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Office of Economic Policy

Department of the Treasury
Washington, D.C. 20220

FAX

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Name	Fax Number	Phone Number
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c/o White House Situation Room	757-2679	
From: Jonathan Gruber	202-622-2633	202-622-0563

REMARKS: ☒ Urgent ☐ For your review ☐ Reply ASAP ☐ Please comment

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Rr 121



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 8, 1997

MEMORANDUM FOR BOB SHIREMAN

FROM: Jon Gruber 

SUBJECT: Student Loan Program Results

We have made good progress on rewriting our paper on the student loan interest rate formula for next year. Our statistical analysis is completed, unless we obtain more current data on *Blue Chip Economic Indicators* interest rate estimates. Even then, revising our estimates and the relevant text is only a matter of perhaps a days work.

At this point, we have a relatively non-technical paper with two technical appendices. The papers are in pretty good shape structurally, but need a lot of finessing in terms of presentation. With my being gone until this Friday in Japan, I think that it is not realistic to expect the papers to be done until the end of next week (roughly Dec 19).

In the meantime, we have prepared for you a summary table (attached) that shows our results for four scenarios:

1. The 1997/98 student loan interest rate for loans in repayment using the current student loan formula, and the estimated net return to lenders;
2. The 1998/99 student loan interest rate for loans in repayment using the new student loan formula, and the estimated net return to lenders;
3. An alternative formula for next year that would hold students harmless, i.e., by retaining the interest rate required by the new formula; and
4. An alternative formula for next year that would allow lenders to receive the minimum rate of return on their assets which they presumably need to justify their student loan originations.

Attached to this memo is also another memo that describes our different approaches for thinking about target rates of return. This is obviously a tricky endeavor, and we present three different ways of going about it. The most analytically rigorous approach is the third, which uses the regulatory structure of the banking sector to back out the required rate of return on the assets that underlie student loans. This also gives the lowest estimate for the target rate of return. After looking across these approaches, and talking to experts, our feeling is that a sensible range of target rates of return is 75 to 100 basis points; the bottom of this range could readily be justified by our regulatory methodology, but would most likely be roundly criticized as inadequate by the

industry and perhaps by outside observers as well.

The results of these estimates, under the Administration's FY 1999 budget assumptions and the latest *Blue Chips* projections, show that:

- The current student loan formula provides lenders a rate of return above the range of assumed minimum rates of return required. Under administration assumptions about interest rates, the rate of return for 1997/98 is almost twice the lower bound on the required rate of return.
- The estimated rate of return under the new formula does not come close to providing lenders an adequate rate of return. In fact, for loans in repayment, the rate of return is negative.
- An alternative formula for next year that mirrors the interest rate under the new formula but indexes the rate to T-bills could be T-bill plus 1.79 percentage points (Administration assumptions) or T-bill plus 1.93 percentage points (Blue Chip). This formula would hold students harmless, but would not satisfy lenders' required minimum rate of return.
- A formula that could satisfy lenders' minimum needs would require a much larger spread above T-bills, i.e., T-bill plus 2.45 percentage points or T-bill plus 2.70 percentage points (Administration assumptions) for a 75 and 100 basis point rate of return, respectively. The comparable numbers for *Blue Chip* would be T-bill plus 2.54 percentage points and T-bill plus 2.79 percentage points.

Because these estimates reflect the FY 1999 budget assumptions, they should be held closely and not provided to others at this time.

It has been brought to my attention that Don Feuerstein is on a panel today at the Consumer Bankers Association "Student Lending Conference." The panel's topic for discussion is the 1998 changes in the student loan interest rate. Don has been cited in a recent private sector financial news letter as reportedly advising Secretary Riley that the yield change for next year is workable. Our numbers do not support this view, and I have confidence in the conclusions drawn from our estimates. It would be inappropriate and potentially embarrassing to the Administration if Don stated this view at the CBA Conference, even if he qualifies such a statement as reflecting only his own views.

Once again, I'm sorry that this has taken so long. Some of the technical aspects of this endeavor have proved much more difficult than anticipated. I think that we're very close to a high quality report - thanks for your patience.

12/5/97

Ways of Looking At the 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 might be.

Return on Alternative Assets

A paper by CRS on the student loan program presented estimated returns on alternative assets as a frame of reference for judging returns on student loans. This approach focuses on banks' decisions on how to allocate available funds among alternative uses. CRS reported estimated returns on Ginnie Mae securities (marketable securities backed by pools of government guaranteed or insured mortgages; these securities are considered to be quite liquid in an active secondary market) as 1.2 percentage points and on adjustable-rate mortgages as 1.25 percentage points. These estimates have not been analyzed or confirmed with other sources..

Rules of Thumb

Perceptions of normal returns are, of course, benchmarked in the average actual returns received by the industry. The Federal Reserve reports that net, after-tax return on assets averaged 1.185 percentage points over the 1993-96 period (*Federal Reserve Bulletin*, June 1997). Average before-tax returns were 1.78 percent. These returns are averages across all assets. They leave open the question of the appropriate adjustment for asset characteristics.

One Federal Reserve analyst has said that rates of return after-tax for banks generally would be in the range of 1 percent to 1.3 percent with collateralized assets (e.g., mortgages) and government guaranteed assets at the bottom end of that range. Indeed, government guaranteed assets possibly could receive a return a bit below one percent. A one percent after-tax return would correspond to a 1.5 to 1.7 percent rate of return before-tax, depending on the effective tax rate (the actual average tax rate in the 1993-96 period was 0.34 percent, but estimates around .4 are frequently used for the marginal rate, including both federal and state and local taxes)

Financial industry participants have reported that a pretax return of 1 (one) percentage point to 1.25 percentage should be adequate for student loans.

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. If a bank targets a return on capital of 15 percent after tax, or 25 percent before tax, and its ratio of equity capital to assets is .08, then rate of return on assets must be about 1.2 percent. This is about the average situation for banks as reported for the 1993-96 period.

Regulation requires a ratio of capital not to total assets but to risk-adjusted assets. The required ratio is 8 percent, but Federal Reserve analysts tell us that the actual ratio to risk adjusted assets is closer to 12 percent.

The risk adjustment lowers the total volume of assets by scaling down the amount of capital required according to risk categories. Student loans fall in the 20 percent risk category, meaning that if banks aim for capital of 12 percent of risk-adjusted assets, they will hold capital equal to only 2.4 percent of assets in the form of student loans. Applying this capital ratio to the 25 percent target rate of pretax return on equity, gives a target return on assets of 0.6 percent.

From this perspective, banks could be satisfied with a 60 basis point return (pretax) on student loans. This is a very stringent level, however, in view of two considerations:

- there has been a trend upwards in banks' capitalization, and this trend is encouraged by regulators as a market-based form of over-all safety and soundness regulation.
- nonbank lenders, in particular participants in the secondary market for student loans, are likely to need higher capitalization over the long-term. Although these lenders are not subject to regulatory standards, the environment in the financial community -- in particular, the judgements of rating agencies -- will be influenced by the posture of regulators. These nonbank lenders are important to maintain the liquidity of student loans; their viability can help to keep banks satisfied with lower returns on student loans. Limited data on Student Loan Corp and Sallie Mae capitalization suggests target capital ratios of 3 or 4 percent could be appropriate.

Given the desirability of achieving an adequate rate of return on capital, with sufficient capitalization for nonbank lenders, a target pretax return on assets of 0.75 to 1 percent seems appropriate.

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	1.27	n.a.	n.a.
Future Formula:				
10-year CMT + 100	n.a.	n.a.	8.86	7.20
Estimated net return to lender	n.a.	n.a.	-0.23	-0.23
Alternative Formulas:				
To hold student harmless	n.a.	n.a.	T-bill + 1.79	T-bill + 1.93
To maintain lenders minimum required net rate of return:				
75 basis points	n.a.	n.a.	T-bill + 2.45	T-bill + 2.54
100 basis points	n.a.	n.a.	T-bill + 2.70	T-bill + 2.79

n.a. Not applicable

Assumptions:

OMB estimates are based on Fiscal Year 1999 budget estimates.

Blue Chip estimates are based on the November 10 Blue Chip release.

12/05/97

12/09/97 11:41 6 002/003

THE CONSUMER Federation of America said that banks should try new ways to help low-income families save money. *Page 3*

COMMUNITY BANKING

A SOUTH CAROLINA court dismissed a shareholder suit alleging Carolina First executives unfairly profited from a deal with a technology start-up firm. *Page 6*

MORTGAGES

A SURGE in refinancings in the second half has put the mortgage industry on track to exceed its 1996 originations volume. *Page 7*

THE RESIDENTIAL mortgage real estate investment trust market continues to heat up with four companies conducting initial public offerings in November. *Page 7*

TECHNOLOGY

CORESTATS and other technology companies that will help to improve the way of doing business. But Core Capital's investment that was apparent just within reach. *Page 13*



INVESTMENT PRODUCTS

PEPINAM INVESTMENTS promoted Vincent Esposito to national sales director for its \$126 billion asset mutual funds business. *Page 14*

CORPORATE FINANCE

WACHOVIA prepares to pay a \$100 million dividend to its shareholders, a move that will help the bank build up its capital. *Page 15*

AS THE LEVERAGED BUYOUT industry enters

no record dimensions, Chicago's Cullen, who has been running down by splitting himself in two. *Page 9*

CREDIT/DEBIT/ATM

AT&T's credit card unit is up for sale, but that has not stopped it from launching its first major advertising campaign in four years. *Page 10*

THE MASTERCARD VETERAN whom Fujitsu-ICL Systems has tapped to run its automated teller machine business in the Americas says her mission will be to



Giving Women Credit

Butch Adams

Diana E. Kirk, right, started the Women's Financial Group at Zions Bancorp to serve women who prefer to deal with other women. She recruited Lori Chillingworth from KeyCorp to help run the effort. *See story on page 8*

Resigned to Direct Student Lending, Banks Target Curb on Their Own Rates

◆ By OLAF de SENERPONT DOMIS and JARET SEIBERG

WASHINGTON — Seeking to preserve a profitable niche, industry officials are asking lawmakers to repeal a law that could force banks out of the student loan business.

As of July 1, banks will have to peg interest rates on newly originated student loans to 10-year Treasury bonds instead of 3-month notes. The change is expected to cost the industry more than \$260 million a year, increase the

amount of interest rate risk lenders must bear, and eliminate the market for student loan securities.

"I am not certain we'll be making student loans if this takes effect," said Jon A. Veenis, president of Norwest Student Loan Center, Sioux Falls, S.D.

The problems stem from a 1993 law that created the government's direct student loan program. The provision pegging rates to 10-year Treasuries was included to reduce the

See page 3

Retail Market

◆ By CAREY GILLAM

12/5/97 p.1

H.F. Ahmanson & Co., the nation's second-largest thrift company, is pulling out of branch banking in Florida, citing intense competition in a rapidly consolidating market.

The California-based company, parent of Home Savings of America, has agreed to sell its 27 Florida branches, along with \$3.4 billion of deposits, to SouthTrust Corp. for \$300 million. The deal, announced Thursday, followed a similar transaction between the two companies earlier this year.

"Clearly the competitive landscape in Florida has changed over the last couple of years, and very dramatically over the last couple of months," said Adrian Rodriguez, a Home Savings spokesman. "It was increasingly difficult for us to compete."

Though out-of-state banks and thrifts once flocked to Florida to serve a booming population, mergers are now creating some daunting competitors.

Most notably, NationsBank Corp. struck a deal in August to acquire Barnett Banks Inc. And Wachovia Corp. has two deals pending in the state — one for the \$820 million-asset 1st United Bancorp of Boca

See back page

Wells Fargo CEO's Vision Echoes Microsoft Way

◆ By JEFFREY KUTLER

NEW ORLEANS — Wells Fargo & Co. chairman Paul Hazen lived up to star billing at the Retail Delivery '97 conference by sounding like Bill Gates.

In a speech 24 hours after one by the software magnate, Mr. Hazen endorsed one of the Microsoft Corp. chairman's big ideas — the electronic presentment and auto-



Target: Impending Rate Curb on Student Loans

Continued from page 1

cost of the direct loan program, but it was worded so broadly that it also applies to loans made by private-sector banks.

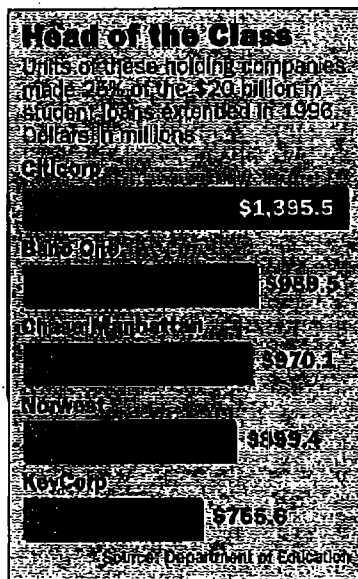
It requires lenders as of July 1 to set the rate on new student loans 100 basis points above the rate on the 10-year Treasury bill. The new rate will be 145 basis points lower than the current rate, which is calculated by adding 310 basis points to the price of a 91-day Treasury note.

Lenders have known of this problem for four years. But rather than working to repeal this particular provision, they have been trying to correct it by eliminating the direct loan program outright.

"Getting rid of the direct loan program would have taken care of this problem, but unfortunately that didn't happen," said Consumer Bankers Association president Joe Belew.

"For a while, we were far too passive on this," an industry source added.

Attention now is focused on eliminating the interest rate pro-



vision. Led by Sallie Mae, lobbyists are telling lawmakers that banks will abandon the program if changes are not made.

"Student loans will simply become unprofitable for private lenders under this formula," said Mary F. Bushman, a lobbyist with ARSA Data Corp., Fleet Financial Group's student loan unit.

Repealing the measure will not be easy.

As the law stands, seven million students a year will pay less for their loans. In addition, if the private lenders are forced from the market, business would increase for the direct loan program — a pet project of the Clinton administration.

"Part of problem is political — you have this perception that it is the lenders versus the students," Mr. Belew said. "On top of that, it is difficult to get anyone's attention focused on this because it is so arcane."

To overcome opposition, lenders have been floating a compromise that would peg rates to a different index such as Libor or commercial paper. Lenders also are offering to accept a decrease in government subsidies.

The subsidies exist because the government caps student loan rates at 8.25%. To prevent banks from taking losses when rates rise above this threshold, the Department of Education makes up the difference each quarter between 8.25% and the rate calculated using the government's formula.

Details on the compromise are

still sketchy, and lenders declined to discuss the offer on the record. But Sallie Mae executive vice president Paul Carey said lawmakers cannot let this problem go unaddressed.

"There needs to be a resolution of this," Mr. Carey said. "There are other ways to price student loans that are efficient that would work just fine. The 10-year Treasury index just doesn't make sense to anybody."

Lenders said the formula that kicks in July 1 would yield about 125 basis points per loan, but their exposure to interest swings would rise dramatically because their portfolios would be loaded with long-term, fixed-rate debt.

The risk could be mitigated with derivatives, but the cost of these complex hedges would erase already thin profits. One estimate by the Congressional Research Service said these instruments would cost up to

120 basis points, leaving banks with 5 basis points in profit to cover all other costs.

The index in the 1993 law "can result in a greater likelihood that the program will become unprofitable at certain points in the business cycle," CRS said in a July report. "The result could be a shutdown of the guarantee delivery system."

Mr. Carey said the market for student loan securities will die if a compromise is not reached. The problem: Investors will receive a return based on a long-term investment, even though they are holding a short-term instrument.

This mismatch in price and term makes the product very risky because the return is extremely sensitive to changes in interest rates.

Also, Mr. Carey questioned why lawmakers want to mess with a proven product. "We issue over \$100 billion of debt tied to the current index," he said. "We all know we can raise capital tied to the 91-day T-bill. No one has ever funded off this new index." ◇

Consumer Group Calls on Banks to Offer Savings Plans for Low-Income Families

◆By LOUIS WHITEMAN

holds in San Jose, Calif., and an unnamed town in northwest

den of tracking when a check is cashed, Mr. Brobeck said.

Draft Overhaul of Call Reports Wouldn't Ease Load, Banks Say

WASHINGTON — The American Bankers Association criticized proposed government revisions to next year's quarterly financial statements as a "missed opportunity" to eliminate red tape.

CLASSIFIED FAX

Department of the Treasury

2100

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(CLASSIFICATION)

DATE: 12/08/97

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	Robert Shireman	757-2679
	Office No.	456-2803
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From:	Jonathan Gryber		2026222633
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MEMORANDUM

To: Gene Sperling
From: Bob Shireman
Date: November 26, 1997
Subject: **Student Loans**

The attached OMB document describes the current issue we are facing over the 1998 interest rate change. I would appreciate your thoughts.

Strategically, we should probably not make any move until we are ready for a full negotiation. But I am not feeling totally comfortable with that. It is no longer possible to justify the change to the 10-year instrument, because the excuse we once had -- that the 10-year rate was our assumed "cost of borrowing" -- is gone as of the FY 2000 Budget (because of changes in credit reform that were included in the reconciliation bill).

Should we signal a willingness to be reasonable by proposing a move to T-bill plus 2.1 (which holds students harmless)? Some argue that that simply gives the industry something without getting anything in return, and/or it could be seen as a sign of weakness. The counter-argument is that it puts us on firmer policy ground: we agree that we should not be imposing unnecessary "hedging" costs on the industry, while we are firm on holding students harmless.

Student Loans

- ISSUE 2:** What package of amendments should the Administration be prepared to put forward, and when, in the event Congress decides to change the July 1, 1998 student interest rate prior to HEA reauthorization?
- Option 1:** The Administration's HEA proposals should recognize the problem underlying the July 1 rate, and remedy it by changing the rate to the 91-day T-bill plus 2.1 percentage points (i.e., using the benchmark instrument lenders prefer, but setting the spread at a level that will not increase costs to students).
- Option 2:** The Administration should not include any changes to the July 1 rate in its HEA reauthorization proposals. If Congress decides to act prior to reauthorization, the Administration should use the leverage this issue provides to squeeze out inefficiency in the FFEL program (e.g., through GA restructuring and recall of reserves), ensuring that students are held harmless. (HRD Recommendation)

DESCRIPTION OF ISSUE: HEA sets the maximum interest rate paid by students at the same level for both programs. The rate in effect today is 91-day T-bill + 2.5 percent while students are in-school (when loans have minimal servicing requirements), and T-bill + 3.1 percent for loans in repayment, with an 8.25 percent cap. The 1993 amendments, which envisioned most of the volume in direct lending by 1998, changed the rate beginning July 1, 1998 to the 10 year bond rate + 1 percent (roughly equivalent to T-bill + 2.1 percent), capped at 8.25 percent for students and 9 percent for parents. Borrower rates are adjusted annually. The July 1 rate is the Department's rate for borrowing from Treasury, and was also the rate agencies were required to use for credit reform discounting until just recently.

Lenders claim that the July 1 rate change is seriously problematic for two reasons: (1) switching to the 10-year note creates interest-rate risk since there is currently no securitization market for loans at the 10-year rate (securitization is now tied to LIBOR, an instrument very similar to the T-bill); and (2) the new rate, even if benchmarked against T-bills (at T+2.1) would not provide enough profit margin for lenders to stay in the program. Bank analysts assert they will lose 140 to 160 basis points under the new rate. When direct lending was viewed as able to absorb significant new volume, this threat was not alarming. Given ED's current management problems and clear inability to take on a rapid increase in direct lending, however, Administration officials now want to avoid serious disruptions in FFEL that could limit student access to loans.

NEC asked Treasury for an analysis of the effect of the July 1 interest-rate change. Treasury's internal analysis indicates that switching to the 10 year benchmark will increase hedging risk by roughly 60 basis points, confirming the lenders' claims that the change will reduce lender yield by up to 160 basis points. ED, NEC, and OMB are all in agreement that the Administration should be

willing at some future time to negotiate on the benchmark instrument (sticking with T-bills or perhaps adopting LIBOR). What's still at issue is what our starting point should be for negotiations, what rate we believe we should end up with, and what other legislative fixes we should try to get in return for lender relief.

This issue must be looked at in the context of other proposals affecting lender subsidies. There is wide variation in what is now in effect under current law, what is scheduled to go into effect on July 1, and what was included in the Administration's 1998 Budget and ED's proposals for 1999.

(Note: "Special allowance" is a Federal payment to noteholders when the borrower payment rate is below the guaranteed rate of return, or when T+3.1 is greater than 8.25%. Under current economic assumptions, ED is not projecting special allowance payments in 1999 through 2003. Default risk is the difference between a 100% Federal guarantee and the lender/holder default liability in the event of default.)

	Now in Effect: <u>Current Law</u>	July 1, 1998: <u>Current Law</u>	FY 98 Budget <u>FY 99 ED Request</u>	HRD 99 <u>Rec.</u>
In-school rate	T+2.5	10 yr + 1 (= T+2.1)	10 yr	10 yr +0.4 (=T+1.5)
Repayment rate	T+3.1	10 yr + 1 (= T+2.1)	10 yr + 1	10 yr + 1
Special allowance	Paid <u>qtr'ly</u> if borrower interest hits cap	Paid <u>qtr'ly</u> if borrower interest hits cap	Paid <u>annually</u> if borrower interest hits cap	Paid <u>annually</u> if borrower interest hits cap
Lender/holder Default risk	2 percent	2 percent	5 percent	2 percent

At present, OMB does not have any analysis that shows what combination of lender subsidy reductions is most defensible: how much can lender profits be squeezed without forcing out so many lenders that loan access is threatened. Changes to certain subsidies could have differential effects on different types of lenders. For example, reductions to the in-school interest rate are thought to hit

small lenders harder. Reducing the lender insurance rate would not significantly affect lenders/holders with effective servicing and low default rates such as Sallie Mae.

During the BBA negotiations, lenders/holders fended off cuts in their subsidies by claiming that their continued participation in the guaranteed loan program was already jeopardized by the scheduled July 1, 1998 interest rate change in current law. Throughout the summer and fall, Congress has given serious consideration to amendments to cancel the July 1 change, but has held off because of pressure from higher education and student associations and the Administration's firm position. Recently, representatives of the lending industry have told OMB that they could "live with" a rate of T- plus 2.75 percent (assuming no reductions in other subsidies). ED officials have signalled no interest in changing their 1999 policies, but ED staff acknowledge that their proposals were not based on analysis of how the proposals would affect lenders. Treasury has given very preliminary indications that lenders could live with an interest rate of T+2.1 (the current law equivalent), but have not been asked to factor in the other proposed subsidy cuts.

Proposals to pay the special allowance annually and to reduce lender insurance save the government money. Reducing student the student interest rate costs the government, while increasing the rate saves money. To illustrate, if the scheduled rate change were cancelled and the rate after July 1 remained at T+3.1, then:

- the Direct Loan program would save \$3 billion over five years, because of increased interest payments from students; and
- FFEL costs would increase by \$1 billion, because of increased default costs and special allowance payments to lenders.

On a net basis, the higher interest rate (about 100 basis points) would save \$2 billion for both programs combined.

Option 1 would openly acknowledge the work done by Treasury (already known to the banking community) and the conclusions that are being reached within the Administration regarding the unnecessary hedging risk. Shifting to T+2.1 would not raise the effective rate paid by students, but would reduce projected costs to holders and lenders by 60 basis points, and would thus be a major gesture and perhaps the starting point for an alliance with lenders aimed at program modernization. There are serious risks to this approach, however. Republicans in Congress could find a vehicle for passing the Administration's proposed interest rate change before July 1 and before HEA negotiations get in full swing.

Option 2 holds back from public view the endgame strategy and allows the interest rate issue to be used to its full advantage in negotiating GA restructuring and other program reforms. This strategy appears to be preferred by both NEC and Education, and HRD supports it. If the lenders are successful in getting Congress to move on this issue next spring, the Administration could adopt a

negotiating strategy with the following objectives:

- Students should be held harmless from the effect of an interest rate change.
- Savings through modernization (e.g., GA restructuring, electronic origination and reporting by lenders) should translate into lower interest costs for students and smaller administrative subsidies to guaranty agencies.
- If we cannot reach agreement with Congress and the FFEL community on an appropriate interest rate, the Administration could compromise with legislation that (1) annually lowers the maximum interest rate over a two or three year period, and (2) requires a study by a recognized non-partisan body (e.g., the National Academy of Sciences) on a methodology for setting the rate to go into effect July 1, 2000. This study could include an examination of possible auction models.

RECOMMENDATION: Option 2. Do not include any change to the July 1, 1998 interest rate in the higher education reauthorization. But task ED, under NEC tutelage and with OMB support, to engage in open discussion and debate on the issue involving the student groups, the college associations, and Republicans and Democrats on the Hill. Use Treasury analysts to run forums on the interest change. Keep attention focused on the tension between maintaining loan access (i.e., keeping banks in) and not hurting students (i.e., not increasing their net costs) and find other sources of savings for some movement on interest rates (i.e., GA restructuring and modernization of the relationship with banks). The debate should commence in December in a staged fashion so that by February/March, serious negotiations in a well informed climate can begin. Assuming no change in leadership at ED, a leadership role for NEC (Shireman) is essential.

OMB Predictions

in FY94 Budget

Year	3-month	10-year	Difference
1991	5.40	7.90	2.50
1992	3.50	7.00	3.50
1993	3.20	6.70	3.50
1994	3.70	6.60	2.90
1995	4.30	6.60	2.30
1996	4.70	6.50	1.80
1997	4.80	6.50	1.70
1998	4.90	6.40	1.50



These were the relevant projections (Administration)
at the time the decision was made in 1993
to go to 10-year plus 1 in 1998.

• 3-year + 3.10 would be 8.00%

• 10-year + 1.00 would be 7.40%

= a 60 basis point reduction in repayment,
and the same rate during in-school period.

GAO

United States
General Accounting Office

Notes

GAO

U.S. General Accounting Office
~~NGB Education & Employment~~
441 G St., NW, Washington, DC 20548

Health, Education, and
Human Services Division



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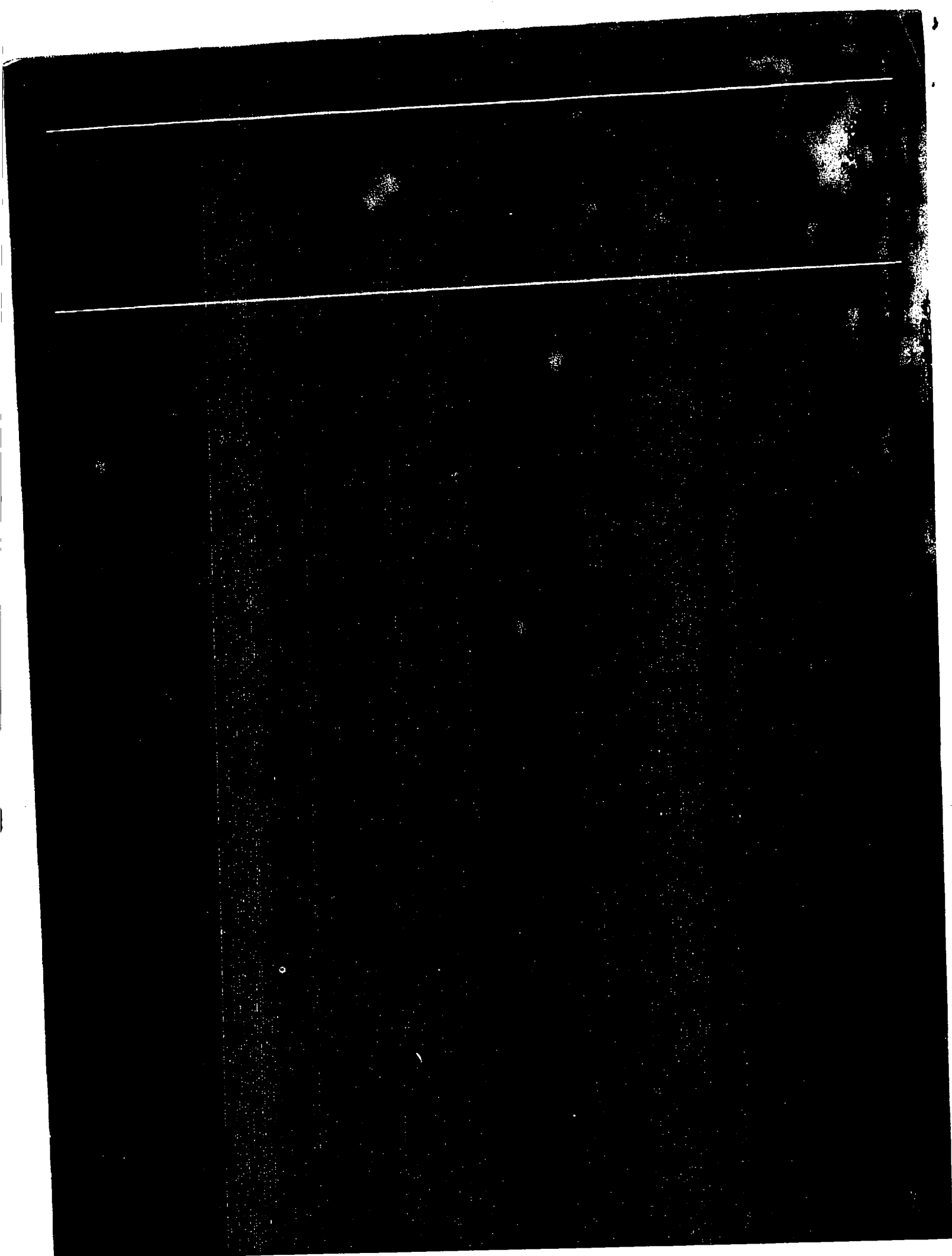
Difficult questions
should be directed
to Wayne Upshaw,
easy questions should
come to me

January 1992

STAFFORD STUDENT LOANS

Lower Subsidy
Payments Could
Achieve Savings
Without Affecting
Access





Human Resources Division

B-246534

January 6, 1992

The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

The Honorable William Ford
Chairman, Committee on Education
and Labor
House of Representatives

Student access to private loan capital has greatly improved since the inception of the guaranteed student loan programs. Initially, commercial lenders made student loans only to borrowers who resided in their state or local jurisdiction. This severely limited students' access to subsidized loans. To remedy this situation, the Congress established the current special allowance formula to attract a large number of financial institutions, thereby making student loans more readily available. Between fiscal years 1977 and 1985, the number of participating lenders increased from about 4,000 to over 11,000.

Since bank deregulation, however, the financial services industry has operated on a more sophisticated level. In particular, commercial banks now make loans across state lines through the use of regional branch-banking networks and bank holding companies. This process has helped transform the guaranteed student loan programs from a regional into a national operation, making the need for the current subsidy rate less clear.¹

The cost of the Stafford Student Loan Program has come under increased scrutiny by public policymakers. Cost-saving measures recently undertaken by the Congress have focused primarily on shifting costs to student borrowers by raising student loan interest rates, limiting program eligibility, and establishing unsubsidized loan programs. With reauthorization of the Higher Education Act serving as the backdrop, the Congress is exploring alternative ways to cut costs without adversely affecting the program's mission—to assure student accessibility to loan capital. This report focuses on probable program impacts if

¹Four separate programs now exist: the Stafford, Parent Loans for Undergraduate Students, Supplemental Loans for Students, and Consolidation Loans. The umbrella term for these programs is the Stafford Student Loan Program.

the Congress reduces the federal subsidy paid to commercial lenders who make or hold guaranteed student loans.

Many specialists in educational finance contend that lenders' profits from the subsidy are above the amounts needed to maintain adequate participation in the student loan program. Lowering this subsidy is an attractive option because a small reduction can generate significant savings. Our principal objective was to determine the effect that lower rates of return, as a consequence of reducing the subsidy rate, could have on the volume of Stafford loans supplied by commercial lenders.²

Background

Guaranteed student loan programs are the largest single source of federal financial assistance provided to students pursuing postsecondary education. Under present law, a student typically borrows from a commercial bank, which often sells the loan to another bank or financial institution. Each state establishes or designates an agency—called a guaranty agency—to, among other things, guarantee student loans within its jurisdiction. Guaranty agencies insure lenders against defaulted loans, and in turn are reinsured by the Department of Education. Guaranty agencies must also serve as or appoint a lender of last resort.

To insure an adequate stock of private loan capital, the federal government makes incentive payments—the special allowance—to commercial lenders who participate in guaranteed student loan programs. The special allowance is a quarterly supplemental interest payment intended to yield lenders a near-market rate of return. Lenders bill the Department of Education quarterly for their special allowance payments for the life of the loan. At \$1.7 billion, special allowance payments accounted for about one-third of the guaranteed student loan programs' costs in fiscal year 1989.

The Department has used a legislatively set formula tied to government securities to calculate special allowance payments since fiscal year 1977. Two components comprise the formula. The first component is set equal to the bond equivalent yield on 91-day Treasury bills. The second component is an additional interest supplement—the special allowance factor—of 3.25 percent. If the borrower's interest rate is below this guaranteed yield, the Department pays lenders the difference.

²Stafford loans comprised about 78 percent of guaranteed student loans made in fiscal year 1989.

The Congress has adjusted the special allowance payment formula in the past. The most recent adjustments occurred in 1986, starting with the Gramm-Rudman-Hollings budget sequester (Public Law 99-177). The sequester temporarily reduced the special allowance factor from 3.5 to 3.1 percent for new loans made between March 1 and September 30, 1986. The reduction applied to the first four quarterly subsidy payments for each loan made during that period. Subsequently, the Higher Education Amendments of 1986 reduced the special allowance factor from 3.5 percent—a factor that had prevailed since fiscal year 1977—to 3.25 percent for most new loans made after November 15, 1986.

Results in Brief

The rate of return most commercial lenders receive on Stafford loans is probably higher than the return necessary to retain them in the program. As such, moderate reductions to the special allowance could generate substantial savings without jeopardizing the program's reliance on private loan capital. A special allowance factor of 3 percent could generate cumulative savings of about \$421 million between fiscal years 1992 and 1996—a present value of \$344 million. This could, in turn, cause the cumulative loan volume from commercial lenders to decline by about 1 percent over the same period if loan supply remains insensitive to changes in the relative rate of return.

Guaranty agencies will continue to bridge the difference between student loan demand and loan capital supplied by commercial lenders through their direct loan programs. Historically, guaranty agencies have made between 1 and 7 percent of Stafford loan volume annually—adjusted for inflation. Guaranty agency lending accounted for about 3 percent of Stafford loans in fiscal year 1989. The guaranty agency lending necessary to offset the drop in commercial loans caused by a moderate reduction in the special allowance factor is well within their demonstrated lending capacity.

A reduction in the special allowance could increase the student loan market share controlled by large-scale commercial lenders.³ High-volume lenders have rarely left the program or curtailed their participation level. Therefore, a drop in future commercial loan supply caused by lowering the special allowance is likely to result from a few small-volume lenders leaving the program rather than a proportionate decrease by all

³Traditionally, a small proportion of lenders with high loan volumes make a substantial portion of all loans. For example, in fiscal year 1989 the 100 largest originating lenders comprised only about 1 percent of all program lenders but disbursed 60 percent of the dollar value of all Stafford loans.

lenders. To capitalize on economies of scale, high-volume commercial lenders may absorb some of the student loan market abandoned by these small lenders.

Scope and Methodology

We used multiple regression analysis—a standard statistical method—to measure the effect that a lower special allowance could have on the supply of Stafford loans made with private capital. Our statistical analysis focused on the relationship between commercial lenders' rates of return and the supply of Stafford loans they financed. This allowed us to predict the commercial supply of Stafford loans that corresponds to lower special allowances. Appendix I provides further details on our statistical methodology.

To supplement our statistical analysis, we also

- analyzed the lending activities of guaranty agencies to determine their capacity to continue financing Stafford loans with public funds,
- surveyed a judgmental sample of commercial lenders to determine the relative role profitability played in their student loan lending practices, and
- examined trends in commercial lender participation to determine if it changed since the latest revisions to the special allowance.

We obtained information from the guaranty agencies on the volume of Stafford loans they originated. As a safety-net feature, the student loan program relies on these institutions to safeguard student access to subsidized loans by supplementing private loan capital with public funds. As lenders of last resort, the law requires guaranty agencies to make loans to students who qualify for Stafford loans but are unable to obtain them from a commercial lender.

Large scale lenders dominate the student loan market and, as such, are vital constituents of guaranteed student loan programs. Therefore, we collected information on commercial lenders who originated a high volume of Stafford loans. First, we ranked commercial lenders in descending order based on loan volume for each fiscal year, 1977 through 1986. Second, we traced the lending activity of the lenders who accounted for at least 60 percent of Stafford loan volume for each fiscal year, 1977 through 1989. Third, we interviewed representatives from the 1977 lender cohorts who had either stopped, significantly reduced,

or recently started their participation. The respondents gave us information regarding the extent to which changes in student loan profits influenced their present lending practices.

We also analyzed the trends in the number of commercial lenders who have actively participated in the Stafford loan program. Under our definition, an active lender is one who made at least one Stafford loan during the fiscal year. This allowed us to quantify changes in lender participation rates and levels that have occurred since the last adjustment to the special allowance.

We performed our work between August 1990 and May 1991 in accordance with generally accepted government auditing standards.

GAO's Analysis

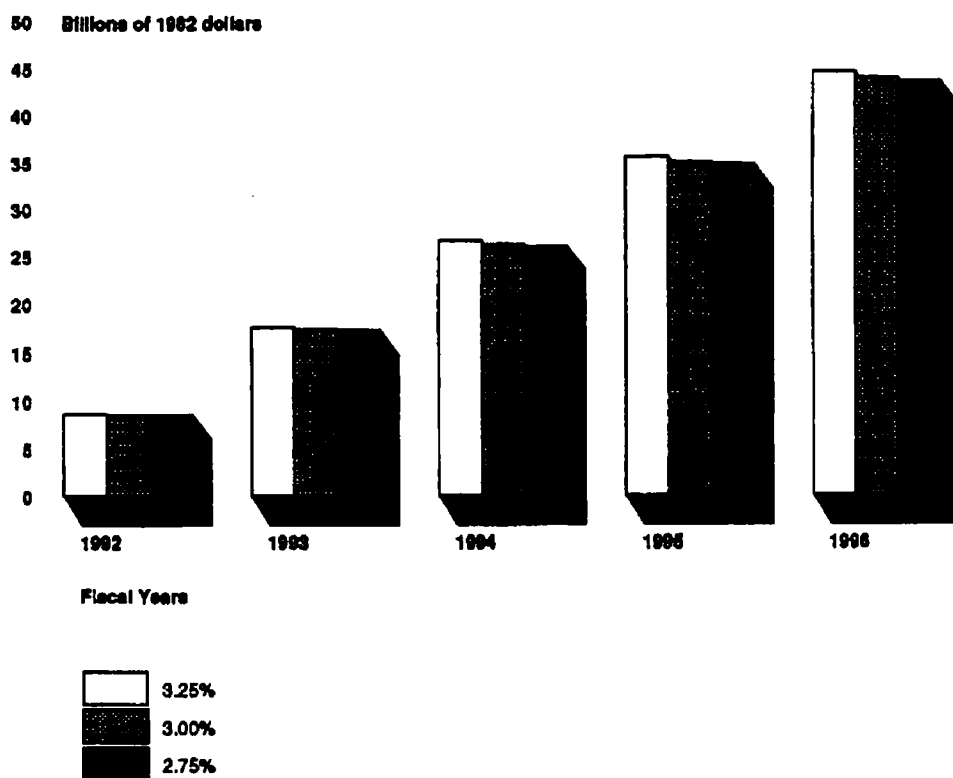
A Lower Special Allowance Should Cause Little Change in Commercial Lending

The commercial supply of Stafford loans has changed very little in response to fluctuations in the relative yield on student loans.⁴ This suggests that the rate of return to Stafford lenders is higher than what is necessary to maintain their interest in the program. For example, the 1986 reductions in the special allowance factor had no observable effect on lender participation in the Stafford program. The financial return on Stafford loans is high relative to comparable investments, so that other factors likely govern the program's supply of private loan capital. Therefore, we expect that a minor reduction in the special allowance factor would have a negligible effect on the commercial supply of Stafford loans.

To demonstrate the effect that lower special allowance factors could have on the commercial supply of Stafford loans, we generated a 5-year forecast of loan volume, assuming three different special allowance factors. The baseline forecast used the current factor of 3.25 percent. Our other two projections used special allowance factors of 3.0 and 2.75 percent, respectively. Figure 1 displays the results, expressed in 1982 dollars.

⁴The relative yield is the difference between the return on Stafford loans and the yield on 10-year Treasury notes.

Figure 1: Projected Commercial Loan Supply (1992-96)



Special Allowance Factors

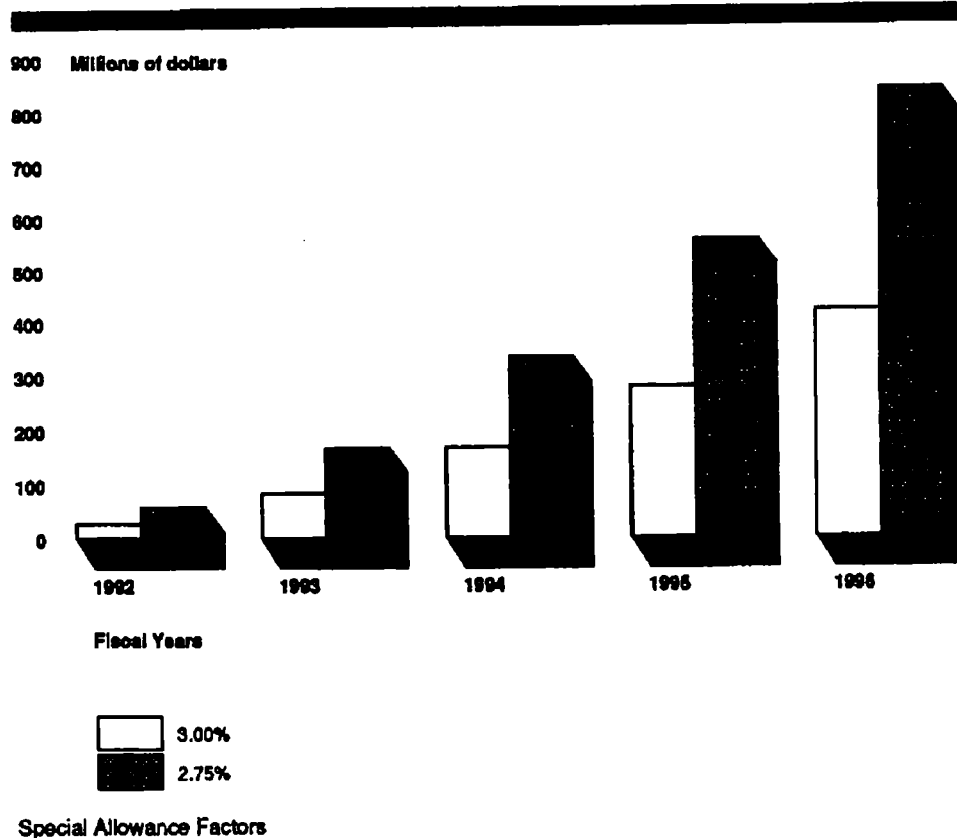
Figure 1 shows that future commercial loan supply is similar under all three scenarios. The disparity in the three forecasts results from different rates of growth. Under the baseline forecast, cumulative loan volume would reach about \$44.2 billion for the 5 years ending in fiscal year 1996—an average annual growth rate of 1.7 percent. For the same period, under different allowance factors, the results would be as follows.

- 3.0 percent: cumulative loan volume would reach about \$43.7 billion—an average annual growth rate of 1.4 percent—or about 1 percent lower than the baseline forecast.
- 2.75 percent: cumulative loan volume would reach about \$43.2 billion—an average annual growth rate of 1.2 percent—or about 2 percent lower than the baseline forecast.

A Smaller Special Allowance Means Significant Program Savings

Substantial program savings could accompany a moderate reduction in the special allowance factor. The savings are affected by lower subsidy rates rather than a lower quantity of loans. Figure 2 shows cumulative savings through 1996 if the special allowance factor is reduced to either 3.0 or 2.75 percent. This analysis assumes that the lower special allowance formula takes effect at the beginning of fiscal year 1992. Because guaranty agency lending would make up the difference between student loan demand and loans supplied by commercial lenders, our savings estimates do not reflect a decline in the overall supply of Stafford loans.

Figure 2: Potential Cumulative Savings Under Lower Special Allowance Factors (1992-96)



Because the lower subsidy factors would only affect new loans, the savings would be realized gradually over time. As the number of student loans subject to the reduced special allowance factor increases, the new rate would have a greater effect on program savings. After 5 years, the total savings associated with reducing the special allowance factor would be as follows.

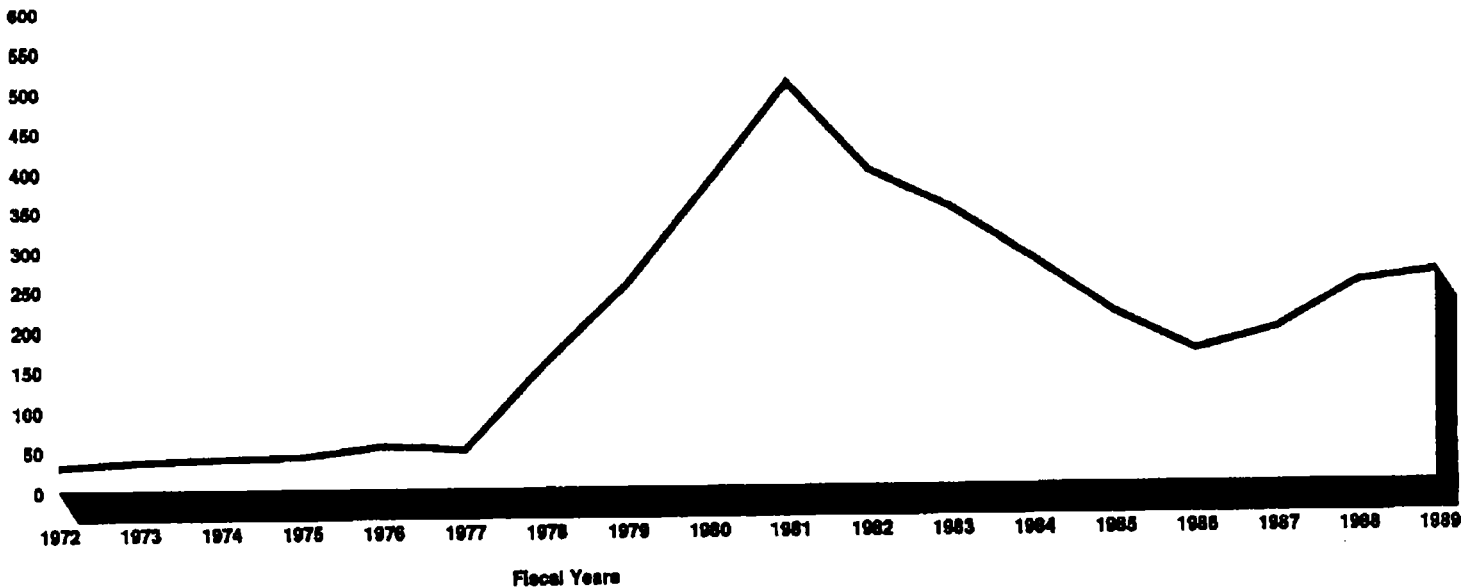
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- At 3.0 percent, savings would be about \$421 million—a present value of \$344 million.
 - At 2.75 percent, savings would be about \$838 million—a present value of \$685 million.

Guaranty Agencies Would Continue to Ensure Access

Guaranty agencies can readily fill the gap between student loan demand and commercial loan supply caused by a moderate reduction in the special allowance factor. In comparison to their historical lending activity, guaranty agencies' current Stafford loan volume is relatively small. Moreover, a recent surge in guaranty agency lending is attributable to some of the agencies voluntarily deciding to finance Stafford loans to students who are ineligible for the federal in-school interest subsidy. This suggests that—in terms of making loans to qualifying students—the guaranty agency lending structure has the capacity to accommodate additional demand.⁵

Figure 3 illustrates how guaranty agencies' Stafford loan volume has changed over time.

⁵Although the law obligates guaranty agencies to offset private loan capital shortfalls, we believe—for the ranges we specify—the agency lending induced by a moderate reduction in the special allowance factor is (1) an appropriate supplemental measure and (2) consistent with using direct loan programs as a safety net for student borrowers.

Figure 3: Guaranty Agency Stafford Lending by Dollar Volume (1972-89)

Source: Department of Education

Guaranty agency lending peaked at \$502 million in fiscal year 1981, adjusted for inflation. This peak had declined to \$259 million—a 48-percent reduction—by fiscal year 1989. As a percentage of dollar volume, guaranty agency lending peaked at 7.4 percent in fiscal year 1979. Guaranty agencies accounted for about 3 percent of Stafford loans originated in fiscal year 1989.

Legislative changes and program maturity explain the most notable patterns in guaranty agency lending that occurred between fiscal years 1977 and 1981, and fiscal years 1986 and 1989. Between 1977 and 1981, the volume of Stafford loans made by guaranty agencies increased almost 1,000 percent—from \$48 to \$502 million. This coincided with the implementation of the Middle Income Assistance Act of 1978, which greatly expanded the pool of eligible students but preceded the widespread private sector participation exhibited today.

Beginning in 1981, guaranty agencies' Stafford loan volume declined for 5 consecutive fiscal years. Initially, this was due in part to a needs test that required Stafford loan applicants with incomes greater than

\$30,000 to show need to qualify for federally subsidized loans. Consequently, the pool of eligible applicants contracted. Moreover, as the program's popularity grew with lenders, the need for guaranty agencies to make loans diminished. Between fiscal years 1977 and 1981, the number of commercial lenders and their volume of loan originations grew by about 90 percent and 685 percent, respectively.

Changes mandated by the Higher Education Amendments of 1986 appear largely responsible for the recent growth in guaranty agency lending. This legislation requires, among other things, that all Stafford loan applicants show need in order to qualify for a federally subsidized loan. In an attempt to "re-enfranchise" the middle class, some guaranty agencies began making Stafford loans to students displaced by the needs test.⁶ As a result of these special loan programs, guaranty agency lending increased by almost 80 percent between fiscal years 1986 and 1989.

High-Volume Lenders Seldom Leave the Program

High-volume commercial lenders—those most crucial to the program's success—rarely leave the Stafford loan program. We defined the largest lenders as those included in the cohort that accounted for at least 60 percent of Stafford loan originations in fiscal years 1977 through 1986. We measured program retention by determining what proportion of these lenders continuously participated through fiscal year 1989. The retention rates for the lender cohorts ranged from 98 to 100 percent.

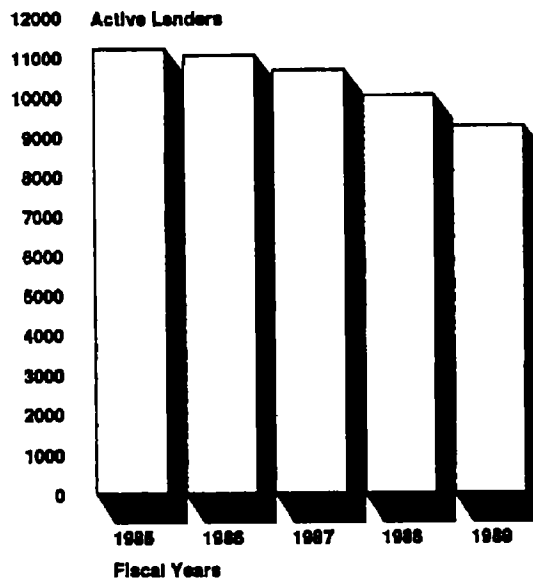
Our survey indicated that high-volume lenders discontinue or curtail their participation generally for reasons other than dissatisfaction with student loan profits. For illustrative purposes, consider the cohort of commercial lenders in fiscal year 1977. The top 160 lenders accounted for about 62 percent of all Stafford loans made in that year. We found that 156—about 98 percent—made Stafford loans in 1989. Only 2 of the 4 lenders who no longer originate loans stopped because of their dissatisfaction with student loan profits.

⁶ Although these loans are guaranteed against default, guaranty agencies usually do not receive special allowance payments for them.

A Lower Special Allowance Could Result in More Loans by Fewer Lenders

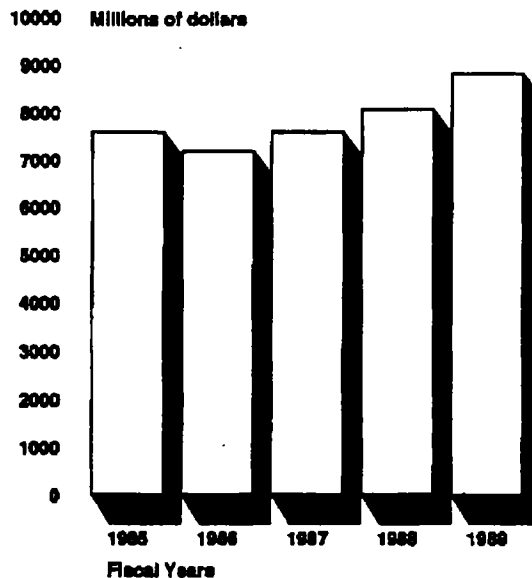
A reduction in the special allowance factor could accelerate the trend toward reducing the number of participating lenders and concentrating the student loan market among large-scale lenders. Since the 1986 revisions to the subsidy, Stafford loan volume from commercial lenders has risen in spite of a decline in the number of active lenders. Figures 4 and 5 show the trend in commercial lender participation between fiscal years 1985 and 1989.

Figure 4: Active Lenders, in Thousands (1985-89)



Source: Department of Education.

Figure 5: Amount of Stafford Loans Made by Commercial Lenders (1985-89)



Source: Department of Education.

Before fiscal year 1985, the number of commercial lenders who made Stafford loans had increased each year since the program's inception. The number of lenders has declined slightly each year since 1985, from 11,179 to 9,207 or about 18 percent by fiscal year 1989. During this same period, however, the dollar value of Stafford loans made by commercial lenders increased about 16 percent, from \$7.6 to \$8.8 billion.

During this same period, the proportion of commercial lenders who made the largest share of Stafford loans had also declined. The largest 230 commercial lenders accounted for 60 percent of Stafford loans made in fiscal year 1985. By fiscal year 1989, the largest 100 lenders accounted for the same percentage of Stafford loans.

Because commercial lenders with high volumes rarely leave the program, the subsidy reductions probably forced some marginal lenders to leave. This kind of "market shakeout" is common among industries, such as student loan operations, that exhibit economies of scale.⁷ In the student loan market, some low-volume lenders who were unable to take advantage of economies of scale in their operations discontinued their

⁷Economies of scale exist when lower unit costs are achieved by expanding the scale of operation—increasing output. In such situations, smaller scale operations tend to be inefficient; that is, their average total costs are greater than in a larger scale enterprise.

student loan business. It is likely that larger, more efficient lenders absorbed these vacated market shares. We believe that another reduction in the special allowance would add momentum to this trend.

Limitations of Our Statistical Analysis

Our forecasts of commercial loan supply expected under lower special allowance factors should be viewed with caution. The forecasts are predicated on the relationship between loan supply and the relative rate of return on Stafford loans described by the regression equation. A regression model's scope is restricted ordinarily to the interval of values observed during the analysis period, in this case the range of changes in relative returns received by lenders between 1973 and 1989. The linear regression model appears appropriate for estimating the change in loan supply associated with reductions to the special allowance that fall within this range. In particular, we believe that it adequately supports our recommendation for a reduction of the special allowance to 3.0 percent. Using the regression results to estimate the effect of a reduction that falls far outside the observed range would be hazardous because we cannot be sure that the regression equation that fits the past data is appropriate over a wider range of values.

Conclusion

A modest reduction to the special allowance factor could help reduce the costs of guaranteed student loan programs to the federal government, yet still provide enough incentive to ensure adequate levels of commercial lender participation. A lower special allowance factor would achieve substantial program savings without (1) adversely affecting the Stafford loan program's reliance on loan capital supplied from the private market, (2) attenuating students' access to subsidized loans, or (3) discouraging the segment of commercial lenders most vital to the program from participating. We estimate that reducing the special allowance factor to 3 percent would result in about a 1-percent decrease in projected commercial loan volume. Any reduction in participation by lenders is likely to be balanced at least in part by increased volume from high-volume lenders.

Recommendation

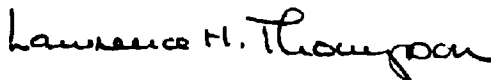
We recommend that the Congress lower the special allowance factor to 3 percent.

Agency Comments

The Department of Education, the Student Loan Marketing Association (Sallie Mae), and two national trade and professional associations for

commercial banks—the Consumer Bankers Association, and the American Bankers Association—provided written comments on a draft of this report. While the Department generally agreed with our findings and recommendation, it suggested undertaking concurrent legislative measures to reinforce the financial condition of guaranty agencies. Sallie Mae and the two trade associations, citing inadequate profits for lenders, recent declines in lender participation, and guaranty agencies' inability to fill the ensuing gap between Stafford loan demand and supply, expressed misgivings about our conclusions and recommendation. Appendix III contains our evaluation of their comments.

We are sending copies of this report to the Secretary of Education, other congressional committees, and other interested parties. This report was prepared under the direction of Franklin Frazier, Director, Education and Employment Issues, who can be reached on (202) 275-1793. Other major contributors are listed in appendix V.



Lawrence H. Thompson
Assistant Comptroller General

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Abbreviations

ABA	American Bankers Association
CBA	Consumer Bankers Association

Statistical Methodology

We used multiple regression analysis to quantify the impact of lower special allowance factors on the commercial supply of Stafford loans. Our task involved estimating a commercial supply curve for Stafford loans.¹ With regression analysis we estimated the commercial loan volume associated with changes in the difference between the return on student loans and the yield on Treasury bonds, while controlling for the effects of other supply-related variables. With the results of this statistical technique, we predicted the volume of Stafford loans that corresponded to lower special allowance factors.

Before specifying the final regression equation, we conducted diagnostic tests to identify possible violations of the assumptions underlying the general linear model. The results indicated cointegration between the natural logarithms of commercial loan volume and activities of the Student Loan Marketing Association (Sallie Mae). Therefore, our analysis consisted of a two-step estimation procedure: a long-run model and an error-correction model that captured the short-run dynamics.

Data Sources

The data used to specify the regression models came from three different sources. The Department of Education supplied the information on total Stafford loan commitments. Guaranty agencies provided data for the years in which they made Stafford loans.² Lastly, Sallie Mae provided the information on its loan purchasing and warehousing activities. The database is expressed in 1982 dollars and contains 67 quarterly observations from first quarter 1973 through third quarter 1989. Each independent variable is defined in appendix II.

For our 5-year forecast of Stafford loan volume, the Congressional Budget Office provided us with projections on the unemployment rate, the 91-day Treasury bill (T-bill) rate, and the yield on 10-year Treasury notes.

¹Because market observations typically entail only equilibrium prices and quantities, separating out demand and supply effects—termed the identification problem—is difficult. However, the identification problem does not exist in the guaranteed student loan market. Student loan demand and commercial loan supply are not equal, and both are observed separately. Throughout the program's history, student loan demand has exceeded commercial loan supply. Guaranty agencies have made up the difference either in their role as lenders of last resort or under specialized loan programs that serve students who fall outside of the program's intended target group.

²For our modeling, we defined the volume of commercial lending as the difference between these two sources.

Regression Equation for Long-Run Model

Commercial loan volume—expressed in natural log form—is the long-run model's dependent variable. Table I.1 displays the long-run model's regression coefficient estimates and their associated standard errors. The coefficient estimates show a direct relationship between commercial loan volume and Sallie Mae activities; a 10-percent increase in Sallie Mae activities increases commercial student loan volume by almost 5 percent. This is expected because the Congress created Sallie Mae for the sole purpose of providing capital to commercial lenders so that they can make student loans. Events that provide more lending capital, such as increases in Sallie Mae's activities, would increase commercial student loan volume. Conversely, events that reduce lending capital would reduce commercial loan volume.

Table I.1: Regression Equation for Long-Run Model^a

Variable	Regression coefficient	Standard error
Sallie Mae warehousing and purchasing	0.4706 ^b	0.0534
Constant	-2.6919 ^b	0.3152
R ²	0.5370	

^aThe dependent variable is commercial loan volume. Variables are expressed in natural log form.

^bSignificant at 5-percent level of confidence

Regression Equation for Short-Run Model

Change in commercial loan volume—also expressed in natural log form—is the short-run model's dependent variable. We estimated the short-run model using the error-correction term—calculated from the long-run model—as a regressor. The regressor is the one-period lag of the residual from the long-run model. The sign of this coefficient is negative. When transitory conditions cause loan supply to move above its long-run equilibrium during one period, loan supply will decline in the next period. Table I.2 shows the results of the short-run error-correction model.

Table I.2: Regression Equation for Short-Run Model

Variable	Regression coefficient	Standard error
Change in relative rate of return	-0.0075	0.0149
Lagged change in relative rate of return	0.0453 ^b	0.0148
Change in unemployment rate	0.0066	0.0366
Second quarter	0.1533	0.2473
Interaction term—second quarter/trend	0.0282 ^b	0.0113
Second quarter interaction term squared	-0.0003 ^b	0.0001
Third quarter	1.1645 ^b	0.2703
Interaction term—third quarter/trend	0.0256 ^b	0.0119
Third quarter interaction term squared	-0.0003 ^b	0.0001
Fourth quarter	0.4494 ^c	0.2325
Interaction term—fourth quarter/trend	-0.0222 ^c	0.0109
Fourth quarter interaction term squared	0.0002 ^c	0.0001
Trend	-0.0034	0.0091
Trend squared	0.0001	0.0001
Gramm-Rudman-Hollings	-0.0251	0.0774
Lagged-error correction term	-0.1595 ^c	0.0818
Rho	0.1124	0.1646
Constant	-0.5164 ^b	0.1894
R ²	0.9790	

*The dependent variable is the change in the Natural Log of commercial loan volume.

^bSignificant at 5-percent level of confidence.

^cSignificant at 10-percent level of confidence.

The coefficient estimate associated with the variable of interest—the rate of return—is negative, which is the “wrong” sign. More important, however, the estimate is very small and not statistically significant at any of the conventional confidence levels. This suggests that commercial loan volume is unresponsive to variations in lenders’ rate of return within the observed ranges.

On the other hand, the coefficient associated with the one-period lag of rate of return is positive and statistically significant. Although this coefficient is also fairly small, it suggests that lowering the rate of return would have a negative effect on commercial loan supply in the following quarter. Based on this coefficient, a 1-percentage-point cut in the special allowance factor would reduce commercial loan volume by about 4.5 percent.

In specifying our regression models, we may have omitted several variables that could affect student loan volume. However, our analysis of the regression's residuals did not indicate any systematic pattern of exclusion. As specified, the most influential variables are the seasonality terms, lagged change in the rate of return, and the error-correction term.

Variables Used in the Regression Models

Sallie Mae Activities	Serves as a proxy for the secondary market for guaranteed student loans. Secondary market participants purchase loans from originating lenders, thereby providing them money to make new loans. Sallie Mae holds about 50 percent of all guaranteed student loans.
Change in Relative Rate of Return	The one-period change in the difference between the rate of return on Stafford loans and the yield on 10-year Treasury notes. It is an indicator of the return from Stafford loans relative to comparable investment opportunities.
Lagged Change in Relative Rate of Return	Measures the change in the relative rate of return from two periods ago to the previous period.
Change in Unemployment Rate	Measures the change in the unemployment rate from the previous period to the current one. The unemployment rate captures effects on commercial loan volume associated with business cycle fluctuations.
Quarterly Indicators and Interaction Terms	Capture the fluctuations in loan volume that occur seasonally over the course of the year.
Trend/Trend Squared	Capture any tendency of loan volume to exhibit increases or decreases over time that are unexplained by the other variables.
Gramm-Rudman-Hollings	Captures the uncertainty related to the return on student loans caused by the possibility of Gramm-Rudman-Hollings sequestrations.
Lagged-Error Correction Term	Captures the deviations from loan volume predicted by the long-run model, lagged one period.

Agency Comments and Our Evaluation

The Department of Education, the Student Loan Marketing Association (Sallie Mae), and two associations representing commercial banks—the Consumer Bankers Association (CBA) and the American Bankers Association (ABA)—commented on a draft of this report.

The Department of Education

The Department generally concurred with our findings and expressed support for our recommendation, along with some reservations. Notably, the Department suggested that the Congress develop new lender-of-last-resort provisions in conjunction with a reduction to the special allowance factor. While we are not in a position to make such a recommendation, given the critical role of loan assistance, we acknowledge the merit of strengthening the program's safety net. Therefore, we encourage the Department to submit a proposal pursuant to this goal regardless of whether the Congress lowers the special allowance factor.

Sallie Mae, CBA, and ABA

Our evaluation focuses on three prominent concerns identified by Sallie Mae, CBA, and ABA. These include low profitability of student loans, recent declines in lender participation, and guaranty agencies' inability to increase lending activity. These organizations also referred to concerns about lender practices and program conditions that lack major implications to the Stafford program and, therefore, we did not address them.

Low Profitability of Student Loans

All three organizations claimed that Stafford loans are barely profitable. Each cited a recent CBA study that showed the average pretax yield on student loans is 89 basis points, or less than 1 percent, which compares unfavorably to other types of loans.¹ They also asserted that a reduction in the special allowance factor would further reduce the profit level and drive many lenders out of the student loan business. Also, CBA suggested that 10-year Treasury notes are not appropriate for computing the relative profitability of Stafford loans.

Our statistical modeling indicated that changes in commercial loan volume were invariant to changes in the relative rate of return. This suggests that the rate of return on Stafford loans was higher than the return required to maintain the level of commercial loan volume needed to meet student loan demand. Empirical support for this contention was

¹One hundred basis points equal 1 percentage point.

provided in 1986 when commercial loan volume did not decrease noticeably as a result of the 25-basis-point reduction. Our regression analysis indicates that another small reduction would not materially affect loan volume.

We selected the yield on 10-year Treasury notes to calculate historical relative rates of return on Stafford loans, because this investment instrument entails a comparable risk factor and expected income schedule. Besides using the 10-year Treasury notes, we also compared lenders' relative rates of return from Stafford loans to other investments with similar risk and maturities, such as municipal and state bonds. We found that the gross return from student loans was consistently higher than the return on these investments and, on average, higher than the return on several other comparable investments.

Recent Declines in Lender Participation

Sallie Mae, CBA, and ABA referred to reductions in the number of lenders participating in the student loan program. CBA and Sallie Mae note that lender participation declined 29 percent from 1987 to 1990, with Sallie Mae emphasizing the drop in 1990.

The Stafford program is primarily intended to serve students, and as such, we believe the proper concern is with the commercial student loan volume supplied, not the number of participating lenders. Although throughout the program's history some lenders have withdrawn from the program as loan volume increased, market share has become more concentrated among the largest lenders—those most critical to the program's success. Our review of lender participation data shows that the largest lenders seldom discontinue or curtail their participation. For example, only 2 of the largest 160 commercial Stafford loan lenders in 1977 had withdrawn from the program as of fiscal year 1989.

When we began our review, data on the Stafford program only extended to fiscal year 1989. However, our analysis incorporated the declines in commercial loan volume occurring in fiscal years 1977 (5 percent), 1982 (25 percent), and 1986 (4 percent), which were all of greater magnitude than the approximate 1-percent drop in 1990 reported by Sallie Mae. Including 1990 data would not alter the results reached or the conclusions drawn by our work.

We agree that the Stafford program's 1990 statistics warrant careful review. However, given the relatively minor drop in commercial loan

volume, diagnosing 1990 as the beginning of a long-term condition would be premature.

Guaranty Agencies' Inability to Increase Lending Activity

Sallie Mae, CBA, and ABA expressed doubts that guaranty agencies can make up for the potential drop in commercial loan volume expected to accompany a reduction to the special allowance factor. ABA suggested that lenders will first reduce loans to students attending trade schools, causing guaranty agencies to increase their lending to the highest-risk borrower population. Sallie Mae noted that legal constraints prohibit many guaranty agencies from making direct loans, and that three guaranty agencies performed most of the direct lending undertaken in 1989.

For the ranges specified in the report, we anticipate that only a moderate decline in commercial loan volume would accompany a reduction to the special allowance factor. This leads us to believe that guaranty agencies can bridge the gap between loan demand and commercial loan supply, even if that entails making more loans to riskier students. Guaranty agency costs may rise, because loans to high-risk students might be more expensive to service and collect, but the underlying capacity exists.

The law requires states to serve as the ultimate lender of last resort. Some states that do not allow their guaranty agencies to make direct loans instead funnel public funds through their agencies to third parties, such as nonprofit educational foundations, who administer direct loan programs on their behalf. In other cases, commercial banks perform lender-of-last-resort functions for guaranty agencies. Our report does not account for the lender-of-last-resort activities of commercial banks and thereby may actually understate the historical levels of direct lending. Also, Sallie Mae—at the Secretary of Education's request—can make direct loans to satisfy any student loan demand unmet by commercial institutions and guaranty agencies.

Comments From the Department of Education



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF POSTSECONDARY EDUCATION

SEP 10 1991

Franklin Frazier, Director
Education and Employment Issues
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to review the GAO Draft Report, "Stafford Student Loans: Lower Subsidy Payments Could Achieve Savings Without Affecting Access," GAO/HRD 91-100, issued July 30, 1991.

All participants in the Stafford Loan Program can, and should make a contribution to reducing costs and improving the effectiveness of that program. The Department also agrees with your conclusion that a moderate reduction in the special allowance, from the present 3.25 percent to either 3 or 2.75 percent could generate significant cost savings in the Stafford Loan Program. Therefore, the Department sees merit in the change you suggest. In our Reauthorization proposal, the Administration has already proposed to reduce the special allowance to 3 percent for lenders with cohort default rates above 20 percent. We would have few problems implementing this reduction in our operations.

We believe that your analysis that a reduction in the special allowance would accelerate the current trend of smaller lenders discontinuing their participation in the Stafford Loan Program is correct. We share your view that this action would further concentrate student loan activity at a few hundred large lenders.

However, a special allowance reduction must be carefully studied before reaching a decision. Your analysis indicates that the 1986 reduction in the special allowance from 3.5 percent to 3.25 percent had no observable effect on lender participation in the Stafford Loan program. A recent Department study, Lender Profitability in the Student Loan Program, also found that current Stafford Loan subsidies provide a high level of profitability. That study found that Stafford Loans are currently more profitable than many other lending activities, and pose substantially less risk than many other types of loans because of the Federal guarantee. However, several recent trends in the Stafford Loan program have emerged which did not exist in 1986 and the 1985-89 period of the Department's study.

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202

Page 2 - Franklin Frazier

These trends have already had an impact on loan profits and have affected loan access for students. These are:

- o Guarantee agencies are scrutinizing lenders' default claims more closely, and guarantors have increasingly denied claims because of the lender's failure to comply with due diligence requirements;
- o Secondary markets are having trouble arranging financing and this has resulted in less liquidity and driven some lenders from the program; and
- o Lenders have begun to restrict lending to students attending trade schools because those loans are less profitable because of their higher operational costs, lower average loan amount, and shorter in-school periods.

The Administration is committed to increasing access to postsecondary education, enhancing choice, and ensuring the financial stability of guarantee agencies. We must be careful that any reduction in special allowance does not interfere with our achievement of these objectives.

Therefore, we assume that while Stafford Loans would continue to be profitable under a reduced special allowance, the combination of a reduced subsidy and higher costs incurred from denied default claims will shift lenders away from making less profitable loans. In turn, this will create a greater demand on guarantee agencies who are required to serve as the Lender of Last Resort. Some guarantee agencies simply could not meet a high demand, and this could negatively affect the financial stability of others. New Lender of Last Resort legislative provisions should be developed in combination with any special allowance reduction to preserve loan access to students and to safeguard the financial stability of guarantee agencies.

Thank you again for this opportunity. If you have any questions, please contact Ernst Becker, Director of the Division of Quality Assurance at 708-5620.

Sincerely,


Michael J. Farrell
Acting Assistant Secretary

Comments from the Student Loan Marketing Association

STUDENT LOAN MARKETING ASSOCIATION
1050 Thomas Jefferson Street, N.W.
Washington, D.C. 20007-3871
202-298-3075

ALBERT L. LORD
Executive Vice President and
Chief Operating Officer

August 26, 1991

Mr. Joseph J. Eglin, Jr.
Assistant Director
U.S. General Accounting Office
Human Resources, Division
GAO Building
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Eglin:

We appreciate the opportunity to comment on the GAO draft report regarding possible changes to the Special Allowance paid on guaranteed student loans. You can be certain we have considered your report carefully. We believe the observations and conclusions to support GAO's recommendation for a 50 basis point reduction in the Special Allowance are seriously flawed.

The central conclusion of the GAO report is that aggregate GSL lending volume will be reduced only minimally by the proposed 50 basis point reduction in lender compensation. Important to this conclusion is your assertion that guarantors, acting as lenders of last resort, will mitigate the loss of commercial lender support.

This letter addresses, in some detail, the key assumptions made in your report. As a general observation, however, we struggle with your concept that commercial banks will continue to participate in this program virtually without compensation (the average after-tax return of the student loan would fall to about 25 basis points). Further, we believe there is substantial wishful thinking involved in the notion that guarantors have the capital and capability to be significant direct lenders.

Current information on the GSLP lending activity by commercial lending institutions and guaranty agencies provide no basis for these conclusions. Sallie Mae is a keen observer of the economics of student lending as well as the behavior of commercial lenders and guarantors. Our view as to the effect of GAO's proposed special allowance reduction is very different than your conclusion. Congressional reliance on the GAO's reported findings would imperil future GSLP access for a significant population of eligible borrowers.

Mr. Joseph J. Eglin, Jr.
August 26, 1991
Page Two

We believe the GAO's prediction of a \$1 billion decline in lending attributable to the recommended cuts in the Special Allowance is grossly understated. But even if GAO's conclusion were to be close to correct, we view seriously the significance of that \$1 billion decline in loans to students. We do not dismiss so lightly borrowers' loss of access to nearly 400,000 student loans.

Our detailed observations follow:

ASSESSMENT OF COMMERCIAL LENDER COMMITMENT TO GSLP PARTICIPATION

"A lower Special Allowance should cause little change in commercial lending." (GAO Report, p. 7)

Recent trends in commercial lender GSLP participation indicate that such lending is in a critical period. From 1987 to 1990, commercial lender participation in the GSLP declined by about 29%, with the largest decrease occurring in 1990 (see Exhibit I). The decline of commercial lender GSLP participants (28.6%) exceeded the decline in total U.S. financial institutions (17.75%). Approximately 38% of GSLP lender withdrawal was voluntary as differentiated from those resulting from institutional merger or failure. This circumstance indicates to us that commercial lender support for the GSLP has waned substantially since 1986. We expect further erosion in support even without a change in the Special Allowance.

In support of its case for further reduction of the Special Allowance, the GAO has, based principally on anecdotal information, surmised that "When large-scale lenders discontinue or curtail their [GSLP] participation, it is generally for reasons other than dissatisfaction with student loan profits" (GAO Report, p. 13). This notwithstanding the fact that in the same paragraph the GAO acknowledges that 50% of lenders it surveyed who ceased originating loans did so because of dissatisfaction with student loan profits. We believe that all program participants are motivated by compensation which appropriately rewards risk taking. The other reasons (not enumerated in your report) lenders may have cited, such as program complexity, onerous due diligence requirements, high program administration expense, losses due to default claim rejection, etc., all translate into profitability-related concerns. We suspect more than 90% of lender terminations are caused by compensation insufficient to cover the risks in the GSLP.

In asserting that "The rate of return most commercial lenders receive on Stafford loans is probably higher than the return necessary to retain them in the program" (GAO Report, p. 4), the GAO directly contradicts our experience with the largest lenders in the program. The GAO overstates the real return on the GSL and

Mr. Joseph J. Eglin, Jr.
August 26, 1991
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understates banks' required return on assets. Heightened concern about bank capital has focused their attention on asset returns. As a rule of thumb, well run banks have after-tax asset returns of about 100 basis points--not the 25 basis points after-tax return contemplated in the proposed cut. GAO also overstates the profitability of GSLP assets when compared to other bank lending and seems to dismiss other factors that have reduced GSLP profitability well beyond the 25 basis point Special Allowance cut in 1986. Specifically, these factors are:

- o Introduction of substantial lender risk-sharing, accordingly, a substantial increase in loan losses;
- o Increased complexity and costs; and
- o A resultant reduction in the student loan's liquidation value in the marketplace.

We strongly believe that 1990 was a turning point in commercial lender perception of GSLP participation. As the higher earnings contributions of loans eligible for the payment of a T-bill + 3.50 special allowance have declined, lenders have become far more aware of the lower net return and more sensitive to increasing servicing costs. Increasingly, commercial lenders have ceased program participation or are adopting short-term GSLP strategies designed to facilitate withdrawal from the program should the value of participation further deteriorate. The most visible of these strategies include:

- o Cessation of lending to high cost/high risk segments of the student borrower population.
- o Transfer of GSLP origination and servicing functions to a third-party agent to eliminate further investment in GSLP operations.

As has been widely noted by the industry's most experienced observers, the net effects of lender response to declining portfolio profitability over the last 24 months have been:

- o The well-publicized diminution of GSLP access for certain proprietary school and community college students.
- o A withdrawal of "national" and regional lenders from what are perceived as low-profit state markets.
- o Commercial lender refusal to provide funding for guaranty agency-sponsored loan of last resort programs.

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Page Four

- o Concentration of high-volume GSLP servicing capability among relatively few contract servicing organizations that currently service 87% of all outstanding GSLP loans.

These effects were concretely evidenced in 1990 when, for the first time since 1986, commercial lenders' GSLP origination volume declined (see Exhibit II). This decline was not addressed in the GAO Report. This 1990 drop in loan volume occurred in a period in which there was no evidence of a corresponding decline in loan demand. In fact, enrollment and education cost statistics suggest an increase in loan demand. This reduction in commercial lender-generated loan volume directly contradicts the GAO's assumption that large lenders who continue GSLP participation will fully absorb unmet loan demand resulting from cessation of lending activity by former GSLP lenders. Moreover, the current existence of localized access problems points up the weakness in the GAO's failure to acknowledge important differences in geographic and school sector-based support among commercial lenders. Failure to acknowledge these differences will inevitably lead to dubious conclusions regarding the potential impact of further reduction in the Special Allowance on loan access.

ASSESSMENT OF THE RELATIVE PROFITABILITY OF GSLP ASSETS

"The financial return on Stafford Loans is high relative to comparable investments." (GAO Report, p.7)

Our examination of the relative net rates of return on various consumer loan products that constitute "comparable investments" to GSLP loans reveals that the GAO's conclusion on this point is simply incorrect. In fact, comparative average 1989/1990 net return data released by the Consumer Bankers Association and the Federal Reserve indicates that the average net return on student loan is substantially below that of other types of consumer loans. Specifically, an analysis of 1989 pre-tax returns on various guaranteed and consumer loan products delivered through commercial lending institutions (see Exhibit III) reveals that:

- o The average Guaranteed Student Loan produces a net yield of 89 basis points.
- o The average unsecured consumer loan portfolio produces a net yield of 230 basis points--nearly three times that of a GSL portfolio.
- o The average portfolio of 100% guaranteed/collateralized SBA loans produces a net return of 267 basis points--three times that of a GSL portfolio.

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- o The average credit card portfolio produces a net return of 328 basis points--nearly four times that of a GSL portfolio.

Each of the returns set forth above is net of credit losses to be comparable to GSL returns.

The above consumer loan return information is in marked contrast to the assertion made by the GAO. Since there is no source data referenced by GAO, we are not able to square their observations with the industry-provided statistics. Not surprisingly, we conclude from the above comparisons that the more than 50% cut in net earnings inherent in the GAO's recommended Special Allowance reduction would precipitate broad-based reevaluation of GSLP participation among large, mid-size and small commercial lenders. At a minimum, one could expect banks to focus their support on the least costly segment of the student loan market.

ASSESSMENT OF GUARANTY AGENCY CAPABILITY TO ASSURE ACCESS

"Guaranty agencies would continue to assure access." (GAO Report, p. 10)

Based on its assertion that "Guaranty agencies can readily fill the gap between student loan demand and commercial loan supply" (GAO Report, p. 10), it appears that the GAO views the guaranty agency community as a ready and able "access assurance fall-back" if lender participation were to decline to or beyond the level forecast by the GAO as a consequence of a second cut in Special Allowance. We find no evidence in the report or elsewhere to support this view and, conversely, find considerable evidence to support the view that guaranty agencies cannot be counted on to serve as "safety nets" for borrowers displaced from the program. This view is supported by the following observations:

- o A large number of guaranty agencies are not legally empowered under their existing charters to engage in direct lending activity. Those that are so empowered are generally limited to making loans to either residents of or students attending schools in their designated state of operation.
- o Many guaranty agencies currently do not have the operational ability to implement and administer direct lending programs. They cannot be expected to be uniformly responsive to satisfying unmet loan demand in their states via a direct loan program. As a group they lack the efficiencies to originate loans within the cost limits

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imposed under a reduced Special Allowance payment structure.

- o Three quarters of all 1989 direct lending volume produced by guaranty agencies was generated by three guaranty agencies and guaranty agency-affiliated direct loan agencies. Nearly half of that lending represented non-subsidized guaranteed loans to students from middle to high income families who did not otherwise qualify for need-based Stafford loans, and whose loans are the least costly to administer. This type of lending activity is far from the global capability envisioned by the GAO.

Guaranty agencies and guarantor-affiliated direct loan agencies will encounter the same return related problems as commercial lenders under the reduced GSLP earnings rate scenario proposed by the GAO. Under last resort loan programs, it is likely that returns would be even narrower for guaranty agencies than for commercial lenders. Specifically, state agency lenders principally will make loans to students who cannot obtain them from commercial lenders who view them as "high cost" borrowers. Student loans to high default borrowers represent a net cost to lenders not a net return. Accordingly, rather than being the answer, guarantors could be put in a position of depleting their already thin capital levels.

Another key issue that the GAO has not addressed in its discussion of guaranty agency-administered direct loan programs is the question of how guaranty agencies would fund potentially high volume direct lending activity. Most guaranty agencies do not have the financial wherewithal to fund such programs. In fact, numerous agencies are struggling to maintain solvency as a consequence of the "Spend Down" of agency reserves earlier mandated by law as a revenue enhancing measure. Those agencies that could reasonably access the U.S. capital market would likely pursue tax-exempt financing which would both: 1) be limited by the agency's allocation of tax-exempt funding authority under its state's tax-exempt financing cap; and 2) to the extent successful, have the effect of eroding Federal savings associated with a reduction in Special Allowance payments.

Finally, we suggest that the fact that very few guaranty agencies have actually implemented agency-funded loan of last resort programs casts serious doubt on the GAO's apparent assumption that such programs can or will be implemented simply by Federal fiat. The last resort obligations of guaranty agencies were not imposed by law as a means for the general substitution of guaranty agencies for unwilling financial institutions. Rather, it was to provide a safety net for particular locales evidencing access problems. Picking up the pieces left by a generalized defection of program lenders is not

Appendix V
Comments from the Student Loan Marketing
Association

Mr. Joseph J. Eglin, Jr.
August 26, 1991
Page Seven

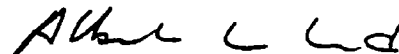
contemplated in the law and would, no doubt, be resisted by guaranty agencies.

CONCLUSION

The data and observations presented in this response to the GAO's report on, and recommendation for, a 50 basis point reduction in Special Allowance payments suggests that such action could be expected to have a significant adverse impact on future private sector support for the GSLP and, derivatively, on student and parent access to GSLP loans. In the light of the realities of the environment in which the GSL program operates today, it verges on recklessness to suggest severely cutting an already marginal return on the grounds that an earlier cut did not produce such dire program consequences.

While we recognize the Federal government's desire to reduce the costs of GSLP administration, we think the GSLP is at the point where commercial lender GSLP participants cannot be expected to withstand further reduction in Special Allowance and where viable replacements for those lenders will simply not materialize.

Sincerely,



Albert L. Lord
Executive Vice President and
Chief Operating Officer

Enclosures

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*OK Eli Ready Comm.
Chair (cc)*

Jon A. Veenis
President

Record Type: Record

NORWEST BANKS

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To: Robert M. Shireman

cc:

Subject: Re: BARRONS - SALLIE MAE

Barron's

11/22/97

Sallie Mae Snubs New Student Loan Program: A Barron's Feature
By Jim McTague

NEW YORK (AP-Dow Jones)--A federal law passed this month to open up to private-sector lenders the business of consolidating government-guaranteed student loans has already backfired and driven market giant Sallie Mae to the sidelines.

Some big bank lenders like Crestar and Student Loan Corp., which is 80% owned by Citicorp, will offer to consolidate student loans—that is, bring together into one package the several loans a student may have taken out while in college. But Sallie Mae, by far the largest participant in the student-loan market, and small banks are snubbing the program, mainly because the federal government insists on taking too big a cut of any profits. Sallie Mae had been handling 34% of all consolidations.

This is yet another problem for Sallie Mae created by Congress and a reason analysts like Smith Barney's Tom O'Donnell have cut estimates, causing Sallie's share price to plummet in recent weeks. As we've previously reported, another federal law that takes effect next July squeezes profits on student loans so dramatically that lenders predict students might have a problem borrowing tuition money. Congress went home this month without fixing that looming problem, spooking investors. Sallie Mae is confident repairs will be made before July.

An internal Treasury study will recommend some kind of adjustment in the law.

But there's always the possibility that any cure could be as bad as, or only slightly better than, the looming problem. That's keeping investors with weak stomachs out of the stock, which analysts had been predicting has the potential in the next year to hit \$180 a share.

Another scare factor: CEO Al Lord, who led a coup last summer against the

old management, has filed to sell 7,800 of his 41,000 shares of Sallie Mae. "From a public-relations standpoint," grouses O'Donnell of Smith Barney, "not a positive move." But he doesn't think the sale foreshadows negative news from the company. O'Donnell has, however, lowered his estimate for Sallie's fourth-quarter earnings to \$2.48 a share from \$2.58. For the full year, he looks for earnings of \$9.25 a share, and for 1998, he calls for \$11.10.

Though the larger problem in July is likely to be revisited by Congress, there's hardly any prospect of an adjustment in consolidation loan fees by Congress until after next year's general elections. But Sallie Mae can live without that line of business.

Sallie Mae Vice President J. Paul Carey told Barron's last week that the company had quietly dropped its Smart Loan consolidation product because the new law gives the government one-third of the spread on each transaction. "These loans were fairly low-yielding prior to passage of the law," Carey said. Sallie was able to charge the weighted average of the loans consolidated, rounded up to the nearest whole percent. The new law fixes rates on consolidated loans at the T-bill rate plus 3.1 percentage points, capped at 8.25%, with the Department of Education taking 1.05% and leaving the consolidator with a profit of 2.05%. Additional consolidations are labor intensive, each one costing \$350 up front because loans that have been sold off by the originators have to be tracked down.

Still another turnoff for Sallie Mae: The law is effective for just one year. Carey said it would take four months to prepare payment algorithms reflecting the new pricing and to run tests on them.

Sallie Mae had been consolidating about \$2 billion in government-guaranteed student loans originated by banks each year under the Federal Family Education Loan Program. Until enactment of the new law two weeks ago, the Department of Education had the exclusive right to consolidate loans made under President Clinton's 1994 Direct Loan Program. But Electronic Data Systems, which has a \$525 million contract with the department for origination, consolidation and servicing of student loans, was unable to meet the demand. A backlog of 80,000 applications shut down the direct-loan consolidation program last summer.

Republican Buck McKeon of California, who chairs the House Subcommittee on Postsecondary Education, Training and Lifelong Learning, promoted the Emergency Loan Consolidation Act of 1997 as a way of relieving the logjam of

applications

by giving the Department of Education some private-sector competition. After all, President Clinton had promoted the direct-lending program in 1994 as healthy competition for banks getting fat making student loans guaranteed by the government. What was good for the goose was good for the gander.

Congress, much to the consternation of banks and Sallie Mae, passed the legislation without a single hearing or a single minute of debate. President Clinton threatened to veto the bill, but wound up signing it. We're told part of

the reason is that he realizes it eventually will embarrass Republicans.

Students already are writing to Congress griping about not being able to do business through Sallie Mae.

EDS expects to have the Education Department's notorious loan-consolidation program back up and running in December, according to spokesman Randy Dove. In

the meantime, some 40,600 applications that were deactivated or withdrawn by EDS

when it shut the program now are fair game for private consolidators under the new law.

This Congressionally inspired turmoil has not been fun for Carey and other members of the dissident group that ousted Sallie Mae's old management. "Some shareholders thought we were magic men and as soon as we walked in all of these problems would be solved," he quipped ruefully.

11/19/97

Beren Dellin, Susan
Maxnard, Jill Qualey, Ben Carter

Sam: Night

- How get allocated ??

- Year-by-year churning...

Cap - Need in students -
in 600's?

1.

2.

3. Govt set up - hands pay gov

- If hands pay gov - that is what the (govt)

- How and an obligation to make loans work??

Downside

- Asset selection - may try not to lend to higher risk, lower loans.

- Churning - random chance?? issue for banks and

- 'Local' externalities - local ba

(- How to treat an obligation)

(- Secondary Mkt??)

- Defaults / due diligence

G.A. role??

Beck QUESTIONS a paper on this and answer
- Jan/Feb.

Computer

- Pauline: Need to rcs on first yr old
ramp-up spending (is 2nd yr only curriculum,
or new also ??)
AND how costs / numbers of schools / students interact.

- Arjun Kallan * Gubner



EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

SENIOR ECONOMIST

November 19, 1997

MEMORANDUM FOR JOHN GRUBER, TREASURY, 622-2633
BOB SHIREMAN, NEC, 456-2223

FROM: AARON EDLIN

SUBJECT: Auctions for College Loans

Enclosed is information for our 12:30 meeting on auctions for college loans.

Attachment

URGENT

November 19, 1997

Issues for discussion regarding auction/market mechanisms for federally-guaranteed student loans

Problems with rate of return regulation

- ☐ Difficult to set rate correctly
 - ☐ If too low, lenders unwilling to make loans.
 - ☐ If too high: accessibility is reduced; government and students pay too much; and banks profit, or worse yet, spend money on marketing.

Basic choices for the auction/market mechanism

- ☐ Frequency of bidding
- ☐ What is bid: quantity and fixed/variable interest rate
- ☐ Prices to bid on
 - ☐ Bid on rate while loan deferred (in school or otherwise), holding rate during repayment fixed: government will capture cost-savings from auction.
 - ☐ Bid on rate during repayment, holding rate during deferment fixed: students capture cost-savings.
 - ☐ Bid on both rates: government and students split cost-savings.
 - ☐ Bid an amount paid for right to make loan (this is the Sallie Mae proposal): government captures cost-savings. *at a set i rate*
- ☐ Whom to bid to
 - ☐ Government: government may have an advantage if students are poorly-informed or make poor choices.
 - ☐ Students: students may be better able to take into account the value of borrowing from a single lender; however, they may not be as able to find the best deal among the many lenders.
- ☐ Emphasis on multiple-sourcing?
 - ☐ Multiple-sourcing may keep the number of bidders high in the future
 - ☐ May also ensure that loans get made today
- ☐ Option vs. obligation to lend

Possible pitfalls

- ☐ Willingness to make loans
 - ☐ As competition squeezes profit margins, we are more likely to see lenders avoiding high-cost borrowers, or even all borrowers, in reaction to events such as an adverse change in interest rates.
 - ☐ Possible remedies include:
 - ☐ strengthening current regulations requiring lenders to lend to all eligible students (these regulations exist in HEAL, do they exist for FFELP?)
 - ☐ making lending an obligation for winning bidders, not an option, and imposing fines.
 - ☐ multiple-sourcing.
- ☐ Other pitfalls?

setting the cap on the rate? ? assume that the market...

HEAL: The Health Education Loan Assistance Program

Background

HEAL is a federally-insured loan program for graduate students in schools of medicine and other health professions. HEAL's legislative authority expired in October 1995; currently loans are being made only to students who first borrowed prior to that date. If not reauthorized by Congress prior to October 1998 the program will be discontinued. In FY1996 \$200 mln in loans were disbursed, with \$4 bln in loans outstanding. As of 1996, the default rate was less than 5 percent.

Interest Rate Determination

Interest rates on HEAL loans are capped at the rate on the 3-month T-bill plus 3 percent. In addition, the Public Health Service Act requires the HHS Department to allocate insurance authority to lenders offering more favorable terms to borrowers. A yearly bidding system was implemented in FY1993, and since then interest rates have fallen from T-bill plus 3 percent to T-bill plus 1.5 percent.

The bidding process:

- 1) HEAL announces the amount of available insurance authority and sends out a bidding form to authorized lenders.
- 2) Bidders name the interest rate at which they are willing to lend and the amount of insurance authority they are requesting, as well as any lending restrictions (e.g., state of residence).
- 3) HEAL calculates the cost to a borrower of each lender's bid under the following scenario: \$10,000 loan in final year of school, followed by 3 year internship/residency, 9 month grace period, and 25-year repayment. This works out to about \$30,000 dollars for a typical bid.
- 4) Based on these costs, HEAL divides the bidders into "cost bands". All bidders with a borrowing cost within \$500 to \$750 of the lowest-cost bidder are placed in the lowest cost band.
- 5) HEAL insurance authority is allocated to all bidders in the lowest cost band, and then allocated to bidders in progressively higher cost bands until the insurance authority is exhausted.

Results of the FY1998 Auction

There were two auctions: medicine and non-medicine (dentists; podiatrists, etc.). In the medical auction bidders were competing for \$49 million in authority. Nine lenders submitted bids, and were divided into two cost bands. Only the three bidders in the lowest cost band received authority. The interest rates of the winning bidders were equivalent to T-bill + 1.5 percent. Only one of the winning bidders, the Pennsylvania Higher Education Assistance Agency, requested national authority and the full \$49 mln; the other two winners requested small amounts for residents of Vermont and Rhode Island.

In the non-medical auction bidders were competing for \$36 mln of authority. The three winning bidders (Pennsylvania, Mellon Bank, and Star Bank) all requested national authority and bid markups of about 1.5 to 1.7 percent.

Problems?

- The schools dislike switching lenders every year. To minimize disruptions, HEAL has switched from allocating authority on a fiscal-year basis to allocating authority on an academic-year basis.
- The number of lenders has fallen over time, from over twenty in FY1992 to less than five for the coming year. It is not clear how much of the reduction is due to the auction, and how much is due to the reduction in insurance authority that has occurred during the phase-out of the program.
- According to a HEAL administrator there have not been any cream-skimming problems. Regulations require lenders to make loans to all eligible schools/students.

11/14/97

- non-packets will go in (except 2)

- PKEEs will serve their own...

- helps say checks in many amounts still, and repeat

- PKEE and

^{EN} Family implementation guidance - any nuances?

- Loan referrals...

• SM

Glitch: 18 bases p + fee

$2T + 2.05$

- Large loans okay, but not smaller...

BA. KEMAS

- G.L. ACA - numbers don't add up...

- (Mc. LIBER)

- FHA - mortgages...

- Electronic communication

- the loan mode

- PM centres

- spot audits

Don't need the 'notice of guarantee'

(some of the qd basis pt wd be reduced thru
regulatory relief)...

- Need year or two
EEE sds

Partsec Bd'n Electronic Sds Council
- propose - Dallas MARTA Bd +



Kathryn B. Stack

10/07/97 02:02:40 PM



Record Type: Record

To: Robert M. Shireman/OPD/EOP, Wayne Upshaw/OMB/EOP

cc:

Subject: Re: interest rate

I haven't sat down to go over the numbers myself yet. Does this address your concern Bob?

----- Forwarded by Kathryn B. Stack/OMB/EOP on 10/07/97 02:01 PM



William_Graham @ ed.gov

10/07/97 12:24:00 PM

Record Type: Record

To: Kathryn B. Stack

cc:

Subject: Re: interest rate

Message Creation Date was at 23-SEP-1997 09:29:00

William: Any conclusions on why our numbers on the cost to students don't match up with CBO's (multiplying the DL savings by 3)?

Bob and Kathy --

Sorry to take so long on getting back but here's the story.

First, CBO doesn't do estimates of student costs; they only do federal costs. For most of our papers, however, we use these estimates as the basis for our projections of costs to students.

CBO estimates the federal savings of the change to be \$1.4 billion in BA and \$1.150 in outlays, 98-02. They do not break this out for FFEL and Direct Loans. (The proposal increases the cost of FFEL and reduces the cost of DL.) If CBO's split is the same assumed in the ED model the breakout would be:

FFEL cost: 653 million
DL savings: -2,053 million
Total: -1,400 million

As a preliminary approach, the total cost to students for the change would

be three times the DL value since DL has 1/3 the market. This would yield an estimate of \$6.2 billion in additional student costs.

This amount needs to be adjusted, however, because CBO estimates do not account for Direct Loan borrowers who choose an alternative repayment plan. For unknown reasons, CBO assumes that a borrower's choice of repayment plan has no effect on the federal cost of a loan. (ED does not accept this assumption and calculates a separate subsidy rate for each repayment option.) CBO does recognize that choice of repayment plan will affect student costs, since interest accrues longer under the alternative plans.

Assuming the mix of alternative repayment plans estimated by ED (which, based on unofficial discussions, CBO seems to do), the cost to students of negating the interest rate break in July 1997 goes up to \$7.3 billion.

**DEPARTMENT OF THE TREASURY****OFFICE OF MARKET FINANCE****1500 PENNSYLVANIA AVENUE, N.W.****WASHINGTON, D.C. 20220****FACSIMILE TRANSMISSION COVER SHEET****NUMBER OF PAGES INCLUDING THIS COVER SHEET: ____**

Recipient's Name	Bob Shireman
Firm or Office	NEC
Voice Phone Number	456 5351
Fax Phone Number	202-456 2223

Sender's name	Jill Ouseley
Office	Office of Market Finance
Voice Phone Number	(202) 622-2630
Fax Phone Number	(202) 622-0244

March 26, 1993

**SECTION 432A
ANNUAL AUCTION OF RIGHTS TO MAKE FFELP LOANS**

- (a) **STATEMENT OF PURPOSE.** In order to assure that the return on loans made under this part is a market rate, this section provides for the auction of rights to make such loans.
- (b) **CREATION OF RIGHTS.** (1) Annually, the Secretary shall issue rights to make loans under this part during such fiscal year (other than loans made pursuant to Section 428C hereof). Each right shall have a nominal value of \$1.00 and an eligible lender shall be required to own rights with a nominal value equal to the initial principal balance of all loans made under this part which the lender originates (other than loans made pursuant to Section 428C hereof). Rights allocable to a specific 12-month period shall not be transferrable to any other 12-month period.
- (2) The Secretary shall contract with a trustee to administer the auction process. The trustee shall be an entity authorized to perform all the duties required of the trustee in this section and shall have a capitalization of at least \$_____. The trustee shall manage the auction process, provide a mechanism to facilitate the exchange of rights between eligible lenders and establish a book-entry registry of all rights issued.
- (3) On or prior to March 1 of each year, the Secretary shall make and publish a determination of the value of rights the Secretary shall issue by auction for the 12-month period beginning on the succeeding July 1. The Secretary's determination will reflect the Secretary's reasonable estimate of the total dollar amount of new loans to be made under this part

C:\REPP\432A

during such 12-month period (other than loans made pursuant to Section 428C hereof).

(c) AUCTION PROCEDURES. (1) On or prior to April 1 of each year, any eligible lender wishing to make loans under this part during the 12-month period beginning on the succeeding July 1 shall submit a bid (or bids) to the trustee in accordance with procedures the Secretary shall establish by regulation. Each such bid shall state the name of the bidder, the number of rights for which the bid is made and the price per right that the bidder is prepared to pay for such rights. All or part of an eligible lender's bid (or bids) may be designated as a non-competitive bid(s).

(2) Non-competitive bids are bids that are awarded at the same price as competitive bids. The maximum total amount of rights awarded on a non-competitive basis to any eligible lender in an auction shall be \$_____ million.

(3) Determinations of awards of rights shall be made by the trustee after closing time for receipt of bids. In determining auction awards, the trustee shall accept in full all non-competitive bids received by the closing time. Then, competitive bids shall be accepted, starting with the highest bids through successively lower bids until all rights are awarded. Bids at the lowest price shall be prorated, if necessary, so that final awards exactly equal the amount of rights authorized for issuance. If the amount of non-competitive bids would absorb most or all of any auction, competitive bids will be accepted in an amount determined by the trustee to be sufficient to provide a fair determination of the price of rights auctioned and the issuance of non-competitive bids shall be prorated.

E:\MSPP\432A

(4) The price of all rights auctioned for any 12-month period shall be the price of the lowest bid accepted.

(5) After the conclusion of the auction, the trustee shall announce the auction results and provide notice of awards to successful competitive and non-competitive bidders.

(6) Recipients of auction awards must submit payment for all awards received no later than _____ days following receipt of the award. Payment shall be made in the manner designated by the Secretary.

(d) TRANSFER OF RIGHTS. Subject to the limitations in subsection (f), all rights acquired by eligible lenders under this section may be freely transferred to other eligible lenders at such price and on such terms as such eligible lenders may agree, provided that the trustee is notified of such transfer before the transfer shall become effective. Such notice shall be made in the manner prescribed by the trustee.

(e) ADDITIONAL ISSUANCE. At any time following the award of rights for a 12-month period, an eligible lender may apply to the trustee for additional rights for such period and, subject to limitations set in subsection (f), the trustee shall award such additional rights to the eligible lender. The price of each such right shall be the price of rights auctioned for such 12-month period as described in subsection (c)(3) plus _____ percent of such amount. Payment for additional rights must be submitted at the same time as the request is made to the trustee for such additional rights.

(f) DIVERSITY. In order to assure a broad market for the making of loans under this part, the Secretary may establish limits on

C:\REPP\432A

the total amount of rights that an eligible lender can own for any 12-month period, whether by way of initial auction award, purchase from another eligible lender or acquisition in an additional issuance.

(g) Reconciliation. As of the final day of each 12-month period for which rights are issued, an eligible lender must own rights with a nominal value equal to the original principal amount of loans made by the lender for such 12-month period (other than loans made pursuant to Section 428C). In the event the nominal value of rights owned by the eligible lender is less than the original principal amount of loans made by such lender for such 12-month period, the insurance programs under this part shall only cover loans with an original principal amount equal to the nominal value of rights held by the lender. The determination of which loans made during such 12-month period are covered by insurance shall be determined chronologically, beginning with loans made on the first day of such period.

(h) PAYMENTS NON-REFUNDABLE. Payments to the Secretary for rights shall not be refundable in any circumstance, including cases where an eligible lender does not in fact in a 12-month period make eligible loans in an amount which equals rights held by such eligible lender for such period.

~~all~~ ~~David~~ Gary Gensler, David Wilcox, Peter Giszewski,
Janet? ~~Wilcox~~, Maxwood, Gensler...

11/7/4x

Embedding of crisis

① ~~Embedding of crisis~~

- Marginal caps - new loans only

PRK

② ~~Embedding of crisis~~

③ Is there a crisis of T & X

- Dave Wilcox

- Is this where the soap dealer thinks he's getting...

① Max ad capped

② Max of elim. bidding - per yield curve difference

- 'Capable material'

* What is cost of market funds is a bank...

BR bank @ LIBOR - what is cost
in the bank

L 15/11

at 10

L 15/11 - offering rate

- Sell. underwriting and costs of M&A

Costs
- LIBOR + 10

red: LIBOR...

- T-bill to CCBOR

- call @:

- history

- boards - Dave

- some of symptoms...

notes: SEC - go to T-bill + less

1. Cost of matched funds

2. ~~BS~~ " to match CMT -

3. BOR - what can they bear -

Wilcox

- call ~~Allen~~ ~~larger~~ @ Fed.

- ~~prepaid~~ risk - 4

- Accounting RTS.

	Student Rate						Cost	Bank Return					
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>		<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
current - tbill + 3.1	8.25	8.25 8.15	8.20	7.86	7.60	7.60	1.36 2.01	1.72 1.07	1.72 0.97	1.74 1.09	1.74 1.09	1.74 1.09	1.74 1.09
proposed - 10 yr + 1	7.75	7.20 6.80	6.80	6.60	6.40	6.40	1.66 2.61	0.92 -0.03	0.27 -0.68	0.04 -0.91	0.18 -0.77	0.24 -0.71	0.24 -0.71
back to t-bill, student held whole	7.75 0.50	7.20 1.05	6.80 1.40	6.60 1.26	6.40 1.20	6.40 1.20	1.36 2.01	1.22 0.57	0.57 -0.08	0.34 -0.31	0.48 -0.17	0.54 -0.11	0.54 -0.11

1.6% of net - gross
 1.0% for gross - gross

Citicorp - now
 125 any use. 100 day
 125 - no, 100 day is inf. available @ Citicorp

Meeting on Student Loan Interest Rates - 11/7

I) Introduction - the policy issues

- current interest rate: 90 day + 2.5/3.1
- change in July 98: 10 year + 1 - *average* (set)
- issue: can banks bear this?

II) Cost Factors for Banks

Cost	Estimate (basis points)
Servicing	50-60
Overhead	15-35
Default Risk	7
Prepayment Risk	4
Origination Fee	5
Cost of Matched Funds - t-bill	55-90
Total - t-bill	136-201
Cost of Matched Funds - CMT	85-150
Total	166-261

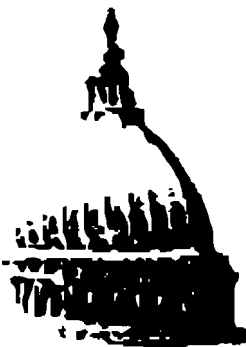
at least 30 days

Questions:

- 1) Costs of matched funds - what time frame?
- 2) Present range or average?

- maybe is avg.

*- sensitive to rate:
non-year: on*



U.S. PIRG FAX

To: Bob Shireman

Of: _____

Fax: _____

From: Ivan

Number of pages including this cover sheet: 8

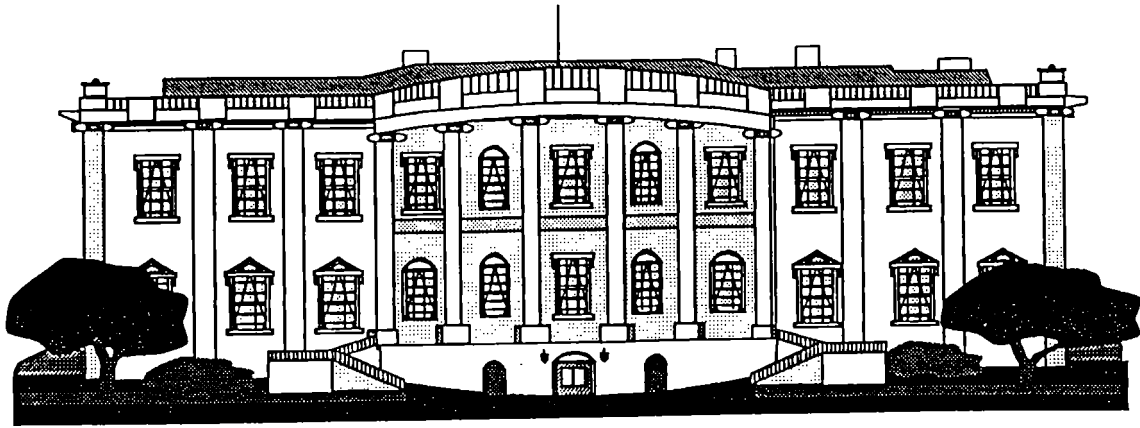
Please call 202-546-9707 if you have trouble receiving this fax.

Message: This proposal scores at
over \$2.5 Billion because of
the split interest rate mechanism
scam. I think it will die
w/out us lifting a finger.

U.S. Public Interest Research Group

218 D Street, SE • Washington, DC 20003

phone: 202-546-9707 • fax: 202-546-2461



The White House

National Economic Council

To: John Grobler

Phone: _____ Fax: _____

From: **Bob Shireman**

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

Pages including cover sheet: 8

Comments: Indiscreet / Hill developments

Note use of LIBOR. I assume your

work continues.

- Bob



PROPOSAL GOALS

- ◆ Reduce Interest Rates and Up Front fees for Student Loan Borrowers
- ◆ Preserve Choice for Schools and Students Among Federal Loan Programs
- ◆ Assure Long-Term Stability in the FFELP

THE PROPOSAL

- ◆ Reduce the borrower interest rate cap from 8.25% to 7.5% to 7.75% to 8.0%
X.XX% .
- ◆ Reduce the borrower paid loan origination fee by up to 2% for borrowers of Subsidized Stafford Loans.
- ◆ Reduce borrower interest rates by .25% in repayment
 - ◆ 91-Day Treasury Bill + 2.85% in repayment,
91-Day Treasury Bill + 2.50% in-school.
 - ◆ Lender return would be set at an equivalent rate indexed to 1-Month LIBOR rates.
- ◆ Undo the scheduled interest rate change for PLUS loans, providing parents with a lower interest rate.
- ◆ Revise the Congressional Methodology as it applies to dependent and independent students.

LOWER COSTS FOR STUDENTS

- ◆ Reducing the borrower interest rate cap to X.XX% provides borrowers with long-term, permanent protection against interest rate volatility and inflation.
- ◆ The proposal reduces the borrower rate by .25% in repayment.
- ◆ Targeting the origination fee reduction on borrowers who have been judged needy enough to qualify for Subsidized Stafford loans, allows those borrowers to have their up-front fees cut in half (from 4% to 2%).

LOWER COSTS FOR STUDENTS

- ◆ The 1993 cap reduction from 9% to 8.25% has already provided significant interest rate protection for borrowers -
- for the last 3 years, the rate would have exceeded 8.25% if not for the new cap.
- ◆ The .25% reduction in borrower interest rates lowers the cost of borrowing by \$175 for a borrower with \$11,000 in Stafford loans and by \$318 for a borrower with \$20,000 in Stafford loans.
 - ◆ For all borrowers who receive student loans over the next five years, this could mean certain savings of more than \$2 billion.
 - ◆ Add to this an additional savings of \$1.5 billion from reduced origination fees and potentially significant savings attributable to lowering of the rate cap.

ASSURING THE AVAILABILITY OF STUDENT LOANS

- ◆ The 10-Year Treasury Note formula, scheduled to take effect in 1998, will make the funding of FFELP loans extremely difficult.
 - ◆ If that formula is left in place, it is certain to reduce the number of FFELP lenders and the services and benefits they provide to schools and students.
- ◆ The proposal to lower borrower interest rates is supported by all of the providers of private capital for FFELP loans.
- ◆ The proposal includes a significant, but not destabilizing, 10% cut in yield to FFELP lenders.
 - ◆ In contrast to the extreme yield cuts of 68% to 100% attributable to the 10-Year Treasury Note formula.

ASSURING THE AVAILABILITY OF STUDENT LOANS

- ◆ Lenders and secondary markets will be assured of being able to generate sufficient capital to meet the demand for FFELP loans.
- ◆ Schools and students will continue to have real choices among competing federal loan programs.
- ◆ Maintaining reasonable returns on FFELP loans enables lenders and secondary markets to continue making long-term improvements and investments in FFELP technologies and services which benefit students and schools.

WHAT IS LIBOR?

- ◆ LIBOR stands for the “London InterBank Offer Rate”.
 - ◆ It is the interest rate at which banks lend money to each other.
- ◆ U.S. Dollar LIBOR rates are set each morning based on the rate quotations provided by 16 global banks -- including such U.S. banks as Chase, Citibank, and Bank of America.
 - ◆ LIBOR rates are set for various “maturities”, including 1-month and 3-month terms.
- ◆ Numerous corporate and consumer loans in the United States are made and repaid each day based on interest rates indexed to LIBOR rates.

USING THE ADVANTAGES OF LIBOR

- ◆ Special Allowance payments would be based on a quarterly average of 1-Month LIBOR rates:
 - ◆ 1-Month LIBOR + 2.50% in repayment,
 - ◆ 1-Month LIBOR + 2.15% in-school.
- ◆ LIBOR-based special allowance is more compatible with funding sources for FFELP loans, permitting lenders to absorb, and pass on to borrowers, a full .25% cut in their revenue stream.



William_Graham @ ed.gov

10/24/97 03:43:00 PM

Record Type: Record

To: Robert M. Shireman

cc:

Subject: Re[4]: Lender interest hedging and increasing lender yie

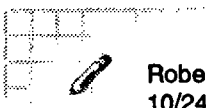
Message Creation Date was at 24-OCT-1997 14:56:00

Why would it have a Federal cost? (Unless they're whacking their yield even below the equivalent of the 10-year plus 1). Do you know what the increment that they are using above LIBOR is?

The idea is to keep the student unharmed and so to make the lender yield LIBOR + 3.1% they have to come up with savings for students. They are proposing such things as cutting the origination fees in half and reducing student interest rates to LIBOR + 2.75% in repayment (without changing SAR.)

Our previous work indicated that the cost to student's of canceling the interest rate break was \$7-\$10 billion FY 98-02. Since the lenders are offering to keep student's whole but not take a hit themselves, the money has to come out of Treasury.

As soon as we see the actual proposal we will cost it out.



Robert M. Shireman
10/24/97 03:28:24 PM

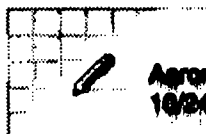
Record Type: Record

To: Aaron S. Edlin/CEA/EOP
cc:
bcc:
Subject: Re: student loan interest rates

We're going to start looking into those possibilities, and we would love your help. Whatever we do, we need to be careful not to increase the cost to students. So as long as our approach still allows us to set a maximum rate that the student pays, it makes sense to explore these options.

I'm copying this to Kathy Stack at OMB, who is supposed to make some of these discussions occur within the Administration. (Kathy, maybe we could ask Aaron to lead a group of Education and Treasury folks in figuring out how something like this would work?)

Aaron S. Edlin



Aaron S. Edlin
10/24/97 02:54:43 PM

Record Type: Record

To: Robert M. Shireman/OPD/EOP
cc:
Subject: student loan interest rates

Bob,

My main thought after last Friday's student loan interest rate meeting was that we are barking up the wrong tree.

Do you know of any sound reason why we shouldn't go the free-market route?

If not, what are the political forces that stand in the way of having banks bid to the government?

Rate of return regulation is notoriously difficult. So difficult, that the United States is trying hard to abandon it even in industries long thought to have increasing returns to scale, industries where competition is not viable or involves inefficient replication of fixed costs.

Why, then, should we continue to use rate of return regulation in student loans, an area where there are multiple competing lenders. Instead of spending a huge amount of time trying to find an appropriate rate of return,

and probably getting it wrong, shouldn't a system be created in which lenders bid to the government or to students to provide loans at low interest rates? Competition could drive banks toward the break-even point far better than regulation, despite treasury's admirable efforts.

The only real worry that I am able to conjure is a "cream skimming". Lenders might try to only loan to good repayment risks (economizing on debt collection costs and the two percent of the loan that isn't guaranteed). Presumably, this could be regulated easily. Lenders could be required to lend to all eligible borrowers. This wouldn't fully solve the problem, because lenders would try to only amortized to good risks. This problem is also probably controllable, however. Lenders could be required to provide an 800 number, and the department of education or college financial aid officers could provide a list of lenders phone numbers to each eligible student.

-- Aaron

Email composed using speech recognition software.
Misrecognized words are common.

G. E. DeSeve

10/24/97 03:30:23 PM

Record Type: Record

To: Robert M. Shireman/OPD/EOP

cc:

Subject: Re: Lender interest hedging and increasing lender yield

Bob, I think we need some more sophistication here. What the folks are saying is that a rate that is fixed for ten years only costs them 60 basis points to hedge. LIBOR is denominated in various terms. Today three month LIBOR was 5 13/16 and the 91 day Treasury bill was 4.98. I find it very hard to believe that simply changing instruments with the same maturity and having less than a 90 basis point spread costs 35 basis points. I also find it hard to believe that hedging the 91 day against the 10 year only costs 60 basis points. I would like to get access to the data and a desk. Gary Gensler has just joined Treasury from Goldman and (ethics permitting) probably has the best view on this. Perhaps we can add him to our team.

reset annually



William_Graham @ ed.gov
10/24/97 12:07:00 PM

Record Type: Record

To: Robert M. Shireman

cc:

Subject: Lender interest hedging and increasing lender yield

Under current law, next July the interest rate on student loans moves from being based on the 91 day T-bill to being based on the 10 year bond rate. Lenders have argued this causes them problems and are requesting a return to the old formula. The Administration has stated repeatedly that they are willing to discuss changing the instrument on which student payments are made but will not consider increasing lender's interest yield.

According to a preliminary Treasury report, lender's have a 60 basis points hedging cost when the interest rate is based on the 10 year rate instead of the 91 day rate. (Hedging cost are payments lenders make to protect themselves from interest variability risk.) Thus, without changing student's interest rates, changing the determination instrument back to the 91 day rate **EFFECTIVELY INCREASES LENDER'S YIELD BY OVER 1/2 PERCENT.**

Lenders are now proposing to base student's interest rates on the London Inter Bank Offer Rate (LIBOR). OMB is reviewing but is leaning towards accepting this instrument. Lender's have told Hill staff that they currently pay 35 basis points to hedge the 91-day rate against the LIBOR rate. So, changing the instrument from 10 year rate to the LIBOR rate **EFFECTIVELY INCREASES LENDER YIELD BY ALMOST A FULL PERCENT** (60 basis points from moving 10 year to 91-day PLUS 35 basis points moving 91-day to LIBOR.)

Without adding federal or student costs, lender's yields can effectively be increased by nearly a full percentage point just by changing the determination instrument.

MEMORANDUM

To: Kathy Stack - 54875
Bill Menth - 57230
John Gruber - 622-2633
Maynard Colmeiz - 622-1294
Chris Carroll - 56809
Sandy Korenman - 56853
Wayne Upshaw - 54875
Pauline Abernathy - 401-9027
David Longanecker - 708-9814
Don Feuerstein - 415-771-6807

+ bel

= 230

From: Bob Shireman

Date: October 16, 1997

Subject: **Student Loan Interest Rate Meeting**

Attached are documents for your review prior to the meeting tomorrow. The primary document we will be discussing is the draft paper from Treasury. I have also included related papers from the Education Department, CRS, and Wall Street analysts. The issues I would like to discuss include:

- Interest rate/yield curve projections and alternative assumptions
- Hedging costs *- posted as is - attached as is...*
- Other lender costs
- Assumptions regarding the impact of the 8.25% cap
- Alternative approaches

- LIBOR?

44 pages. Please call 456-5351 if you have problems w/this fax.

DRAFT

The Financial Viability of the Student Loan Program

Executive Summary

The current student loan formula is based on the bond equivalent rate for 3-month T-bills plus a spread of 2.5 percentage points for loans for students who are in school or loans that are temporarily deferred, or plus 3.1 percentage points for loans that are being repaid. For loans in consolidation, the interest rate is based on the weighted average interest rate on all outstanding loans being consolidated and then rounded to the nearest whole number. The rate that the student pays is capped at 8.25 percent and the Government pays any excess above this rate in the form of a Special Allowance Payment (SAP). The new formula will change to the average bond equivalent rate for 10-20 year Treasury securities, or for the bond equivalent rate of securities with a comparable maturity established by the Secretary of Education in consultation with the Secretary of the Treasury. The speculation is that this will be the rate for the average of 10-year Treasury notes. The student's rate is still capped at 8.25 percent and the Government still would pay the SAP.

Lenders have expressed their concern that the new formula involves a new risk to them because of a mismatch among the short term source of their funds and the rate for long term securities which will be reset annually and which will determine the student loan interest rate. Starting in mid-1998, the new formula for student loans will force lenders' to protect themselves against the risk from this mismatch by hedging the differential interest rate streams in some way, probably through a swap contract. This risk has not been a problem up to now, because the maturity of the instrument for lenders' short term funding is closely matched by the maturity of the instrument for determining the student loan interest rate.

Lenders participating in the student loan program incur various costs, or risks that have a cost. These include their cost of funds, servicing/overheads costs, origination fees, default risk, and a risk from loan prepayments. Starting next year, lenders will have to factor in their hedging costs to their total cost burden. In order for student loans to be profitable for lenders, the student loan interest rate must provide a sufficient margin above the total of these costs. A rule of thumb used in the banking industry is that lenders need a pre-tax rate of return of between 1.65 percent and 2.0 percent for an investment to be competitive. Because student loans are guaranteed by the Federal Government, a competitive rate of return could be even lower, perhaps as low as 1.0 percent. The unique nature of future student loans, which presumably will require lenders to hedge their risk, could raise the minimum pre-tax return above 1.0 percent to perhaps 1.3 percent, which is still less than for a non-guaranteed loan.

This paper provides estimates of lenders' costs and gross return for student loans under the current student loan formula for 1997 and under the new loan formula beginning July 1, 1998. We have estimated these variables using different interest rate and cost assumptions.

DRAFT

2

Our results show that under the current student loan formula, lenders appear to be earning a pre-tax rate of return on student loans that is very favorable compared with what they could earn from alternative investment opportunities. Switching to the new student loan formula reduces lenders' net return substantially, as their costs rise because of the need to hedge their loans and because the formula reduces the student loan interest rate. Modifying our assumptions does not change the basic finding that lenders probably would not earn an adequate rate of return, if the new student loan formula comes into effect.

There are various remedies to rectify this situation. One remedy is to retain the current structure of the student loan formula, but reduce the spread between the 3-month T-bill rate and the student loan interest rate so that students would pay approximately the same interest rate they would pay under the new formula. This change would effectively eliminate the need for lenders to hedge their risk from student loans because of a costly mismatch that results from switching to the new student loan formula. This, in turn, should eliminate the substantial cost from hedging that lenders would otherwise incur. The result is an interest rate that would be favorable to students and a pretax net rate of return for lenders that is competitive with comparable alternative investments.

DRAFT

THE FINANCIAL VIABILITY OF THE STUDENT LOAN PROGRAM

Introduction

- The current formula for calculating student loan interest rates, which is based on the bond equivalent yield of 3-month T-bills,¹ appears to provide lenders a net rate of return (before taxes) that is very competitive with their other investment opportunities, such as Ginnie Mae securities or adjustable home mortgages. Past experience suggests that a confluence of several factors, e.g., interest rate changes, student loan demand, and periodic Congressional changes in the student loan formula, in due diligence regulations, and changes in other program features, has been followed by reductions in the number of lenders participating in the student loan program². The impact of these changes is only suggestive, however, because their timing does not coincide precisely with the timing of the reductions in participating institutions.

Scaling the number of originators by the number of banks and thrift institutions in existence, participants as a share of total depository institutions declined from a peak of 62.6 percent in 1985 to 53.9 in 1991, 56.6 percent in 1993, and to 42 percent last year. In addition there has been a greater concentration of loan originations by financial institutions. In fiscal year 1996, the top 10 institutions originated 40 percent of guaranteed loan originations as compared with 37 percent in fiscal year 1994; the top 25 originated almost 60 percent of the total student loans originated as compared with about 55 percent in 1994. And, the top 100 lenders originated nearly 84 percent of total student loans in 1996 as compared with about 79 percent in 1994. Moreover, since 1994, about 20 percent of the top 100 lenders originating student loans in 1995 either no longer participate in the student loan program or they sharply curtailed their loan originations.

- The Student Loan Reform Act of 1993 scheduled a change in the interest rate that borrowers would pay for new student loans starting in 1998. Under the current formula, which applies to new loans made between July 1, 1994 and June 30, 1998, lenders receive the rate on 3-month T-bills 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.³

¹ As used hereafter, the terms 3-month T-bills, 10-20 year Treasury securities, and 10-year Treasury notes refer to the bond equivalent rate of such securities or securities of constant maturity.

² Part of the decline in active lenders since 1994 may be due to the decline in the number of guaranteed student loans, as some borrowers decided to apply for direct loans from the Federal Government instead.

³ For loans in consolidation, the loan interest rate is the weighted average of the interest rates on all outstanding loans being consolidated, rounded upward to the nearest whole percent.

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Loans are reset quarterly for lenders and annually for borrowers. Starting with loans finalized after June 30, 1998, lenders' gross yield on new loans will be based on a longer-term interest rate, the average rate for 10-20 year Treasury securities, plus 1.0 percentage point,⁴ with the rate reset every 12 months

- By law, the Secretary of Education determines the applicable rate of interest, after consultation with the Secretary of the Treasury, that lenders can charge borrowers. The Secretary of Education has authority to determine the "comparable maturity" period. At OMB's direction, the Department of Education (DoE) may use the 10-20 year Treasury rate, or something closely approximating it, reflecting the maturity period for the discount rate that the Treasury Department charges DoE for budget scoring purposes. Based on the interest rate assumptions for the 1997 *Mid-Session Review*, the formula change for next year would reduce the loan rate to borrowers, relative to the rate they would pay under the current formula.⁵ In all likelihood the formula change also would reduce the net return to lenders. As discussed later in this paper, this change would reduce lenders' annual gross return in 1998/99, relative to 1997/98, by 47 basis points (for an in-school loan) and by 105 basis points (for loans in repayment). The comparable numbers for 1999/00

Because the loan interest rate has been between 7 and 9 percent for many years, we assume that the weighted average rate rounded to the nearest whole number will be 9.0 percent for many years in the future. Also, currently, a lender receives a SAP in any quarter in which the average 3-month T-bill rate for the quarter plus 3.1 percentage points is greater than the cap on the rate that the student pays, currently 8.25 percent. The SAP is the difference between the two rates.

⁴ The change in the formula for 1998 and subsequent years evolved late as the SLRA of 1993 went through 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, i.e., the average rate on Treasury securities maturing in 10-20 years. This approach has no exact economic logic, because it entails short-term repricing of a longer term loan. The market would use a 1-year rate for a 1-year reset.

⁵ A lower student loan interest rate in 1998 depends on the shape of the yield curve next year. Historical experience (since the early 1960s) suggests that because the rate that the student pays is capped at 8.25 percent, as it has been under current law, the average difference between 10-year Treasury notes plus 1.0 percentage point and the 3-month T-bill rate plus 2.5 (3.1) percentage points has been only -3 (-28) basis points. Since the cap on student loan interest rates will continue to apply in the future, the reduction in the student loan interest rate under the new formula may not be significant.

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relative to 1997/98 are 87 and 145 basis points.⁶ The critical policy issue for the loan program is whether lenders offering student loans currently have a sufficiently large profit margin to absorb these losses and any additional costs so that the opportunity cost of educational loans relative to other investment opportunities of lenders is still favorable.

- As noted, under the new loan formula, borrowers would pay a lower interest rate for student loans made after July 1, 1998. At the same time, however, the new loan formula involves more risk to lenders because of a mismatch between the short term source of funds to lenders and the long term maturity of student loans. This risk has been virtually nonexistent under the current formula, because lenders fund in the short term, e.g., 3-month LIBOR, whose term is closely matched to the 3-month T-bill interest reset period used to set the student loan rate. Starting in mid-1998, however, the new formula for student loans will force lenders to protect themselves against the risk from this mismatch by hedging the differential interest rate streams in some way, probably through a swap contract.

From the lender's perspective, tying the floating rate to the average rate on 10-20 year securities (or something close to it, such as 10-year Treasury notes) will entail a real cost because such floating rate arrangements are unusual. Typically, the rate on floating rate instruments is tied to a short-term rate that more closely represents the cost of funds to the lender. By creating an unusual instrument, for which a market does not exist at this time, the rate structure probably will make it more expensive to hedge the loan.

- Evaluating the future prospects for the net return to lenders or for those purchasing student loan contracts in the secondary market requires an estimate of the spread between lenders' costs and revenues, the latter based on the average interest rate for 10-20 year Treasury securities. Estimating the value of some of the costs incurred by lenders making student loans is either straight forward or the costs are not significant, e.g., origination fees, default risk, prepayment risk (although some financial market experts think this could be large). Two other key factors, (1) servicing/overhead costs and (2) hedging costs could be more difficult to estimate. On the revenue side, making projections of the rate for 10-20 year Treasury securities, or for whatever bond equivalent rate of the securities with a "comparable maturity" established by the Secretary of Education,⁷ is risky, but there are

⁶ Using what we think may be more realistic interest rate assumptions, the formula change would reduce lenders' gross return for in-school loans and loans in repayment in 1998/99 by 27 and 85 basis points, respectively. In 1999/00, the gross return on in-school loans would be higher than in 1997/98; same as the previous year but higher than in 1997/98; the return for loans in repayment would be reduced by 44 basis points relative to 1997/98.

⁷ For simplification and analytical purposes, we will assume that the security with a comparable maturity established by the Secretary of Education will be 10-year Treasury notes rather than the average of 10-20 year Treasury securities. This assumption has relatively little impact on the

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estimates that provide us some guidance, such as the latest Administration assumptions for the 1997 *Mid-Session Review*; *Blue Chip Economic Indicators*, the futures market; or historical experience.

Assumptions for Lenders' Costs

Using the *Mid-Session Review* economic assumptions for 10-year Treasury notes, the **student loan interest rate**, is 7.2 percent (6.2+1.0) for 1998/99, and 6.8 percent (5.8+1.0) for 1999/00.⁸ The 3-month T-bill rate assumed for the *Mid-Session Review* is 5.27 percent in 1998 and 5.10 percent in 1999. Under these assumptions, the spread between the 3-month T-bill rate and 10-year Treasury securities is 93 basis points in 1998/99 and 70 basis points in 1999/00.

These projections assume a relatively flat yield curve, which is consistent with the structure of current market rates. The projections are well below historical experience since 1962, however, and may be too optimistic. Although it may be a reasonable assumption that the yield curve in 1998 will be relatively flat, it may be more realistic to assume a steeper curve for 1999. Thus, an alternative assumption for interest rates is that the 3-month T-bill rate is 5.45 percent in 1998⁹ and the spread between 3-month T-bills and 10-year Treasury securities will be .95 percentage points. For 1999, an alternative assumption for the 3-month T-bill rate is that the rate will be 5.24 percent and the spread is 0.96 percentage points. Our alternative assumptions for **student loan interest rates**, therefore, are 7.4 percent (5.45+.95 +1.0) for 1998/99, and 7.2 percent (5.24 +.96+1.0) for 1999/00.

- The next key variable is the lenders' **matched funds rate**. The general assumption is that lenders borrow at LIBOR, which is approximately comparable to the 3-month T-bill rate plus some amount of basis points above that rate. One source estimates their all-in cost to finance loans is 30 basis points above the 3-month T-bill rate. Both a private guarantor of student loans and a brokerage house have told us they would estimate the current spread for a traditional bank or an institution securitizing student loans to be about 75 to 80 basis points. A large financial institution told us they assume an average bank can borrow at 3-

student loan interest rate because the two rates should be very close (see footnote 8).

⁸ These estimates are the second calendar quarter rates for 10-year Treasury notes for 1998 and 1999 plus 1.0 percentage point. If OMB assumptions for 10-20 year Treasury securities were used, the comparable rates would be 7.1 percent (6.11+1.0) for 1998/99 and 6.72 percent (5.72+1.0) for 1999/00.

⁹ See Appendix A for the source of this and other rates. A 5.40 3-month T-bill rate is about 13 basis points higher than the projected 3-month T-bill rate for the *Mid-Session Review*.

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month LIBOR, which is approximately equal to 3-month T-bills plus 40+ basis points.¹⁰

For this analysis, we assume the spread over the 3-month T-bill is 40 basis points, which is close to the spread over the past year and since 1981. For our initial estimates, we assume a matched funds rate of 5.67 percent for 1998/99 and 5.50 percent for 1999/00. Using the alternative assumptions for 3-month T-bills noted above, our alternative assumptions for the cost of matched funds is 5.85 percent in 1998/99 and 5.64 percent for 1999/00.

- **Servicing/overhead costs** are another variable that has a significant impact on lenders' net return. A private guarantor of student loans quoted us 15 basis points for overhead expenses. We assume this figure is close to the mark.

Estimates of servicing costs are more difficult to make. A 1993 CRS study noted that Sallie Mae reported their servicing costs were 66 basis points. A later (1997) CRS study estimated Sallie Mae's in-school servicing costs are 35 basis points, but their costs for the repayment period are much higher, about 100 basis points. A private guarantor estimates that servicing costs for a traditional bank are about 60 basis points. This figure is also cited in the latest Sallie Mae annual financial report as the cost of servicing Sallie Mae's entire portfolio over the course of a year, i.e., total servicing costs as a percent of total loans. Assessing all these estimates, we assume servicing costs are 60 basis points.¹¹

- Finally, the last major factor to be estimated which affects lenders' costs under the new formula is **hedging costs**. We have talked with several financial institutions about this issue. One source that made an estimate of hedging costs for Sallie Mae believes the cost of managing the risk from the mismatch between the payment stream from student loans and the source of lending is high. This risk, they argue, is complicated by the risk of prepayments and the possibility that the change in the formula could reduce the supply of student loans, which in turn could reduce Sallie Mae's portfolio gross earnings against which they would offset their costs. The fact that loan interest rates are reset (annually, starting with the implementation of the new formula next year) for lenders is another complicating factor.

Even if one could estimate the cost of an appropriate swap transaction, everyone agrees that selling one would be very difficult, because currently there is no market for swapping a single fixed rate asset (say, a 10-year student loan) which is reset yearly for a series of short term assets, say LIBOR or something similar. One could argue, of course, that the

¹⁰ For the past year, the average spread between 3-month LIBOR and 3-month T-bills has been 37 to 62 basis points. Since 1981, the average spread has been 42 basis points.

¹¹ It costs lenders less to service student loans when students are in school. Thus, we assume overhead and service costs for loans in the in-school status are one-third the cost for loans in repayment or consolidation.

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market is thin only because it has not been developed. But lenders may not be willing to take the risk today at a high price with the hope that they can hedge against such risk in the future at a lower price, after a market has developed.

Financial experts generally agree that it would be expensive to arrange a swap for the type of risk the new student loan formula creates. Such a swap arrangement, they say, is complicated by the reset provision, prepayments, and the price volatility of the basic asset, which could require an insurance premium. One institution also maintains that lenders will be reluctant to take a chance on, say, a 15-year student loan that is tied to a long-term interest rate which is reset every 12 months, if they can't be assured they can sell the loan before it matures. The lack of assurance of capital market liquidity for future student loans will make it more costly to offer them to borrowers.

The Goldman Sachs' swap model estimated the cost of a swap for student loan assets would be about 60 basis points. Another financial institution estimated the cost would be between 60 and 70 basis points. We have assumed, initially, that hedging costs are 65 basis points, the average of these two estimates. As an alternative and conservative assumption, we assume, arbitrarily, that hedging costs are about 50 basis points.

- In addition to these key cost factors, there are several other risks and costs that lenders incur by participating in the student loan program. One risk is from the possibility of default on loans in repayment. The probability of default on in-school loans, and to a lesser extent loans in consolidation, is small. The Federal Government pays the interest cost on a subsidized student loan while a student is in school. The Government also guarantees 98 percent of a student loan, thereby reducing substantially the cost of default to the lender. One source told us that their **default costs** are only 7 basis points. We assume this is a reasonable estimate.
- 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. We have assumed that the 0.5 percent fee is amortized over the average lifetime of a student loan, which is about 11 years (4 years in-school and 7 years of repayment). Thus, the annual cost is 5 basis points for in-school loans and loans in repayment. In addition, 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. The 1.05 rebate fee is added to the .05 origination fee, bringing the total fee to 1.10 percent for loans in consolidation.
- 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 be unable to reinvest these funds at the same return earned on the student loan. Prepayments reduce the average life of a loan portfolio, thereby increasing the over-the-life cost of certain fixed expenses, e.g., origination support, claim losses, and risk

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Estimates of **prepayment costs** appear to be somewhat arbitrary. The CRS estimates the **prepayment cost** is 60 basis points for loans in repayment. Currently, it is possible for students to **consolidate** guaranteed loans into the direct loan program while still in school. Moving loans into the direct program provides advantages to students, especially the option of income-contingent repayment, which could reduce significantly the repayment burden for some borrowers. In order to keep loans in the guarantee version of the program rather than losing them to the direct version, some lenders offer favorable terms to promote consolidation of loans by borrowers, and they incur a promotion expense in the process.

One financial institution we spoke with assumes that prepayment costs are about 4 to 5 basis points. Another private source estimates their prepayment costs are 4 basis points. A third source thinks that prepayments are a much greater risk than this, partly because borrowers have an incentive to take out a home equity loan to prepay their student loan, if the spread is not too large. The interest on a home equity loan is tax deductible and, therefore, reduces the effective cost of a student loan to the borrower. Interest on student loans currently is not deductible. The Taxpayer Relief Act of 1997, enacted last summer, allows certain individuals who have paid interest on qualified education loans to claim a deduction for this expense. However, the Act limits the interest deduction to the first 60 months in which interest payments are required and also limits the amount of interest that can be deducted.

We agree that prepayment of student loans is a possible complication for lenders. Because various lenders told us they do not think prepayment is a major problem, however, we assume the cost for lenders is 4 basis points, which is consistent with the cost estimated by several sources.

Summary Results

Taking all of these cost factors into consideration, Table 1 shows our initial estimate of lenders' net return (before taxes) from student loans for 1997/98 to 1999/00. Except for 1997/98,¹² these estimates reflect *Mid-Session Review* assumptions for interest rates.

- Under the current student loan formula, it appears that lenders are earning a rate of return on student loans that is very favorable compared to what they could earn from alternative investment opportunities. Our estimate for 1997/98 shows that the weighted average net return (before taxes) to lenders is 1.71 percent. This is competitive with the lower end of

¹² Data for 1997/98 interest rates are actual rates for the last week in May, 1997 prior to June 1, 1997.

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a range for a pre-tax return for banks of between 1.67 percent and 2.1 percent.¹³ and with the return on other Government guaranteed loans. Because student loans are guaranteed by the Federal Government, lenders should be willing to accept a rate of return which falls well below the lower end of this range and is less than the return on other investments that are not guaranteed. In fact, one large financial institution indicated to us that if loans are risk-weight adjusted, a Government guaranteed student loan could earn as low as 1.0 percent before taxes and still be competitive with alternative investment opportunities. Our estimate of the weighted pre-tax rate of return on student loans in 1997/98 suggests that the current student loan formula provides lenders a very generous margin of profit.

- The key factor in this favorable profit picture is the relatively large gross return (i.e., student loan interest rate) that lenders receive under the current loan formula. The return to lenders would change dramatically, however, if the new student loan formula changes 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.¹⁴ Furthermore, we have already noted that this change in the formula imposes a significant new risk for lenders, namely the mismatch between their short term source of funds and the long term maturity of a student loan. This risk has been virtually nonexistent under the current loan formula, because the maturity of the instrument for lenders' short term funding is closely matched by the basis of the formula for determining the student loan interest rate.

Table 1 shows that switching to the new student loan formula could reduce the weighted average pre-tax return to lenders from 1.71 percent in 1997/98, when the old formula applies, to 0.22 percent in 1998/99 and 0.04 percent in 1999/00. Obviously, these estimated net returns to lenders under the new student loan formula and using the *Mid-Session Review* assumptions are not sufficient to make student loans competitive in 1998/99 or 1999/00.

- We recognize that our initial assumptions for some lenders' costs could turn out to be

¹³ A rule of thumb in the banking industry is that lenders need an after-tax rate of return of about 1.0 percent to 1.3 percent for an investment to be competitive. Assuming that the average total income tax rate for a bank is 40 percent, the range for a competitive before-tax rate of return is 1.67 percent to 2.1 percent.

¹⁴ Since 1962, the rate for 10-year Treasury notes plus 1.0 percentage point has been less than the 3-month T bill rate plus 3.1 percentage points by an average of 88 basis points. 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. The difference for the in-school rate was only 3 basis points. The *Mid-Session Review* assumes this difference will be much larger in the coming years: 1.05 percentage points in 1998, 1.40 percentage points in 1999, 1.26 percentage points in 2000, and 1.20 percentage points from the year 2001 through 2007.

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inaccurate. For example, our estimate for hedging costs may be too high (or too low), although the two estimates we received suggest we are not. Certainly, interest rates in 1998 and 1999 could well be higher or lower than the estimates in the *Mid-Session Review*, for example. For the purpose of recalculating our estimates, we have lowered our estimates for hedging costs to 50 basis points and have raised the interest rate assumptions as noted earlier.

At the same time, it is necessary to modify the presumed minimum pretax net rate of return that is necessary to provide a competitive rate of return to lenders. A 1.0 percent pre-tax rate of return assumes there is a secondary market for student loans, which there is under the current student loan formula. However, a number of sources have told us that lenders are concerned about the liquidity of loans that would be originated under the new loan formula, because of the risk from lending long but borrowing short. This concern would raise the break even point for an otherwise virtually riskless student loan so that the lower end of the range of a profitable pre-tax return might be about half-way between 1.0 percent and 1.67 percent, or 1.3 percent.

Plugging these revised assumptions into Table 2, lenders' net returns in 1998/99 and 1999/00 are 0.37 percent and 0.40 percent, respectively. These results are still grossly inadequate to provide a competitive pretax rate of return to lenders in 1998/99 and 1999/00.

The estimates in these two tables suggest that it could be risky to assume that lenders would earn a normal rate of return next year, or the year after, if they are required to offer students loans based on the new loan formula.¹⁵ If this observation is correct, it is very likely that the new student loan rate for 1998 and beyond could have a serious negative impact on the viability of the FFEL program.

A Possible Remedy

- Assuming the results shown above are within reason, which we believe they are, a remedy is possible that would satisfy an objective of assuring that the student loan interest rate next year is close to or lower than what it would be under the new formula, and that lenders continue to receive a competitive rate of return for their investment. As noted above, the results obtained for 1997/98 suggest that under the current student loan formula, lenders are earning a rate of return on student loans that is very favorable relative to their alternative investment opportunities. It would be possible, therefore, to retain the structure of the current formula but reduce the spread between 3-month T-bills and the

¹⁵ If the new formula was already in place today, the risk-adjusted net return for student loans would be 0.37 percent, using current interest rates, a 40 basis point mark-up over the 3-month T-bill rate as the cost of matched funds, and hedging costs equal to 50 basis points. Obviously, this is well below the pre-tax rate of return lenders would need to offer such loans.

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student loan interest rate and still reduce the interest rate borrowers are charged. This would effectively eliminate the need for lenders to hedge their risk from student loans because of the mismatch resulting from switching to the new formula scheduled to take effect next year.

- Tables 3 and 4 show the results from retaining the current structure of the student loan formula but narrowing the spread currently allowed above the 3-month T-bill rate. These tables assume that the T-bill rates for 1998/99 and 1999/00 are 5.45 percent and 5.24 percent, respectively. There are no hedging costs because the formula uses the 3-month T-bill rate. The formula spread is 1.9 percent in 1998/99 and 2.25 percent for 1999/00. It also is assumed that retaining the structure of the current formula eliminates the potential problem of loan liquidity facing lenders under the new student loan formula. Therefore, we assume a 1.0 percent pretax rate of return, rather than, say, 1.3 percent, is the minimum return required in order for lenders to participate in the student loan program.

Concluding Remark

- It must be pointed out that the bottom line estimates in this paper are only as good as the assumptions for interest rates and lenders' costs on which the estimates are based. While we believe the assumptions are reasonable, we recognize that financial market conditions can change dramatically from where they are now or from where they are projected to be in the future. Moreover, the methodology used to estimate lenders' net return is based on assumptions of average costs for all lenders. Obviously, the cost structure for any particular lender may be significantly different. Nevertheless, we think the bottom line estimates in this paper are a reasonable approximation of the financial situation facing lenders and borrowers now and in the near future.

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Appendix A

Appendix A provides additional details about some of the assumptions used in this paper.

1. An alternative assumption for interest rates is that the 3-month T-bill rate for 1998 is 5.45 percent. This is the *Blue Chip Economic Indicators* consensus forecast for the third quarter of 1998, converted to a bond equivalent basis. This estimate is higher than the 5.05 percent average closing price in the futures market since mid-September for 3-month T-bills maturing in June, 1998, but close to the closing price of 5.2 percent since the end of May for 3-month T-bills maturing in March, 1998. For 1999, the rate is 5.24 percent, which is the *Blue Chip* projection for the 3-month T-bill (This figure is for the calendar year, because *Blue Chip* has annual data only after 1998.

The spread between 3-month T-bills and the average of 10-year Treasury securities in 1998 is 0.95 percentage points, which is the spread projected in the *Blue Chip* economic forecast. (If we had used the spread from the futures market, it would be 1.72 percentage points, which is close to a 1.68 percentage point spread for the period 1981 to date.) For 1999 the spread between 3-month T-bills and 10-year Treasury securities is 0.96 percentage points, which is the forecast in *Blue Chip*.

2. In estimating a lender's matched funds rate, it could be argued that the cost of funds for banks may be lower than the 3-month T-bill or 3-month LIBOR rate. For example, banks with a stable deposit base may have an effective cost for these funds that is lower than the 3-month T-bill rate. The question is whether larger banks have a stable deposit base they can count on. Alternatively, because we are talking about a \$25-30 billion guaranteed loan program and there is considerable concentration of student loan originations among a relatively small number of banks, some banks might have to borrow large amounts at the 3-to 6-month jumbo CD rate, which is generally well above the 3-month T-bill rate but less than 3-6 month LIBOR.

The general view, however, is that the matched funds rate is closer to the 3-month T-bill rate plus about 40 basis points. Using the *Mid Session Review* estimates for 3-month T-bills, the matched funds rate for 1998/99 is 5.27 percent plus 40 basis points or 5.67 percent, and 5.10 percent plus 40 basis points or 5.50 percent for 1999/00. Our alternative assumptions are 5.45 percent (a *Blue Chip* consensus forecast) plus 40 basis points or 5.85 percent and 5.24 percent plus 40 basis points or 5.64 percent for 1998/99 and 1999/00, respectively.

3. We agree that prepayment of student loans is a possible complication for lenders. On the one hand, lenders currently may be offering price incentives to discourage students from prepaying their loans and moving into the direct loan version of the program. In the future, however, the squeeze on lenders' net return because of the new student loan formula may make it impossible for lenders to continue offering these price incentives, and there could be an increase in prepayments.

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On the other hand, a sizable log jam of applications waiting to be processed for consolidation into the direct loan version appears to be discouraging new applications from students. Because of this logjam, the Department of Education has suspended temporarily the privilege of switching to the direct loan program. In addition, the demand for student loans is likely to be fairly stable over time. An increase in the future college age population should generate increased demand for new student loans, which could offset existing borrowers' incentive to prepay their student loans and a possible slower growth in future loan demand because of the tuition tax credits included in the recently enacted tax bill. Unless colleges, universities and training institutions raise their tuition because of the tax credit, the credit will reduce the gross amount of funds a student needs to finance his/her higher education.

On average, many student loans probably are prepaid at some point. Loan repayment periods are for up to 10 years after a student leaves school, but the average loan probably is paid-off or sold by the lender before then (some lenders sell their loans after the in-school period when the Government stops paying the interest for the borrower). Because various lenders told us they do not think prepayment is a major problem, we assume the cost for lenders is 4 basis points, which is consistent with the cost estimated by several sources.

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TABLE 1. RISK-ADJUSTED NET RETURN FOR FFEL STUDENT LOANS, 1997-1999
(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99			7/1/99 to 6/30/00		
	In-School or Deferment	Repayment	Consolidation	In-School or Deferment	Repayment	Consolidation	In-School or Deferment	Repayment	Consolidation
Student loan interest rate	7.67	8.26	9.00	7.20	7.20	9.00	6.80	6.80	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.67	5.67	5.67	5.50	5.50	5.50
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs	0.20	0.60	0.60	0.20	0.60	0.60	0.20	0.60	0.60
Overhead	0.05	0.15	0.15	0.05	0.15	0.15	0.05	0.15	0.15
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
Hedging costs	0.00	0.00	0.00	0.65	0.65	0.65	0.65	0.65	0.65
Subtotal	5.98	6.48	7.53	6.73	7.23	8.28	6.56	7.06	8.11
Net return	1.69	1.77	1.47	0.47	-0.03	0.72	0.24	-0.26	0.89
Weighted Average Net Return		1.71			0.22			0.04	

Note: Table is for new student loan formula. The 3-month T-bill rate for 1997/98 is the actual rate for the last week in May, 1997 prior to June 1, 1997. Interest rates for 1998/99 and 1999/00 are based on the economic assumptions for the 1997 Mid Session Review.

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TABLE 2. RISK-ADJUSTED NET RETURN FOR FFEL STUDENT LOANS, 1997-1999
(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99			7/1/99 to 6/30/00		
	In -School or Deferment	Repayment	Consolidation	In -School or Deferment	Repayment	Consolidation	In -School or Deferment	Repayment	Consolidation
Student loan interest rate	7.67	8.25	9.00	7.40	7.40	9.00	7.20	7.20	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.85	5.85	5.85	5.64	5.64	5.64
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs	0.20	0.60	0.60	0.20	0.60	0.60	0.20	0.60	0.60
Overhead	0.05	0.15	0.15	0.05	0.15	0.15	0.05	0.15	0.15
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
Hedging costs	0.00	0.00	0.00	0.50	0.50	0.50	0.50	0.50	0.50
Subtotal	5.98	6.48	7.53	6.76	7.26	8.31	6.55	7.05	8.10
Net return	1.69	1.77	1.47	0.64	0.14	0.69	0.65	0.15	0.90
Weighted Average Net Return		1.71			0.37			0.40	

Note: Table is for new student loan formula. Interest rates for 1998/99 and 1999/2000 are from the Blue Chip Economic Indicators.

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TABLE 3. ALTERNATIVE RISK-ADJUSTED NET RETURN FOR FFEL STUDENT LOANS, 1997-1999
(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99			7/1/99 to 6/30/00		
	In-School or Deferment	Repayment	Consolidation	In-School or Deferment	Repayment	Consolidation	In-School or Deferment	Repayment	Consolidation
Student loan interest rate	7.87	8.25	9.00	7.35	7.70	9.00	7.14	7.49	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.85	5.85	5.85	5.64	5.64	5.64
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs	0.20	0.60	0.60	0.20	0.60	0.60	0.20	0.60	0.60
Overhead	0.05	0.15	0.15	0.05	0.15	0.15	0.05	0.15	0.15
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
Hedging costs	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Subtotal	5.98	6.48	7.53	6.26	6.76	7.81	6.05	6.55	7.60
Net return	1.89	1.77	1.47	1.09	0.94	1.19	1.09	0.94	1.40
Weighted Average Net Return		1.71			1.02			1.05	

Note: Table is for alternative student loan formula: 3-month T-bill rate plus 1.9 percent for in-school loans and 3-month T-bill rate plus 2.25 percent for loans in repayment. Interest rates are from Blue Chip Economic Indicators.

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DRAFT**TABLE 4: STUDENT LOAN RATES AND LENDERS' NET RETURNS UNDER ALTERNATIVE ASSUMPTIONS
(PERCENT)**

FORMULA	STUDENT LOAN RATE			LENDERS NET RETURN		
	1997/98	1998/99	1999/00	1997/98	1998/99	1999/00
Current:						
3-month T-bill plus 2.5/3.1 percent	7.67/8.25	N.A.	N.A.	1.71	N.A.	N.A.
New for 1998/99:						
10-year plus 1 percent	N.A.	7.40/7.40	7.20/7.20	N.A.	0.37	0.40
Alternative:						
3-month T-bill plus 1.9/2.3 percent	N.A.	7.35/7.70	7.14/7.49	N.A.	1.02	1.05

N.A. not applicable

Note: Student loan interest rates shown are for in-school loans and loans in repayment.

Assumptions:**Student loan interest rates:**

Current formula: 3-month T-bill is the actual rate for the last week in May, 1997 prior to June 1. The rate was 5.17%.

New formula: For 1998/99, the 10-year note rate is T-bills plus 0.95 percentage points plus 1. The T-bill rate is 5.45% (a Blue Chip Economic Indicators forecast) and the 0.95 percentage points is the consensus spread between T-bills and 10-year notes in the Blue Chip forecast. For 1999/00 the assumed T-bill rate is 5.24% and the spread is .96 percentage points (Blue Chip projections).

Alternative formula: The rates shown in the table are based on the same assumed rates for T-bills under the new formula, i.e., 5.45% for 1998/99 and 5.24% for 1999/00. The formula spread is the amount that would be necessary to assure a competitive net return to lenders and approximately the same student loan rate a borrower would pay under the new formula. These amounts are 1.9 percent for in-school loans and 2.25 percent for loans in repayment.

Lenders' net return:

Assumes a 1.0 percent pre-tax return, rather than, say, 1.3 percent, is the minimum return required in order for lenders to participate in the student loan program (see p. 8 of the text).

M. COMIEZ

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STUDENT LOAN CHANGES WOULD COST BORROWERS \$5.6 BILLION

Legislation currently being considered for introduction in Congress would reverse an important student loan benefit won in 1993. Disguised as a plan to "reduce" interest rates and fees, the new legislation would instead *prevent* lower interest rate from going into effect next year. The bill provides some benefits to students, but these are more than outweighed by the \$7.3 billion cost to students. The net cost to students who take out loans over the next five years: \$5.6 billion.

Under current law, students will save \$7.3 billion on loans made over the next five years. The Student Loan Reform Act of 1993 changed the formula for determining the interest rate on student loans from the 91-day Treasury bill plus 3.1 percentage points (or 2.5 during the in-school and deferment periods), to the 10-year Treasury note plus one percentage point. Using CBO interest rate projections, borrowers will save \$7.3 billion on a net present value basis (discounting the savings to the year the loan is originated). (On a cash basis, students who borrow over the next five years will pay \$10.9 billion less in interest).

All estimates point to significant savings for students. This is not an issue of one expert's forecasts versus another's. Interest rate projections from CBO, OMB, and the private sector's Blue Chip projection all show that students will benefit from a significant reduction in the interest rate paid. For example, for 1998, both the Blue Chip and CBO forecast a reduction of 1 percentage point, while OMB forecasts a reduction of 1.14 percentage points. *In fact, students come out better under the 1998 scenarios forecast by all 50 of the private sector economists that make up the Blue Chip consensus.*

The Congressional proposal would cost students \$5.6 billion over five years. Don't be fooled by the title of the legislation ("A Bill . . . to reduce interest rates and origination fees for student loans.") This is a classic bait and switch. The legislation lowers the origination fee and makes a minor interest rate change, saving borrowers about \$1.7 billion. But there's a catch: before these benefits are provided, the legislation increases the interest rate that borrowers will pay, costing them \$7.3 billion. The net cost to borrowers is \$5.6 billion on a net present value basis (\$9 billion on a cash basis).

They are holding low-income students hostage to protect bank profits. The interest rate provisions are included in a draft bill that also makes important changes to ensure that all deserving low-income students have access to Pell Grants. Supporters are cynically holding those students hostage in order to increase student loan interest rates at the behest of banks.

Education Dept.

Comparison of Student Loan Interest Rates under Current Law and House Subcommittee Proposed Policy

	Calendar Year				
	1998	1999	2000	2001	2002
Three Month Treasury Bill Rate					
CBO	5.00%	4.60%	4.20%	3.90%	3.90%
OMB	5.27%	5.06%	4.72%	4.50%	4.50%
Ten Year Treasury Note Rate					
CBO	6.10%	5.80%	5.50%	5.50%	5.50%
OMB ¹	6.11%	5.72%	5.44%	5.25%	5.20%
In Repayment Student Interest Rates under Current Law ²					
CBO	7.10%	6.80%	6.50%	6.50%	6.50%
OMB	7.11%	6.72%	6.44%	6.25%	6.20%
In Repayment Student Interest Rates under House Subcommittee Policy					
CBO	8.10%	7.70%	7.30%	7.00%	7.00%
OMB	8.25%	8.16%	7.82%	7.60%	7.60%
Savings to Students under Current Law					
CBO	1.00%	0.90%	0.80%	0.50%	0.50%
OMB	1.14%	1.44%	1.38%	1.35%	1.40%

¹ Represents the comparable maturity rate for a 10-20 year loan on a fiscal year basis

² For loans originated after July 1, 1998

Budget Service
9/12/97

House Subcommittee Proposals--Cost to Students and Parents

(In millions of dollars)

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>1998-02</u>
Cost to Students of Repeal of Scheduled Interest Rate Reduction						
NPV Basis	612	1,501	1,620	1,737	1,836	7,306
Cash Basis	965	2,288	2,423	2,557	2,694	10,927
Reduction of In-School and Grace Period Interest Rate						
NPV Basis	-41	-45	-48	-51	-54	-239
Cash Basis	-63	-67	-72	-77	-82	-361
Allow Consolidation Loans from DI, into FFEL						
NPV Basis	-	-	-	-	-	-
Cash Basis	-	-	-	-	-	-
* Students may benefit from lower interest rates under FFEL consolidation. CBO has not yet costed, but should be minimal.						
Allow FFEL Borrowers to Retain Stafford Benefits When Consolidating						
NPV Basis	-	-	-	-	-	-
Cash Basis	-	-	-	-	-	-
* Students may benefit from lower interest rates under FFEL consolidation. CBO has not yet costed, but should be minimal.						
Reduce Origination Fee by 1 Percent on All Non-Consolidated Loans						
NPV Basis	-145	-305	-325	-340	-335	-1,450
Cash Basis	-152	-320	-341	-357	-352	-1,523
Total Cost						
NPV Basis	426	1,151	1,247	1,346	1,447	5,617
Cash Basis	750	1,900	2,009	2,123	2,260	9,043

Budget Service
9/15/97

Comparison of Administration and CBO Interest Rates

The table below shows the scheduled interest rate for student loans (Stafford and Unsubsidized Stafford) after July 1, 1998.

Administration Interest Rates Mid Session Review

	<u>Base Interest Rates</u>			<u>Comprable Add-On</u>			<u>Student Rate</u>
	<u>91-Day</u>	<u>1 Year</u>	<u>10 Year</u>	<u>91-Day</u>	<u>1 Year</u>	<u>10 Year</u>	
FY 98	5.45%	5.89%	6.11%	1.66%	1.22%	1.00%	7.11%
FY 99	5.27%	5.58%	5.72%	1.45%	1.14%	1.00%	6.72%
FY 00	5.02%	5.28%	5.44%	1.42%	1.16%	1.00%	6.44%
FY 01	4.68%	5.02%	5.25%	1.57%	1.23%	1.00%	6.25%
FY 02	4.50%	4.84%	5.20%	1.70%	1.36%	1.00%	6.20%
FY 03	4.50%	4.84%	5.20%	1.70%	1.36%	1.00%	6.20%
Average 98-02	4.98%	5.32%	5.54%	1.56%	1.22%	1.00%	6.54%

The 91 -Day and 1 Year rate are the rates associated with the third quarter of the prior calander year (e.g., the FY 98 91-Day rate is the July-Sept 1997 rate).

Congressional Budget Office

	<u>Base Interest Rates</u>			<u>Comprable Add-On</u>			<u>Student Rate</u>
	<u>91-Day</u>	<u>1 Year</u>	<u>10 Year</u>	<u>91-Day</u>	<u>1 Year</u>	<u>10 Year</u>	
FY 98	5.00%		6.10%	2.10%		1.00%	7.10%
FY 99	4.60%		5.80%	2.20%		1.00%	6.80%
FY 00	4.20%		5.50%	2.30%		1.00%	6.50%
FY 01	3.90%		5.50%	2.60%		1.00%	6.50%
FY 02	3.90%		5.50%	2.60%		1.00%	6.50%
FY 03	3.90%		5.50%	2.60%		1.00%	6.50%
Average 98-02	4.32%		5.68%	2.36%		1.00%	6.68%

26-Sep-97
Budget Service



Don_Feuerstein @ ed.gov
10/15/97 01:10:00 PM

Education Dept.

Record Type: Record

To: Robert M. Shireman

cc:

Subject: Scheduled Interest-Rate Reduction

Bob:

In case any of this is of use to you for your Friday meeting.

Since writing it, I have discovered that Sallie Mae compensated for the 1993 Amendments by increasing its leverage and actually raised its ROE from 34 percent in 1993 to 38 percent in 1996. Student Loan Corporation reduced its leverage, and its ROE fell from an astounding 43 percent to a still respectable 19 percent.

Don

Forward Header

Subject: Scheduled Interest-Rate Reduction

Author: Don Feuerstein at wdca09

Date: 9/14/97 1:23 PM

Pauline said that you would like a memo from me on this subject. William and I agreed that I would handle the impact on lenders to supplement Budget Service's analysis of the impacts on students and the budget.

I have seen a number of seemingly sophisticated analyses of lender impact. Since all such analyses are based on interest-rate projections for substantial future periods, I consider their precision to be more illusory than real. As I once irritated my Wall Street colleagues by testifying before a Senate committee, any interest-rate guru who truly believed in his forecasting ability would surely not share his forecasts with anyone else. Moreover, we do not have any reliable data on the current profitability of bank lenders other than Citicorp. I shall do my analysis on a broad-brush basis.

In 1993, when the scheduled change from 91-day T-bill plus 3.1 percent to comparable maturity (probably 10-year bond) plus 1.0 percent was enacted, the new formula would actually have resulted in higher interest rates if it had been implemented immediately. Although the then official interest-rate projections correctly (in hindsight) called for a reversal of that advantage, lenders were apparently willing to take the risk and did not vigorously, if at

all, oppose the change.

Today, the slope of the yield curve (a line plotted with interest rate and maturity as coordinates) is quite flat; and the 10-year bond rate is only some 1.3 percent higher than the 91-day bill rate. Thus, at today's rates, the change would mean a loss of approximately 0.8 percent in net interest to lenders ($1.3 + 1.0 - 3.1$). Most interest-rate projections, including CBO's and OMB's, are for a relatively, but possibly less, flat slope to continue. (The impact on lenders of the scheduled change will be determined by the slope of the yield curve rather than its absolute level. Any steepening would be to lenders' advantage under the scheduled change.)

A sophisticated analysis of lender profitability would consider (1) the different interest rates for in-school, deferment and repayment, (2) the fact that lenders actually fund at varying premiums over the 91-day bill rate (or discounts in the case of tax-exempt or bank-deposit/retail-CD funding), (3) the cost of defaults and (4) origination and holding fees. Some analysts would also impute a cost for the risk of early termination through default, repayment or forgiveness. (I would not.) The Congressional Research Service did such an analysis that showed 1996-97 "risk-adjusted spreads" of 1.02 percent for loans in repayment and in consolidation and 1.94 percent for loans in school.

I believe that the cost factors used by CRS are overstated, and that lenders' pretax spreads for taxable funding are in the range of 1.75 to 2.25 percent. Tax-exempt funding could potentially add another 1.0 to 2.0 percent, and bank deposit/retail-CD funding, 0.1 to 0.6 percent. The next largest cost components after funding are servicing and general overhead, and the substantial economies of scale for these functions result in the wide range for the spread. In any event, the change in the level of interest rates would only reduce lenders' returns for normal taxable funding by 30-50 percent.

The scheduled change would not only lower returns under current projections. It would also make them more volatile, because long-term rates fluctuate more, at least on an absolute basis, than short-term rates. Lenders correctly argue that this increased volatility further lowers their returns, either because they must now purchase a hedge contract to eliminate the increased risk, or because an additional cost should be imputed for this risk if they choose not to do so. Various "expert opinions" have been submitted on the cost of hedging. One such submission claims an additional cost of 0.6 percent. Such a cost would reduce lenders' returns for taxable funding by another 22.5-30 percent.

In my opinion, any attempt to quantify the cost of hedging now is substantially overstated, because there is currently no supply of investor funds paying interest at the 10-year bond rate reset annually. Accordingly, the swap dealer writing the hedge contract would have to take the risk of the hedge itself rather than laying it



off to an investor and would charge a substantial premium for taking that risk. But such a supply of funds could be developed in a relatively short period of time by paying investors a premium for them until the instruments were commonly found on their approved-investment lists, when the premiums could be substantially reduced or eliminated.

The bottom line of all this, in my opinion, is that lenders do have a legitimate complaint about the scheduled change in interest rates, but no crisis exists. If the change goes into effect on July 1, 1998, as scheduled, the current trend for small banks (typically with high funding and servicing/administration costs) to leave the program will probably be accelerated; but Sallie Mae, the large banks and other secondary markets with tax-exempt funding will remain. Many of these small banks are now only pipelines for Sallie Mae anyway. The problem should be fixed as part of a more comprehensive package of reforms in reauthorization, rather than piecemeal by a total repeal of the scheduled change in our appropriations bill. The lenders have been unable and/or unwilling to develop a compromise solution that would not place the entire burden on students. Lender returns, especially for Sallie Mae, large banks and tax-exempt secondary markets, are sufficiently robust to absorb a substantial part of the cost.

CRS Report for Congress

Congressional Research Service • The Library of Congress

Student Loans: What is the Problem With Converting to the 10-Year Interest Rate Benchmark?

Barbara Miles
Specialist in Financial Institutions
Economics Division

Summary

Beginning June 1, 1998, the index for setting the interest rate on federally backed student loans will be changed from the 3-month Treasury bill rate to the 10-year Treasury note rate. This adds a cost to the program for private lenders who make student loans; the cost may be sufficient to remove some of them from the program. More to the point, without any fundamental market-oriented change in the way the interest rate is set each year, the new index 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.

Background

Federally backed student loans for postsecondary education are made by private sector lending institutions under the auspices of the Federal Family Education Loan program (FFEL) and by the federal government under the auspices of the Direct Loan program (DL). FFEL and DL provide the same loans on essentially the same terms and conditions, and may be properly thought of as simply two delivery systems for one program. For both systems, the government accepts most (FFEL) or all (DL) of the cost of defaults, and that will not be affected by the interest index shift. Similarly, the other costs of making loans -- origination, servicing, fees and taxes -- would be unaffected by the change. The scheduled shift in how the interest rate is set raises concerns for the FFEL loans, however, because it introduces a potentially expensive funding cost for private lenders, who have the option to stop making the loans should they cease to provide competitive rates of return. The DL would continue to make loans as an entitlement for students, without regard to costs and returns.

Currently, the interest rate on FFEL loans made to students is set at 2.5 percentage points above the bond-equivalent yield of the 91-day Treasury bill while the student is in school (or deferment) and the government is paying interest on the



student's behalf.¹ When the student has left school and is repaying the loan, the loan is repriced at 3.1 percentage points above the Treasury bill. For students, the interest rate is reset annually. Lenders, however, may receive a special allowance payment (SAP) in any quarter that the 91-day bill results in a loan rate that is higher than what the student pays. This arrangement results in student loans that are significantly protected from interest rate risk, particularly for banks and other institutions that rely on short-term deposits.

The change that will, absent legislation, take effect for the 1998-99 school year would produce student loan interest rates of 1.0 percentage points above the 10-year Treasury note, throughout the life of the loan. For lenders, the rate would be reset quarterly as at present. On average, over the past decade and a half, the note rate plus 1.0 percentage point has been almost the same as the bill rate plus 3.1 percentage points. Thus, on average, it might be expected that lenders would find their profits mostly unaffected by the formula change. This is not the case, however, because there has been considerable volatility in the interest rate spread between the note and bill rates, and a prudent lender would have to take that into consideration in funding loans.

The formula shift raises two immediate difficulties for lenders with significant holdings of student loans. First, under current economic and financial conditions, the new formula results in lower gross return to lenders (lower interest rates) than the old formula. For 1996, the spread between the 10-year note rate and the 3-month bill rate was about 1.4 percentage points. Thus, had the new formula been in place in 1996, lenders could have expected to lose 0.7 percentage points of gross yield from the formula change (during the period of the loan when the rate was set at the bill rate plus 3.1 percentage points). The Congressional Budget Office (CBO) has forecast rates for 1997 and 1998 which imply a gross yield to lenders lowered by about 0.9 percentage points for those years, and has projected rates through the year 2007 that imply a long-term loss in gross yields of about 0.5 percentage points.²

The second difficulty for lenders stems from the potential volatility between the note and bill rates and, thus, between the two formulae. Over the past 15 years, the spread between the bill and note rates has varied from a very narrow 0.1 percentage points to a very wide 4.5 percentage points on a quarterly basis. The narrow spread implies a potential loss of profitability while the wide spread implies excess profits for the lenders, and higher budget costs for the government whenever it is paying a SAP. Volatility in the bill-note rates is not expected to be so extreme in the foreseeable future. Nonetheless, both CBO's pessimistic and optimistic alternatives to the baseline forecast include a narrowing of the bill-note spread at points within the economic cycle in future years. One of the pessimistic scenarios implies a reduction in gross yield to lenders of about 1.7 percentage points.

¹ This is for the Stafford "subsidized" portion of the program, which is the largest of the lending programs. For more detail on the student loan programs, see *The Federal Family Education Loan Programs*, by Margot Schenet, CRS Report 94-810 EPW, updated December 12, 1996.

² *The Economic and Budget Outlook: Fiscal Years 1998-2007*, January 1997.

Volatility imposes a cost on lenders. Specifically, the cost is the risk due to interest rate fluctuations. A prudent lender will attempt to account for this cost by reducing exposure to the interest rate risk (reducing the volume of student loans as a proportion of all assets the lender holds), or by hedging the differential interest rate streams in some way.³ Historically, this was not a problem for student loans because the program, with its quarterly adjustments, made any hedging unnecessary. With the formula shift, however, the gross yields on the loans vary according to a 10-year note rate that is less reflective than the 3-month bill rate of the cost of funds to private lenders. In addition, as noted above, the spread between the note and the bill rates is not constant over time.

Financial markets offer a number of hedging techniques and instruments that enable lenders to avoid risk, but hedging is not cost-free. The cost imposed by this new interest rate risk can be measured by what it might cost to hedge a 10-year stream of income, adjusted quarterly against a 3-month stream that matches up (as does the current student loan rate) with the common short-term borrowing strategy relied on by banks. One way this could be done is through a swap contract, under which the lender would pay an interest rate linked to the 10-year note rate (that is, the interest rate it would receive from its student borrowers under the new formula) and would receive in return an interest payment linked to the 3-month rates (roughly, the rate it received under the old formula). For example, a swap might involve exchanging payments linked to 10-year rates based on the Treasury constant maturity index ("CMT") for payments linked to short-term "LIBOR" rates.⁴ Currently, such a swap could be made for about 0.35 percentage points on a one time, straight-up basis. In fact, however, the swap would probably be more complicated, requiring annual hedges for the life of loans as well as future hedges for loans to be made after the loan rate is set (in June) but prior to the loan payout (in September and January), and thus be more expensive.⁵

The cost of interest rate risk would be added to the expected yield reduction to get the total expected profitability reduction owing to the shift to the 10-year index. The total loss of profitability could, therefore, vary from about 0.85 percentage

³ It does not matter if the lender actually sets up a formal hedge. The cost of the loans to the lender will include an allowance for interest rate risk as a real cost of making and holding the loans. Risk-adjusting the yields on loans means subtracting from the gross yields the costs of raising money to fund the loans, the hard costs of originating and servicing the loans and paying special fees and taxes on them, and the estimated costs of the risks being undertaken from possible defaults, interest rate swings, losses of anticipated income from early repayments and the like.

⁴ The 10-year constant maturity index represents the current average interest rate on all outstanding Treasury debt that has a remaining life of 10 years. It is not the same as the 10-year note rate, which tends to be more volatile and which it lags. LIBOR is the term that refers to short-term London interbank offered rates.

⁵ The CMT-LIBOR swap is not the strict hedge that lenders would seek to cost or remove interest rate risk. An alternative measure has been developed between the 3-month bill and a quarterly reset 10-year CMT by Goldman Sachs & Co. for Sallie Mae, that indicates a loss of lender returns of between 0.69 and 1.59 percentage points.

CRS-4

points to as much as 1.20 percentage points, based on current interest rate projections in the CBO baseline forecast.

If it is true that lenders of large scale earn between 1.0 and 1.8 percentage points on student loans, then the new costs owing to the interest rate formula shift are significant. Depending upon economic expectations of lenders, student loans could vary from a reasonably competitive rate of return, to a projected loss.

Lenders may, of course, have some room to absorb the loss of profitability. In particular, the interest rate reductions commonly offered to certain borrowers with good repayment records could be foregone, and costs of other risks could prove to be less than expected. The net loss to lenders would still be real, but might leave profitability within a range that is competitive with other loans and investments. The analysis summarized here assumes that the CBO baseline will hold and that the sort of interest rate shifts that generally accompany recessions will not occur. Depending on what economic assumptions are made, excess profits could easily be present or absent, or profits could be below competitive rates, even loss producers. The basic difficulty with setting student interest rates by fiat remains what it always has been: since market mechanisms -- such as an auction for origination rights by lenders⁶ -- are not used to reduce program costs, the only measure of the competitiveness of lender profits will be lender willingness to continue to make and hold student loans.

⁶ For background, see *Reducing Federal Student Loan Costs: The Options Are Narrowing*, by Barbara Miles and Dennis Zimmerman, CRS Report 97-255 E, February 25, 1997.

CRS Report for Congress

Reducing Federal Student Loan Costs: The Options Are Narrowing

February 25, 1997

Barbara Miles
Specialist in Financial Institutions

Dennis Zimmerman
Specialist in Public Finance
Economics Division



Feb. '97

Excess Lender Returns

Student loans enjoy cost advantages over other types of lending: they are mostly protected from default risk by the government guarantee; and they are significantly protected from interest rate risk, particularly for banks and other institutions that rely on short-term deposits. Previous comparisons of risk-adjusted spreads (earnings minus costs) for different types of financial investments led to the conclusion that, as of 1993, lenders were receiving greater-than-competitive returns from student loans.⁴ The earnings advantage on student loans -- at least for lenders with large portfolios of such loans -- varied considerably from year to year, but appeared to be on the order of 0.7% from 1989 to 1993. The cost to the federal government for its interest payments was, therefore, higher than necessary, and savings could be obtained by eliminating those excess profits.

Subsequently, several program changes have reduced gross returns to lenders and loan profitability. Previously the loan interest rate was set at 3.25 percentage points above the bond-equivalent yield of the 91-day Treasury bill through 1992, and 3.1 percentage points in 1993 and 1994. It is now 2.5 percentage points above the bond-equivalent yield while the student is in school and the government is paying interest on the student's behalf (for the Stafford Subsidized program). When the student has left school and is repaying the loan, the loan is repriced at 3.1 percentage points above the Treasury bill.

While the gross return on the loans has been lowered during the in-school period, the cost of the loans to lenders has been raised. First, a 0.5% fee is now levied on lenders at origination. Second, lenders are required to share default costs by accepting 98%, rather than 100%, reimbursement. Risk-sharing increases bank lender costs in two ways, as out-of-pocket losses and as higher bank regulatory capital requirements. Third, lenders are now faced with increased prepayment costs because of competition from loan consolidation into the new direct loan program operated by ED. This cost is heightened because of the one-way nature of consolidations: that is, FFEL program loans can be consolidated into direct loans, but direct loans may not be consolidated into FFELs. Fourth, lenders are now required to rebate 1.05 percentage points annually on all new consolidation loans held.

The cost each of these changes imposed on lenders is reflected in table 1, which estimates the current risk-adjusted spread for student loans made in the 1996-97 school year. The estimating methods and simplifying assumptions are discussed in Appendix A.

⁴ See Miles and Zimmerman (1993). Risk-adjusted spreads are calculated by subtracting from the gross loan price: the cost of funds matched for maturity with the loan; the costs of servicing the loan; and the costs assigned to the various interest rate and credit risks that vary by type of loan. The adjustments require simplifying assumptions on which analysts will differ. Nonetheless, the technique offers general orders of magnitude.

Due mainly to the low cost of retail deposits at banks, loans are still very profitable during the in-school (and deferment) period, at 1.94 percentage points. Once the student leaves school and goes into repayment, however, the lender return drops to 1.02 percentage points. This occurs despite the upward repricing of the loan in repayment because the primary lenders (banks) generally sell the loans, just before they enter repayment, to large secondary market investors that have higher costs of funds than banks. These costs are not fully offset by scale advantages in servicing. Loans that have entered repayment also have higher costs due to the risks of prepayment.

Table 1. Risk-Adjusted Spreads For FFEL Student Loans 1996-97 Academic Year			
	<u>In-School & Deferment</u>	<u>In Repayment</u>	<u>In Con- solidation</u>
Student Loan Interest Rate	7.68	8.25	9.00
Effective Rate	--	--	8.20
Less Costs:			
Matched Funds	5.10	5.55	5.55
Origination/Holding Fee	.17	--	1.05
Servicing	.35	1.00	.50
Default Risk	.00	.08	.08
Prepayment Risk	.12	.60	.00
Risk-Adjusted Spreads	1.94	1.02	1.02
Student Loans (over-the-life)		1.25	
Adjustable Rate Mortgages		1.25	
Ginnie Maes		1.20	
Source: Calculations by CRS. For details, see Appendix A.			

assumes lender
classroom reduction

??

If a student's loans in repayment are consolidated into a single loan, the returns are virtually the same. This occurs despite the benefits that accrue to lenders from: rounding up the blended interest rate on loans being consolidated to the next whole percentage point (in this case, raising it from 8.25% to 9.0%); a decline in servicing costs that results from spreading those costs over a larger loan amount; and the virtual elimination of further prepayment risk.

Part of the increase in return that would normally be expected from these benefits is taken by the government requirement that 1.05 percentage points be rebated annually by loan holders. Another part is taken by increased competition among lenders which has begun to produce significant savings for

students (as opposed to the government). Secondary market lenders are offering a variety of rate reductions to entice students to consolidate with them. For example, students who will allow direct withdrawal from bank accounts can expect an immediate 0.25 percentage point reduction on the interest rate they pay, and students with good repayment records after 48 months can expect up to a 2.0 percentage point reduction for the remaining life of the consolidated loan. Thus, the allowed consolidation interest rate (9.0%) shown in table 1, has been competed down to an effective rate of 8.2%, about the same rate as for unconsolidated loans in repayment.⁵

The resulting risk-adjusted weighted spread averages about 1.25 percentage points over a typical loan account term of 3 in-school years and 8 repayment years. This is lower than previously estimated for 1992 and 1993 loan years (prior to rule changes) and is about comparable to the spread obtainable on investments that share some characteristics with student loans. Adjustable rate mortgages, for example, also are secured (by a home, or by insurance which is sometimes federal), are somewhat protected from interest rate risk, and are highly liquid. These mortgages have been producing risk-adjusted yields of about 1.25 percentage points. Furthermore, mortgage-related securities, which are fully guaranteed by the government ("ginnie maes"), as of last June were yielding about 1.2 percentage points.⁶

The spread estimates for student loans are for current interest rates only. Interest rate risk is not completely eliminated for these loans. When interest rates rise, private lender costs of funds tend to rise relative to the government borrowing rates that determine the student loan rates, so that lender returns decline. Thus, the attempt to adjust lender returns by setting the interest rate margin will return competitive profits under some financial conditions, excess profits under others, and less than competitive profits under still others. An auction procedure that would allow a market-determined margin is more likely to result in efficient allocations of the federal government's guarantee.

These estimates are based upon assumptions that may prove inaccurate. The agreement of some larger lenders to certain fee increases proposed in the last budget cycle suggests excess returns may still exist. This agreement was predicated, however, on the condition that competition from the direct lending program be capped at 10% of volume. That cap would reduce prepayment risks and compensate lenders for the fee increases.

⁵ These estimates apply only to loans made in 1996, and to consolidation loans which will be made up of loans originated in 1996.

⁶ The adjustable rate mortgages example ignores the use of "teaser" rates. Adjustable mortgages commonly carry interest rates that are 2.0% to 2.5% over the relevant index and matched costs of funds, servicing costs of about 0.25%, default risks of 0.25%, and prepayment risks of about 0.75%. As of June, 1996, ginnie maes were returning net interest of about 1.80%. Servicing costs are about 0.2%, default is zero, and prepayment costs are about 0.4%.

Appendix A

The calculations in table 1 make several simplifying assumptions: the loans will be held by depository originators for 3 in-school years; the loans will enter repayment and will be held by an institution with near-prime borrowing rates; and lenders have a large portfolio of student loans so that certain fixed costs, such as servicing, can be spread across a large investment. The student loan interest rates are based upon the last auction of Treasury bills prior to June 1, 1996, converted to bond-equivalent yield, and raised by the 2.5 and 3.1 percentage point margin, respectively. These are the rates that became effective July 1, 1996, and that hold for the 1996-97 academic year. (Yields and costs for alternative investments are figured on the same time frame.) The consolidated loan rate is the blended rate on in-repayment loans being consolidated, rounded up to the next whole percentage point. If all loans being consolidated are at the current 8.25% rate, the consolidated rate would be 9.00%. However, competition has taken the form of reductions in the rates that students pay, most importantly up to 2.0 percentage points after 4 years of on-time repayment. The weighted average impact of this is to reduce lender-received rates to about 8.20 percentage points.

The cost of funds is the interest and non-interest cost of a matched certificate of deposit plus the cost of required capital backing for both the guaranteed and the nonguaranteed portions of the loan. For depository institutions, the 2% of the loans that is not reimbursable in the event of default must be backed by a capital reserve to the same extent as any completely private loan would be. This risk-sharing adds approximately 0.13 percentage points to the funding cost of the loan for banks and thrifts. Because a special allowance may be paid to lenders quarterly, the matching maturity is considered to be 3 months.

The origination fee of 0.5% is paid by the originating lender at the time of origination. A loan held for 3 years before entering repayment and being sold to a secondary lender implies an average cost of 0.17 percentage points. (A loan expected to be held for a shorter period would be more costly.)

Servicing costs are lower during the in-school period, mainly covering the acceptance of interest payments from the government and mandatory bookkeeping. Fixed fees charged by Sallie Mae for in-school servicing (about \$24 per loan) imply an annual cost of 0.35 percentage points. Servicing costs for the repayment period are considerably higher, and are assumed to be equal to Sallie Mae's reported per loan costs plus a 0.28 percentage point servicer profit margin. Sallie Mae's reported servicing costs have risen slightly in the past few years. This mostly reflects the competitive need to provide better support and smoother transitions into repayment for students who have the alternative of moving their loans into the direct loan program.

Prepayment costs are those incurred when students repay or consolidate loans prior to the lender's original expectation, exposing the lender to the

possibility of lower earnings on reinvestment of the funds, or to loss of otherwise amortized up-front fees paid in connection with the loans. There is considerable reason to believe that prepayment costs have risen, mainly because of the direct loan alternative. In general, there is no reason for a student to repay a loan while in school. The main reason for prepayment prior to the direct program competition was loan consolidation to simplify repayment and lower monthly payments (over longer terms) after the loan became the student's responsibility to repay.

Currently, however, it is possible for a student to consolidate guaranteed loans into the direct program while still in school. Moving one's loans into the DL program provides advantages to the student. First, subsequent direct loans are automatically consolidated and require no further action on the student's part. Second, the direct program holds the option of income-contingent repayment which could dramatically reduce the repayment burden for some borrowers, at least for a time. But consolidation is a one-way action: guaranteed loans may be consolidated into direct loans, but direct loans may not be consolidated as guaranteed loans. This has set off considerable price competition among private lenders to keep loans in the guarantee version of the program rather than losing them to the direct version. For example, some lenders are offering interest rate discounts to borrowers after a 4-year period of faithful repayment. The 0.60 percentage point cost for the in-repayment period reflects this competition. The 0.12 percentage point cost for the in-school period is an arbitrary one-fifth of that amount. Once a loan is consolidated, there is little or no risk of losing the loan account's profitability.

Default costs are nonexistent during the in-school period. It is only when the loan enters borrower repayment that risk arises. About half of the estimated expected default costs on table 1 are due to the risk-sharing now in effect. The rest of the default costs are due to losses lenders have anticipated and reserved against in connection with the 1986 adoption of heightened "due diligence" requirements by ED for monitoring and collecting loans.



Potomac Outlook

Charles A. Gabriel, Jr.

Subject:

Sallie Mae

April 23, 1997

Proxy Challenge Obscuring The Battle Over Future Rates On Student Loans

Political Risk Is Alive And Well For Sallie Mae

The impending proxy battle over who should be tapped to manage a reorganized and eventually privatized Sallie Mae has overshadowed industry concerns over whether the private lenders and their supporters on Capitol Hill will be successful in seeking a legislative "fix" to block a July 1, 1998 shift in the yield on guaranteed student loans.

Under terms of the 1993 Student Loan Reform Act, all new loans originated under both the Federal Family Education Loan (FFEL) and Federal Direct Student Loan (FDSL) programs after July 1, 1998 (once they have passed the in-school, grace, or deferment periods and reach repayment) will shift from carrying an interest rate equal to 310 basis points above the 3-month T-bill rate to a new—and currently *lower*—yield equal to the rate on the 10-year Treasury note plus 1%.

[The administration further advanced this notion by proposing in the Fiscal 1998 budget that the 10-year be used as a base rate in calculating yields on loans during the in-school, grace, and deferment periods as well. Currently, these loans carry a rate equal to the 91-day T-bill plus 250 basis points.]

The spread between the 3-month and 10-year is currently around 150 basis points—which would fall far short of making up the loss of 210 basis points under the new regime (i.e., the difference between the 325 basis point add-on associated with the 3-month and the 100 basis points to be added to the 10-year). This spread between the two maturities has actually widened 30 basis points since Valentines Day when the yield curve was at its flattest level in recent months.

Failure to talk the Administration into going along with a plan to abort the shift during the repayment period (or, for that matter, if Congress were to adopt Clinton's plan to use the 10-year during the in-school period—which we doubt) would pose the most immediate threat to banks, who originate the loans and typically hold them during the in-school or grace or deferment periods. Sallie Mae, for the most part, would continue to buy grandfathered loans as they enter repayment over the next few years.

Still, the impact on Sallie's future margins would become clouded, in our opinion, if the scheduled changes are allowed to take place. Dreams of turning the company's shares into a "\$300 stock" within five years, a controversial goal that Committee to Restore Value at Sallie Mae (CRV) leader Al Lord has used to capture the imagination of institutional shareholders, could, in effect, be ended well before the climax.

In essence, the industry has a hell of a sales job to do with the White House and Capitol Hill. And both sides in the proxy battle seem to be treating the issue dismissively with shareholders, saying that it will be "fixed", or headed off, in Congress.

While a "fix" may happen, in the near-term it would have to be attached to a budget agreement, which is by no means a sure thing. Moreover, making the industry's headache go away most assuredly would come at an as yet to be determined price. The issue gives the White House and the Department of Education leverage—in the budget battle and, perhaps eventually, with regard to reauthorization of the Higher Education Act, which has to be legislated sometime next year. Depending on the mood in the bond markets, the White House might even have the moral high ground.

Eager to "fix" the problem before it grows into something more politically controversial (or worrisome for shareholders), the industry has actively engaged the White House in "discussions" in recent weeks. Industry lobbyists are using three principal arguments to try to persuade the White House to abort the scheduled shift in loan rates:

- ☐ If the 10-year had been used as the base rate for yield calculations over the past fifteen years, students would have had to pay more, rather than less, as they would now.
- ☐ The Congressional Budget Office (CBO) has forecasted that keeping the 3-month T-bill as the base rate would save billions of dollars toward either deficit reduction or the provision of new benefits for students. (CBO's original forecast of around \$2 billion in 5-year savings from the shift as it would apply to the FDSL program has to be amended, however, with the recent steepening of the yield curve—perhaps now to a level of around \$1.2 billion.)
- ☐ Many private lenders are already reevaluating their participation in the FFEL program because of past cuts in margins, as well as proposals for additional rate reductions, risk sharing, and origination fees proposed by the administration in its fiscal 1998 budget. Another round of *drastic* changes—which the shift to the 10-year might reflect once interest rates stabilize and the yield curve flattens—might do harm to the goal of preserving two healthy and competitive federal student loan programs.

Look Back 30 Years—Not 15—To See The Trend Going Forward, Analysts Say. The problem with the first of these arguments is that many observers believe that the history of the past 15 years is a poor harbinger indeed for the likely movement of interest rates the *next* 15 years. The high spread between short- and long-term debt securities engineered by Alan Greenspan in the early 1990s to help restore the health of the banking industry was an aberration; even more out of line were the Fed's rate-spiking moves of the early 1980s. Many now believe that a permanently flatter yield curve is likely to assert itself going forward.

Banking consultant Bert Ely has speculated that even though real rates may remain in the 4% range, the flatter yield curve of the 1960s—not the volatile patterns demonstrated in the 1980s or early 1990s—is likely to be closest to what we will see in years ahead. As the accompanying exhibit shows, spreads between the 3-month and 10-year over that period were extremely modest—suggesting that a repeat of such a pattern would whack industry yields on student loans downward by 100 basis points or more.

Meanwhile, Budget Savings Equal Only A Third Of The Pain That Might Be Felt By Students... The second argument, about budget savings that could be achieved, also might meet with mixed success depending on the direction of interest rates in coming months. If the economy continues to show signs of strength and the Fed is compelled to tighten, the yield curve could further steepen and CBO would have to lower the level of budget savings it would attach to maintaining the 3-month T-bill as a base rate. While this might seem to take some of the steam out of the industry's case, it might help in other respects because the decision to make the shift would look like more of a wash for students (e.g., with a higher 10-year rate, relative to the 3-month).

Right now, the Administration is focused not only on the savings associated with the proposed shift's impact on direct loans, but its impact on FFEL loans as well. The \$1 billion net five-year addition to the costs students would have to pay under the FDSL actually *triples* to a total net impact of over \$3 billion when you also take into account the fact that higher rates would now also be charged on FFEL loans.

...And Industry Margins Are Going To Take A Hit, One Way Or Another. As for the industry's pleas for consideration of the potential damage to the private lender "ecosystem", those arguments *do* resonate with supportive members in the Republican Congress—but not enough to head off the likely imposition of at least \$2 billion or so in new fees and subsidy cuts in the context of budget reconciliation or the reauthorization of the Higher Education Act. To this extent, the industry would have to claim that the net of its two self-contradictory arguments about the shift to the 10-year (i.e., that history says students will be better off with the status quo, while they, the lenders would somehow be worse off under the new regime) goes beyond the range of pain already foreseen for them in the Republican budget of 1995 (which also held over \$2 billion in subsidy cuts, but was vetoed) or consensus plans likely to emerge in 1997.

The Bottom Line: Dismissing Political Risk Could Be Risky. The whole issue serves to demonstrate that whomever and whatever Sallie's shareholders choose to back in May, the notion that the company will somehow cease to face political risk as a result of gradually privatizing is off base. As this pertains to the proxy battle votes at the two scheduled shareholder meetings (CRV's on May 9 and the company's on May 15), we suggest that shareholders weigh this political factor—how each side's plan might impact the political debate and which management group might be best able to influence it—in their decisions.

To: Bob Shireman; Senior Policy Advisor; National Economic Council
From: Jonathan E. Gray
Senior Research Analyst
Sanford C. Bernstein & Co., Inc.
Date: October 14, 1997
Subject: Impact of Current Law on Profitability and Availability of FFEL Loans

Executive Summary:

Current legislation, re-formulating the yield on student loans to a yield 100 basis points above the 10-Year T-bond, if implemented today, would eliminate the profitability of the student loan, and actually create a shallow loss on the student loan over its life. While the yield curve is currently flat (i.e. the 10-year T-Bond yield is lower than normal) even under normal circumstances the profitability on student loans would be reduced to about one-third what banks currently earn on other assets.

In addition, because the spread between 10-Year T-Bonds and 91-Day T-Bills is highly volatile, the profitability of the student loan asset would in turn be volatile at a very low level. Thus, the availability of student loans would be hostage to the vicissitudes of the credit markets.

The current law, if implemented would assuredly restrict the availability of student loans through the private sector. It is impossible to predict how severely the supply of student loans might be curtailed. While it would not be "rational" for any bank to remain in the program, some might try to remain active to "serve the community" or to secure relationships with young consumers in the hope of doing business with them in the future, and such banks might feel that the volume of student loans they make would limit the size of the resultant losses. However, banks that did remain in the program would quickly find their volume of applications for student loans balloon, as other lenders would be exiting the program in droves.

Finally, while there are many ways to look at returns on investment for banks, the current return appears to be below average for bank lenders. This creates a dis-incentive for banks to participate. If implemented, current law will create a far more powerful dis-incentive beginning July 1998. With roughly five or six million student borrowers relying upon banks for loans, there would seem little time to resolve this issue.

The fact that investment returns on student loans are already sub-standard for bank lenders is important. The only reason the private sector has remained active in the student loan business is that most of the largest bank lenders have been able to securitize and sell student loans profitably. In addition, Sallie Mae, as a GSE, has had preferential capital requirements which made portfolio investment in student loans profitable. However, Sallie Mae is now privatizing, and will, as the banks do, securitize and sell.

Question: What happens if the credit markets are ever in turmoil, and become closed for student loan securities? If the spreads don't justify portfolio investment by banks, and they can't be sold profitably, the program will shut down.

Analysis:

Current law calls for a re-formulation of the yield paid to lenders on student loans made after July 1998, from the current rules to a yield 100 basis points (bp) above the "Department of Education's cost of funds." The law has, we understand, been interpreted to mean that the yield would be set 100 bp above the yield on the 10-Year T-Bond. We estimate that the effect of such a reformulation would be to reduce the effective spread on student loans by 90-140 bp.

The 10-Year T-Bond "normally" yields approximately 155 bp above the 91-day T-Bill. Thus, a student loan with a yield 100 bp above the 10-year T-Bond would provide a spread of 255 bp versus the T-Bill, as compared to the current spread of 310 bp (i.e. during repayment), a reduction of 55 bp in the loan spread versus the T-Bill.

In addition, it is believed that the loan would re-price in yield once a year, versus once a quarter currently, and thus, to match-fund the loans (i.e. fund them without interest rate risk) under the T-Bond formula would require that the lender use 1-year debt instead of 3-month debt. This would increase borrowing costs at least 35 bp, and possibly more. Thus, the effect of the current law, assuming a "normal" yield curve, would be to reduce the student loan spread by 90 bp.

We estimate the effect of such a change in spread would be to reduce the value of the student loan asset by 80% (*see Exhibit 2*).

The above analysis assumed a "normally sloped" yield curve with the 10-Year T-Bond yield 155 bp above the 3-month T-Bill. However, the yield curve has recently been 55 bp flatter than normal, with the 10-Year T-Bond yield just 100 bp above the 3-month T-Bill (for the week ended Oct. 3rd the 3-month T-bill yield was 5.07%, the 10-year T-Bond 6.06%, a spread of just 99 bp). The current 100 bp spread between the T-Bond and T-Bill plus the 100 bp spread above the T-Bond would provide a spread over the T-Bill of just 200 bp, 110 bp below the current 310 bp spread. In addition, if the loans reprice annually rather than quarterly, the cost of funding with 1-Year debt instead of 3-month debt would add another 35 bp. This would effectively reduce the spread by 140-145 bp, eliminating the profitability of the student loan program completely (*see Exhibits 1, 2 & 5*).

Indeed, if the current law were implemented today, there would be a loss on every student loan made, the net present value of which would approximate 160 bp (*see Exhibit*

2). A bank making \$300 million in student loans annually would be booking a loss of roughly \$5.0 million, or roughly \$400,000 per year over 12 years.

Moreover, this would still leave the bank with additional spread risk over the life of the asset, namely the risk that the spread between the T-Bond and the T-Bill declined further. Not only would current law essentially eliminate the profitability of the student loan beginning in July 1998, but would make the profitability a function of the slope of the yield curve. This would make the availability of student loans a hostage to the volatility of the credit markets.

We believe that the additional cost to hedge this yield curve risk may exceed 100 bp.

Description of Accompanying Exhibits:

Exhibit #1: Proxy for Bank Profitability at Different Student Loan Spreads

Exhibit #2: The Net Present Value of Student Loan Asset Backed Securities (ABS)

Exhibit #3: Value of Student Loans Under Current 310 bp Spread

Exhibit #4: Value of Student Loans Under T-Bond Formula With Normal Yield Curve

Exhibit #5: Value of Student Loans Under T-Bond Formula With Flat Curve (Sept 1997)

Exhibit 1

Proxy for Bank Profitability at Different Student Loan Spreads

<u>Student Loan Profitability Under Alternate Scenarios:</u>					
	<u>Profitability for U.S. Banks: 1Q97</u>	<u>Current Law</u>	<u>10-Year T-Bond</u>		<u>25 BP Reduction in Spread</u>
			<u>Normal Curve</u>	<u>Flat Curve</u>	
In School Spread vs T-Bill		2.50%			2.50%
In Repayment Spread vs T-Bill		3.10%			2.85%
Pretax Spread on assets	1.71%	1.05%	0.25%	-0.25%	0.69%
Aftertax Spread on Assets	1.03%	0.63%	0.15%	-0.15%	0.41%
Contribution from Capital @ 5.00% T-Bill	0.23%	0.23%	0.23%	0.23%	0.23%
Return on Assets	<u>1.26%</u>	<u>0.86%</u>	<u>0.38%</u>	<u>0.08%</u>	<u>0.65%</u>
Average Core Capital for U.S. Banks March Quarter, 1997	7.8%	7.8%	7.8%	7.8%	7.8%
Return on Equity	16.2%	11.1%	4.9%	1.1%	8.3%

Student Loan ABS Valuation: Net Present Value

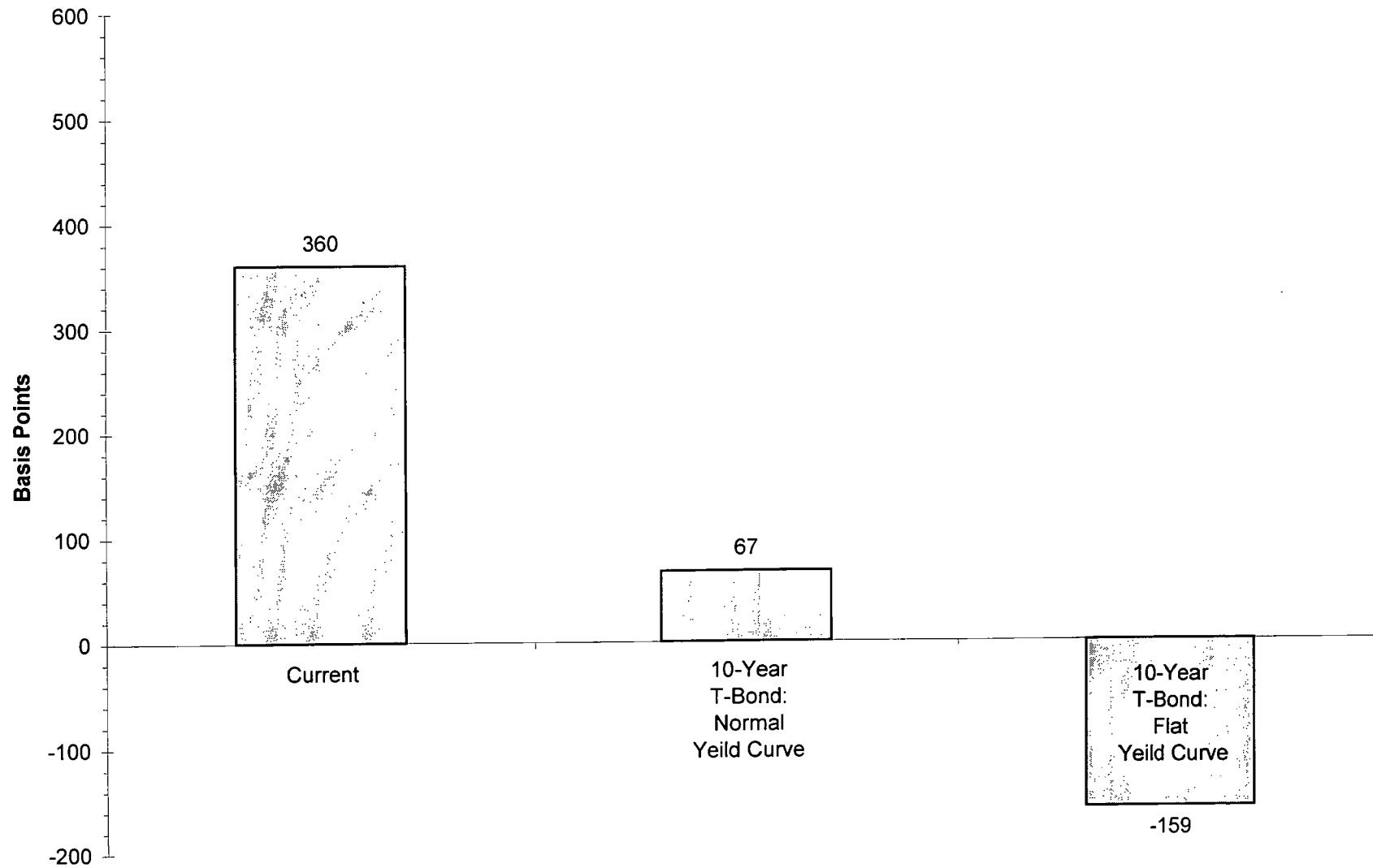


Exhibit 3
Current Environment

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Value of Originated Production @ 310 bp SAP (basis points):

		Orig G&A +					Pretax ROA
Year		SAP	Serv G&A	50 BP Orig Fee	COF v T-Bill	Other Costs ¹	
1	In School	250	-40	-180	-70	0	-40
2	In School	250	-40		-70	0	140
3	In Repayment	310	-100		-70	-24	116
4	In Repayment	310	-100		-70	-24	116
5	In Repayment	310	-100		-70	-24	116
6	In Repayment	310	-100		-70	-24	116
7	In Repayment	310	-100		-70	-24	116
8	In Repayment	310	-100		-70	-24	116
9	In Repayment	310	-100		-70	-24	116
10	In Repayment	310	-100		-70	-24	116
11	In Repayment	310	-100		-70	-24	116
12	In Repayment	310	-100		-70	-24	116

1 - Borrower benefits 10 bp, claims expense 6 bp and
risk sharing 8 bp (20% default rate x 2% = 40 bp Over 5 years = 8 bp per year).

Paydown @ 16% Annually

Year		Pretax ROA
1	100%	-40
2	100%	140
3	84%	97
4	71%	82
5	59%	69
6	50%	58
7	42%	49
8	35%	41
9	30%	34
10	25%	29
11	21%	24
12	17%	20
	53%	

Discounting @ 10% Factor

Year		Pretax ROA	Residual ROA
1	100%	-40	0
2	90%	126	14
3	81%	79	19
4	73%	60	22
5	66%	45	24
6	59%	34	24
7	53%	26	23
8	48%	19	21
9	43%	15	19
10	39%	11	18
11	35%	8	16
12	31%	6	14
Pretax Valuation =		390	213
Less: Issuance Costs		-30	18
Pretax Gain on Sale =		360	

Undiscounted Cash Flow as % Avg Securitized Loans = 34

10-Year T-Bond Plus 100 bp: Normal Yield Curve**Value of Originated Production @ 220 bp SAP (basis points):**

Year		SAP	Serv G&A	Orig. G&A	COF v T-Bill	Other Costs ¹	Pretax ROA
1	In School	220	-40	-180	-70	0	-70
2	In School	220	-40		-70	0	110
3	In Repayment	220	-100		-70	-24	26
4	In Repayment	220	-100		-70	-24	26
5	In Repayment	220	-100		-70	-24	26
6	In Repayment	220	-100		-70	-24	26
7	In Repayment	220	-100		-70	-24	26
8	In Repayment	220	-100		-70	-24	26
9	In Repayment	220	-100		-70	-24	26
10	In Repayment	220	-100		-70	-24	26
11	In Repayment	220	-100		-70	-24	26
12	In Repayment	220	-100		-70	-24	26

¹ - Borrower benefits 10 bp, claims expense 6 bp and
risk sharing 8 bp (20% default rate x 2% = 40 bp Over 5 years = 8 bp per year).

Paydown @ 16% Annually

Year		Pretax ROA
1	100%	-70
2	100%	110
3	84%	22
4	71%	18
5	59%	15
6	50%	13
7	42%	11
8	35%	9
9	30%	8
10	25%	6
11	21%	5
12	17%	5
	53%	

Discounting @ 10% Factor

Year		Pretax ROA	Residual ROA
1	100%	-70	0
2	90%	99	11
3	81%	18	4
4	73%	13	5
5	66%	10	5
6	59%	8	5
7	53%	6	5
8	48%	4	5
9	43%	3	4
10	39%	2	4
11	35%	2	4
12	31%	1	3
Pretax Valuation =		97	56
Less Issuance Costs		-30	5
Pretax Gain (Loss) on Sale =		67	

Undiscounted Cash Flow as % Avg Securitized Loans = 9

Exhibit 5

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10 Year T-Bond Plus 100 bp: Flat Yield Curve
Value of Originated Production @170 bp SAP (basis points)

Year		SAP	Serv G&A	Orig. G&A	COF v T-Bill	Other Costs ¹	Pretax ROA
1	In School	170	-40	-180	-70	0	-120
2	In School	170	-40		-70	0	60
3	In Repayment	170	-100		-70	-24	-24
4	In Repayment	170	-100		-70	-24	-24
5	In Repayment	170	-100		-70	-24	-24
6	In Repayment	170	-100		-70	-24	-24
7	In Repayment	170	-100		-70	-24	-24
8	In Repayment	170	-100		-70	-24	-24
9	In Repayment	170	-100		-70	-24	-24
10	In Repayment	170	-100		-70	-24	-24
11	In Repayment	170	-100		-70	-24	-24
12	In Repayment	170	-100		-70	-24	-24

1 - Borrower benefits 10 bp, claims expense 6 bp and
risk sharing 8 bp (20% default rate x 2% = 40 bp Over 5 years = 8 bp per year).

Paydown @ 16% Annually

Year		Pretax ROA
1	100%	-120
2	100%	60
3	84%	-20
4	71%	-17
5	59%	-14
6	50%	-12
7	42%	-10
8	35%	-8
9	30%	-7
10	25%	-6
11	21%	-5
12	17%	-4
	53%	

Discounting @ 10% Factor

Year		Pretax ROA	Residual ROA
1	100%	-120	0
2	90%	54	6
3	81%	-16	-4
4	73%	-12	-5
5	66%	-9	-5
6	59%	-7	-5
7	53%	-5	-5
8	48%	-4	-4
9	43%	-3	-4
10	39%	-2	-4
11	35%	-2	-3
12	31%	-1	-3
Pretax Valuation =		-129	-35
Less: Issuance Costs		-30	-3
Pretax Gain on Sale =		-159	

Undiscounted Cash Flow as % Avg Securitized Loans =

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