Massachusetts from 1987 to 2009, a foreclosure lowers the price of a house within 0.05 miles by 1 percent. According to Fannie Mae data for the Chicago MSA, a foreclosure within 0.9 kilometers can decrease the price of a house by as much as 8.7 percent; however, the magnitude decreases to under 2 percent within five years of the foreclosure. Research using Maryland data for 2006–2009 finds that a foreclosure results in a 28 percent increase in the default risk to its nearest neighbors. Other papers document various magnitudes of the negative effect on nearby properties." (citations omitted.) Bureau of Consumer Financial Protection, 12 CFR Part 1024, Mortgage Servicing Rules Under the Real Estate Settlement Act, (Regulation X); Final Rule, *Federal Register* / Vol. 78, No. 31, / Thursday, February 14, 2013, at p. 10854.

hounded by the collection process. Shortcomings of laws that preclude going bankrupt on federal or private student loans mean that excessive indebtedness by borrowers of student loans can be especially harmful, as it becomes impossible to shed their unmanageable debt and start over, as the bankruptcy code allows in other cases. Another bankruptcy provision prevents reduction in mortgage principal to correspond to the value of a home that has lost substantial value. This prevents many overly indebted borrowers from reducing their unmanageable housing debt and regaining financial footing.

Federal credit agencies vary widely in their attention to a balance between extending too much credit and too little. The federal student loan program lacks balance by design: undergraduate loans are a categorical entitlement, and the Department of Education must fund all applicants so long as they meet eligibility requirements. Thus, the program extends credit to undergraduate students up to the statutory maximum, without regard to their income, current indebtedness, or likely job prospects.

Other credit agencies, which are authorized to underwrite credit they extend, may articulate program objectives without regard to borrower outcomes. Thus, the SBA sets forth four performance goals for its lending programs, none of which relate to borrower outcomes.<sup>16</sup> By contrast, FHA balances its output objec-

tives with an outcome measure, the “Percent of loans endorsed with credit score <680 without a 90 day delinquency during the first three years,” and several measures for housing counseling and outcomes of counseling for borrowers.<sup>17</sup>

Turn then to the left side of the curve in Figure 4. Here the story is more complicated. For example, government policy can be wasteful and counterproductive even if it seeks to lend to borrowers who are low risk and would otherwise have reasonable access to commercial lending markets. Thus, in an apparent effort to serve more middle-class borrowers, policymakers have expanded the FHA single-family loan limits to a top mortgage size of \$636,150. However, because of the way this exposes FHA to increased adverse selection (that is “cherry picking” by the private sector), defaults have actually increased:

“Our research so far has shown that higher-balance FHA loans have been defaulting at rates approximately 20% higher than loans that were within the historical scope of the FHA. ... By continuing to insure mortgages for the highest-income borrowers, the FHA is undertaking risks that it has not undertaken very often and for which its risk-management capacity may not be sufficient. In particular..., the FHA is subject to adverse selection by the private sector. This is likely to be more se-

<sup>16</sup> Small Business Administration, “Summary of Performance and Financial Information: Fiscal Year 2015,” pp. 4–5.

<sup>17</sup> Department of Housing and Urban Development, “FY 2015 Annual Performance Report and FY 2017 Annual Performance Plan,” p. 17.

rious in markets with which it has less experience.”<sup>18</sup>

Other difficulties arise when government programs, by lending to low-risk borrowers, displace private credit. Sometimes fees in a government program may be structured to create a cross-subsidy to borrowers who are less creditworthy. While some policymakers find this to be an acceptable, even desirable, trade-off, others have concerns. Cross-subsidization disadvantages some borrowers, as when some creditworthy borrowers in the SBA business loan program may pay more for their credit than if they accessed the commercial credit market. In the case of FHA, burdens of the cross-subsidy largely fall, not on taxpayers as a whole, but rather on the pool of generally less affluent but still creditworthy homebuyers who avail themselves of the FHA program rather than accumulating a larger down payment or obtaining private mortgage insurance. Cross-subsidies are hidden, so that borrowers who pay too much for their credit never realize that they are being taxed. The argument against cross-subsidies is that taxes should be borne broadly and that the cost of accomplishing any particular public program objective (for instance, promoting homeownership) should be transparent and fully disclosed in the budget, not buried in the fees that a credit program charges.

Another disadvantage of poor targeting occurs when credit, and especially subsidized credit, becomes capitalized into the price of the product or activity that the credit supports. Thus, trillions of dollars of government-backed mortgage credit encourage significant increases in home prices in areas where buildable land is limited, while over a trillion dollars of federal student loans can encourage increases in school tuition for students who face limited enrollment opportunities. That these effects sometimes are hard to measure does not detract from their consequences, which—because the higher prices affect everyone in the relevant market—can be especially burdensome for less affluent people in these markets, whether borrowers or not.

Another issue involves the long-term displacement of private lending in a market. Key lender interest groups may favor the financial security of participating in a government guaranteed loan program under a largely defined framework rather than being subject to the rigor of greater competition in a private market. Once established, stakeholder interests may make it difficult for government to recede from playing a large role in a particular credit market, even where it appears the private sector has the capacity and experience necessary to provide credit by itself. A prominent example currently applies to the housing sector. Although the government’s share has

<sup>18</sup> Robert Van Order and Anthony M. Yezer, “FHA: Recent History and Future Prospects,” *Housing Policy Debate*, vol. 24, no. 3, pp. 644–650, at p. 647. See also, Chen L. Miller, “Two Essays on Real Estate Finance: 1) Effects of FHA Loan Limit Increases by ESA 2008: Housing Demand and Adverse Selection; and 2) Comparison of Two Affordable Housing Finance Channels,” PhD Dissertation, George Washington University School of Business, January 31, 2017; for a discussion of this effect before the financial crisis, see, e.g., Dwight M. Jaffee and John M. Quigley, “Housing Policy, Mortgage Policy, and the Federal Housing Administration,” chapter 5 in Deborah Lucas, *Measuring and Managing Federal Financial Risk*, University of Chicago Press, 2010, pp. 97–130.

declined since the financial crisis, the home mortgage market remains locked in the grips of government-backed credit programs—including the two failed government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac still in government hands, plus FHA and VA—accounting for two-thirds of total home mortgage originations.<sup>19</sup>

### C. Budgeting for federal loans and loan guarantees

*The Federal Credit Reform Act helped to reduce borrower defaults by creating an incentive for policymakers to spread federal credit among more borrowers rather than giving a deeper subsidy to fewer borrowers. However, some budget problems remain that deserve attention.*

While this report suggests areas needing improvement, one also needs to recognize the considerable progress that credit programs have made in reining in high levels of default that existed a few decades ago. Since its enactment, the Federal Credit Reform Act of 1990 (FCRA) has encouraged dramatic improvements in accountability and creditworthiness of most federal loan and loan guarantee portfolios. Instead of measuring program costs on a cash basis, which resulted in losses from loan guarantees, for example, being booked only after default when a lender made a claim on

the federal guarantee, Credit Reform measures the present value of income (from fees and recoveries on defaulted loans) and expenses (outlays for loans that default) and creates a credit subsidy estimate from the net value.<sup>20</sup>

Credit Reform thus means that policymakers have a choice: for a given level of appropriations, they can either provide deeply subsidized credit to fewer borrowers or less subsidized credit to a larger number of borrowers. This trade-off has encouraged policymakers to shift federal credit programs to emphasize less risky, that is, less subsidized, loans so that they can spread the benefits of federal credit to an increased number of constituents. Many agencies run credit programs that are recorded in the federal budget as having a “zero” or even negative credit subsidy—they are running a surplus; in other words, expected losses from delinquency and default (on a present-value basis) are equal to or below expected returns from fees and recoveries on defaulted loans. This has meant great improvement in focusing federal credit programs to avoid the right side of the curve (or in balancing with borrowers from the left side) in Figure 4, above.<sup>21</sup> But it has also meant that federal credit programs have been able to grow rapidly and serve borrowers for whom federal rather than private credit may not be the better option. The availability of negative subsidies produced by certain major federal credit programs to offset federal spending on other (usually non-credit)

<sup>19</sup> See Urban Institute, Housing Finance at a Glance: A Monthly Chartbook, February 2017 (online at [http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-february-2017/view/full\\_report](http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-february-2017/view/full_report))

<sup>20</sup> See the background paper on “Credit Programs and the Federal Budget Process” for a more complete explanation of the credit subsidy calculation process. The present value is calculated using Treasury rates as the discounting factor.

<sup>21</sup> Student loans are an outlier in this respect. As entitlements, they benefit from automatic (so-called “mandatory”) appropriations that spare the program from discipline that the FCRA otherwise imposes.

programs has provided a perhaps perverse incentive in the budget process to increase these programs beyond the levels that public policy objectives might otherwise justify.

Past substantial improvement being noted, further improvements in budget scorekeeping can provide additional benefits. While programs with low default rates can find it easy to charge fees that help to score a zero or negative credit subsidy, there is a downside as well. That is that an unexpected risk, such as a decline in borrower creditworthiness caused by a downturn in the relevant part of the economy, can cause credit subsidies suddenly to turn positive, thereby constraining the number of borrowers who can be served by a given credit level of appropriations at a time when credit is especially needed for countercyclical stabilization.<sup>22</sup>

This problem is compounded if an agency lacks a strong linkage between information used to manage the program and information used to calculate credit subsidy estimates. Also, if lenders or program managers neglect to report defaults promptly, for example, then a program may be abusing the reestimation

process that Congress provided under the FCRA. What may be needed is a process for external review of the data by a respected and credible outside source. Here, the FHA provides a good model. The Federal Housing Act (as amended) requires FHA to commission an annual independent actuarial report on its single-family loan program.<sup>23</sup> The result has been higher-quality information, and increased discipline in the FHA loan program, and greater capacity to anticipate surprises. By law, the FHA must also maintain a two-percent reserve.<sup>24</sup> Coming close to tapping the FHA reserve provides good feedback about increased risk that FHA may be taking on.<sup>25</sup>

#### D. Evaluating outcomes: data and analysis

*Federal credit programs vary widely in the quality of data they use to manage their programs. Many loan guarantee programs lack information about defaults because they merely record claims by lenders who seek reimbursement for losses that they suffer from defaulted loans. While some programs collect and use data about borrower outcomes, most do not.*

<sup>22</sup> This “unexpected risk” element of credit programs is often cited as one of two shortcomings in the implementation of the FCRA (the other, discussed below in the text, is the treatment of administrative expenses). The Congressional Budget Office, some economists, and other observers have argued that the issue of “unexpected risk” could be addressed by employing a market, or “fair value,” interest rate in credit subsidy calculations, rather than using the government’s lower (risk-free) interest rate in such calculations. See the background paper on “Credit Programs and the Federal Budget Process.”

<sup>23</sup> 12 U.S.C. Sec. 1708 (a)(4) “Annual independent actuarial study”: “The Secretary shall provide for an independent actuarial study of the Fund to be conducted annually, which shall analyze the financial position of the Fund. The Secretary shall submit a report annually to the Congress describing the results of such study and assessing the financial status of the Fund. The report shall recommend adjustments to underwriting standards, program participation, or premiums, if necessary, to ensure that the Fund remains financially sound. The report shall also include an evaluation of the quality control procedures and accuracy of information utilized in the process of underwriting loans guaranteed by the Fund. Such evaluation shall include a review of the risk characteristics of loans based not only on borrower information and performance, but on risks associated with loans originated or funded by various entities or financial institutions.”

<sup>24</sup> 12 U.S. Code § 1711, “General Surplus and Participating Reserve Accounts.”

<sup>25</sup> Robert Van Order and Anthony M. Yezer, “FHA: Recent History and Future Prospects,” *Housing Policy Debate*, vol. 24, no. 3, 2014, pp. 644-650, at p. 646.

Data quality varies considerably across federal credit programs. One factor is the nature of the loan program. Some programs generate relatively few very large loans, while other programs involve large numbers of very small loans. Programs with relatively few large loans include the Department of Transportation's TIFIA infrastructure program, or large loan programs of the Export-Import Bank of the United States and Overseas Private Investment Corporation, or the Department of Energy Title XVII alternative energy loans. Because they keep close track of each individual loan, such programs tend to have very good data. Loan underwriting is detailed and thorough, loans are carefully monitored, and outcomes can be easily determined.

Consider, for example, the Transportation Infrastructure Finance and Innovation Act (TIFIA) loan program. TIFIA tracks and ranks projects according to the amount of private financing that a project is able to attract. Figure 5 below shows TIFIA projects ranked by this measure in 2014. TIFIA has now begun to assess TIFIA-supported infrastructure projects in terms of a more significant outcome measure: each project's effects on transportation. The next TIFIA annual Report to Congress is expected to present those outcomes.

By contrast, there can be considerable variation in data quality for programs with large numbers of smaller-sized loans.<sup>26</sup> Some programs have adopted sophisticated portfolio

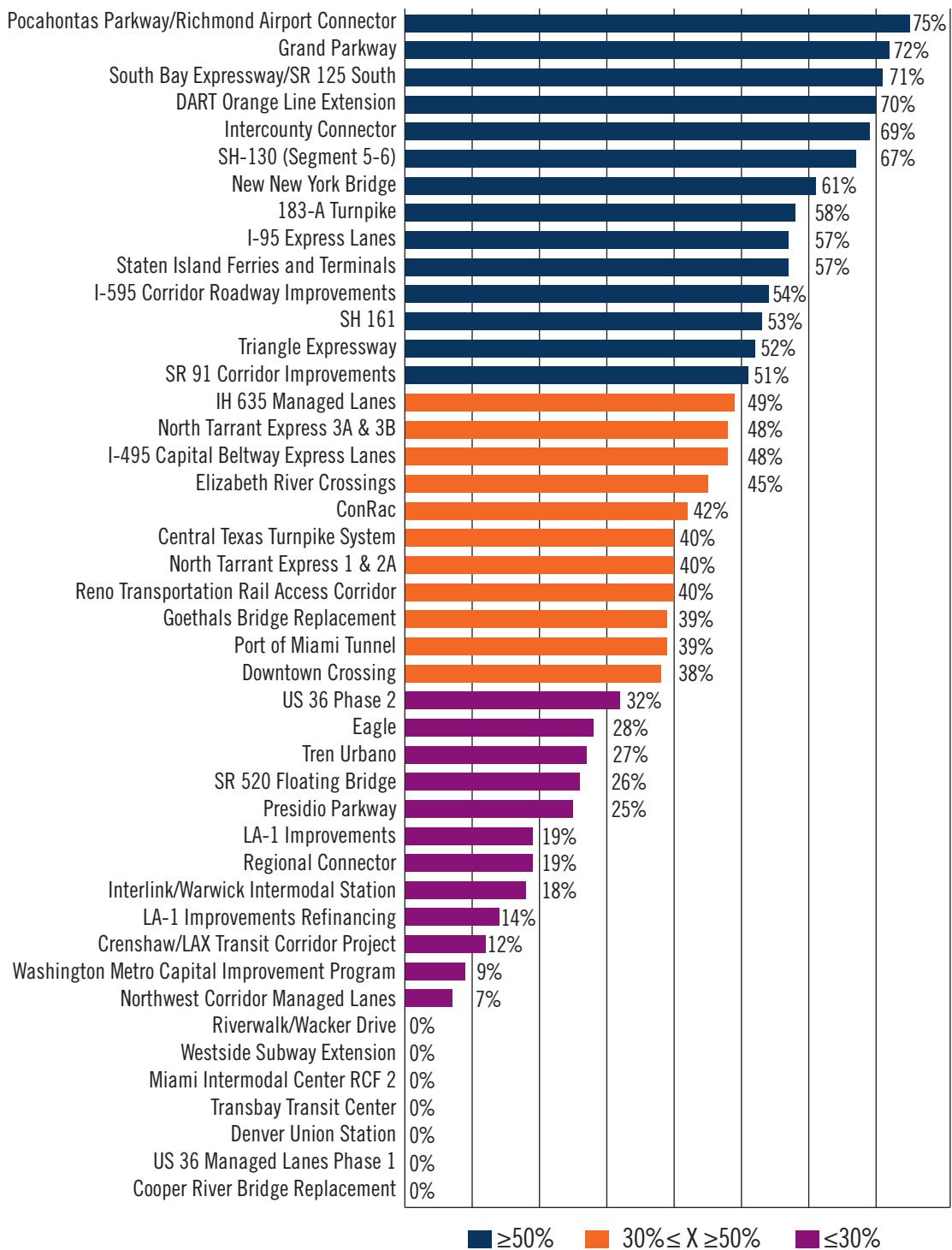
monitoring systems, sometimes in response to unexpected losses and often in response to the incentive that the Credit Reform Act creates to reduce defaults. An example of the former is Ginnie Mae, a wholly owned government corporation located within the Department of Housing and Urban Development. Ginnie Mae manages a very large portfolio of over \$1.6 trillion of mortgages that are pooled and used to create securities that it guarantees. In 1989, an issuer of Ginnie Mae mortgage-backed securities failed, exposing the government to potentially billions of dollars of losses. The agency then moved promptly to build two management information systems, to track the performance of servicers, frequently issuers of its mortgage pools, and the lenders who originated the mortgages in those pools. These systems are now combined into the Ginnie Mae Portfolio Analysis Database System (GPADS), an off-site tool that helps track counterparty risk using portfolio statistics and comparing issuers with broader peer group activity. Other credit agencies also have developed effective portfolio monitoring systems.

However, portfolio management tools are not always useful for evaluating program outcomes. Loan guarantee programs, for example, may maintain records only on claims rather than defaults. A claim results when a lender takes a loss on a federally guaranteed loan and turns to the credit agency for compensation. However, defaults occur more frequently than claims. For instance, if a borrower becomes seriously delinquent on an FHA-in

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<sup>26</sup> This might appear counter-intuitive since, from a statistical perspective, more observations (i.e., loans) should tend to improve the accuracy of information. However, in the case of some programs with large numbers of loans, the underlying data may not be gathered or preserved in a form that allows for systematic evaluation of outcomes.

**Figure 5. Attracting Private Capital to TIFIA Projects**



Source: TIFIA 2014 Report to Congress

sured home mortgage, the lender may offer a short sale to avoid a potentially more costly foreclosure. Although the borrower may have become 90-days delinquent, which is the usual measure of a default, and may have lost the home, FHA might not record a claim on the insurance fund, and the portfolio information would understate negative borrower outcomes. Research for this report sought to use default data from both FHA and SBA to generate two different outcome measures, but foundered because only claims data were readily available.

FHA outcome measures are unrealistically favorable in another way as well. Research suggests that FHA does not distinguish between new mortgages and refinancing in its calculations. Thus, a borrower who takes out an FHA mortgage, (1) refinances into a new mortgage, and then (2) defaults would be counted as having one successful outcome and one default—leading FHA to calculate a 50 percent success rate when the borrower in reality has only postponed eventual failure.<sup>27</sup>

By contrast, direct loan programs may have access to information about loan defaults.

The Department of Education increasingly makes default and school graduation rate data available—and easily accessible—in a College Scorecard so that multiple users can consider and possibly publish such information by themselves.<sup>28</sup> The Department also has released the underlying data to the public, and users are already taking advantage. Individuals and organizations have repackaged the data for easier use, published returns on investment for colleges by matriculated students' income level, and used the data to evaluate the performance of accrediting agencies.<sup>29</sup>

The publication of College Scorecard data illustrates the principle that data quality improves along with the number of people who use it. The president of a for-profit college noticed discrepancies between College Scorecard statistics and other numbers the Department of Education had published. Even though the Scorecard's numbers made repayment rates for his institution's students look better, he submitted a public comment letter on a new regulation and pointed out anomalies in the reported data for three-, five-, and seven-year repayment rates.<sup>30</sup>

<sup>27</sup> Andrew Caplin, Anna Cororaton, and Joseph Tracy, "Is the FHA Creating Sustainable Homeownership?" *Real Estate Economics* 43, no. 4 (November 1, 2015): 959–60.

<sup>28</sup> The Department of Education partnered with the US Digital Service to develop the College Scorecard, a web-based repository of data on higher education outcomes. Prospective students can look up graduation rates, 10-year incomes, and student loan repayment rates, enabling them to make better-informed decisions about their educations. The Scorecard complies with government privacy protections because data are aggregated at the institutional level. See, <https://collegescorecard.ed.gov/>.

<sup>29</sup> Ben Hamner, "Exploring the US College Scorecard Data," Kaggle, accessed February 2, 2017, <https://www.kaggle.com/benhamner/d/kaggle/college-scorecard/exploring-the-us-college-scorecard-data>; "Good Colleges For Low Income Students," PayScale, accessed February 2, 2017, <http://www.payscale.com/college-roi/roi-by-income-level>; Annie Waldman, "Methodology: How We Analyzed College Accreditation Data," ProPublica, November 3, 2015, <https://www.propublica.org/article/methodology-how-we-analyzed-college-accreditation-data>.

<sup>30</sup> Danielle Douglas-Gabriel, "This College President Found an Error in the College Scorecard. So Why Did It Take 5 Months to Fix?" *Washington Post*, January 26, 2017, <https://www.washingtonpost.com/news/grade-point/wp/2017/01/26/this-college-president-found-an-error-in-the-college-scorecard-so-why-did-it-five-months-to-fix/>.

Yet, the federal student loan program is limited in the amount of outcome-related data that it can generate. Stakeholders supported enactment of a 2008 law that precludes the federal government from maintaining loan-level databases that track individual student outcomes over time.<sup>31</sup> While this law nominally appears to protect student privacy, its major thrust is to prevent the Department of Education from maintaining individual outcome (“unit record”) data, revealing for example, the schools where the incidence of overly indebted nongraduating students is greatest.<sup>32</sup> If protecting student privacy had been the true goal, more narrowly focused legislation would have sufficed without denying the Department of Education and outside researchers the ability to track loan-level outcomes.

The law has had significant consequences for the ability of the Department of Education to evaluate outcomes and, to the extent authority is available, to manage them:

“Significant data gaps exist in the higher education sector, including data related

to loan performance, student outcomes, and certain key demographic, labor, and wage data about student loan borrowers. Evidence suggests that some borrowers who default share certain characteristics, including attendance at proprietary schools or failure to complete a program of study. Improved access to key data is needed, including access to data related to predictors of future borrower distress, performance of borrowers in alternative repayment arrangements, and the efficacy of various interventions, and should inform policymakers and market participants seeking to target resources and reduce defaults.”<sup>33</sup>

Similarly, the SBA commissioned the Urban Institute to assess “potential duplication of SBA’s main financial assistance programs by state or local programs, establishing a baseline measure of SBA customer satisfaction, and interviewing participating lenders about their underwriting practices.”<sup>34</sup> Unfortunately, however, there were legal impediments

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<sup>31</sup> The law is posted on the website of the National Association of Independent Colleges and Universities (NAICU), [https://www.naicu.edu/docLib/20081030\\_HEA101-studentunit.pdf](https://www.naicu.edu/docLib/20081030_HEA101-studentunit.pdf), accessed 01-08-2017. In relevant part, the law reads: “... nothing in this Act shall be construed to authorize the development, implementation, or maintenance of a Federal database of personally identifiable information on individuals receiving assistance under this Act, attending institutions receiving assistance under this Act, or otherwise involved in any studies or other collections of data under this Act, including a student unit record system, an education bar code system, or any other system that tracks individual students over time.” For background on lobbying that led to the law, see e.g., Clare McCann and Amy Laitinen, “College Blackout: How the Higher Education Lobby Fought to Keep Students in the Dark,” New America Foundation, 2014, <http://preview.staging.newamerica.org/downloads/CollegeBlackoutFINAL.pdf>.

<sup>32</sup> To some extent the Department of Education has been able to use other types of data, based on sampling, to work around the limits of the legislation. See, e.g., the Gainful Employment Regulations, 34 CFR Part 668, *Federal Register*, vol. 76 no. 113, June 13, 2011, pp. 34386-34559.

<sup>33</sup> Consumer Financial Protection Bureau, “Student loan servicing: Analysis of public input and recommendations for reform,” September 2015, p. 3.

<sup>34</sup> US Government Accountability Office, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program’s Performance*, GAO-07-769, July 2007; Shelli B. Rossman and Brett Theodos, with Rachel Brash, Megan Gallagher, Christopher Hayes, and Kenneth Temkin, “Key Findings from The Evaluation of the Small Business Administration’s Loan and Investment Programs,” Urban Institute, January 2008, available at [http://www.urban.org/search?search\\_api\\_views\\_fulltext=%2C%20Key%20Findings%20from%20The%20Evaluation%20of%20the%20Small%20Business%20Administration%E2%80%99s%20Loan%20and%20Investment%20Programs](http://www.urban.org/search?search_api_views_fulltext=%2C%20Key%20Findings%20from%20The%20Evaluation%20of%20the%20Small%20Business%20Administration%E2%80%99s%20Loan%20and%20Investment%20Programs).

that precluded undertaking a comparison between businesses receiving and those not receiving SBA credit to evaluate the difference in outcomes.<sup>35</sup>

In summary then, while federal credit programs have been increasing the amount of information relevant to portfolio management, there is considerable room for improving the extent that loan and loan guarantee programs generate information for the analysis needed to understand and improve borrower outcomes.

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<sup>35</sup> The GAO reported on this: “One component of the study that will not be undertaken is an analysis to determine how outcomes for firms assisted through financial assistance programs, such as 7(a), would differ in the absence of SBA assistance. The impact study, as designed by the Urban Institute, required the use of credit scores for firms that did not receive SBA assistance. Though costs associated with this component of the study initially prohibited SBA from undertaking it, SBA officials explained that they were advised that they are legally prohibited from obtaining credit score data from firms with which they have no relationship. Ibid. *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program’s Performance*, p. 16.

## III. Recommendations: Improving Borrower Outcomes

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### A. Determine benefits and costs to borrowers of the riskiest loan

*Because defaults cause the greatest harm to borrowers, credit programs should use their riskiest loans as the first place to measure borrower benefits and costs of their programs. If these are out of balance, a program can ratchet its standards up or down so that the benefits to creditworthy borrowers outweigh the costs to those who default. Some programs, most notably student loans, may not have authority to do this, except indirectly.<sup>36</sup>*

If borrower defaults represent perhaps the greatest costs to unsuccessful borrowers, a useful approach begins by considering the riskiest loans, that is, those with greatest chances of defaulting, that a program will accept. Private lenders often refer to their “credit box” which is the range of underwriting criteria (such as amount of down payment required, amount of risk-sharing with a lender, or a borrower’s FICO score<sup>37</sup>) that they will accept when extending credit. Dimensions of

the credit box depend on the nature of the loan (to an individual or business, collateralized or not, etc.), the appropriate criteria of creditworthiness for such loans, and the risk appetite of the organization. The most important part of the credit box is the bottom: to ensure net benefits of their programs go to borrowers, federal program agencies need to determine credit criteria of the riskiest loans that they consider acceptable for the program.

The FHA provides a good example: In 2016, the average credit score for an FHA borrower was 680. The 2016 FHA Annual Report shows major characteristics of FHA borrowers that have made FHA a mainstay of the residential mortgage market, especially for less creditworthy borrowers:

- 82.1 percent of FHA purchase loans were for first-time homebuyers, accounting for 722,075 purchase loans.
- 10.9 percent of FHA borrowers were African-American and 17.5 percent were Hispanic.

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<sup>36</sup> Student loans have no underwriting criteria. Because they are a categorical entitlement, the Department of Education must fund all applicants so long as they meet eligibility requirements.

<sup>37</sup> A FICO Score, named for the Fair, Isaac Company, is a widely-accepted measure of a borrower’s creditworthiness. In this report the term “credit score” means a FICO score.

- In the 2015 calendar year, FHA insurance was used for 25 percent of all purchase loans in America, but was used for 47 percent of home purchases by African-American households and 49 percent of purchases by Hispanic households.<sup>38</sup>

For most borrowers, FHA mortgage insurance provides a significant benefit. The policy question then becomes the balance between benefits and costs of borrowers at the lowest part of the FHA credit box. Once a program such as FHA measures benefits and costs to these riskiest borrowers, it can adjust the minimum upwards or downwards, depending on the analysis.

FHA provides a useful example (especially because FHA tends to have access to better-quality credit data than some other programs), of seeking to weigh benefits and costs of the riskiest home mortgages. While FHA can lend to borrowers with even lower credit scores, consider borrowers with a low FICO credit score of 620 who can take out a low down payment FHA-insured mortgage. Unfortunately, the combination of a low FICO score and low down payment means the chances of default can be significant. For a borrower with a FICO score of 620 and a small down payment of 3.5 percent, the chances of defaulting are about 20 percent.<sup>39</sup>

Because defaults cause harm, both before and after foreclosure, they should not be taken lightly. Defaulting families come under considerable emotional and financial stress as they struggle to save their home. Tension can resonate throughout the household and particularly in children. Leaving the home will disrupt the household, especially as family members then may then move to relatively unattractive quarters and, if the new residence is outside the old neighborhood, children may need to change schools. Researchers have documented how health effects, economic hardship, and food insecurity increase.<sup>40</sup> If the home is left vacant, and especially if it is foreclosed on, there can be significant adverse effects on other home values and crime in the neighborhood as well as increased defaults on other houses in the area.

Thus, even as the FHA single-family program is performing an important credit function for its average borrower, the program may be causing significant harm to the one-out-of-five less creditworthy FHA borrowers who default on their mortgage loans, and to their communities. In addition, there is another group of borrowers, whose loans become troubled but somehow contribute sufficient resources to avoid default. One example would be someone who borrowed for a home, could not sustain the mortgage, and then used a short sale to extricate themselves. While this may not be recorded as a default, it is a case of excessive borrowing bringing finan-

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<sup>38</sup> Department of Housing and Urban Development, *Annual Report to Congress Regarding the Financial Status of the Mutual Mortgage Insurance Fund Fiscal Year 2016*, p. 5.

<sup>39</sup> Based on Wei Li and Laurie Goodman, "Measuring Mortgage Credit Availability Using Ex-Ante Probability of Default," Urban Institute, November 2014.

<sup>40</sup> See, e.g., Laryssa Mykyta, "Housing Crisis and Family Well-being: Examining the Effects of Foreclosure on Families," SEHSD Working Paper #2015-07, US Census Bureau, 2015; Julia B. Isaacs, "The Ongoing Impact of Foreclosure on Children," Brookings Institution, 2012; G. Thomas Kingsley, Robin E. Smith, and David Price, "The Impacts of Foreclosures on Families and Communities: A Primer," Urban Institute, 2009.

cial harm and stress to a household. Thus, while defaults are a good primary measure of costs to borrowers, more sophisticated evaluation of outcomes also is needed, as is discussed in sections III.C and IV.C, below.

Consider now benefits to the four-out-of-five low-FICO borrowers who remain in their homes. If there are employment opportunities in the area, then the home itself can be a major benefit to a family by providing a safe and healthful place to live.<sup>41</sup> Homeownership as an investment, rather than as a place to live, is more doubtful. Everything depends on the house appreciating in value, which is far from certain. Furthermore, the home's illiquidity can work against a borrower. If a householder works at a large firm that suddenly closes and departs for another part of the country, then owning a home could become a burden rather than benefit. The family may find that the value of its house drops just as its major employer leaves. While renters might try to follow the company to its new location, an “underwater” homeowner (one whose mortgage amount exceeds the price of the home) would find that more difficult.

That scenario is but one reflection of the problem of helping low-FICO borrowers to buy a home. In contrast to middle-class homeowners, who may maintain some investments in a diversified portfolio, low-FICO borrowers are likely to have their investments tied up

in one large undiversified asset: their house. Especially if borrowers in low-income areas find that their homes do not appreciate significantly in value, the home can become a poor investment. Average real home prices (adjusted for inflation) in the U.S. have not appreciated significantly over the past several decades. In addition, there are costs of maintaining a home, paying property taxes and insurance, and other obligations of home ownership. While homeownership can be beneficial for some disadvantaged borrowers,<sup>42</sup> FHA needs to monitor the bottom of its credit box to ensure the balance of benefits and costs for the least creditworthy FHA borrowers that the program serves.

If outcomes for the riskiest loans are in doubt, FHA can determine how much to ratchet its credit box upwards to shift the cost-benefit balance for borrowers in a more positive direction. Moreover, by tracking characteristics of the minimally acceptable loan over time, a lending program can construct an early warning signal. If borrower or loan credit characteristics of the FHA portfolio change, then the program may need to adjust underwriting criteria for its riskiest loans, and possibly its pricing, to compensate.

As FHA considers how to adjust its credit box to ensure protection of borrowers taking out the most risky loan, it can adjust a variety of factors including FICO score thresholds and

<sup>41</sup> William M. Rohe and Mark R. Lindblad, “Reexamining the Social Benefits of Homeownership after the Foreclosure Crisis,” Chapter 3 in Eric S. Belsky, Christopher E. Herbert, and Jennifer H. Molinsky, *Homeownership Built to Last: Balancing Access, Affordability, and Risk after the Housing Crisis*, Brookings Institution Press, 2014.

<sup>42</sup> Christopher E. Herbert, Daniel T. McCue, and Rocio Sanchez-Moyano, “Is Homeownership Still an Effective Means of Building Wealth for Low-income and Minority Households? (Was it Ever?),” Chapter 2 in Eric S. Belsky, Christopher E. Herbert, and Jennifer H. Molinsky, *ibid.*

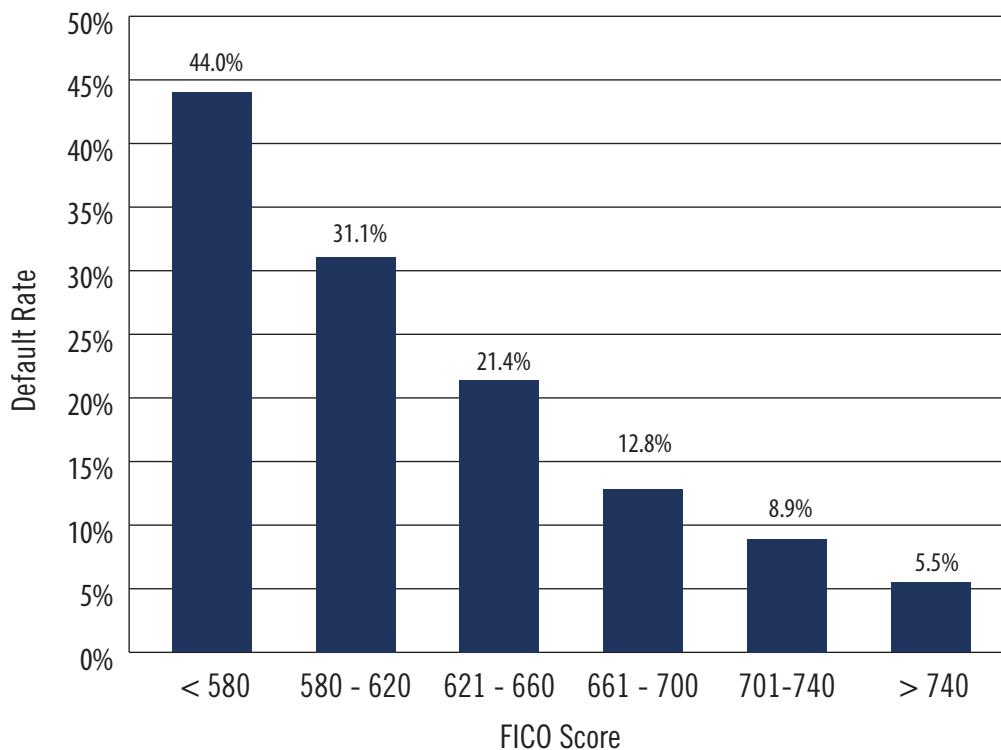
required down payments. One of the key adjustments FHA can make is the FICO score. Figure 6, below, shows how mortgage defaults vary according to borrower FICO scores.

Other credit factors are also important in determining the riskiest loan. Figure 7, below, shows how high loan-to-value ratios (LTV; that is, low equity in the home) at the time of origination can greatly magnify the chances a borrower will default. Loan-to-value means the ratio of a borrower's mortgage debt to the

value of the home. A higher down payment leads to a lower LTV. To reduce the incidence of defaults, program managers (or private lenders in a guaranteed loan program) can adjust any or all of the principal credit factors.

Another outcome-based approach is to measure the “sustainability” of program loans. For FHA, sustainability is the median life of a mortgage loan that FHA guarantees before it defaults. The sustainability of loans booked in a given year can be an important measure of the value

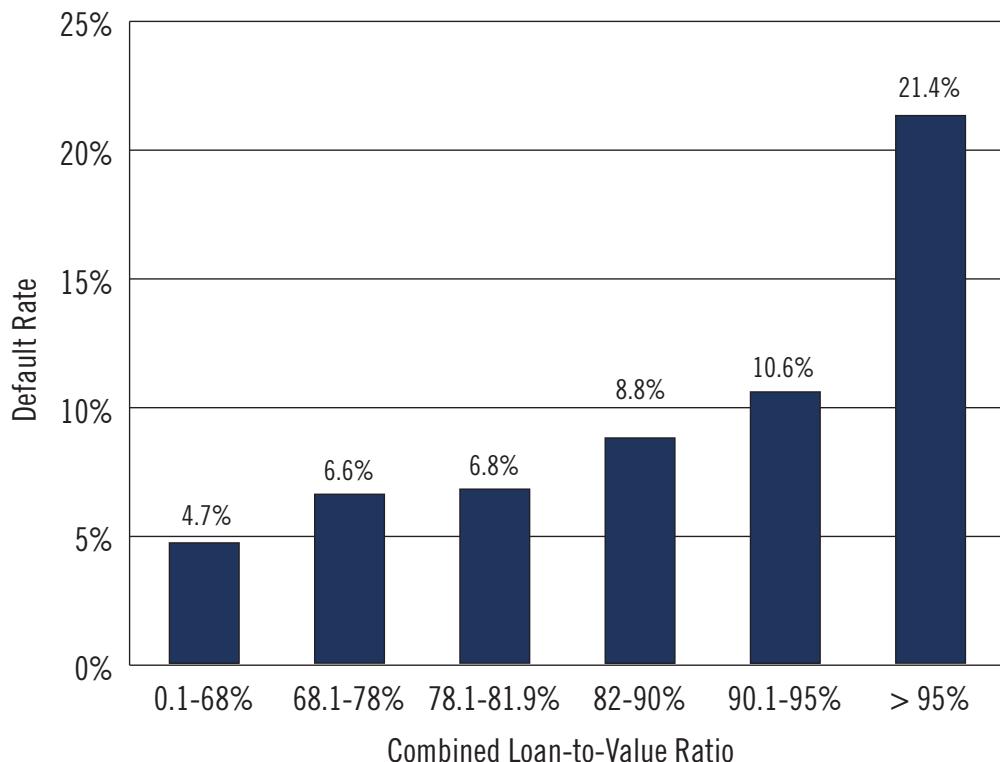
**Figure 6. How Mortgage Default Rates Vary with FICO Score**



*Source:* Based on Wei Li and Laurie Goodman, “Measuring Mortgage Credit Availability Using Ex-Ante Probability of Default,” Urban Institute, November 2014.<sup>43</sup>

<sup>43</sup> The underlying data are taken from Tables A.1 and A.2, using the “average” variables for loan-to-value ratio and back-end debt-to-income ratio. As Li and Goodman do, this graph represents a weighting of expected default rates to reflect a basket of 90 percent loans originated in 2001-2 and 10 percent loans originated in 2005-6.

**Figure 7. How Mortgage Defaults Vary with Loan-to-Value Ratio**



**Source:** Based on Wei Li and Laurie Goodman, “Measuring Mortgage Credit Availability Using Ex-Ante Probability of Default,” Urban Institute, November 2014.<sup>44</sup>

of a program to its borrowers.<sup>45</sup> Sustainability also can reveal important information about student loan borrower outcomes. The riskiest student borrowers—who tend to attend pro-

prietary schools or community colleges rather than four-year colleges and universities—may be those who suffer most from unsustainable loans that lead to failed educational outcomes.<sup>46</sup>

<sup>44</sup> These are default rates for borrowers with 621-660 FICO scores. The underlying data are taken from Tables A.1 and A.2, using the “average” variables for back-end debt-to-income ratio.

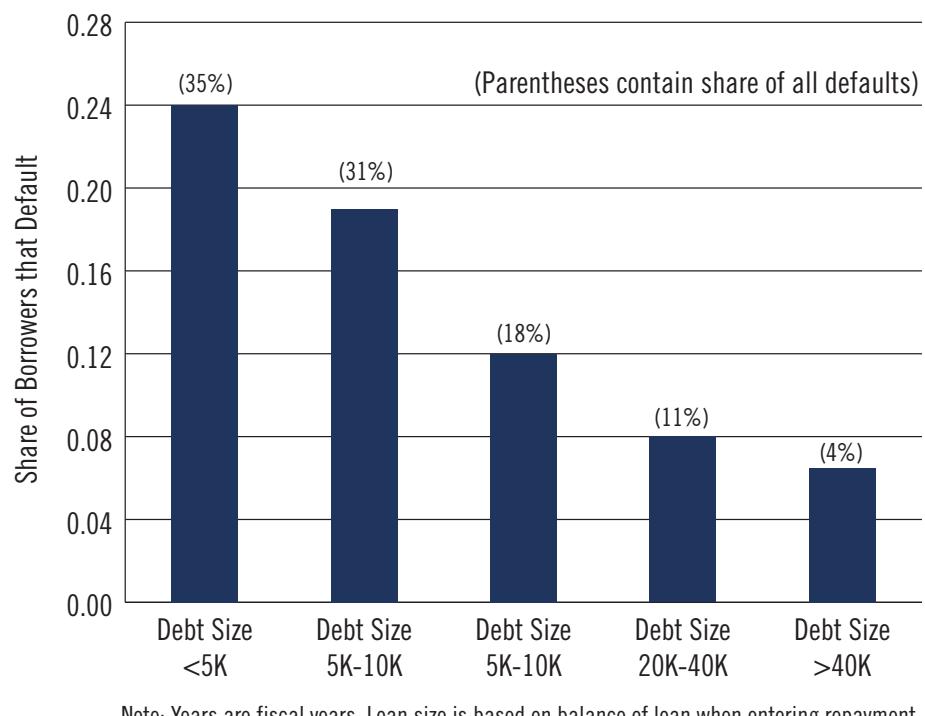
<sup>45</sup> Andrew Caplin, Anna Cororaton, and Joseph Tracy, “Is the FHA Creating Sustainable Homeownership?” *Real Estate Economics*, Vol. 43 No. 4, 2015, pp. 957–992: “We produce first estimates of the sustainability of homeownership for recent Federal Housing Administration (FHA) borrowers. Unfortunately, the FHA does not produce its own statistics on sustainability. Neither does it permit researchers access to its data on internal refinances. This imposes significant barriers to entry for researchers who wish to track FHA borrower performance over time. We carefully construct the required tracking data to overcome this barrier. We forecast that no more than 75% of the 2007–2009 vintages of FHA borrowers will be able to successfully exit the FHA system. Our work raises questions about FHA’s role, its accounting and its accountability.”

<sup>46</sup> “Repayment outcomes tend to be worse among borrowers who attend for-profit or community colleges; those who are low-income or independent; those who attend part time; and, especially, those who do not complete their degrees. .... ....Defaults are concentrated among borrowers with small-volume loans, in large part because these borrowers are less likely to have completed their degrees. Loans of less than \$10,000 accounted for nearly two-thirds of all defaults for the 2011 cohort three years after entering repayment. Loans of less than \$5,000 accounted for 35 percent of all defaults.” Council of Economic Advisers, “Investing in Higher Education: Benefits, Challenges, and the State of Student Debt,” July 2016, pp. 4-5.

This is reflected in Figure 8, below, showing the proportion of borrowers with different sized loans who defaulted within three years of entering repayment. Poor-quality education coupled with low prospects for graduation would seem to be major contributors to students emerging from an educational experience with debt burdens and defaults but little else to show for their efforts. Again the most disadvantaged borrowers may be those most harmed by their experience.

The lifetime default rate by dollar volume for unsubsidized federal student loans for undergraduates in the 2017 cohort is projected to be 27 percent. Given that defaults are concentrated in lower-balance loans, the proportion of student borrowers unable to handle the debt that the Department of Education provides them is likely greater than one in four.<sup>47</sup> To measure sustainability, the measure for student loans must be adjusted to compensate for both (1) the artificially long time the law per-

**Figure 8. Share of Student Borrowers Who Default by Year 3 by Loan Size, 2011 Repayment Cohort**



*Source:* Council of Economic Advisers, “Investing in Higher Education: Benefits, Challenges, and the State of Student Debt,” July 2016, p. 42.

<sup>47</sup> Department of Education, *Student Loans Overview, Fiscal Year 2017 Budget Proposal*, p. Q-31.

mits to elapse before a student loan default formally occurs and (2) the multitude of deferral options that can mask data about the number of people taking on unsustainable debt burdens in an effort to improve their prospects.<sup>48</sup> For all loans, including student loans, it would be good to adopt a standard measure of the percent of loans for the riskiest borrowers that go into ninety-day nonperformance within five years. It is time to gather information about sustainability of loans using a common methodology across programs.

To take outcome analysis to a higher level, programs must move beyond using defaults as the primary measure of borrower outcomes. As will be discussed in Section IV.C. below, improved access to data, and especially data that can be correlated combined with Census or Internal Revenue Service (IRS) information, for example, can help to measure borrower outcomes in more sophisticated ways, such as by correlating borrower expenditures funded by student loans, FHA home mortgages, or SBA small business loans with outcomes such as income or wealth or children's education later in life.

## B. Strengthen oversight of lenders and other program partners to reduce defaults

*Ensuring that lenders and other program partners (schools in the case of student loans) market, originate, and service sustainable loans can help prevent defaults. Some agencies provide good models of lender oversight. Program managers should consider a variety of techniques—including third-party ratings and disciplinary actions—to assure top performance by program partners. Also laws should set clear standards and permit application of a series of graduated remedies for poor performers.*

The relationship between a federal credit agency and its partners depends on several elements: (1) contractual provisions the agency applies to the relationship, (2) how the agency selects its partners, (3) how the agency monitors partners' performance, and (4) how the agency promotes partners that perform well while weeding out poor performers.

Two types of program partner are especially important for federal credit agencies: (1) contractors to help the agency manage its

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<sup>48</sup> Federal student loans are considered delinquent in 270 days of nonpayment. This contrasts with commercial lending practices and virtually every other federal credit program, which consider a 90-day delinquency to be a default. The stakeholder and budget issues, rather than policy issues involved in this convention became clear in the 1998 reauthorization of the Higher Education Act: "Officials at for-profit colleges and, to a lesser extent, community colleges, argued that while the default rate provisions had appropriately helped kill off poor quality colleges, it had also endangered legitimate institutions that served large numbers of low-income students who needed loans to pay their college bills. In part to respond to those complaints, but also to offset the costs of new programs and increased funds provided in the 1998 Higher Ed Act bill, Congress altered the cohort default rate calculation by extending, to 270 days from 180 days, the amount of time before the federal government deems a delinquent borrower to be in default." Doug Lederman, "A More Meaningful Default Rate," *Inside Higher Ed*, November 30, 2007. (The extension of default date allowed the credit budget estimates to diminish artificially since FCRA measures the present value of future defaults and an extension of time for a default to be recognized reduces the present value calculation).

programs, and (2) lenders that originate and service loans for loan guarantee programs. With respect to selecting program partners that are contractors, the federal procurement process has become increasingly difficult. Some agencies may seek to avoid new procurements whenever possible. Some agencies, notably the SBA, utilize the Section 8(a) program for disadvantaged small businesses, which allows agencies to select the contract staff with appropriate skills needed to carry out complex projects up to a value of \$ 4 million. The project that developed SBA One, an automated lending platform, for example, relied on a hand-picked Section 8(a) contractor.<sup>49</sup>

With respect to the contractual relationship of an agency with its partners, the Office of Federal Student Aid (FSA) has neglected to require reporting of loan performance information in a standardized way from its many contract servicers. It would seem imperative, if FSA is to increase the quality of its data analytics and reduce unnecessary staff burdens, that FSA should require standardized reporting by its servicers. Agencies that do require standardized reporting, such as FHA, SBA and Ginnie Mae, can conduct analyses to determine performance of their lending portfolios in multiple dimensions.

Another significant partner for federal credit agencies is the lender that implements much of a guaranteed loan program. As with other program partners, lender performance can vary widely, for example, in the quality of loans they originate. Lender monitoring systems can help to detect poor performers before the volume of poorly originated or serviced loans reaches unmanageable proportions. Again, results matter: improper origination of loans to people or businesses that cannot carry the debt load means increased defaults and harm to those borrowers. Poor servicing also can contribute to borrower harm, such as when a servicer fails to apply available default aversion approaches allowed by law for the program.

The SBA manages a sophisticated lender monitoring system that relies on a combination of commercially generated reports about the financial condition of a lender as well as the lender's portfolio of SBA guaranteed loans, and SBA monitoring done directly or through contractors. SBA generates and monitors a score for each participating lender on a range of criteria. Called the PARRIS score, this rating captures 22 important aspects of each lender's condition and SBA guaranteed loan performance.<sup>50</sup>

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<sup>49</sup> A particular advantage of the Section 8(a) program is that it allows the agency to conduct extensive discussions with the contractor to help shape the project to meet the agency's precise needs and make appropriate cost adjustments without the impediments to good communication that the federal procurement process otherwise might create. Agencies that require services through larger procurements need to make careful use of the pre-solicitation period to visit a range of contractors and conduct market research before actually designing the scope of work.

<sup>50</sup> See, e.g., Small Business Administration, "SBA, Revised Risk-Based Review Protocol for SBA Operations of Federally Regulated SBA Lenders," SBA Policy Notice, December 29, 2014. See also Small Business Administration, "SBA Lender Risk Rating System," Notice and Request for Comments, *Federal Register*, vol. 79, no. 82, April 29, 2014; and Maria Contreras-Sweet, Administrator, Small Business Administration, testimony before the Senate Committee on Small Business and Entrepreneurship, May 26, 2016.

The question then becomes how to deal with a lender performing significantly below its peer group. It can be difficult to eject such lenders from some programs. Needed is a system of graduated remedies so that agencies may take well-defined steps to encourage improving a lender's performance before terminating its participation in the program. Graduated remedies can include a reduction in the volume of loans that the lender can make, an increase in the fees that the lender pays, removal of delegated underwriting authority so that a lender needs to find a stronger performing correspondent bank to submit its loans to a guaranteed loan program, or some form of temporary suspension pending an independent management review that the lender pays for.

The SBA has devised a useful system of graduated responses. SBA issues increased supervisory actions to participating lenders that fail to meet SBA program requirements. These range from (1) credit audits, to look at individual lender loan files; to (2) field audits, to look at a lender's full program operations, loan documentation, etc., to (3) suspension or debarment of individual agents or representatives; and (4) removal of a lender's delegated underwriting authority; or finally (5) outright debarment of a lender. Lenders in the early stages of these supervisory actions feel pressure both because of the slowdown audits can cause and because they must pay for the costs of an audit. SBA faces less pressure to

apply draconian sanctions when lower-level remedies push lenders to bring their program operations into proper order. Also, having a well-defined and clearly disclosed system of graduated responses helps provide documentation for an agency's general counsel to be able to make a cogent case for termination in those cases when graduated remedies do not work.<sup>51</sup>

FHA has had a systematic program of lender sanctions in place since the 1990s, following a law that provides FHA with authority to act against lenders "if the Secretary determines that the mortgage loans originated or underwritten by the mortgagee [that is, lender] present an unacceptable risk to the insurance funds."<sup>52</sup> The determination is based on a comparison of early defaults on loans the lender originates with the average in the area. The Department of Housing and Urban Development, FHA's parent agency, issued regulations specifying that FHA may take actions, including removing a lender's authority to engage in delegated underwriting or termination, if the lender's loans exceed twice the normal default and claims rate for that area. In addition, FHA places a lender with one-and-a-half times the area default rate onto its Credit Watch list.<sup>53</sup> FHA's Neighborhood Watch program publishes data on the performance of loans that a lender originates compared to the average default and claims rate of loans in that geographic area.<sup>54</sup>

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<sup>51</sup> Currently at some agencies, a lack of such documentation makes it difficult to eject a poorly performing lender.

<sup>52</sup> 12 USC Section 1735f-11, "Review of mortgagee performance and authority to terminate."

<sup>53</sup> 24 CFR 202.3, "Approval status for lenders and mortgagees."

<sup>54</sup> The Neighborhood Watch website is found at <https://entp.hud.gov/sfnw/public/>.

This approach has major advantages. It sets a specific standard for performance, thereby sparing FHA the need to try to defend a more ambiguous standard. And the system provides a nice gradation of remedies: from posting of the lender's performance on Neighborhood Watch and implicating the lender's reputation; to possible removal of delegated underwriting authority, thereby allowing the lender to participate in the program, but under greater scrutiny; and finally—only if those more moderate remedies don't work—allowing FHA to terminate the lenders' participation in the program.<sup>55</sup>

By contrast to the way that SBA and FHA deal with poor lender performance, stakeholder influence has limited the Federal Student Loan program to setting lax standards for poorly performing schools. The law currently establishes a standard for post-secondary schools such that a school will be excluded from participating in the federal student loan and Pell Grant programs if it maintains a three-year cohort default rate of 30 percent for three consecutive years.<sup>56</sup> As a report of the Council of Economic Advisers points out, this measure of school performance is “susceptible to artificial manipulation, which may occur if an institution pushes students into deferment or forbearance until the measurement window expires.”<sup>57</sup> By setting such a low standard for the worst schools, the law virtually ensures that many of the neediest students will suffer

harm from enrolling in those schools—including wage garnishment and other federal sanctions.

There is evidence suggesting that students at the bottom of the program's credit box are most harmed by such a lax standard of school performance. Figure 9, below, shows how students from low income households, as measured by ZIP codes of borrowers at the time they took out their loans, have failed to make significant progress in paying down their student loan debt five years after they left school, especially compared to borrowers from higher-income households.

One problem that some credit programs currently face is the growth in program participation of nonbank lenders. This deprives credit agencies from assurance that the lending partner is being supervised for safety and soundness by a bank regulator. Charles Tansey, former SBA Associate Administrator for Capital Access, and Senior Vice President of the Small Business Group at the Export-Import Bank of the US (now a Senior Fellow at the Golub Center for Finance and Policy at MIT), suggests that credit programs use independent rating or institutional analytic services to assess the financial strength of participating lenders so that the credit agency can receive early warning if the lender comes under financial pressure and gains incentive to ship bad loans into a government program, just to

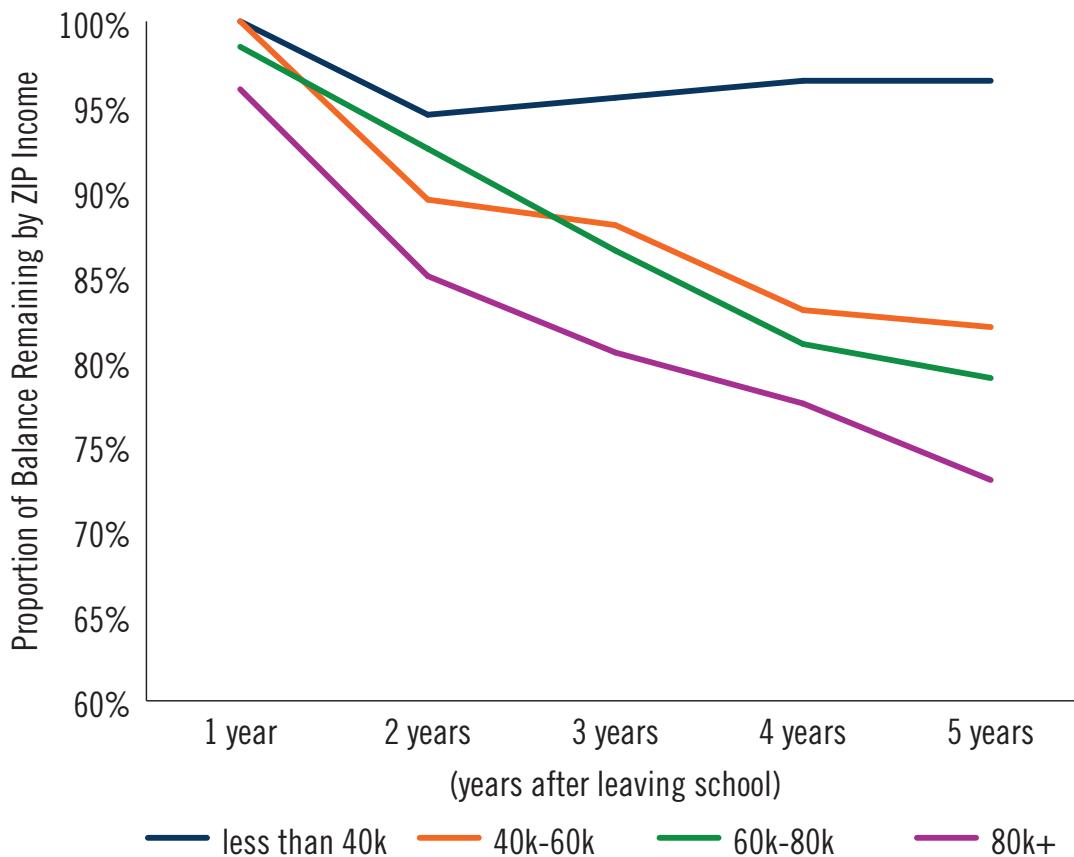
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<sup>55</sup> Trying to expand the number of borrowers at the bottom of the FHA credit box, FHA recently relaxed these standards for lenders operating in the most disadvantaged areas, but it is too soon to measure the effects on borrower outcomes.

<sup>56</sup> Department of Education, *Student Loans Overview, Fiscal Year 2017 Budget Proposal*, p. Q-30.

<sup>57</sup> Council of Economic Advisers, *Using Federal Data to Measure and Improve the Performance of U.S. Institutions of Higher Education*, September 2015 and updated January 2017, p. 22.

**Figure 9. 2009 Cohort Repayment Rates by Income**



*Source:* Andrew Haughwout, Donghoon Lee, Joelle Scally, Wilbert van der Klaauw, “Student Loan Borrowing and Repayment Trends, 2015,” Federal Reserve Bank of New York, April 16, 2015, slide 31.

try to stay afloat. Often, the agency will have enough historical data to craft the underwriting criteria that can be used by the rating services or institutional analysts in performing the assessment. The SBA has adopted this approach for lenders in the SBA Section 7(a) guaranteed loan program.

Finally, credit programs are subject to stakeholder influence with respect to oversight of lenders and other partners. Some astute lender

trade associations may favor increased agency oversight to detect and address the small proportion of lenders with the highest borrower default rates. These stakeholders recognize that lender outliers that originate or service loans with a serious default rate can imperil the program’s overall subsidy rate under Credit Reform, and thereby disadvantage the entire program. On the other hand, for a program such as student loans, where it is increasingly clear that specific subsets of schools

have the highest propensity to lead their student borrowers into default, less congenial stakeholders may be able to obtain legislation or congressional report language or otherwise prevent the program from addressing key sources of default and borrower harm.

### C. Improve program information

*Program managers should continuously improve program data and make such data public to the maximum degree possible. This can (1) improve program operations and internal evaluations; (2) promote external evaluations and linkages to other relevant data sources; and (3) better inform borrowers about the loans they are considering. In many cases agencies will need added authority to be able to collect appropriate outcome-related information.*

Over time, the quality of program information has become stronger. Needed now is to set a basic two-part standard: first, agencies should generate high-quality program performance information (e.g., annual origination volume, cohort delinquency rate, cohort default rate, cohort recovery rate, timing of write-offs versus default) in such a form that program managers, budget officials, and the public can access. Second, agencies should work with and supplement this information to maintain a continuing assessment of borrower outcomes.

Many agencies seem to be able to generate basic loan portfolio information for a data warehouse, for example. However, some agencies report that data definitions often are unclear, leading managers to interpret infor-

mation inconsistently. If such information becomes public, such as in a one-time report, this opens the door for contradictions to emerge. Part of the solution can come from creating a systematic reconciliation process between the original data and that in the data warehouse; other parts of the solution may require designation of a program official to assist data users with obtaining and understanding the meaning of particular pieces of data. In this way agencies can protect themselves from the loss of reputation that can occur if the publicly available numbers do not add up.

To strengthen information discipline, major credit programs might usefully follow the FHA model and commission annual actuarial reports. FHA benefits from these reports when managers can adjust FHA pricing, and potentially other program aspects such as the credit characteristics of the least creditworthy loans the program makes, to hold to the baseline (in FHA's case this is a two-percent loss reserve) that the program seeks to achieve. When accompanied by audits to validate program information, this can give increased confidence to managers that program outcomes are positive.

Errors can creep into any dataset. However, access by multiple users allows for feedback when a particular user finds anomalies that didn't appear for other uses. Making credit portfolio information public can allow outside users to select data segments in different ways and reach their own conclusions.

There is more to be done. To reveal actual program outcomes, researchers need to com-

bine agency portfolio data with other datasets to draw analytical conclusions—such as the effect of demographic changes on delinquencies and defaults, for example—for program managers and policymakers. Thus, in 2015 the Federal Reserve Bank of New York convened a one-day meeting on student loan data. William Dudley, President of the New York Fed, explained why high-quality student outcome data was badly needed:

“But there are many important questions still left unanswered. What is the relationship between the amount and type of educational investment that people make and their outcomes? What attributes are associated with borrowers who are more successful at repaying their student loans? Are there particular types of degrees that are associated with better performance with respect to student debt repayment or with better living standards earlier in life? What are the best interventions to help borrowers avoid the consequences of delinquency and default, and to limit any default costs to taxpayers? Do borrowers who use programs like income-based repayment eventually succeed in paying off their debts? How do income-based repayment programs affect important decisions such as labor supply, consumption and household formation?

“These are important questions for the nation, as the human capital of our citizens is far and away our most important asset, and student loans are an important mechanism for financing needed investments in that asset. But it is very hard to answer these questions with existing data. We need to link information on borrower decisions about the kind and amount of education they receive to long-run outcomes for them and for the overall economy.”<sup>58</sup>

Former Treasury Deputy Secretary Sarah Bloom Raskin reportedly pointed to other uses of such data:

“Raskin reiterated her previous call for better data on student loans. She argued that since student debt poses a significant risk for the U.S. Treasury—which ultimately is responsible for financing the federal government—her department needs data to model and mitigate risks. For example, better data would help policymakers predict which borrowers were at higher risk of default and design policies or systems that could help borrowers avert it. The federal government can’t form good policy with incomplete data and conjecture, Raskin reportedly said...”<sup>59</sup>

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<sup>58</sup> William C. Dudley, President and Chief Executive Officer, Remarks at the Convening on Student Loan Data Conference, Federal Reserve Bank of New York, New York City, March 4, 2015. Mr. Dudley also has suggested that excessive student debt burdens can affect the overall economy: “The rising burden of student debt is weighing on interest rates in the U.S...., Federal Reserve Bank of New York President William Dudley said. The growing pile of student debt is “obviously one headwind to economic activity” that “probably pushes in that direction of lower equilibrium real rates” because it limits households’ spending power, Dudley said Monday during a press briefing in New York.” Matthew Boesler and Shahien Nasiripour, “Student-Debt Overhang Is Pushing Down U.S. Rates, Dudley Says,” *Bloomberg*, April 3, 2017.

<sup>59</sup> Shahien Nasiripour, “The Federal Government Has No Idea How Much Americans Owe on Student Loans,” *Huffington Post*, March 15, 2015.

There are important privacy issues when a federal credit program publishes portfolio data—especially for personal loan programs such as FHA mortgage insurance or student loans—that can be traced back to the individual borrower. That means that credit programs may need to scrub portfolio data of identifying personal characteristics before publishing it. If publication still would violate privacy protections, credit agencies can follow the approach of IRS or the Social Security Administration of allowing access by professionally qualified researchers who sign appropriate confidentiality agreements and then publish aggregated data not susceptible to identification of particular individuals. As former Deputy Secretary Raskin suggested, credit agencies such as the Office of Federal Student Aid at least could allow Treasury Department analysts access to data to use or publish with appropriate privacy protections.

Borrowers are credit programs' most important partners in achieving stable portfolios and favorable outcomes. They are the supposed beneficiaries of the policies and also bear the burden of policy failure. Credit programs should make it a priority to put useful data in the hands of these borrowers so that they can make the right decisions. With their focus on consumer outcomes, the Consumer Financial Protection Bureau or the Federal Trade Commission may be able to help credit agencies identify good resources and approaches for this work. Credit agencies will need to (1) generate relevant data, (2) devise ways to

present information in a form that consumers can understand and use as the basis for their decisions, and (3) test the use of program information that may be of most benefit to different categories of borrower. A precondition to developing useful borrower information is that the credit program first generates the type of data that would be of actual use in helping a borrower to decide whether to take out a loan and for what purposes.

One area where information might be important for borrowers before they apply for an SBA loan to enter or expand a small business involves the line of business (NAICS Code) of the business. It turns out that defaults vary significantly according to NAICS Code; before exhausting their personal resources and taking on debt, prospective borrowers might benefit from information about their chances for success. It would be helpful if SBA could use available default data, for example from its lender monitoring system, to show variations in default rates for the major lines of business that attract most small businesses to SBA funding.

Sometimes providing information by itself may not be enough. Some borrowers are either not getting or not considering information important to making good choices about debt. One survey found that 28 percent of a sample of first-year college students with federal loans believed that they did not have any federal debt. Only a quarter of students could estimate their debt within 10 percent of the correct amount.<sup>60</sup> In such cases, improve-

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<sup>59</sup> Shahien Nasiripour, "The Federal Government Has No Idea How Much Americans Owe on Student Loans," *Huffington Post*, March 15, 2015.

ments to program design may be needed, especially for programs that have become too complex. Federal student loans offer 56 different repayment options. Some forms of deferred repayment may have tax consequences, others not.<sup>61</sup> The Department of Education lists seven alternatives for repayment (not all of them income-driven): standard, graduated, extended, pay-as-you-earn, revised pay-as-you-earn, income-based, income-contingent, and income-sensitive.<sup>62</sup> Research has shown that, when faced with choices that are too complex or too many, people are more likely to make no choice at all.<sup>63</sup> Programs need to simplify borrower choices (and expand opportunity for counseling borrowers, especially disadvantaged borrowers) to help ensure that information disclosures can have meaningful results.<sup>64</sup> Program simplification also might allow some agencies to become more efficient in their operations.

Combining credit program portfolio data with externally generated data about demographics, income, etc., can help to improve bor-

rower outcomes. For instance, OMB reports that “ERS [the USDA Economic Research Service] is combining administrative data collected by the Rural Business-Cooperative Service (RBS) with business establishment data from the National Establishment Times Series data and other data sources to assess impacts of selected RBS grant and loan programs on rural business survival and growth.”<sup>65</sup> The result of information about outcomes could be programs of consumer awareness or even policymaker consideration of legislation for a streamlined program structure such as economist Susan Dynarski has suggested for the massive federal direct student loan program.<sup>66</sup>

To conduct such analyses, agencies will need to (1) ensure that they are legislatively permitted to gather relevant data and track outcomes, and (2) improve their evaluation capabilities. It would also help for federal loan programs to publish their portfolio data, taking account of privacy concerns, so outside analysts can conduct academic research to shed light on benefits and costs of various program features

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<sup>60</sup> Beth Akers and Matthew M. Chingos, “Are College Students Borrowing Blindly?” Brookings Institution, December 2014.

<sup>61</sup> Jack Remondi, “Navient chief: There are 56 options for repaying federal student loans. It’s time to simplify,” *Washington Post*, August 26, 2016.

<sup>62</sup> <https://studentaid.ed.gov/sa/repay-loans/understand/plans>

<sup>63</sup> Sheena S. Iyengar and Mark R. Lepper, “When Choice Is Demotivating: Can One Desire Too Much of a Good Thing?” *Journal of Personality and Social Psychology* 79, no. 6 (2000): 995–1006.

<sup>64</sup> The Federal student aid program does provide useful information on cost and graduation rates of schools and other factors about price versus value that is likely to be useful for some student borrowers, and especially those from well-educated families. See <https://collegecost.ed.gov/>.

<sup>65</sup> Office of Management and Budget, “Using Administrative and Survey Data to Build Evidence,” white paper submitted to the Commission on Evidence-Based Policymaking, July 15, 2016.

<sup>66</sup> See Susan Dynarski, “An Economist’s Perspective on Student Loans in the United States,” working paper, Brookings Institution, September 2014.

and potential alternatives.<sup>67</sup> Credit agencies also can invite outside analysts into the agency for up to two years, the allowed term for Intergovernmental Personnel Act (IPA) agreements. IPA analysts then are bound by confidentiality rules so that results of their research, when published, can be screened to ensure that privacy of borrowers has been completely protected. The data could also be provided to an academic or other nonprofit organization to establish a publicly available loan performance analytics platform.

#### D. Increase risk-sharing and price credit to improve outcomes

*Policymakers should permit credit program agencies to vary program fees and to share significant risk of default with lenders, other program partners, and borrowers, even if only on a limited experimental basis.*

Risk-sharing can be a valuable way to encourage lenders to make higher quality loans. An illustrative contrast in this regard may come from performance of VA home loans versus FHA insured mortgages. While FHA provides

100 percent insurance of the mortgage, meaning that the lender bears no risk from default, VA provides a 25 percent loan guaranty up to \$36,000, with the lender bearing the remaining risk. The Urban Institute analyzed defaults of the two programs and found that, even holding borrower incomes and credit scores constant, VA loans defaulted at a significantly lower rate. As will be discussed below, there are some differences in administration of the FHA and VA programs. Even so, it seems that lender “skin in the game” can provide a critical incentive to discouraging borrower defaults. It would be good to allow federal programs to vary the amount of risk-sharing with lenders and other private parties (schools in the student loan program) and run experiments to find the optimal amount of risk-sharing that reduces defaults while not discouraging lending to creditworthy borrowers.

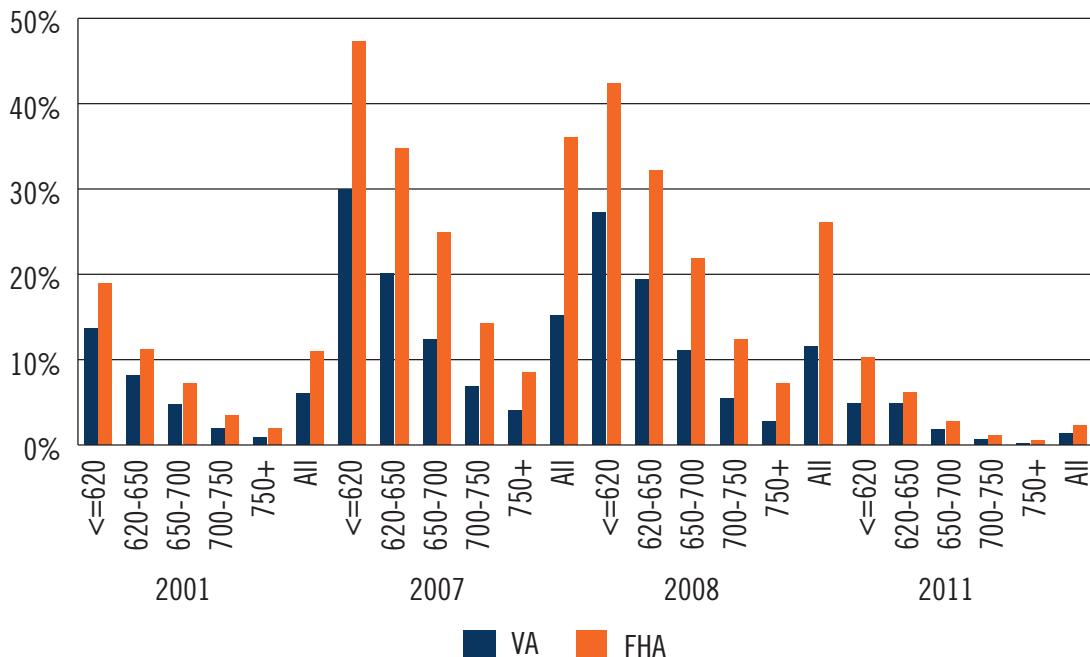
Figure 10, below, based on the report from the Urban Institute, compares default rates for FHA single-family mortgages with those of VA home loans, across a range of FICO scores. The Urban Institute found no appreciable difference between the two samples with respect to loan-to-value ratio and the ratio of mortgage payment to borrower income.

<sup>67</sup> In congressional testimony, Ben Miller of the Center for American Progress recommended: “The first step in fixing data transparency is to create a tool that would allow the public to run its own analytics off the data held in NSLDS [the National Student Loan Data System]. This does not mean giving access to anything close to personally identifiable data. It would look like PowerStats, a tool the Department of Education’s National Center for Education Statistics (NCES) created to let the public run queries off the sample surveys it administers. With it, anyone can generate statistics about the rate at which students borrow, average amounts, and other important data.”

“Building a similar tool for NSLDS could satisfy many research and analysis questions. With it users could answer some of the key questions raised above—what is the longer-term default rate on loans? Do borrowers who use forbearance ultimately repay? What are the risk characteristics in terms of institutions and students most associated with poor loan outcomes? This system would not need to produce results at the institutional level, but would have to generate answers by institution type and major student characteristics. And it could include the same privacy protections—including jail time and fines for those who violate rules—that NCES already established for PowerStats.”

Prepared Statement of Ben Miller, Senior Director, Postsecondary Education, Center for American Progress Before the United States House of Representatives Committee on Oversight and Government Reform, Subcommittee on Government Operations and United States House of Representatives Education and the Workforce Committee Subcommittee on Higher Education and Workforce Training, November 18, 2015, p. 9

**Figure 10. Default Rates of FHA Mortgages and VA Loans, According to FICO Score**



Source: Laurie Goodman, Ellen Seidman, and Jun Zhu, “VA Loans Outperform FHA Loans. Why? And What Can We Learn?” Urban Institute, July 2014.<sup>68</sup>

Another factor for some credit programs relates to pricing levels. Figure 11, below, comes from FHA which, thanks partly to the discipline imposed by the requirement for an annual actuarial report, possesses superior data to many other programs. The variation in level of FHA loan defaults shows how a loan program operates in a financial context that can change rapidly, especially in cases of major financial disruptions such as the financial crisis (the red bars). In today’s constrained budget environment systematic underpricing

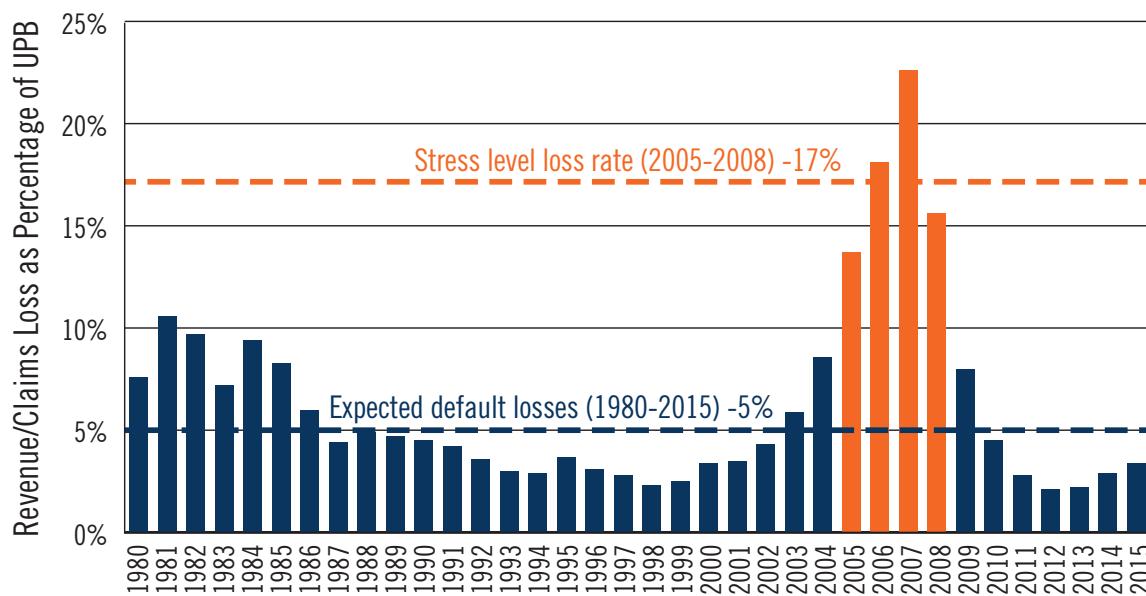
can cause budget problems when the credit cycle changes and favorable economic times end for a program.

By tracking and reporting on the extent that pricing levels reflect actual credit costs over time, an agency can provide important information about how pricing might be adjusted to make a program financially sustainable in bad times as well as good. The FHA approach to tracking pricing vis-à-vis outcomes<sup>69</sup> is something that would benefit all major fed-

<sup>68</sup> The paper did not control for income, LTV, or geography, or payment-to-income (a proxy for debt-to-income). However, they found that only the inclusion of income changed the results, and “VA default rates [were] considerably lower and the largest differences occur[red] in the lower-income/lower-credit score borrowers.” Laurie Goodman, Ellen Seidman, and Jun Zhu, “VA Loans Outperform FHA Loans. Why? And What Can We Learn?” Urban Institute, July 2014, pp. 3-8.

<sup>69</sup> FHA program losses are a useful proxy for defaults and thus borrower outcomes.

**Figure 11. Tracking Program Losses Over Time**



Source: Federal Housing Administration, *Annual Report to Congress: The Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2015*, November 16, 2015, p. 39.

eral credit programs. In addition, the agency can relate pricing levels to program outcomes to help decide how to improve the benefit-cost balance.

Besides pricing levels, credit programs can consider pricing individual loans. The private sector seeks to price for the risk of loans so that high-risk borrowers pay more for a loan than would lower-risk borrowers. The Export-Import Bank of the United States similarly sets loan fees based on the risks of the country to which exports are directed, that

is, the sovereign risk exposure of the loan, as well as financial characteristics of the loan and whether the borrower is sovereign or non-sovereign.<sup>70</sup>

By contrast, major credit programs such as federal student loans and FHA mortgage insurance generally do not price according to risk. While the lack of risk-based pricing traditionally has been seen as virtuous, because disadvantaged borrowers would gain easier access to federal credit, there can be costs in terms of borrower outcomes. Consider again FHA:

<sup>70</sup> Ex-Im rates countries on a 7-point sovereign risk scale. In addition, “The basic sovereign risk exposure fee, i.e., the minimum fee for a country, is determined by five variables: exposure fee level of the country, percentage of cover, the “quality” of product provided, and the length of the drawdown and repayment periods.” Export-Import Bank of the United States, “Exposure Fees,” available at <http://www.exim.gov/tools-for-exporters/exposure-fees/medium-term-indicative-fees>.

“The failure of FHA pricing to reflect risk [creates] a missed opportunity: Variations in insurance costs can prompt households to make sensible decisions. Raising prices to households with a poor credit history who are considering purchasing a house with a low down payment and a high payment-to-income ratio would signal to households that they are making a costly decision...[P]olicymakers should implement risk-based pricing. As much as possible, the FHA should avoid excessive risk layering and charge suitably higher fees to borrowers with low credit scores who want high-LTV loans.”<sup>71</sup>

Here experimentation and pilot programs may be helpful, by testing what kinds of price signals can lead to positive outcomes, such as when a household defers homeownership to accumulate more of a down payment and thereby reduces the chance of defaulting.

### E. Improve outcomes with effective counseling

*Policymakers should authorize agencies to make greater use of credit counseling, especially for disadvantaged borrowers.*

Counseling can prepare vulnerable borrowers to take on debt. A good example comes from the SBA’s disaster loan program. In June 2008 Cedar Rapids, Iowa, suffered the greatest flood in its history, with a crest of 31 feet that inundated 10 square miles of the city. The Cedar Rapids business community came together quickly to develop a coordinated plan to support businesses and assist them to return to operation.<sup>72</sup> Cedar Rapids Small Business Development Centers (SBDCs) counseled small businesses to create business plans to cope with the disruption caused by the disaster.<sup>73</sup> Because a disaster changes the entire context in which a small business operates, business owners can find it hard to develop a business plan that takes account of the locality’s post-disaster circumstances. Following Hurricane Sandy and building on the Cedar Rapids experience, SBA obtained appropriations for SBDCs to provide counseling services. When a small business applies for a disaster loan and is turned down, SBA contacts the applicant suggesting that they consult their local SBDC for assistance with the application and the associated business plan. This counseling has proved valuable in generating a higher percentage of successful loan reapplications, meeting SBA’s credit criteria, by the counseled businesses.

<sup>71</sup> Robert Van Order and Anthony M. Yezer, “FHA: Recent History and Future Prospects,” *Housing Policy Debate*, vol. 24, no. 3, 2014, pp. 644-650, at pp. 648-9. Risk layering is the combination of risks that can result from multiple forms of relaxed standards, such as low down payments (i.e., high loan-to-value ratios, or LTV), high debt-to-income ratios, and low credit scores. The result of risk-layering is a significant increase in likelihood that a borrower will default.

<sup>72</sup> The Cedar Rapids Area Chamber of Commerce, “First Business Case Management Program for a Natural Disaster: Cedar Rapids, Iowa – June 2008 Flood,” January 2012.

<sup>73</sup> The SBA provides funding, oversight, and support to SBDCs to provide small businesses support for their growth and development. SBA also supports the SCORE Association, a nonprofit association of thousands of volunteer members (“Service Corps of Retired Executives”) who are trained to serve as counselors, advisors and mentors to business owners and who played a role in mentoring businesses in Cedar Rapids.

The logic of counseling a disadvantaged borrower before taking out a loan is compelling. For instance, appropriate first-time homebuyers can be counseled to undertake the financial planning and budgeting needed to understand whether they are ready and to prepare them for homeownership.<sup>74</sup> They may also come to understand that they might want to purchase a smaller home than their hearts would desire, so that their loan is sustainable over the long term. If it has the authority, the agency can undertake counseling experiments to determine the most cost-effective way to improve borrower outcomes.

Here too, stakeholder influence plays a role. While students would benefit from learning about the benefits and costs of alternative educational choices, stakeholders have obtained enactment of a law that limits the authority of schools to counsel borrowers who may find themselves taking on more debt than they can handle.<sup>75</sup> Furthermore, federal credit programs will need to specify in contract or regulation which party is obligated to provide counseling

and at what stage in the process. Navient, the largest student loan servicer, for example, has contended in court that it has no obligation to counsel borrowers and that its “role is to collect payments owed by borrowers ... and there is no expectation that the servicer will ‘act in the interest of the consumer.’”<sup>76</sup>

Finally, post-purchase counseling can help moderately delinquent homeowners try to avoid default and foreclosure. Researchers into this approach to improving borrower outcomes argue that, “Efforts to promote homeownership among LMI [low- and moderate-income] households will only succeed if accompanied by measures to control default rates and increase curing rates for borrowers already reaching delinquency.”<sup>77</sup> In other words, by intervening early when a borrower becomes delinquent, programs may be able to prevent the progression from early delinquency to default. This is similar to the precept in student loans that the best way to reduce default rates is to ensure that the student makes the first payment on his or her loan.

<sup>74</sup> A study by Freddie Mac economists, for instance, using data from Freddie Mac’s affordable housing outreach program, shows that prepurchase homeownership counseling could reduce 90-day delinquencies (i.e., defaults) of first-time homebuyers by 29 percent, or an average of \$ 1,000 per originated loan. Gabriela Avila, Hoa Nguyen, and Peter Zorn, “The Benefits of Pre-Purchase Homeownership Counseling,” Freddie Mac Working Paper, April 2013. See also Wei Li, Bing Bai, Laurie Goodman, and Jun Zhu, “NeighborWorks America’s Homeownership Education and Counseling: Who Receives It and Is It Effective?” Urban Institute, September 2016, indicating that the housing counseling program of NeighborWorks reduced defaults of vulnerable homebuyers by an estimated 16 percent. The value of counseling depends in part on the point in the credit cycle (e.g., before or after the financial crisis) of the data being evaluated.

<sup>75</sup> Thus, as a letter from the Department of Education explains, while schools may encourage students to undertake counseling, “An institution may not *require* students to participate in counseling beyond the required entrance counseling for first-time student borrowers as a condition for receiving a Direct Loan, regardless of when or where the earlier counseling occurred.” Office of Federal Student Aid, “Loan Counseling Requirements and Flexibilities,” April 6, 2015, emphasis in original.

<sup>76</sup> “Memorandum of Law In Support Of Defendants’ Motion To Dismiss Plaintiff’s Complaint Under Rule 12(B)(6) or, In The Alternative, For a More Definite Statement Under Rule 12(e),” filed in the case of *Consumer Financial Protection Bureau v. Navient Corporation, et al.*, Civil Action No. 3:CV-17-00101, United States District Court For The Middle District of Pennsylvania, Filed March 24, 2017, pp. 20-21.

<sup>77</sup> Lei Ding, Roberto G. Quercia, and Janneke Ratcliffe, “Post-purchase Counseling and Default Resolutions among Low-and Moderate-Income Borrowers,” *Journal of Real Estate Research*, vol. 30, no. 3, 2008, pp. 315-344. “Curing” occurs when a borrower becomes current on a delinquent loan.

## IV. Recommendations: Improving Program Outcomes

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### A. Anticipate increased resource constraints and their implications for program management and outcomes

*Many credit agencies find themselves in a squeeze between increasing volumes of credit they provide and seriously constrained budgets to administer that credit. Risk-based budgeting is a way for credit agencies to prioritize their resources to protect their core missions and supporting activities; less important activities need then to be jettisoned.*

#### Increased budget pressures

Discretionary spending of the federal government has decreased significantly over the past 20 years, both in real terms and as a percent of GDP and agencies are likely to face continuing reductions in their administrative budgets. Meanwhile, policymakers and program constituencies will increasingly seek to achieve a “zero” or “negative” credit subsidy level so that credit programs can serve more constituents despite budget constraints. Credit pro-

grams continue to grow in volume, with credit managers under pressure to “get the money out the door” before the fiscal year ends.

Unless properly managed, the collision of these two forces—the simultaneous downward pressure on administrative budgets and desire for ongoing program growth—could result in reduced outcomes for some federal credit programs and their borrowers. Some lenders, servicers and other private-sector credit program participants may be able to take advantage of weakened federal oversight and originate or service loans in ways that lead to worse borrower outcomes. Diminished management capacity could lead to growing delinquencies and defaults that could shift credit budgets to a positive subsidy that would require appropriations to fund credit programs in the future.<sup>78</sup> Resource constraints also can obstruct an agency’s ability to perform its mission and serve the most pressing borrower needs. Thus, the Export-Import Bank found itself unable to expand much-needed credit to the small business sector because of its limited number of staff underwriters. This was

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<sup>78</sup> A notable exception is the Federal Direct Student Loan program, which is an entitlement and is funded as a “mandatory” expenditure under the budget rules.

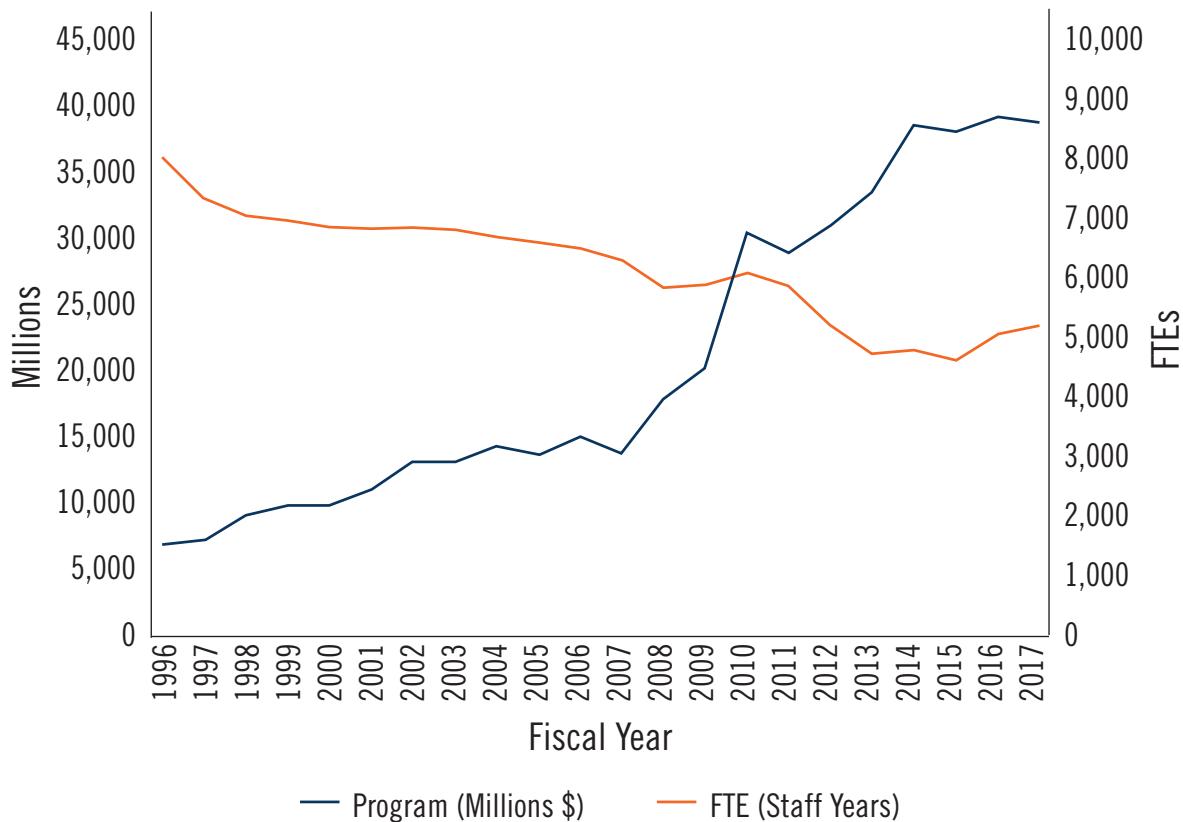
particularly damaging to small businesses seeking to grow after the financial crisis when private lenders had pulled back. Federal credit agencies will need to focus on outcomes to address such adverse scenarios.

Each credit program is different and faces different pressures, risks, and opportunities. Figure 12 below shows the decline in staffing (“FTEs”) at one major federal credit agency, USDA’s Rural Development mission, which

lost about 1,000 people in the last ten years, even as program outlays almost trebled. Other programs and agencies display similar patterns. The current budget climate is likely to exacerbate these trends.

Agencies would be foolhardy if they failed to plan for contingencies that an administrative budget squeeze can cause. One danger is that continuing political conflict over budget priorities could lead to another round of arbitrary

**Figure 12. Program Level vs Staffing (excluding Recovery Act)**



Source: USDA Rural Development, *President’s Budget Justification 2017*, p. 28-15, available at [http://www.obpa.usda.gov/fy17explan\\_notes.html](http://www.obpa.usda.gov/fy17explan_notes.html).

budget reductions, known as sequestration, that the federal government experienced in 2013.<sup>79</sup> Caught by surprise, agencies scrambled to mitigate the impact of sequestration cuts on their workforces. Some agencies offered voluntary buy-outs instead of imposing furloughs or even lay-offs of employees. The cost in too many cases was the departure of experienced managers and staff. Agencies discovered that they had failed to implement succession planning.

Another sequestration, or large-scale departures of seasoned staff for any reason, could seriously affect agency performance. If programs display trends such as in Figure 12, this should be taken as a warning; agencies have only limited time to conduct succession planning and workforce training to ensure that key positions continue to be occupied by knowledgeable and capable people. Human capital losses also will occur as increasing numbers of employees reach retirement age and leave the agency. This can have a cascading effect that could lead to increased default rates (or other problems) and consequent increases in credit subsidy requirements and even policymaker loss of confidence in particular programs.

Managers need to monitor staffing levels against workload trends and other indicators such as Information Technology (IT) bud-

gets and Salary and Expense (“S&E”) budget trends. The first step is to publish and respond to annual trends in workload versus agency staff size. Agencies must constantly review their ways of doing business to ensure that they are protecting their core missions while possibly sacrificing less important activities to their budget shortfalls. As with other federal programs, credit agency managers must anticipate these questions.

### Risk-based budgeting

One approach agencies should consider adopting is risk-based budgeting. Instead of the frequent practice of simply allocating cuts pro rata across activities, agencies will need to categorize their activities: (1) those prescribed by law or that otherwise are essential to carrying out the agency’s core mission, (2) those to sustain agency capabilities long term, (3) those of special value to important constituencies, and (4) those that would be valuable if funds are available. Cuts then can be allocated to protect the first two categories, applying most cuts to the fourth, to the extent necessary and politically feasible. Agencies often may need to obtain clearance from OMB and the relevant appropriations subcommittees to obtain optimal benefits from this approach.<sup>80</sup>

<sup>79</sup> See, US Government Accountability Office, “2013 Sequestration: Agencies Reduced Some Services and Investments, While Taking Certain Actions to Mitigate Effects,” GAO-14-244, March 2014.

<sup>80</sup> See, e.g., Thomas H. Stanton, “Risk Management and the Dynamics of Budget Cuts,” chapter 10 of Thomas H. Stanton and Douglas W. Webster, eds., *Managing Risk and Uncertainty: A Guide for Government Decision Makers* (John Wiley & Sons, Inc., 2014); and, for an excellent analysis of risk-based budgeting in the private sector context, “Cut Costs to Grow Stronger,” chapter 5 of Paul Leinwand and Cesare Mainardi, *Strategy That Works: How Winning Companies Close the Strategy-Execution Gap* (Harvard Business Review Press, 2016).

Only a few agencies have undertaken risk-based budgeting. The Office of Federal Student Aid (FSA) is a leader in this regard. Over a decade ago FSA created an Investment Committee, now the Investment Review Board (IRB), chaired by the Chief Operating Officer (the chief executive of FSA) and attended by senior FSA managers, to make investment decisions more systematically. The IRB hears requests for approval to spend money that has already been budgeted for the fiscal year. The FSA strategic plan includes metrics for each strategic goal, and the IRB reviews the status of each ongoing project and maintains scorecards for each approved project. Following a review, the IRB might allocate support to a troubled project or otherwise help project managers to deal with problems in a proactive way.

The role of the IRB has grown over time. The board now reviews and prioritizes all of FSA's appropriated funds. Along with the investment portfolio, budget allocations for staffing get

especially close attention. The IRB currently reviews about 30 budget line items and about 100 investments. To assist the IRB in decision making, the Office of Chief Financial Officer (CFO) produces roughly 70 scenarios of the investment portfolio. Many of these are updates reflecting baseline change requests that have the effect of increasing the funding level for some investments while decreasing others. Decisions are based on risk. The CFO's office prepares explanations of the risks of budget shortfalls, compared to the president's requested budget, so that congressional committees can make informed decisions about the level of funding to appropriate.<sup>81</sup>

Another example of a risk-based budget approach comes from the Government Accountability Office (GAO), which proactively worked to prepare for upcoming budget cuts in a short period. The leadership set forth two principles to shrink its budget: (1) Maintain at all costs the quality of work product;

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<sup>81</sup> For instance, the FSA FY 2016 *Annual Report* provides seven examples of risks that could result from substantial budget cuts that the Congress was considering: "... even a small variation in any of FSA's volumes can significantly impact its budget. This places all other expenditures and plans associated with those expenditures at risk. This risk must be managed as long as the federal government pays for mandatory Direct Loan expenditures using discretionary administration funding. As of the end of this fiscal year, the House and Senate are proposing to fund Student Aid Administration loan-servicing activities at \$855 million, \$44 million short of the level proposed in the FY 2017 President's Budget. In addition, the anticipated FY 2017 costs of loan servicing have increased... In total, these changes will result in a \$61 million loan servicing budget shortfall that must be cut from other operations, given the risky budgeting process. These cuts would have devastating impacts on the operations of Federal Student Aid. A few examples are listed below:

- Increases the likelihood of a data breach or system intrusion, which would place personally identifiable information of over 130 million students and borrowers at risk;
- Increases the risk of school oversight failures and limits the ability to address school oversight challenges for over 6,000 schools;
- Decreases ability to provide loan servicing oversight necessary to protect over 42 million borrowers and limits the ability to address contractor oversight and system implementation issues;
- Increases the risk of a systems infrastructure failure and limits the ability to manage system change, which would jeopardize the delivery of over \$125.7 billion of aid annually;
- Decreases transparency to the public and limits the ability to support policy decisions with data;
- Decreases the outreach and awareness efforts to tens of thousands of students that are most in need of assistance."
- Eliminates plans to address thousands of Office of Inspector General (OIG) fraud referrals."

*FSA Annual Report FY 2016*, pp. 49-50.

and (2) have the least possible impact on the available work force. Applying these principles led to important decisions about priorities. Maintaining product quality meant reducing the number of reports done each year. GAO worked closely with its congressional clients to ensure agreement on congressional priorities for its work. With respect to the second principle, the GAO decided not to close field offices. Instead it instituted a major telework program for its employees. This reduced overhead costs substantially, and especially rent costs, achieving cost savings without sacrificing quality.

### Activity-based costing

One valuable tool for identifying and achieving resource savings is activity-based costing, which identifies costs of each major activity. In the late 1990s SBA faced a set of staffing and program output trends more severe than those in Figure 7. Under pressure from shrinking staffing resources, SBA commissioned a cost allocation study, which was a slimmed-down version of activity-based costing. The analysis revealed that SBA staff spent excessive time trying to manage nonperforming loans. Further investigation showed that this work yielded few results and insufficient returns to justify the allocation of staff.

Once it made this diagnosis, SBA changed regulations governing its Section 7(a) business loan program to require lenders to liquidate defaulted loans rather than (as had been the case until then) simply putting nonperforming loans

back to SBA for resolution. Then, to deal with nonperforming loans still on its books, SBA engaged in sales of billions of dollars of those loans to private companies for collection under contractual guidelines to ensure borrower protections against unfair practices. That way SBA could free up large numbers of staff, especially in field offices, to engage in more productive mission activities such as promoting SBA loans to small businesses and lenders.<sup>82</sup> These actions were prudent: while SBA had almost 4,000 staff (so-called FTEs) in 1988, this had dropped to just over 3,000 by 1996 and today stands at just over 1,900. The experiences of SBA and other agencies with asset sales also shows how well-designed objectives can help to ensure that borrower outcomes are respected when a loan is sold; purchasers of the loans were held to high standards of fair treatment of delinquent or defaulted borrowers.

In today's constrained resource environment, agencies similarly can benefit from cost allocation analysis to explore where they might change business processes to diminish or end less productive activities in favor of those more central to the agency's mission. Again, consultation with stakeholders and policymakers is needed to make the case for change.

### Enterprise Risk Management

Another powerful management tool is Enterprise Risk Management (ERM). Reduced to its basic elements, ERM allows agencies to ask and respond to the question: "What are the

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<sup>82</sup> See, e.g., Thomas H. Stanton, "Lessons Learned: Obtaining Value from Federal Asset Sales," *Public Budgeting & Finance*, Spring 2003.

risks that could prevent our organization from achieving its mission and objectives (including risks of missing a major opportunity or standing still while the world changes)?” Rather than distracting top management with a myriad of small risks, ERM seeks to improve the flow of information up and down the hierarchy and across business units and with stakeholders so that top managers have a good picture of major risks and rewards when they make decisions.<sup>83</sup>

Enterprise Risk Management allows agencies to consider risks beyond those, such as credit risk or counterparty risk, that they already anticipate. By eliciting information from across the agency and from stakeholders, the risk office can identify a range of risks that a risk committee, often the top management of the agency sitting as a risk committee, can deliberate in a process of constructive dialogue and then prioritize. Risks can be accepted, avoided, reduced, or shared. Prioritizing risks allows an agency to allocate its scarce resources (dollars, staffing, management attention) to address the greatest risks facing the organization. The risk officer facilitates identification, analysis, prioritization and deliberations about how best to address risks, while each manager owns the risks inherent in his or her operation. Focusing on major risks allows an agency to consider risk-reward tradeoffs in its activities. Credit agencies frequently extend credit to borrowers that the private sector considers too risky to serve; what is important is for the agency to understand the

amount of risk it is taking and to make a considered decision whether the results are within an acceptable range.

Effective execution of Enterprise Risk Management becomes especially important during times of budget uncertainty and constraints. The core question of ERM changes from asking, “What are the major risks that could prevent our organization from achieving its mission and objectives,” to asking, “As we refocus our mission to operate with a significantly reduced budget, what are the major risks that could prevent our agency from accomplishing its mission and objectives?”

Resources are increasingly available for agencies, including an excellent *ERM Playbook* and the Association for Federal Enterprise Risk Management (AFERM), a growing community of practice that offers online training and a network of people from organizations at various stages of ERM implementation who can help share experiences and approaches to practicing ERM effectively.<sup>84</sup>

## B. Improve budgeting for credit administration

*Policymakers in both executive and legislative branches should revise credit budget rules to require inclusion of administrative expense funding in credit program subsidy costs. This would create an incentive for federal agen-*

<sup>83</sup> OMB Circular A-123, “Management’s Responsibility for Enterprise Risk Management and Internal Control,” released July 15, 2016; Thomas H. Stanton and Douglas W. Webster, eds., *Managing Risk and Performance: A Guide for Government Decision Makers* (John Wiley & Sons, 2014); and Thomas H. Stanton, *An Agency Guide for ERM Implementation*, Association of Government Accountants, 2017.

<sup>84</sup> The *Playbook* and other resources are available without charge on the AFERM website, [www.AFERM.org](http://www.AFERM.org).

*cies to make cost-effective investments in staff, systems, and processes, if these could be offset by savings from lower defaults.*

The Federal Credit Reform Act was incomplete in that it did not include in the cost of credit programs the resources used to administer these programs. This places credit programs in a bind: the quality of credit a program provides, both in terms of precision of targeting and minimization of default, depends in part on the quantity and quality of available staff and other resources. Delinking administrative costs from credit subsidies means that default-aversion measures, such as counseling or improved servicing or stronger lender oversight that cost program resources, cannot be offset by budget savings from reducing defaults. Separating administrative from budget costs also leads to the risks, discussed above, of too few resources allocated to managing too much credit.

The budget separation also means that the “credit subsidy” appropriation pays for only a portion of the actual cost to the federal taxpayers of extending credit to intended beneficiaries. In this respect, it seems misleading to say that a credit program conveys a zero or negative subsidy. If administrative expenses were included in the subsidy calculation, programs would need to charge higher interest rates or raise fees and premiums if policymakers choose to ensure that taxpayers are not “subsidizing” a particular credit support

program of the federal government. Also, having program beneficiaries pay for administrative expenses could provide relief for credit programs from restraints on discretionary spending that undermine good program management practices.

This shortcoming in the FCRA methodology also means that direct loans are priced more advantageously to borrowers than guaranteed loans. That is because loan guarantees are administered by private lenders, who typically set interest rates and fees on borrowers sufficient to cover their costs. Meanwhile, direct loans are administered by federal agencies, so their full administrative costs are paid as part of agency overhead expenses and not charged to the borrower.

While not all issues of credit budgeting are susceptible of being addressed easily, it seems appropriate to revisit the separation of administrative costs from the credit subsidy appropriation. When the federal government extends credit support, it can be pennywise and pound foolish to skimp on the costs of oversight. If a program is to be successful, the federal government needs to retain capacity to ensure that, on balance, the credit is repaid. The trend of ever-increasing volumes of federal credit outstanding and oversight by increasingly constrained agencies will lead inexorably to greater costs than if adequate oversight had been maintained. It is time to combine administrative costs with credit subsidy budgets.<sup>85</sup>

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<sup>85</sup> Another important issue for federal credit programs in the budget process concerns the discount rate used to calculate credit subsidies. FCRA requires that the Treasury interest rates for comparable periods be used to make such subsidy calculations. The Congressional Budget Office and others have suggested that the more appropriate methodology would employ market risk adjusted, or “fair value,” interest rates. For a discussion of this issue, see the accompanying chapter on “Credit Programs and the Federal Budget Process.”

### C. Improve program evaluation

*Especially at a time of resource constraints, it can be cost-effective for credit agencies to dedicate a small amount of resources to program evaluation. This can help policy makers and managers to target credit programs to achieve the most beneficial outcomes for taxpayers and borrowers.*

It makes sense, even at a time of resource constraints, for agencies to spend some resources on evaluating how well they are improving the lives of people and enterprises they are trying to serve. Here the US Department of Labor provides a good model. Working with congressional leaders, the department established its office of evaluation in 2010, to:

“(1) build evaluation capacity and expertise in the Department; (2) ensure high standards in evaluations undertaken by, or funded by the Department of Labor; (3) facilitate the use of evaluation and research findings for performance management priorities; (4) ensure the independence of the evaluation and research functions; and (5) make sure that evaluation and research findings are available and accessible in a timely and user-friendly way, so they inform policymakers, program managers, and the public. To further these goals, the Department of Labor is also building partnerships with the academic community

and other outside parties to leverage private-sector research expertise.”<sup>86</sup>

From the 2012 fiscal year to the 2015 fiscal year Congress authorized the department to set aside a small amount, up to half of a percent (0.5 percent) of operating agency budgets, for the department’s program evaluations and, in 2016 increased the allocation to up to three-quarters of a percent (0.75 percent).<sup>87</sup> That amounted to about \$ 8 million in 2016, and the percentages, for a major credit program such as FHA, SBA, or federal student loans, would seem to be a reasonable investment.

The department adopted three principles for its evaluation work:

“1) prioritize studies that focus on measuring the effectiveness of key program outputs and outcomes consistent with the overall Departmental Strategic Plan and the agency Operating Plans; 2) encourage the most rigorous evaluation designs possible, particularly experimental designs, but in a manner that is realistic given the programmatic missions/goals, programmatic maturity, data availability, and analytic capability; and 3) expand the knowledge, capacity, value, and understanding of high quality evaluation designs and methods department-wide. All evaluations are related to the Strategic Plan, statutory requirements, or emerging departmental priorities.”<sup>88</sup>

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<sup>86</sup> U.S. Department of Labor, FY 2016 Congressional Budget Justification: Departmental Management, p. DM-111.

<sup>87</sup> Andrew Feldman, “Strengthening Results-Focused Government: Strategies to Build on Bipartisan Progress in Evidence-Based Policy,” Brookings Institution, January 2017, p 42.

<sup>88</sup> U.S. Department of Labor, FY 2016 Congressional Budget Justification: Departmental Management, p. DM-113.

For federal credit agencies, creating—or enhancing an existing—evaluation capability would help to ensure a focus on program outcomes and not merely the volume of credit that a program provides. Strong evaluation offices with skilled staffs can gather and analyze information about program outcomes, including analysis of the impact of a program on the least advantaged borrowers at the bottom of the credit box. Such offices should publish results and make recommendations for improving outcomes. Recommendations would go to the agency leadership, or, when new authority may be required, to Congress. By generating data, good evaluation offices can help inform both program management and policymakers about the benefits and costs of program alternatives.

Maintaining a focused program requires that an agency obtain useful and well-supported feedback about what its program is accomplishing. Independent evaluation offices can focus upon outcome measures, rather than mere outputs such as the volume of credit that an agency extends each year. The most useful evaluations relate to variables that an agency by law may adjust, either directly or indirectly. For some agencies, these may include factors relating to creditworthiness of the borrower and the loan, ancillary services such as counseling, and pricing.

It is inevitable that some borrowers will not succeed. As noted above, program managers and policymakers must decide how much risk of failure they are willing to accept. Independent evaluation offices can provide information and make recommendations to improve borrower outcomes by using all the tools of government, not just credit. For instance, their recommendations might give attention in deliberations on where to draw the line in an appropriations bill between rent vouchers and homeownership credit, especially for people with reduced capacity to bear the debt burden of homeownership.<sup>89</sup> Similarly, for the federal student loan program, rigorous evaluations could contribute to decisions on seeking funding for Pell Grants instead of student loans to better aid certain borrowers with an unacceptably high propensity to default. Or Community Development Block Grants may be able to provide disaster grant assistance for businesses that do not qualify for an SBA disaster loan, although this would require coordination across agencies. Other tradeoffs also may be possible, such as expanding the volume of multifamily mortgage insurance so that greater numbers of disadvantaged households might become renters, rather than hazarding the possibilities of indebted homeownership.

In sum, having evaluation offices with sufficient staff and resources to conduct ongoing

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<sup>89</sup> Thus, scholars from the Harvard Joint Housing Center advocate a “tenure-neutral” approach to policy, where the goal of quality, affordable housing drives the question of which form of assistance is most appropriate. Christopher E. Herbert, Daniel T. McCue, and Rocio Sanchez-Moyano, “Is Homeownership Still an Effective Means of Building Wealth for Low-income and Minority Households? (Was it Ever?)”, Joint Center for Housing Studies, Harvard University, Chapter 2 in Eric S. Belsky, *Homeownership Built to Last: Balancing Access, Affordability, and Risk after the Housing Crisis*, Brookings Institution Press, 2014. As discussed earlier, the problem with the other tools is that credit budgeting—as presently practiced—may make federal credit appear relatively more attractive from a budget perspective than grants, vouchers or tax expenditures to achieve similar policy ends.

rigorous analyses of federal credit programs is a critical element in helping to limit the damage that can be caused by excessive lending. In addition, it seems likely that ensuring that agencies have a strong credit program evaluation capacity could prove cost-effective not only in improving the value of credit programs for borrowers, but also by developing approaches to averting borrower defaults that save taxpayers money.

#### D. Increase experimentation and pilot projects to improve borrower benefits vs. costs

*Experiments and pilot programs are another way for credit agencies to focus their efforts on achieving the most beneficial results. Technology is changing lending practices so rapidly that agencies need to experiment with potentially cost-effective innovations. Experimentation and pilot programs will require a change in mind-set for some programs and possibly an increase in authority.*

Federal credit agencies show an impressive ability to recognize and, when permitted, to implement significant program innovations. Ideally, a credit agency would conduct regular experiments and pilot programs to determine how best to focus its credit programs as markets and public priorities evolve. There would be a continuing cycle of lending-measuring outcomes-revising-and again lending. However, the way that policymakers and private

stakeholders become accustomed to a particular pattern of federal involvement means that federal credit programs may become much less nimble than their private-sector counterparts. As Sarah Wartell of the Urban Institute, and a former FHA official, has testified, FHA has difficulty engaging in demonstration projects:

“...FHA tends to adopt new programs or program changes for its entire portfolio. There are exceptions, of course. FHA did begin to pilot note sales before expanding the program. But too often, unlike private-market participants that will try out a new business practice or insure a small portfolio and test performance before applying a strategy to the whole business, the statutory and regulatory environment for FHA leads to “all or nothing” policy changes. The length of the administrative procedures required also leads to full implementation rather than testing, because an evolutionary or phased change strategy would require iterative regulatory changes and sap so much administrative energy. These practices inherently increase risks to the Fund because new policies go into effect without enough evidence of their likely impact.”<sup>90</sup>

Stakeholder influence also plays a role in the lack of sufficient agency pilot projects and agency inertia more generally. In 2014 FHA proposed a pilot program of expanded housing counseling and providing incentives in the form of lowered mortgage insurance premiums for less credit-

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<sup>90</sup> Written Testimony of Sarah Rosen Wartell, President, Urban Institute, before the House Financial Services Committee Subcommittee on Housing and Insurance, April 10, 2013, p. 8

worthy borrowers who, with counseling, might lower their chances of default.<sup>91</sup> Congress declined to fund the proposal, effectively killing it. Among concerns that stakeholders expressed was that the pilot, and especially incentives for borrowers, would cost too much and would require an increase in already uncompetitive FHA fees.<sup>92</sup> Congress similarly rebuffed an initiative of the SBA proposing to shift funding away from small-business training programs to fund advanced training to encourage growth of slightly larger companies, those with the potential but not necessarily the expertise to accelerate hiring and add new revenue streams. While SBA contended that the new program would generate greater economic growth than the current program, Congress declined to approve the change.<sup>93</sup>

The Office of Federal Student Aid appears to be more active than other programs in developing pilot programs and experiments. One example is a joint program between FSA and the Treasury to test new forms of loan collec-

tion.<sup>94</sup> Another is a pilot program to assess the effectiveness of providing credit to selected partnerships between innovative postsecondary institutions and non-traditional sources of education such as online programs and intensive “boot camps” for disadvantaged students.<sup>95</sup>

FSA also is actively engaged in experimentation through its Office of Customer Experience in collaboration with a behavioral research group at the General Services Administration (GSA). Experiments focus on students transitioning to make their first loan repayments, struggling borrowers, and borrowers needing assistance to find good options in selecting a loan repayment plan. The experiments generally involve providing e-mail communication with one group of borrowers but not to a control group and then measuring the difference in responses. Experiments may include pools of several hundred thousand borrowers. The experiments generally seek to implement aspects of the Student Aid Bill of Rights issued by the White House in 2015.<sup>96</sup>

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<sup>91</sup> FHA, “Blueprint for Access: What FHA is Doing to Expand Access to Mortgage Credit for Underserved Borrowers,” 2014. The blueprint pointed to research showing significantly reduced default rates for borrowers, and especially first-time borrowers if they first receive counseling; see also US Department of Housing and Urban Development, Federal Housing Administration (FHA), “Homeowners Armed With Knowledge (HAWK) for New Homebuyers,” Notice, *Federal Register*, Vol. 79, No. 94, May 15, 2014.

<sup>92</sup> Ben Lane, “Congressional budget bill kills HUD homeowner assistance program; HAWK [Homeowners Armed with Knowledge] program designed to offer savings on FHA-insured loans,” *Housingwire*, December 17, 2014.

<sup>93</sup> See, e.g., J.D. Harrison, “House committee rips SBA for unauthorized pilot programs, contracting woes,” *Washington Post*, March 26, 2014; and J.D. Harrison, “SBA shifting funding away from small-business training programs, draws fire from Congress,” *Washington Post*, May 8, 2013.

<sup>94</sup> David Lebryk, Treasury Fiscal Assistant Secretary, “Working to Achieve Better Outcomes for Student Loan Borrowers,” *Treasury Notes*, February 11, 2016; David Lebryk, “An Update on the Fiscal-Federal Student Aid Pilot for Servicing Defaulted Student Loan Debt,” *Treasury Notes*, July 1, 2016.

<sup>95</sup> U.S. Department of Education, “FACT SHEET: Department of Education Launches the Educational Quality through Innovative Partnerships (EQUIP) Experiment to Provide Low-Income Students with Access to New Models of Education and Training,” October 14, 2015.

<sup>96</sup> See, White House, “FACT SHEET: A Student Aid Bill of Rights: Taking Action to Ensure Strong Consumer Protections for Student Loan Borrowers,” March 10, 2015. The five elements of the Student Aid Bill of Rights are: Every student deserves access to a quality, affordable education at a college that’s cutting costs and increasing learning. Every student should be able to access the resources needed to pay for college. Every borrower has the right to an affordable repayment plan. And every borrower has the right to quality customer service, reliable information, and fair treatment, even if they struggle to repay their loans.

For homeownership, FHA may find it helpful to adopt some administrative features from the VA home loan program. As noted earlier, Urban Institute researchers have found that VA loans perform better than FHA loans.<sup>97</sup> Besides the matter of loan-to-value ratios discussed earlier, they also point to a “residual income test” that VA, but not FHA, applies to check on the borrower’s ability to pay for ordinary living expenses—such as food, clothing, transportation, and medical expenses—besides making mortgage payments and paying for the other costs of homeownership. The difference between FHA and VA borrower outcomes would seem to pose an ideal opportunity for an FHA pilot program to test whether to adopt the residual income test.

Two other differences between the FHA and VA programs also offer opportunities for useful pilot programs. One relates to risk-sharing with lenders between the two programs, discussed earlier. The other opportunity relates to servicing troubled loans, where VA practices appear superior to those of the FHA program.<sup>98</sup>

In one area—technical improvements—it seems possible for agencies to make substantial gains in program performance. One outstanding example from SBA is called SBA One, launched in March 2015. SBA One is an automated lending platform to streamline the process for lenders participating in the SBA guaranteed loan program. The platform as-

sists lenders with a broad range of capabilities from determining SBA loan eligibility to closing loans. Likened by some to a “TurboTax for SBA Lenders” the platform simplifies participation in the SBA program for smaller lenders who might otherwise be deterred by the formalities of the SBA loan origination process. The platform has processed some 5,000 loans to this point and now will be deployed to reach out to some 8-10,000 smaller lenders who do not currently offer SBA loans to their small business customers. Since the initial launch, SBA has made numerous system improvements in response to input from lenders.

Especially at a time of budget constraints on program administration, new program initiatives will be necessary. Private credit markets are increasingly fluid, and credit programs need well-designed program initiatives to remain focused on the “sweet spot” of favorable outcomes for borrowers. Business management guru Peter F. Drucker long ago described the idea of staying focused in terms of two budgets, one to maintain the current business, amounting to perhaps 80-90 percent of spending, and the second “budget for the future” to be maintained in bad times as well as good. The budget for the future funds new products and services and technologies and also activities such as outreach that can help build on the organization’s successes.<sup>99</sup> Much more than private companies, federal credit agencies will need to consult stakeholders and policymakers to make the case for the types of

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<sup>97</sup> Laurie Goodman, Ellen Seidman, and Jun Zhu, “VA Loans Outperform FHA Loans. Why? And What Can We Learn?” Urban Institute, July 2014.

<sup>98</sup> Ibid.

<sup>99</sup> Peter F. Drucker, *Management Challenges for the Twenty-First Century*, HarperCollins 1999, pp. 88-89.

pilot program or new activity the agency may initiate. But the opposite posture —standing still—can leave agencies and their programs less capable of managing their programs as constituents, particularly borrowers, evolve in their needs.

## V. Providing Support to Agencies for Improved Credit Outcomes

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### A. Promote sharing of promising practices among credit agencies

*OMB and Treasury have important contributions to make in strengthening federal credit programs. Agencies show leadership in different management practices and OMB and Treasury can encourage sharing of these practices. Treasury can also become an advocate for shared services across programs to help conserve scarce resources. The Federal Credit Policy Council can be strengthened as a forum for exchange of information about promising practices.*

Different credit agencies have adopted different best practices to manage their programs. Central government organizations such as the Treasury and OMB and recently the GSA behavioral research team can make important contributions in facilitating the sharing of these practices among credit programs. Many years ago, OMB dedicated a senior executive to assist in improving federal credit programs. The official worked with John Koskinen, then OMB Deputy Director for Management, to create and manage a Federal Credit Policy Working Group (FCPWG). The FCPWG pro-

vided a roundtable forum for federal credit agencies to meet in a non-threatening environment to exchange views and also share experiences and learn from one another. In 1996 OMB worked with the Financial Management Service of the Treasury Department to hold a three-day conference on promising practices of federal credit agencies. The conference and related work helped to shape a multi-year OMB agenda for strengthening financial soundness and sustainability of federal loan and loan guarantee programs, showing the benefit of a central organization such as OMB using its authority and ability to convene officials from multiple agencies to achieve substantial program improvements.

Towards the end of the George W. Bush Administration, OMB again undertook to use its influence to improve management of federal loan and loan guarantee programs. OMB developed a credit program scorecard that measured an agency's progress on a red-yellow-green scale. OMB then arranged for interviews with federal credit agencies to determine how their programs scored on issues such as program focus, and how programs originated and serviced loans, managed their

portfolios, and collected debt. Of interest is the way that OMB shifted emphasis, from providing support at the time of the FCPWG to exercising more of an oversight role a decade later.

This experience suggests a question that is likely to be in the minds of each credit agency. That is whether Treasury and OMB are offering to assist with management improvements or seeking to prescribe policy direction and reduce budget impacts of credit programs. The two roles can conflict and role definition will be essential to make each role work, especially the supporting role.

The Treasury can make an important contribution in encouraging shared services across credit programs. There is a Treasury unit from the Office of Financial Stability that performed well in developing credit subsidy models to score the Troubled Asset Relief Program (TARP) program for budget purposes.<sup>100</sup> With TARP winding down, that office has become a shared service provider, assisting other credit programs to create the credit subsidy models that they need to score their operations. When agencies contract with the office for its consulting services, the office commits that it will operate in a supporting role. For instance, the agency rather than the TARP team remains in charge of the agency's data. This allows agencies to use the office without concern that, because it is in Treasury, it will usurp a policy role in addition to the support that it provides.

Treasury still must decide whether it seeks to exercise an oversight function for federal credit programs or play a more supportive role. In interviews the authors of this report learned that even the excellent Treasury TARP team, which has helped a number of agencies with their credit budgeting, has run into this difficulty. Some credit agencies apparently shy away from seeking support from the TARP team, for fear that they would also be inviting Treasury to weigh in on credit policy, and that Treasury would tell them how to conduct their business instead of just providing technical help.

OMB and Treasury can find a number of possible solutions. One traditional solution is to separate roles into separate organizations. For instance, Treasury might play a supportive role through the former Financial Management Service (now folded into the Treasury's Fiscal Service), while exercising a supervisory function through Domestic Finance. Alternatively, particular officials at Treasury might articulate that they will play a supportive rather than supervisory role. Treasury's Chief Risk Officer appears to have addressed this issue and has helped Treasury to make a significant contribution to promoting Enterprise Risk Management in the federal government, and among federal credit agencies in particular.

Treasury has now encouraged creation of a Federal Credit Policy Council (FCPC), hosted by several individual credit agencies in rotation, to help credit agencies to work on common prob-

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<sup>100</sup> Under the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), TARP (the “Troubled Asset Relief Program”) allowed the Treasury to purchase or insure up to \$700 billion of financial assets to help banks and other institutions weather the financial crisis.

lems, share promising practices, and provide a collaborative and confidential forum where credit managers can ask one another about management problems and possible solutions.

The Federal Credit Policy Council then would seem similar to the federal Chief Financial Officers (CFO) Council, the federal Performance Improvement Council, or the Council of Inspectors General on Integrity and Efficiency (CIGIE). Those councils work because of the common roles of the participants who are CFOs, Performance Improvement Officers, or Inspectors General, respectively. By contrast—absent hands-on leadership from a senior OMB or Treasury official—it has proved more difficult to assemble credit program officials, who may be program managers or budget officials, into a coherent group. Nevertheless, a reinvigorated FCPC that meets regularly could make important contributions to improving program outcomes and management and address many of the issues that this report has raised.

### **B. Help credit agencies legislatively to improve data, analysis of outcomes, and program performance**

*The most important value that Treasury and OMB can add to federal credit programs is to support cross-cutting legislation to create a framework that provides agencies authority to collect and evaluate outcome-related information, engage in experimentation and pilot programs, and improve oversight of lenders and other program partners.*

Treasury and OMB also can help agencies to develop effective—and cost-effective—evaluation strategies. These could include developing appropriate outcome and program performance measures, fashioning the most important research questions to be answered with available data, helping coordinate credit program access to data at the Census Bureau and at other government agencies to shed light on outcomes, and sharing approaches to ensuring appropriate rigor in evaluations so that policy makers can confidently rely on the evaluation results.

This report has made recommendations for improving the performance and evaluation of federal credit programs. Congress and program stakeholders may not be immediately receptive to many of them, especially those that would overturn already established rules and policies. The individual credit program agency officials should not have to shoulder this mission by themselves. Administration leadership should come from the White House, Treasury, and OMB as well.

In particular, Treasury and OMB need to support federal credit agencies through the legislative process. This report has flagged many ways that stakeholders have affected legislation or exerted other influence that impedes achieving better outcomes and in some cases even precludes development of information to measure outcomes. In contrast to individual credit agencies, Treasury and OMB are ideally positioned to work with key congressional committees—the congressional budget committees, governmental affairs committees, and House Ways and Means Commit-

tee—to overcome influence of stakeholders that sometimes may influence the specialized congressional authorizing committees and appropriations subcommittees to take steps that impair credit program outcomes. In contrast to specialized committees and subcommittees (those serving specialized areas such as agriculture, education, and housing, for example), the budget and governmental affairs committees and House Ways and Means take a broader view across government. Thus, for example, the budget committees led enactment of the Federal Credit Reform Act, and the governmental affairs committees led enactment of the Government Performance and Results Act, while Ways and Means drove improvements in oversight of Government-Sponsored Enterprises (GSEs).

Treasury and OMB could work with the budget committees to require improved credit program information by focusing on outcomes, perhaps starting with a required actuarial study for major credit programs. They could work with the governmental affairs committees to require programs to analyze and track outcomes,<sup>101</sup> including by combining datasets in a privacy-protected way with other government agencies, such as IRS and the Social Security Administration. Only the non-specialized committees, prompted by Treasury and OMB, may be able to overcome the way that some stakeholders have impeded even the development of suitable information to measure outcomes in a systematic way.

<sup>101</sup> The Government Performance and Results Act already requires agencies to include “outcome-oriented goals” in their strategic plans. 5 U.S.C. 306(b).

## VI. Improving Borrower Outcomes: An Action Plan

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The transition from volume to a focus on outcomes will require action from many players.

### Federal Credit Agencies:

1. Assess the extent that your agency has access to information about borrower outcomes, starting with defaults and moving to other outcome measures.
2. Strengthen or build the agency's evaluation capabilities; develop appropriate outcome measures for each program.
3. Examine the riskiest loan that each program makes: what are the benefits to successful borrowers vs. costs to those that default?
4. Use available authority to adjust credit standards to ensure that on balance program benefits are positive, while protecting borrowers from taking on too much debt.
5. Examine the quality of oversight of lenders and other program partners; learn from other agencies whether cost-effective improvements can be made.
6. Explore whether the agency has authority to apply risk-based pricing and increased risk-sharing with lenders and

other program partners; apply these in pilot programs or across the board.

7. Explore possibilities for including borrower counseling where it can be made cost-effective.
8. Use available authority to increase experimentation and pilot programs, both to stay abreast of developments in the credit markets and to improve borrower outcomes.
9. Plan for increasing resource constraints; apply risk-based budgeting to help set agency priorities.
10. Seek additional authority to engage in activities to improve agency cost-effectiveness without diminishing borrower outcomes.

### Treasury:

1. Work with credit agencies to develop a template and seek authority for agencies to collect and evaluate outcome-related information, engage in experimentation and pilot programs, and improve oversight of lenders and other program partners.
2. Support credit agency shared services.

**OMB:**

1. Work with agencies to implement risk-based budgeting to protect core missions and activities at a time of diminished budget resources.
2. Work with agencies to seek legislative changes that reduce administrative burdens in a cost-effective way. Seek authority selectively to remove restrictions on budget accounts so that agencies can undertake cost-effective redeployment of scarce budget resources.

**Treasury and OMB:**

1. Continue strengthening the Federal Credit Policy Council as an effective forum for exchanging information about promising practices.
2. Support changing credit budget rules to allow combining administrative costs and credit subsidies.

**Other Stakeholders:**

1. Take a longer view: Strengthening programs now is far preferable to risking political over-reaction if a program, especially in the event of inadequate administrative resources, fails to serve borrowers in a cost-effective way.
2. Represent your better association members: privately indicate support for activities, such as improved lender oversight, that can help keep credit subsidies and political risk within acceptable bounds.

## VII. Conclusion: Making Outcomes Better

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*The huge volume of federal credit outstanding means that too many borrowers end up defaulting on their loans. A focus on outcomes can help these borrowers, by preventing them from taking on debt they cannot handle, by ensuring that program lenders originate and service loans properly, and by taking other measures to avert unnecessary defaults. Treasury and OMB have important roles to play in seeking the authority that agencies need to manage their programs effectively.*

Credit programs continue to grow in volume, with credit managers under pressure to “get the money out the door” before the fiscal year ends. It is time to change the focus from the volume of credit an agency extends to borrower outcomes. Agencies need to look at the riskiest loans that they originate or guarantee and determine the actual impact on borrowers. Then each program needs to adjust its credit box to ensure that, on balance, borrowers are being helped more than being harmed. Agencies also should place increased emphasis and organizational focus on program evaluation. Policymakers need to ensure that agencies have the authority, resources, and mandate to generate information, evaluate outcomes, and

conduct pilot programs, for instance, to vary the amount of risk-sharing with lenders and other program partners to determine effects on portfolio quality and borrower outcomes. With a focus on outcomes, federal loan and loan guarantee programs can approach the goal of smaller but more effective government needed for agencies to succeed in today’s budget environment.

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