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[Student Loan Programs] [2]

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Office of Economic Policy **Department of the Treasury**
Washington, D.C. 20220

FAX

Date: 1 / 20/98

Number of pages including cover sheet: 13

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To: Bob Shireman	456-2223	456-2803
From: Jonathan Gruber	202-622-2633	202-622-0563

REMARKS: ___ Urgent ___ For your review ___ Reply ASAP ___ Please comment

Mr. Shireman

This is being forwarded per your conversation with Mr. Gruber. However Jon is still reviewing this.

Chris Devlin

- (esp Commissions - Mark Zuberman

  - Ignores - study of adequacy of aid...

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 annuallly. 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 equivalaent 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. quarterly? no!

Lenders have argued that loans under the new formula will not be profitable. In important part, the alleged lack of profitability stems from the mis-match in maturities between the long-term index to which the student loan rate will be adjusted and the typically short-term cost of funds for banks. This mis-match entails a risk for the lender because the spread between long-term and short-term rates can be expected to vary somewhat unpredictably over the life of the loan. Consequently, banks can be expected to swap the return from the 10-year (with annual reset) indexed asset they hold into a commonly used short-term (most likely LIBOR) stream of income. By contracting to give up a stream of income indexed to the 10-year rate (while offsetting their short-term cost of funds with the other side of the contract), banks essentially would tie their borrowing as well as their lending costs to a long-term yield. As a result, they would not benefit from the normally positive, though variable, spread between long- and short-term yields.

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. [to be re-re-checked]

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 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-bills[1] 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

[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]

of this 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, chosing 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 likley 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 origniations 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 profitabiity for lenders are made using these alternative interest rate assumptions. The Budget projections and most of the alternatives assume that the yeild 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 contact 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 inorder 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 the10-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 CRS[6] 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 availaable 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 FY1999 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 securities[7] 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.

- **Judgemental 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 a 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, down from 13.2 percent in 1994.

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 somewhat below the rule of thumb calculations and the opinion of outside experts. But it is slightly above the level justified by the required rate of return on capital held to back up these loans, which may be justified by informal pressures from regulators and rating agencies toward higher capitalization.

Summary Results and Some Empirical Evidence

As shown in Table 3, our estimate of the the pre-tax weighted net return to lenders in

[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.

1997/98, for in-school loans and loans in repayment, is about 1.52 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 1.37 to 1.42 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 1.53 percent under the current formula in 1997/98 -- or about 1.40 after discounts to students -- to 0.16 percent under the new formula next year if the 1999 Budget assumptions are borne out, or from 1.38 percent to 0.16 percent if *Blue Chip* assumptions prove accurate.[11] Clearly, these estimates, if

[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).

[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).

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 fact that the yield curve historically has been much steeper than is currently projected and the neglect to recognize that lenders would hedge their student loans if returns were indexed to a long-term rate were the reasons in 1993 for expecting that the new formula would be financially acceptable. 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.

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 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 0.42] percent rate of return next year, using 1999 Budget

assumptions, or 0.44 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 2.26 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.

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 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.

for 1999 ?

(what about 5-yr avg or another approach ?)

Pauline_Abernathy @ ed.gov
01/17/98 08:14:00 PM

Record Type: Record

To: Robert M. Shireman

cc:
Subject: FW: July 1 Interest Rate Debate

If the FFEL community is spinning your comments as confirming that there will be a mass exodus, then we need to spin back! As I understood it, you said the Admin was open to a more efficient instrument.

Do you have ideas for how best to spin back that a more efficient instrument is one thing but hurting students another, the industry has cried wolf before, they just had an amazingly profitable year, SM's profits were just reported up 25% from last year, etc. Do we have a good surrogate to do this?

Mike asked Don to talk with Barmak about his strategy before Weds' mtg so we can have a discussion of the pros and cons of this approach Weds before 1 Dupont locks in on this approach. Is that consistent with what you saw as the purpose of Weds' mtg?

_____ Forward Header _____
Subject: FW: July 1 Interest Rate Debate
Author: "Nassirian; Barmak" <NassirianB@aascu.nche.edu> at Internet
Date: 1/16/98 2:20 PM

FYI Only.

> -----Original Message-----
> From: Nassirian, Barmak
> Sent: Friday, January 16, 1998 2:16 PM
> To: Sullivan, Jerry; Coolidge, Nancy; Fooks, Karen; Bruce, Charles
> W.; Elmendorf, Edward; Dowling, Earle E.; 'Ed Vignoul'; 'Kay Jacks';
> Austin, Orlo; Pugh, Susan L.; 'susan oflaherty'; 'Carolyn Sabatino
> (614) 593-9118'; 'Hooyman@hope.edu'; Frishberg, Ivan
> Subject: July 1 Interest Rate Debate
>
> Happy New Year. I am sure everyone has already seen the article on
> the student loan interest rate formula in this week's Chronicle Of
> Higher Education. As you will note, the article's main thrust is that
> the White House--i.e., Bob Shireman--now concedes that there may be
> some truth to the lenders' claim that they would have problems with
> the scheduled reindexation of student loan rates. This public
> acknowledgement, heavily spinned by the FFEL industry as proving that
> there will be mass exodus out of FFEL on July 1, increases the
> probability of some kind of legislative change to interest rates real
> soon. I thought I would write a quick note to direct loan supporters

> to inform you of where AASCU and the students are on this, and to ask
> for your consideration and support of our strategy. If, after reading
> this memo, you wish to forward it to other colleagues, feel free to do
> so judiciously.
>
> BACKGROUND
>
> The 1993 Student Loan Reform Act included a provision--scheduled to
> take effect on July 1, 1998--that will change the formula for
> calculation of interest rates on both direct and government-guaranteed
> student loans. The variable rate on student loans has been indexed to
> 91-day Treasury bills, plus a margin of 310 basis points in repayment.
> The post-July, 1998 formula will change the index to the
> bond-equivalent rate on "an instrument of comparable maturity" plus
> 100 basis points. "Instrument of comparable maturity" has been
> interpreted by OMB to be the 10-year Treasury note, on the theory that
> the standard repayment term on these loans is 10 years. (This is a
> somewhat peculiar interpretation in that the variable interest rate on
> student loans is "reset" once a year.) In any case, under today's
> interest rate circumstances, the new formula would save borrowers in
> excess of $10 billion nominal dollars over the life of loans made over
> the next five years in comparison to the formula currently in effect.
>
>
> For the past year, lenders have attempted to undo the July 1998
> interest rate changes, perhaps because more than $7 billion of the
> savings to borrowers will come in the form of reduced interest
> payments to holders of FFELP paper. The public explanations offered
> by lenders for their opposition to the new formula has consisted of
> their claim that the 10-year index is inefficient and inordinately
> expensive for purpuses of capitalizing their portfolios, that hedging
> against rate movements is expensive, and that the "10-yr + 100" rate
> would not necessarily produce rate reductions for students. On the
> basis of these premises, lenders initially attempted to maintain the
> current rate formula. Because of the current flat yield curve, the
> retention of the 91-day+310 formula would be a major rate increase on
> borrowers, and to make this more palatable, lenders have proposed a
> clever sweetener: immediate reduction of upfront fees. What is
> interesting here is the budgetary offset for this otherwise generous
> idea: direct loans.
>
> To better understand the effects of a rate change from "10-year + 100"
> to a short-term index, consider the following. If interest rates on
> all student loans (direct and FFELP) increase, several interesting
> facts ensue:
>
> 1- Borrowers will pay more to lenders.
>
> 2- Note that interest payments made in repayment on Subsidized
> FFELP loans (and all interest accrued on Unsubsidized FFELP loans) go
> directly from borrowers to lenders, and do not appear as a FEDERAL
> cost increase. However, since the federal government does pay
> interest costs on Subsidized FFELP loans during the in-school, grace
> and deferment periods, the FEDERAL costs of the FFELP would increase,

> but in an amount substantially below the actual cost increase to
> borrowers themselves.
>
> 3- Now, if a rate increase is uniformly mandated for both FFELP and
> direct loans, to the extent that the federal government itself is a
> lender, it, too, receives a huge windfall (like all lenders) from a
> rate hike on borrowers. Indeed, the federal windfall is so large that
> it can conveniently "pay for" the additional federal costs of the
> FFELP rate hike, and have a couple of billion dollars left over. It
> is in this sense that the lender proposals to date "look good," in
> that they generate budget savings. These budget savings are, needless
> to say, the direct result of higher interest payments by borrowers.
>
> 4- Now, this is the cute part of the sleight of hand. Several
> iterations of FFELP industry proposals to "fix" the "interest rate
> problem" have included a provision to take the left-over savings
> referred to in item 3 above, and distribute them to ALL borrowers.
> Another way of looking at this is that under these scenarios, ALL
> borrowers pay more, ALL banks receive more, and then the additional
> profits of ONE bank (i.e., direct lending) are used to moderately
> offset the rate increases on the customers of ALL banks!
>
> AASCU's STRATEGY
>
> While we at AASCU are in no position to necessarily diagnose the
> veracity of prophesies of doom with regard to the interest rate
> debate, we do believe that some legislative change is likely. In
> addition, there is no question that shorter-term indexation can, in
> fact, produce some efficiency for lenders, which we would support as a
> means of lowering the final cost to borrowers. Having conceded this
> much, however, we DO NOT believe that direct lending, as a loan
> operation, suffers the financing problems cited by lenders in their
> pursuit of a new formula. The FFELP industry's numerous presentations
> have never included a claim that the federal government or direct
> loans would confront any problems whatsoever with the July 1 interest
> rate formula. The federal government has neither the basic financing
> problems lenders claim they face with the 10-year index, nor does the
> actual yield on direct loans result in an operational loss for the
> federal government (in comparison with FFELP, direct loans are a money
> saver even with all of the opponents' efforts to artificially inflate
> direct lending costs). It is our view, therefore, that even if
> everything lenders have claimed is assumed to be true, nothing offered
> so far would induce us to tamper with the July 1 interest rate formula
> for direct loans. This, in our opinion, is the only possible starting
> point for a good faith effort to address FFELP industry's concerns
> with regard to FFELP interest rates.
>
> ADVANTAGES OF THE PROPOSED STRATEGY
>
> 1- By holding direct loans harmless from an interest rate hike, we
> would be in a substantially more flexible position with regard to
> making concessions to lenders. On the other hand, knowing that the
> rate on direct lending could be significantly lower than today's rates
> would moderate lenders' natural tendency to seek the highest allowable

> rate they can. In this way, both sides of the issue, the vendors and
> the consumers, would be induced to move closer to a reasonable middle
> ground.
>
> 2- By taking the direct loan piggy-bank off the table prior to any
> negotiations, we would unmask the actual federal costs of an interest
> rate hike in FFELP. This will not only moderate the profit-maximizing
> tendencies of lenders, it also forecloses the possibility of
> policymakers effectuating a hike for the sake of federal savings with
> which they would fund political pet projects.
>
> 3- Even after a maximum allowable interest rate on FFELP is
> negotiated under this scenario, each lender would be economically
> induced to set the lowest possible rate, and/or to provide the highest
> quality of service in order to remain competitive. This will have not
> only the obvious advantage of helping borrowers and schools, but also
> produces a set of circumstances in which FFELP rates would, for the
> first time in the history of the program, be set by competitive market
> conditions rather by legislative mandates.
>
> 4- Borrowers would not be harmed by such a system, in that we would
> insist on the retention of two-way consolidation--including in-school
> consolidation--as an integral part of any agreement. Not only would
> direct loan borrowers have access to lower rates by virtue of their
> schools participation in direct lending, FFELP borrowers would have
> the option of consolidating their FFELP loans into direct loans if, in
> their judgement, the combination of interest rate/quality of service
> in FFELP does not match the rate/quality of service in direct loans.
>
> 5- AASCU, ACE, and other higher education groups are already on
> record in our March 1997 reauthorization submission to Congress as
> supporting price competition in the student loan programs. In
> contrast to what we described as a "mechanical level playing
> field"--in which the natural advantages of each loan program are
> legislatively eliminated to create two lowest-common-denominator
> programs with identical features--we proposed that the natural
> advantages of each program be sustained and fortified. The question of
> interest rate differentials was one of the issues we addressed (and
> were roundly criticized for by many of our friends). Specifically, we
> endorsed the concept of non-identical interest rates as perfectly
> agreeable to us in that it helped borrowers. That same logic, which
> our friends in direct lending and our FFELP colleagues assumed would
> always work out to the advantage of FFELP, is at work in justifying
> the retention of the July 1 rate for direct loans and a higher rate
> for FFELP. It is our view that the FFELP industry mantra of "level
> playing field" cannot be cited in opposition to our proposal in that
> we have consistently supported the prerogative of every lender
> (including direct lending) to set the lowest rate it (and perhaps it
> alone) is able to offer to its borrowers.
>
> WHERE DO WE GO FROM HERE?
>
> It is important is for the leading supporters of direct lending to be
> aware of the interest rate debate, and to provide their input and

> advice with regard to the game plan. Perhaps we could schedule a
> conference call to discuss details.

SOLVING THE FFELP INTEREST RATE INDEX PROBLEM

The Dilemma

- The 10-year Treasury Note based index begins July 1st
- Loan returns will be inconsistent and unpredictable
- Lenders will withdraw from the program
- Access problems for millions of students

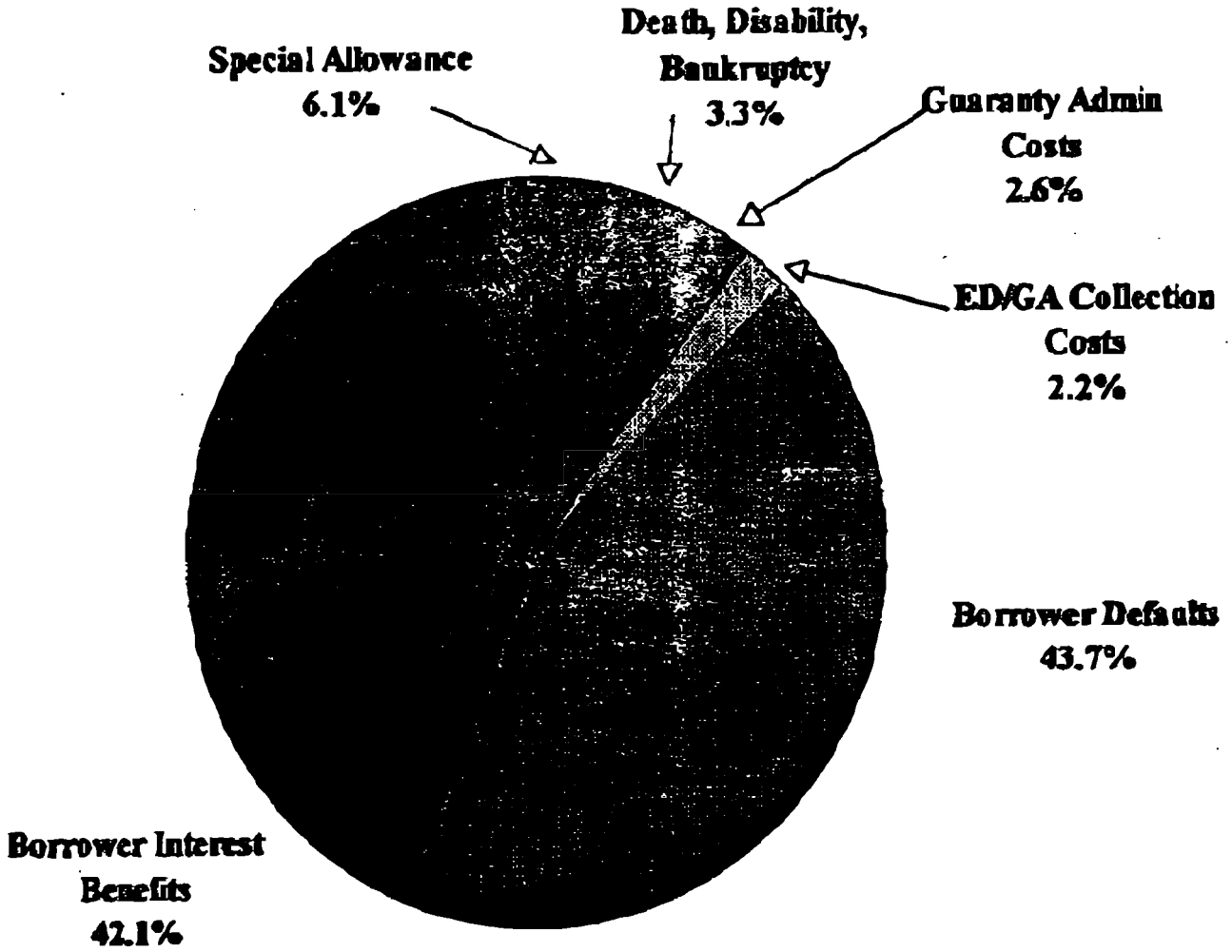
"Current law would effectively reduce spread by 90-140 basis points in July 1998, eliminate profitability and disrupt flow of loans to students."

Jonathan Gray
Sanford Bernstein & Co.
October 1997

The Current Loan Program Works

- $34 billion annually (two-thirds from the private sector)
- 6 million borrowers
- Cost-effective
- Reliable
- High quality service
- Competitive

Federal Costs of the FFELP



Comparable Consumer Loans

Loan Type	Current Rates
FFELP Loans	8.25% (unsecured, 10+ years)
Automobile Loans	9.33% (secured, 5 years)
Home Equity Loans	9.30% (secured, 5 years)
Personal Loans	14.13% (fixed, 1-5 years)
Credit Cards	16.51% (unsecured)
Mortgages	7.23% (fixed, 30 year)

Source: Bloomberg, BanxQuote

Lender Returns are Competitive

- Returns must be adequate to attract capital
- Requires significant lender investment
  - Systems development
  - Electronic delivery
  - Servicing operations
- Few new entrants into the student loan business

Lender Returns are Competitive

Risk Adjusted Spreads for Student Loans - 1996-97:

Student Loans	1.25%
Adjustable Rate Mortgages	1.25%
Ginnie Maes	1.00%

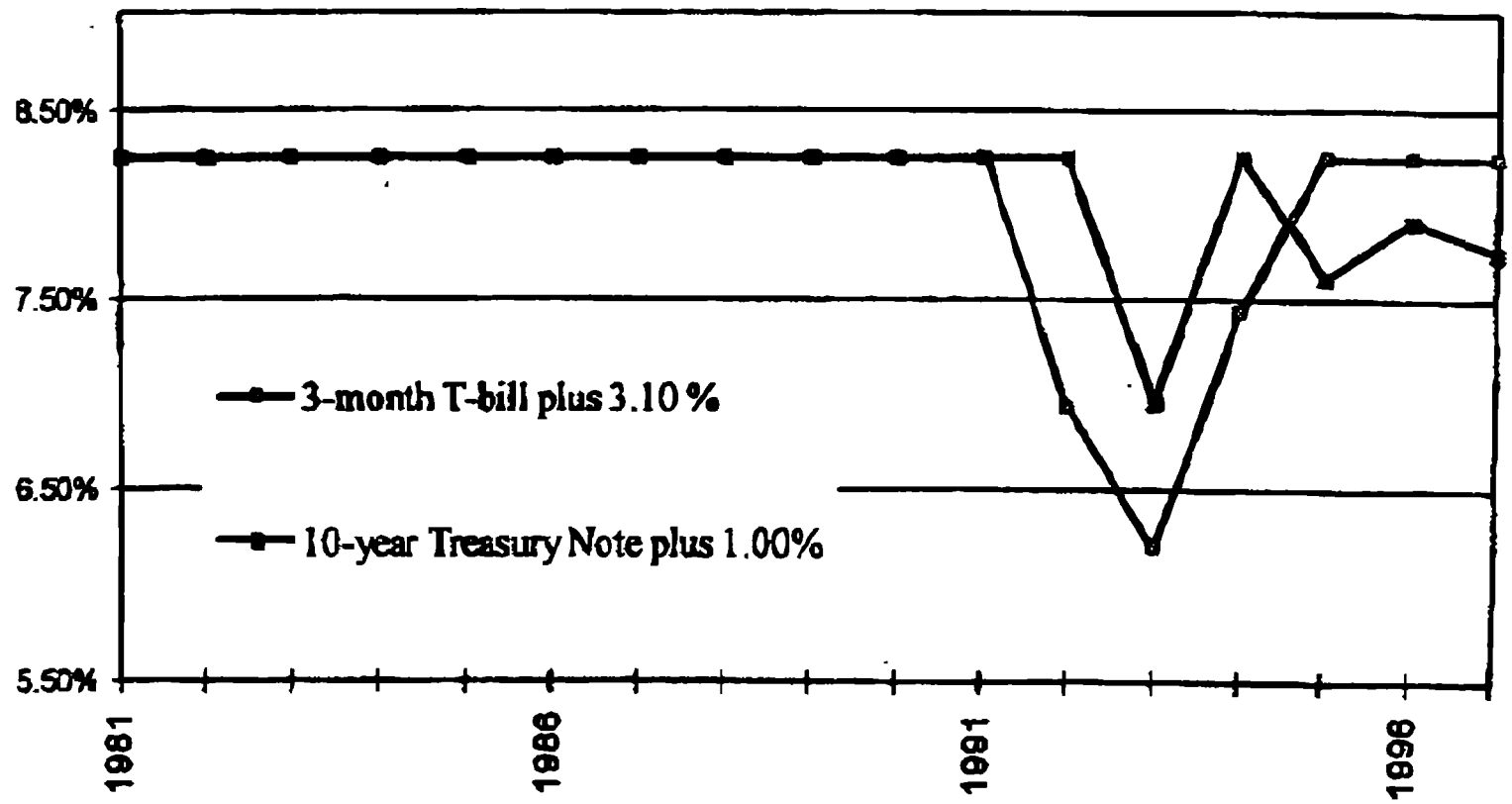
" The resulting risk-adjusted weighted spread averages about 1.25 percentage points....and is about comparable to the spread obtainable on investments that share some characteristics with student loans."

Source: Congressional Research Service Report - February 25, 1997

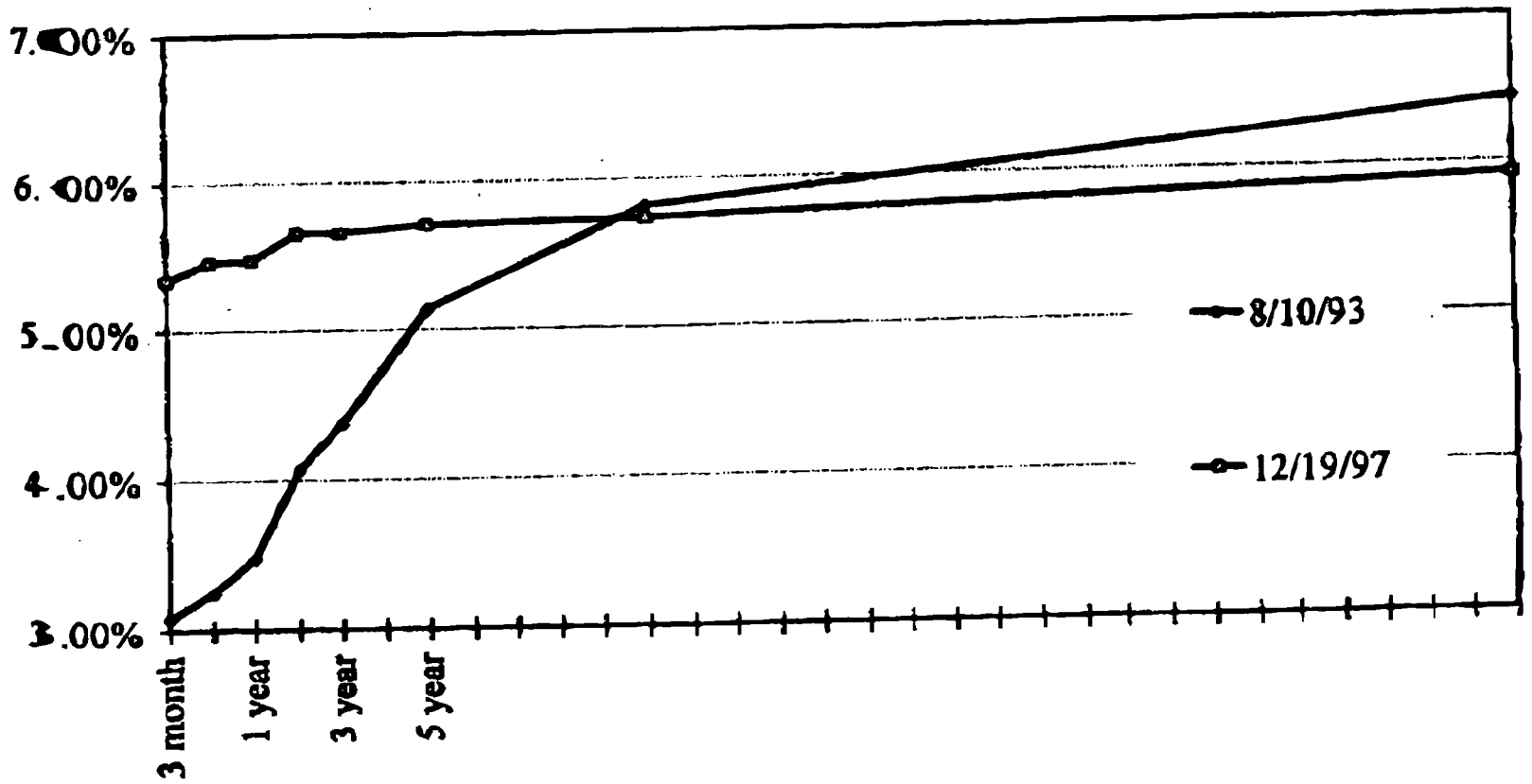
10 Year v. 91 Day Tbill: Borrower Impact

- Not intended to reduce borrower's interest rate
- Historically does not benefit students
- FFELP was assumed to be nonexistent in 1998

Borrower Interest Rates: 1981-1997



Treasury Yield Curves: 8/93 and 12/97



10 Year v. 91 Day Tbill: Lender Impact

- Inconsistent/unprofitable returns = No Capital In
- Losses in today's interest rate environment
- Unfundable in many interest rate scenarios
- Lender returns and borrower access tied to shap curve

Loan Rates and Lender Returns

	Interest Rates on OBRA Enactment Date (8/10/93)		Current Interest Rates	
FFELP Interest Rates	Tbill + 3.10%	10-Year + 1.00%	Tbill + 3.10%	10-Year + 1.00%
Treasury rate	3.11	5.78	5.35	5.75
Spread	3.10	1.00	3.10	1.00
Student rate	6.21	6.78	8.25	6.75
Lender rate	6.21	6.78	8.45	6.75
Short Term Funding Cost	3.61	3.61	5.85	5.85
Servicing and Hedging	1.45	2.45	1.45	2.45
Return to Holder	1.15	0.72	1.15	-1.55

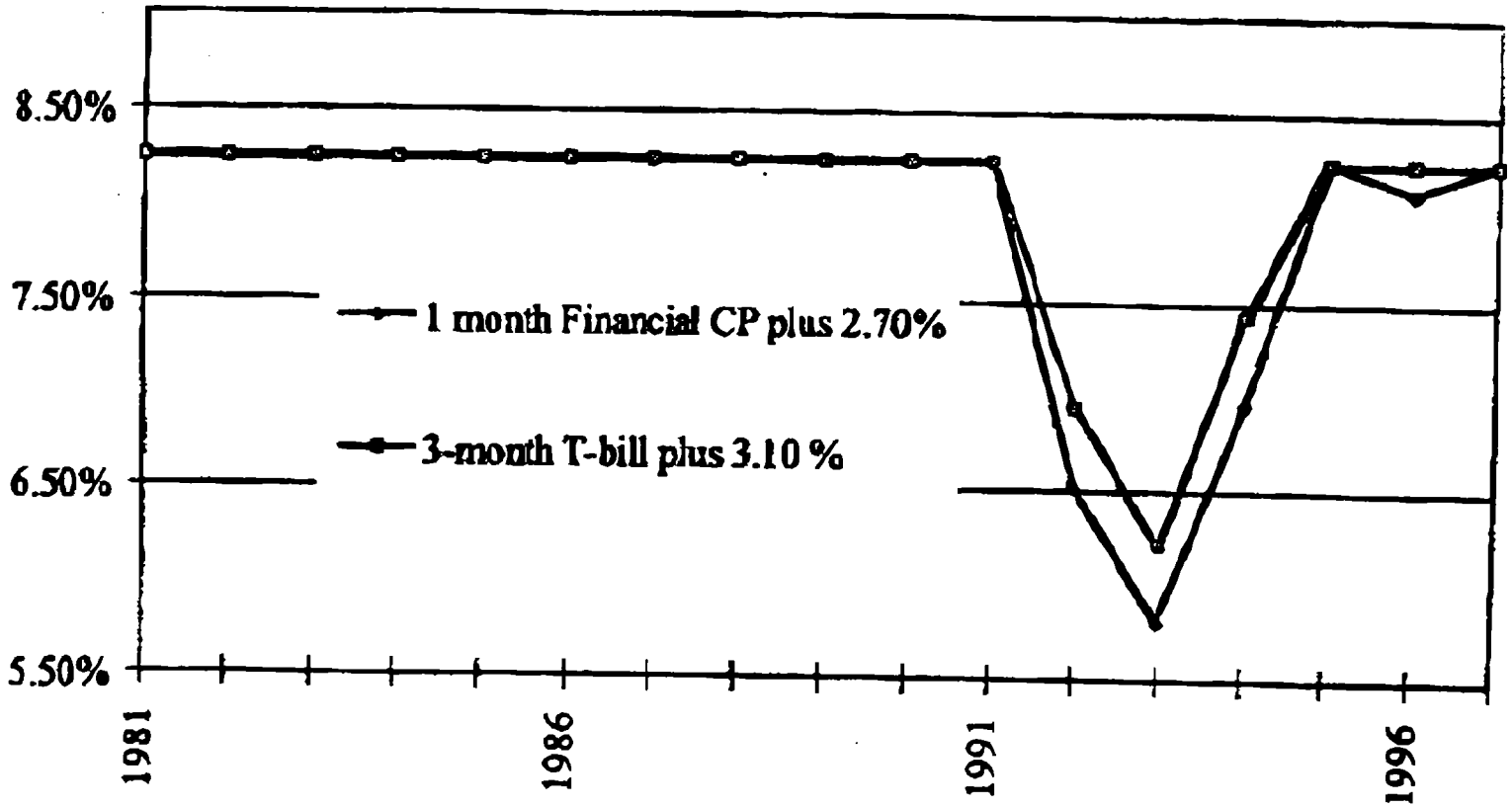
A Solution: Commercial Paper Rate Index

- Enhances efficiency and reliability of FFELP program
- Borrowers benefit
- Government benefits
- Schools benefit
- Lenders benefit

Commercial Paper Rate Based Index

- Floating rate
- One month CP + 2.10% interim status
- One month CP + 2.70% in repayment

Commercial Paper v. 91 Day Tbill



Borrowers Benefit

- Lower than today's TBill +3.10% rate
- 20 basis points better than TBill + 3.10% historically
- Historically lower than 10-year note
- Ensures:
  - Access
  - Choice of providers
  - Continuance of payment incentives

The Government Benefits

- Generates significant budget savings
- Ensures stability of private sector program
- Government could spend to enhance program for borrowers

Schools Benefit

- Continued FFELP/FDSLP competition
- Ensures choice of program
- Fosters innovation
- Enhances quality customer service

Lenders Benefit

- Index better tracks lender's cost of funds
- Adequate returns on capital
  - Spurs investment in quality
  - Ensures innovation
- Allows competition to benefit borrowers

Other Benefits for Students

Congress can budget to provide additional benefits to students:

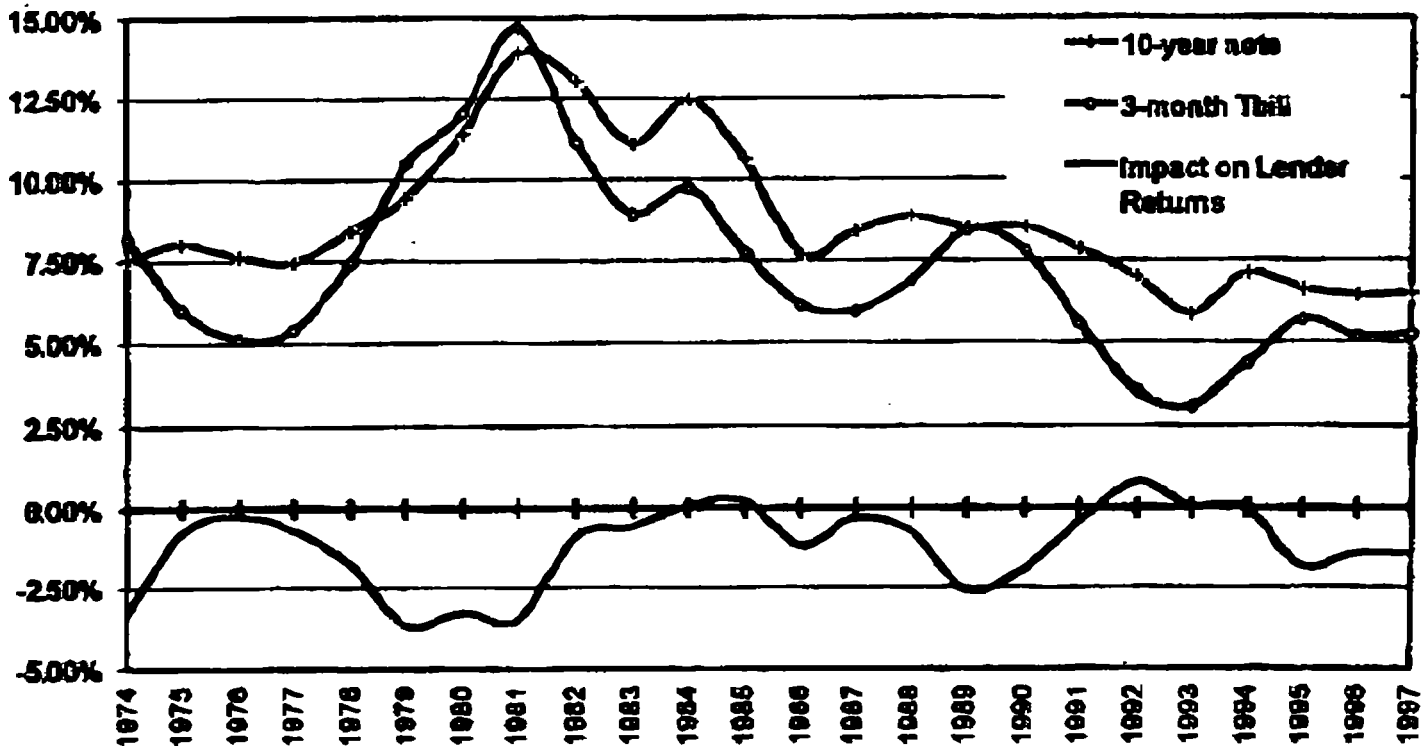
- Lower interest rate cap for students
- Origination fee reduction for students
- Other Administration and Congressional proposals

Next Steps

- Call House/Senate Representatives now
- Call authorizing committee members now
- Enlist support of the commercial paper solution among other leaders/decision makers
- Time for action is now

Appendix

Impact to Lender Returns



Borrower Interest Rate Comparison

Year	Borrower Interest Rate, 8.25% Cap		
	1-month	3-month	10-year
Historical Data	Financial CP	Tbill	Note
May	plus 2.70%	plus 3.10%	plus 1.00%
1991	8.25%	8.25%	8.25%
1992	6.52%	6.94%	8.25%
1993	5.80%	6.22%	6.96%
1994	6.96%	7.43%	8.25%
1995	8.25%	8.25%	7.61%
1996	8.09%	8.25%	7.90%
1997	8.25%	8.25%	7.74%
Avg 1991-1997	7.45%	7.66%	7.85%
CBO Forecast			
1998	8.08%	8.20%	7.10%
1999	7.72%	7.82%	6.80%
2000	7.28%	7.35%	6.53%
2001	7.02%	7.09%	6.50%
2002	7.02%	7.09%	6.50%
Avg 1998-2002	7.42%	7.51%	6.69%
Avg 1981-1990	8.25%	8.25%	8.25%

3-month Tbill: last auction in May, 10-year note: May auction

Historical data: source H.15 Financial commercial paper and Libor based on monthly averages

CBO forecast: October 22, 1997

1-month Financial CP forecast assumes 3 bp spread to 3-month Financial CP

Every year, each formula, capped at 8.25%

SallieMae

FAX COVER SHEET

Bob Shireman from DMF

TO: ~~Pauline Abernathy~~

FAX PHONE: 401-3095

DATE: January 13, 1998

FROM: Peg Clark
SALLIE MAE
1050 THOMAS JEFFERSON STREET, NW
WASHINGTON, DC 20007

Contact Phone: 202-298-2921
FAX Phone: 202-337-1207

THANKS.

 # OF PAGES (including cover) 9

COMMENTS:

Pauline,

Thanks so much for setting up the conference call - I am faxing the information to you that we discussed, in preparation for a meeting at the Department. The entire package is extensive and the issue is complex, so, as Marianne said, we would very much appreciate an opportunity to share this recent idea with you and let you know what we have heard from the FFELP lending community. Again, Marianne Keler, Paul Carey and I would like to come over and meet with you, Mike etc. This is a top priority for us, so whatever and whenever you can squeeze us in would be great.

Peg

Implied Borrower Interest Rates

Year	Borrower Interest Rate, 8.25% Cap		
	1-month	3-month	10-year
Historical Data	Financial CP	Tbill	Note
May	plus 2.70%	plus 3.10%	plus 1.00%
1991	8.25%	8.25%	8.25%
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1994	6.96%	7.43%	8.25%
1995	8.25%	8.25%	7.61%
1996	8.09%	8.25%	7.90%
1997	8.25%	8.25%	7.74%
Avg 1991-1997	**7.45%**	**7.66%**	**7.85%**
CBO Forecast			
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2002	7.02%	7.09%	6.50%
Avg 1998-2002	**7.42%**	**7.51%**	**6.69%**

3-month Tbill: last auction in May, 10-year note: May auction

Historical data: source H.15 Financial commercial paper and Libor based on monthly averages

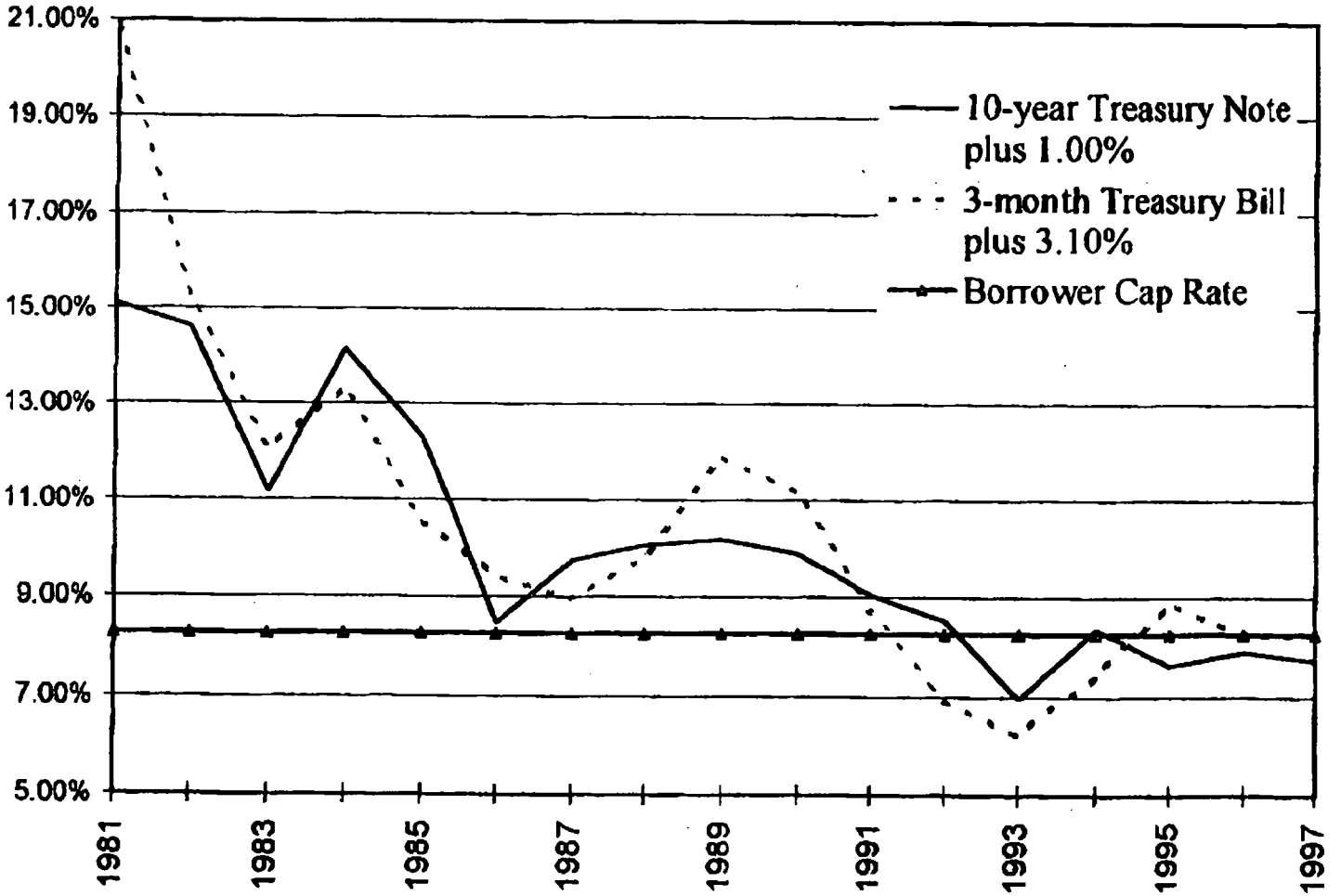
CBO forecast: October 22, 1997

1-month Financial CP forecast assumes 5 bp spread to 3-month Financial CP

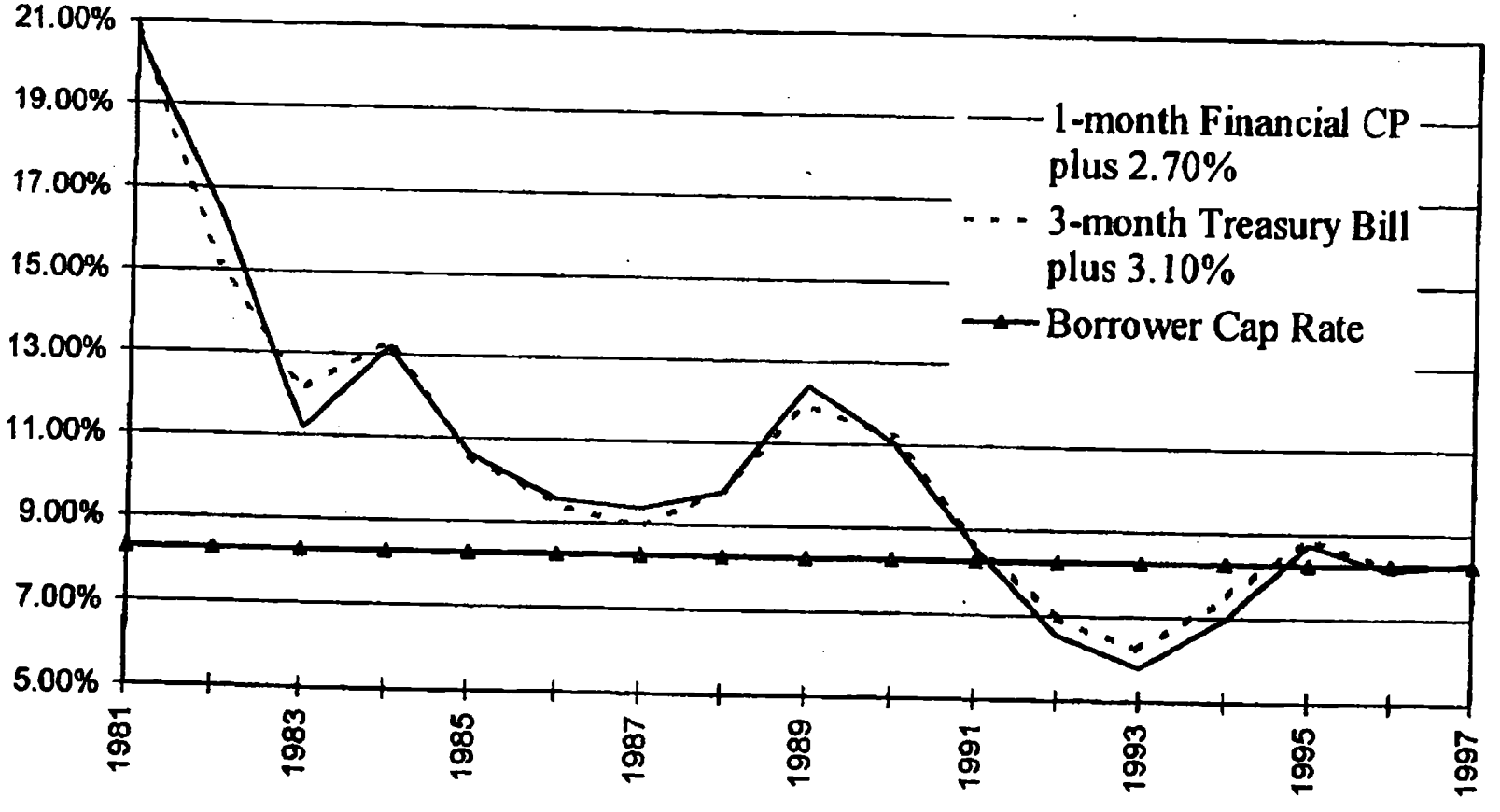
Avg 1981-1990	**8.25%**	**8.25%**	**8.25%**

Every year, each formula, capped at 8.25%

Implied Borrower Interest Rates
10-year Note v. 3-month Tbill



Implied Borrower Interest Rates
1-month CP v. 3-month Tbill



Federal Reserve Release

Commercial Paper

Release | About | Outstandings | Historical discount rates | Historical outstandings

About Commercial Paper and Rate Calculations

Commercial paper consists of short-term, unsecured promissary notes issued primarily by corporations. Maturities range up to 270 days but average about 30 days. Many companies use commercial paper to raise cash needed for current transactions, and many find it to be a lower-cost alternative to bank loans.

The Federal Reserve Board's information on commercial paper (CP) is derived from data supplied by The Depository Trust Company (DTC), a national clearinghouse for the settlement of securities trades and a custodian for securities. DTC performs these functions for almost all activity in the domestic CP market.

Data on rates for CP are updated daily with a one-day lag. Data on CP outstanding are available as of the close of business each Wednesday and as of the last business day of the month; these data are also posted with a one-day lag.

The Federal Reserve Board disseminates its information on commercial paper primarily through its World Wide Web site. In addition, the Board publishes one-, two-, and three-month rates on AA nonfinancial and AA financial CP weekly in its H.15 Statistical Release and monthly in its G.13 Statistical Release. It also publishes some data on CP outstanding in the monthly *Federal Reserve Bulletin*.

To calculate CP interest rate indexes, the Federal Reserve Board uses DTC's data for certain trades to estimate a relation between interest rates on the traded securities and their maturities. In this calculation, the trades represent sales of CP by dealers or direct issuers to investors (that is, the offer side) and are weighted according to the face value of the CP so that larger trades have a greater effect on the resulting index. With the relation between interest rates and maturities established, the reported interest rates represent the estimated interest rates for the specified maturities.

Interest rates calculated through the process described above are a statistical aggregation of numerous data reflecting many trades for different issuers, maturities, and so forth. Accordingly, the reported interest rates purport to reflect activity in certain segments of the market, but they may not equal interest rates for any specific trade. As with other statistical processes, this one is designed to minimize the difference

between the interest rates at which actual trades occur and the estimated interest rates.

CP trades included in the calculation are chosen according to the specifications listed in the table below. Data to assess CP trades relative to these criteria are updated daily from numerous publicly available sources. SIC code classifications are taken from the SEC Directory of Companies Required to File Annual Reports with the Securities and Exchange Commission. When an issuer's primary SIC code is not reported in the SEC directory, the primary SIC code reported in the issuer's financial reports is used; otherwise, SIC codes are determined upon consultation with the Office of Management and Budget's Standard Industrial Classification Manual or its Supplement.

For a discussion of econometric techniques for fitting the term structure of interest rates, including bibliographic information, see, for example, Mark Fisher, Douglas Nychka, and David Zervos, "Fitting the Term Structure of Interest Rates with Smoothing Splines," Finance and Economics Discussion Series 95-1 (Board of Governors of the Federal Reserve System, January 1995).

Criteria for Calculating CP Interest Rate Indexes

Item	AA financial	AA nonfinancial	A2/P2 nonfinancial
Short-term credit rating	Programs with at least one "1" or "1+" rating but no ratings other than "1"		Programs with at least one "2" rating but no ratings other than "2"
Long-term credit rating	Programs with at least one "AA" rating, including split-rated issuers		Programs with at least one "A" or "BBB"/"Baa" rating, including split-rated issuers, but none with any ratings outside the "A"-"BBB"/"Baa" range
Credit rating agencies considered	Duff & Phelps Credit Rating Co., Fitch Investors Service, Moody's Investors Service, and Standard & Poor's		
Credit rating reviews	Programs that would be included in an index calculation are excluded when (1) the issuer's credit ratings are under review and (2) a one-notch upgrade or downgrade would violate either credit rating criterion		
SEC registration types	Both traditional programs (3(a)3) and private placements (4(2)) are included		
Placement	Both dealer-placed and directly placed programs are included		
Industries included (primary SIC codes)	6000-6999, excluding 6189 (asset-backed CP) and 6200-6299 (security broker/dealers)	100-5999, 7000-9999	100-5999, 7000-9999
Excluded trades	Foreign and credit-enhanced programs; secondary, repurchase agreement/financing, and interest-at-maturity trades		
Weights	Trades are weighted by their face values		

May 12, 1997, announcement

Federal Reserve Release

Commercial Paper

Release | About | Outstandings | Historical discount rates | Historical outstandings

Data as of January 7, 1998

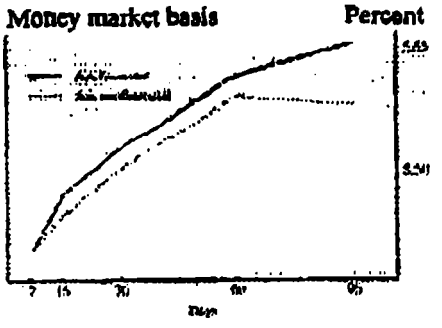
Commercial Paper Rates and Outstandings

Derived from data supplied by The Depository Trust Company
Posted January 8, 1998

Discount rates

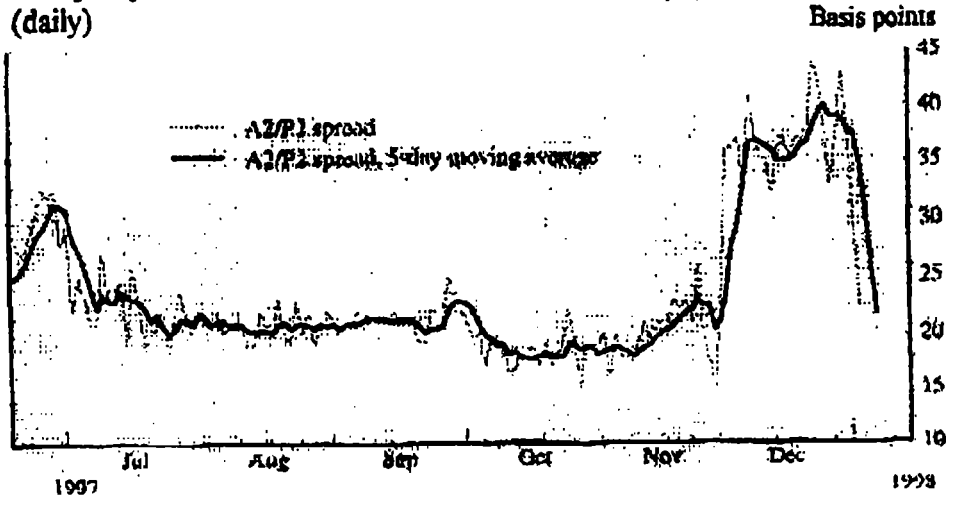
Term	AA financial	AA nonfinancial	A2/P2 nonfinancial
7-day	5.45	5.45	--
15-day	5.47	5.46	--
30-day	5.48	5.47	5.67
60-day	5.49	5.48	--
90-day	5.48	5.45	--

Yield curve



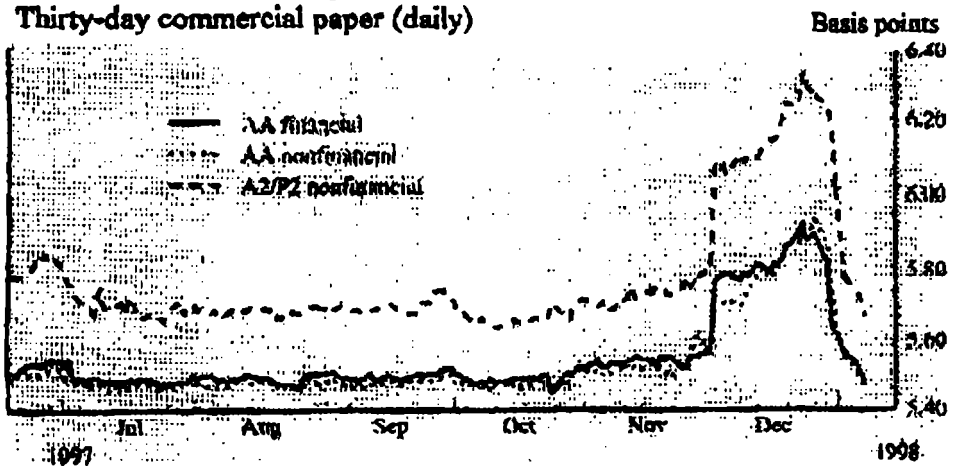
Discount rate spread

Thirty-day A2/P2 less AA nonfinancial commercial paper (daily)



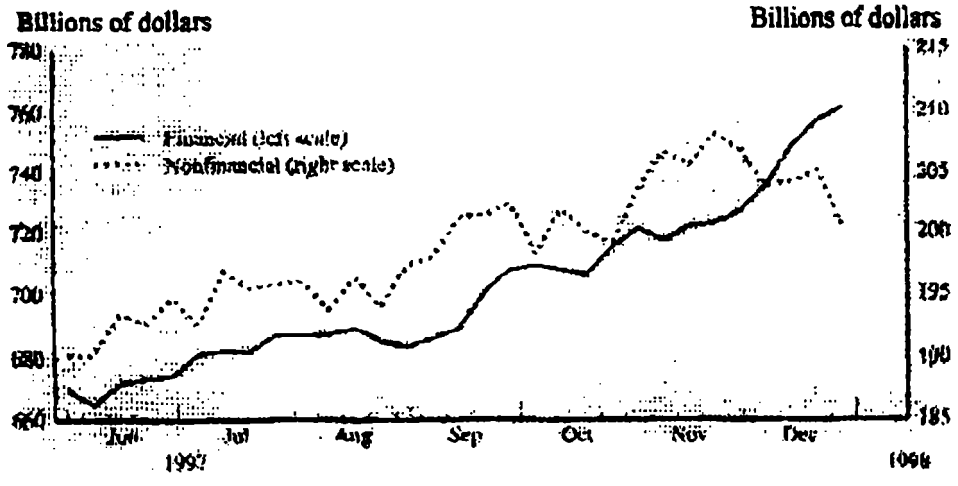
Discount rate history

Thirty-day commercial paper (daily)



Outstandings

Weekly (Wednesday), seasonally adjusted



Commercial paper outstanding
Commercial paper outstanding, miscellaneous categories

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tombutts @ umich.edu
01/16/98 09:52:00 AM

Record Type: Record

To: Robert M. Shireman

cc:
Subject: fwd: Washington, We Have A Problem

>MR-Received: by mta LEELA; Relayed; Fri, 16 Jan 1998 08:23:54 -0600
>Alternate-recipient: prohibited
>Date: Fri, 16 Jan 1998 08:22:18 -0600 (CST)
>From: "Mariko Gomez mg01@swt.edu" <MG01@a1.swt.edu>
>Subject: fwd: Washington, We Have A Problem

>MIME-version: 1.0
>Posting-date: Fri, 16 Jan 1998 08:23:00 -0600 (CST)
>Importance: normal
>Priority: normal
>A1-type: MAIL
>Hop-count: 1
>
> Attached is the beginning of propoganda scare tactics. Later.
> Gomez
>
>Date: Thu, 15 Jan 1998 17:21:56 CST
>From: croemer <croemer@tcjc.cc.tx.us>
>Subject: fwd: Washington, We Have A Problem
>To: mg01 <mg01@swt.edu>
>Message-id: <vines.kng8+IcdjoA@IDT01.tcjc.net>
>MIME-version: 1.0
>Content-type: MULTIPART/MIXED; BOUNDARY="Boundary_(ID_/OB+7GJV5JKrmEHT4mGCeA)"
>Delivery-date: Thu, 15 Jan 1998 17:27:00 CST
>Posting-date: Thu, 15 Jan 1998 17:23:43 CST
>Importance: normal
>A1-type: MAIL
>
>Have you seen this? Get on the TASFAA list serve. It's just the beginning.
> Thanks again for this afternoon. Micki
>----------
>Original Text
>From: "Allen, Gordon" <GAllen@gfbank.com>, on 1/15/98 3:21 PM:
>To: "'TASFAA Listserve Members'" <tasfaa@post.cis.smu.edu>
>
>Printed below is an article written for the next ATLE newsletter.
>(Footnotes were dropped to accommodate TASFAA Listserve.) At the
>request of several of my school colleagues, I am sending it out to each
>of you now since the deadline for the next TASFAA newsletter has passed.
> G.A.
>
>WASHINGTON,

>WE HAVE A PROBLEM!
>
>By Gordon Allen
>
>It may not have the significance of Apollo 13, but in student lending it
>is definitely a matter of life support. Negotiations in Washington are
>not going well and the deadline is getting dangerously close for
>originating lenders to anticipate changes made by the Budget
>Reconciliation Act of 1993. Effective July 1, 1998, Section 427A(h) of
>the Higher Education Act changes the interest rate calculation on
>Federal Family Educational Loan Program loans. The current interest
>rate calculation is 2.5% or 3.1%, whichever applies, added to the 91 day
>T-bill. The new formula adds 1% to a security to be identified by the
>Secretary of Education that appropriately reflects the term of the FFELP
>loan. The Secretary has currently identified the 10-year Treasury index
>as the appropriate security and it will replace the 91-day Treasury
>bill.
>
>If applied today, the new calculation will reduce the rate on an FFELP
>loan by 145 basis points for repayment loans and approximately 85 basis
>points for an in-school loan. Most originating lenders can not make
>FFELP loans at a rate of 6.81%. An even worse effect is that student
>loan secondary markets will likely not be able to pay a fair price for
>these loans. That would eliminate any avenue for the originating lender
>to produce income by selling the loans. Originating lenders now face
>some difficult questions concerning what to do and when to do it. Is
>there an equitable plan for all parties concerned? Who will take the
>loss? Whether it is loss of profit or loss of access to loan money at
>the beginning of the fall semester, one thing is clear. The risk of
>disruption in the 98-99 financial aid cycle is becoming more real every
>day.
>
>As is always the case, timing is critical in the financial aid delivery
>cycle. A loan made on or after July 1 is in the 98-99 cycle. That
>cycle will begin in approximately February of 1998 when students apply
>for financial aid, parents file their 1997 tax returns and schools begin
>to package financial aid. The first fall cycle loan is then processed
>in March or April with volume increasing steadily up to the beginning of
>the fall semester in September. Of course, disbursement of these loans
>will occur after the beginning of the fall semester. However,
>originating lenders would certainly not want to accept an application
>for a loan, get it guaranteed, notify the student of approval and then
>not fund it after July 1. In order to prevent such an occurrence,
>lenders must consider an appropriate action for fall-spring loans as
>they occur. That is March or April, not July.
>
>Assuming that Section 427A(h) is repealed, here are four options for
>lenders to consider:
>
>Lenders could stop originating all loans until the law change. The most
>effective way to prevent the possibility of loss is simply not to accept
>applications for any loan coming under the new calculation. While this
>plan would cause considerable disruption in the packaging cycle of most
>schools, the lender would incur little risk of loss due to the new

>calculation. Of course, a lender would also want to immediately begin
>to limit marketing, travel and other expenses for the 1998 fiscal year.
>It is unlikely that direct lending or for that matter any other loan
>program would be able to replace the loss of available loan money in
>such a short period of time. Implementation and training at the school
>alone would take too long to be effective for the fall semester.
>Additionally, the overload that is likely to occur on the Department's
>direct loan processor would only add further confusion and delay. This
>option has a high risk of loan money not being available at the
>beginning of the fall semester.
>
>Lenders could defer funding until the law change. This "business as
>usual with conditions" strategy, used before in similar regulatory
>dilemmas, assumes that the law will change in time. Lenders would hold
>disbursements until repeal of the rate calculation presumably no later
>than July 1. If that does not happen, disbursements would continue to
>be held through Re-authorization which is hopefully before the end of
>1998. If the rate calculation never changes, all loans would be
>canceled. Perhaps originating lenders could get the guarantor to hold
>all loans scheduled for disbursement after July 1. This plan preserves
>the fall processing cycle, but puts all the risk of loss on the school
>and student because of resulting loan cancellations if the law does not
>change. It also has a high risk of loan money not being available at
>the beginning of the fall semester.
>
>Lenders could limit the number or amount of loans made. A shared risk
>plan where lenders impose some limit on the loans that will be funded
>under the new calculation is also an option used in the past. Lenders
>impose a total money limit and therefore limit their risk. For example,
>the lender could limit loans to certain types of schools or allocate a
>dollar amount to each school. Another possibility would be to limit
>funding to certain lending conditions such as upper classmen or previous
>borrowers or loans above a certain amount. All loans not in one of
>these categories could be held for funding until after the rate is
>changed or simply returned as not within the lender's product offerings.
> With this plan, lenders are only at risk for those loans within the
>limit. The remainder of the risk is assumed by the schools or students
>outside the limit. For them, this option again has a high risk of loan
>money not being available at the beginning of the fall semester. That
>is just as disruptive to the school as the two above options since all
>students are not served.
>
>Lenders could continue business as usual. This plan ignores the risk
>and preserves the 98-99 financial aid delivery cycle. Business as usual
>means that all marketing activity and related support services would
>continue without interruption and proceeding totally on the presumption
>that the law will change in time. Typically Congress has acted when
>financial aid delivery is to a large degree adversely affected. The
>lender takes all of the risk. However, since the rate only applies to
>new loans after July 1, the profitability of a lender's portfolio would
>gradually deteriorate. How much deterioration would be a matter of
>individual choice. The lender would be in the position of waiting on
>Congress and the Administration to negotiate a compromise quickly. That
>is not likely to happen.

>
>Most lenders involved in the student loan business would want to pursue
>the last option, business as usual, to preserve the relationship with
>the school. They would also agree that the most important issue at hand
>is to deliver financial aid on time. But, this is not a position that
>originating lenders will hold very long. If the FFELP continues to
>deteriorate, senior management must at some point conclude that
>investing in federally insured student loans is less attractive as a
>part of the overall consumer loan portfolio than other types of consumer
>loans. In that circumstance, schools and students take all of the risk.
> There will not be a private lender around, which advances student
>lending "back to the future" in 1975 when private lenders were reluctant
>to participate because of government ineptitude and micro-management.
>
>Another consequence of this situation is the effect on serialization
>that is related to how many times a student will borrow before finishing
>school. The student loan industry has spent a considerable amount of
>time and money educating the consumer that it is desirable to keep the
>same lender throughout the borrowing period. By using the same lender
>each year, a condition of multiple lenders, secondary markets or
>servicers is avoided which is a known cause of student loan defaults.
>If lenders leave the FFELP in a short period of time because of the rate
>change, serialization will be adversely effected. Default rates will go
>up and it will take years to unravel the confusion just as it did
>before. Considering that defaults are the business of Texas Guaranteed
>Student Loan Corporation, the Texas guarantor, one possible option to
>consider is a migration of loan applications from originating lenders to
>TGSLC through the lender of last resort facility. With this option, at
>least serialization problems would be centralized where they belong.
>
>All of the above options are in some way based on the assumption that
>the rate calculation will change at least to something that will provide
>some profit. In past debates on like issues, loss of profitability has
>been ignored and certainly this situation is no different. While not a
>fair price, it does represent a rate reduction to students making it a
>popular move on the surface. It is still important for the originating
>lenders and secondary markets to communicate with Senators,
>Representatives, congressional staff, lobbyists and professional
>association to get across the message. Repeal of this law by July 1 is
>critical to the financial stability of the student lending industry.
>However, it is much more important to have the schools support this
>position as necessary to maintain the smooth deliver of financial aid in
>the 98-99 cycle. A silent vote is a no vote. The situation requires
>action on the part of the schools. Originating lenders and secondary
>markets must actively seek that support in any way possible. Financial
>stability in the student lending industry is much less an issue to
>Congress than smooth delivery of financial aid and only a school can
>effectively present that point.
>
>If the law is not repealed or if it is replaced with some other adverse
>calculation, disruption in the 98-99 financial aid delivery cycles will
>be minor in comparison to the loss of the FFELP. The point has already
>been made that there in no more fat in this program. "
>can result in a greater likelihood that the program will become

>unprofitable at certain points in the business cycle. The result could
>be a shutdown of the guarantee delivery system and assumption of all
>student lending by the direct governmental delivery system for student
>loans." Does anybody remember FISL?
>
>
>Date: Thu, 15 Jan 1998 17:27:29 CST
>MIME-version: 1.0
>Content-type: TEXT/PLAIN; CHARSET=US-ASCII
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>A1-type: DOCUMENT
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> id <01ISEWOR3BOY94DU6M@swt.edu> for MG01@a1.swt.edu; Thu,
> 15 Jan 1998 17:23:41 CST
>Received: from IDT01.tcjc.net by swt.edu (PMDF V5.1-9 #20823)
> with SMTP id <01ISEWNL0YZI94DVS9@swt.edu> for mg01@swt.edu; Thu,
> 15 Jan 1998 17:23:41 -0600 (CST)
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>Resent-message-id: <01ISEWOR3EX094DU6M@swt.edu>
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Table 1.
Comparison of CBO's Economic Projections, Calendar Years 1998-2008

	Estimate[a]	Forecast		Projected								
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nominal GDP (Billions of dollars)												
January 1998	8,081	8,461	8,818	9,195	9,605	10,046	10,529	11,038	11,565	12,112	12,684	13,280
September 1997	8,053	8,415	8,802	9,223	9,672	10,165	10,684	11,227	11,794	12,388	13,011	n.a.
Nominal GDP (Percentage change)												
January 1998	5.8	4.7	4.2	4.3	4.5	4.6	4.8	4.8	4.8	4.7	4.7	4.7
September 1997	5.5	4.5	4.6	4.8	4.9	5.1	5.1	5.1	5.1	5.0	5.0	n.a.
Real GDP (Percentage change)												
January 1998	3.7	2.7	2.0	1.9	2.0	2.1	2.3	2.3	2.2	2.2	2.2	2.1
September 1997	3.4	2.1	1.9	2.1	2.2	2.4	2.4	2.4	2.3	2.3	2.3	n.a.
GDP Price Index (Percentage change)												
January 1998	2.0	2.0	2.2	2.3	2.4	2.4	2.5	2.5	2.5	2.5	2.5	2.5
September 1997	2.0	2.4	2.6	2.6	2.6	2.6	2.6	2.6	2.7	2.7	2.7	n.a.
Consumer Price Index[b] (Percentage change)												
January 1998	2.4	2.2	2.5	2.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
September 1997	2.4	2.7	3.0	3.0	3.0	3.1	3.1	3.1	3.1	3.1	3.1	n.a.
Civilian Unemployment Rate (Percent)												
January 1998	4.9	4.8	5.1	5.4	5.6	5.8	5.9	5.9	5.9	5.9	5.9	5.9
September 1997	5.0	5.1	5.5	5.8	5.9	6.0	6.0	6.0	6.0	6.0	6.0	n.a.
Three-Month Treasury Bill Rate (Percent)												
January 1998	5.1	5.3	5.2	4.8	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
September 1997	5.2	5.4	4.7	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	n.a.
Ten-Year Treasury Note Rate (Percent)												
January 1998	6.4	6.0	6.1	6.0	5.9	5.9	5.9	5.9	5.9	5.9	5.9	5.9
September 1997	6.4	6.2	5.8	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	n.a.
Tax Bases (Percentage of GDP)												
Corporate profits												
January 1998	9.9	9.7	9.2	8.8	8.5	8.3	8.2	8.1	8.0	7.9	7.8	7.7
September 1997	9.5	9.1	8.8	8.6	8.3	8.1	8.0	7.9	7.8	7.7	7.7	n.a.
Wages and salaries												
January 1998	48.0	48.4	48.5	48.6	48.6	48.6	48.6	48.7	48.8	48.8	48.8	48.8
September 1997	48.0	48.2	48.2	48.2	48.2	48.2	48.3	48.3	48.3	48.3	48.4	n.a.

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

NOTES: Percentage change is year over year. n.a. = not applicable.

a. Estimates of nominal GDP, real GDP, and the GDP price index are based on data for the first three quarters of 1997 published November 26, 1997.

b. The consumer price index for all urban consumers.

Issues Mktg.

- Problem
- Timing - Pre-reauth
  Reauth w/ delay
  Reauth w/ longer delay → reforms next year ? (2-step)
- Approach - Single rate
  Split rate
  Other ?
- 6A. reforms

1/15/98

Don G., B. Reed
Shelley Ann D., Joan B., Zuck,
Marshall, Alex A., MM,
Marianne, S. Day

Timing

- health - no by fall /

- leaders - March ?
Later if they see a solution on horizon

- Recycling

2 Heads: ad oppose separate

Goodling: open

That's our leverage — to get: - best deal for students...

- no cleanup on ed'n

Add:

- IPA

- neutralizing...

- Cedar on appropriations

Rumors — Ed says must go thru...

=> Are hemorral Day signaling... ?

Marle
If agent → UNSTOPPABLE as separate...

- Speckle features must be

When on explor.

- AFR Actually -

. probe II — CINC on EI-Sec

. distance learning
. clarification, simplification...
. can meche side — complementary...
. career from drug fees...
. coon forgiveness for relics. -

- Focus on getting a compromise
- [illegible] think [illegible]

~~[illegible] issue process~~

- encourage the community [illegible] a rec. [illegible] ...

If not ...

Relax

- Compromise ... → temp. deal ... ?

- permanent ... ?

- include [illegible] or not ?

What if can't reach agmt ? & no sign agmt ...

- will [illegible]

→ Capacity of P. Cr.

→

- who would say ... categories.

Ability to [illegible]

Split rule

- Banks - Major of students in ...
  - 10 yr x 1 for D.C.
  - "By the way" in PREC...

=> same Morrowell...

D.C. - hold students harmless...

[redacted]

→ Have a facilitate bargaining pressure for schools to make

- Good position, but...

Banks and go ahead.

Progress: Schools, sanctions & Grades → get there

to

- Explain: they all need to be together...

* House Rep / Clean: house back, speedent, infer ed...
→ whig group..
"we might have to impose a solution..."

Notice - the public - they want to ... at ... ...

(Senate?)

... - ... - the political support the ... ...

Minutes from Treas

Swap -

Allow - Securitizations
swap dealers - pro-bank &
- higher cost - bigger mkt
- K hedging ..

Prepmt risk - LCA -> will raise the risk...
- only mod dec..., still ...

[margin: that's where we'll get hurt *]

Servicing - issues of large congregation...
Citicorp: was at 130 bp, 3 yrs ago, now 95 - higher say it's in blip

* Big vs. Small banks ...

[Non-prefer - no one!]

What is reqd rate of return? - economically sound...
CMS says 125; rule is 'express' - they say 100 bp.
75 bp - Reg. rqts on K holdings - theoretically 0... to portfolio K hold
=> 66 bp -> round to 75 (15% ROE)

Need to resolve

(1) [illegible]

☐ Check

- [illegible] eqn.

- WM - simple rate 3rd qtr. 10/20 yr..

→ bigs 25 bp

[illegible] day [illegible] [illegible] [illegible]

- longer-term yield curve...

(2) If #s are right -
why aren't discounts bigger: why allow DSC to rise 1/3 of mkt?

(Dave [illegible])

2 [illegible]..

⇒ Mtg in distress

Add (3) Longer-term + avg. 5 yrs.

+ - CBO economics..

Next steps

- Research #s
  - comprehensiveness
- Dynamics — 3 mo. / 6 mo / 1 yr. . . and they be able to understand. . .

- 2-year rate . . .

TABLE 1: INTEREST RATE ASSUMPTIONS

(Percent)

	1997	1998	1999
OMB			
3-month T-bill	5.17	5.13	5.01
10-year note	6.75	5.86	5.80
Spread	1.58	0.73	0.79
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.
10-year note	—	5.39	n.a.
Spread	—	0.5	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

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

(In Percent)

Formula or Net Rate of Return	1997/98		1998/99	
	Administration	Blue Chip	Administration	Blue Chip
Current Formula:				
3-month T-bill + 2.50/3.10	7.67/8.25	7.67/8.25	n.a.	n.a.
Estimated net return to lender	1.52	1.38	n.a,	n.a.
Future Formula:				
10-year CMT + 1.00	n.a.	n.a.	6.86	7.10
Estimated net return to lender	n.a.	n.a.	0.16	0.16
Alternative Formulas:				
To hold student harmless	n.a.	n.a.	T-bill + 1.73	T-bill + 1.76
Estimated net return to lender	n.a.	n.a.	0.42	0.44
To maintain lenders minimum required net rate of return:				
75 basis points	n.a.	n.a.	T-bill + 2.06	T-bill + 2.07

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.

1/14/97

STULOSUM

TABLE 4: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS, ALTERNATE BASIS

(In Percent)

Formula or Net Rate of Return	1997/98 Administration	1998/99 Administration
Current Formula:		
3-month T-bill + 2.5/3.10	7.67/8.25	n.a.
Estimated net return to lender	1.36	n.a,
Future Formula:		
10-20 year sinple interest + 1.00	n.a.	7.11
Estimated net return to lender	n.a.	0.16
Alternative Formulas:		
To hold student harmless	n.a.	T-bill + 1.98
Estimated net return to lender	n.a.	0.67
To maintain lenders minimum required net rate of return:		
75 basis points	n.a.	T-bill + 2.06

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.

1/14/97

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 yeilds 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	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04
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.

stuloa18

M. Comiez

White House Signals Shift on Formula for Calculating Interest Rates on Student Loans

BY STEPHEN BURD

WASHINGTON

The Clinton Administration is taking more seriously than before the warnings of lenders that the guaranteed-student-loan program could collapse if the government does not a halt an impending change in the formula used to calculate the interest rate that borrowers pay on their loans.

For months, White House officials have expressed doubts about the lenders' concerns, accusing them of crying wolf to protect their profits. But one of the chief skeptics, Robert Shireman, a senior policy adviser at the National Economic Council, signaled a change in the Administration's viewpoint last month when he acknowledged that "there is general agreement" that the new formula would be "inefficient for lenders in the guarantee program."

Speaking at the annual meeting of the Consumer Bankers Association, Mr. Shireman said the White House "would like to work with" lenders and representatives of the leading higher-education associations to find a solution that would not harm students.

LOWER RATES FOR STUDENTS

As of July 1, 1998, the formula used for calculating the interest rate on student loans will be based on the rate of 10-year Treasury notes rather than that of 91-day Treasury bills, as it is now. The change will result in a lower interest rate for students. The current rate on guaranteed student loans is 9 per cent; using the 10-year Treasury note, it would fall to 7.1 per cent.

The transition was required as part of a 1993 law that created the federal government's direct-loan program. It was intended to reduce costs for students as the government replaced the guaranteed-student-loan program with direct lending, which it expected to do after five years.

But direct lending, now in its fourth year, has captured only a third of the student-loan volume.

Bankers complain that switching to the 10-year Treasury note will make it more difficult for them to raise the money they need to make student loans. Investors are hesitant to take risks based on such long-term financial instruments, they said, because the longer the investment, the less predictable their return will be. As a result, it will no longer be profitable for them to continue making student loans, and they would be forced to leave the federal loan program, they said.

THE 'IMPENDING CRISIS'

For almost a year, lenders have been trying to persuade their Republican supporters in Congress to draft legislation to block the formula change. But the lawmakers have been reluctant to take such action, because they knew that doing so would prompt heated opposition from the Clinton Administration and student-aid advocates who say it would cost students billions of dollars.

Staff members for those lawmakers say they can no longer ignore the "impending crisis," however. They say they will offer plans to avert the problem within the next few months, when they draft legislation to extend the Higher Education Act, which governs the federal student-aid programs.

Lenders hope the White House will include its own proposal to fix the problem in the President's proposed fiscal-1999 budget, which will be released early next month. Even if they did not agree with the specifics of a proposal, the lenders say, it could "jump-start" negotiations for a solution.

For months, White House officials have expressed skepticism about the lenders' concerns, accusing them of crying wolf.

In an interview, Mr. Shireman said it was "unlikely" that the Administration would craft its own proposal. Instead, he said, the White House would encourage lenders to engage in "serious discussions" with higher-education associations and students to develop a solution to the problem.

He acknowledged that the Administration was taking lenders' fears more seriously, saying the lenders had provided the Administration with "better and more complete information about the nature of the problem."

Lenders, however, say the Administration was forced to change its tune, after an analysis, requested by Mr. Shireman from the Treasury Department, demonstrated that their concerns about the revised formula were valid. The Treasury Department has not made such an analysis public, and Mr. Shireman said he "could not confirm or deny" whether one even exists.

'WE COULDN'T DO IT'

Observers say White House officials are acting because they are afraid that lenders may not be bluffing, as originally suspected. A breakdown of the guaranteed-loan program, which controls about 70 per cent of the federal student-loan market, would be a political disaster for the Administration.

Joseph L. McCormick, who heads the Education Department's Direct Loan Task Force, spoke candidly last month at the Consumer Bankers Association's meeting.

"It would be remiss of me to say we could take up the slack," he said when asked whether the direct-loan program would be able to accommodate the flood of borrowers who would seek to enter it if the guaranteed-loan program shut down. "If all the lenders took a walk July 1, we couldn't do it."

While some lenders are pleased that the White House has shown a change of heart, others remain skeptical. "The Administration may have finally become aware of the real problems it will face after July 1st," said Mark Cannon, executive director of the Coalition for Student Loan Reform, an advocate for the guaranteed-student loan program. "But I've seen little to suggest that they are serious about averting a train wreck." ■

WASHINGTON ALMANAC

In Federal Agencies

HUMAN SUBJECTS. The Department of Education has issued final rules that amend department regulations regarding the protection of children as research subjects. The regulations are now consistent with those of the Department of Health and Human Services, and further basic educational assistance that reservists under the Montgomery GI Bill–Selected Reserve will receive in fiscal 1998 (*Federal Register*, December 18, 1997, Pages 66,277-9).

Washington People

RITA COLWELL, president of the Uni-

The Chronicle of Higher Education Academe Today

GOVERNMENT & POLITICS

January 16, 1998

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456 -

Date: 12/12/97 Fax: 2223

To: Bob Shimm

Office of :

From: Jon Ong

Number of Pages (including cover sheet): 8

If there are any problems with this transmission, please contact me at: (202)401-0020

Comments:

Goodling draft from Sept 97, never introduced. (This fell into the hands of students, who protested loudly.)

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H.L.C.

[STAFF DRAFT]

105TH CONGRESS
1ST SESSION

H. R. _____

IN THE HOUSE OF REPRESENTATIVES

Mr. ____ introduced the following bill; which was referred to the Committee on _____

A BILL

To amend the Higher Education Act of 1965 to reduce interest rates and origination fees for student loans made during academic year 1998–1999.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; REFERENCE.

(a) SHORT TITLE.—This Act may be cited as the "____ Act of 1997".

(b) REFERENCES.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal

is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.).

SEC. 2. LOAN PROVISIONS FOR LOANS MADE AFTER JULY 1, 1998.

(a) FFEL LOANS.—

(1) INTEREST RATES.—Subsection (h) of section 427A (20 U.S.C. 1077a(h)) is repealed.

(2) IN-SCHOOL AND GRACE PERIOD RULES FOR LOANS MADE AFTER JULY 1, 1998.—Section 427A(g) (20 U.S.C. 1077a(g)) is amended—

(A) in paragraph (1), by striking ", but subject to subsection (h),"; and

(B) by redesignating paragraph (3) as paragraph (4); and

(C) by inserting after paragraph (2) the following new paragraph:

"(3) RATE FOR LOANS MADE AFTER JULY 1, 1998.—For any loan under section 428 or 428H for which the first disbursement is made on or after July 1, 1998, the rate determined under paragraph (2) shall be determined by substituting '2.3 percent' for '2.5 percent' in subparagraph (B) of such paragraph.".

(3) CONSOLIDATION LOANS.—Section 428C (20 U.S.C. 1078–3) is amended—

(A) in subsection (a)(4)—

(i) by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively; and

(ii) by inserting after subparagraph (B) the following new subparagraph:

"(C) made under part D of this title;";

(B) in subsection (b)(4)(C)(ii)—

(i) by inserting "made before the date of enactment of the ____ Act of 1997," after "consolidation loan" in subclause (I);

(ii) by striking "or" at the end of subclause (I);

(iii) by inserting "or (II)" before the semicolon at the end of subclause (II);

(iv) by redesignating subclause (II) as subclause (III); and

(v) by inserting after subclause (I) the following new subclause:

"(II) by the Secretary, in the case of a consolidation loan made on or after the date of enactment of the ____ Act of 1997, except that the

Secretary shall pay such interest only on that portion of the loan that repays Federal Stafford Loans for which the student borrower received an interest subsidy under section 428 or Federal Direct Stafford Loans for which the borrower received an interest subsidy under section 455; or"; and

(C) by striking paragraph (5) of subsection (b); and

(D) in subsection (c)(1), by adding at the end the following new subparagraph:

"(D) A consolidation loan made on or after the date of enactment of the ____ Act of 1997, shall bear interest at an annual rate on the unpaid principal balance of the loan that is equal to the rate specified in section 427A(f).".

(4) UNSUBSIDIZED LOANS.—Subsection (f) of section 428H (20 U.S.C. 1078–8(f)) is repealed.

(5) ORIGINATION FEES.—Section 438(c)(2) (20 U.S.C. 1087–1(c)(2)) is amended—

(A) by striking "(other than" and everything that follows through "Amendments of 1981" and inserting "(including loans made

under section 428H, but excluding loans made under sections 428C and 439(o))"; and

(B) by adding at the end the following new sentence: "With respect to any such loan for which the first disbursement is made on or after July 1, 1998, the preceding sentence shall be applied by substituting '2.0 percent' for '3.0 percent'.".

(b) DIRECT LOANS.—

(1) INTEREST RATES.—Section 455(b) (20 U.S.C. 1087e(b)) is amended—

(A) by striking paragraph (3);

(B) in paragraph (4)—

(i) by striking "(A)"; and

(ii) by striking subparagraph (B); and

(C) by redesignating paragraphs (4) and (5) as paragraphs (3) and (4).

(2) IN-SCHOOL AND GRACE PERIOD RULES FOR LOANS MADE AFTER JULY 1, 1998.—Section 455(b)(2) is amended by adding at the end the following new subparagraph:

"(C) For any Federal Direct Stafford Loan or Federal Direct Unsubsidized Loan for which the first disbursement is made on or after July 1, 1998, the rate determined under

subparagraph (B) shall be determined by substituting '2.3 percent' for '2.5 percent' in clause (ii) of such paragraph.".

(3) ORIGINATION FEES.—Section 455(c) is amended adding at the end the following new sentence: "For any Federal Direct Stafford Loan or Federal Direct Unsubsidized Loan for which the first disbursement is made on or after July 1, 1998, the preceding sentence shall be applied by substituting '3.0 percent' for '4.0 percent'.".

SEC. 3. NEED ANALYSIS CHANGES FOR ACADEMIC YEAR 1998–1999.

(a) DEPENDENT STUDENTS.—Section 475(g)(2)(D) (20 U.S.C. 1087*oo*(g)(2)(D)) is amended by striking "$1,750" and inserting "$2,250".

(b) INDEPENDENT STUDENTS.—Section 476(b)(1)(A)(iv) is amended—

(1) by striking "$3,000" each place it appears in subclauses (I) and (II) and inserting "$5,500"; and

(2) by striking "$6,000" in subclause (III) and inserting "$8,500".

(c) EFFECTIVE DATE.—The amendments made by this section shall be effective with respect to determina-

tions of need under part F of title IV for periods of instruction beginning on or after July 1, 1998.

December 17, 1997

Post-it™ brand fax transmittal memo 7671	# of pages ▸ 2
To: Bob Shireman	From Ed Elmendorf
Co.	Co.
Dept.	Phone #
Fax # 456 2223	Fax # 296 5819

To: Bob Shireman
NEC

From: Ed Elmendorf
AASCU

Subject: July, 1998 Interest Rate Issue

I appreciate your inquiry regarding AASCU's perspective on a possible interest rate compromise. I hope you understand that we are not opposed to a reasonable compromise, and that we have attempted to induce our colleagues within the loan industry to craft a proposal that treats them, the students, and the federal government fairly.

I decided to write this brief message to better articulate our position:

1- I am convinced that any compromise offered by the Administration in its budget request will be perceived by the industry as an opening gambit, and will simply encourage them to turn up their grass roots lobbying effort in hopes of extracting more concessions from you. As you well know, the most lenders have offered up thus far has been 20 basis points during the in-school period, and for you to put the offer of what may be a 50-60 basis point increase above "10-year plus 1.00" would send very much the wrong signal.

2- I am also candidly concerned about the possibility that some in the Administration may be inclined to finance new initiatives (such as a reduction of up-front fees for all or some of the borrowers) by a rate hike. Clearly, this mode of self-financing would be bad policy and unacceptable to us. It would be tantamount to picking the pockets of borrowers to give them front-end discounts amounting to a fraction of additional costs imposed on them through a simultaneous—and related—policy change.

3- I strongly urge you to leave yourself, and us, enough "wiggle room" to negotiate with our lender colleagues in a substantive and unconstrained manner. Such a process could only be effectuated if the parties can focus on the single problem of the interest rate without the additional restrictions of having to accomplish goals not directly and inextricably linked to it.

4- I have not spoken with the students about this, but suggest that you speak with them before any final budget or policy decisions are made. I suspect they would see any major concession this early in the same light as we do, and that they would also encourage you not to get into horse-trading too soon.

5- It is crucial that we all agree that substantively, even if one were to concede the veracity of lenders' claims about financing costs and lender yield, direct loans should be taken off the table in any negotiation on the interest rate issue. To this extent, I certainly hope that, even if you decide against our tactical advice with regard to timing, that no changes whatsoever would be proposed in connection with direct loan interest rates.

In general, I would hope to see nothing about the rate question in the President's upcoming budget request. But if some placeholder has to be inserted for this purpose, the less said, the better. The down side of a numerical placeholder is that is predicates itself on policy assumptions that the lenders, the students, and we can extrapolate from the numbers. In some ways, that would be a repeat of recent history that I know none of us particularly enjoyed, and that is entirely avoidable.

Comparison of Interest Rates

Mid Session Review
July 1997

	91 -day	10 year	91 -day +2.5%	91 -day +3.1%	10 year +1%	91 -day Equivancy	Change from Current Practice In School	Change from Current Practice In Repayment
FY 98	5.45%	6.11%	7.95%	8.55%	7.11%	1.66%	0.84%	1.44%
FY 99	5.27%	5.72%	7.77%	8.37%	6.72%	1.45%	1.05%	1.65%
FY 00	5.02%	5.44%	7.52%	8.12%	6.44%	1.42%	1.08%	1.68%
FY 01	4.68%	5.25%	7.18%	7.78%	6.25%	1.57%	0.93%	1.53%
FY 02	4.50%	5.20%	7.00%	7.60%	6.20%	1.70%	0.80%	1.40%
					Avg:	1.56%	0.94%	1.54%

President's Budget
December 1997

	91 -day	10 year	91 -day +2.5%	91 -day +3.1%	10 year +1%	91 -day Equivancy	Change from Current Practice In School	Change from Current Practice In Repayment
FY 98	5.19%	6.11%	7.69%	8.29%	7.11%	1.92%	0.58%	1.18%
FY 99	5.13%	6.03%	7.63%	8.23%	7.03%	1.90%	0.60%	1.20%
FY 00	5.01%	6.03%	7.51%	8.11%	7.03%	2.02%	0.48%	1.08%
FY 01	4.91%	6.03%	7.41%	8.01%	7.03%	2.12%	0.38%	0.98%
FY 02	4.81%	6.03%	7.31%	7.91%	7.03%	2.22%	0.28%	0.88%
					Avg:	2.04%	0.46%	1.06%

Change from Mid-Session Review to President's Budget

	91 -day	10 year	91 -day +2.5%	91 -day +3.1%	10 year +1%	91 -day Equivancy	Change from Current Practice In School	Change from Current Practice In Repayment
FY 98	-0.26%	0.00%	-0.26%	-0.26%	0.00%	0.26%	-0.26%	-0.26%
FY 99	-0.14%	0.31%	-0.14%	-0.14%	0.31%	0.45%	-0.45%	-0.45%
FY 00	-0.01%	0.59%	-0.01%	-0.01%	0.59%	0.60%	-0.60%	-0.60%
FY 01	0.23%	0.78%	0.23%	0.23%	0.78%	0.55%	-0.55%	-0.55%
FY 02	0.31%	0.83%	0.31%	0.31%	0.83%	0.52%	-0.52%	-0.52%
					Avg:	0.48%	-0.48%	-0.48%

10-Dec-97
Budget Service

Table 1: Economic Assumptions

(Percent)

	1997/98	1998/99	1999/00
OMB			
3-month T-bill	5.17	5.13	5.01
10-year note	6.75	5.86	5.80
Spread	1.58	0.73	0.79
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

Note: Data are for the second calendar quarter.

2nd qtr

newtab1

12/15/97

Table 2: Cost Assumptions

(Percent or Basis Points)

	Current Policy	Future Policy
All-in costs a/	T-bills +.65	CMT + .12
Servicing/overhead b/	0.95	0.95
Default risk	0.07	0.07
Prepayment risk	0.04	0.04
Origination fee	0.05	0.05
Total	6.96	7.06

Note: Total costs are based on FY 1999 budget assumptions.

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.

b/ Includes both servicing and overhead costs.

newtab2

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

(In Percent)

Formula or Net Rate of Return	1997/98		1998/99	
	Administration	Blue Chip	Administration	Blue Chip
Current Formula:				
3-month T-bill + 310	8.25	8.25	n.a.	n.a.
Estimated net return to lender	1.40	1.22	n.a,	n.a.
Future Formula:				
10-year CMT + 100	n.a.	n.a.	6.86	7.10
Estimated net return to lender	n.a.	n.a.	-0.20	-0.16
Alternative Formulas:				
To hold student harmless	n.a.	n.a.	T-bill + 1.73	T-bill + 1.76
Estimated net return to lender	n.a.	n.a.	0.03	0.05
To maintain lenders minimum required net rate of return:			.28	.30
75 basis points	n.a.	n.a.	T-bill + 2.45	T-bill + 2.46
100 basis points	n.a.	n.a.	T-bill + 2.70	T-bill + 2.71

Note: Formula estimates are for loans in repayment.

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.

12/05/97

STULOSUM

- Secondary Mkts - 80%

- Holders - 20%

TABLE 4: SWAP ESTIMATES (IN BASIS POINTS)

SWAP	Goldman Sachs 11/14/97	Goldman Sachs 5/16/97	J.P.Morgan 11/14/97	Bankers Trust 11/14/97	Citicorp 11/21/97	Paine-Webber 11/14/97	Paine-Webber Recent Past	Paine-Webber 10/7/97
3-month T-bill for LIBOR (weekly reset, quarterly pay)								
4 year	T-bill + 69	T-bill + 49.2	T-bill + 70	T-bill + 68	T-bill + 70	T-bill + 75	a/	
7 year	T-bill + 68	T-bill + 49.2	T-bill + 70	T-bill + 66	T-bill + 69	T-bill + 73	b/	
10 year	T-bill + 67.5	T-bill + 46.4	T-bill + 69	T-bill + 66	T-bill + 69	T-bill + 73		
10-year CMT (fixed) for LIBOR (CMT quarterly reset)								
4 year	CMT + 6.5	CMT - 23.8	CMT - 35	CMT + 6	CMT + 35	N.A.		
7 year	CMT + 4.5	CMT - 32	CMT - 43	CMT + 6	CMT + 43	N.A.		
10 year	CMT + 2.5	CMT - 36	CMT - 48	CMT + 5.5	CMT + 49	N.A.		
10 year CMT (annual reset) for LIBOR								
4 year	CMT + 9.5	CMT - 20.8	CMT + 26	CMT + 27	CMT + 31	CMT + 15		CMT/1-mo. LIBOR
7 year	CMT + 7.5	CMT -10.6	CMT + 21	CMT + 26	CMT + 27	CMT + 11		CMT - 5 *
10 year	CMT + 5.5	CMT - 4.6	CMT + 16	CMT + 24	CMT + 25	CMT + 9		
3-MONTH T-BILL	5.26	5.18	5.27		5.23	5.25		
3-month LIBOR	5.88	5.82	5.88		5.875	5.875		
10-year CMT	5.88	6.54	5.81		5.82	5.88		

* CMT reset annually; paying LIBOR + 5 on an amortizing basis matched to the paydown of the loan portfolio over a 7 year period.

a/ Paine-Webber estimates that the T-bill/LIBOR swap for the recent past has been T-bill -5.

b/ Paine-Webber provided an swap estimate (November 5) of T-bill + 77bps for 4 years; +75bps for 7 years; and + 74bps for 10 years.

swapest

M COMIEZ

William C. Menth
12/15/97 09:35:19 AM

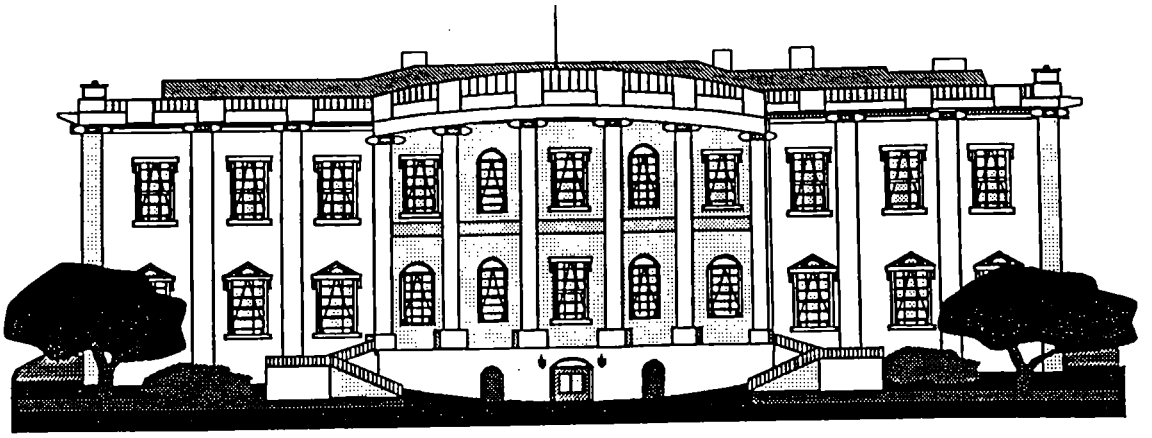
Record Type: Record

To: Arthur W. Stigile/OMB/EOP, Wayne Upshaw/OMB/EOP, Kathryn B. Stack/OMB/EOP, Robert M. Shireman/OPD/EOP

cc:
Subject: Re: Interest rate projections

The 10-year and 30-year Treasury rates are bond-equivalent rates. A bond equivalent rate of, say, 8 percent means that two semiannual interest payments are made in the amount of 4 percent of principal. Principal is paid at maturity. Though Treasury bonds offer no opportunities for the reinvesment of interest earnings, an equivalent simple annual equivalent rate, assuming that interest earnings could be invested at the coupon rate, would be 8.16 percent.

As explained in the footnotes to the credit table, the credit rates are simple annual rates. The 30-year Treasury rate for the period in question is 6.10 percent on a bond-equivalent basis and 6.19 percent on a simple annual basis. On the simple annual basis, the 30-year rates is above the rates for credit acounts in both the 10-20 year interval (6.03%) and the 20+ year interval (6.11%)



The White House

National Economic Council

To: John Gruber

Phone: _____ Fax: _____

From: **Bob Shireman**

Phone: (202) 456-2803 Fax: (202) 456-2223

Pages including cover sheet: 4

Comments: As we discussed: the average equivalency for 10-20 yr bond (under Gradar Reform) would be T-bill plus 227 basis points (FY 1999-2003)

Treasury Rates for Credit Accounts
(For use in the OMB credit subsidy model)

Fiscal Year	Similar Maturity Interval				
	1 year or less	More than 1 year and less than 5 years	More than 5 years and less than 10 years	More than 10 years and less than 20 years	20 years or more
1992	4.06	5.52	6.93	7.59	7.59
1993	3.25	4.58	5.90	6.65	6.65
1994	4.06	5.36	6.21	6.77	6.77
1995	5.99	6.78	7.11	7.26	7.39
1996	5.45	5.96	6.33	6.64	6.77
1997	5.50	6.19	6.51	6.77	6.89
1998	5.16	5.67	5.97	6.11	6.16
1999 thru 2008	5.31	5.66	5.87	6.03	6.11

Notes:

1. All rates are stated as simple annual rates, which differ from bond equivalent rates and bank discount rates. The 10-20 year and the 20+ year intervals were a single interval in the 1992-1994 Budgets. The separate intervals were effective with the 1995 Budget.

2. The rates for 1992-1997 are actual fiscal year averages; the rates for later years are estimates. Actual fiscal year averages are derived from the prevailing market yields during the fiscal year, excluding the last five business days, on outstanding fixed-rate Treasury securities, categorized on the basis of their remaining maturity.

3. The estimated rates for FY 1998 are unchanged from the original 1998 Budget assumptions (last year) and should continue to be used for execution of the 1998 Budget, as enacted.

4. Beginning with the 1999 Budget, estimated rates are based on estimated market yields for October 1st of the budget year (e.g., October 1, 1998 for the 1999 Budget) and are held constant for all subsequent years. For the formulation and execution of the 1999 Budget, the rates shown should be used for 1999 and for all subsequent years, until replaced by actual rates.

5. The rates above are used to calculate credit subsidy cost, to reestimate credit subsidy cost, and to calculate the interest income and expense of the financing accounts. They can be used in the OMB subsidy model without modification.

TREASURY BILL, NOTE, AND BOND RATES

Year	Treasury bills (1)			Treasury notes and bonds (2)					
	91-day	182-day	364-day	2-year	3-year	5-year	7-year	10-year	30-year
Calendar year:									
1996	5.02	5.10	5.22	5.84	5.99	6.18	6.34	6.44	6.70
1997	5.05	5.14	5.32	5.94	6.07	6.20	6.30	6.36	6.61
1998	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1999	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
2000	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
2001	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2002	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2003	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2004	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2005	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2006	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2007	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2008	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
Fiscal year:									
1997	5.04	5.15	5.35	6.00	6.14	6.29	6.40	6.46	6.72
1998	5.00	5.03	5.09	5.53	5.62	5.72	5.80	5.88	6.12
1999	4.91	4.95	5.02	5.46	5.55	5.66	5.74	5.82	6.06
2000	4.80	4.86	4.94	5.41	5.50	5.62	5.71	5.80	6.05
2001	4.71	4.77	4.86	5.32	5.42	5.54	5.64	5.72	5.98
2002	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2003	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2004	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2005	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2006	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2007	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2008	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95

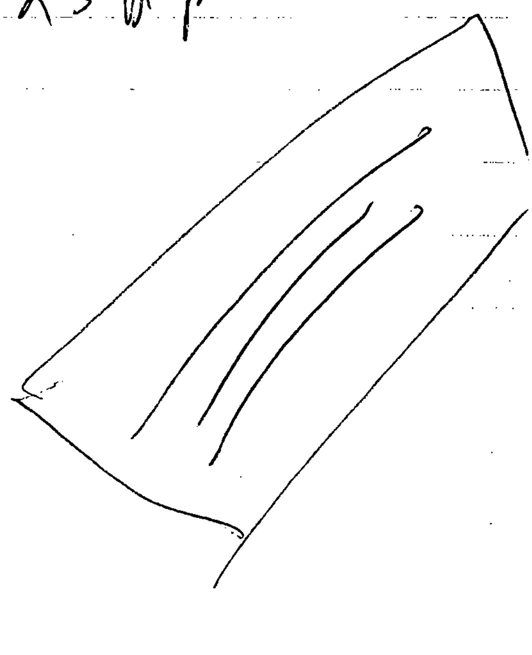
1. Bank discount basis.
2. Bond equivalent rates.

FY	91-day	19-20 yr		Equivalency T-bill +
1998	5.00	6.11		211
1999	4.91	6.13	-98	212
2000	4.80	"		223
2001	4.71	"		232
2002+	4.69	"	-76	234
				234
				222.4

Issues, Treasury analysis — 99-03 avg. T+ 227

- Credit est. vs. 19 year

- Reduce costs / efficiencies
  → cover the 23 b.p.??



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*** ACTIVITY REPORT ***
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MEMORANDUM

To: Gene Sperling
From: Bob Shireman
Date: December 13, 1997
Re: Student Loan Options for the FY 1999 Budget

Given the relatively small increases for student aid programs on the discretionary side, I think it is important that we have a good talking point for what we plan to do on student loans. My recommendation is that we phase out the fees that are charged on need-based (Stafford) loans, so that we can say that we are "eliminating loan fees for needy students." Of course, doing this costs some money.

At the same time, we need to decide what kind of message we want to send to the lending community (and Congress) about our willingness to change the interest rate structure that is scheduled to take effect next July. Moving toward a fix can *save* us money.

I am suggesting that we do both. While I do not yet have a cost estimate, I believe we can make these changes and still have net savings of close to $3 billion to be used for other purposes.

Overview

Two related decisions on student loans need to be made for purposes of the FY 1999 Budget:

- Should we propose a change to the interest rate structure that is currently scheduled to go into effect on July 1, 1998? Proposing a change can provide us with more savings.

- How much of the savings that we propose in the program should we reinvest in students, by reducing student fees? The more savings we provide, the less savings are left for other purposes.

A decision about what interest rate structure will be proposed in the Budget will not stop our continuing work exploring other approaches, such as auctions, for reducing government subsidies or borrower interest rates.

Background

Under the Student Loan Reform Act of 1993, a new maximum interest rate on all Federal direct and guaranteed loans is scheduled to go into effect on July 1, 1998. Instead

of the current rate of the 91-day T-bill plus 310 basis points (250 during the in-school period), the rate will be roughly* the 10-year Treasury note plus 100 basis points. The government guarantees lenders these returns, on a quarterly basis under the current T-bill rate, and on an annually adjusted basis under the coming T-note rate. Under both rates, students never pay more than 8.25% (the government pays the lenders above that cap).

The 1993 change, which was made at the Administration's request in the final stages of the legislative process, and was not the subject of public debate or extensive analysis, had two elements:

The change in the *instrument* (from T-bill to T-note) was intended to match the discount rate that we use internally to determine, under budget rules, the long-term costs of the student loan programs. This issue is now moot: the reconciliation bill this year amended the Budget Act in a way that provides a better approach (beginning with the FY 2000 Budget) to approximate the government's cost of funds for the purposes of assessing the costs of credit programs.

The change in the *rate* was intended to give students a reduction in interest rates once direct lending was expected to be the dominant program. Based on the interest rate projections at the time, students were expected to enjoy a **60 basis point reduction** in the rates during repayment. (The rate during the in-school period would have been unchanged).

Current interest rates and projections show a flatter yield curve than projected in 1993. As a result, students stand to receive, under the FY 1999 Administration projections, a reduction of between 76 and 98 basis points in the interest rate on loans.

In the guarantee program, lenders and secondary markets are facing a double whammy: the change to the 10-year T-note does not match the usual funding for lenders and secondary markets, so it imposes some hedging costs on their financing operations. On top of that, the spread that they would receive is reduced because of the current yield curve situation. (Conspiracy theorists on Capitol Hill and in the lending community claim that we devised this scheme in order to drive them out of business so that direct lending will take over).

The flattened yield curve has also had an impact on the Direct Loan Program: the lower rates mean that the income that the government gets from student payments is lower than if the rate had simply been reduced by 60 basis points. This affects the estimated cost of the program, and is part of the reason that CBO now claims that the two programs are about equal in long-term cost to taxpayers. (In other words, if students pay more, it *reduces* the net cost of the Direct Loan Program to the government. In the guarantee

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*It is actually an average of 10-year and 20-year rates, which is somewhat higher. Those are the rates referred to in the paper when I use the term 10-year T-note.

program, however, higher interest rate *increase* government costs because we partially subsidize the rates but we do not share in what borrowers pay).

One solution that we have explored has been to shift back to using the T-bill, but at a rate that is "equivalent" to what students would be paying in July without any change in the law. This is the position that we have taken informally in our discussion with the higher education groups and Capitol Hill. Using an average of our projections over the next five years, that would put the rate at T-bill plus 227 basis points (compared to 310 currently, a reduction of 83).

Important leverage for reform. The interest rate issue is the only real leverage we have on issues that we would like to address in the reauthorization of the Higher Education Act. Now that we are in a situation where we must manage two programs, it is critical that we streamline and improve the financial incentives in the guarantee system. We are proposing these changes in the reauthorization. We have told lenders and guaranty agencies that if they want a higher return than is now scheduled, they will have to work with us to root out inefficiencies in the system, reducing lender costs and producing savings that can compensate students for us moving to a higher rate. There is some support for reform in the industry, but they complain that the difference between the July rate and a profitable rate is too great for students to come out "whole"; they are concerned that there there are not enough potential savings to cover the distance.

Analysis

Education, Treasury, OMB, CEA and NEC all agree that, ultimately, it is not advisable to impose hedging costs on the industry by insisting on the peg to 10-year T-notes.

A Treasury analysis of the financing and servicing costs of for-profit lenders and secondary markets indicates that the new rate -- even if pegged to the T-bill -- does not provide a sufficient return for them to continue in the business. The tax-exempt secondary markets may show different results, but the amount of capital that they can provide is limited. Treasury has determined that in order to make the program sufficiently profitable, the rate would need to be moved back closer to what was intended when the 1993 change was adopted: T-bill plus 250 basis points. Education has tended to approach this issue differently, and may provide me with an alternative analysis on Monday.

Interest Rate Options

1. No change in the interest rate structure

Under this approach, we would not make any adjustment to the interest rate structure in the Budget. We would tell lenders and Congress that we will continue to work with them to determine the extent of the problem and to explore possible solutions.

As a sign of good will, we can show them that the further hits on lenders that had been in the FY 1998 Budget have been dropped.

Argument for: We should not give up any ground on the interest rate unless and until we can get something for it. After their 1995 experience, Republicans are afraid of anything that provides ammunition to accuse them of increasing the cost of student loans. If we hang tough, then we can enter into negotiations in February, get the maximum reform of the system and savings for students, and end up at the justifiable interest rate of perhaps T-bill plus 250 basis points. Remember that we can afford to hang tough because unlike previous reauthorizations, we do not risk that students will be without loans, because this time we have the Direct Loan Program as a safety valve.

Argument against: This is not a good starting point for negotiations because it is not justifiable. The reason for using the 10-year T-note is gone, and the current yield curve makes the rate too low for lenders under any analysis. Further, a more realistic rate brings in mandatory savings that can be ploughed back into students' pockets and/or other needs in the FY 1998 Budget.

2. Move to an "equivalent" rate.

Under this approach, we would change the interest rate to T-bill plus 227 basis points, preserving an average 83 basis point reduction for students. Further, the in-school rate would be reduced to T-bill plus 150 basis points, continuing current policy that recognizes the minimal servicing costs during that period (and providing us with some additional savings). We would claim to be moving in the lenders' direction by eliminating the hedging costs imposed by using the T-note.

Argument for: This places us on firmer footing by moving back to the T-bill rate. It demonstrates good will, giving some solace to members of both parties on Capitol Hill who have contacted us about this issue. At the same time, it maintains a strong pro-student position. It leaves enough distance for us to be able to demand significant reforms of the guarantee system, to get savings to compensate students for moving the rate up somewhat.

Argument against: This is the worst of both worlds. It puts us on the record saying that there is a problem, but it is a solution that we do not have numbers to justify. Treasury's analysis would indicate that it is 20-30 basis points too low for lenders to be profitable enough to stay in the business.

3. True fix of the interest rate.

This approach would adopt the 60 basis point reduction that was intended when the interest rate shift was originally adopted in 1993, and would adopt an additional reduction during the in-school period, continuing current policy that recognizes the minimal servicing costs during that period (and providing us with some additional

savings). This is the lowest level that the Treasury analysis considers profitable under current cost conditions.

We would need to stand firm on this rate. Lenders seeking greater profit levels would need to work with us to reduce their costs through reforms of the guarantee system, something that we support.

Frank Raines has further suggested that something be done to encourage more competition among lenders -- so that more of them charge a rate that is lower than the maximum set in law. One approach would be to use the rate in the Direct Loan Program to amplify reductions offered by leading lenders in the guarantee system. Under this approach, the direct loan rate would be based on the rates offered by the 25 percent of lowest-rate lender volume.

Argument for: This rate is enough for lenders *and* it preserves the rate reduction that students were promised in 1993 (even going a little further by reducing the in-school rate). Lenders would say it is not enough, but they -- and others on Capitol Hill and in the higher education community -- would see the proposal as a responsible move. Given the new student loan interest tax deduction, we do not need to demand that new borrowers receive an additional 23 basis point reduction that is solely the result of shifts in the yield curve. If anything, it would be better to use these savings to focus a fee reduction on needy students.

Argument against: This gives away the store to the lending community. They will consider this to be our opening position, and we could end up with only a 30-40 basis point reduction for students, rather than the 60 that was intended. If we want to end up with 60, we have to start with more. Further, some may portray this approach as increasing costs to students over what the current interest rate environment would provide.

Student Fee Options

A. Equalize fees. I consider this the an imperative, the minimum necessary under any scenario. Currently, those in the Direct Loan Program pay a 4 percent fee to the government. In the guarantee program, some agencies have used a loophole to charge only 3 percent (essentially using our money to make up the difference), undermining the level playing field that was intended in 1993. Our reauthorization proposal would equalize fees at the lower 3 percent level, a "25 percent reduction" in fees. To show our continued support for the Direct Loan Program, we *must* use some savings to make this change.

B. Cut fees in half for needy students. We could go further by reducing fees on need-based loans to 2 percent -- a 50 percent cut overall -- in 2002 (the current OMB passback). This is similar to the proposal in our FY 1998 Budget.

C. Eliminate fees on needy students. We could completely phase out fees on need-based loans (2 percent in 2001, 1 percent in 2002, eliminated in 2003).

Recommendations

I think it is important that we have a student loan proposal that we can brag about. I also would be more comfortable with an interest rate policy that we can justify. The combination of options 3 and C give us both.

I am concerned, however, that this approach gives up negotiating ground. To address that, I would sit down with the higher education community and friends in Congress to to get them all to agree not to move from this reasonable position. We can hang tough because it will be the industry and Republicans who most want to move a bill.

Net savings from different policy combinations (billions $)

Remaining ~~savings~~ ~~available if~~: Student Fee Policy. / Interest rate policy:	A. Equalize fees at 3% (from 4% current max)	B. *Further reduce* fees on need-based loans	C. *Eliminate* fees on need-based loans
1. No change in interest rate	$2.28	$1.94	$1.28
2. Goodwill gesture on interest rate	$2.75	$2.42	$1.76
3. True fix of interest rate	$3.85	$3.50	$2.90

FY	91-day	19-20 yrs		Equivalent T-bill +
1998	5.00	6.11	-	211
1999	4.91	6.13	-98	212
2000	4.80	"		223
2001	4.71	"		232
2002+	4.69	"	-76	234
				234

222.4

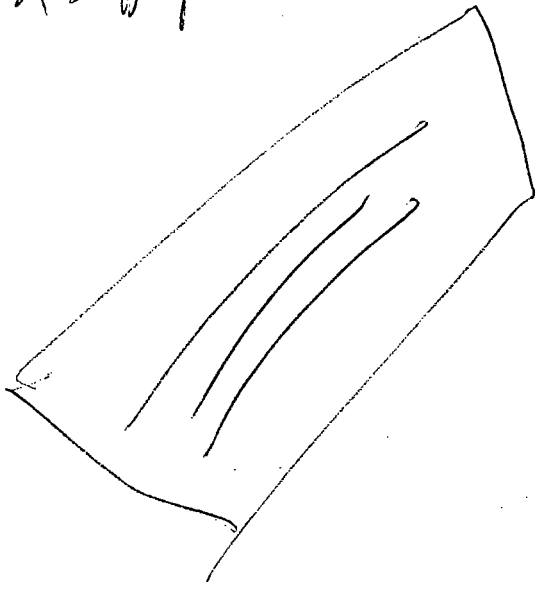
Issues - Treasury analysis

99-93 T# avg. 227

- Credit ext. vs. 10 year

- Indice costs/efficiencies

→ Carr the 23 to p. 7.?



99 Assumptions

TREASURY BILL, NOTE, AND BOND RATES

Calendar Quarter	Treasury bills (1)			Treasury notes and bonds (2)					
	91-day	182-day	364-day	2-year	3-year	5-year	7-year	10-year	30-year
1996 Q1	4.95	4.91	4.84	5.27	5.38	5.57	5.79	5.91	6.30
1996 Q2	5.04	5.15	5.35	6.12	6.29	6.49	6.66	6.72	6.93
1996 Q3	5.14	5.26	5.47	6.18	6.36	6.54	6.67	6.78	6.97
1996 Q4	4.97	5.07	5.23	5.80	5.94	6.10	6.24	6.34	6.61
1997 Q1	5.06	5.13	5.34	6.04	6.19	6.36	6.48	6.56	6.82
1997 Q2	5.07	5.28	5.55	6.27	6.42	6.57	6.66	6.70	6.93
1997 Q3	5.06	5.13	5.28	5.90	6.01	6.13	6.23	6.24	6.53
1997 Q4	5.00	5.04	5.10	5.56	5.65	5.76	5.84	5.92	6.16
1998 Q1	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1998 Q2	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1998 Q3	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1998 Q4	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1999 Q1	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
1999 Q2	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
1999 Q3	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
1999 Q4	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
2000 Q1	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
2000 Q2	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
2000 Q3	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
2000 Q4	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
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2001 Q2	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
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2001 Q4	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
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1997	5.05	5.14	5.32	5.94	6.07	6.20	6.30	6.36	6.61
1998	5.00	5.03	5.09	5.52	5.61	5.71	5.78	5.86	6.10
1999	4.88	4.92	4.99	5.44	5.53	5.64	5.72	5.80	6.04
2000	4.78	4.84	4.92	5.40	5.49	5.62	5.71	5.80	6.05
2001	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2002	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2003	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2004	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2005	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2006	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2007	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2008	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
Fiscal year:									
1997	5.04	5.15	5.35	6.00	6.14	6.29	6.40	6.46	6.72
1998	5.00	5.03	5.09	5.53	5.62	5.72	5.80	5.88	6.12
1999	4.91	4.95	5.02	5.46	5.55	5.66	5.74	5.82	6.06
2000	4.80	4.86	4.94	5.41	5.50	5.62	5.71	5.80	6.05
2001	4.71	4.77	4.86	5.32	5.42	5.54	5.64	5.72	5.98
2002	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2003	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2004	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2005	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2006	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2007	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95
2008	4.69	4.75	4.84	5.30	5.39	5.52	5.61	5.70	5.95

1. Bank discount basis.
2. Bond equivalent rates.

6.56

ADDITIONAL INTEREST RATES AND BOND YIELDS

Calendar Quarter	Prime Rate	Treasury Bills Bond Equivalent Rates (3) 91-day	182-day	364-day	London Interbank Rate (4)	AAA State & Local Rate (5)	Mortgage Rate (6)
1996 Q1	8.33	5.08	5.10	5.09	5.40	5.40	7.24
1996 Q2	8.25	5.18	5.36	5.65	5.52	5.72	8.11
1996 Q3	8.25	5.28	5.48	5.79	5.59	5.68	8.16
1996 Q4	8.25	5.10	5.28	5.53	5.53	5.44	7.71
1997 Q1	8.27	5.20	5.34	5.64	5.56	5.44	7.79
1997 Q2	8.50	5.21	5.50	5.88	5.81	5.47	7.92
1997 Q3	8.50	5.19	5.34	5.58	5.73	5.23	7.47
1997 Q4	8.50	5.13	5.27	5.41	5.65	5.27	7.24
1998 Q1	8.50	5.13	5.26	5.39	5.65	5.23	7.17
1998 Q2	8.50	5.13	5.26	5.39	5.65	5.23	7.17
1998 Q3	8.50	5.13	5.26	5.39	5.65	5.23	7.17
1998 Q4	8.50	5.13	5.26	5.39	5.65	5.23	7.17
1999 Q1	8.25	5.01	5.15	5.29	5.51	5.18	7.10
1999 Q2	8.25	5.01	5.15	5.29	5.51	5.18	7.10
1999 Q3	8.25	5.01	5.15	5.29	5.51	5.18	7.10
1999 Q4	8.25	5.01	5.15	5.29	5.51	5.18	7.10
2000 Q1	8.25	4.91	5.06	5.22	5.38	5.18	7.10
2000 Q2	8.25	4.91	5.06	5.22	5.38	5.18	7.10
2000 Q3	8.25	4.91	5.06	5.22	5.38	5.18	7.10
2000 Q4	8.25	4.91	5.06	5.22	5.38	5.18	7.10
2001 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2001 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2001 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2001 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2002 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2002 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2002 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2002 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008 Q1	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008 Q2	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008 Q3	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008 Q4	8.00	4.81	4.97	5.14	5.27	5.11	6.98

3. "Bond equivalent rates" are based on a semi-annual payment of interest.
4. LIBOR is 3-month U.S. Dollar denominated.
5. Moody's rate for State & local general obligation debt.
6. FHLMC contract rate on conventional mortgage commitments.

ADDITIONAL INTEREST RATES AND BOND YIELDS

Year	Prime Rate	Treasury Bills Bond Equivalent Rates (3)			London Interbank Rate (4)	AAA State & Local Rate (5)	Mortgage Rate (6)
		91-day	182-day	364-day			
Calendar year:							
1996	8.27	5.16	5.30	5.52	5.51	5.56	7.80
1997	8.44	5.18	5.36	5.63	5.69	5.35	7.60
1998	8.50	5.13	5.26	5.39	5.65	5.23	7.17
1999	8.25	5.01	5.15	5.29	5.51	5.18	7.10
2000	8.25	4.91	5.06	5.22	5.38	5.18	7.10
2001	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2002	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008	8.00	4.81	4.97	5.14	5.27	5.11	6.98
Fiscal year:							
1997	8.38	5.18	5.36	5.66	5.66	5.40	7.72
1998	8.50	5.13	5.26	5.40	5.65	5.24	7.19
1999	8.31	5.04	5.18	5.32	5.54	5.19	7.12
2000	8.25	4.94	5.08	5.24	5.41	5.18	7.10
2001	8.06	4.84	4.99	5.16	5.30	5.13	7.01
2002	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2003	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2004	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2005	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2006	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2007	8.00	4.81	4.97	5.14	5.27	5.11	6.98
2008	8.00	4.81	4.97	5.14	5.27	5.11	6.98

3. "Bond equivalent rates" are based on a semi-annual payment of interest.
4. LIBOR is 3-month U.S. Dollar denominated.
5. Moody's rate for State & local general obligation debt.
6. FHLMC contract rate on conventional mortgage commitments.

Treasury Rates for Credit Accounts
(For use in the OMB credit subsidy model)

Fiscal Year	Similar Maturity Interval				
	1 year or less	More than 1 year and less than 5 years	More than 5 years and less than 10 years	More than 10 years and less than 20 years	20 years or more
1992	4.06	5.52	6.93	7.59	7.59
1993	3.25	4.58	5.90	6.65	6.65
1994	4.06	5.36	6.21	6.77	6.77
1995	5.99	6.78	7.11	7.26	7.39
1996	5.45	5.96	6.33	6.64	6.77
1997	5.50	6.19	6.51	6.77	6.89
1998	5.16	5.67	5.97	6.11	6.16
1999 thru 2008	5.31	5.66	5.87	6.03	6.11

Notes:

1. All rates are stated as simple annual rates, which differ from bond equivalent rates and bank discount rates. The 10-20 year and the 20+ year intervals were a single interval in the 1992-1994 Budgets. The separate intervals were effective with the 1995 Budget.

2. The rates for 1992-1997 are actual fiscal year averages; the rates for later years are estimates. Actual fiscal year averages are derived from the prevailing market yields during the fiscal year, excluding the last five business days, on outstanding fixed-rate Treasury securities, categorized on the basis of their remaining maturity.

3. The estimated rates for FY 1998 are unchanged from the original 1998 Budget assumptions (last year) and should continue to be used for execution of the 1998 Budget, as enacted.

4. Beginning with the 1999 Budget, estimated rates are based on estimated market yields for October 1st of the budget year (e.g., October 1, 1998 for the 1999 Budget) and are held constant for all subsequent years. For the formulation and execution of the 1999 Budget, the rates shown should be used for 1999 and for all subsequent years, until replaced by actual rates.

5. The rates above are used to calculate credit subsidy cost, to reestimate credit subsidy cost, and to calculate the interest income and expense of the financing accounts. They can be used in the OMB subsidy model without modification.