BUDGET COMMITTEE

Judd Gregg, Ranking Member
http://budget.senate.gov/republican

Contact: Betsy Holahan (202)224-6011

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Budget Perspective:
Estimates of the Budgetary Impact of the Financial Reform Bill Are Misleading

CBO estimates that the financial reform bill currently under consideration in the Senate (both S. 3217 as introduced and the Dodd/Lincoln substitute amendment to S. 3217) would "reduce" the deficit by about $20 billion over the next 10 years. While those estimates will change as a result of amendments to the legislation, they lead one to draw the wrong conclusions about the effect of the bill on the federal budget.

The Orderly Liquidation Fund – An Insurance Program with Pre-Paid or Post-Paid Premiums?

The centerpiece of the "Restoring American Financial Stability Act" is a new program to facilitate the liquidation of failing financial companies that pose a significant risk to the financial stability of the United States. To provide funds to cover the costs of such liquidations, the Federal Deposit Insurance Corporation (FDIC) would be required to assess fees on systemically-important firms – bank holding companies (with assets of $50 billion or more, such as Bank of America, Citigroup, Goldman Sachs and Morgan Stanley) and nonbank financial institutions regulated by the Federal Reserve (such as Prudential, Hartford, American Express and General Electric).

In the reported bill and substitute amendment, the FDIC would begin to collect the OLF fees (which are classified as federal revenues) one year after enactment of the legislation and would invest the fees in Treasury securities. The bill would require that the OLF have a target size of $50 billion (adjusted periodically for inflation), and that it reach its target size within 10 years.

Accordingly, federal revenues would rise (in the case of the substitute amendment) by $43.9 billion over 2011-2020 while the OLF is being capitalized. CBO estimates that payments out of the fund would total $26.3 billion over the next 10 years, resulting in a "decrease" in the deficit of $17.6 billion, which became the headline piece of budgetary information about the bill.

The Shelby/Dodd amendment to the substitute, adopted by a 95-3 vote, would remove both the target size of the OLF and the requirement that the OLF be capitalized within 10 years. Instead, the FDIC would incur any liquidation costs first (by borrowing from the Treasury) and then over five years would assess fees sufficient to recoup the net cost of the liquidation. This amendment would reduce the near-term increase in federal revenues that CBO had estimated for the reported bill and substitute (an estimate of the impact of the amendment is not yet available). As a result, the amendment would make the bill appear to "reduce" the deficit by less than the introduced versions over 2011-2020.

In both the reported measure and the substitute as amended, the full cost of the liquidation of failing financial companies is paid for by the financial services industry. Why does one structure of the OLF result in an estimated "decrease" in the deficit, and another does not?

The Complications of the OLF Do Not Fit Neatly Into Simple Budget Presentations

The orderly liquidation authority established in the financial reform legislation is essentially an insurance policy against the default of systemically important firms. The rules governing federal budgetary accounting are inadequate to deal with the complexities of federal insurance programs.

The federal budget is (except for credit programs) almost entirely based on a cash method of accounting, which recognizes income when received and expenses when paid. While the cash method works well for most budgetary transactions, it does not work so well for insurance-type transactions where there is a significant timing difference between the receipt of "premiums" and payment of "claims."

Because Congress recognized this timing difference as a problem in federal direct loan and loan guarantee programs, it enacted the Federal Credit Reform Act of 1990 to require that the budget reflect only the expected subsidy costs (net present value of cash flows in and out over the life of the loan) of federal credit programs at the time the federal government commits to the loan. This, for example, prevented loan guarantee programs from showing guarantee fees as cash budgetary savings in the near-term, while the cash outlays for defaulted guaranteed loans showed up outside of the budget window.

But the Credit Reform Act does not affect federal insurance programs, even though insurance programs share many of the same mismatches of income versus outgo over time that credit programs have. As a result, CBO has no choice but to estimate the effect of the OLF in this bill on a cash basis even though it makes it appear as if the federal government's fiscal situation has improved. One should not conclude from such an estimate, however, that the federal government and taxpayers are better off, since cash accounting does not take into account the timing differences inherent in federal insurance programs and the future claims on the government's resources created by this new insurance program.

A Better Way of Budgeting for Federal Insurance is Needed

The last major piece of legislation to be considered by the Congress, the health care reform legislation, also contained a new federal insurance program that distorts the true effect of the bill on the federal deficit.

The Community Living Assistance Services and Supports (CLASS) Act included in the health care reform measure provides new federal insurance for long-term care expenses. That program collects premiums for five years before beginning to pay out benefits, and was characterized as "a Ponzi scheme of the first order" by Senate Budget Chairman Kent Conrad. The CLASS Act distorts the budget because the premiums collected today should be held in reserve to pay future claims rather than used as an offset for new entitlement spending.

Similarly, the savings from the OLF should not be viewed as a reduction in the deficit or be used as an offset for other legislation under the Statutory Pay-As-You-Go Act of 2010. The "savings" are an artifact of a budgeting system that does not currently accommodate the timing differences inherent in federal insurance programs. A better way of accounting for these cash flows is needed to prevent distortions in the evaluation of the government's fiscal position. –