



Testimony
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Services, House of Representatives

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AUTO INDUSTRY

A Framework For Considering Federal Financial Assistance

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G A O

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Highlights of [GAO-09-247T](#), a testimony before the Committee on Financial Services, House of Representatives

Why GAO Prepared This Statement

The current economic downturn has brought significant financial stress to the auto manufacturing industry. Recent deteriorating financial, real estate, and labor markets have reduced consumer confidence and available credit, and automobile purchases have declined. While auto manufacturers broadly have experienced declining sales in 2008 as the economy has worsened, sales of the “Big 3” (General Motors, Chrysler, and Ford) have also declined relative to those of some other auto manufacturers in recent years because higher gasoline prices have particularly hurt sales of sport utility vehicles.

In addition to causing potential job losses at auto manufacturers, failure of the domestic auto industry would likely adversely affect other sectors. Officials from the Big 3 have requested, and Congress is considering, immediate federal financial assistance.

This testimony discusses principles that can serve as a framework for considering the desirability, nature, scope, and conditions of federal financial assistance. Should Congress decide to provide financial assistance, we also discuss how these principles could be applied in these circumstances. The testimony is based on GAO’s extensive body of work on previous federal rescue efforts that dates back to the 1970s.

To view the full product, including the scope and methodology, click on [GAO-09-247T](#). For more information, contact Katherine Siggerud at (202) 512-2834, J. Christopher Mihm at (202) 512-3236, or Gary L. Kepplinger at (202)-512-5400.

AUTO INDUSTRY

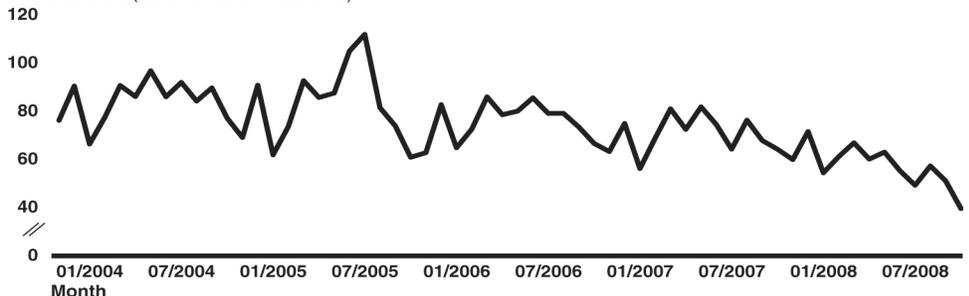
A Framework for Considering Federal Financial Assistance

What GAO Found

From our previous work on federal financial assistance to large firms and municipalities, we have identified three fundamental principles that can serve as a framework for considering future assistance. These principles are (1) identifying and defining the problem, (2) determining the national interests and setting clear goals and objectives that address the problem, and (3) protecting the government's interests. First, problems confronting the industry must be clearly defined—separating out those that require an immediate response from those structural challenges that will take more time to resolve. Second, Congress should determine whether the national interest will be best served through a legislative solution, or whether market forces and established legal procedures, such as bankruptcy, should be allowed to take their course. Should Congress decide that federal financial assistance is warranted, it is important that Congress establish clear objectives and goals for this assistance. Third, given the significant financial risk the federal government may assume, the structure Congress sets up to administer any assistance should provide for appropriate mechanisms, such as concessions by all parties, controls over management, compensation for risk, and a strong independent board, to protect taxpayers from excessive or unnecessary risks.

These principles could help the Congress in deciding whether to offer financial assistance to the domestic auto manufacturers. If Congress determines that a legislative solution is in the national interest, a two-pronged approach could be appropriate in these circumstances. Specifically, Congress could 1) authorize immediate, but temporary, financial assistance to the auto manufacturing industry and 2) concurrently establish a board to approve, disburse, and oversee the use of these initial funds and provide any additional federal funds and continued oversight. This board could also oversee any structural reforms of the companies. Among other responsibilities, Congress could give the board authority to establish and implement eligibility criteria for potential borrowers and to implement procedures and controls in order to protect the government’s interests.

Number of Vehicles Sold By the Big 3, 2004 to 2008
Vehicles sold (in hundreds of thousands)



Source: IHS Global Insight.

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

We appreciate the opportunity to testify on possible federal assistance to the domestic auto industry. The current economic downturn has added to the significant financial stress facing that industry. Deteriorating financial, real estate, and labor markets have reduced consumer confidence and available credit, and automobile purchases have declined. After reaching a recent high of about 1.8 million in July 2005, the number of vehicles sold in the United States dropped to about 800,000 in October 2008, approximately a 54 percent decline. While most auto manufacturers have experienced declining sales in 2008, recent economic conditions have particularly hurt sales of the "Big 3" domestic auto manufacturers (General Motors, Ford, and Chrysler), in part because these companies have historically derived most of their sales from vehicles such as sport utility vehicles, which are less fuel efficient, but more profitable than small cars. Higher gasoline prices over the past several years, which rose to over \$4 per gallon in the summer of 2008 before falling steeply this fall, have contributed to a sharp decline in consumer demand for these vehicles. The tightening of the credit markets has also affected the Big 3 and their suppliers, which together employ about 730,000 people. In addition to potential job losses at auto manufacturers, the collapse or partial collapse of the domestic auto industry would adversely affect auto dealers, suppliers, and other sectors.

Officials from the Big 3 have requested immediate federal financial assistance, reporting that their companies are experiencing significant financial stress.¹ Less than three days ago, the Big 3 submitted business plans to Congress that describe their requests for federal assistance and restructuring plans. Congress has asked us to review these plans. In deciding whether to provide financial assistance, Congress must consider and balance

¹For example, as of September 30, 2008 General Motors reported total liabilities of over \$169.4 billion with total assets of about \$110.4 billion, resulting in negative equity of nearly \$59 billion. General Motors, has requested total financial assistance of \$18 billion. As of September 30, 2008 Ford reported total liabilities of debt of about \$242.6 billion with total assets of about \$242.1 billion, resulting in negative equity of approximately \$0.5 billion. Officials from Ford have requested a "stand-by" line of credit up to \$9 billion, to be used if conditions worsen. Because Chrysler is privately owned, data on its financial condition is not currently available to the public. Nevertheless, officials from Chrysler have stated that without immediate assistance, its liquidity could fall below the level necessary to sustain operations. Chrysler has requested \$7 billion of financial assistance.

the perceived need for expedience with the need to put a structure in place to ensure that the interests of taxpayers are safeguarded and the specific problems that have put the industry in its current financial crisis are addressed.

In my statement today, I will discuss principles that could serve as a framework for considering the desirability, nature, scope, and conditions of possible federal financial assistance and, should Congress decide to provide financial assistance, how these principles could be applied in these circumstances. My remarks are based on our extensive body of work on previous federal financial assistance efforts that dates back to the 1970s, including those efforts directed to individual large corporations, such as the Chrysler Corporation and Lockheed Aircraft Corporation, as well as municipalities and commercial aviation.²

Summary

- From our previous work on federal financial assistance to large firms and municipalities, we have identified three fundamental principles that can serve as a framework for considering future assistance. First, the problems confronting the industry need to be clearly defined—distinguishing between those that require an immediate financial response from those that are likely to require more time to resolve. Second, Congress must determine whether the national interest will be served best through a legislative solution, or whether market forces and established legal procedures, such as bankruptcy reorganization, should be allowed to take their course. Should Congress decide that federal financial assistance is warranted, it is important that Congress establish clear objectives and goals for this assistance. Third, given the significant financial risk the federal government may assume on behalf of taxpayers, the structure Congress sets up to administer any assistance should provide for appropriate mechanisms, such as concessions by all parties,

²GAO, *Troubled Financial Institutions: Solutions to the Thrift Industry Problem* (GAO/GGD-89-47, Feb. 21, 1989), *Resolving the Savings and Loan Crisis* (GAO/T-GGD-89-3, Jan. 26, 1989), *Guidelines for Rescuing Large Failing Firms and Municipalities* (GAO/GGD-84-34, Mar. 29, 1984), and *Commercial Aviation: A Framework for Considering Federal Financial Assistance* (GAO-01-1163T, Sept. 20, 2001).

controls over management, compensation for risk, and a strong independent board, to protect taxpayers from excessive or unnecessary risks.

- Congress could apply these principles when deciding whether to offer any financial assistance to the domestic auto manufacturers. If Congress determines that a legislative solution is in the national interest, a two-pronged approach in applying the principles could be appropriate in these circumstances. Specifically, Congress could 1) authorize immediate, but temporary, financial assistance to the auto manufacturing industry and 2) concurrently establish a board to approve, disburse, and oversee the use of these initial funds and provide any additional federal funds and continued oversight. This board could also oversee any structural reforms of the companies. Among other responsibilities, Congress could give the board authority to establish and implement eligibility criteria for potential borrowers and to implement procedures and controls in order to protect the government's interests.

Principles for Large-Scale Federal Financial Assistance Efforts Could Guide Congressional Consideration of Auto Manufacturers' Requests

We have identified three fundamental principles that can serve as a framework for considering large-scale federal assistance efforts. These principles are (1) identifying and defining the problem, (2) determining the national interests and setting clear goals and objectives that address the problem, and (3) protecting the government's interests.

- **Identify and define the problem:** The government should clearly identify and define the specific problems confronting the industry—separating out those that require an immediate response from those structural challenges that will take more time to resolve. According to the auto manufacturers, the most immediate threat to the industry comes from inadequate cash reserves and negative projected cash flows combined with a tightening or denial of credit by commercial lending institutions. General Motors and Ford have not been profitable since at least 2006, and sales have

decreased substantially for the Big 3 in 2008.³ In this regard, deteriorating financial and real estate markets, weakening labor markets, and high fuel prices have contributed to reductions in consumers' demand for new vehicles, particularly less fuel-efficient vehicles. In addition, tightening consumer credit has made it difficult for some consumers to obtain auto loans. The industry, however, also faces structural challenges that will need to be dealt with, including higher labor and pension costs than competitors, dealership relationships and structure, and fleet characteristics—especially in the area of fuel efficiency.

- **Determine national interests and set clear goals and objectives that address the problem:** After defining the problem, Congress must determine whether a legislative solution best serves the national interest. If Congress determines that the benefits of federal intervention exceed those of bankruptcy reorganization for one or more of the domestic manufacturers, Congress could draft legislation to guide the availability and use of federal assistance. It is important that the legislation include a clear and concise statement of the objectives and goals of the assistance program. A statement of the objectives and goals of the program would help Congress and program administrators determine which financial tools are needed and most appropriate for the industry and for company-specific circumstances; provide criteria for program decisions; and serve as a basis for monitoring progress. Finally, although Congress may decide that there is a compelling national interest in providing financial assistance to help ensure the long-term viability of the Big 3, companies receiving assistance should not remain under federal protection indefinitely. Identifying the conditions that will signal an end to that protection would serve as congressional guidance on when the industry should emerge from the assistance program.
- **Protecting the government's interest:** Because these assistance programs pose significant financial risk to the federal government, appropriate mechanisms should be included to protect taxpayers from excessive or unnecessary risks. Mechanisms,

³Chrysler is a private company and does not report its profits or losses publicly.

structures, and protections should be implemented to ensure prudent use of taxpayer resources and manage the government's risk consistent with a good faith attempt to achieve the congressional goals and objectives of any federal financial assistance program.⁴ This can be achieved through the following four actions—all of which have been used in the past.⁵

1. Concessions from others: Congress should require concessions from others with a stake in the outcome—including management, labor, suppliers, dealers, and creditors. The concessions are not meant to extract penalties for past actions, but to ensure cooperation and flexibility in securing a successful future outcome.
2. Controls over management: The government must have the authority to approve an aid recipient's financial and operating plans and new major contracts. The authority is meant to ensure a restructuring plan with realistic objectives and to hold management accountable for achieving results.
3. Collateral: To the extent feasible, the government should require that the recipient provide adequate collateral, and that the government be in a first lien position.
4. Compensation for risk: The government should receive compensation through fees and/or equity participation in return for providing federal aid. The government's participation in any upside gains is particularly important if the program succeeds in restoring the recipient's financial operational health.⁶

Using the Principles As A Framework for Considering Financial Assistance for the Auto Manufacturing Industry

Congress could apply these principles if it decides to offer financial assistance to the domestic auto manufacturers. If Congress determines that the systemic, economic

⁴GAO-01-1163T.

⁵GAO/GGD-84-34.

⁶In a previous financial assistance package for Chrysler, the government obtained equity participation in the form of warrants that allow the government to purchase shares of a recipient's stock at a specified price. A decision on whether equity participation should be included as well as its form and amount should be made on a case-by-case basis.

consequences of risking the immediate failure of any or all of these companies are too great, a two-pronged approach in applying the principles could be appropriate. Specifically, Congress could 1) authorize immediate, but temporary, financial assistance to the auto manufacturing industry and 2) concurrently establish a board to approve, disburse, and oversee the use of these initial funds and provide any additional federal funds and continued oversight. This board could also oversee any structural reforms of the companies. Among other responsibilities, Congress could give the board authority to establish and implement eligibility criteria for potential borrowers and to implement procedures and controls in order to protect the government's interests.

The federal government has a range of tools it could use to provide such bridge assistance, including loans and loan guarantees.⁷ Historically, the federal government has used loans and loan guarantees in its financial assistance to specific companies. In providing such credit assistance, the government has assumed that the federal role is to help the industry overcome a cyclical or event-specific crisis by gaining access to cash in the short term that it otherwise cannot obtain through the markets. Credit assistance assumes that the aided companies will eventually return to financial health and have the capacity to pay back the loans. The government has offered such assistance in return for companies providing various forms of collateral and/or equity to protect taxpayer interests, as well as for various concessions by interested parties to share the risk and promote shared responsibility. For example, any federal assistance to an auto manufacturer might seek to ensure that all parties, including labor and management, share responsibility for bringing the company back to profitability, and that no party makes excessive concessions relative to the other parties. Finally, accountability should be built in so that Congress and the public can have confidence that the assistance was

⁷Loan guarantees help borrowers obtain access to credit with more favorable terms than they may otherwise obtain in private lending markets because the federal government guarantees to pay lenders if the borrowers default, which makes extending credit more attractive to lenders. Loan guarantees have the advantage of encouraging private-sector participation and potential expertise, with higher levels of federal guarantees likely generating the most participation. The Office of Management and Budget's Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables* prescribes policies and procedures for justifying, designing, and managing federal credit programs. This guidance states that lenders should have a substantial stake in full repayment, generally 20 percent. Limiting the federal guarantee to 80 percent ensures that lenders share in the risks associated with the loan. However, given the current problems in the credit sector, lenders may be unable to provide large loans and unwilling to accept such risks.

prudent and consistent with the identified objectives. For example, as a condition for receiving federal assistance, the auto manufacturers should be required to provide program administrators and appropriate oversight bodies with access to their financial records and submit detailed operating and financial plans indicating how the funds and other sources of financing will be used to successfully return the companies to profitability. Such information would allow program administrators to oversee the use of funds and to hold the companies accountable for results.

Congress should concurrently establish a board to approve, disburse, and oversee the use of these initial funds and provide any additional federal funds and continued oversight. This board could also oversee any structural reforms of the companies. The federal government has established boards to implement past financial assistance efforts, including when providing assistance to Lockheed in 1971 and Chrysler in 1980. More recently, in the aftermath of the 2001 terrorist attacks on the United States, Congress created the Air Transportation Stabilization Board (ATSB) to provide loan guarantees to the airline industry. The voting members of ATSB included a member of the Board of Governors of the Federal Reserve System and representatives from the Departments of the Treasury and Transportation. While the exact membership of a board to provide financial assistance to the Big 3 auto manufacturers could differ, past federal financial assistance efforts suggest that it would be prudent to include representatives from agencies knowledgeable about the auto manufacturing industry as well as from those agencies skilled in financial and economic analysis and assistance. In creating such a board, it will be crucial for Congress to ensure that the board, similar to boards created to implement past federal financial assistance efforts, has access to all financial or operational records for any recipients of federal assistance so that informed judgments and reviews can occur.⁸ It would also be important to ensure that the board has the authority and resources to hire or contract for necessary legal, financial, and

⁸In addition, prior federal assistance programs for failing firms and municipalities gave GAO the authority to audit the accounts of the recipients and the right of access to the records needed to do so. This authority enabled GAO to support congressional oversight of the assistance program.

other expertise.⁹ For example, ATSB hired an executive director, financial analyst, and legal counsel to help the board carry out its duties.

Beyond access to records and expertise, however, to succeed in achieving the goal of a restructured industry, the board is likely to need the authority to implement procedures and controls to protect the government's interests. This would include bringing the parties with a stake in a successful outcome to the table. Our review of past large-scale financial assistance efforts leads us to conclude that all of these parties must make concessions—not as penalties for past actions but rather to ensure cooperation in securing a successful future. The board would also need authority to approve the borrower's operating and financial plans and major new contracts to ensure the plans are realistic and to assess management's efforts in achieving results. In addition, the federal government should be the first creditor to be repaid in the event of a bankruptcy or when the company returns to profitability. In 1980, when providing assistance to Chrysler, Congress mandated that Chrysler meet additional policy-oriented requirements such as achieving certain energy efficiency goals and placed limits on executive compensation. More recently, as a condition of receiving federal assistance in the wake of the September 11 terrorist attacks, the Air Transportation Safety and System Stabilization Act required that airlines limit executive compensation.¹⁰

In addition, the board, consistent with congressional direction, could require that manufacturers, with the cooperation of labor unions, take steps to help control costs. Such steps could include reducing excess capacity by closing or downsizing manufacturing facilities, reducing work-rule restrictions that limit flexibility in terms of which workers can do what types of jobs, and ending contracts with dealerships that require the manufacturer to pay a large buyout to a dealer if a product line is eliminated. Some of these steps should be specifically addressed in the legislation. It will be important to keep in mind, however, that the affected parties will cooperate only if the assistance program offers a better alternative than bankruptcy. The government should

⁹Staff could also be detailed from federal agencies represented on the board to support the board's review and oversight function.

¹⁰P.L. No. 107-42.

not expect creditors, for example, to make concessions that will cost them more than they would expect to lose in a bankruptcy proceeding.¹¹ Finally, Congress should provide the board with enough flexibility to balance requirements in each recipient's business plan to achieve and maintain profitability.

The board could be the logical entity to establish and implement clearly defined eligibility criteria for potential borrowers, consistent with statutory direction provided by Congress, and establish other safeguards to help protect the government's interests and limit the government's exposure to loss. The safeguards could vary, depending on the nature of the financial assistance tools used. Examples of safeguards over loans and loan guarantees that have been used in the past include the following:

- Potential borrowers have been required to demonstrate that they meet specific eligibility criteria, consistent with congressional direction as to the problems to be addressed and the objectives and goals of the assistance.
- Potential borrowers have been required to demonstrate that their prospective earning power, together with the character and value of any security pledged, provided reasonable assurance of repayment of the loan in accordance with its terms.
- Potential borrowers have been required to clearly indicate the planned use of the loans so that the board could make appropriate decisions about the borrower's financial plan and terms and conditions, as well as collateral.
- The government has charged fees to help offset the risks it assumed in providing such assistance.
- For loan guarantees, the level of guarantee has been limited to a given percentage of the total amount of the loan outstanding.

¹¹GAO/GGD-84-34.

To further enhance accountability and promote transparency, the board should monitor the status of federal assistance on a regular basis and require regular reporting from companies receiving assistance. This reporting should, at a minimum, include information on cash flow, financial position, and results of independent audits. In addition, the board should be required to provide periodic reports to Congress. This reporting should include status reports on the amount and types of assistance provided to the auto manufacturing industry, periodic assessments of the effectiveness of the assistance, and status of any repayments of loans that the federal government has provided to the industry.

In addition to providing oversight and accountability of the federal funds, the board could be charged with overseeing efforts of the assisted companies to implement required changes and reform. The board would likely need to consider industry-specific issues in implementing financial assistance and industry reform. Employee compensation would be one of those issues, and a very complex one. Benefits for auto industry workers represent a significant long-term financial commitment of the companies seeking assistance, much of it to retirees and their families. Although success in a company's future will depend in part on sacrifice from all stakeholders, most of the changes in this area will necessarily take effect over the long term. The complexities of these arrangements and their interface with active workers and with existing government programs will make implementing federal assistance particularly challenging. For example, the board would need to consider the impact that a possible bankruptcy filing by an auto manufacturer would have on the Pension Benefit Guaranty Corporation, the federal agency that insures private employers' defined benefit pensions, and whose cumulative balance is already negative.

Concluding Observations

In conclusion, Congress is faced with a complex and consequential decision regarding the auto manufacturers' request for financial assistance. The collapse or partial collapse of the domestic auto manufacturing industry would have a significant ripple effect

throughout other sectors of the economy and serve as a drag on an already weakened economy. However, providing federal financial assistance to the auto manufacturing industry raises concerns about protecting the government's interests and the precedent such assistance could set for other industries seeking relief from the current economic downturn.

My remarks today have focused on principles Congress may wish to consider as it contemplates possible financial assistance for the auto manufacturing industry. These principles are drawn directly from GAO's support of congressional efforts over several decades to assist segments of industries, firms, the savings and loan industry, and municipalities. Although the principles do not provide operational rules outlining exactly what should be done, they do provide a framework for considering federal financial assistance. By defining the problem, determining whether a legislative solution to that problem best serves the national interest, and—assuming that such a solution is appropriate—establishing an appropriate governance structure, Congress might better assure itself and the American people that the federal assistance will achieve its intended purpose.

Thank you Mr. Chairman, Ranking Member Bachus, and members of the committee for having me here today. We at GAO, of course, stand ready to assist you and your colleagues as you tackle these important challenges.

Contacts

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