

FOIA MARKER

This is not a textual record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Collection/Record Group: Clinton Presidential Records
Subgroup/Office of Origin: National Economic Council
Series/Staff Member: Bob Shireman
Subseries:

OA/ID Number: 13218
FolderID:

Folder Title:
[Student Loan Programs] [1]

Stack:	Row:	Section:	Shelf:	Position:
S	15	1	11	1

McKee, Adler, Gaudin

2/11/98

• strong direct loan program *

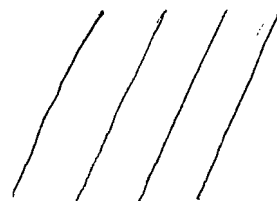
• Student costs

• manageability, efficiency...

• Taxpayer costs

• External process, no position on any possible Δ .

- Bob Cochran, Sally Stroup



• Dec 8 & 9 - 'Get together and present a solution.'

Deadline

- Feb, 25 mark-up - sch comm.

- March 18 full comm.

Car April - floor

- Commercial Paper - 'Books & SM.'

- ML smt: 'there's always dance leading'

C.P.

U.S.S.A. - want healthy survival... Balance: minimize costs & spreads
and access to loans (softer ^{softer} bank pro. financing)

- 1% reduction \$18M (400 - 10 yr. repair - 4000 savings

- 400k - 20 yrs. → \$6400

⇒ Margin

CI proposal does not address that...

Barnack:

- So far - unrealistic premises...

6 bp reduction

- 'real' reduction?

Outlines - Barnack

- First

- Exchange from assumption of positional bargaining - not a starting pt.

① Solve the PRREP problem. Legitimate industry concern...

→ use the most efficient order - 30 day CIBOR

⇒ What margin? Between: 10% and 91% 3.1

Margins - 58% - adj. rate not. 10 yr. fixed

- S.M. response: strong neg. response from schools...

'80 wants level playing field'

- Cooper to SD - low rates after X months...

Barnet: Support discouraging...

Dallas:

- Loans to students @ lowest rate possible.
- SALE loan program.

July (- ^{SALE} ~~SALE~~ from m/s
- FRACP schools - if lenders not
- heavy FRM lenders

IF explore rate $\rightarrow$ pressure for schools to switch...
but it has been the reverse in the past...

► Terms & conditions same, but discouraging allowed...

Rep. Gordon

$\Rightarrow$ Dallas - split the diff

Use: In HBA - need by Per or Med



National Association of
Graduate-Professional Students

Bryan Hannegan
President

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Graduate-Professional Students

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- ≈ Federal Legislative Advocacy
- ≈ More Benefits Added All the Time ... See our Home Page

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American Association of Dental Schools
1625 Massachusetts Avenue, NW, Washington, DC 20036-2212

Gina G. Luke
Legislative Analyst
Division of Government Affairs

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Top Ten Ways Congress Can Act to Reduce Student Debt

Presented by the National Association of Graduate-Professional Students (NAGPS), the American Association of Dental Students (AADS) and the American Medical Student Association (AMSA)

In a report titled "Graduating Into Debt", released in 1996, the Education Resources Institute and the Institute for Higher Education Policy described an alarming increase in graduate and professional student debt. Between 1993 and 1995, graduate and professional student borrowing increased by \$3.3 billion to a total loan volume of \$7.7 billion, an increase of 74% in just two years! In 1995, over 1 million graduate and professional students used a student loan to pay for their cost of education, an increase from 620,000 student borrowers in 1993. These increases in student loan debt impact a student's ability to save for home purchases, educational costs for their children, investment, or business startup capital. Given the need for Reauthorization of the Higher Education Act, and the potential for modest spending increases in education programs, the opportunity exists for Congress to take actions that would make the pursuit of an advanced degree more affordable for more Americans, by reducing student loan costs, increasing the amount of grant dollars available, and providing additional tax incentives for education spending and investment. We believe that the time is NOW for Congress to take any or all of the following actions:

1. Restore permanently the Section 127 income tax exclusion on employer-provided educational assistance
2. Make technical amendments to the Internal Revenue Code, exempting all scholarships, fellowships and tuition assistance from income tax *- 117(d) vs. indirect costs rules*
3. Expand the adjusted gross income limits on the Student Loan Interest Deduction to eliminate the "marriage penalty" for married couples. *- increase for Merv*
4. Authorize six years of eligibility for the Pell Grant and allow students who complete their undergraduate degrees in less than six years to use their remaining eligibility for an advanced degree program. *- if P.G. eligible as an undergrad.*
5. Authorize a new Title IX Graduate Fellowship program which includes "support for women and underrepresented minorities" and "arts, social sciences and the humanities" as "areas of National Need", and provide additional funds for this program in the FY 99 Budget.
6. Reauthorize the State Student Incentive Grant (SSIG) program and the Perkins Loan program, and provide increased funding for both in FY99 appropriations. Eliminate caps on the amount of Perkins Loans a student may receive as part of their financial aid package.
7. Increase annual limits in both subsidized loan programs from \$8,500 to \$10,500 per year, with a corresponding increase in aggregate subsidized limits from \$65,500 to \$79,500.
8. Preserve current aggregate (subsidized + unsubsidized) loan limits at \$138,000, but allow all health professions school students to borrow up to \$189,125 in aggregate limits in the Stafford Loan program, regardless of whether or not HEAL loans were previously offered at their school. *- still have need, going to private lending programs.*
9. Reduce student loan interest rates in both loan programs from 8% to 7% as planned under current law.
10. Eliminate or reduce "origination fees" on all student loans, and extend the interest-free grace period for loan repayment from six months to one year on subsidized loans. *- dental exam*

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February __, 1998

Mr. Joe Belew
President
Consumer Bankers Association
1000 Wilson Boulevard, Suite 3012
Arlington, Virginia 22209

Dear Joe:

This is in response to your letter of February 2, concerning the change in interest rates under the Federal Family Education Loan Program scheduled for July 1.

I am surprised that you "read with disappointment" my letter of January 14. As you recognize, that letter indicated that the Department is "open" to considering a change in the reference rate for student loans to reduce lenders' cost/risk in funding those loans. Apparently, your disappointment is over the Department's unwillingness, in the absence of sufficient information about the current profitability of different types of lenders, to take the initiative in proposing a new level of interest rates that would be fair both to students and to lenders.

Having read in the press about my last letter to you, I am not sure about the audience to which your latest letter is directed. Moreover, you and I both already know that certain of the assertions in that letter are incomplete at best:

1. It is true that the scheduled change in interest rates would have resulted in an increase in rates if immediately implemented when enacted, but it was never intended to be implemented at enactment. Although the unusually flat yield curve that now exists was not then projected, the then projections did include sufficient flattening to result in a substantial rate decrease.

2. It probably is true Sallie Mae's return on equity has been increased by income acceleration as the result of securitization. Although we have not been furnished with any information as to Sallie Mae's current pro forma returns in the absence of any income acceleration, analysis would suggest that Sallie Mae would still be one of the most profitable publicly held financial institutions in history even on that basis.

3. It is true that not all lenders are as profitable as Sallie Mae, but Sallie Mae does hold, or own the residual equity in, almost a third of all FFELP loans and has a contractual interest in a large percentage of additional loans that are presently in its pipelines. Moreover, the fact that some or all of the other lenders are less profitable than Sallie Mae does not mean that they are not still earning premium returns. That is in fact the case for the other two major lenders whose financial data have been presented to us.

4. It is true that we have recently met with representatives of your organization. In one such meeting, the profitability information on the other two lenders was presented. In the other, the possibility of a significant rate concession to students was raised by your own representatives.

5. It is true that you have proposed an alternative interest-rate formula based on commercial-paper rates. You already know, however, that we view the rate increment that is part of the proposal as the economic equivalent of repeal, with no substantial protection for students and a possible increase in profitability for lenders.

6. Finally, it is true that the Department of Treasury's analysis of this issue has not been released. It has not yet been completed.

I agree that a meaningful dialogue between lenders and the Department would be useful. That objective will not be advanced by indirect public statements of information known at best to be incomplete. If lenders are willing to provide the financial information that is necessary for an informed policy judgment on this matter, appropriately balancing the interests of students and lenders, I, for one, am willing to engage in meaningful dialogue with you at any time.

Sincerely,

Donald M. Feuerstein
Senior Advisor



CONSUMER BANKERS ASSOCIATION

The Association for Retail Banks and Thrift Institutions

1000 Wilson Boulevard, Suite 3012, Arlington, Virginia 22209-3908

Tel.: 703/276-1750 • Fax: 703/528-1290

February 2, 1998

Donald M. Feuerstein
Senior Advisor
U.S. Department of Education
ROB-3, Room 4624
7th & D Streets, SW
Washington, D.C. 20202

Dear Don:

I read with disappointment your letter of January 14th, written in response to my letter to Senator Robb relating to the change in borrower interest rates on federal student loans scheduled to go into effect on July 1, 1998.

I understand that you have met with at least two of the members of the CBA Education Funding Committee, as well as with others involved in the FFEL program. From your letter, it appears that the Department is open to considering alternative reference rates that would reduce lenders' cost in funding student loans. CBA and its member institutions are interested in working with you on this. We are currently exploring a one-month commercial paper reference rate and would be interested in the Department's analysis of this approach.

Over the past several months, CBA and others have been working on approaches that balance necessary lender return with the shared interest in minimizing borrower costs. In this regard, we note that when the new borrower interest rate formula was enacted in 1993, its immediate implementation would have resulted in a small increase in borrower interest costs. We also note, most importantly, that the extraordinarily flat yield curve now in existence was unforeseen in 1993. These factors must be kept in mind when options for modifications in the interest rates are explored.

In your letter you reference the financial results of Sallie Mae, but do not indicate whether you consider these results typical of other lenders. I believe these results are not typical of virtually all loan providers in FFEL. In fact, the return on asset ratio for this product is significantly less than the rest of other assets that banks carry on their balance sheets. Also, it must be noted that Sallie Mae's return on equity ratio is largely a product of that company's heavy use of asset securitization as a new financing tool for its portfolio.

Any resolution of the 1998 interest rate issue that results in most current lenders being forced to leave the program is, in our view, unacceptable. Without a reasonably broad participation of lenders of all sizes in the program, the stability and technological innovation that has characterized FFEL in recent years would not be possible.

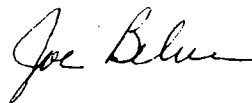
Development of a resolution to the 1998 interest rate issue will require initiative and good faith on the part of FFEL program participants, but also on the part of the Department. In this regard, we are disappointed that you indicate that "we do not have sufficient information to formulate a solution to the lenders' funding problem ourselves." We believe this is regrettable and that, in the interest of assuring the stability of the FFEL program, the Department should consider convening a small working group of FFEL loan providers to sit down with you and others from the Department, review financial issues, and explore a resolution to this issue. Members of the Consumer Bankers Association would be active participants in such a meeting.

We also understand that an analysis of the 1998 interest rate issue was prepared by the Department of Treasury at the request of the National Economic Council, but that it has not been released. Publicly releasing this report, regardless of its contents, would be a good first step towards moving towards resolution of this issue. We would recommend that this report serve as the basis for discussion in the meeting with loan providers and the Department that we are recommending.

Finally, please let me politely object to your characterization of the 1998 interest rate problem as the "lenders' funding problem." From talking to both CBA members and others involved in providing capital for student loans, it should be clear that there is, at a minimum, a significant risk of a crisis in student loans coming this summer. To us, the issue is whether loans will be available to all students that need them to attend school. We would urge you to adopt this perspective. Politics should be set aside and we should all roll up our shirt sleeves and find a resolution to this difficult issue.

We remain interested in working with the Department. Please let us know if we can schedule a working session with you to share ideas on how to proceed.

Sincerely,

A handwritten signature in cursive script, appearing to read "Joe Belew".

Joe Belew

January 14, 1998

Mr. Joe Belew
President
Consumer Bankers Association
1000 Wilson Boulevard, Suite 3012
Arlington, Virginia 22209

Dear Joe:

Senator Robb has asked us to respond to your letter of October 24 concerning the change in interest rates under the Federal Family Education Loan Program scheduled for July 1.

As you know from our prior discussions of this subject, the Department has no desire to impose unnecessary costs or risks on the private lending activity that it subsidizes. The method for determining the intra-governmental cost of funds has been revised since the scheduled change was enacted in 1993, and the Department is open to consider alternative reference rates that would reduce lenders' cost or risk of funding student loans. When the scheduled change was enacted, however, it was clearly intended to reduce student borrowing costs. Any further change to facilitate lenders' funding should not be at the expense of students. This is particularly so in light of the very high levels of profitability of those lenders whose financial results are publicly reported. Thus, the Department has not seen any basis for simply repealing the scheduled change.

There is very little data available on the current profitability of student loans to the categories of lenders other than Sallie Mae: (1) banks that originate and hold loans through repayment, (2) banks that originate loans but sell them before repayment and (3) other secondary markets, which finance the bulk of their holdings with tax-exempt funds. Any change in interest rates will affect these categories differently. Accordingly, we do not have sufficient information to formulate a solution to the lenders' funding problem ourselves. We understand that lenders are working on a student-oriented solution. We shall carefully consider any such proposal. Of course, we shall need sufficient supporting data to evaluate its impact on each category of lender.

Sincerely,

Donald M. Feuerstein
Senior Advisor

cc: Senator Charles S. Robb

- take larger

- Feb. 25

- ...
- ...
- ...



p. 56

+ will this be the ... ??

spare camp

Now: School ...

... ..

A.H.

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Author: David Longanecker at WDCA01
Date: 2/3/98 5:57 PM
Priority: Normal
TO: Stephanie Babyak at WDCB01
TO: James Kvaal at WDCA08
TO: Jane Glickman at WDCB01
Subject: Re: Congressional Quarterly interview

----- Message Contents -----

At this point I think we should refer all calls to Shireman. I am sure that he was the Administration official. With respect to our ability to respond, we are currently assessing precisely what our capability is to respond today and how long it will take us to gear up, if necessary. That analysis won't be completed until next week.

dal

----- Reply Separator -----

Subject: Congressional Quarterly interview
Author: Jane Glickman at WDCB01
Date: 2/3/98 5:34 PM

David,

Sue Kirkoff of Congressional Quarterly has requested an interview about the upcoming change in the interest rate for student loans.

I know you spoke to Bob Shireman last week regarding the call from Al Crenshaw of the Washington Post on the same subject, and I believe the two of you decided he'd take the call. (I assume you saw the story in Sunday's paper or in yesterday's clips, page 21). However, Shireman is NOT quoted, I'm not sure if he is the White House official referred to in the article who said the new formula "is a considerable reduction for students," and "whether for-profit lenders can afford that is a reasonable question." Perhaps this issue is still considered too volatile and the Administration is still testing the waters before we speak "on the record."

The article also includes this statement, "Education Department officials have conceded in recent weeks that if private lenders pull out, the government's direct loan program could not fill the gap."

We need to be prepared to explain what is meant, considering that we have been so pleased with our recent track record on loan origination. Does this mean that the direct loan program would not have the capacity to accommodate a large influx of new schools and their accompanying loan volume by next year, and/or that we don't have the administrative budget to handle it.

Please let me know if you have any insight into why the Post article did not quote Shireman, and thus whether you should speak to Congressional Quarterly on the record.

If I'm being overly cautious, let me know, and we can set it up for tomorrow.

1/93

1/94

1/95

1/96

1/97

12/97

SOURCE: Bloomberg News

New Student Loan Formula Doesn't Rate With Lenders

A little-noticed change in the formula governing interest rates in government-guaranteed student loans is threatening to disrupt this fall's education finance market, lenders and others involved in tuition finance say.

CASH FLOW

Albert B. Crenshaw

The change, enacted five years ago when it appeared that the government would be taking over most if not all higher-education lending, was designed to lower costs for student borrowers. But the government's direct loan program has not expanded to the anticipated levels, and private lenders say they cannot lend profitably at the rates dictated by the new formula, which is scheduled to go into effect July 1.

Since private loans continue to make up roughly 70 percent of all student loans, a mass pullout by private lenders likely would cause major headaches for students and colleges this fall.

Education Department officials have conceded in recent weeks that if private lenders pull out, the government's direct loan program could not fill the gap.

Likewise, some nonprofit lenders have told Clinton administration officials that while the new formula is not a problem for them, they doubt they have the capacity to meet all the demand either.

The administration has been studying the issue and has asked the Education and Treasury departments to analyze the situation to see if any changes should be made in the formula.

Congress also is studying the matter, and many members agree that a fix is needed. Congress is not always able to act quickly, however, and with college acceptance due soon and parents anxious to get next fall's financing lined up, a delay could be painful.

"Lenders want to offer some reassurance to their school customers," said Fritz Elmendorf of the Consumer Bankers Association. "They are not quite wanting

See CRENSHAW, H4, Col. 1

2 International investors seek a safe haven in European stocks.

3 Increasingly, mutual fund companies are charging "adviser" sales fees.

7 Workplace: Justices address the issue of contract workers.



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Dispute Could Disrupt Student Loan Program

CRENSHAW, From H1

to panic anybody, but there is a real issue of being able to follow through on loan commitments. We are really looking for some assurance the problem will be fixed in a satisfactory way."

J. Paul Carey, executive vice president at Sallie Mae, which buys large numbers of student loans from lenders each year, said he is optimistic the problem will be solved but if it isn't the consequences could be "pretty dramatic."

Indeed, the whole federal student aid program is due for reauthorization by Sept. 30, so the problem could be fixed in the new bill, but it is not clear whether that would reassure banks enough for them to go ahead during the spring and summer and write the roughly \$25 billion worth of loans provided annually by the private sector.

The new formula as written would in current market conditions result in sharply lower interest rates for students, and the White House is anxious to see that happen. In the view of some administration officials, much of the banks' griping is aimed at protecting a very profitable business. But they say they will be willing to try to work out a deal if the analysis shows the loans really will be unprofitable.

The new formula "is a considerable reduction for students," said one White House official. "Whether for-profit lenders can afford that is a reasonable question. ... If I can predict what the Treasury study will show, it's that lenders can take a hit, but probably not that big a hit."

The new formula is "untimely" for two reasons, said Mark Cannon, executive director of the Coalition for Student Loan Reform, a group of state and nonprofit organizations that administer and fund the federal guaranteed student loan program.

First, "the luster is off the direct loan program, which has been shown

to have a number of managerial problems." Second, interest rates have changed dramatically since 1993, with short-term rates rising and long-term ones falling. This has altered the performance of the formula considerably.

Student loan rates are set by taking the interest rate on a Treasury security and adding to it a certain amount, or "spread," much like the formula for an adjustable-rate mortgage.

Under the current formula, the Treasury instrument is the 91-day T-bill. The spread is 3.1 percentage points (2.5 percentage points while the student is in school). Thus, if 91-day T-bills are paying 4 percent, the rate on the student loan would be 7.1 percent after the student leaves school. There also is a ceiling, so students do not pay more than 8.25 percent.

The new formula is based on the 10-year Treasury note, and the spread is 1 point. Thus if the 10-year note rate is 5 percent, the rate on the student loan would be 6 percent.

The two formulas seemed to yield fairly similar results in 1993. The "yield curve," which shows the different rates lenders charge for loans over various time periods, was fairly steep at that time, meaning long-term rates were substantially higher than short-term ones.

Thus, according to an analysis done by Sallie Mae, T-bill rates were 3.11 percent in August 1993. With a spread of 3.1 percentage points, the student loan rate would be 6.21 percent. At the same time, the 10-year note was carrying a rate of 5.78 percent. With a spread of 1 percentage point, the student rate would be 6.78 percent.

Today, though, things have changed. The rate on the T-bill last month was 5.25 percent, so students would pay 8.25 percent (8.35 were it not for the ceiling). Ten-year note rates, though, were 5.55 percent, so

under the new formula the student rate would be 6.55 percent.

Carey said student loans, though guaranteed by the government, are expensive to service. Also, the loans are not fixed-rate—they vary as the rate on the 10-year note changes—so that it is much more difficult for Sallie Mae or other financial firms to match their own borrowings with it.

Under the new formula, a loan would be worth only 95 percent to 96 percent of its face value the day it was signed, Carey said. This means a lender that made such a loan and then tried to sell it to Sallie Mae could expect only 95 cents or 96 cents on the dollar—and that assumes no profit for Sallie Mae.

Sallie Mae, bankers and other financial firms have suggested other instruments upon which to base the formula, including the T-bill, the London inter-bank offered rate (LIBOR) and commercial paper. Administration officials agree that the 10-year note is an "inefficient instrument" for private lenders, and is studying alternatives.

Lenders also contend that the new formula wouldn't necessarily be cheaper for students year in and year out, and they point to studies showing that in the period since 1981, the current formula produced lower rates than the new one would have.

Students—and their parents—planning to borrow for the fall semester obviously should watch this issue closely. Those planning to borrow might check with their school and see what advice the institution is giving.

It would be a political disaster for the administration if the loan program ran aground, but the lenders, knowing that, also may try to drive a hard bargain. Remember, this is the administration that told them five years ago that they were part of the problem of higher education costs and that vowed to drive them out of the marketplace.

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costs and tuition prices.

The Commission recommends the achievement of five policy goals: strengthening institutional cost control, improving market information and public accountability, deregulating higher education, rethinking accreditation, and enhancing and simplifying Federal student aid.

The Commission's specific recommendations for Congress in the area of student aid are to continue the existing student aid programs and simplify and improve the financial aid delivery system. They call for further technological improvements that will cut costs and simplify. They also recommend that Congress investigate the feasibility of broadening eligibility requirements for Federal student aid to include part-time students.

One of the more significant findings said, "the Commission has found no conclusive evidence that loans have contributed to rising costs and prices. One commissioned paper suggests that Federal loan availability has helped contribute to rising prices. Another paper suggests that the capital available through loans has allowed colleges to increase their charges--and allowed independent colleges in particular to maintain enrollment--in ways that would not have been possible otherwise. The Commission knows of other studies which come to conclusions opposite to these. This question should be studied in greater detail and with much greater attention to empirical facts."

Bob

Shireman
456-2223

from AMF

3

The full report can be found on either the American Council for Education or the *Chronicle of Higher Education's* websites. They are www.acenet.edu and www.chronicle.com.

ED Will Propose FCC for Perkins Loan Program

Following widely publicized reports that the Department of Education would propose no new Federal Capital Contributions (FCC) for the Federal Perkins Loan program in its upcoming FY 1999 budget, postsecondary institutions in the program cried foul. Following discussions between schools and ED, the Department made clear that new FCC would be in the budget.

Under the Perkins program, federal funds are matched with institutional funds on a one-to-three match for capital used for the campus-based loans. Borrowers pay an attractive five percent interest rate. Notwithstanding the attractiveness of the loans for borrowers, both Democrat and Republican administrations have periodically called for elimination of the program, suggesting that it is duplicative with the larger FFEL and Direct Loan programs. The administration will deliver its budget proposal to Capitol Hill on February 2nd.

Shireman Expects 1998 Interest Rate Resolution

Senior Policy Advisory Robert Shireman of the National Economic Council told *Student Lending* that he expects there will be a "solution" to the problem prior to July 1, 1998, the date on which the new rates go into effect. Shireman also noted, however, that there had been no new progress on a solution in the last week. "I think there will be a considerable effort on the part of all parties concerned to make a change before July 1, including the administration," he said.

(Continued on page 10)

Shireman reportedly has received a report from the Treasury Department concluding that the borrower interest rates based on the 10-year bond are not feasible in the FFEL program. While he has declined to release the report, it is believed to have influenced his opinion.

Shireman's position differs from that of Donald M. Feuerstein, Senior Advisor at ED. In a Jan. 14, 1998 letter to Joe Belew, President of the Consumer Bankers Association, Feuerstein noted, "we do not have sufficient information to formulate a solution to the lenders' funding problem ourselves."

NEWS IN BRIEF

□ Higher Education Washington Inc., announced the birth of their new newsletter *Information Technology in Postsecondary Education (ITPE)*. The first issue went out on Jan. 20, 1998. For subscription information call Stephanie Harris at (202) 842-4989 or email her at <hewi96@aol.com>.

□ \$12.5 billion in student loan asset-backed securities were issued in 1997, according to an article in the *American Banker*, as compared to \$8 billion in 1996. In 1997, a total of \$185.1 billion in asset backed securities were issued in all categories, led by \$64.9 billion in the home equity loan category.

□ ELM Resources had their biggest day of disbursements ever on Jan. 14 with \$38 million of FFEL loans being disbursed.

□ Princeton University plans to eliminate the use of student loans for students from families with incomes below \$40,000, according to an article in the *Wall Street Journal*. The initiative also includes modifying need analysis for students from incomes below \$90,000 by eliminating consideration of home equity.

PEOPLE

• Mark Brenner joined the Education Finance Council as General Counsel on Jan. 26. Formerly of the Oversight Subcommittee of the House Committee on Education and the Workforce, Brenner will be responsible for managing regulatory and legal issues and special projects.

• Gregory Lancaster resigned as a member of the CBA Educational Funding Committee this month. He asked that Andrew D. Fornarola, Senior Vice President of Marine Midland Bank, be appointed to fill the vacancy.

• Educational Funding Company, a majority-owned subsidiary of American Express, named Mark K. Webb as President and CEO. Webb has been with American Express for 14 years in various positions.

• Sally Katzen has been appointed Deputy Assistant to the President for Economic Policy. She will serve as Deputy Director at the National Economic Council. Katzen has been the Administrator of the Office of Information and Regulatory Affairs in the Office of Management and Budget since 1993.

• The Project EASI Steering Committee welcomed Postsecondary Electronic Standards Council Director Lysbeth (Betsy) Bainbridge and Education Finance Council Director of Government Affairs Kathleen Smith last week as its two newest members.

REGULATORY/ADMINISTRATIVE NEWS

January, 1998: The Department of Education issued three Dear Guaranty Agency Director letters on disaster area designations: Disaster Letter 98-02 regarding winter storms in New York; Disaster Letter 98-03 regarding flooding in Tennessee; and Disaster Letter 98-04, regarding flooding in North Carolina.



tombutts @ umich.edu
01/27/98 07:21:00 AM

Record Type: Record

To: Robert M. Shireman

cc:

Subject: More on interest rate--finaid-l

from finaid-l - Note the last one from Ivan.

Date: Mon, 26 Jan 1998 05:02:26 -0500
From: Anthony Rosati <rosati@GUSUN.GEORGETOWN.EDU>
Subject: More on this "Interest Rate Thing"

The following was sent to me directly... Thought I would share with y'all...

From: NEFSC MGL <NEFSCMGL@aol.com>
Date: Sun, 25 Jan 1998 16:03:12 EST
To: rosati@gusun.georgetown.edu
Subject: Re: FINAID-L Digest - 23 Jan 1998 to 24 Jan 1998

As the Illinois Designated Account Purchase Program(IDAPP) we originate loans nationally on a not-for-profit basis. We are more than willing to give some of the interest rate back to the students and we are ready to work with the 10 year t-bill instrument as our funding source.

This change will result in some banks leaving but we agree with your contention that other organizations will fill in the gaps.

We disagree with your statement that this is taxpyers money. The capital used by the private sector to make these loans is private funds - not tax money. In our situation we float tax free bonds to originate loans in our home state but we use private taxable funds for loans everywhere else.

We actually see the present law as favorable to us because it should result in more loan volume.

If you need a lender that will be around after July 1,1998 call a National affiliate of IDAPP at 800 353-3357.

Thanks...

Michael G. Lewis senior Vice President

@=====

Tony Rosati	NAGPS Chief Information Officer	
6630 Moly Drive	NAGPS Board of Directors, 1992-1998	

| Falls Church VA 22046 | NAGPS Webmaster (webmaster@nagps.org) |
| 703-237-4323 | Owner, T-ASSIST Discussion List |

=====

Personal WWW Page >>> <http://www.access.digex.net/~rosati/>

| NAGPS WWW Site >>> <http://www.nagps.org/NAGPS/> |

@=====

Date: Mon, 26 Jan 1998 08:30:40 -0500

From: Anthony Rosati <rosati@GUSUN.GEORGETOWN.EDU>

Subject: Re: Interest Rates, Interest of Students, General Interest...

>Mr. Rosati,

>

>I couldn't have said it more..... "eloquently", but your message
>rings true. It's unfortunate that many of our colleagues have been
>duped into thinking that lenders, for some reason, have the student's
>best interest at heart. The hard truth is that they do not, and it
>is up to the financial aid community (even their responsibility), to
>ensure the students get the best product and services available.

>

>thanks for the response, I hope it serves as a nice wakeup call.

>

>Edward Hastings
>Assistant Director
>Dartmouth College
>

Dear Edward & Others,

The key here is to realize that, left to themselves, all corporate entities seek to maximize profits. It is the PEOPLE who lead them, and those who INTERACT with them, who can change that course to a more reasonable and reasoned one.

Corporations have identities, but they are NOT human ones. We, as men and women, who have moral fiber and ethics (whether we apply them or not) are bound to examine the actions of others, whether human or not, and to conclude how to deal with them.

We must impinge upon the individuals who run the lending institutions two important lessons:

1. Student Lending is NOT a profiteering market arena
2. In dealing with Public Works Projects (and federal student lending programs are really just that - work for the public good), customer service is EVERYTHING.

That's all from my end, today...

Tony Rosati
NAGPS CIO, SEcretary & Webmaster
NAGPS Board of Directors

@=====

| Tony Rosati | NAGPS Chief Information Officer |

6630 Moly Drive	NAGPS Board of Directors, 1992-1998
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703-237-4323	Owner, T-ASSIST Discussion List

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| Personal WWW Page >>> <http://www.access.digex.net/~rosati/> |

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| NAGPS WWW Site >>> <http://www.nagps.org/NAGPS/> |

@=====

Date: Mon, 26 Jan 1998 09:54:50 -0500
From: Paul Zakariasen <102370.2067@COMPUSERVE.COM>
Subject: Re: FINAID-L Digest - 23 Jan 1998 to 24 Jan 1998

I would be careful what you espouse. If the FFELP program collapses, many of the students who you "think" you are protecting will be left out in the cold. The banking community will exit the student loan business, but also will many students because they have no access to student loans. Yes, there is the Direct Loan Program (talk about tax dollars!!), but the rush of schools trying to enter the direct loan program would grind that program to a halt. Furthermore, there would be immeasurable delays (think "consolidation loans"). This would literally shut down many small schools because their students will have no immediate access to student loans. Just imagine thousands of schools flooding the phone lines of the Direct Lending Task Force to sign up for direct lending when they realize July 1st their friendly banker won't front the money for that \$2,625 Sub Stafford! Now, how is that serving the student? I'm not a great lover of the banks, especially when I withdraw at a "non-system ATM", but we all should look at the bigger picture which is access for all students to finance their education. Anyway, is 8.25% all that bad an interest rate CAP?

Just MY two cents.

Mike Kotchevar
Northwest Technical Institue
Eden Prairie, MN 55344
finaid@nw-ti.com
Date: Mon, 26 Jan 1998 11:02:55 -0500
From: Dominic Yoia <yoia@CSE.BRIDGEPORT.EDU>
Subject: Re: FINAID-L Digest - 23 Jan 1998 to 24 Jan 1998

This is a multi-part message in MIME format.

-----75D4A807C98C6CF703BF7C8E

Content-Type: text/plain; charset=us-ascii

Content-Transfer-Encoding: 7bit

I've been reading comments both pro and con on this issue, so I just figured why not jump in on this lively debate and add my 2 cents worth.

Firstly, let's not all jump so quickly to "cast the first stone" at the lenders. Remember that it is OK for them to make a profit, they are "for-profit" businesses and they make these profits by lending money whether it be mortgages, car loans, student loans, etc.

Secondly, it is in the best interest of ALL OF US to assure that the student loan business (and it is a business) remains competitive. As much as everyone may like to criticize the FFELP or Direct Loan programs, competition has made BOTH programs much better than they were just a few years ago.

Every year, many schools continue to cut expenses to the bone, and we're all still around. Cutting into the profits of lenders will not push them out of the student loan programs, it simply will make them run more efficiently. After all, what other loan programs come with a 100% guarantee? I somehow don't foresee all of the lenders running for the hills and leaving the student loan programs behind.

So, having said all that, I vote for whatever best benefits the student. And to date, that seems to be a slightly lower interest rate with these new interest rate provisions. Because student loans are not a zero-sum game, I cast my vote with 100 confidence that everyone will benefit.....students (lower interest rates).....schools (better service due to stronger competition).....and lenders (more loan volume). Ain't America Great!

Nick :-)

-----75D4A807C98C6CF703BF7C8E

Content-Type: text/x-vcard; charset=us-ascii; name="vcard.vcf"

Content-Transfer-Encoding: 7bit

Content-Description: Card for Dominic Yoia

Content-Disposition: attachment; filename="vcard.vcf"

begin: vcard
fn: Dominic Yoia
n: Yoia;Dominic
org: University of Bridgeport
adr: Office of Financial Aid;;126 Park
Avenue;Bridgeport;CT;06601;USA
email;internet: yoia@cse.bridgeport.edu
title: Director of Financial Aid
tel;work: (203) 576-4568
tel;fax: (203) 576-4941
Date: Mon, 26 Jan 1998 11:06:57 -0500
From: Tony Rosati <rosati@GUSUN.GEORGETOWN.EDU>
Subject: Reply to Re: Educating about (fwd)

FYI, some more comments I received...

*** Comments From: STORYKA - Story, Kaye; 01/26/98 09:54am
we implemented the direct loan program with approximately \$40
million annually in loans with no additional staffing---but it
did take training..training..training.. and due to turnover
has presented some problems.

Date: Mon, 26 Jan 1998 11:48:46 -0500
From: Maryanne Belmont <mbelmont@BARNEY.SUFFOLK.EDU>

Subject: Re: FINAID-L Digest - 23 Jan 1998 to 24 Jan 1998

Actually Mike, if the FFELP program were to collapse, the banking community stands to make a lot of money because students would have to resort to private loans - furthermore, if the FFELP program collapses, the same number of students would suffer - all of them. Not just those who receive their Federal loans through DL institutions. Why should private banks benefit from FEDERAL LOANS? And why should students pay their guarantee fees? If the Gov. is lending the money, by all means, the Gov. should reap any benefits that are generated from that loan. It just doesn't make sense to have private banks handling Federal loans - and making a profit on it to boot.

Nobody asked, just my opinion

On Mon, 26 Jan 1998, Paul Zakariasen wrote:

> I would be careful what you espouse. If the FFELP program collapses, many
> of the students who you "think" you are protecting will be left out in the
> cold. The banking community will exit the student loan business, but also
> will many students because they have no access to student loans. Yes,
> there is the Direct Loan Program (talk about tax dollars!!), but the rush
> of schools trying to enter the direct loan program would grind that program
> to a halt. Furthermore, there would be immeasurable delays (think
> "consolidation loans"). This would literally shut down many small schools
> because their students will have no immediate access to student loans.
> Just imagine thousands of schools flooding the phone lines of the Direct
> Lending Task Force to sign up for direct lending when they realize July 1st
> their friendly banker won't front the money for that \$2,625 Sub Stafford!
> Now, how is that serving the student? I'm not a great lover of the banks,
> especially when I withdraw at a "non-system ATM", but we all should look
> at the bigger picture which is access for all students to finance their
> education. Anyway, is 8.25% all that bad an interest rate CAP?

>
> Just MY two cents.

>
> Mike Kotchevar
> Northwest Technical Institue
> Eden Prairie, MN 55344
> finaid@nw-ti.com

>
> -----
> This message | Submissions -> FINAID-L@lists.psu.edu
> was sent via | Subscribe/unsubscribe -> LISTSERV@lists.psu.edu
> the FINAID-L | List owner (Bob Quinn) -> REQ1@psu.edu
> mailing list | backup (Pete Weiss) -> FINAID-L-REQUEST@lists.psu.edu
> -----| send 1-line text INFO FINAID-L -> LISTSERV@LISTSERV.NET
>

Date: Mon, 26 Jan 1998 12:05:57 -0600
From: Margaret Robinson <finaid@JINX.SCKANS.EDU>
Subject: Direct Loan vs. FFELP

Just putting in my two cents worth on Direct Loans and FFELP. We are a very small private college and are participating in both loan programs. This is the third year for Direct Loans.

The competition has been good for both programs and I don't want to see either program eliminated and both need improving. However, we have more problems with FFELP loans and virtually no problems with Direct Loans. Going Direct did not increase our work load nor has it put a burden on our resources. I personally do all the Direct Loans - granted a small number in comparison - and my assistant does all the FFELP. The problems we have been having are tied to things beyond our control - the merging of banks. When information is not transferred completely and correctly, it causes all sorts of havoc. A lot of time is being spent taking care of these problems and correcting mistakes made on the part of the lender/servicer. We are not having to deal with these kinds of issues with Direct Loan (the relocation of the LOC and the problems that occurred did not impact us).

My assistant's frustrations with FFELP loans are too numerous to list. She is hoping we will increase our Direct Loan volume next year and would love for it to be 100%. That is not in my plans, yet, but certainly a consideration. We would be SAVING a lot of time and resources if we did move totally to Direct Loans, but I want to be able to give our students the option.

For whatever it's worth.

Margaret Robinson
Director of Financial Aid
Southwestern College
Winfield, KS
Date: Mon, 26 Jan 1998 11:53:57 -0600
From: Roger Vick <ROGER@LTFA.LATECH.EDU>
Subject: FDSL vs FFEL Program

Ladies and Gentlemen:

I have been involved with this controversial discussion of DSL and FFEL since it's inception.

As far as I am concerned, DSL is a direct drain on the Federal Government and taxpayer funds whereas FFEL is a leveraged lending program. All of the noise of costs and savings ignore the source of the principal of each loan.

Secondly, I find a significant difference between lenders providing service in a competitive environment and contractors to the Federal government meeting the letter of the contract. This comparison addresses all aspects of the Title IV programs. The student and the school certainly do not get a better level of service from the contractor.

Third, my processing of FFELP loans requires a minimum of labor in the office and a very simple procedure to impart to the student-borrower. This saving in time and labor allows me to use my

limited staff resources to resolve individual student problems, thereby providing better service to the student. Each administrative procedure that requires labor draws staff away from assisting those students with real problems.

Much of the borrowing I see each academic year is within the cost of attendance but far above what is really needed. There is no effort from the student to defer "wants" until graduation and employment. Interest rates seem to be more a political issue than a deterrence to students attending school.

The bottom line is there is a cost of doing business and the consumer or the taxpayer is going to pay some of the cost. In my opinion, the FFEL program provides the best combination of services for the cost.

Date: Mon, 26 Jan 1998 20:10:47 -0500
From: Ivan Frishberg <ivan@PIRG.ORG>
Subject: Re: FDSL vs FFEL Program

Pardon me, but last I checked, this is not a debate of FFELP vs FDLP. This has very little to do with the Direct Loan program. If you take the loan industry folks at their word (I do some times, and other times I use my own judgement) the Interest Rate Change issue is about the yield on FFELP loans, and who is responsible for maintaining that yield at a certain level. What decides that level depends on who you are:

If you are a banker, it is about maximizing profits and gaining competitive edge over your rivals in the industry.

If you are the government, it is about not paying out any more money than you have to and ensuring that you have met your promises to voters.

If you are a student, it is about trying to find the money to pay for school without placing yourself at a financial risk.

If you are stuck in the 104th Congress, being wooed by certain associations, listen to Rush (not the band), then this is a debate about FFELP vs FDLP.

My missive has two points to it:

1) This is an FFELP program and should not be fixed by direct loan borrowers, and

2) If we debate this issue from the perspective of FFELP vs FDLP it will not do justice to the real issue, and it will disengage all those folks who are too busy to spend time reliving the 104th Congress.

Ivan

Ivan Frishberg, | Internet: ivan@PIRG.org
PIRG's Higher Education Project | Phone: (202) 546-9707
U.S.Public Interest Research Group | Fax: (202) 546-2461
218 D St., SE, Washington, DC 20003 | WWW: www.pirg.org

End of FINAID-L Digest - 25 Jan 1998 to 26 Jan 1998

FACSIMILE COVER SHEET
OFFICE OF ECONOMIC POLICY

DATE January 22, 1998

NUMBER OF PAGES TO FOLLOW: 3

TO: Bob Shireman

NEC

ADDRESSEE'S FAX NUMBER: (202) 456-2223

ADDRESSEE'S CONFIRMATION NUMBER: (202) 456-5351

FROM: Susan Lepper

Economic Policy, U.S. Treasury Dept.

SENDER'S FAX NUMBER: (202) 622-2563

SENDER'S CONFIRMATION NUMBER: (202) 622-1761

COMMENTS/SPECIAL INSTRUCTIONS:

U N C L A S S I F I E D



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 22, 1998

TO: Bob Shireman, Maureen McLaughlin, Wayne Upshaw, other recipients of the
January 20 Student Loan Paper

FROM: Jon Gruber

SUBJECT: Revised Tables

Two revisions are necessary to the previously distributed tables:

- the CBO interest rate forecasts on Table 1 had not been updated for the January release; the new numbers have a somewhat smoother contour from 1998 to 1999 which removes some anomalies resulting from use of the September forecast in Table 3.
- Table 3 needed to be updated for the new CBO numbers; and in the course of doing so, an arithmetic error in the last column, for 5-year average -Administration forecast assumptions, was discovered. With these changes, the estimated net return to lenders under the "hold student harmless" formula is below any rates of return that might be assumed to be required by lenders, under any of the alternative economic assumptions.

cc. Messrs. Wilcox, Gensler

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

(In Percent)

Formula or Net Rate of Return	1997/98		1998/99			5-yr. ave.
	Administration	Blue Chip	Administration	Blue Chip	CBO	Admin.
Current Formula:						
3-month T-bill + 2.50/3.10	7.67/8.25	7.67/8.25	n.a.	n.a.	n.a.	n.a.
Estimated net return to lender	1.51	1.36	n.a.	n.a.	n.a.	n.a.
Future Formula:						
10-year CMT + 1.00	n.a.	n.a.	6.86	7.10	7.2	6.76
Estimated net return to lender	n.a.	n.a.	0.18	0.17	0.35	0.15
Alternative Formulas:						
To hold student harmless	n.a.	n.a.	T-bill + 1.73	T-bill + 1.76	T-bill +1.70	T-bill +1.83
Estimated net return to lender	n.a.	n.a.	0.35	0.37	0.32	0.45
To maintain lenders minimum required net rate of return:						
75 basis points	n.a.	n.a.	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28

Note: Formula estimates are a weighted average for loans in-school and in repayment. The weights are based on the relative share of loans outstanding for each loan status, i.e., in-school= 36.08 percent and repayment= 63.92 percent.

n.a. Not applicable

Assumptions:

OMB estimates are based on Fiscal Year 1999 budget estimates.

Blue Chip estimates are based on the December Blue Chip release.

1/22/98

STULOSUM

TABLE 1: INTEREST RATE ASSUMPTIONS

	(Percent)			
	1997	1998	1999	6-year ave.
OMB				
3-month T-bill	5.17	5.13	5.01	4.93
10-year note	6.75	5.86	5.80	5.76
Spread	1.58	0.73	0.79	0.83
Blue Chip				
3-month T-bill	5.17	5.34	5.13	--
10-year note	6.75	6.10	6.10	--
Spread	1.58	0.76	0.97	--
CBO				
3-month T-bill	5.17	5.30	5.20	--
10-year note	6.75	6.00	6.10	--
Spread	1.58	0.70	0.90	--
DRI				
3-month T-bill	5.17	5.19	4.83	--
10-year note	6.75	5.8	5.82	--
Spread	1.58	0.61	0.99	--
Futures Market a/				
3-month T-bill	--	4.89	n.a.	n.a.
10-year note	--	5.39	n.a.	n.a.
Spread	--	0.5	n.a.	n.a.

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1;
all other data are for the second calendar quarter.

n.a. Not available.

a/ Futures market rates for June, 1998 as of January 14, 1998.

newtab1

1/22/98

**FAX COVER**

**Education Branch
Executive Office of the President
Office of Management and Budget
Washington, D.C. 20503**

TO:Bob Shireman**FAX NUMBER:**62223**FROM:**Kathy Stahl**DATE:**1/27**TIME:**12:00 12:15**NUMBER OF PAGES: Cover +**~~8~~ 7**Notes:**FYI

January 26, 1998

MEMORANDUM

TO: Interested Parties

FROM: Deborah Kalcevic

SUBJECT: CBO Revised January 1998 Baseline Projections for the Student Loan Programs.

Attached are five tables which detail the costs, loan volumes, and subsidy rates for both the guaranteed and direct student loan programs for the Revised January 1998 Baseline. CBO has revised the January 1998 student loan projections. The revisions will be incorporated into the February baseline estimates. Below each table is summarized:

- Table 1. includes the cost projection for each budget account associated with the student loan programs--the numbers which are shown on the CBO computer runs in Function 500.
- Table 2. includes the loan volume and subsidy rate projections for all guaranteed and direct student loans
- Table 3. includes the loan volume and subsidy rate projections for the guaranteed student loans
- Table 4. includes the loan volume and subsidy rate projection for the direct student loans
- Table 5. the Sec 458 expenditures under the capped entitlement for direct loan administrative expenses

For your information, below is a summary of the definitions of budget authority, program obligations, and outlays as they apply to the student loan program subsidy or "program" accounts:

subsidy budget authority Subsidy budget authority figures express what total subsidy costs would be if all the loans for which an application was received during a year were made. But all loans are seldom made--only about 90 percent. This is because prospective borrowers either do not show up for school or decide not to take the loan.

subsidy obligations Subsidy obligations are the costs associated with all loans for which there actually will be at least one cash disbursement [shown on the attached

tables as Net Annual Loan Volume]. Typically, the subsidy obligation estimates are not included on budget tables.

subsidy outlays

Subsidy outlays reflect the subsidy obligations adjusted for the timing of the loan dollar disbursements. Because of the multiple disbursement requirements and the timing of the academic school year calendars compared to the federal fiscal year, only about two-thirds of the dollars are disbursed to the borrowers during the first fiscal year. The remaining dollars are disbursed in the following year.

Table 1

16-Jan-98

CBO REVISED JANUARY 1998 BUDGET ACCOUNT TOTALS: STUDENT LOAN PROGRAM BASELINE

		(by fiscal year, in mil. \$)										
		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Guaranteed Loan Program Program (Subsidy) Account	BA	2,985	3,031	3,187	3,362	3,530	3,662	3,785	3,903	4,016	4,128	4,289
	OP	724	853									
	OL	2,579	2,739	2,848	3,001	3,156	3,287	3,401	3,510	3,572	3,676	3,825
Guaranteed Loan Program Liquidating Account	BA	-165	-283	-295	-271	-231	-179	-129	-89	-59	-37	-23
	OP	14	-23									
	OL	-126	-265	-294	-276	-237	-187	-136	-95	-63	-40	-25
Guaranteed Loan Program DISCRETIONARY Administrative	BA	46	48	50	52	53	55	57	59	62	64	66
	OP	10										
	OL	46	47	50	52	53	55	57	59	61	64	66
Guarantee Agency Reserves	BA	0	0	0	0	-1,000	0	0	0	0	0	0
	OP	0	0									
	OL	0	0	0	0	-1,000	0	0	0	0	0	0
Direct Loan Program Program (Subsidy) Account	BA	535	1,034	1,045	994	980	1,007	1,030	1,050	1,066	1,084	1,102
	OP	250	181									
	OL	559	786	951	923	899	911	938	953	969	984	1,001
Direct Loan Program Mandatory Administrative	BA	507	610	705	750	750	750	750	750	750	750	750
	OP	146	165									
	OL	483	557	634	701	733	745	749	750	750	750	750
TOTAL Student Loan Programs	BA	3,908	4,441	4,692	4,887	4,083	5,295	5,493	5,673	5,836	5,989	6,184
	OP	1,145	1,175									
	OL	3,541	3,864	4,188	4,401	3,604	4,811	5,004	5,177	5,289	5,434	5,617

TABLE 2

16-Jan-98

TOTAL GUARANTEED AND DIRECT LOAN PROGRAMS, Revised January 1998 Baseline

	1997 Preliminary	1998	1999	2000 (by fiscal year)	2001	2002	2003	2004	2005	2006	2007	2008
TOTAL ALL NEW LOANS [New Guaranteed and Direct Loans]												
Net Annual Loan Volume (Mil \$)	28,948	30,319	32,203	34,060	35,980	37,812	39,421	41,041	42,652	44,213	45,812	47,514
Net Number of Loans (000)	7,953	8,080	8,337	8,581	8,841	9,080	9,253	9,419	9,575	9,712	9,852	10,007
Average Loan Amount	\$3,640	\$3,752	\$3,862	\$3,969	\$4,070	\$4,164	\$4,260	\$4,357	\$4,454	\$4,552	\$4,650	\$4,748
Subsidy Rate a/b/c ^d	10.46%	10.71%	11.56%	11.38%	11.10%	10.94%	10.86%	10.76%	10.65%	10.54%	10.43%	10.31%
SUBSIDIZED STUDENT LOANS [New Guaranteed and Direct Loans]												
Net Annual Loan Volume (Mil \$)	16,581	17,084	17,653	18,215	18,830	19,418	19,874	20,333	20,786	21,214	21,666	22,136
Net Number of Loans (000)	4,840	4,899	4,977	5,054	5,147	5,235	5,289	5,346	5,406	5,462	5,529	5,603
Average Loan Amount	\$3,426	\$3,488	\$3,547	\$3,604	\$3,658	\$3,709	\$3,758	\$3,803	\$3,845	\$3,884	\$3,919	\$3,950
Subsidy Rate a/b/c ^d	17.46%	17.79%	18.51%	18.50%	18.37%	18.34%	18.39%	18.41%	18.42%	18.43%	18.43%	18.43%
UNSUBSIDIZED STUDENT LOANS [New Guaranteed and Direct Loans]												
Net Annual Loan Volume (Mil \$)	9,854	10,490	11,596	12,696	13,808	14,948	15,785	16,716	17,630	18,524	19,377	20,318
Net Number of Loans (000)	2,704	2,757	2,923	3,079	3,234	3,375	3,482	3,578	3,662	3,730	3,791	3,857
Average Loan Amount	\$3,644	\$3,806	\$3,967	\$4,124	\$4,270	\$4,400	\$4,534	\$4,672	\$4,814	\$4,961	\$5,112	\$5,268
Subsidy Rate a/b/c ^d	1.78%	2.61%	4.27%	4.31%	4.21%	4.20%	4.27%	4.31%	4.32%	4.33%	4.33%	4.33%
PARENT LOANS [New Guaranteed and Direct Loans]												
Net Annual Loan Volume (Mil \$)	2,512	2,744	2,954	3,149	3,342	3,546	3,762	3,992	4,236	4,494	4,769	5,060
Net Number of Loans (000)	408	425	437	448	460	471	483	495	507	520	533	546
Average Loan Amount	\$6,151	\$6,460	\$6,752	\$7,023	\$7,270	\$7,526	\$7,791	\$8,065	\$8,349	\$8,642	\$8,946	\$9,261
Subsidy Rate a/b/c ^d	-1.74%	-2.41%	-1.39%	-1.32%	-1.34%	-1.32%	-1.25%	-1.22%	-1.20%	-1.18%	-1.18%	-1.18%

a/ The subsidy rate is the net present value of the future federal cash flows associated with the loan dollars disbursed to borrowers each year. For example, the 1999 federal cost associated with the \$32,208 million in new loan volume would be \$3,734 million or 11.56% of the new loan volume [\$32,208 * .1156 = \$3,734]. Another way to look at the cost of the loan programs is that overall it will cost the federal government on average about 11 1/2 cents for each new dollar loaned in 1999.

b/ The subsidy rates for guaranteed loans DO NOT include any administrative cost payments to guaranty agencies. These payments, when paid, are included in the budget on a cash basis in another budget account. Furthermore, the subsidy rates for direct loans DO NOT include any federal administrative costs associated with collecting the loans. Those costs are also included on a cash basis in another budget account.

c/ The subsidy rates were calculated using the CBO January 1998 interest rate forecast. These rates would be different if other forecasts are used.

TABLE 3

16-Jan-98

TOTAL GUARANTEED LOAN PROGRAMS, Revised January 1998 Baseline

	(by fiscal year)										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
	Preliminary										
TOTAL ALL NEW LOANS [New Guaranteed Loans Only]											
Net Annual Loan Volume (Mil \$)	18,816	19,707	20,932	22,139	23,387	24,578	25,624	26,677	27,724	28,738	29,778
Net Number of Loans (000)	5,170	5,252	5,419	5,578	5,747	5,902	6,015	6,123	6,224	6,313	6,404
Average Loan Amount	\$3,640	\$3,752	\$3,862	\$3,969	\$4,070	\$4,164	\$4,260	\$4,357	\$4,454	\$4,552	\$4,650
Subsidy Rate a/ b/ c/	12.39%	13.92%	13.33%	13.25%	13.23%	13.21%	13.14%	13.04%	12.94%	12.84%	12.73%
SUBSIDIZED STUDENT LOANS [New Guaranteed Loans Only]											
Net Annual Loan Volume (Mil \$)	10,778	11,105	11,475	11,840	12,239	12,622	12,918	13,216	13,511	13,789	14,083
Net Number of Loans (000)	3,146	3,184	3,235	3,285	3,346	3,403	3,438	3,475	3,514	3,550	3,594
Average Loan Amount	\$3,426	\$3,488	\$3,547	\$3,604	\$3,658	\$3,709	\$3,758	\$3,803	\$3,845	\$3,884	\$3,919
Subsidy Rate a/ b/ c/	19.61%	21.07%	20.27%	20.36%	20.47%	20.59%	20.65%	20.68%	20.70%	20.72%	20.72%
UNSUBSIDIZED STUDENT LOANS [New Guaranteed Loans Only]											
Net Annual Loan Volume (Mil \$)	6,405	6,819	7,537	8,252	8,976	9,651	10,260	10,866	11,460	12,028	12,595
Net Number of Loans (000)	1,758	1,792	1,900	2,001	2,102	2,194	2,263	2,326	2,380	2,425	2,464
Average Loan Amount	\$3,644	\$3,806	\$3,967	\$4,124	\$4,270	\$4,400	\$4,534	\$4,672	\$4,814	\$4,961	\$5,112
Subsidy Rate a/ b/ c/	2.80%	5.20%	5.41%	5.58%	5.78%	5.93%	6.00%	6.04%	6.06%	6.07%	6.07%
PARENT LOANS [New Guaranteed Loans Only]											
Net Annual Loan Volume (Mil \$)	1,633	1,784	1,920	2,047	2,172	2,305	2,445	2,595	2,753	2,921	3,100
Net Number of Loans (000)	265	276	284	291	299	306	314	322	330	338	346
Average Loan Amount	\$6,151	\$6,460	\$6,752	\$7,023	\$7,270	\$7,526	\$7,791	\$8,065	\$8,349	\$8,642	\$8,946
Subsidy Rate a/ b/ c/	2.33%	2.70%	2.93%	3.05%	3.22%	3.36%	3.43%	3.47%	3.49%	3.51%	3.51%
REFINANCED LOANS--OUTSTANDING DIRECT LOANS CONSOLIDATED INTO GUARANTEED LOANS											
Net Annual Loan Volume (Mil \$)	0	300	0	0	0	0	0	0	0	0	0
Net Number of Loans (000)	0	30	0	0	0	0	0	0	0	0	0
Average Loan Amount	\$0	\$10,000	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Subsidy Rate a/ b/ c/	0.00%	6.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

a/ The subsidy rate is the net present value of the future federal cash flows associated with the loan dollars disbursed to borrowers each year. For example, the 1999 federal cost associated with the \$20,932 million in new loan volume would be \$2,790 million or 13.33% of the new loan volume [$\$20,932 \times .1333 = \$2,790$]. Another way to look at the cost of the loan programs is that overall it will cost the federal government on average about 13 1/3 cents for each new dollar loaned in 1999.

b/ The subsidy rates for guaranteed loans DO NOT include any administrative cost payments to guaranty agencies. These payments, when paid, are included in the budget on a cash basis in another account.

c/ The subsidy rates were calculated using the CBO January 1998 interest rate forecast. These rates would be different if other forecasts are used.

TABLE 4

TOTAL DIRECT LOAN PROGRAMS, Revised January 1998 Baseline

16-Jan-98

	(by fiscal year)											
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Preliminary											
TOTAL ALL NEW LOANS [New Direct Loans Only]												
Net Annual Loan Volume (Mil \$)	10,132	10,612	11,271	11,921	12,593	13,234	13,797	14,364	14,928	15,474	16,034	16,630
Net Number of Loans (000)	2,784	2,828	2,918	3,004	3,094	3,178	3,239	3,297	3,351	3,399	3,446	3,502
Average Loan Amount	\$3,640	\$3,732	\$3,862	\$3,969	\$4,070	\$4,164	\$4,260	\$4,357	\$4,454	\$4,552	\$4,650	\$4,748
Subsidy Rate a/b/c	6.87%	6.74%	6.26%	7.90%	7.15%	6.73%	6.52%	6.51%	6.57%	6.26%	6.14%	6.02%
SUBSIDIZED STUDENT LOANS [New Direct Loans Only]												
Net Annual Loan Volume (Mil \$)	5,804	5,980	6,179	6,375	6,590	6,796	6,956	7,117	7,275	7,425	7,583	7,748
Net Number of Loans (000)	1,694	1,715	1,742	1,769	1,802	1,832	1,851	1,871	1,892	1,912	1,935	1,961
Average Loan Amount	\$3,425	\$3,486	\$3,547	\$3,604	\$3,658	\$3,709	\$3,758	\$3,802	\$3,845	\$3,884	\$3,919	\$3,950
Subsidy Rate a/b/c	13.47%	11.68%	13.24%	15.04%	14.46%	14.16%	14.16%	14.19%	14.19%	14.19%	14.10%	14.10%
UNSUBSIDIZED STUDENT LOANS [New Direct Loans Only]												
Net Annual Loan Volume (Mil \$)	3,449	3,672	4,059	4,443	4,833	5,197	5,525	5,851	6,171	6,477	6,782	7,111
Net Number of Loans (000)	947	965	1,023	1,078	1,132	1,181	1,219	1,252	1,282	1,306	1,327	1,350
Average Loan Amount	\$3,641	\$3,806	\$3,967	\$4,124	\$4,270	\$4,400	\$4,534	\$4,672	\$4,814	\$4,961	\$5,112	\$5,266
Subsidy Rate a/b/c	-0.11%	-2.20%	2.13%	1.96%	1.29%	0.99%	1.06%	1.10%	1.10%	1.09%	1.09%	1.09%
PARENT LOANS [New Direct Loans Only]												
Net Annual Loan Volume (Mil \$)	879	960	1,034	1,102	1,170	1,241	1,317	1,397	1,482	1,573	1,669	1,771
Net Number of Loans (000)	143	149	153	157	161	165	169	173	178	182	187	191
Average Loan Amount	\$6,151	\$6,460	\$6,752	\$7,023	\$7,270	\$7,526	\$7,791	\$8,065	\$8,349	\$8,642	\$8,940	\$9,261
Subsidy Rate a/b/c	-9.29%	-11.90%	-9.40%	-9.42%	-9.81%	-10.00%	-9.95%	-9.93%	-9.91%	-9.88%	-9.82%	-9.88%
REFINANCED LOANS—OUTSTANDING GUARANTEED LOANS (BOTH PRE-1992 AND POST-1992) CONSOLIDATED INTO DIRECT LOANS												
Net Annual Loan Volume (Mil \$)	600	600	700	700	700	700	700	700	700	700	700	700
Net Number of Loans (000)	62	55	56	54	100	100	100	100	100	100	100	100
Average Loan Amount	\$9,716	\$11,000	\$12,500	\$13,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000
Net Subsidy Rate a/b/c	-0.11%	-1.37%	3.01%	2.86%	2.23%	1.93%	1.98%	2.01%	2.01%	2.02%	2.02%	2.02%

a/ The subsidy rate is the net present value of the future federal cash flows associated with the loan dollars disbursed to borrowers each year. For example, the 1999 federal cost associated with the \$11,271 million in new loan volume would be \$931 million or 8.26% of the new loan volume (\$11,271 * .0826 = \$931). Another way to look at the cost of the loan programs is that overall it will cost the federal government on average about 8.14% cents for each new dollar loaned in 1999.

b/ The subsidy rates for direct loans DO NOT include any federal administrative cost associated with collecting the loans. Those costs are included on a cash basis in another budget account.

c/ The subsidy rates were calculated using the CBO January 1996 interest rate forecast. These rates would be different if other forecasts are used.

TABLE 5

SECTION 458—Student Loan Administration Account, Revised January 1998 Baseline

		(in millions of dollars)														
		1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Direct Loan Direct Administrative Costs	BA	21	98	151	197	231	306	388	487	571	571	571	571	571	571	571
	OT	4	67	108	157	201	260	332	420	508	552	567	571	571	571	571
Guaranteed and Direct Loan Indirect Administrative Costs	BA	47	82	117	141	121	140	167	113	29	29	29	29	29	29	29
	OT	21	69	88	124	127	133	152	132	75	44	32	29	29	29	29
Guaranteed Loan Guaranty Agency Payments	BA	98	213	167	153	155	164	150	150	150	150	150	150	150	150	150
	OT	98	213	167	153	155	164	150	150	150	150	150	150	150	150	150
TOTAL	BA	260	284	435	491	507	610	705	750	750	750	750	750	750	750	750
	OT	122	349	363	434	483	557	634	701	733	745	749	750	750	750	750

Committee on Education and the Workforce

William L. Clay, Ranking Democratic Member

U.S. House of Representatives

2101 Rayburn House Office Building

OFFICE NUMBER- (202) 225-3725

FAX NUMBER- (202) 226-4864

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January 26, 1998

MEMORANDUM**TO:** Interested Parties**FROM:** Deborah Kalcevic**SUBJECT:** Change in CBO Methodology for Estimating Student Loan Baseline Costs

CBO has recently enhanced the way in which it estimates subsidy costs for student loan programs. Below is a discussion of this change.

BACKGROUND

The Congressional Budget Office (CBO) computes the budgetary effects of both guaranteed and direct student loans on the federal subsidy cost basis according to federal statute. Since its inception in 1992, this computation method has been referred to as "credit reform".

Under credit reform, program costs for a fiscal year include the present value of all future net federal cash expenditures associated with loans made during that year. This present value is computed by reducing the level of each year's projected net cash expenditures by an expected interest rate--generally an interest on long-term government securities. This computation is known as discounting, which expresses future cash flows in today's dollars, with the interest rate as the key variable that permits the bridging between two time periods.

The type of federal cash flows associated with guaranteed loans differs from those associated with direct loans. Guaranteed loan costs include the cost of the guarantee; costs associated with default, death, disability, and bankruptcy. Additional costs are incurred for net variable interest payments to lenders. By contrast the net federal costs in the direct loan program include the original cash disbursement of the loan amount to the borrower. These disbursements are offset over time by the amount of principal and variable interest repaid by the borrower. The net present value or the subsidy costs for both guaranteed and direct loans depend on when the cash expenditure or receipt occurs during the maximum 30-year life of the loans (the average life of both types of loans is 15 to 20 years).

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The estimated cash flows for both student loan programs are substantially affected by the interest rate forecast used to estimate the net variable interest payments and receipts. The interest payments made or received by the government are annually adjusted payments based on the actual rate at the time the payments are made.

Twice annually CBO prepares a 2-year detailed forecast of interest rates. To provide a 10-year projection for budget estimates, the forecasted rates are smoothed out to reflect a stable environment without cyclical patterns. These projections are then used to estimate the subsidy costs of the student loan programs.

ISSUE

As discussed above, both guaranteed and direct student loans have annually-adjusted borrower interest rates. Currently, the rate is the 91-day Treasury bill rate plus 3.1 percentage points (2.5 percentage points when the borrower is in school). Starting in July 1998, the rate will be the 10-year Treasury bond plus 1.0 percentage point. For the borrowers, this rate has been capped by statute at 8.25 percent, limiting the borrower's interest rate risk. By statute, the government bears all the risk of higher interest rates and incurs the increased interest costs during any period the rate exceeds the 8.25 percent cap. In the guaranteed loan program the government pays lenders the amount of interest above the cap. In the direct loan program, the cap lowers expected interest revenue to the government.

Since 1992, the mean interest rate forecasts used by CBO have been low enough over the projection period that the 8.25 percent cap was rarely exceeded. Using the current CBO forecast, the variable loan interest rates average about 6.9 percent in almost every year. Under the old methodology, which assumed that future interest rates are known with certainty, the 8.25 percent cap was not exceeded, and no additional interest costs had been included in the estimates of the federal subsidy costs. And, thus, no cost had been assigned to the government's sole risk of higher interest rates.

History, however, indicates that over a long period of time fluctuations in interest rates occur with sufficient frequency and magnitude that the interest rate ceiling is likely to be exceeded in some future years, even if the average interest rate is below 8.25 percent. As such, prudent budgeting under credit reform requires that the federal subsidy costs of the programs reflect the expected costs of interest rates rising above forecasted level and exceeding the cap. Thus, the CBO baseline now includes expected cash expenditures that account for the probability that the actual interest rates would exceed forecasted interest rates and trigger the associated federal costs of exceeding the cap.

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ESTIMATING THE COST OF THE CAP

CBO developed a vector autoregressive model to compute 1,000 simulated forecasts of the 10-year bond rate plus 1.0 percentage point, centered around the CBO economic forecast of interest rates but with random shocks. Probabilities were developed by analyzing how often and by how much these simulated forecasts exceeded the 8.25 percent interest rate cap. These probabilities were then used in the student loan program cost models to estimate subsidy costs.

Relative to its baseline interest rates, CBO estimates that there is roughly a three-in-ten chance that, in any given year, interest rates on the 10-year Treasury bond would cause the interest rate on student loans to be capped. When the 8.25 percent cap is exceeded, on average, it is estimated to be exceeded by roughly 150 basis points. As the attached Table 1 indicates, the present value of these increased student loan costs add \$0.4 billion to the subsidy costs in 1998, \$1.2 billion in 2008, and \$10.0 billion over the 1998-2008 period.

LEGISLATIVE NOTE

The enhancement to the student loan subsidy cost model to include the likely volatility in interest rates has implications for the subsidy costs of certain student loan program changes. One legislative proposal from the last session of Congress was to keep the variable interest rate formula that is in place until July 1998. As the attached Table 2 shows, relative to the Revised January 1998 baseline, this proposal would increase costs by \$0.2 billion in 1998, \$0.7 billion in 2008, and \$6.1 billion over the 1998-2008 period.

The increase arises for two reasons. First, the probability of the more volatile short-term rates exceeding the 8.25 percent cap is about 60 percent greater than that of the long-term rates exceeding the cap. Second, in the years the 8.25 percent cap is exceeded, on average the 91-day Treasury bill rate with its 3.1 percentage point add-on, exceeds the cap by roughly 200 basis points. This level is approximately one-third higher than that using the 10-year Treasury bond with an add-on of 1.0 percentage point.

Table 1.

Impact of the Methodology Enhancement on the Revised January 1998 Student Loan Program Baseline

		(preliminary staff estimates, by fiscal years, in millions of dollars)										
		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total Student Loan Program	BA	3,307	3,731	3,874	3,963	3,064	4,204	4,343	4,470	4,582	4,689	4,812
Under Prior Methodology	OL	3,174	3,252	3,478	3,594	2,708	3,842	3,978	4,101	4,173	4,275	4,391
Change for the Probability of Interest Rates Exceeding 8.25%	BA	601	710	818	924	1,019	1,091	1,150	1,203	1,254	1,300	1,372
	OL	367	612	710	807	896	969	1,026	1,076	1,116	1,159	1,226
Total Student Loan Program	BA	3,908	4,441	4,692	4,887	4,083	5,295	5,493	5,673	5,836	5,989	6,184
Revised January 1998 Baseline	OL	3,541	3,864	4,188	4,401	3,604	4,811	5,004	5,177	5,289	5,434	5,617

Table 2.

Proposed Changes to the Student Loan Programs Estimated Relative to the Revised CBO January 1998 Baseline

(preliminary staff estimates, by fiscal year, in millions of dollars)												1998-2002	1998-2008
1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Total	Total	
Eliminate the change in the formula for establishing the variable interest rate on subsidized and unsubsidized student loans and on parent loans which is to take place in July 1998. The change would set the rate at the comparable maturity rate (10-year bond rate) + 1% for student loans and the 10-year bond rate for parent loans. This proposal would keep the current student loan formula of the 91-day Treasury bill rate +2.5% while the borrower is in school and deferment and the 91-day Treasury bill rate + 3.1% while the borrower is in repayment and the current parent loan formula of the 365-day Treasury bill rate +3.1% (Assumes all new loans are affected.)													
BA	275	625	610	620	640	660	675	690	700	725	750	2,770	6,970
O	175	465	555	560	575	595	610	625	625	645	665	2,330	6,095

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Box 2-1.**Pricing Interest Rate Caps on Student Loans**

The budgetary effects of student loans are computed as subsidies under the principles of credit reform, which were designed to correct an imbalance in measuring the costs of federal loan programs relative to grant programs. Those principles require the Office of Management and Budget (OMB) and the Congressional Budget Office to take into account all aspects of credit programs that could eventually affect cash flows to the government and estimate the present value of those costs. The present value is the amount of funds that would have to be set aside today, together with interest, to cover all current and future net costs for a particular set of loans. In the case of student loans, the future costs generally reflect the total subsidization of interest on certain loans while the student is in school or nonrepayment of a loan because of bankruptcy, disability, or death.

Less obvious in a period of relatively low interest rates are the potential costs associated with the caps on interest rates that can be charged on student loans. Under current law, the maximum interest rate that lenders can charge students is determined by a formula: during repayment, loans issued before July 1998 carry a maximum interest rate of the 91-day Treasury bill rate plus 3.1 percentage points, and loans awarded after June 1998 will use an interest rate based on the 10-year Treasury note rate plus 1.0 percentage point—but the interest rate in either case cannot exceed 8.25 percent. With guaranteed loans, interest rates above 8.25 percent trigger special-allowance payments to the lender based on the rate determined by the formula and the 8.25 percent

cap. In the direct loan program, the federal government absorbs the difference in the form of forgone receipts. The cap exists to limit the costs to borrowers in times of high interest rates, and the special allowance ensures that lenders will still be willing to supply the funds.

Until now, CBO and OMB have assigned little, if any, cost to the interest rate caps—and therefore the special allowances—because their forecasts of interest rates tended to result in levels that were below the 8.25 percent rate. For example, under CBO's baseline forecast, student loan rates after June 1998 are not anticipated to exceed 8.1 percent. However, fluctuations in interest rates occur with sufficient frequency and magnitude that the 8.25 percent interest rate ceiling could conceivably be reached. An accurate assessment of the subsidy costs of the program should reflect the possibility that interest rates will become high enough to invoke the cap. Consequently, CBO has begun to estimate the subsidy costs of the interest rate ceiling.

Relative to its baseline interest rates, CBO estimates that in any given year, there is nearly a 30 percent chance that interest rates on 10-year Treasury notes will cause the interest rate on student loans to be constrained by the cap and that the average special-allowance payment in those years would be an additional 150 basis points. The present value of those payments (or lost receipts) adds roughly \$1 billion to the annual subsidy costs of student loans over the next decade.

OFFICE OF MANAGEMENT AND BUDGET**HUMAN RESOURCES DIVISION****DATE:**1-21-98**TO:**Bob Shireman
_____**FROM:****BARRY WHITE
DEPUTY ASSOCIATE DIRECTOR****COMMENTS:****NUMBER OF PAGES**
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Wayne Healy!

01/16/98

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January 14, 1998

VIA FACSIMILE: 202/622-0073

The Honorable Robert E. Rubin
 Secretary of the Treasury
 U.S. Department of Treasury
 1500 Pennsylvania Ave., NW
 Washington, DC 20220

Dear Secretary Rubin:

The Committee on Education and the Workforce is charged with ensuring the effective, efficient and economical operation of the Department of Education and programs created pursuant to the Higher Education Act. Included among those programs are the Federal Family Education Loan Program (FFELP) and the William D. Ford Federal Direct Student Loan Program (FDSLP). It has come to this Committee's attention that the Department of Treasury has drafted a report or analysis through the Office of the Deputy Assistant Secretary for Policy Analysis, at the behest of the National Economic Council, addressing the impact of a change to the formula for calculating interest rates on student loans.

The report is designed to analyze whether changing the formula for calculating interest rates from the "91-day T-bill" to the "10-year Treasury note rate" is problematic. Essentially, the report is supposed to determine whether changing the formula will push leveraged private capital out of the FFELP essentially destroying the most widely used student loan program. One of the main areas which the report is supposed to discuss is whether the volatility of the "10-year rate" makes it uneconomic to make student loans.

Although members of your staff have acknowledged the existence of such an analysis, they have refused to discuss the findings with our staff. We also note that Robert Shireman, a senior policy adviser at the National Economic Council who, according to your staff has been involved in the analysis, was recently quoted in the Chronicle of Higher Education as being unable to confirm or deny whether such an analysis exists.

54094

We cannot stress enough the importance of this matter to the continued viability of the student loan program. Any information in the hands of the United States Treasury Department which sheds light on this issue should not be withheld from the United States Congress for any reason.

Please provide the Committee with two copies of the draft report as written by Maynard Comicz in an unredacted form. Your cooperation in providing this information no later than the close of business, January 28, 1998, will be appreciated. If you have any questions, please contact Sally Stroup or George Conant at 202-225-6558.

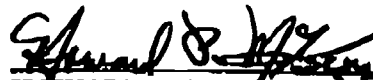
Sincerely,



BILL GOODLING

Chairman

Committee on Education
and the Workforce



HOWARD P. "BUCK" MCKEON

Chairman

Subcommittee on Postsecondary
Education Training and Lifelong Learning

cc: The Honorable Jim Jeffords
The Honorable Edward Kennedy
The Honorable William Clay
The Honorable Dale Kildee
The Honorable Richard Riley
The Honorable Franklin Raines



**The Committee on Education
and the Workforce**
Subcommittee on Oversight and Investigations
B346a Rayburn House Office Building
Washington, DC 20515
Phone: (202) 225-7101 Fax: (202) 225-3909

To: Hon Franklin Raines

From: X **Mark Brenner, Professional Staff Member**
 Lauren Fuller, Professional Staff Member
 Lisa King, Professional Staff Member
 Derrick Max, Professional Staff Member, Economist
 Leigh Stadthaus, Oversight Associate

Fax #: 395-3888

of Pages: 3

Comments: cc of Rubin letter

If you have any problems with this transmission, please contact Leigh Stadthaus at 202/225-7101.

TABLE 1: INTEREST RATE ASSUMPTIONS

	(Percent)			
	1997	1998	1999	5-year ave.
OMB				
3-month T-bill	5.17	5.13	5.01	4.93
10-year note	6.75	5.86	5.80	5.76
Spread	1.58	0.73	0.79	0.83
Blue Chip				
3-month T-bill	5.17	5.34	5.13	--
10-year note	6.75	6.10	6.10	--
Spread	1.58	0.76	0.97	--
CBO				
3-month T-bill	5.17	5.40	4.70	--
10-year note	6.75	6.20	5.80	--
Spread	1.58	0.80	1.10	--
DRI				
3-month T-bill	5.17	5.19	4.83	--
10-year note	6.75	6.10	5.80	--
Spread	1.58	0.61	0.99	--
Futures Market a/				
3-month T-bill	--	4.89	n.a.	n.a.
10-year note	--	5.39	n.a.	n.a.
Spread	--	0.5	n.a.	n.a.

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1;
all other data are for the second calendar quarter.

n.a. Not available.

a/ Futures market rates for June, 1998 as of January 14, 1998.

newtab1

12/15/97

TABLE 2: COST ASSUMPTIONS
(Percent or Basis Points)

	Current Policy		Future Policy	
	In-School	Repayment	In-School	Repayment
All-in costs a/	T-bills + .65	T-bills +.65	CMT + .12	CMT+.12
Servicing/overhead b/	0.32	0.95	0.32	0.95
Default risk	0.07	0.07	0.07	0.07
Prepayment risk	0.04	0.04	0.04	0.04
Origination fee	0.05	0.05	0.05	0.05

- a/ For current policy, all-in costs include only the cost of matched funds;
for future policy, all-in costs include the cost of financing plus the cost of a swap.
Costs to banks are reduced by 0.028 percent of this total because that amount is assumed to be financed by equity.
- b/ Includes both servicing and overhead costs.

newtab2

0.65% - 10-yr bond + annual reset

low end of budget costs

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

(In Percent)

4/8-2007

Formula or Net Rate of Return	1997/98		1998/99			5-yr. ave.
	Administration	Blue Chip	Administration	Blue Chip	CBO	Admin.
Current Formula:						
3-month T-bill + 2.50/3.10	7.67/8.25	7.67/8.25	n.a.	n.a.	n.a.	n.a.
Estimated net return to lender	1.51	1.36	n.a.	n.a.	n.a.	n.a.
Future Formula:						
10-year CMT + 1.00	n.a.	n.a.	6.86	7.10	7.2	6.76
Estimated net return to lender	n.a.	n.a.	0.18	0.17	0.35	0.15
Alternative Formulas:						
To hold student harmless	n.a.	n.a.	T-bill + 1.73	T-bill + 1.76	T-bill + 1.80	T-bill + 1.63
Estimated net return to lender	n.a.	n.a.	0.35	0.37	0.77	0.65
To maintain lenders minimum						
required net rate of return:						
75 basis points	n.a.	n.a.	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28

- need 75

compare to 7 + 290

- 7.80

?

- half way

Note: Formula estimates are a weighted average for loans in-school and in repayment. The weights are based on the relative share of loans outstanding for each loan status, i.e., in-school= 36.08 percent and repayment= 63.92 percent.

n.a. Not applicable

Assumptions:

OMB estimates are based on Fiscal Year 1999 budget estimates.

Blue Chip estimates are based on the December Blue Chip release.

1/20/97

STULOSUM

TABLE 4: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS, ALTERNATE BASIS
(In Percent)

Formula or Net Rate of Return	1997/98	1998/99
	Administration	Administration
Current Formula:		
3-month T-bill + 2.5/3.10	7.67/8.25	n.a.
Estimated net return to lender	1.51	n.a.
Future Formula:		
10-20 year simple interest + 1.00	n.a.	7.11
Estimated net return to lender	n.a.	0.18
Alternative Formulas:		
To hold student harmless	n.a.	T-bill + 1.98
Estimated net return to lender	n.a.	0.62
To maintain lenders minimum		
required net rate of return:		
75 basis points	n.a.	2.28

Note: Formula estimates are a weighted average for loans in-school and in repayment. The weights are based on the relative share of loans outstanding for each loan status, i.e., in-school= 36.08 percent and repayment= 63.92 percent.

n.a. Not applicable

Assumptions:

Data are based on Fiscal Year 1999 budget estimates. The estimated rate for securities having a maturity of more than 10 years and less than 20 years is stated as a simple annual rate, which differs from bond equivalent rates and bank discount rates.

Handwritten: *Good*
Form 12

1/20/97

STULOSUM

TABLE 5: SWAP ESTIMATES (IN BASIS POINTS)

SWAP	Goldman Sachs 11/14/97	J.P.Morgan 11/14/97	Bankers Trust 11/14/97	Citicorp 11/21/97	Paine-Webber 11/14/97
3-month T-bill for LIBOR (weekly reset, quarterly pay)					
4 year	T-bill + 69	T-bill + 70	T-bill + 68	T-bill + 70	T-bill + 75
7 year	T-bill + 68	T-bill + 70	T-bill + 66	T-bill + 69	T-bill + 73
10 year	T-bill + 67.5	T-bill + 69	T-bill + 66	T-bill + 69	T-bill + 73
10 year CMT (annual reset) for LIBOR					
4 year	CMT + 9.5	CMT + 26	CMT + 27	CMT + 31	CMT + 15
7 year	CMT + 7.5	CMT + 21	CMT + 26	CMT + 27	CMT + 11
10 year	CMT + 5.5	CMT + 16	CMT + 24	CMT + 25	CMT + 9

Note: quoted yields on November 14, the date of most of these swap quotes were around: 3-month T-BILL, 5.26%; 3-month LIBOR, 5.88%; 10-year CMT, 5.81 to 5.88%.

swapest

M COMIEZ

TABLE 6: RISK-ADJUSTED PRE-TAX NET RETURN for FFEL STUDENT LOANS, 1997 and 1998
(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99 (OMB Estimates)			7/1/98 to 6/30/99 (Blue Chip Estimates)		
	In-school or Deferment	Repayment	Consolidation	In-school or Deferment	Repayment	Consolidation d/	In-school or Deferment	Repayment	Consolidation d/
Student Loan Interest Rate	7.67	8.25	9.00	6.86	6.86	9.00	7.10	7.10	9.00
Less Costs:									
All-in cost of funds a/	5.80	5.80	5.80	5.95	5.95	5.95	6.15	6.15	6.15
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs/overhead b/	0.32	0.95	0.47	0.32	0.95	0.47	0.32	0.95	0.47
Default risk	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
Prepayment risk	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>
Subtotal	6.28	6.91	7.48	6.43	7.06	7.63	6.63	7.26	7.83
Net Return c/	1.55	1.50	1.68	0.60	-0.03	1.54	0.64	0.01	1.34
Weighted Average Net Return		1.54			0.36			0.38	

Note: OMB estimates for interest rates are for the 1999 budget. Blue Chip estimate is for December 10, 1997.

a/ Assumes all-in cost of funds for 1997/98 is T-bill + 65 basis points; for 1998/99 the all-in cost is CMT +12 basis points.

b/ Assumes that servicing/overhead costs in-school are 33 percent of the cost for repayment; for consolidation loans these cost are 50 percent of repayment.

c/ Adjusted to allow for the assumption that only 97.2 percent of the loan principal is financed by borrowing and the rest comes from equity.

d/ For loans already consolidated before 1998-99.

Appendix A

1. Table 1 shows that several different forecasts of future interest rates project a relatively flat yield curve for the next two years. Only the future's market data for 1998 show a spread between the 3-month T-bill rate and the 10-year Treasury note that is similar to historical experience. Although the *Blue Chip Economic Indicators* consensus forecast for the next two years reflects a relatively flat yield curve, their projected rates are higher than those forecast by the Administration in the *FY 1999 Budget* and higher generally than the other forecasts shown in the Table. Thus, an alternative to the Administration's projections for interest rates is that the 3-month T-bill rate for 1998 is 5.34 percent. This is the *Blue Chip* consensus forecast for the second quarter of 1998, converted to a bond equivalent yield basis. The *FY 1999 Budget* estimate for 1998 is nearly the same as the 5.12 percent average closing price in the futures market since mid-September for 3-month T-bills maturing in June, 1998; the *Blue Chip* estimate is higher than the futures market rate.

Using the latest budget economic assumptions for 10-year Treasury notes, the student loan interest rate is 6.86 percent ($5.86+1.0$) for 1998/99, and 6.8 percent ($5.8+1.0$) for 1999/00.¹ Our alternative assumptions for student loan interest rates are 7.1 percent ($6.1+1.0$) for both 1998/99 and 1999/00. Both of these are *Blue Chip* estimates.

2. Lenders have several options for obtaining funds to finance their portfolio of student loans: they can finance their loans by using the bank deposits of their customers; they can sell new debt; or they can saturate some or all of their loan portfolio by a public issuance of student loan asset-backed securities.

We consulted a number of financial experts about lenders' cost of financing through new debt issues, and the range of estimates that we received was between T-bill plus 50 basis points to T-bill plus 80 basis points, with more of the estimates towards the higher end of this range. Since lenders borrow at LIBOR, this amounts to a spread over LIBOR of roughly 0-30 basis points; the historical spread between T-bill and LIBOR rates has averaged 43 basis points, and it is currently 60 basis points.

An analysis of actual debt financing for 1997 indicates that a significant amount of financing has been obtained by securitizing existing loan portfolios. Nearly all of these securitizations were based on T-bills. This may be because student loans are indexed to T-bills, which would preclude a basis risk and the need to hedge by arranging a swap agreement. Another explanation could be that lenders expect the spread between T-bills and LIBOR will narrow in the future. Based on these actual financings, the average cost of matched funds for the first 11 months of 1997 has been T-bills plus about 65 basis points, although the most recent

¹ These estimates are the second calendar quarter rate for 10-year Treasury notes for 1998 and 1999 plus 1.0 percentage point. If OMB assumptions for 10-20 year Treasury securities are used, the comparable rates would be 7.11 percent ($6.11+1.0$) for 1998/99 and 7.03 percent ($6.03+1.0$) for 1999/00. These rates are based on the estimated market yield as of October 1 of the budget year.

offerings were T-bills plus about 85-89 basis points. For our analysis, we assume the cost of matched funds for 1997/98 is T-bills plus 65 basis points. This would translate to LIBOR plus 5 basis points. Using FY 1999 budget assumptions, the estimated cost of matched funds for 1997/98 is 5.8 percent ($5.15 + 0.65$). The comparable estimated rate using *Blue Chip* assumptions is 5.94 percent ($5.29 + 0.65$).

In estimating a lender's matched funds rate, it has been argued that the cost of funds for banks may be lower than the 3-month T-bill or the 1-to-3-month LIBOR rate. For example, banks with a stable deposit base may have an effective cost for these funds that is lower than the 3-month T-bill rate. However, larger banks may not have a stable deposit base on which they can rely. Moreover, we are talking about a \$20-25 billion guaranteed loan program. There is considerable concentration of student loan originations among a relatively small number of large banks who don't normally have large amounts of internal funds that have not been committed already. Thus, banks might have to borrow large amounts at the 3-to 6-month jumbo CD rate, if they don't want to finance their student loans by selling other debt or securitizing their loan portfolios. The rates on this source of funds generally are well above the 3-month T-bill rate, although less than 3-6 month LIBOR rates.

3. When there is a basis risk between lenders' assets and liabilities, the all-in cost of financing student loans consists of the cost of selling debt plus the cost of a swap. Estimating the basis risk between 3-month T-bills or 10-year CMT indexed assets and LIBOR based securities is difficult because the cost varies over a wide range depending on changes in the slope of the yield curve and the spread. Estimating this cost is even more difficult if the indexed asset being hedged has uncommon characteristics such as the annual reset provision for 10-year CMTs under next years student loan formula.

Lenders' cost of funds to finance student loans is generally correlated closely with LIBOR rates. The basis risk between T-bill indexed assets, such as those issued under the current student loan formula, and LIBOR based liabilities is not as great as it would be between 10-year CMT indexed assets reset annually and LIBOR based liabilities. Moreover, as noted above, much of the current financing for student loans comes directly from T-bill based securitization, so that there is no need to hedge.

Under the new loan formula for next year, lenders presumably would seek to raise funds at LIBOR and simultaneously enter into a long-term amortizing basis swap, because of the basis risk between assets and liabilities. Lenders financing their student loan portfolio by this option would issue LIBOR indexed securities and simultaneously enter into an amortizing interest rate swap where the lender would agree to pay the swap counterparty the 10-year CMT plus or minus some spread in exchange for LIBOR. As noted previously, issuing floating rate notes indexed to 10-year CMTs with an annual reset is neither a deep or efficient market capable of financing a large annual student loan program. Thus, this swap should be more costly for lenders than a swap involving T-bills.

At our request, several major financial institutions provided us estimates for the cost of a swap under the terms of both the current and the new student loan formula. Most of the estimates were made for the same day and were based on 3-month LIBOR.² Using these swap estimates, we calculated the net interest margin lenders would have before consideration of all cost other than the cost of hedging.³

Table 5 shows that the estimates provided us of the cost of swapping T-bills for LIBOR falls within a relatively narrow range. This is not surprising, because presumably swap dealers use similar swap curves to make their estimates. The modest differences may reflect differences of when the estimates were made within the specified day, small differences in the dealers' cost for making the swap, and differences between dealers in their swap models.⁴

The estimated costs of swapping CMTs for LIBOR were more varied, with the costs clustered around two ranges that are widely separated. This pattern is somewhat surprising, because of the similarity of estimates for swapping T-bills. This wider band of cost estimates may reflect the fact that there isn't a ready market for swapping long term assets that are reset annually, like CMTs, for short term assets. Hence, the risk and cost to dealers are higher, because they may have to hold the long term assets longer than they would like, until a buyer for the swap can be found. Dealers could have very different estimates of the cost of this risk.

The swap estimates provided us are summarized below.

- Most of the cost estimates to swap T-bills for LIBOR clustered in a narrow band of 68 to 70 basis points. When the cost of matched funds is factored in, total all-in costs would be about 73 to 75 basis points, assuming that the cost of matched funds in 1997 is LIBOR plus 5 basis points. Since we have actual data indicating that the cost of

² Although the student loan formula is not indexed to LIBOR, this difference does not create a problem for the analysis.

³ Net interest margin is the difference between interest earnings from loans and interest expenses from borrowing, which is then expressed as a percent of interest-earning assets. For our purposes, the estimate of net interest margins would be for new loans. It does not take into account the fact that total interest earnings received currently by lenders include interest earnings on outstanding loans whose terms were more than T-bills plus some spread but capped at 8.25 percent, e.g., the earlier fixed 9 percent loans made in the 1980s.

⁴ A swap agreement will be for several years. It is unlikely that the relationship between T-bills, CMTs, and LIBOR will stay the same over the entire maturity of the swap. In fact, swap dealers' models reflect the historical as well as the current and anticipated relationship between different types of securities. The future relationship perhaps may be influenced more by historical relationship than the current relationship, especially if the current relationship is a dramatic departure from the past.

financing in 1997 has averaged approximately T-bills plus 65 basis points, we assume that a financing indexed to T-bills is less costly than a financing indexed to LIBOR, and that generally a swap was not necessary this year.

- The swap estimates for the new student loan formula clustered around two widely separated ranges: at the lower end the estimates range from 5.5 basis points to 15 basis points and at the upper end they range from 16 to 31 basis points.⁵ Assuming these clusters of estimates are correct, we assume that lenders would opt for the lower cost swap.
- Swap estimates are tied closely to the term structure of interest rates on which they are based. Because the interest rate assumptions in the FY 1999 budget imply little change in the yield curve next year, we assume that the estimated cost of a swap for the current interest rate environment is applicable for next year. Thus, our assumption for the all-in cost of funds under the new formula is CMT + 12 basis points. This estimate includes CMT plus an average 7 basis points for the cost of a swap and another 5 basis points for the cost of matched funds.
- Based on these estimates, the average weighted net interest margin for lenders under the current loan formula (1997/98) is approximately 8.05 percent minus 5.8 percent (T-bills + .65 basis points) or 2.25 percent. For the new formula (1998/99) and using OMB assumptions, the average weighted net interest margin would be 6.86 percent minus 5.95 percent (CMT + 12) or 0.91 percent.

It should be noted that a swap agreement is not for a one-time payment. The agreement generally will be for 4 payments a year for several years. Subsequent payments will vary if the rates for LIBOR and CMTs on each future reset date are different than the rates at the time the swap agreement is consummated. The spread over/under CMT would not change, of course.

In evaluating these estimates for the cost of a swap, there are important complications that must be noted. The estimates assume that the dollar amounts being swapped are not large. If the amounts rise sharply, as they would for a \$20-25 billion program, the swap would cost more because the demand for LIBOR in return for 10-year CMTs would be rising. Presumably, the estimates provided us for the cost of a swap transaction reflect a relatively small amount currently coming to the swap market. If the student loan formula is indexed to 10-year CMTs, the basis risk is greater than it is with T-bills and there will be a greater demand placed upon the swap market either by lenders directly or indirectly by secondary market investors. In either case, the cost of a swap could rise. Thus, the above estimates may be a floor rather than a ceiling for estimating the effects of a swap.

4. Estimating overhead costs for their student loan program requires lenders to allocate

⁵ These ranges reflect an assumed 4, 7, and 10 year maturity of the swap.

the share of their fixed costs that are incurred for this purpose. A large secondary market company that purchases student loans quoted us 15 basis points for overhead expenses. A guaranty agency quoted us 35 basis points. As noted earlier, it is possible that some lenders may misallocate their costs between overhead and servicing. Therefore, the more reliable number may be the total of overhead and servicing costs combined. Our estimate for this total number is examined in the following discussion of servicing costs.

5. There are two approaches that lenders may use to estimate their servicing costs. One way is to view these costs as the ratio of all such costs incurred in any given time period to the total value of the loan portfolio for that period. Alternatively, we can think of servicing costs in terms of the average annual cost over the life of a single loan as a percent of the average annual remaining principal of the loan, and then calculate the ratio of these two averages. Looking at servicing costs this way, the ratio rises sharply over the life of the loan because the loan principal declines from year to year while servicing cost rise sharply during the in-school period and then levels off during the repayment and consolidation periods. Using this approach would mean taking the average of some very large numbers, which could bias the average upward. Obviously, these two approaches for estimating servicing costs depend on the average maturity of a lenders portfolio: a lower average maturity will be influenced by the lower relative cost of servicing the portfolio and a higher average maturity will be influenced by the higher costs relative to the remaining principal.

A 1993 CRS study⁶ noted that Sallie Mae reported their servicing costs were 66 basis points. A private guaranty agency estimates that servicing costs are about 60 basis points for a traditional bank. A similar figure is also cited in the latest Sallie Mae annual financial report as the cost of servicing Sallie Mae's entire portfolio over the course of a year, i.e., total servicing costs as a percent of total loans.

A later (1997) CRS study⁷ estimated Sallie Mae's in-school servicing costs are 35 basis points, but their costs for the repayment period are much higher, about 100 basis points. This latter figure apparently was based on the average annual servicing cost of a loan over the life of the marginal loan as a percent of the remaining principal of the loan outstanding. We think this approach of using averages of large numbers to estimate servicing costs overstates servicing costs.

The financial statements filed with the Securities Exchange Commission by a major originator of student loans report that their combined operating expenses averaged about 110 basis points from 1992 to 1994, 102 basis points in 1995, and about 95 basis points in 1996 and

⁶ Barbara Miles and Dennis Zimmerman, "Federal Family Educational Loans: Reduced Costs, Direct Lending, and National Income," Congressional Research Service, February 22, 1993, PP. CRS-18 and 19.

⁷ Miles and Zimmerman, 1997, *op. cit.*

1997. This significant decline in operating expenses reflects largely the larger volume of student loans they hold, the economies of scale resulting from this larger volume, and increased productivity from a more experienced workforce. Similarly, a guaranty agency that estimated its overhead costs were 35 basis points also estimated its servicing costs were 60 basis points, for a combined total of 95 basis points.

If we consider servicing and overhead costs as one cost in order to avoid the problem of allocating these costs to the correct category, our assumption for total servicing/overhead costs is 95 basis points. It costs lenders less to service student loans when students are in school and when loans are consolidated. Thus, we assume overhead and servicing costs for loans in the in-school status are one-third the cost for loans in repayment and loans in consolidation are one-half the cost.

6. Because student loans are guaranteed by the Federal Government, the risk of default is very small. During the in-school period it is almost nonexistent. The Federal Government pays the interest costs for subsidized loans while the student is in school. For non-guaranteed loans, students can defer interest payments until after they graduate. Several sources told us their default costs are low; one source said their default costs are only 7 basis points. We assume this is a reasonable estimate.

7. Loan originators are required to pay a 50 basis point origination fee to the Department of Education. Although this is a one-time fee paid when the loan is originated, we have assumed that the cost of the fee is amortized over the average lifetime of a student loan, which is about 11 years (4 years in-school and 7 years of repayment). Thus the annual cost is 5 basis points for in-school loans and loans in repayment. For consolidation loans the 5 basis points origination fee is added to the 1.05 percent rebate fee, for a total fee of 1.10 percent.

8. Many financial market experts think that prepayment costs are not a serious problem because borrowers tend not to have the resources to prepay their loans until well after they have graduated. Others, however, think that prepayment risks can be a problem, partly because borrowers may have a tax incentive to take out a home equity loan to prepay their student loan, if the spread is not too large. Until recently, interest on student loans has not been tax deductible. The Taxpayer Relief Act of 1997, enacted last summer, allows certain individuals who have paid interest on qualified education loans to claim a deduction for this expense. However, the Act limits the interest deduction to the first 60 months in which interest payments are required and also limits the amount of interest that can be deducted.

Currently, it is possible for students to consolidate guaranteed loans, taken out while in school, into the direct loan program. Moving loans into the direct program provides advantages to students, especially the option of income-contingent repayment, which could reduce significantly the repayment burden for some borrowers. In order to keep loans in the guaranteed program rather than losing them to the direct loan program, some lenders offer favorable terms to promote consolidation of loans by borrowers, and they incur a promotion expense in the process.

These price incentives may not be necessary at this time, however, because of the logjam of applications and the temporary suspension of the program which allows borrowers to consolidate their guaranteed loans into a consolidated direct loan. Moreover, in the future, the squeeze on lenders' net return because of the new student loan formula may make it impossible for lenders to continue offering these price incentives. And finally, the Emergency Student Loan Consolidation Act of 1997 (LCA), enacted in October, 1997, could discourage many lenders from offering to consolidate students loans for borrowers.

The LCA makes it too costly for lenders to offer students the option to consolidate their loans, because it changes the formula for determining consolidation loan rates. The LCA also makes consolidation less attractive to lenders, because the law is only temporary and because the start up costs to configure computer programs will be expensive. Sallie Mae, which had been handling about 40 percent of all consolidations, has indicated it will not continue to participate in this part of the student loan program because it may no longer be profitable for them.⁸ Furthermore, it is possible that if lenders are concerned about prepayments, they may sell their student loans to avoid this problem.

Estimates of prepayment costs appear to be somewhat arbitrary. The CRS⁹ estimated that lenders prepayment costs are high. But various lenders have told us they do not think prepayment is a major problem. This was before enactment of LCA. It is not clear what the impact of the Act will be, but, because it is effective only until October 22, 1998, it should have limited impact. We assume the prepayment cost for lenders is 4 basis points, which is consistent with the cost estimated by several sources before the enactment of LCA.

⁸ Student Loan Corporation, which is a subsidiary of Citibank and is the largest originator of student loans, has indicated they will continue to offer consolidation loans.

⁹ Miles and Zimmerman, 1993, *op. cit.*

1/21/98

• Sol/re Mac

- react
- politics

• Treasury analysis

- which set of 10-yr auction

*

Notes:

- ROR -

- 125 - alternative assets

- academic - reg'd rate of return (what and how)

□ present interest as a whole?

* - ROR on group held...

→ 50 bp

⇒ split diff.

(what's link)

- de-interaction?

- Under CBO projections, banks and some
of economy

- What is the rate of use
'comparable maturity'

1/7/11

- 19-20 x bands

band - ~~approx~~ 10

Concl:

- Access high, per
in mid 1/3
small disc.
market shrinking

- Why not major discounting?

Answer:
- Credit made by schools,
not student

needs

Appendix

- compare to CHS

~ why not more discounting...

⇒ end of week
of Feb. 2

- Susan
by end of week

RD:

- Cooper

- Wild Cove

The Financial Viability of the Student Loan Program

Executive Summary

The current student loan formula is based on the bond equivalent yield for 3-month T-bills plus a spread of 2.5 percentage points for loans to students who are in school or for loans that are temporarily deferred, and a spread of 3.1 percentage points for loans that are being repaid, with the rate reset annually. For loans in consolidation, the interest rate has been based on the weighted average interest rate on all outstanding loans being consolidated; recent legislation changed this to 3-month T-bills plus 3.1 percentage points. The rate that the student pays on all loans is capped at 8.25 percent and the Government pays any excess above this rate in the form of a Special Allowance Payment (SAP).

Effective July 1, 1998, a new formula will be based on the average bond equivalent yield for 10-20 year Treasury securities, or a rate for securities with a comparable maturity [recheck language of this phrase] established by the Secretary of Education in consultation with the Secretary of the Treasury. The widespread expectation outside the Administration is that the index the two Secretaries will select will be the bond equivalent yield for 10-year Treasury notes (CMTs). The spread above this index rate will be 1.0 percentage point for both in-school and in-repayment loans. The student's interest rate still would be capped at 8.25 percent and the Government still would pay the SAP.

Lenders are concerned that loans under the new formula will not be profitable. Part of the reason is the implicit reduction in the interest rate on student loans under the new formula, resulting from the sharp cut in the markup from 2.50/3.10 percentage points over the benchmark rate to 1.0 percentage point. In addition, the alleged lack of profitability stems the cost that banks will have to incur once the new formula is in force, in order to swap out of the 10-year (with annual reset) asset they will hold into a LIBOR related asset.

This paper provides estimates of lenders' costs (including servicing, default and pre-payment costs as well as cost of funds) and the gross return from student loans under the current student loan formula and under the formula scheduled to become effective on July 1, 1998. We have made these estimates under various assumptions about interest rates.

Our results show that under the current formula, lenders appear to be earning a pretax rate of return on student loans that is more than adequate. Switching to the new student loan formula would reduce lenders' net return substantially. This conclusion appears to be robust across interest rate assumptions.

Moreover, only part of this substantial reduction in lender margins arises from the need to hedge. That is, moving back to short-term interest rates as a basis for determining the student loan rate while holding borrowers harmless -- i.e., pegging the student loan rate at the same level

as it would be under the new formula -- does not produce a competitive rate of return on the banks' investments in these loans. Holding borrowers harmless could be achieved by keeping the current basis for indexing student loans but reducing the rate students pay to 3-month T-bill plus about 1.75 to 1.80 percentage points. In order to assure that lenders receive a competitive rate of return, we estimate the formula would have to be 3-month T-bill plus about 2.30 percentage points. This rate setting formula would both deliver substantial savings to students and maintain bank participation in the guaranteed student loan program over the long-term.

Our confidence in this analysis is fairly high. We must note, however, observations that present a strong challenge. Over the past several years, not only have the number of lenders participating in the loan program fallen relative to the total number of banks and thrift institutions but the scale of participation of some remaining lenders has declined while the Federal Government's full-scale direct loan program, enacted in 1993, has captured about one-third of the market. If, as we claim, the rate of return under the current formula were more than generous enough at least for those large loan holders benefitting from scale economies, it seems that these lenders should have been able to retain market share despite competition from the direct loan program. If our assessment of the adequacy of return to lenders under the current formula is wrong, there may be less room than we assert to squeeze the banks, and so less room to benefit students.

Setting student loan interest rates by fiat is a hit or miss proposition, which only by chance will result in the minimum rate lenders need to participate in the student loan program. One way to assure the loan rate is not too high or too low is to allow the market to set the loan rate directly. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans. The experience of the Health Education Assistance Loan (HEAL) program using an auction system for allocating the insurance authority for HEAL loans suggests that an auction could work for the Federal Family Education Loan program as well.

THE FINANCIAL VIABILITY OF THE STUDENT LOAN PROGRAM

Introduction

The current formula for calculating student loan interest rates applies to new loans made between July 1, 1994 and June 30, 1998. Under this formula, lenders receive the bond-equivalent yield of 3-month T-bills¹ plus 2.5 percentage points for in-school loans and loans in deferment, or the 3-month T-bill rate plus 3.1 percentage points on loans in repayment. Loans are reset quarterly for lenders and annually for borrowers, with an 8.25 percent cap on the borrower's rate.

A lender receives a Special Allowance Payment (SAP) in any quarter in which the average rate for 3-month T-bills auctioned during the quarter plus 2.5/3.1 percentage points [check] is greater than the borrower's interest rate (either the formula interest rate established at the last annual re-set or the cap of 8.25 percent). The SAP is the difference between the quarterly re-set rate from the formula and the rate the student pays, divided by four (for a quarterly payment).

Until recently, the loan interest rate for loans in consolidation was the weighted average of the interest rates on all outstanding loans being consolidated, rounded up to the nearest whole percent; this figure is currently 9.0 percent. On October 22, 1997, the Congress enacted the Emergency Student Loan Consolidation Act of 1997. This law makes several temporary changes in the guaranteed student loan consolidated program. Among other things, these changes, which will be in effect until October 1, 1998, set the interest rate for all new consolidation loans at the T-bill rate plus 3.1 percent, with the rate capped at 8.25 percent.

The Student Loan Reform Act of 1993 (SLRA) scheduled a change in the formula determining the rate that borrowers would pay for new student loans starting in mid-1998. Starting with loans finalized after June 30, 1998, the SLRA requires that lenders' gross yield on new loans be based on "the bond equivalent rate of the securities with a comparable maturity as established by the Secretary of Education", in consultation with the Secretary of the Treasury, [check] plus 1.0 percentage point,² with the rate reset every 12 months. For the purpose of this

¹ As used hereafter, the terms 3-month T-bills or T-bills, and 10-year Treasury notes (CMTs) refer to the bond equivalent yield for such securities or securities of that constant maturity.

² The change in the formula for 1998 and subsequent years evolved late as the SLRA of 1993 went through the Congress, with the intention of reducing the loan interest rate charged students and of tying the interest rate on student loans to the discount rate that the Treasury Department charges the Department of Education for budget scoring purposes, which was then the average rate on Treasury securities with a remaining maturity of 10-20 years calculated on a "simple interest basis". The language in the legislation did not exactly implement this intent and, in the event, the budget scoring for credit programs is now in the process of change [check details]

paper, we have assumed that the chosen bond equivalent yield of securities with a comparable maturity will be the 10-year Treasury constant maturity yield. This yield was chosen because it is a commonly used benchmark in financial markets within the appropriate maturity range, is regularly published in official sources, and is forecast in private as well as government budget analyses.³ Based on the 10-year CMT interest rate assumptions for the 1999 budget, the formula change for next year would reduce the loan rate to borrowers, relative to the rate they would pay under the current formula.⁴ As noted later in this paper, in all likelihood the formula change also would reduce the net return to lenders.

The cost to a borrower for a student loan includes more than the interest on a student loan. The Federal Family Education Loan (FFEL) program authorizes lenders to collect from borrowers an origination fee (currently, 3 percent of the loan principal borrowed), which is paid to the Federal Government, and an insurance premium (no more than 1 percent), which is paid to guaranty agencies. These one time fees, which are intended to offset the Federal subsidy costs and to defray default costs, are disbursed to the Government and guaranty agencies at the same time as the loan is disbursed to the student.

In the past, lenders have not always collected the full amount of these fees from borrowers, choosing instead to absorb part of the fees as a way of reducing the cost to the borrower in order to meet competition. This appears most likely to be done on a school-by-school basis depending on the repayment characteristics and future income prospects of graduates of the school. Lenders also may not always charge borrowers the full rate of interest authorized by the student loan formula, although our understanding is that direct competition on a loan interest rate basis is rare. One exception to this assertion is a Sallie Mae formula for reducing the loan rate in repayment, based on a borrower's good payment performance over a period of time. [more to be added on the competitive features of the market]

On the lenders' side of the market, the new loan formula introduces a new risk, and hence a new cost, because of the peculiar structure of the proposed loan contract. Under this contract, lenders would receive a return tied to a long-term yield, repriced annually, while they would presumably be funding themselves at a short-term rate, the most common among banks being LIBOR. Although the risks resulting from the mismatch between the short-term sources of borrowed funds (liabilities) for lenders and the long-term yields of student loans (assets) are mitigated by the annual repricing of the rate on the long-maturity asset, the remaining basis risk is notably larger than under the current loan formula with the asset return linked to a short-term rate. Starting in mid-1998 with the new formula for student loans, therefore, lenders are very

³ The yield on the actual Treasury note closest to 10-years in maturity is also forecast in futures markets and a corresponding forward rate may be derived from the yield curve.

⁴ A lower loan rate for students in 1998-99 depends on market interest rates, in the event, being at a level where the 8.25 percent cap is not in effect. If it were, the student loan rate would not be affected by the new formula.

likely to protect themselves against the new risk by hedging the differential interest rate streams through a swap agreement.

The cost of this swap agreement will detract from the overall profitability of the loan contract from the banks' perspective. Moreover, creating an unusual instrument, for which a market does not exist at this time, probably boosts the cost of obtaining such swaps. The critical policy issue for the loan program is whether lenders offering student loans currently have a profit margin that is sufficiently large to absorb this and any additional costs, so that the return on educational loans relative to other investment opportunities of lenders is still favorable.

Evaluating the future prospects for the net return to lenders or for those purchasing student loan contracts in the secondary market requires estimating the spread between lenders' revenues -- based on the 10-year Treasury yield -- and lenders' costs. The next section describes our methodology for measuring costs.

Assumptions for Lenders' Costs

The following discussion attempts to describe the costs of a representative lender big enough to have achieved some degree of scale economies. We realize that analyzing the situation for an "average lender" may not describe accurately the cost structure all lenders or loans. Student loan originators range in size and funding sources and different parts of the student population are said to vary in how expensive they are to serve. Realistically, however, we have no choice than to use available data to approximate the "average lender". Furthermore, from a theoretical perspective, it is reasonable to assume that arbitrage is taking place continuously in the market place. For instance, the market for originations is influenced by the presence of an active secondary market, into which loans may be sold and where buyers of loans also have differing funding sources. Given the possibilities for origination, and for securitization or sale into the secondary market, among these different market participants, any excess profits realized by one type of entity should be available to all, or there would be a rush towards a particular type of activity (such as securitization). What works for one participant should work for all participants.

The interest rate and cost assumptions for lenders used in this paper are shown in **Tables 1 and 2** and are discussed below. **Appendix A** includes a more detailed discussion of these assumptions.

- The 1999 Budget projections for **interest rates**, CBO projections and market projections are shown in Table 1 and estimates of profitability for lenders are made using these alternative interest rate assumptions. The Budget projections and most of the alternatives assume that the yield curve will remain relatively flat, consistent with the structure of current market rates. Interest rate levels are projected to change rather little and the spread between long-term and short-term rates is projected to remain well below average historical experience since 1962, consistent with a favorable inflation outlook and expectations of federal deficit reduction that adds to national saving.

- The **lenders' matched funds** rate is assumed to be the 3-month T-bill, or the 1-or-3-month LIBOR, rate plus a given spread. In actuality, the size of the spread depends the size and creditworthiness of the lender, and the purpose of the borrowing (e.g., warehousing loans or securitizing loans). We are assuming an "average" spread.
- Under the new formula, the need for **hedging** affects lenders' costs. We talked with several major financial institutions which provided us estimates of the cost of swaps, the instrument that lenders use to hedge basis risk. We chose conservative estimates of the costs of hedging but we emphasize that the swap quotes we obtained are for a contract that is, at this stage, hypothetical. It is not surprising, therefore, that cost estimates varied somewhat among institutions. The market for swapping between 10-year Treasuries and LIBOR is not a deep market to begin with, meaning that swap brokers may charge a premium because of the risk of having to hold one side of the contract for a while. In addition, the particular swap envisioned here is complicated by the annual reset provision for the 10-year Treasury yield. Some experts suggest that this market would be even thinner and hence the contract could be difficult or expensive to obtain; the absence of an assured efficient swap market could make some lenders reluctant to take a chance on student loans under the new formula. Others argue that the presence of strong demand for this swap contract would lead an efficient swap market to emerge over time.
- **Servicing and overhead costs** (an estimate of the total seems likely to be more accurate than estimates of the separate pieces) include a share of expenses such as general management, legal, accounting, human resources, and marketing costs plus direct costs for servicing the loan such as expenses for collections, borrower correspondence, reporting and account maintenance, and filing guarantee claims. Servicing costs seem to vary among lenders depending on the size of lenders and the efficiency of their operations. Larger lenders probably are more efficient owing to economies of scale. Costs may differ also among parts of the student population depending, e.g., on whether or not the students typically complete four or more years of schooling possibly at an expensive school, thus accumulating a large total loan for given costs of billing.
- The possibility of **default** on loans in repayment also implies some small cost to lenders. Recent data suggest that default rates may be declining. The probability of default on in-school loans, and to a lesser extent loans in consolidation, generally has been small. The Federal Government pays the interest cost on a subsidized student loan while a student is in school. Most important, the Government guarantees 98 percent of a student loan, thereby reducing substantially the cost of default to the lender. (Currently, a borrower pays a guaranty agency a loan insurance premium of 1.0 percent of the loan amount to help defray default costs; the lender may pick up part of this cost to the borrower in order to reduce the overall loan rate but is not required to do so nor assumed here to do so.)
- Another cost for lenders is the one-time 50 basis point **origination fee** paid by loan originators to the Department of Education. This fee cannot be passed on to borrowers,

who already pay a separate 3 percent origination fee to the Federal Government to help offset the cost of the Federal subsidy. In addition to this origination fee, holders of consolidation loans must pay to the Federal Government a **rebate fee**, calculated on an annual basis, equal to 1.05 percent of the loan principal plus interest, which is then added to the 50 basis point origination fee.

- Lenders offering student loans face a risk of prepayment of loans attributable to defaults, loan consolidation, and advance payments from borrowers. When prepayment occurs, lenders may not be able to reinvest these funds at the same return earned on the student loan. Prepayment also reduces the life of a loan, thereby increasing the over-the-life cost of certain fixed expenses, e.g., origination support. Consequently, lenders may face a **prepayment risk** which results in a cost to them. Many financial experts, however, think that prepayment costs are not a serious or costly problem.

Table 2 provides a summary of the cost assumptions used for this paper. The two major costs for lenders are their all-in cost of funds (matched funds plus hedging) and servicing/overhead costs. For the former, the rates are 5.80 percent (5.15 on the 3-month T-bill] +0 .65 spread) for 1997/98 and 5.95 percent (5.83 on the 10-year CMT +0 .12 margin on the swap and spread on matched funds) for 1998/99.⁵ The estimated servicing/overhead cost for loans in repayment status is 95 basis points. For in-school loans, the estimated cost is one-third the cost for loans being repaid, or 32 basis points. All other costs combined are 16 basis points and are assumed to be the same every year.

Target Rate of Return for Student Loans

The viability of various student loan formulae depends on the appropriate target rate of return for the lender for this particular asset. There are a number of approaches to determining what this target rate might be.

- **Return on Alternative Assets**

A 1997 paper by the CRS⁶ on the student loan program presented estimated returns on alternative assets as a frame of reference for judging returns on student loans. This approach keys on the idea that no profit-maximizing bank would allocate part of its portfolio to an asset that was dominated by other available assets. CRS estimated returns

⁵ The interest rate assumptions are average rates for the school year starting on July 1 and are from the Administration's FY-1999 Budget.

⁶ Barbara Miles and Dennis Zimmerman, "Reducing Federal Student Loan Costs: The Options are Narrowing," Congressional Research Service, February 25, 1997, p. CRS-5.

on Ginnie Mae securities⁷ at 1.20 percentage points and estimated the return on adjustable-rate mortgages to be 1.25 percentage points. These estimates have not been analyzed or confirmed with other sources.

- **Judgmental Rules of Thumb**

A Federal Reserve analyst and several financial market participants have said that banks generally earn a net return, after- tax, of 1 percent on collateralized assets (e.g., mortgages) and government-guaranteed assets. Indeed, government-guaranteed assets possibly could receive an after-tax return somewhat below one percent. A one percent after-tax return would correspond to a 1.67 percent rate of return before-tax, assuming a marginal tax rate of 40 percent, including federal, state, and local taxes.

- **Deriving the Return on Assets from the Return on Capital**

The ultimate criterion that a financial institution must meet is a competitive rate of return on its capital. The return on its capital and the return on its assets are related by the ratio of capital to assets.

Banking regulations require a ratio of capital to *risk-adjusted* assets. The required ratio is 8 percent but recent history shows ratios well above that. The industry -wide average currently stands at around 12.5 percent, below the 13.2 percent level in 1994 but up substantially from the level of 9.49 at the end of the first quarter of 1990.

Student loans have a risk weighting factor of 20 percent, meaning that in the calculation of risk-adjusted assets, student loans count only to the extent of 20 cents on the dollar. Thus, if a bank aims to hold capital equal to 12.5 percent of risk adjusted assets, it will hold only \$2.50 dollars in capital for every \$100 in student loans. Applying this capital ratio to the 25 percent target rate of pre-tax return on equity gives a target net return on assets of 50 basis points.

In light of the above calculations, *we use 75 basis points as our central estimate of the target rate of return for student loan originators.* This is substantially below the rule of thumb calculations and the opinion of outside experts, and somewhat below CRS estimates of the returns on alternative assets. But it is slightly above the level justified by the required rate of return on capital held to back up these loans, a margin that may be justified by informal pressures from regulators and rating agencies toward higher capitalization.

⁷ These are marketable securities backed by pools of government guaranteed or insured mortgages; these securities are considered to be quite liquid in an active secondary market.

Summary Results and Some Empirical Evidence

As shown in Table 3, our estimate of the pre-tax weighted net return to lenders in 1997/98, for in-school loans and loans in repayment, is about 1.51 percent.⁸ This return, however, does not allow for discounts from the maximum student loan rate that banks may charge. Sallie Mae offers a "Great Rewards Program" that allows borrowers who have made 48 consecutive loan payments on time a 2 percentage point discount of the loan rate. This translates to about a 10-15 point reduction for their entire portfolio.⁹ If this discount is the competitive standard for the industry, then banks' net returns are actually 1.36 to 1.41 percent after the cost of the discounts. Thus, it appears that, under the current student loan formula, lenders are earning more than an adequate rate of return on student loans compared with the minimum required rate of return but perhaps only about an adequate rate of return when compared to that available on comparable assets.

The financial statements for a major student loan originator appear consistent with the conclusion that earnings under the current formula are adequate or more than adequate. These statements indicate that its annual pre-tax rate of return for calendar year 1997 will be about 1.45 percent.¹⁰ We estimate that over the preceding four years, this institution had a much higher average pre-tax rate of return of about 1.68 percent.

The return to lenders would change dramatically if the new student loan formula were changed from the 3-month T-bill rate plus 2.5/3.1 percentage points to the rate for 10-year Treasury notes plus 1.0 percentage point, in part because this change imposes a significant new risk for lenders and, therefore, raises the all-in cost of funding as a result of hedging.

Table 3 shows that switching to the new student loan formula for loans in school and in repayment could reduce the weighted average pre-tax return to lenders from 1.51 percent under the current formula in 1997/98 -- or about 1.38 after discounts to students -- to 0.18 percent under the new formula next year if the 1999 Budget assumptions are borne out, or from 1.36

⁸ If the return on consolidation loans is included, the weighted pretax return would be 1.46 percent (see Table 6).

⁹ Sallie Mae estimates that on the basis of current experience, less than 20 percent of borrowers qualify for a discount under these terms.

¹⁰ For the first three quarters of 1997, this financial institution reported a net interest margin of 2.41 percent and operating expenses of .96 percent of average insured student loans. Assuming that its other costs were about .16 percent of its student loan assets, its pretax rate of return is 1.45 percent ($2.41 - .96 - .16 = 1.29 + .16$ allowance for the amount of loan assumed to be financed by equity rather than debt).

percent to 0.16 percent if *Blue Chip* assumptions prove accurate.¹¹ Clearly, these estimates, if correct, would not be acceptable to lenders.

The key elements of this estimated result from the new formula are the alteration in the formula spread above the index rate and the estimated all-in cost of funds, which includes the cost of a swap under the new formula. A 1.0 percentage point spread over 10-year CMTs is well below what would be necessary for lenders to earn their minimum target rate of return, regardless of what the yield curve looks like. In addition, the need for lenders to hedge a basis risk between their assets and liabilities adds an additional cost burden.

It may be noted, however, that these findings are somewhat sensitive to substantial interest rate movements within a year, i.e., between the time (end of May) when the student loan rate is determined by formula and the time when a lender actually makes a loan and finances it. For example, if the new formula were in place for the current school year, the risk-adjusted net return on assets for student loans in-school and in-repayment would be 0.94 percent, assuming a 12 basis point mark-up over the 10-year CMT rate as the all-in cost of funds. This is in the range of providing a satisfactory rate of return. However, this rate of return would have been achievable only because long-term yields fell significantly after mid-1997, lowering the rate for 10-year CMTs from 6.75 percent during the second quarter of 1997 (when the formula sets the student loan rate) to 5.86 percent for all of the 1997-98 school year.

The new formula had been expected to be financially acceptable, when it was enacted in 1993 in part because, historically, the yield curve had been much steeper than is currently projected. Adjusting the data for the years when the loan formula rate exceeded the 8.25 percent cap on the student loan interest rate, the 10-year rate plus 1.0 percentage point has been less than the 3-month T-bill rate plus 3.1 percentage points by an average of only 28 basis points since the early 1960s. The 1999 Budget assumptions makes this difference 137 basis points in 1998, 131 basis points in 1999, and 121 basis points from 2000 through 2007 (with the T-bill based index higher); other projections have a similar contour. Additionally, however, there was a failure to recognize that lenders would hedge their student loans if returns were indexed to a long-term rate.

Is there a Remedy?

The results in **Table 3** imply that lenders will not receive a reasonable rate of return in the guaranteed student loan program if the scheduled change of formula takes place in July, 1998.

One possible remedy would involve returning the basis for student loans to a short-term rate, while holding borrowers harmless so that the total cost to a student next year would be no higher than under the new formula. This alternative, however, does not appear sufficient to

¹¹ The comparable numbers including consolidation loans are 1.54 percent in 1997/98 and 0.36 percent and 0.37 percent in 1998/99 under the 1999 Budget and *Blue Chip* assumptions, respectively (see Table 6).

provide a competitive rate of return to banks. Holding borrowers harmless would require that the student loan interest rate is reduced to 3-month T-bill plus 1.73 percent, assuming the Administration's 1999 budget assumptions for interest rates or 1.76 percent using the *Blue Chip* assumptions (see **Table 3**). However, we estimate that a formula which holds borrowers harmless would provide lenders only a 0.35 percent rate of return next year, using 1999 Budget assumptions, or 0.37 percent using *Blue Chip* assumptions. These rates of return are below the target rates described above.

Another possible remedy would involve allowing lenders the minimum rate of return that would make student loans competitive with other assets. We calculate that the loan rate under this approach would be T-bill plus 2.28 percentage points. This loan rate would be substantially higher than would prevail under the formula now scheduled to go into effect at mid-year (roughly 50 basis points). It would represent, however, a significant reduction in the cost relative to the current system (roughly 65 basis points, using a weighted average of the rates in-school and in repayment). Thus, a new formula which allowed banks and students to "split the difference" could provide noticeable savings to students and a competitive rate of return to banks.

One approach to closing the perceived gap between the rate required to hold students harmless and a competitive rate for banks is to assume that, instead of using the 10-year CMT, the Department of Education would instead choose the 10-20 year Treasury security simple interest rate. As noted earlier, there are a number of reasons to prefer the 10-year CMT for this exercise, and our estimates for the 10-20 year Treasury rate are more tentative because we have not explicitly priced out swap arrangements for this hybrid security. Currently, however, the average simple interest rate on 10-20 year securities is about 25 basis points higher than the bond equivalent yield for the 10-year CMT. If we assume that this differential is swapped away when moving to the new formula, there is no difference in the rate of return under the new formula from using the 10-20 year, as shown in **Table 4**. But, the fact that the 10-20 year rate is higher implies *that the rate that holds students harmless provides a net return to banks that is much closer to their target rate of return*. The student harmless rate would be calculated to provide a rate of return of 0.62 basis points, considerably closer to the banks' target rate of return. Thus, with a smaller apparent increase in the cost of borrowing to the student, we could meet the target rate we have assumed to be required by loan originators.

In other words, by claiming that their intention is to use the 10-20 year rate, rather than the 10 year rate, the Department of Education can move much closer to resolving the tension between holding students harmless and providing an adequate rate of return to lenders. But it is important to remember that this claim may be refuted by the higher education community, since the use of this interest rate would seem to contradict the SLRA, as noted earlier.

Why Set the Rate Administratively?

The difficulty of this exercise points out the fundamental problems with regulatory determination of student loan interest rates. Setting these rates by fiat is a hit or miss proposition,

which only by chance will result in the minimum rate lenders need to participate in the student loan program. One way to assure the loan rate is set appropriately would be to *allow the market to set the rate directly*. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans.

One form of auction could be a single price (interest rate) auction for amounts of guaranteed loans to be originated. With this type of auction, bids would be accepted in rank order from the lowest to the highest (interest rate) until the total target quantity of new student loan originations, as estimated by the Secretary of Education, had been awarded. The maximum interest rate that all successful bidders could charge would be the rate for the last bid accepted. Lenders submitting this bid would receive the rights to originate the amount of loans on which they bid. All others bidding a lower rate than the marginal bid also would obtain the right to originate their proposed amount of loans but could charge a rate on these loans up to the maximum rate set in the auction. Some successful bidders could receive a return -- if they charged the maximum rate -- that would be more than they need to originate their share of the total loans. Competition should assure that this differential would be small, however, because lenders would not want to submit a bid price much higher than they need, otherwise they could fail to obtain any of the rights to originate student loans.

The experience of the Health Education Assistance Loan (HEAL) program suggests that such an auction can work. HEAL is a federally-insured loan program for graduate students in schools of medicine and other health professions. The interest rate for both borrowers and lenders is reset quarterly, but rates on HEAL loans are capped at the rate for 3-month T-bills plus 3.0 percentage points. Since FY 1993, there has been an auction system for allocating the insurance authority for HEAL loans and the interest rate spread over the T-bill rate has been well below the cap and declining every year. The lowest rate bid in the first auction was T-bill plus 2.4 percentage points. For the most recent auction in February, 1997 (for the school year 1997/98), the successful bid was T-bill plus 1.5 percentage points.

The auction system for the HEAL program suggests that an auction could be used for the FFEL program, and that such an option should be explored more rigorously. The success of the HEAL auction, however, does not necessarily imply that an auction will guarantee large savings for FFEL. The successful bidders for the HEAL program generally have been not-for-profit State agencies. As such, their debt is not taxable, which allows them to borrow at rates that are well below the cost of funds for others who are not exempt from taxes. If an adjustment is made for the difference between the interest rates for a tax-exempt and a taxable security, the effective student loan interest rate might not be much, if any, different between the HEAL and FFEL programs. Moreover, the HEAL program involves only \$85 millions currently and probably less than \$400 million if an authorization/appropriation is enacted by next fall. The experience with this small program may not be completely transferable to a \$20-25 billion program that has a 98 percent guarantee rather than 100 percent and whose borrowers are more diverse and do not have the same risk characteristics as HEAL borrowers.

Concluding Remarks

The results presented in this paper rest on a number of assumptions about the cost structure of the student loan program, as well as (more critically) projections of the term structure of interest rates and the costs of hedging loans tied to long-term interest rates. These results therefore have a degree of uncertainty that is not accurately reflected in our tables. Nevertheless, some conclusions seem clear. Unless our assumptions are substantially in error, the new formula will provide a rate of return on student loans which is below the target rate of return of lenders in the guaranteed student loan program. And fixes based on simply moving to the short-term rate for student loans, while holding students harmless, probably will not provide an adequate rate of return. In the end, a system which provides incentives for lenders to participate will have to return to the lenders some part of the large projected differential between the current student loan interest rate and that which will prevail after July, 1998.

TABLE 1: INTEREST RATE ASSUMPTIONS

	(Percent)			
	1997	1998	1999	5-year ave.
OMB				
3-month T-bill	5.17	5.13	5.01	4.93
10-year note	6.75	5.86	5.80	5.76
Spread	1.58	0.73	0.79	0.83
Blue Chip				
3-month T-bill	5.17	5.34	5.13	--
10-year note	6.75	6.10	6.10	--
Spread	1.58	0.76	0.97	--
CBO				
3-month T-bill	5.17	5.40	4.70	--
10-year note	6.75	6.20	5.80	--
Spread	1.58	0.80	1.10	--
DRI				
3-month T-bill	5.17	5.19	4.83	--
10-year note	6.75	5.8	5.82	--
Spread	1.58	0.61	0.99	--
Futures Market a/				
3-month T-bill	--	4.89	n.a.	n.a.
10-year note	--	5.39	n.a.	n.a.
Spread	--	0.5	n.a.	n.a.

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1;
all other data are for the second calendar quarter.

n.a. Not available.

a/ Futures market rates for June, 1998 as of January 14, 1998.

TABLE 2: COST ASSUMPTIONS
(Percent or Basis Points)

	Current Policy		Future Policy	
	In-School	Repayment	In-School	Repayment
All-in costs a/	T-bills + .65	T-bills +.65	CMT + .12	CMT+.12
Servicing/overhead b/	0.32	0.95	0.32	0.95
Default risk	0.07	0.07	0.07	0.07
Prepayment risk	0.04	0.04	0.04	0.04
Origination fee	0.05	0.05	0.05	0.05

a/ For current policy, all-in costs include only the cost of matched funds;
for future policy, all-in costs include the cost of financing plus the cost of a swap.
Costs to banks are reduced by 0.028 percent of this total because that amount is assumed to be financed by equity.

b/ Includes both servicing and overhead costs.

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS
(In Percent)

Formula or Net Rate of Return	1997/98		1998/99			5-yr. ave.
	Administration	Blue Chip	Administration	Blue Chip	CBO	Admin.
Current Formula:						
3-month T-bill + 2.50/3.10	7.67/8.25	7.67/8.25	n.a.	n.a.	n.a.	n.a.
Estimated net return to lender	1.51	1.36	n.a.	n.a.	n.a.	n.a.
Future Formula:						
10-year CMT + 1.00	n.a.	n.a.	6.86	7.10	7.2	6.76
Estimated net return to lender	n.a.	n.a.	0.18	0.17	0.35	0.15
Alternative Formulas:						
To hold student harmless	n.a.	n.a.	T-bill + 1.73	T-bill + 1.76	T-bill + 1.80	T-bill + 1.83
Estimated net return to lender	n.a.	n.a.	0.35	0.37	0.77	0.65
To maintain lenders minimum required net rate of return:						
75 basis points	n.a.	n.a.	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28

Note: Formula estimates are a weighted average for loans in-school and in repayment. The weights are based on the relative share of loans outstanding for each loan status, i.e., in-school= 36.08 percent and repayment= 63.92 percent.

n.a. Not applicable

Assumptions:

OMB estimates are based on Fiscal Year 1999 budget estimates.

Blue Chip estimates are based on the December Blue Chip release.

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TABLE 4: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS, ALTERNATE BASIS
(In Percent)

Formula or Net Rate of Return	1997/98	1998/99
	Administration	Administration
Current Formula:		
3-month T-bill + 2.5/3.10	7.67/8.25	n.a.
Estimated net return to lender	1.51	n.a.
Future Formula:		
10-20 year single interest + 1.00	n.a.	7.11
Estimated net return to lender	n.a.	0.18
Alternative Formulas:		
To hold student harmless	n.a.	T-bill + 1.98
Estimated net return to lender	n.a.	0.62
To maintain lenders minimum required net rate of return:		
75 basis points	n.a.	2.28

Note: Formula estimates are a weighted average for loans in-school and in repayment. The weights are based on the relative share of loans outstanding for each loan status, i.e., in-school= 36.08 percent and repayment= 63.92 percent.

n.a. Not applicable

Assumptions:

Data are based on Fiscal Year 1999 budget estimates. The estimated rate for securities having a maturity of more than 10 years and less than 20 years is stated as a simple annual rate, which differs from bond equivalent rates and bank discount rates.

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TABLE 5: SWAP ESTIMATES (IN BASIS POINTS)

SWAP	Goldman Sachs 11/14/97	J.P.Morgan 11/14/97	Bankers Trust 11/14/97	Citicorp 11/21/97	Paine-Webber 11/14/97
3-month T-bill for LIBOR (weekly reset, quarterly pay)					
4 year	T-bill + 69	T-bill + 70	T-bill + 68	T-bill + 70	T-bill + 75
7 year	T-bill + 68	T-bill + 70	T-bill + 66	T-bill + 69	T-bill + 73
10 year	T-bill + 67.5	T-bill + 69	T-bill + 66	T-bill + 69	T-bill + 73
10 year CMT (annual reset) for LIBOR					
4 year	CMT + 9.5	CMT + 26	CMT + 27	CMT + 31	CMT + 15
7 year	CMT + 7.5	CMT + 21	CMT + 26	CMT + 27	CMT + 11
10 year	CMT + 5.5	CMT + 16	CMT + 24	CMT + 25	CMT + 9

Note: quoted yields on November 14, the date of most of these swap quotes were around: 3-month T-BILL, 5.26%; 3-month LIBOR, 5.88%; 10-year CMT, 5.81 to 5.88%.

swapest

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TABLE 6: RISK-ADJUSTED PRE-TAX NET RETURN for FFEL STUDENT LOANS, 1997 and 1998
(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99 (OMB Estimates)			7/1/98 to 6/30/99 (Blue Chip Estimates)		
	In-school or Deferment	Repayment	Consolidation	In-school or Deferment	Repayment	Consolidation d/	In-school or Deferment	Repayment	Consolidation d/
Student Loan Interest Rate	7.67	8.25	9.00	6.86	6.86	9.00	7.10	7.10	9.00
Less Costs:									
All-in cost of funds a/	5.80	5.80	5.80	5.95	5.95	5.95	6.15	6.15	6.15
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs/overhead b/	0.32	0.95	0.47	0.32	0.95	0.47	0.32	0.95	0.47
Default risk	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
Prepayment risk	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>	<u>0.04</u>
Subtotal	6.28	6.91	7.48	6.43	7.06	7.63	6.63	7.26	7.83
Net Return c/	1.55	1.50	1.68	0.60	-0.03	1.54	0.64	0.01	1.34
Weighted Average Net Return		1.54			0.36			0.38	

Note: OMB estimates for interest rates are for the 1999 budget. Blue Chip estimate is for December 10, 1997.

a/ Assumes all-in cost of funds for 1997/98 is T-bill + 65 basis points; for 1998/99 the all-in cost is CMT +12 basis points.

b/ Assumes that servicing/overhead costs in-school are 33 percent of the cost for repayment; for consolidation loans these cost are 50 percent of repayment.

c/ Adjusted to allow for the assumption that only 97.2 percent of the loan principal is financed by borrowing and the rest comes from equity.

d/ For loans already consolidated before 1998-99.

Appendix A

1. Table 1 shows that several different forecasts of future interest rates project a relatively flat yield curve for the next two years. Only the future's market data for 1998 show a spread between the 3-month T-bill rate and the 10-year Treasury note that is similar to historical experience. Although the *Blue Chip Economic Indicators* consensus forecast for the next two years reflects a relatively flat yield curve, their projected rates are higher than those forecast by the Administration in the *FY 1999 Budget* and higher generally than the other forecasts shown in the Table. Thus, an alternative to the Administration's projections for interest rates is that the 3-month T-bill rate for 1998 is 5.34 percent. This is the *Blue Chip* consensus forecast for the second quarter of 1998, converted to a bond equivalent yield basis. The *FY 1999 Budget* estimate for 1998 is nearly the same as the 5.12 percent average closing price in the futures market since mid-September for 3-month T-bills maturing in June, 1998; the *Blue Chip* estimate is higher than the futures market rate.

Using the latest budget economic assumptions for 10-year Treasury notes, the student loan interest rate is 6.86 percent ($5.86+1.0$) for 1998/99, and 6.8 percent ($5.8+1.0$) for 1999/00.¹ Our alternative assumptions for student loan interest rates are 7.1 percent ($6.1+1.0$) for both 1998/99 and 1999/00. Both of these are *Blue Chip* estimates.

2. Lenders have several options for obtaining funds to finance their portfolio of student loans: they can finance their loans by using the bank deposits of their customers; they can sell new debt; or they can saturate some or all of their loan portfolio by a public issuance of student loan asset-backed securities.

We consulted a number of financial experts about lenders' cost of financing through new debt issues, and the range of estimates that we received was between T-bill plus 50 basis points to T-bill plus 80 basis points, with more of the estimates towards the higher end of this range. Since lenders borrow at LIBOR, this amounts to a spread over LIBOR of roughly 0-30 basis points; the historical spread between T-bill and LIBOR rates has averaged 43 basis points, and it is currently 60 basis points.

An analysis of actual debt financing for 1997 indicates that a significant amount of financing has been obtained by securitizing existing loan portfolios. Nearly all of these securitizations were based on T-bills. This may be because student loans are indexed to T-bills, which would preclude a basis risk and the need to hedge by arranging a swap agreement. Another explanation could be that lenders expect the spread between T-bills and LIBOR will narrow in the future. Based on these actual financings, the average cost of matched funds for the first 11 months of 1997 has been T-bills plus about 65 basis points, although the most recent

¹ These estimates are the second calendar quarter rate for 10-year Treasury notes for 1998 and 1999 plus 1.0 percentage point. If OMB assumptions for 10-20 year Treasury securities are used, the comparable rates would be 7.11 percent ($6.11+1.0$) for 1998/99 and 7.03 percent ($6.03+1.0$) for 1999/00. These rates are based on the estimated market yield as of October 1 of the budget year.

offerings were T-bills plus about 85-89 basis points. For our analysis, we assume the cost of matched funds for 1997/98 is T-bills plus 65 basis points. This would translate to LIBOR plus 5 basis points. Using FY 1999 budget assumptions, the estimated cost of matched funds for 1997/98 is 5.8 percent ($5.15 + 0.65$). The comparable estimated rate using *Blue Chip* assumptions is 5.94 percent ($5.29 + 0.65$).

In estimating a lender's matched funds rate, it has been argued that the cost of funds for banks may be lower than the 3-month T-bill or the 1-to-3-month LIBOR rate. For example, banks with a stable deposit base may have an effective cost for these funds that is lower than the 3-month T-bill rate. However, larger banks may not have a stable deposit base on which they can rely. Moreover, we are talking about a \$20-25 billion guaranteed loan program. There is considerable concentration of student loan originations among a relatively small number of large banks who don't normally have large amounts of internal funds that have not been committed already. Thus, banks might have to borrow large amounts at the 3-to 6-month jumbo CD rate, if they don't want to finance their student loans by selling other debt or securitizing their loan portfolios. The rates on this source of funds generally are well above the 3-month T-bill rate, although less than 3-6 month LIBOR rates.

3. When there is a basis risk between lenders' assets and liabilities, the all-in cost of financing student loans consists of the cost of selling debt plus the cost of a swap. Estimating the basis risk between 3-month T-bills or 10-year CMT indexed assets and LIBOR based securities is difficult because the cost varies over a wide range depending on changes in the slope of the yield curve and the spread. Estimating this cost is even more difficult if the indexed asset being hedged has uncommon characteristics such as the annual reset provision for 10-year CMTs under next years student loan formula.

Lenders' cost of funds to finance student loans is generally correlated closely with LIBOR rates. The basis risk between T-bill indexed assets, such as those issued under the current student loan formula, and LIBOR based liabilities is not as great as it would be between 10-year CMT indexed assets reset annually and LIBOR based liabilities. Moreover, as noted above, much of the current financing for student loans comes directly from T-bill based securitization, so that there is no need to hedge.

Under the new loan formula for next year, lenders presumably would seek to raise funds at LIBOR and simultaneously enter into a long-term amortizing basis swap, because of the basis risk between assets and liabilities. Lenders financing their student loan portfolio by this option would issue LIBOR indexed securities and simultaneously enter into an amortizing interest rate swap where the lender would agree to pay the swap counterparty the 10-year CMT plus or minus some spread in exchange for LIBOR. As noted previously, issuing floating rate notes indexed to 10-year CMTs with an annual reset is neither a deep or efficient market capable of financing a large annual student loan program. Thus, this swap should be more costly for lenders than a swap involving T-bills.

At our request, several major financial institutions provided us estimates for the cost of a swap under the terms of both the current and the new student loan formula. Most of the estimates were made for the same day and were based on 3-month LIBOR.² Using these swap estimates, we calculated the net interest margin lenders would have before consideration of all cost other than the cost of hedging.³

Table 5 shows that the estimates provided us of the cost of swapping T-bills for LIBOR falls within a relatively narrow range. This is not surprising, because presumably swap dealers use similar swap curves to make their estimates. The modest differences may reflect differences of when the estimates were made within the specified day, small differences in the dealers' cost for making the swap, and differences between dealers in their swap models.⁴

The estimated costs of swapping CMTs for LIBOR were more varied, with the costs clustered around two ranges that are widely separated. This pattern is somewhat surprising, because of the similarity of estimates for swapping T-bills. This wider band of cost estimates may reflect the fact that there isn't a ready market for swapping long term assets that are reset annually, like CMTs, for short term assets. Hence, the risk and cost to dealers are higher, because they may have to hold the long term assets longer than they would like, until a buyer for the swap can be found. Dealers could have very different estimates of the cost of this risk.

The swap estimates provided us are summarized below.

- Most of the cost estimates to swap T-bills for LIBOR clustered in a narrow band of 68 to 70 basis points. When the cost of matched funds is factored in, total all-in costs would be about 73 to 75 basis points, assuming that the cost of matched funds in 1997 is LIBOR plus 5 basis points. Since we have actual data indicating that the cost of

² Although the student loan formula is not indexed to LIBOR, this difference does not create a problem for the analysis.

³ Net interest margin is the difference between interest earnings from loans and interest expenses from borrowing, which is then expressed as a percent of interest-earning assets. For our purposes, the estimate of net interest margins would be for new loans. It does not take into account the fact that total interest earnings received currently by lenders include interest earnings on outstanding loans whose terms were more than T-bills plus some spread but capped at 8.25 percent, e.g., the earlier fixed 9 percent loans made in the 1980s.

⁴ A swap agreement will be for several years. It is unlikely that the relationship between T-bills, CMTs, and LIBOR will stay the same over the entire maturity of the swap. In fact, swap dealers' models reflect the historical as well as the current and anticipated relationship between different types of securities. The future relationship perhaps may be influenced more by historical relationship than the current relationship, especially if the current relationship is a dramatic departure from the past.

financing in 1997 has averaged approximately T-bills plus 65 basis points, we assume that a financing indexed to T-bills is less costly than a financing indexed to LIBOR, and that generally a swap was not necessary this year.

- The swap estimates for the new student loan formula clustered around two widely separated ranges: at the lower end the estimates range from 5.5 basis points to 15 basis points and at the upper end they range from 16 to 31 basis points.⁵ Assuming these clusters of estimates are correct, we assume that lenders would opt for the lower cost swap.
- Swap estimates are tied closely to the term structure of interest rates on which they are based. Because the interest rate assumptions in the FY 1999 budget imply little change in the yield curve next year, we assume that the estimated cost of a swap for the current interest rate environment is applicable for next year. Thus, our assumption for the all-in cost of funds under the new formula is CMT + 12 basis points. This estimate includes CMT plus an average 7 basis points for the cost of a swap and another 5 basis points for the cost of matched funds.
- Based on these estimates, the average weighted net interest margin for lenders under the current loan formula (1997/98) is approximately 8.05 percent minus 5.8 percent (T-bills + .65 basis points) or 2.25 percent. For the new formula (1998/99) and using OMB assumptions, the average weighted net interest margin would be 6.86 percent minus 5.95 percent (CMT + 12) or 0.91 percent.

It should be noted that a swap agreement is not for a one-time payment. The agreement generally will be for 4 payments a year for several years. Subsequent payments will vary if the rates for LIBOR and CMTs on each future reset date are different than the rates at the time the swap agreement is consummated. The spread over/under CMT would not change, of course.

In evaluating these estimates for the cost of a swap, there are important complications that must be noted. The estimates assume that the dollar amounts being swapped are not large. If the amounts rise sharply, as they would for a \$20-25 billion program, the swap would cost more because the demand for LIBOR in return for 10-year CMTs would be rising. Presumably, the estimates provided us for the cost of a swap transaction reflect a relatively small amount currently coming to the swap market. If the student loan formula is indexed to 10-year CMTs, the basis risk is greater than it is with T-bills and there will be a greater demand placed upon the swap market either by lenders directly or indirectly by secondary market investors. In either case, the cost of a swap could rise. Thus, the above estimates may be a floor rather than a ceiling for estimating the effects of a swap.

4. Estimating overhead costs for their student loan program requires lenders to allocate

⁵ These ranges reflect an assumed 4, 7, and 10 year maturity of the swap.

the share of their fixed costs that are incurred for this purpose. A large secondary market company that purchases student loans quoted us 15 basis points for overhead expenses. A guaranty agency quoted us 35 basis points. As noted earlier, it is possible that some lenders may misallocate their costs between overhead and servicing. Therefore, the more reliable number may be the total of overhead and servicing costs combined. Our estimate for this total number is examined in the following discussion of servicing costs.

5. There are two approaches that lenders may use to estimate their servicing costs. One way is to view these costs as the ratio of all such costs incurred in any given time period to the total value of the loan portfolio for that period. Alternatively, we can think of servicing costs in terms of the average annual cost over the life of a single loan as a percent of the average annual remaining principal of the loan, and then calculate the ratio of these two averages. Looking at servicing costs this way, the ratio rises sharply over the life of the loan because the loan principal declines from year to year while servicing cost rise sharply during the in-school period and then levels off during the repayment and consolidation periods. Using this approach would mean taking the average of some very large numbers, which could bias the average upward. Obviously, these two approaches for estimating servicing costs depend on the average maturity of a lenders portfolio: a lower average maturity will be influenced by the lower relative cost of servicing the portfolio and a higher average maturity will be influenced by the higher costs relative to the remaining principal.

A 1993 CRS study⁶ noted that Sallie Mae reported their servicing costs were 66 basis points. A private guaranty agency estimates that servicing costs are about 60 basis points for a traditional bank. A similar figure is also cited in the latest Sallie Mae annual financial report as the cost of servicing Sallie Mae's entire portfolio over the course of a year, i.e., total servicing costs as a percent of total loans.

A later (1997) CRS study⁷ estimated Sallie Mae's in-school servicing costs are 35 basis points, but their costs for the repayment period are much higher, about 100 basis points. This latter figure apparently was based on the average annual servicing cost of a loan over the life of the marginal loan as a percent of the remaining principal of the loan outstanding. We think this approach of using averages of large numbers to estimate servicing costs overstates servicing costs.

The financial statements filed with the Securities Exchange Commission by a major originator of student loans report that their combined operating expenses averaged about 110 basis points from 1992 to 1994, 102 basis points in 1995, and about 95 basis points in 1996 and

⁶ Barbara Miles and Dennis Zimmerman, "Federal Family Educational Loans: Reduced Costs, Direct Lending, and National Income," Congressional Research Service, February 22, 1993, PP. CRS-18 and 19.

⁷ Miles and Zimmerman, 1997, *op. cit.*

1997. This significant decline in operating expenses reflects largely the larger volume of student loans they hold, the economies of scale resulting from this larger volume, and increased productivity from a more experienced workforce. Similarly, a guaranty agency that estimated its overhead costs were 35 basis points also estimated its servicing costs were 60 basis points, for a combined total of 95 basis points.

If we consider servicing and overhead costs as one cost in order to avoid the problem of allocating these costs to the correct category, our assumption for total servicing/overhead costs is 95 basis points. It costs lenders less to service student loans when students are in school and when loans are consolidated. Thus, we assume overhead and servicing costs for loans in the in-school status are one-third the cost for loans in repayment and loans in consolidation are one-half the cost.

6. Because student loans are guaranteed by the Federal Government, the risk of default is very small. During the in-school period it is almost nonexistent. The Federal Government pays the interest costs for subsidized loans while the student is in school. For non-guaranteed loans, students can defer interest payments until after they graduate. Several sources told us their default costs are low; one source said their default costs are only 7 basis points. We assume this is a reasonable estimate.

7. Loan originators are required to pay a 50 basis point origination fee to the Department of Education. Although this is a one-time fee paid when the loan is originated, we have assumed that the cost of the fee is amortized over the average lifetime of a student loan, which is about 11 years (4 years in-school and 7 years of repayment). Thus the annual cost is 5 basis points for in-school loans and loans in repayment. For consolidation loans the 5 basis points origination fee is added to the 1.05 percent rebate fee, for a total fee of 1.10 percent.

8. Many financial market experts think that prepayment costs are not a serious problem because borrowers tend not to have the resources to prepay their loans until well after they have graduated. Others, however, think that prepayment risks can be a problem, partly because borrowers may have a tax incentive to take out a home equity loan to prepay their student loan, if the spread is not too large. Until recently, interest on student loans has not been tax deductible. The Taxpayer Relief Act of 1997, enacted last summer, allows certain individuals who have paid interest on qualified education loans to claim a deduction for this expense. However, the Act limits the interest deduction to the first 60 months in which interest payments are required and also limits the amount of interest that can be deducted.

Currently, it is possible for students to consolidate guaranteed loans, taken out while in school, into the direct loan program. Moving loans into the direct program provides advantages to students, especially the option of income-contingent repayment, which could reduce significantly the repayment burden for some borrowers. In order to keep loans in the guaranteed program rather than losing them to the direct loan program, some lenders offer favorable terms to promote consolidation of loans by borrowers, and they incur a promotion expense in the process.

These price incentives may not be necessary at this time, however, because of the logjam of applications and the temporary suspension of the program which allows borrowers to consolidate their guaranteed loans into a consolidated direct loan. Moreover, in the future, the squeeze on lenders' net return because of the new student loan formula may make it impossible for lenders to continue offering these price incentives. And finally, the Emergency Student Loan Consolidation Act of 1997 (LCA), enacted in October, 1997, could discourage many lenders from offering to consolidate students loans for borrowers.

The LCA makes it too costly for lenders to offer students the option to consolidate their loans, because it changes the formula for determining consolidation loan rates. The LCA also makes consolidation less attractive to lenders, because the law is only temporary and because the start up costs to configure computer programs will be expensive. Sallie Mae, which had been handling about 40 percent of all consolidations, has indicated it will not continue to participate in this part of the student loan program because it may no longer be profitable for them.⁸ Furthermore, it is possible that if lenders are concerned about prepayments, they may sell their student loans to avoid this problem.

Estimates of prepayment costs appear to be somewhat arbitrary. The CRS⁹ estimated that lenders prepayment costs are high. But various lenders have told us they do not think prepayment is a major problem. This was before enactment of LCA. It is not clear what the impact of the Act will be, but, because it is effective only until October 22, 1998, it should have limited impact. We assume the prepayment cost for lenders is 4 basis points, which is consistent with the cost estimated by several sources before the enactment of LCA.

⁸ Student Loan Corporation, which is a subsidiary of Citibank and is the largest originator of student loans, has indicated they will continue to offer consolidation loans.

⁹ Miles and Zimmerman, 1993, *op. cit.*