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"THE FEDERAL GOVERNMENT AND LOAN GUARANTEE PROGRAMS"

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It is a great privilege to be here with you today. The Economic Club of Detroit has gained a national reputation for excellence as a free forum, a reputation that is most certainly well deserved.

These are difficult economic times. We are experiencing record postwar unemployment and widespread business failures. The problems are particularly acute here in Michigan, and I share your concern about the future of the economy. Though the Federal Government has no formalized industrial policy to deal with our economic problems, one of the more noteworthy developments of the 1970s was the occasional provision of large scale financial assistance to failing firms or municipalities. The Chrysler program is but the most recent example of an ad hoc approach to providing assistance which began with the collapse of the Penn Central railroad in 1970, followed by the Lockheed and New York City loan programs.

GAO has been involved in all of these programs, and much to my surprise, I too have had personal involvement with all of them, first, as an Assistant Secretary of the Navy, later as a partner of Arthur Andersen and Co., and now as Comptroller General. Since circumstances similar to those that led the Congress to assist failing firms and municipalities in the 1970s may recur, I believe it is important that we benefit from our past experience. This afternoon, I would like to share my views on how well these programs have worked, and the lessons we have learned that might help improve the design of any future programs the Government initiates.

With the exception of the Penn Central/Conrail experience, the programs have been structured to restore financial health and avoid bankruptcy. They have all involved the exchange of a federally supported cash infusion for a financial and cost restructuring. In every case, Federal involvement was designed to ultimately return the entity to self sufficiency.

SOME HISTORY

A review of some of our experiences with these programs reveals the diverse nature of the problems and the wide range of actions taken by all parties, including the Federal Government, to achieve a solution.

Penn Central

When the financial collapse of an overextended Penn Central became imminent in 1970, the Government declined to provide financial assistance and bankruptcy resulted. The Government's decision was reached after only about one week of review. At first, the White House indicated to the Penn Central people that they would support a Loan Guarantee Program. However, it was soon determined that the only way they could do this was through the Defense Production Act and Defense officials, including myself, could not make a strong case for why the Railroad was essential to our defense effort. Also Congressional leaders such as Chairman Mahon of the Defense Appropriations Committee and Congressman Wright Patman were very much against the Defense Department becoming involved in what they regarded as a Department of Transportation responsibility.

Later, it was concluded that Federal intervention was necessary to help alleviate the employment problems caused by the railroad bankruptcies and to preserve what many believed to be essential rail service in the Northeast. In 1973, the Government purchased the assets of the Penn Central and several smaller railroads, consolidated them into a new railroad called Conrail, and then funded the necessary rehabilitation of plant and equipment at a cost of between 6 and 8 billion dollars, with the intention of selling Conrail to private interests once it returned to profitability. Conrail is only now beginning to show a profit as various concessions have been obtained and the railroad's physical plant has shrunk. Later this year, the Government will attempt to sell it whole or in pieces.

Lockheed

Although Lockheed was near bankruptcy in 1971, its problems differed substantially from those of Penn Central and, later, Chrysler. Lockheed experienced a severe liquidity crisis due mainly to development costs incurred for the L1011 Tristar aircraft and the settlement of previous disputes with the Defense Department. There was never a serious concern about Lockheed's long-term viability, if it could get past its immediate problem. If the L1011 had been dropped and written off in 1971, the balance of Lockheed's operations would have been profitable with a positive cash flow. It is interesting to note that about a decade later, the Lockheed directors and management did decide to stop the L1011 program. To prevent Lockheed's bankruptcy, the Congress authorized 250 million dollars in loan guarantees as a quid pro quo for restoration of a 400 million dollar credit facility by Lockheed's banks, a British guarantee of Tristar engine delivery, and 100 million dollars in additional prepayments by three L1011 customers. Federal aid was approved to prevent large-scale unemployment; to avoid large potential losses to Lockheed's creditors, suppliers, and customers; to maintain competition in the aerospace industry; and to protect our national defense.

New York City

In New York City's case, rapid growth in municipal employment, a declining tax base and some ill-advised "creative" financing and accounting contributed to an enormous growth in the City's debt and overwhelming short-term refinancing requirements. By 1975, the city could not finance its obligations in the municipal bond market. In response, New York State established the Municipal Assistance Corporation and the Emergency Financial Control Board to lengthen the maturity of the City's debt, reduce the immediate debt service burden, raise new money, control the City's expenditures, and approve financial plans until the reforms necessary to enable the City to return to credit markets were put in place. City-based banks and municipal employee pension funds, which held a lot of short-term City debt, participated in the debt lengthening and financing plan.

This series of actions was still not enough to cover the City's seasonal financing needs. In December, 1975, the Federal Government agreed to make one year direct loans to the City in order to prevent a default, preserve access to municipal bond markets for other State and local government borrowers, and avoid the potential collapse of several large financial institutions that held large amounts of the City's and State's debt. In other words, the Federal Government provided short term financing. The

Federal loan had to be repaid at the end of each fiscal year, and the Secretary of the Treasury had to certify that New York City could repay the loan each time there was a drawdown. In order to help him monitor the financial situation of the City, then Secretary Simon employed my old firm, Arthur Andersen & Co., to help review the financial condition of New York City for the balance of his term in office.

By 1978, the City had repaid the short-term Federal loan each fiscal year, but was still unable to return to the credit markets. Long-term Federal loan guarantees were approved to serve as the cornerstone of a 4.5 billion dollar financing package participated in by the banks and the public.

Chrysler

Since most of you are familiar with the Chrysler situation, I will not dwell on it. In 1980, unable to obtain further credit in the private markets, Chrysler sought and received aid from the Federal government. This aid was conditioned on a sharing of losses and future risk by labor unions, suppliers, dealers, creditors, stockholders, and Foreign, State and local governments.

In the Lockheed and New York City situations, GAO's role was to periodically review the overall program and report to the Congress. In contrast, in the Chrysler and Conrail situations, the Comptroller General is a participant in the programs as a voting member of the Boards established to administer them.

LESSONS LEARNED

What have we learned about the design of financial assistance programs from our experience to date?

Identification of the problem

The first point I'd like to stress is the need for the Government to accurately identify the type of financial problem facing a troubled firm or municipality. For example, is the problem simply a short-term cash flow deficiency, or is it a more deep seated problem? How much of it is due to forces beyond the entity's control? How much of the problem can be controlled by the entity?

When the problem is brought to the Government's attention there is often only a short response time available to avert a crisis. Because of this, the Government should maintain the capability to rapidly assemble a team of experts to evaluate the situation. This capability most logically should reside within the Federal Reserve and the Treasury Department, two agencies almost certain to be involved in designing and administering any aid package put together.

Legislation

Once the problem has been identified, and the decision made that a Federal response is appropriate, legislation is needed. Such legislation must contain a clear statement of the objectives sought by Federal involvement as well as the financial mechanism through which they will be achieved. Whether that means providing credit assistance to an ailing entity, as the Government did for Lockheed, New York City and Chrysler, or allowing bankruptcy followed by reorganization as a temporarily Government-owned enterprise such as Conrail, will depend on both the objectives and the type of problem the recipient is thought to have. But in all cases, focusing on the objectives is critical, and the authorizing legislation should avoid requirements that are tangential to the major goals of the program and which unnecessarily divert the attention and effort of the recipient and the administering Government officials.

Another key principle to be relied on in designing legislation is that the taxpayer's financial interests must be adequately protected. This can best be accomplished by following prudent lending practices as much as possible while still satisfying, for example, the Government's desire to preserve employment levels or meet national security objectives. In this regard, a priority claim on adequate collateral for loans to corporations is especially important to assure that if the Government-coordinated workout does not succeed, the Government can recoup the costs associated with the program through selling assets. This should be an essential quid pro quo for the Government accepting risk on behalf of taxpayers and arranging a workout outside of bankruptcy.

Concessions

When the Federal Government commits its funds either directly or through loan guarantees, many groups of people--such as suppliers, creditors, and workers--stand to benefit from this involvement. As a result, the Federal Government is in a position to require that such groups make economic concessions that contribute to the restoration of a firm's or municipality's financial health. It is preferable that the concession agreements be worked out among the affected parties prior to the passage of legislation, as occurred in the Lockheed and New York City programs. But when, for reasons of time or complexity this cannot take place, as in the Chrysler situation, then the authorizing legislation should include the concession requirement and specify the contributing groups as well as the total contribution to be obtained. However, the legislation should not enumerate the precise concessions that each group must make. The Government agency responsible for administration of the assistance program should be given flexibility to negotiate concessions and other program details.

Concessions were a part of the Lockheed, New York City and Chrysler aid packages. The failure to obtain concessions until just recently in the Conrail solution has proven to be very costly for the American taxpayers. The fact that rail service was viewed as an essential public service may have affected the Government's perceived bargaining leverage. It was not until the early 1980's that the Congress decided to come to grips with the long-recognized problems facing the Northeast rail system by requiring concessions and paving the way for abandoning unprofitable lines.

Oversight

Once an assistance program is authorized and aid is provided, Government oversight is also necessary. In the past, this has sometimes been accomplished by a single overseer, such as the Secretary of the Treasury with the New York City situation, but in the Lockheed and Chrysler programs a special board was established. I believe a loan guarantee board is the appropriate vehicle to provide this oversight. Nevertheless, despite, or perhaps because of, my membership on the Chrysler loan guarantee board, I do not believe that the Comptroller General is a good choice to serve in a voting capacity on future boards. GAO is an independent oversight agency of the Congress and, because of this, there is an inherent conflict created when the Comptroller General is an active participant in an Executive branch program and GAO is responsible to the Congress for later review and oversight of that program. However, I do not wish to rule out the possibility of non-voting membership or some other role that preserves both GAO's independence and the ability to assist the Congress.

One reasonable possibility for Board membership would include the Secretary of the Treasury, because of the analytical capability immediately at his disposal; the Chairman of the Federal Reserve Board, to provide the independent voice; and, the head of the Cabinet level agency whose responsibilities are most closely related to the affairs of the borrower.

Regardless of the makeup of the board, an important element of successful oversight is that the Government should attempt to manage the borrower's operations as little as possible consistent with protecting the taxpayer's interest. The Government simply does not have the expertise to provide day-to-day management of a large corporation or a city. The Congress should require that long-run operating and financial plans be submitted to and approved by the oversight board as a condition for granting assistance. It is appropriate for that board to reject the plans if it believes they call for the Government to take on an unacceptable level of risk or think the program will not succeed on the basis of such plans. However, details of modifying the plan should be left to the borrower. In addition to being necessary for effective oversight, the loss of autonomy resulting from submission of plans and their potential rejection provides a strong incentive for borrowers to relieve their indebtedness to the Government as soon as possible.

Duration of Program and Fees

This final consideration is important because these assistance programs are intended to provide short-term aid. Proper structuring of the terms and conditions of the loans will also encourage repayment when the borrower's financial status has been upgraded enough to allow it to borrow in private capital markets without guarantees. The term of the loan should not be excessively long. Also, annual loan guarantee fees during the entire time loans are outstanding, in addition to compensating the Government for its administrative costs and risk exposure, can be set to encourage repayment. In this regard, the interest rate should not be established below the market rate required of a creditworthy borrower.

THE ALTERNATIVES

The history and lessons learned from the ad hoc approach that the Congress has taken to these situations should provide some insights and guidance for designing future programs for large failing firms or municipalities. Nevertheless, a major question that goes begging is whether the approach taken has been wise.

During the 1930s, the approach the Government took to the problem of business failures in an environment of widespread unemployment was to create the Reconstruction Finance Corporation (RFC). Some people, such as Felix Rohatyn, believe that our present circumstances call for its re-establishment to make aid available to failing firms or municipalities. Others believe that the Government should maintain a hands-off position, allowing market forces to lead to bankruptcies or workouts among the affected parties. For example, Commerce Secretary Malcolm Baldrige was quoted last spring as saying, "One or two major corporations may not make it through the recession, and the Administration will not offer assistance if they fail."

Let me first deal with the idea of a new RFC. A new RFC might be a reasonable industrial policy response for dealing with the common problems of many small or medium size firms and municipalities. However, it would probably not be a good vehicle through which to manage a workout response to the very diverse situations faced by very large entities on the verge of bankruptcy.

An almost universally held view of those who have managed the large loan programs of the 1970s is that it would not be possible to write the necessary all-encompassing eligibility standards and program design features into legislation to adequately take account of the diverse situations and problems faced by large failing entities. For example, how big need a firm or municipality be? What level of employment would qualify for eligibility? What sort of concessions would be mandated?

If an RFC for the larger entities is not appropriate, what about the bankruptcy alternative? Certainly, when Penn Central went through bankruptcy, the trains kept running. Frequently, companies liquidate unprofitable operations, sell off some money-making operations to raise cash, and emerge reconfigured, but healthy. In New York City's case, its buildings would not have disappeared and services would have continued, but a municipal bankruptcy would have meant a federally run city and large Federal outlays to preserve services. And, as I indicated in Conrail's case, the bankruptcy solution and Federal takeover has cost the Government and the American taxpayer between 6 billion and 8 billion dollars. This is in contrast to the 26 million dollars in fees that the Treasury received from the Lockheed loan guarantee program, the 18 million dollars in fees received to date from New York and the 27 million dollars received to date from the Chrysler Corporation.

The economic arguments for bankruptcy and against what are popularly referred to as bailouts are that by removing the threat of bankruptcy from our economic system, we build in incentives for inefficiency, waste, and mismanagement, which lowers the growth potential of the economy and tightens the credit supply for companies that do quite well without subsidies. These arguments have some merit but are a bit oversimplified. Some believe that our current bankruptcy system is not equipped to deal with the failure of a corporate giant.

In a recent interview in the New York Times, Senator Richard Lugar of Indiana was quoted as saying in regard to a possible Chrysler bankruptcy that "Chrysler was the 10th largest corporation in the country. Almost every state was affected; it was truly a national concern. Chapter 11 bankruptcy would not have been appropriate, or feasible, for a company that large." In discussing the possible impact of a New York City default, Senator Lugar points out that "If New York had defaulted, much of urban America would have found it virtually impossible to sell municipal bonds."

Given the difficulties with the alternatives, what can we say about the success of the ad hoc programs? That's the ultimate question. Clearly, as Senator Lugar points out, the answer depends on how these programs have worked in comparison with the bankruptcy alternative.

Lockheed survived its financial crisis and the Federal Government's involvement in the company's affairs ended in 1977. Bankruptcy was avoided, jobs were preserved, and the other objectives of the program were met. Detractors would argue that the preservation of Lockheed jobs occurred at the expense of employment in other aerospace firms. But jobs are jobs, and Lockheed was and continues to be a competitive force in the industry. New York City reentered the municipal bond market in 1981 on an unassisted basis, and badly needed reforms have been put in place. In Chrysler's case, the reconfiguration of operations that has occurred has eliminated many of its problems. In none of these cases have taxpayers spent a dime. However, the Penn Central/ Conrail case is quite a different situation. Though it may be sold later this year to private interests, the approach taken has been very costly (6-8 billion dollars) and it is worth seriously questioning whether a more innovative workout approach might not have achieved the same result sooner and at a lower cost to the Government.

CONCLUDING REMARKS

The ad hoc approach the Congress has taken involves a clash between the political goals that rationalize these programs and the hard-nosed financial approach that must be taken to solve the problem. Despite the conflict, these programs have on balance been handled well. We have not made it easy for beneficiaries--quite the contrary--and we should continue to behave that way in the future.

We are well into an era of growing worldwide economic interdependence and international competition. There is real concern that the U.S. manufacturing base is eroding and taking a back seat to the Japanese and others in producing many of the products we consume. It is essential that the thrust of our many policies affecting the Nation's industrial base result in improving the efficiency and competitive edge of U.S. firms. The large scale financial programs of the 1970s have contributed toward this result. The turnaround of the Chrysler Corporation is a clear case in point. Though costly, the improvement in the efficiency of Northeast rail operations is another.

Later this year, GAO will be issuing a report on this subject that discusses the issues in more detail than I have been able to cover here today. We hope the Congress will consider strongly the guidelines we propose on how to structure and oversee future programs. The failure of any one of the entities that received assistance during the 1970s would have had major regional and national impacts. Careful design of these programs is crucial to avoiding such impacts, and to promoting the broad-based goals of increased domestic manufacturing efficiency and international competition.

END