CREDIT MODIFICATIONS

Topics

- What is a modification?
- How do I estimate the subsidy cost or savings?
- What impact does the subsidy cost or savings have on the budget?
- What do I need to know about financing account transfers?
- What do I need to know about loan asset sales?

DEFINITION

- A government action that:
  - Differs from actions assumed in the baseline estimate of cashflows and…
  - Changes the estimated cost of an outstanding direct loan (or direct loan obligation) or an outstanding loan guarantee (or loan guarantee commitment).

Modifications --

- Require a Government action -- new legislation or administrative action.
- Apply to:
  - Outstanding direct loan or direct loan obligations.
  - Outstanding loan guarantee or loan guarantee commitments.
- May affect one or a group of direct loans or guarantees.
- Apply to pre-credit and post-credit reform credit.

Direct vs. Indirect

- Direct:
  - Altering the terms of existing contracts (forgiveness, forbearance, interest rate reduction, extension of maturity, prepayments without penalty)
  - Selling loan assets
  - Purchasing undefaulted guaranteed loans
- Indirect:
  - Legislation alters administration of the portfolio (new debt collection tools, restrictions on debt collection)

Not modifications

- Non-Government actions permitted within terms of existing contracts (e.g., prepayment without penalty)
- Administrative workouts:
  - Applies to troubled loans & loans in imminent default
  - Actions to maximize loan repayments or minimize guarantee claims
- Additional disbursements to borrowers under the same contract (these are treated as new loans)
- Changes before obligation or commitment

Modification cost

- Difference between the estimated PV of the remaining cash flows before and after the modification.
- Must use the same ”before" cash flows as assumed in the President's budget.
- "After" cash flows are the "before" cash flows adjusted only for effects of the modification.
- Can't do a modification unless you have BA for the cost.
- If a law mandates a modification, it provides the BA.

Estimating the subsidy cost

(Where cash flows to the Government have negative signs and cash flows from the Government have positive signs)

1. Estimate remaining cash flows pre-modification.
2. Discount the cash flow in step 1.
3. Estimate the cash flows post-modification
4. Discount the cash flows in step 3.
5. Subtract results of step 2 from results in step 4.

   Result = cost (+), savings (-), or no cost (zero).

Budget treatment of the cost/savings

- Increased cost = BA, obligation, and outlay in the program account (paid to the financing account).
- Savings = obligation and disbursement in the financing account (paid to a negative subsidy receipt account established for each program).

Financing account transfers

- *Post-1991 modification adjustment transfer* -- adjusts for the disconnect between the interest rate used to calculate the modification cost and the interest rate earned by the cohort.
- *Pre-1992 financing account transfers* -- accounts for the transfer of assets or liabilities from liquidating account to financing account.

Post-1991 modification adjustment transfer calculation

6. Take the difference in cash flows due to the modification (step 1 minus step 3).

7. Calculate the PV of this difference using the interest rate for the cohort.

8. Subtract step 5 (the modification cost) from step 7.

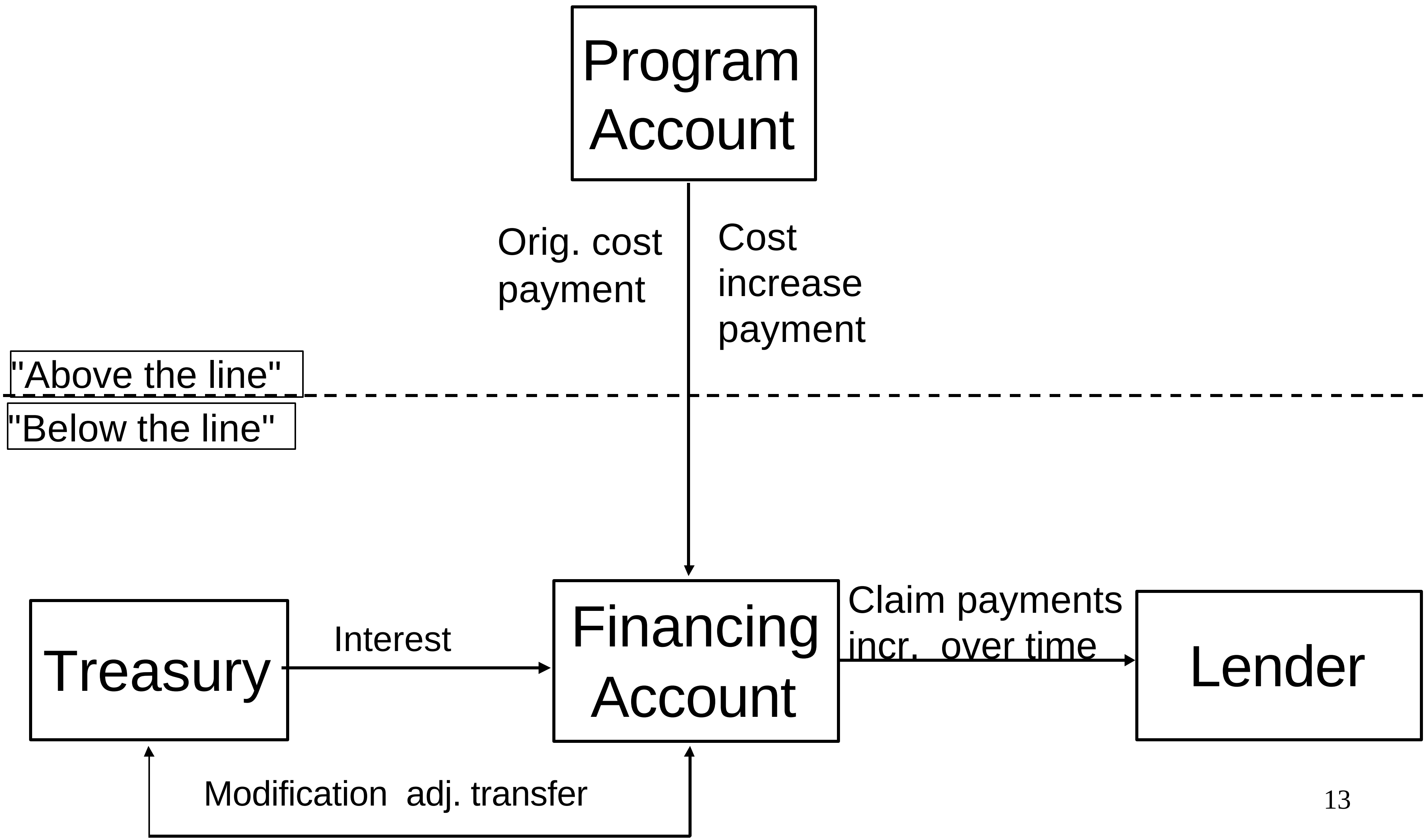
This is the modification adjustment transfer amount.

Modification adjustment transfer (continued)

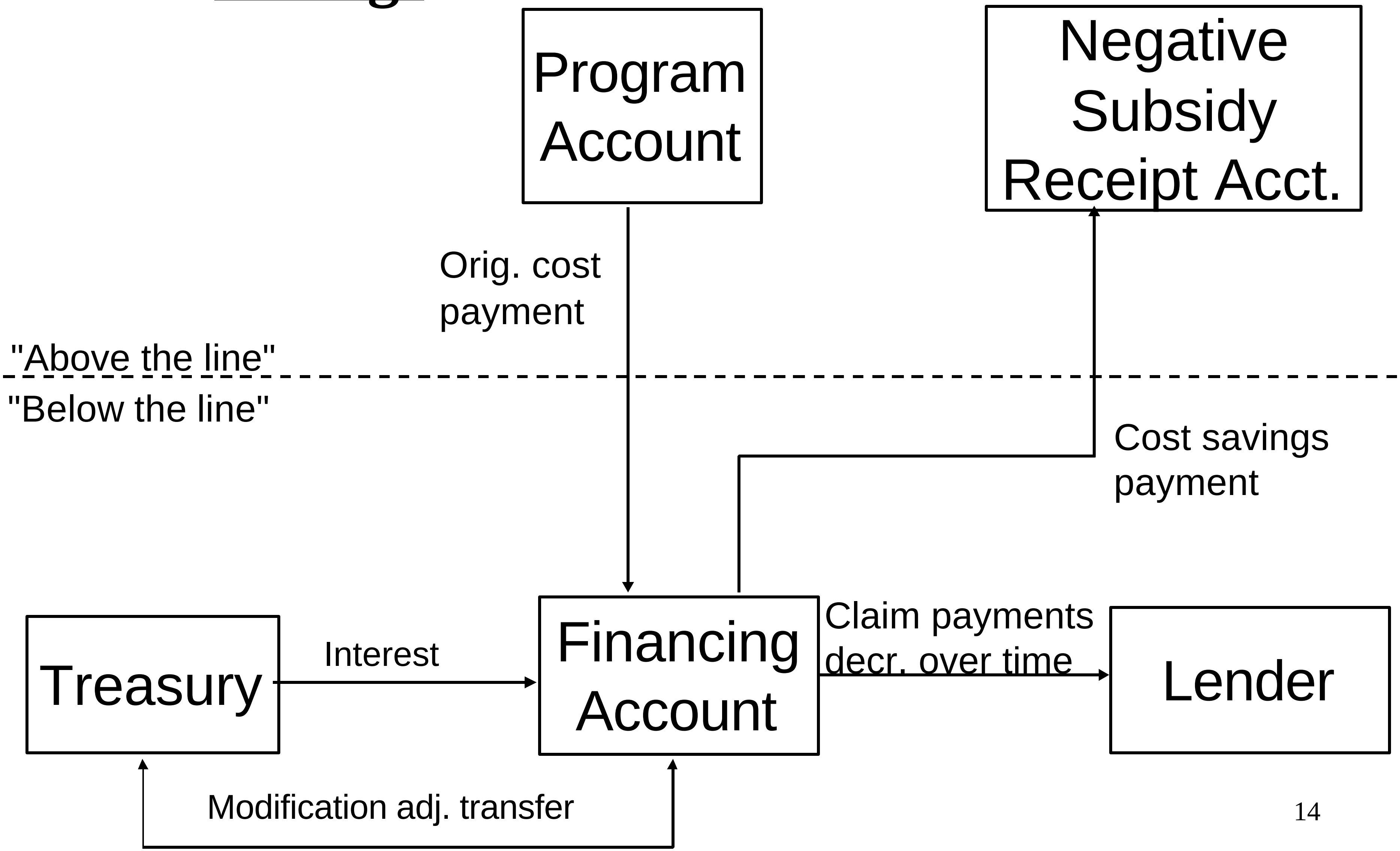
- If cost is *higher* when the current interest rate is used (step 8 is a negative amount), then transfer from the financing account to the general fund.

- If cost is *lower* when the current interest rate is used (step 8 is a positive amount), then transfer from the general fund to the financing account.

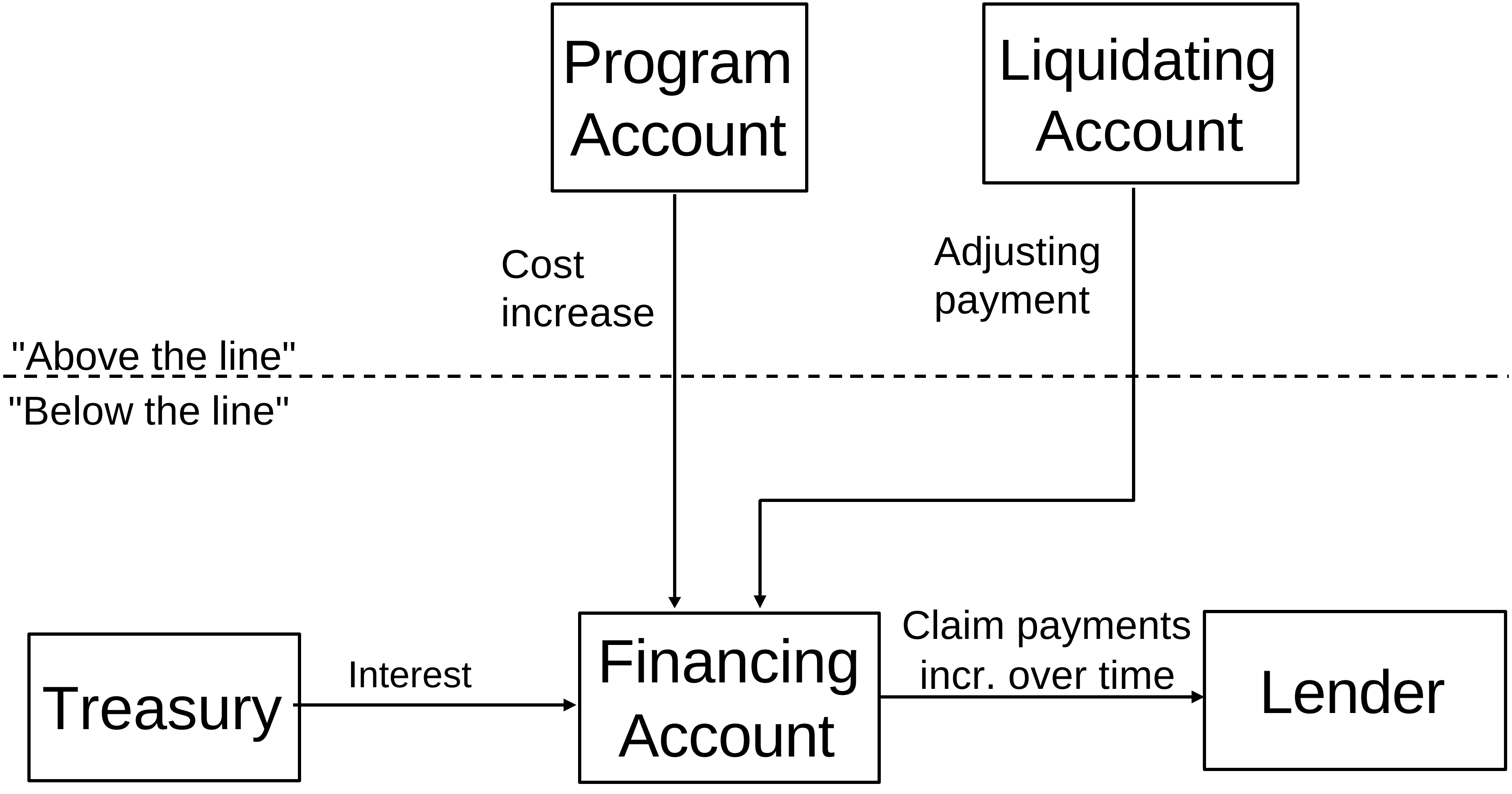
Post-1991 Loan Guarantee Modification Cost Increase



Post-1991 Loan Guarantee Modification Cost Savings



Pre-1992 Loan Guarantee Modification Cost Increase



Delinquent loan asset sales

- Requirement:
- Agencies with over $100 million in loan assets are expected to sell loans that are more than one year delinquent.
- OMB must approve sales -- and exceptions -- based on specific information submitted by the agency.

Exceptions...

- Loans to foreign countries or entities
- Loans in structured forbearance
- Loans written off as unenforceable
- Loans in adjudication or foreclosure
- Loans that have been submitted to Treasury for offset and are expected to be extinguished within 3 years
- Agency can demonstrate that PV of expected cash flows would exceed sales proceeds
- Sale would be inconsistent with Administration policy

Cost of loan asset sales

- If the cash flows for existing loans don't explicitly assume a sale, the sale is a modification.
- The cost or savings is the difference between the net sales proceeds and the PV to the government of keeping the loan assets (hold value).
- Certain costs are netted from gross proceeds (e.g., underwriting, rating agency, due diligence,…see A-11).
- If the sale was assumed in the cash flows, the difference between the estimated and the actual proceeds from the sale is a reestimate (not a modification).

Special Cases

- If asset are sold with recourse, treat as two separate transactions:
  - Sale without recourse (modification), and
  - New loan guarantee.
- If asset sales are sold with a government equity stake (or participation) in cash flows, count the:
  - Cash proceeds from the sale, plus
  - PV of the proceeds from the equity position, minus
  - Transaction costs.

Summary

- Definition:
  - Government action
  - New legislation or administrative action
  - Affects one loan or a group
  - Applies to pre-1992 and post-1991 credit
  - Direct and indirect
  - Not:
    - Workouts
    - Actions permitted within terms of contract
    - Additional disbursements
    - Changes before obligation or commitment

Summary (continued)

- Estimating the subsidy cost/savings - calculate pre- and post-modification subsidy cost

- Budget treatment of cost/savings:
  - Cost = obligation, outlay from program account to financing account.
  - Savings = obligation, disbursement from financing account to receipt account.

Summary (continued)

- Financing account transfers:
  - Post-1991: modification adjustment transfer
  - Pre-1992: direct loan asset or loan guarantee liability transfer from liquidating account to financing account and a one-time adjustment payment.
- Delinquent loan asset sales: Required for agencies w/ $100 million in loan assets (some exceptions).

- -- End --