

FOIA MARKER

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

Collection/Record Group: Clinton Presidential Records

Subgroup/Office of Origin: National Economic Council

Series/Staff Member: Bob Shireman

Subseries:

OA/ID Number: 13218

FolderID:

Folder Title:

[Student Loan Programs] [4]

Stack:

S

Row:

15

Section:

1

Shelf:

11

Position:

1

Facsimile Cover Sheet
U.S. Department of the Treasury
Office of Economic Policy

DATE: October 15, 1997

NUMBER OF PAGES TO FOLLOW: 17

FAX TO: BOB SHIREMAN

National Economic Council

ADDRESSEE'S FAX NUMBER (202) 456-2223

ADDRESSEE'S CONFIRMATION NUMBER (202) 456-2803

FAX FROM: MAYNARD COMIEZ

U.S. Treasury Department

SENDERS FAX NUMBER: (202) 622-1294

SENDERS CONFIRMATION NUMBER: (202) 622-2310

COMMENTS:

Bob,

Attached is another draft of my paper on the student loan program. I have made the changes you suggested and also have revised the interest rate assumptions to reflect more recent data.

I have not made any changes in the hedging cost section, because I haven't heard back from the financial people I spoke with. I did speak with one fellow yesterday, and off the top of his head he didn't think that hedging, say, 95% of the risk rather than 100% would reduce the cost much. But he is thinking about it and will call me back, hopefully by Friday morning. By then I hope to have heard from others.

If you have any questions before you send this out, give me a call.

The Financial Viability of the Student Loan Program

Executive Summary

The Federal Family Education Loan Program (FFEL) has been in existence since 1966. It has provided needy and middle-income borrowers an opportunity to finance their higher education, even if they do not have adequate savings of their own.

Throughout the existence of the program, the formula for calculating the interest rate that lenders earn on a student loan generally has not been a problem for lenders, in so far as their pre-tax rate of return is concerned. The formula for calculating student loan interest rates has provided lenders a return that is competitive with their other investment opportunities. Now, however, a new student loan formula that is scheduled to take effect on July 1, 1998 threatens to jeopardize the financial ability of lenders to continue their participation in the loan program.

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.

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 tempers somewhat the reduction, but it 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.

~~Many~~
 Many back to a 3 mo. T-bill basis, but with
 a lower interest, could both satisfy lender
 needs and provide borrowers with a comparable
 reduction in their cost as what had been
 expected with the 10yr + rate.

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

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.

deferment, or the 3-month T-bill rate plus 3.1 percentage points on loans in repayment.³ 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

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. 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.

as with 03 10 - was 9
 But cap to gov't → cost to student.

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. *really?*

- 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. *what are they? why more realistic?*

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 *what happened?*

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 5.25 percent and the spread is 1.68 percentage points. Our alternative assumptions for **student loan interest rates**, therefore, are 7.4 percent ($5.45+.95+1.0$) for 1998/99, and 7.93 percent ($5.25+1.68+1.0$) for 1999/00.

mess
why such
big diff
??

- 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 financial company 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*.

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 5.65 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.

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. - Guy says 8
- 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. - reasonable? 8
- 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

sharing.

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.

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.

??

- Is that enough?

- 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.

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 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.

Plugging these revised assumptions into Table 2, lenders' net returns in 1998/99 and 1999/00 are 0.37 percent and 1.03 percent, respectively. These results are more positive than those in Table 1. The average weighted pre-tax return to lenders under the new student formula is still less than profitable in 1998/99, but appears to be marginally competitive in 1999/00.

However, the last statement is correct only if an acceptable pre-tax rate of return is 1.0 percent. But, 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. Thus, the estimated net return of 1.03 percent for 1999/00 probably would not be adequate.

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.

The real
Auditing

The ^{very} generous ~~margin~~ profit margin of the current rates suggests, however, that ~~there is room for~~ it would be possible to maintain the (then) interest rate that borrowers can expect saving 1/2% 98. This could be accomplished by ~~then continuing to use the T-bill~~ (or switching to 4% or 5% Treasury note directly markets) but providing a lower mark-up.

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.

Table 5
shows that

an in-school rate of 7.14 and again at 7.14 3,
and provide a sufficient margin for lenders. These rates also are
below the rates that borrowers will be prepared to pay under the 10 year 1/

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 5.25 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 historical experience.) For 1999 the spread between 3-month T-bills and 10-year Treasury securities is 1.68 percentage points, which is the average spread since 1981 (The spread forecast in *Blue Chip* is 0.95.)

NOT
ASSUMABLE
??

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 5.25 percent plus 40 basis points or 5.65 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.

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.

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	7.87	8.25	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	1.89	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.

STULOANS

M. COMIEZ

TABLE 2. RISK-ADJUSTED NET RETURN FOR FFEL STUDENT LOANS, 1987-1999
(Percent)

	7/1/87 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	7.93	7.93	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.85	5.85	5.85	5.65	5.65	5.65
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	6.66	7.06	8.11
Net return	1.69	1.77	1.47	0.64	0.14	0.69	1.27	0.87	0.89
Weighted Average Net Return		1.71			0.37			1.03	

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

STU.LOANS

M. COMIEZ

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	7.67	8.25	9.00	7.35	7.75	9.00	7.15	7.55	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.85	5.85	5.85	5.65	5.65	5.65
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	6.06	6.56	7.61
Net return	1.69	1.77	1.47	1.09	0.99	1.19	1.09	0.99	1.39
Weighted Average Net Return		1.71			1.05			1.07	

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 2.3 percent for loans in repayment. Interest rates are from Blue Chip Economic Indicators.

STLLOAN12

M. COMIEZ

**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	7.93/7.93	N.A.	0.37	1.03
Alternative: 3-month T-bill plus 1.9/2.3 percent	N.A.	7.35/7.75	7.15/7.55	N.A.	1.05	1.07

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 5.25% (a Blue Chip forecast) and the spread is 1.68 percentage points, which is the historical average spread since 1981.

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 5.25% 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.

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 pp. 8-9 of "The Financial Viability of the Student Loan Program)."

M. COMIEZ

STULD11

FACSIMILE COVER SHEET
U.S. DEPARTMENT OF TREASURY
OFFICE OF ECONOMIC POLICY

DATE:

NUMBER OF PAGES TO FOLLOW: 18

FAX TO: BOB SHIREMAN
NEC

ADDRESSEE'S FAX NUMBER (202) 456-2223

ADDRESSEE'S CONFIRMATION NUMBER (202) 456-²⁸⁰³~~6070~~

FAX FROM: MAYNARD COMIEZ
U.S. TREASURY

SENDER'S FAX NUMBERS: (202) 622-1294

SENDER'S CONFIRMATION NUMBER: (202) 622-2310

COMMENTS/SPECIAL INSTRUCTIONS:

Bob,

This is the revised draft we discussed. I have added a couple of paragraphs at the end (including a concluding remark) as well as one paragraph at the end of the Executive Summary.

Let me know if you have any problems with the paper.

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

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.

Memo

To: Bob Shireman 204 456-2223
From: C. Gabriel
Date: June 16, 1997
Re: SLM, FELP/FDSLP

Bob, here are my most recent takes. I think I even refer to you in one of them, although I can't remember which. If you don't mind, please don't tell the industry folks I gave these to you directly. (That might be read as encouraging you with what they believe are bad ideas!)

I continue to be amazed about the state of suspension (i.e., neutrality) that most of the industry players are in as the Sallie Mae proxy battle winds to a conclusion.

Best Regards, Chuck



MANAGEMENT GATHERS VOTES AS ELECTORAL BETS EDGE HIGHER AT SALLIE MAE RESEARCH NOTES

June 16, 1997

Subject: Sallie Mae (SLM--137 1/2)--NYSE
Finance
COM GOV

OPINION

=====

Current: HOLD

Prior: HOLD

RISK: High

Analysts: Jonathan Adams (212) 778-4477
Chuck Gabriel (703) 358-2991

Ind. Div.: \$1.76 Yield: 1.3% Shares: 54.5 mil. 52-Wk. Range: 123-69

EPS	FY	Year	P/E	1Q	2Q	3Q	4Q
Actual	12/96	\$ 6.82		\$ 1.57	\$ 1.63	\$ 1.71	\$ 1.92
Current	12/97	\$ 8.05E	15.3X	\$ 2.09A	\$ 2.10E	\$ 1.94E	\$ 1.93E
Prior		8.10E		2.09A	2.11	1.97	1.94
Current	12/98	\$ 9.00E	13.7X	\$ 2.16E	\$ 2.25E	\$ 2.26E	\$ 2.30E
Prior		9.10E		2.17	2.28	2.30	2.33

Sallie's Stock Price Driven By Electoral Speculation. Sallie Mae's stock climbed by 14.3% between June 11th and June 13th, (compared to a 3.2% rise in the S&P 500), driven by the success of shareholder dissidents (the Committee to Restore Value, or CRV) in forcing management to respond to their demands and raising hopes for a CRV victory in July elections for a new Board of Directors. The speculation was triggered on June 11th when Sallie Mae's CEO, Larry Hough, pledged to step aside if management's proposed Board is victorious, thereby allowing room for a leader with more experience in a private, financial services company. Sallie Mae management claimed that Mr. Hough's decision moved votes in their direction, but investors appeared to ignore this calculus and have emphasized the fact that the CRV continues to succeed in extracting concessions from management. The long, bitter proxy battle will come to a close in mid-July when shareholders vote on a new, 15-member Board to run a privatized Sallie Mae.

We See A Correction, As Management Will Do What It Takes To Win. Sallie Mae management has taken several steps to win shareholder support, including:

- Separating the vote on privatization from the vote on the leadership of the new company.
- Accelerating the use of securitization and share repurchases - two issues that are central to the dissident's business plan.
- Incorporating a minority role (5 out of 15 seats) on management's proposed Board for CRV-supported directors.
- Pledging to replace CEO Hough and Chairman Arceneaux with individuals, or an individual, with greater private-sector experience.

Our view is that compromise is usually the path to victory, while partisanship risks falling in a blaze of glory. We think the movement by management indicates the former approach, while the CRV appears to be taking the latter approach. As evidence of this "live free or die" attitude, CRV leader Al Lord responded to management's offer of five Board seats with an unqualifying "I don't want to be on that Board," (according to Bloomberg News). While the CRV has clearly won many battles with management, we

maintain that investors are focusing too much on individual battles rather than the electoral war.

By preliminary measures, the pro-management and pro-CRV forces have been almost evenly split. Moreover, 50% of the outstanding shares are held by just ten institutions, so any move by one or two of these shareholders could easily put either side "over the edge." If management's statements regarding the impact of its concessions are correct, we believe SLM is due for a correction under the most likely outcome - a victory by management.

Business Fundamentals Warrant A Hold Either Way. Sallie Mae is currently trading at 17.1 times our 1997 earnings estimate of \$8.05 per share and 15.3 times our 1998 estimate of \$9.00 per share. We believe the company's long-term, annual growth potential for recurring earnings is approximately 15% and do not believe the shares should trade at a premium to this growth rate. Our estimates are based on management's business plan, but we do not believe the CRV's business plan offers sustained earnings in excess of these estimates. Therefore, we believe the shares are now fully valued. Furthermore, Sallie Mae currently trades at 7.3 times its 1996 book value, well ahead of the multiple of 3.0 to 4.0 found in other financial services companies. As points of comparison, GSEs Fannie Mae and Freddie Mac trade at 3.6 and 3.9 times book value, respectively.

A Second "July Announcement" Should Be Watched Carefully. In addition to settling the company's proxy battle, Sallie Mae will receive word on a critical court case affecting a 30 basis point government "offset fee" on loans held by Sallie Mae. In January of 1997, the US Court of Appeals ruled that this fee did not apply to securitized loans. If the Department of Education (DOE) accepts this ruling, Sallie Mae could realize an additional 100 basis points on each securitization, a boost to earnings we think could equal approximately \$1.35 in 1998. Should the DOE seek a further delay in the final determination of this ruling, we believe the stock would be adversely affected. Combining the risk inherent in the upcoming election and possible disappointment from the DOE, we repeat our Hold rating for Sallie Mae.

Prudential Securities



Potomac Outlook

Charles A. Gabriel, Jr.

Subject:

Sallie Mae

June 12, 1997

POLITICAL RISK HANGOVER THROBS BEHIND THE SCENES AMIDST INVESTOR EUPHORIA OVER SALLIE MAE

Two important inflection points in the life of Sallie Mae were in evidence yesterday in Washington.

The first relates to an apparently now permanent and voluntary decision to shift the company's top management. The second involves an opportunity to head off a major dose of future political risk that is proving a "dry well" in the education committees on Capitol Hill.

CEO Larry Hough's announced decision to step down once the company has been privatized represents perhaps the last and most drastic move by management to address the challenge from the dissident shareholders' group, the Committee to Restore Value at Sallie Mae (CRV). Sallie sources reflected that: a) the move emanated from Hough himself; and b) it was strategically designed to meet concerns raised by large shareholders (i.e., that it was "poll-tested", increasing the odds that enough undecided institutions might be swayed for management to remain in control after the company's next board meeting in July). *Nevertheless, the reaction to Hough's announcement, itself, seemed a metaphor for the way the seemingly personal battle between he and CRV head Al Lord has played out against the backdrop of shareholders seeking to maximize their own self-interest: On the day of Hough's announcement, Sallie Mae's stock came within a whisker of becoming an official "four bagger", rising over six points (to \$126 3/8)—less than a point below a four-fold gain, measured against its election day 1994 low of 31 3/4.*

Meanwhile, however, even as the company's proxy battle and the expected fruits of its future privatization continued to dominate investors' focus, a looming political challenge continued to edge closer: Specifically, Sallie Mae and other private lenders in the student loan industry were forced to abandon efforts to negotiate a compromise "fix" (in the context of this week's Hill action on fiscal 1998 balanced budget reconciliation legislation) to head off a harmful shift in the interest rate carried on all federally guaranteed student loans originated after July 1, 1998.

The administration, major players in the higher education community, and their supporters on Capitol Hill continued to take a hard line in insisting that the company pay a steep price in exchange for a measure ensuring that student loan yields will continue to be based on the 91-day T bill (instead of the scheduled shift to use of the 10-year Treasury note mandated by the Student Loan Reform Act of 1993). The industry had proposed to "give back" to borrowers the \$1.6 billion or so in budget "savings" the Congressional Budget Office had estimated would come from heading off the interest rate shift (as a result of students being forced to pay the higher total interest rates currently projected to result from a decision to stick with the 91-day-plus-310-basis-point-formula. Specifically, the industry offered to pick up one percentage point of the borrower-paid origination fee, and to agree to a lower overall interest rate cap on student loans (down to 7.7% from the current 8.25%). But the first proposal wasn't seen as going far enough by representatives of the colleges and universities in Washington, and congressional conservatives balked at committing to buy down interest rates to a lower level in the future (a potentially costly proposition under some scenarios).

Moreover, even if the solution were acceptable in its entirety, the mentality among the higher ed representatives (dubbed by industry lobbyists as the "One Dupont Circle crowd" because of their location in that part of Washington) seemed to be to force the industry to pay far more—upwards of \$3 billion, covering the total out-of-pocket costs that borrowers would be forced to absorb (not just those additional costs associated with borrowers under the federal direct student loan program).

While Sallie sources shrugged off the fact that the industry simply decided to abandon the effort to fix the interest rate problem in the context of reconciliation—*probably the best and only opportunity to resolve the issue for the remainder of this legislative session*—they nonetheless expressed confidence that: 1) the higher ed community understands that they need the private lenders and the Federal Education Loan Program (FELP) going forward, given the huge problems confronting the Federal Direct Student Loan Program (FDSLSP); 2) the shift to the 10-year would create huge maturity-mismatch problems for the private lenders, and hurt their margins sufficiently to limit their willingness to participate (doing damage to the FELP); and 3) the problem can still be fixed in legislation early next year in time to head off the July 1 date for the interest rate shift.

Other industry sources are also hopeful that a solution will emerge, but they note that Sallie Mae has less to lose near-term from the shift, as the company will probably be able to continue buying grandfathered loans (at the old interest rate levels) for several more years—even as the well begins to run dry. *Of course, the company would be less insulated if it were to become an aggressive loan originator, as the CRV has proposed.*

But still other industry sources are growing increasingly pessimistic about the problem getting fixed; and the price that will have to be paid to head it off could even rise.

Thus, we believe that investors should not lose sight of the challenges the company faces ahead—nor of the curbing effect that these challenges could have upon the lusty visions of shareholder gains associated with the CRV's plan in particular.

Please call 703/276-0055 or 800/905-6255 if there are any problems with this transmission.

THE BANKS CAST THEIR VOTE AT SALLIE MAE - TRIMMING ESTIMATES AS LOAN VOLUME IS AT RISK.

RESEARCH NOTES

June 4, 1997

Subject: Sallie Mae (SLM--123 1/4)--NYSE
Finance
EPS SEO GOV

OPINION

Analysts: Jonathan Adams (212) 778-4477
Chuck Gabriel (703) 358-2991

Current: HOLD

Prior: HOLD

RISK: High

Ind. Div.: \$1.76 Yield: 1.4% Shares: 54.5 mil. 52-Wk. Range: 123-69

EPS	FY	Year	P/E	1Q	2Q	3Q	4Q
Actual	12/96	\$ 6.82		\$ 1.57	\$ 1.63	\$ 1.71	\$ 1.92
Current 12/97	\$ 8.05E	15.3X	\$ 2.09A	\$ 2.10E	\$ 1.94E	\$ 1.93E	
Prior	8.10E		2.09A	2.11	1.97	1.94	
Current 12/98	\$ 9.00E	13.7X	\$ 2.16E	\$ 2.25E	\$ 2.26E	\$ 2.30E	
Prior	9.10E		2.17	2.28	2.30	2.33	

Loan sellers are making their voice heard at Sallie Mae. Based on our discussions with management, the company is working through what could be a second-quarter shortfall in loan acquisition volume of as much as \$400 million. The problem stems from a plan put forward by dissident shareholders (organized as the Committee to Restore Value or CRV) to initiate a full-scale origination program if they win control of the company in a special shareholder meeting set for July.

Even A "Symbolic" Move Will Affect Earnings. According to management, three large institutions that had planned to sell loans to Sallie Mae are holding back until the votes are cast. One of these institutions is cited as a top-ten originator in the private, student loan market. Clearly it is in the interest of large banks to "sway the electorate" if it means keeping Sallie Mae out of the origination business. However, we believe the present disruption is more than symbolic and expect some institutions would permanently alter their business relationship with Sallie Mae if the CRV were to win in July. In the short term, management has indicated that it may be able to make up the shortfall, but we are reducing our acquisition estimates by \$200 million (9%) as a minimum impact to earnings.

We Are Reducing Our Estimates For 1997 and 1998: Retaining Our Hold Rating. Our investment thesis toward Sallie Mae has been one of caution in light of the risks that are now emerging as reality: namely, reduction in acquisition volume as the company grapples with a proxy battle and greater political risk if the CRV were to win in July. We now believe the present interruption in loan volume will extend through the final vote in July, and have lowered our projected earnings per share accordingly - in 1997 by \$0.05 and in 1998 by \$0.10.

We believe Sallie Mae's franchise in the student loan industry is unparalleled. However, the company must continue to address a host of issues which threaten its net interest margin. These are "old" issues (because they were legislated in the 1993 Omnibus Budget and Reconciliation Act [OBRA]), but we think they will continue to affect earnings because Sallie Mae has no choice but to replace older, higher-margin loans with newer, lower-margin

loans. We have identified three aspects of OBRA which we think will continue to put downward pressure on earnings.

- Sallie Mae must absorb up to 2% of the principal lost on defaulted loans in its portfolio if the loan is originated after October 1, 1993.
- A 30 basis point annual offset fee is charged against all loans held by Sallie Mae if the loan is originated after August 10, 1993.
- For loans originated after July 1, 1998, the interest margin paid to the holder of most student loans will adjust from 3.1 percentage points over the 91-day Treasury Bill to 1.0 percentage point over a to-be-determined Treasury benchmark (probably the ten-year Treasury Note).

Prudential Securities



Potomac Outlook

Charles A. Gabriel, Jr.

Subject:

Sallie Mae

May 23, 1997

Budget Agreement, Fourth-Year Sign-Up For Direct Lending Spell Victory For Sallie Mae

With the proxy battle for control of Sallie Mae still raging, management was rewarded for its labors on two other important fronts last week.

- ☐ The House fiscal 1998 Balanced Budget Resolution that passed late on May 20, and its Senate counterpart expected to pass today, both assume 5-year savings from the federal student loan programs of just \$1.763 billion. More importantly, none of the \$1 billion amount recommended to come from the private lender-dominated Family Education Loan Program (FELP) would be derived from cuts impacting banks, Sallie Mae, or other secondary markets.
- ☐ Meanwhile, *Education Daily* reported on May 21 that the Department of Education had finally responded to the newsletter's request for a manifest of how many new schools will be aboard for the start of the Federal Direct Student Loan Program's (FDSLP) fourth year. The answer: 65—33 of which had been pre-approved for the third year (and deferred to this year), and fully 49 of which are propriety and trade schools. The General Accounting Office earlier this year had reported that 914, or 56%, of the 1,622 schools cleared to participate in the FDSLP were propriety institutions—which have traditionally carried far higher default rates than two- and four-year public schools; DOE has so far refrained from saying how many of the 1,290 schools actively participating in the program will be returning, the *Education Daily* added.

Both these events are good news. The political risk from cuts in loan subsidies, risk sharing, and higher origination or offset fees seems temporarily deferred—even though: 1) the resolution's recommendations, while likely to be adopted, are not binding; 2) amendments could yet be offered in the budget process to impose additional hits to industry in order to offset the costs of reducing borrower origination fees; 3) there are other venues in which industry subsidies are soon likely to come under attack in any event (e.g., with regard to legislation reauthorizing the federal student loan programs under the Higher Education Act); and 4) political risk could become enhanced if the Sallie Mae proxy battle produces a result seen threatening to banks and other originators in the student loan business. Meanwhile, the news on the underwhelming response to the FDSLP in its fourth-year seems to confirm Sallie Mae management's projections that the program will likely peak out this next year at one or two percentage points above a one-third share and begin to atrophy by a point or so a year thereafter.

The \$1 billion burden falling on the guaranty agencies would represent a substantial reduction in their liquidity-providing cushions against student loan default obligations—but it would only represent two-fifths of the full expropriation of the agencies' combined \$2.5 billion in reserves proposed by the Clinton administration in February. Moreover, the guarantors' concerns that the transfer of reserves be conducted in the least distorting manner will be addressed in the proposal, according to industry sources, as evidenced by the fact that savings from the transfer appear to be deferred until the fifth year of the budget deal, or fiscal 2002. For this reason, the guaranty agencies are expected to go along.

The FDSLP, meanwhile, will itself be targeted for reductions by the budget resolution: Some \$603 million is slated to be drained from the Department of Education's Section 458 account to promote and administer direct lending, and another \$160 million would come from the elimination of the \$10 per loan fee paid to schools participating in the program. The substantial cut in the 458 funding has been made possible by the failure of the FDSLP to grow much more than half way toward its originally projected 60% market share.

Please call 703/276-0055 or 800/905-6255 if there are any problems with this transmission.

Prudential Securities



Potomac Outlook

Charles A. Gabriel, Jr.
Jonathan Adams

Subject:

Sallie Mae

May 16, 1997

Who's Got The "Con"?— Political Risk Could Outstrip Rewards If Management Loses Control Over Sallie Mae

A Sallie Mae shareholders' meeting adjourned quickly yesterday morning after management failed to garner a majority of votes in support of its reorganization plan. Management's proposal garnered 21 million votes (40%), with a roughly equal number and percentage voting in opposition. By comparison, Sallie Mae's dissident shareholders' group, the Committee to Restore Value (CRV), claimed to have garnered just over 23 million votes (or 44%) at its own special shareholders meeting on May 9.

Polls will remain open—and both sides will attempt to woo the roughly 20% of shareholders who have not voted—until June 5, when today's shareholder meeting is scheduled to resume. (Any shift in position relating to one or more of the voting blocks controlled by Sallie Mae's top five institutional shareholders could be decisive, sources predict.) A verdict could become evident at any time in the interim, however, and may be reached at or before a second CRV-sponsored meeting scheduled for two weeks from today, May 29.

Also accompanying news of the result of the meeting were these developments.

- ☐ There was news that the two sides, urged on by a couple of the largest shareholders, had held discussions in the days just prior to the meeting about a compromise board structure that would have the two sides sharing control. Those talks apparently proved fruitless, but perhaps signaled the significant leverage vested in those controlling the top institutional voting blocks.
- ☐ There was evidence that the banking industry finally may be weighing in against the CRV plan.
- ☐ Word came from Sallie Mae's Executive Vice President, Lydia Marshall, and others that loan purchases are being held up as a result of the lingering uncertainty over who will control the company and what future thrust it will take.

Some may even expect Clinton's Direct Lending Program will be the true beneficiary. Perhaps another factor that might be taking effect is that a large proportion of the 21 million shareholders supporting management believe that the real winner in the event of a CRV victory would be the Clinton administration. Specifically, the White House and Department of Education might be able to exploit the controversy over the CRV plan (if pursued by Sallie Mae once adopted) to drive a wedge between banks, guaranty agencies and Sallie Mae. This could help resuscitate the direct lending program.

We add the caveat "*if pursued by Sallie Mae*" because there is a fair degree of thought that CRV head Al Lord has fashioned his aggressive restructuring plan (which runs roughshod over political realities) knowing full well that he will have to move in a far less linear fashion if he is vested with control of the company. To some, this thought might be consoling—that the whole thing has been as much, if not more, about who controls the company as simply two different visions about how to run it. Political risk might not rear up as ugly a head as one might have anticipated, this thinking goes, because Lord et al will back

off when they inevitably encounter damaging resistance from the banks and others in Washington. But then another realization might emerge: what about the \$300 share price within five years that the CRV promised to achieve?

The CRV plan may bring with it significant political risks. We offer one crucial example of why the increased political risk we believe might accompany a CRV victory (again, *if* they stick inflexibly with their plan) might offset the increased opportunities otherwise anticipated to materialize for Sallie Mae under the management's plan, or from the monetization of the company's assets under the CRV proposal itself. The industry disunity that could emerge with a CRV victory could increase odds that the banks and Sallie Mae will be unsuccessful in heading off the scheduled July 1, 1998 shift in the formula for calculating interest rates on guaranteed student loans in repayment. The resulting hit to operating margins (based on prospects for a flattening yield curve) could easily wipe out the 100 basis point boost to the company's earnings anticipated from a far more positive event—a final court ruling in Sallie's favor on the issue of whether it can avoid paying a 30 basis point offset fee on loans purchased for securitization.

Prudential Securities Inc. has initiated fundamental analysis of Sallie Mae with a Hold rating. This is based on the balance of risks and opportunities the company now faces. With the battle for control still raging, and with political risk in our opinion rising for the company (along with the prospect that a shift in management might actually take place), we believe a cautious near-term view is warranted. We are currently projecting earnings per share of \$8.10 in 1997 (an increase of 19% over 1996) and \$9.10 in 1998 (an increase of 12% over 1997), maintaining a wary eye on the 30 basis point offset fee and 1998 adjustments in loan rates. Should management retain control, even under concessions offered to the CRV, we believe the outlook for positive political surprises would improve, requiring a fresh look at the company's earnings potential.

Sallie Mae has provided big rewards for savvy investors in the past and we expect that the story could brighten once key issues are resolved.

History shows that investors in Sallie Mae have to pay close attention. Two of the four major inflection points relating to Sallie Mae the past five years have been driven by political risk—with the other two enabled by what we would characterize as political risk relief. At any given time, this risk is either under- or over-discounted in Sallie's stock price, leading to volatile trading patterns as major developments occur and become fully understood by investors.

In 1992... The stock plummeted, then recovered during the reauthorization of the Higher Education Act, when cuts in interest subsidies were enacted and direct lending was first debated. When the dust settled, direct lending was confined to a 4% of total volume "pilot" program, while a new, unsubsidized guaranteed student loan program was created, holding the prospect for generating huge new loan volumes.

...In 1993-1994... The stock plummeted again when direct lending developed seemingly irresistible momentum after being enacted as a part of the Clinton budget in 1993; it continued to stagnate throughout 1994 as the company's market cap eventually was more than cut in half from its November 1992 share price level in the low 70's.

...In 1995... The life-threatening political signals underlying the disastrous performance of the '93-'94 period (which left the stock selling as low as \$31) were reversed when Republicans were sworn in to take control of the Congress in January 1995. The GOP, in short order, exhibited sympathy for the industry pleas about being crowded out by direct lending, and the administration's plans to beef up the Department of Education—which Republicans wanted to eliminate—in order to effect a federal takeover of the private sector-dominated student loan business were obviously at odds with the new majority's free market, bureaucracy-slashing agenda. Despite this improved political environment, however, the major catalyst for

movement on the stock appeared to be the proxy battle, advanced by current members of the CRV that spring, which forced management to accelerate a number of investor friendly moves it had not yet committed to make, including stock buybacks, expense cutting, and other initiatives.

...In 1996-1997... The success of the 1995 reorganization moves, plus management's decisions to redirect its political efforts toward winning passage of legislation allowing the company to privatize and to build up relationships with both four-year schools and top-loan originators, paid dividends—not the least of which was the apparent stagnation of the direct lending program. But this mixture didn't become truly explosive until it was combined with yet another proxy challenge from the CRV that helped to boost the stock last winter and throughout the spring.

...And In 1997-1998? This raises the question of where the next milestone will fall and what implications it will have for shareholders. *Our view is that upside is in sight, but in at least one increasingly plausible alternative scenario—where the CRV plan is adopted, the administration decides before the end of July to appeal Sallie Mae's court victory on the securitization/offset issue, and a "fix" for the July 1, 1998 interest rate shift fails to materialize—there could be major downside as well. Political risk is now being ignored by shareholders, and the industry could undergo another divisive civil war (as it did to Sallie Mae's detriment in 1993)—just at the outset of a potentially renewed major challenge from the Clinton administration and the Congress.*

Perceived prospects for either side winning could wax and wane. One side, the CRV, has been perceived as being more investor-friendly near-term, which has led Sallie Mae shares to perform well on days when news, or the expectations thereof, has supported a likely CRV victory and less well when Sallie Mae's existing management has seemed likely to retain the upper hand. We believe this market interpretation is erroneous. The issue of company control will be the driving force in the writing of this last script.

- ☐ If management wins, there might be *short term* profit taking to reflect frustration that assets of the company will not be monetized as quickly as CRV has promised. In other words, we expect the "fast" money will exit.
- ☐ If CRV wins, we expect the near-term reaction on the stock to be positive, reflecting the front-loaded earnings targeted by the CRV business plan. However, we think there might be more *medium to long-term* risks—as investors come to the realization that the CRV plan, in our opinion, will not be viable.
- ☐ The biggest reason the CRV plan will not be viable is that we envision a significant increase in political risk for Sallie Mae as the CRV plan pits a reorganized Sallie Mae against the banks. With the industry unable to present a united front, Congress may enact additional margin-squeezing subsidy cuts or "fees" impacting Sallie Mae, in the context of the Higher Education Act reauthorization in 1998—or more importantly, it might balk at modifying the scheduled change in the formula for calculating loan interest rates. To think that remaking the company as a primary competitor with the banks will not prompt any political reaction seems plain naive—and we're amazed that it hasn't been effectively challenged on these grounds to this point.

Please call 703/276-0055 or 800/905-6255 if there are any problems with this transmission.

Prudential Securities



Potomac Outlook

Charles A. Gabriel, Jr.

Subject:

Sallie Mae

May 13, 1997

Sallie & Friends On The Verge Of Winning Key Battle?

Sallie Mae and other private lenders could be on the verge of winning a near-term victory in their battle to hold on to current interest subsidies and other provisions impacting profit margins in the federal guaranteed student loan business.

Specifically, lobbyists for Sallie Mae and the rest of the industry are increasingly hopeful that instructions will be written into the final communiqué on the May 2 balanced budget accord, calling for savings from Title IV student loan programs of as little as \$1.75 billion over five years. A number this small might allow banks, Sallie Mae, and other secondary market associations to essentially avoid new "hits" in their Federal Family Education Loan Program (FELP) loan margins *altogether*.

- ☐ Such a verdict would be the result of industry's efforts, led by Sallie Mae, to prevail upon budget committee members to eschew cuts in student loan subsidies for deficit reduction purposes, and otherwise leave reforms of the federal student loan programs to the authorization committees, who have just begun work on legislation to reauthorize the Higher Education Act. That legislation is expected to pass sometime next year.
- ☐ Speculation has centered on the \$1.75 billion being raised from a combination of three likely measures: 1) a reclaiming of \$1 billion in reserves from the student loan guaranty agencies; 2) major cuts in Section 458 funding used to administer the Federal Direct Student Loan Program (FDSLSP); and elimination of the \$10 per student administration allowance currently passed on to schools under the FDSLSP.

Held aside under such a scenario would be cuts in interest subsidies, increased risk sharing, and other measures that have been endorsed by a majority of Congress in the past, only to be vetoed by President Clinton along with the Republicans' balanced budget bill in December 1995.

In short, Sallie Mae and the industry may be on the verge of skillfully dodging a bullet. (Of course, the revised deficit forecast of the Congressional Budget Office deserves some credit, as well, for having lowered the bar in terms of the level of overall savings members must seek.

Still, a host of concerns remain.

- ☐ As of late yesterday, the savings target number for the loan programs (that will be written into House and Senate drafts of the fiscal 1998 budget resolution taken up in committee tomorrow or Thursday) were not yet locked in stone—and an additional \$1.2 billion in cuts was reportedly discussed over the weekend.
- ☐ Moreover, the industry must remain vigilant against amendments, either on the Senate floor or from authorizers working on the budget reconciliation bill this summer, that would dun them for as much as another \$2.5 billion over five years to help pay for the President's proposed elimination of 2 percentage points of borrower-paid origination fees.

- ☐ Beyond that, Sallie Mae and industry lobbyists are working hard to try to win agreement on a "fix" for the scheduled July 1, 1998 shift in the basis used for calculating the interest rate on student loans during the in-school, grace, and deferment periods. Failure to head off the shift would see the new rate pegged to the 10-year Treasury note plus 100 basis points—a drop from the current formula based on the 91-day T-bill plus 310 basis points.

[As we reported on April 23, the industry is holding discussions with the administration and congressional staff to promote alternative formulas that might shield borrowers from the additional interest rate volatility that they (the lenders) claim might come with the shift. In their zeal to promote direct lending and retain related leverage in the budget and HEA deliberations, however, the Office of Management and Budget (OMB) and Department of Education (DOE) can be expected to drive a hard bargain. Demagoguing on the issue by Hill Democrats—to the effect that the scheduled shift will *benefit* students, not harm them—is also possible, if not likely. As a result, industry representatives are concerned that if they fail to get a "fix" to the 1998 interest rate problem attached to the budget resolution or the reconciliation bill, they will have to fall back on trying to attach a one-year solution to a fiscal 1998 appropriations measure.]

- ☐ Finally, the HEA reauthorization itself remains as a hurdle, as does the goal of achieving a permanent resolution to the controversial issue of how the FELP and FDSLTP programs are scored (i.e., the "fix" for the Credit Reform Scoring Act of 1990, which helped create the direct lending nightmare in the first place in 1993).

What this full plate suggests is that while Sallie Mae and the other privates can feel reasonably with the way things are going to date, there is far more heavy lifting—and potential political risk—to come. These issues likely will take most of Sallie Mae management's time once the ongoing battle for control has been resolved, most likely after the impending May 15 shareholders' meeting.

Please call 703/276-0055 or 800/905-6255 if there are any problems with this transmission.



Potomac Outlook

Charles A. Gabriel, Jr.

Subject:

Sallie Mae

April 14, 1997

"HIRE ED": DISSIDENT SHAREHOLDERS' NOMINATION OF FORMER SALLIE MAE CHAIRMAN COULD BOOST THEIR CAUSE; OTHER REFLECTIONS

Sallie Mae's dissident shareholders' group, the Committee to Restore Value at Sallie Mae (CRV), may have helped itself in its proxy battle with management last Thursday, Washington sources close to the industry speculate. Specifically, CRV's naming of former Sallie CEO Ed Fox as a board member candidate on its proposed alternative slate of directors has won praise in at least some quarters of the capital.

[Fox is one of five new director nominees announced by the CRV on April 10, in addition to the eight members of the group already serving on the Sallie Mae board; he has apparently agreed to serve as chairman should the CRV slate win convincingly at the group's May 9 special meeting, compelling management to endorse the results at the board's officially sanctioned May 15 meeting.]

The reason is that Fox built up a good image "within the beltway" during his stewardship of Sallie Mae prior to his departure in 1990. More importantly, *Fox's perceived strengths could help offset what are perceived as one of CRV leader Al Lord's weaknesses*: Fox is remembered for having maintained generally good relations with Congress, the Executive branch, and the other players in the student loan industry, whereas Lord was credited by some sources for often having raised the blood pressure of other industry lobbyists, particularly in 1993. "He (Fox) would go down there (to the Hill) and say, 'these things are complicated, just trust me on this'—and things would go his way," a banking industry source noted admiringly. (Lord was characterized as saying "this is the way we have to go.") The source expressed doubt about how actively involved in management issues Fox might get this time around, however.

Two senior committee staffers from the House and Senate who worked with Fox during his tenure at Sallie Mae gave him more mixed reviews—both as to his thrust while at the company's helm and his ability to influence the direction of the congressional debate and student loan industry today. The industry and the company's role in it were decidedly different then, the staffers reminded us: banks, guaranty agencies, and other industry players were far more secure in their respective roles; relations were far less strained. Moreover, political risk was very low.

Fox relied on outside counsel for representation of the company on Capitol Hill, a practice which—while adequate for the 'eighties—almost proved fatal during the early 'nineties. "He deserves credit for having built the company up from scratch," but as a result of being "out of the loop" for seven years, "he probably wouldn't know more than a quarter of the members on the education committees today. Things have changed dramatically," one of the staffers commented.

Still, Fox commands respect and could add credibility to the dissidents' revolt. Whether their entreaties to shareholders to "hire Ed" turn out to be another magic card for Lord and the CRV to play remains to be seen.

Just How Much Room For Improvement Is There For Sallie Mae? Despite the CRV's pledge to "repair relations with the Government" as a key item of its business plan, and "significantly reduce Sallie Mae's political activism . . . [working to] repair its existing relationships through constructive participation with the Education Department, Congress and others," there has been fairly wide praise for the way Sallie Mae has conducted its political operations since the disastrous enactment of the Student Loan Reform Act, creating the federal direct lending program in 1993.

Negotiation of the privatization legislation with the Clinton administration, and securing its enactment on Capitol Hill last September 30, was a tremendous achievement. Management's decision to put most of its energy behind seeking

Peter R. Orszag

09/29/97 01:34:33 PM

Record Type: Record

To: Robert M. Shireman/OPD/EOP

cc:

Subject: Re: Who from CEA 

Chris Carroll and perhaps Sandy Korenman...



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

Record Type: Record

To: Robert M. Shireman

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.

didland @ umich.edu

*Wade: zach
perce*

*FINAID-L@psu.edu
psuvm.psu.edu*

Maxmond
622-1230
1288

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 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.

*- what abt
lenders saying
w/ other
lenders?*

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 SLRA also 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 or loans in deferment, or the 3-month T-bill

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.

*A's actually for borrowers
but SAP is 3.1%*

rate plus 3.1 percentage points on loans in repayment.³ 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 a 10-20 year rate, or something closely approximating it, reflecting the maturity period of the rate at which it is assumed the Department borrows. Based on the interest rate assumptions for the 1997 *Mid-Session Review* (not released), 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 However, in all likelihood the formula change also would reduce the net return to lenders. 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).

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. 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 at the last minute as the SLRA of 1993 went through Congress, with the intention of tying the interest rate on student loans to the rate that OMB 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. *(AND the discount rate has now changed)*

⁵ A lower student loan interest rate in 1998 depends on the shape of the yield curve next year. Historical experience 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.

*what
period
??*

*1st
reduction*

*600
150*

The comparable numbers for 1999/00 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 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 Goldman Sachs and others 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 increase lenders' gross return for in-school loans in 1998/99 but reduce their gross return by 45 basis points for loans in repayment. In 1999/00, the gross return on in-school loans would be the 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

Other sources indicate this would not ultimately be a problem. Prefer to say that it is not clear, may be a problem, why risk it.

What's wrong w/ mid-ss. return? = what are the assumptions?

X
??

estimates that provide us some guidance, such as the latest Administration assumptions for the 1997 *Mid-Session Review*; 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 5.40 percent in 1998⁹ and the spread between 3-month T-bills and 10-year Treasury securities will be 1.4 percentage points. For 1999, an alternative assumption for the 3-month T-bill rate is that the rate will be closer to a DRP estimate of 5.13 percent than the *Mid-Session Review* estimate, and the spread is 1.68 percentage points. Our alternative assumptions for **student loan interest rates**, therefore, are 7.8 percent ($5.40+1.4+1.0$) for 1998/99, and 7.81 percent ($5.13+1.68+1.0$) for 1999/00.

- The next key variable is the lenders' **matched funds rate**. The general assumption is that lenders borrow at 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. A private guarantor of student loans has told us they would estimate the spread for a traditional bank to be 75 basis points. This probably is too high. PNC Bank of Pittsburgh assumes an average bank can borrow at 3-month LIBOR, which is

average of 10-20 year Treasury securities. This assumption has relatively little impact on the 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*.

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 what PNC Bank estimates and close to the spread over the past year and since 1988. This assumption is perhaps conservative. 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 5.8 percent in 1998/99 and 5.53 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 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 Goldman Sachs about this because they made an estimate of hedging costs for Sallie Mae. Goldman Sachs 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 quarterly 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 48 to 56 basis points. Since 1988, the average spread has been 43 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.

- Lend says he plans to cut costs in half

- talked?

- currently not after '98

see p. 3

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.

*Key
question*

Financial experts at PNC Bank agree with Goldman Sachs 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. PNC Bank 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. PNC Bank estimated the cost would be between 60 and 70 basis points. We have assumed, initially, that hedging costs are 65 basis points, the average for Goldman Sachs and PNC Bank. As an alternative assumption, we assume 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

sharing.

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.

A private source estimates their prepayment costs are 4 basis points. Goldman Sachs thinks that prepayments are a much greater risk than this, 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, whereas the interest on a student loan is not. The home equity tax deduction feature reduces the effective cost of a student loan to the borrower. PNC Bank assumes that prepayment costs are closer to 4 to 5 basis points.

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. This is consistent with the cost estimated by PNC Bank and others.

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 a range for a pre-tax return for banks of between 1.67 percent and 2.1 percent.¹³ and with

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

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

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, PNC Bank indicated 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 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 than the estimates in the *Mid-Session Review*, for example. For recalculating our estimates, we have lowered our estimates for hedging

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: 1.17 percentage points in 1998, 1.40 percentage points in 1999, 1.26 percentage points in 2000, and 1.20 percentage points through 2007.

See new
table - can
use T-bill and
lower rate is
okay

not relevant if T-bill is used.

or lower?

costs to 50 basis points and have raised the interest rate assumptions as noted earlier.

Plugging these revised assumptions into Table 2, lenders' net returns in 1998/99 and 1999/00 are 0.77 percent and 1.05 percent, respectively. These results are more positive than those in Table 1. The average weighted pre-tax return to lenders under the new student formula is still less than profitable in 1998/99, but appears to be marginally competitive in 1999/00.

However, this is correct only if an acceptable rate of return is 1.0 percent. But, a 1.0 percent 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 returns might be about half-way between 1.0 percent and 1.67 percent, or 1.3 percent. Thus, the estimated net return of 1.05 percent for 1999/00 probably would not be adequate.

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.

i.e. 1.00 would be okay if T-bill rather than 0.77

- what and for the government as for students are concerned?

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.

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 5.40 percent. This is the average closing price in the futures market since the end of May for 3-month T-bills maturing in March, 1998. As of August, there had not been any quotes in the futures market for a June, 1998 3-month T-bill.

The spread between 3-month T-bills and the average of 10-year Treasury securities in 1998 is 1.4 percentage points (the approximate average spread in the futures market since the end of May). For 1999 the spread between 3-month T-bills and 10-year Treasury securities is 1.68 percentage points, which is the historical average spread since 1981.

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 5.40 percent plus 40 basis points or 5.80 percent and 5.13 percent plus 40 basis points or 5.53 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.

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. This is consistent with the cost estimated by PNC Bank and others.

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	8.25	9	7.2	7.2	9	6.8	6.8	9
Less costs:									
Matched funds	5.57	5.57	5.57	5.67	5.67	5.67	5.5	5.5	5.5
Origination/holding fee	0.05	0.05	1.1	0.05	0.05	1.1	0.05	0.05	1.1
Servicing costs	0.2	0.6	0.6	0.2	0.6	0.6	0.2	0.6	0.6
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	0	0	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. Interest rates for 1998/99 and 1999/00 are based on the economic assumptions for the 1997 Mid-Session Review.

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	7.8	7.8	9	7.81	7.81	9
Less costs:									
Matched funds	5.57	5.57	5.57	5.8	5.8	5.8	5.53	5.53	5.53
Origination/holding fee	0.05	0.05	1.1	0.05	0.05	1.1	0.05	0.05	1.1
Servicing costs	0.2	0.6	0.6	0.2	0.6	0.6	0.2	0.6	0.6
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	0	0	0.5	0.5	0.5	0.5	0.5	0.5
Subtotal	5.98	6.48	7.53	6.71	7.21	8.26	6.44	6.94	7.99
Net return	1.69	1.77	1.47	1.09	0.59	0.74	1.37	0.87	1.01
Weighted Average Net Return		1.71			0.77			1.05	

Note: Table is for new student loan formula. Interest rates for 1998/99 are based on the futures market; rates for 1999/00 are from DRI.

- The following Table indicates that it would be possible to retain the structure of the current student loan formula, but narrow the spread currently allowed above the 3-month T-bill rate, and provide a competitive rate of return for lenders while reducing the student loan interest rate from what it otherwise would be under the new formula for next year and what the rate is for 1997/98 under the current formula. This result is possible because using the structure of the current student loan formula would, for all practical purposes, eliminate the need for lenders to hedge their student loans, which imposes a substantial cost on lenders.
- It must be pointed out that these estimates 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 what they are now. 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. Thus, these estimates are essentially illustrative of the conclusion stated above.

**TABLE: 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	7.67/8.26	N.A.	N.A.	1.71	N.A.	N.A.
New for 1998/99:						
10-year plus 1 percent	N.A.	7.8/7.8	7.81/7.81	N.A.	0.77	1.05
Alternative:						
3-month T-bill plus 1.9/2.3 percent	N.A.	7.3/7.7	7.03/7.43	N.A.	1.05	1.09

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 1.4 percentage points plus 1. The T-bill rate is 5.4% (a futures market estimate) and the 1.4 percentage points is the approximate average spread between T-bills and 10-year notes in the futures market since the end of May. For 1999/00 the assumed T-bill rate is 5.13 (a DRI estimate) and the spread is 1.6 percentage points, which is the historical average spread since 1981.

Alternative formula: The rates shown in the table are based on the same assumed rates for T-bills under the new formula, i.e., 5.4% for 1998/99 and 5.13% for 1999/00. The formula spread is the amount that is necessary to assure a competitive net return to lenders and approximately the same student loan rate a borrower would pay under the new formula.

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.

Office of Economic Policy

Department of the Treasury
Washington, D.C. 20220

FAX

Date: 9/24/97
Number of pages including cover sheet: 16

Name	Fax Number	Phone Number
To: Bob Shireman	456-2223	456-5351
From: Jon Gruber	202-622-2633	622-0563

REMARKS: ☐ Urgent ☐ For your review ☐ Reply ASAP ☐ Please comment*Hedging costs and. nr adequate.**Maynard*

~~The Financial Viability of the Student Loan Program~~

Executive Summary

The Federal Family Education Loan Program (FFEL) has been in existence since 1966. It has provided needy and middle-income borrowers an opportunity to finance their higher education, even if they do not have adequate savings of their own.

Throughout the existence of the program, the formula for calculating the interest rate that lenders earn on a student loan generally has not been a problem for lenders, in so far as their pre-tax rate of return is concerned. The formula for calculating student loan interest rates has provided lenders a return that is competitive with their other investment opportunities. Now, however, a new student loan formula that is scheduled to take effect on July 1, 1998 threatens to jeopardize the financial ability of lenders to continue their participation in the loan program.

Prob's
M 70's
→ SM

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.

anly ady.

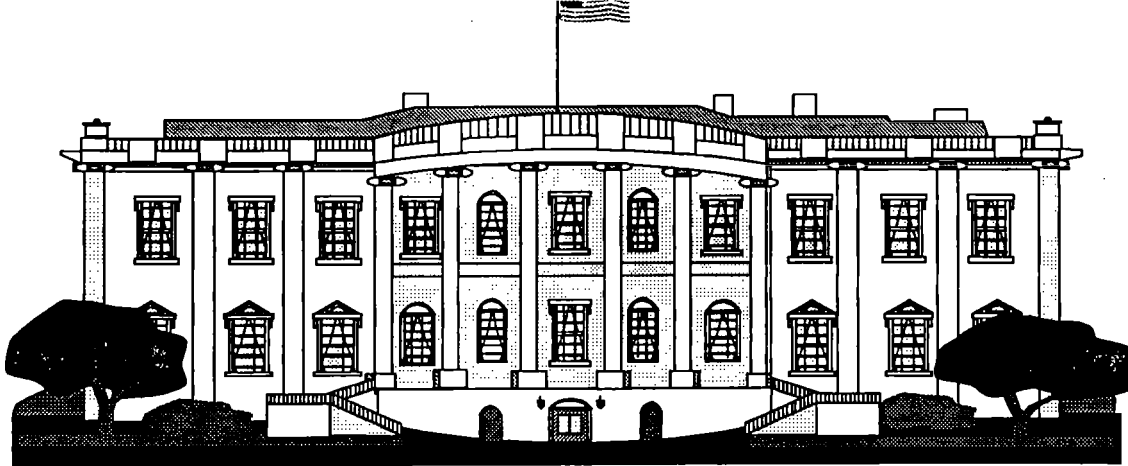
Lenders have expressed their concern that the new formula involves a new risk to them because of a mismatch among the short term source of their funds and the rate for long term securities which will be reset annually and which will determine the student loan interest rate. Starting in mid-1998, the 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.

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 tempers somewhat the reduction, but it 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.



The White House

National Economic Council

To: Chuck Babcock

Phone: _____ Fax: _____

From: **Bob Shireman**

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

Pages including cover sheet: _____

Comments: The preliminary analysis from Treasury
suggests that the interest rate can be lowered substantially without
risking loan availability. Treasury does suggest that
we switch back to using the T-bill (91-day) rather than
10-year note.



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 a range for a pre-tax return for banks of between 1.67 percent and 2.1 percent.¹³ and with

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

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

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, PNC Bank indicated 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 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 than the estimates in the *Mid-Session Review*, for example. For recalculating our estimates, we have lowered our estimates for hedging

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: 1.17 percentage points in 1998, 1.40 percentage points in 1999, 1.26 percentage points in 2000, and 1.20 percentage points through 2007.

See new
sit - can
use T-bill
and 10%
may

if T-bill is used.

costs to 50 basis points and have raised the interest rate assumptions as noted earlier.

Plugging these revised assumptions into Table 2, lenders' net returns in 1998/99 and 1999/00 are 0.77 percent and 1.05 percent, respectively. These results are more positive than those in Table 1. The average weighted pre-tax return to lenders under the new student formula is still less than profitable in 1998/99, but appears to be marginally competitive in 1999/00.

However, this is correct only if an acceptable rate of return is 1.0 percent. But, a 1.0 percent 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 returns might be about half-way between 1.0 percent and 1.67 percent, or 1.3 percent. Thus, the estimated net return of 1.05 percent for 1999/00 probably would not be adequate.

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.

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.

- The following Table indicates that it would be possible to retain the structure of the current student loan formula, but narrow the spread currently allowed above the 3-month T-bill rate, and provide a competitive rate of return for lenders while reducing the student loan interest rate from what it otherwise would be under the new formula for next year and what the rate is for 1997/98 under the current formula. This result is possible because using the structure of the current student loan formula would, for all practical purposes, eliminate the need for lenders to hedge their student loans, which imposes a substantial cost on lenders.
- It must be pointed out that these estimates 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 what they are now. 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. Thus, these estimates are essentially illustrative of the conclusion stated above.

**TABLE: 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	7.67/8.26	N.A.	N.A.	1.71	N.A.	N.A.
New for 1998/99:						
10-year plus 1 percent	N.A.	7.8/7.8	7.81/7.81	N.A.	0.77	1.05
Alternative:						
3-month T-bill plus 1.9/2.3 percent	N.A.	7.3/7.7	7.03/7.43	N.A.	1.05	1.09

N.A. not applicable

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

Assumptions:

Student loan interest rates:

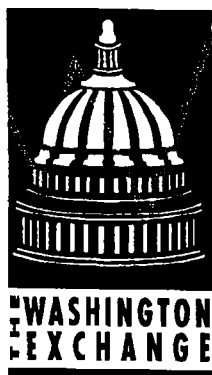
Current formula: 3-month T-bill is the actual rate for the last week in May, 1997 prior to June 1. The rate was 5.17%.

New formula: For 1998/99, the 10-year note rate is T-bills plus 1.4 percentage points plus 1. The T-bill rate is 5.4% (a futures market estimate) and the 1.4 percentage points is the approximate average spread between T-bills and 10-year notes in the futures market since the end of May. For 1999/00 the assumed T-bill rate is 5.13 (a DRI estimate) and the spread is 1.6 percentage points, which is the historical average spread since 1981.

Alternative formula: The rates shown in the table are based on the same assumed rates for T-bills under the new formula, i.e., 5.4% for 1998/99 and 5.13% for 1999/00. The formula spread is the amount that is necessary to assure a competitive net return to lenders and approximately the same student loan rate a borrower would pay under the new formula.

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.



fax from:

THE WASHINGTON EXCHANGE

TO: Bob Shireman
OMB
202-456-2223

FROM: ETHAN SIEGAL

PAGES: 2___(INCLUDES COVER)

DATE: OCTOBER 3, 1997

ATTACHED IS THE BARRON'S ARTICLE THAT I MENTIONED TO YOU. HAVE A NICE WEEKEND.



Sallie Mae Stands To Suffer If Student-Loan Law Isn't Amended; Fast-Track Authority Likely To Derail



Jim McTague

A FATAL FLAW HAS SURFACED IN President Clinton's 1993 plan to federalize the market for guaranteed student loans and reduce the interest rates charged to college students. Analysts for the government and Wall Street are warning that, beginning in July 1998, interest rates on the loans will be so low — thanks to a formula in student-loan legislation — that banks and other lenders may stop originating the loans.

Companies that buy and sell loans, like SLM Holding Corp.'s Sallie Mae, would be hit hard. The value of student-loan assets would fall by 60% and halve earnings-per-share growth at the secondary-market company, according to Jonathan Gray, an analyst with Sanford C. Bernstein. If Congress refuses to amend the law, "It would be a heart attack for the industry," says Gray. College students would feel the industry's pain. Sixty-five percent of all government-guaranteed education loans are originated by private lenders; the Department of Education originates the rest. If the banks were to drop out, the Education Department would have to fill the breach. But the department's own lending program is bogged down and few people consider it resourceful enough to ride to the rescue.

Gray, who otherwise is bullish on Sallie Mae, is confident the lawmakers will amend the law rather than risk disrupting the flow of loans to student borrowers during an election year. Bankers are less sanguine. "Things are getting ugly," says Joe Belew, president of the Consumer Bankers Association. Consumer groups are accusing the bankers of manufacturing a crisis to keep rates high. No one expects Congress to amend the law in the current session, and Belew doesn't think the lawmakers will act next year because few electioneering congressmen will want to cast a vote that appears to help "greedy bankers" at the expense of college students. "There's less than a 50-50 chance we will get the legislation fixed," is the assessment of John Dean, special counsel to the banking association.

The problem surfaced in a report by the Congressional Research Service last July, which hasn't given the banking industry much time to get a lobbying effort into high gear.

The law mandates that on July 1, 1998, the variable rates on government-insured

Stafford Loans be one percentage point over the yield on 10-year Treasuries instead of two to three percentage points over the 91-day T-bill rate, the formula that has prevailed for the past 17 years.

On average over the past 10 years, rates under both formulas have been about the same, according to Barbara Miles of the Congressional Research Service. But Miles warned in her July report that a narrowing of the spreads between the two financial instruments caused by falling rates would result in big profit declines for banks and even losses for lenders at certain points in the business cycle. The result, she warns, might be an exodus of banks from the student-loan business.

Gray predicts that the bill will be amended within the next six months, with a more moderate reduction in spreads than would occur the way the law currently reads.

When the law was enacted four years ago, the Clinton Administration assumed that at least 50% of all student loans would be made directly by the Department of Education at far less cost to borrowers. Clinton in effect was arguing that the DOE's bureaucrats were as able as private-sector lenders, whom he had accused of price gouging. Because of this optimism, the effects that changes in the loan rate might have on private capital were not considered.

Growth of the DOE's direct-lending program has stopped, at least temporarily, at about 31% of the market, for a number of reasons. A department spokeswoman, Jane Glickman, says congressional opponents of the program tried to slow it down

for two years running and succeeded in scaring off some universities from participating. She correctly points out that the DOE program spurred the private sector to improve its services to borrowers, allowing them to retain a larger share of the business than had been expected. Private lenders like banks still originate about 65% of the four million federally insured student loans and serve students at 80% of the secondary institutions.

Gray says failure to rewrite the law would be a major blow to Sallie Mae. SLM Holding's earnings per share would grow at about 7%-8% a year as it cut costs and acquired assets, well below current Street projections. The stock, which last week traded around \$158 and has in Gray's view a fair market value of around \$190, would instead have fair value of \$140-\$145. If Congress rewrites the bill, Sallie Mae's earnings would grow at a 14%-17% clip, says Gray, suggesting a stock price over \$200 within six to nine months. "It's definitely not a stock for widows and orphans, because of the political risk," says Gray.

Dear David: I've A Problem With Sallie

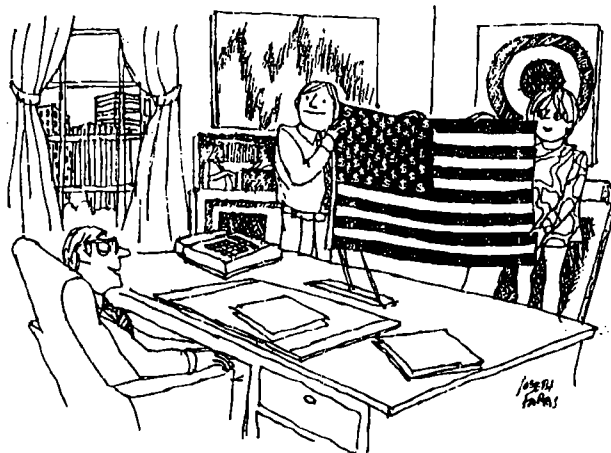
► SALLIE MAE HAD ANOTHER BOMB lobbed at it from Capitol Hill last week. Democratic Rep. David Skaggs of Colorado introduced a bill practically dictated by a Sallie Mae competitor that would preclude it from offering sweet deals to

universities that refinance outstanding debt.

Lee White, a senior vice president in the higher-education-finance department of Denver-based George K. Baum & Co., an investment bank, was ticked off after losing a \$5 million refinancing deal last spring to Sallie Mae's broker-dealer subsidiary, Education Securities Inc. White says he's a casual friend of Skaggs. They got to know one another in the 1980s when White was Colorado's budget director and Skaggs was a state legislator. He wrote Skaggs a "Dear David" letter on June 23 with this complaint: Sallie Mae, which was created by Congress, borrows money cheaply in the debt market and uses some of it to buy higher-yielding tax-free bonds issued by public colleges. Some of those colleges are refunding the bonds in order to issue new ones at a lower rate. Educational Securities has been telling the universities that Sallie Mae will waive the 1%-3% premium it would receive for early redemptions if they retain the broker-dealer as investment banker for the refundings. White says that on the deal his firm lost, Sallie Mae gave up \$50,000-\$100,000 in premiums to San Diego State University. White views that as unfair competition because Sallie Mae's bond purchases were subsidized by the federal government. He wrote Skaggs, "I would appreciate it if you would consider offering legislation with an immediate effective date specifying that Sallie Mae cannot make any exclusive tie-in arrangements regarding bonds acquired by Sallie Mae while it was a government-sponsored enterprise." White adds that Sallie Mae's business in municipal finance has been "almost nonexistent in Colorado." But he says there are four firms in Colorado, including his own, with higher-education-bond departments. "In other words, I am certain that were you to offer such legislation, it would have relatively no negative impact in Colorado, and of course would be welcomed by the investment banking industry as only the fair thing to do."

Skaggs took his casual friend's advice. Though the bill could attract some political contributions, it's unlikely to become law, owing to its narrow focus.

► "FAST TRACK" LEGISLATION IS ON LIFE support. Republicans in the House have just 120 votes in support of the measure, which would give President Clinton the authority he seeks to enter into new trade agreements with no participation by Congress in the negotiating stage, and there aren't enough pro-trade Democrats in the House to provide a winning margin. The upshot: There will be no bill this year and small chance for it in the next congressional session. ■



"I like it. It's cynical and patriotic."

Reg Clark & Rose DiNapoli

~~2375744~~

8/10/97

D also was @ the mtg.

D tax after p/s

1. Hedging costs -

2. Yield / costs

3. Margins i rate net costs

- rose.linapoli@slma.com

Sal/Gr Mac note

- ~~Sal~~ → schools
melanne, Carl Thompson-Gre.

The Financial Viability of the Student Loan Program

Executive Summary

The Federal Family Education Loan Program (FFEL) has been in existence since 1966. It has provided needy and middle-income borrowers an opportunity to finance their higher education, even if they do not have adequate savings of their own.

Throughout the existence of the program, the formula for calculating the interest rate that borrowers would pay for a student loan generally has not been a problem for lenders in so far as their pre-tax rate of return is concerned. The formula for calculating student loan interest rates has provided lenders a return that is competitive with their other investment opportunities. Now, however, a new student loan formula that is scheduled to take effect on July 1, 1998 threatens to jeopardize the financial ability of lenders to continue their participation in the loan program.

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 new formula will change to the average bond equivalent rate for 10-20 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. It is speculated that this will be the rate for the average of 10-year Treasury notes. }?

Lenders have expressed their concern that the new formula involves a new risk to them because of a mismatch between the short term source of their funds and the rate for long term securities 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 until 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. Because student loans are 98 percent guaranteed by the Federal Government, this margin normally would be at least about 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.

20 has's PB

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 for 1998/99 to 1999/00. We have estimated these variables using different interest rate and cost assumptions.

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 tempers somewhat the reduction, but it does not change the basic finding that the lenders probably would not earn a normal rate of return, if they are required to offer student loans based on the new loan formula.

If lenders opt not to participate in the student loan program because of this result, the Federal Government would be forced to expand the direct loan program and assume the entire responsibility of helping student finance their higher education. The Government may be capable of administering the entire loan program, but it may not be the most cost effective provider of loans. The Government could avoid assuming responsibility for administering the entire program by requesting the Congress to repeal the new student loan formula and revert back to the current formula. The President and others are anxious to reduce the interest rate that lenders can charge students to borrow to finance their education from what it would be under the current formula. This paper provides examples of how the current formula, using alternative estimates of student loan interest rates, would allow the Government to lower the future interest cost to students and still provide an adequate pre-tax return to lenders.

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 competitive with their other investment opportunities, such as Ginnie Mae securities or adjustable home mortgages. Past experience suggests, however, that a confluence of several factors, e.g., interest rate changes, student loan demand, and periodic Congressional changes in the student loan formula and other program features, has been followed by reductions in the number of lenders participating in the student loan program.

For example, there was a sharp increase in the spread between LIBOR and 3-month T-bill rates around 1986 and 1987 when lender participation started declining. Moreover, a drop in student loan demand in 1985 relative to new high school graduates and a continuing sharp decline in the interest rate on student loans (including the Special Allowance Payment or SAP) since 1980 may have discouraged lenders. In 1990, the cap on SAP prevented lenders from taking full advantage of the loan formula for computing the SAP cap, i.e., the average 3-month T-bill rate for the quarter in which a loan is made plus 3.25 percentage points. Not since 1977 had the cap prevented lenders from taking full advantage of the SAP. ? ?
- which drop
go for SAP

Finally, the tightening of due diligence regulations in 1993 probably influenced many small lenders to drop out of the student loan program, since student loans were no longer profitable for many of these smaller and non-specialized institutions, because of the added risk exposure and servicing costs resulting from these requirements. Consequently, the ability of these institutions to service loans profitably was lessened, and many either exited the market or outsourced the origination and servicing functions to institutions that are more specialized and could provide these services at less cost.²

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. that
value
too

Following closely these changes and developments, the number of institutions participating in the student loan program fell sharply. Scaling the number of originators by the number of banks and thrifts in existence, participants as a share of total banking 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 SLRA also scheduled a change in the interest rate that borrowers would pay for student loans starting in 1998. Under the current formula, which will apply for the last time to all student loans finalized before July 1, 1998, lenders receive the rate on 3-month T-bills plus 2.5 percentage points for in-school loans or loans in deferment, or the 3-month T-bill rate plus 3.1 percentage points on loans being repaid.³ Starting with loans finalized after June 30, 1998, lenders' gross yield on all 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
- 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 in

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. 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 9.00 percent for many years in the future. Also, 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 student loan interest rate. The SAP is the difference between the two rates. For this analysis, it is not necessary to account for changes in what a lender can receive because of the SAP, other than to note that a lender receives it if 3-month T-bill rates rise after the loan is made.

⁴ The change in the formula for 1998 and subsequent years evolved at the last minute as the SLRA of 1993 went through Congress, with the intention of tying the interest rate on student loans to the rate that OMB 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 the economic cost of the Federal guarantee is either the average interest rate on federal borrowing, if there is a cash outlay, or some private opportunity cost, if the guaranteed loan is repaid (with interest) on schedule but displaces other private borrowing. THOS

1998. Based on the interest rate assumptions for the 1997 *Mid-Session Review* (not yet released), 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 However, in all likelihood the formula change also would reduce the net return to lenders. 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 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 so that the opportunity cost of educational loans relative to other investment opportunities of lenders is still favorable.

7 by
def
True

- As noted, under the new loan formula, borrowers would pay a lower interest rate for student loans made after June 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 the maturity of the instrument for lenders' short term funding, i.e., the 3-month T-bill rate or something similar to it, like 3-month LIBOR, is closely matched by the maturity of the instrument for determining the student loan rate. In addition, the student loan interest rate paid to the lender is reset quarterly (the rate paid by the borrower is reset annually). 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.

1990

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

⁵ It has been reported that the President is committed to assuring that student loan rates next year will be less than they are now. The latest *Mid-Session Review* projections of interest rates would guarantee that result. Apparently, this is why there is great resistance, within parts of the Administration, to repealing the new formula and reverting to the old formula, including the current spread of 2.5/3.1 percentage points over the 3-month T-bill rate. A lower student loan interest rate in 1998 depends on the shape of the yield curve next year. Historical experience suggests that because the student loan interest rate 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 is only -3 (-28) basis points.

⁶ Using what we think may be more realistic interest rate assumptions, the formula change would increase lenders' gross return for in-school loans in 1998/99 but reduce their gross return by 45 basis points for loans in repayment. In 1999/00, the gross return on in-school loans would be the 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.

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 Goldman Sachs and others 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 estimates that provide us some guidance, such as the latest Administration assumptions for the 1997 *Mid-Session Review*; the futures market; or historical experience.

Assumptions for Lenders' Costs

- The economic assumptions for the 1997 *Mid-Session Review* include projections to the year 2007, including projections for Treasury securities with a maturity of 10 years and 10-20 years. Using the *Mid-Session Review* 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, however, and may be too optimistic, perhaps because OMB wants lower interest rates

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 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 the assumptions for 10-20 year Treasury securities were used, the comparable rates would be 7.1 percent ($6.11+1.0$) for 1998 and 6.72 percent ($5.72+1.0$) for 1999.

what?

but Cbl
+ for
any
same?

than, say, the futures market or DRI anticipates in the short run in order to assure a projected budget balance by 2002. 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 for 1998 is 5.40 percent (the average closing price in the futures market since the end of May for 3-month T-bills maturing in March, 1998⁹) and the spread between 3-month T-bills and 10-year Treasury securities will be 1.4 percentage points (the approximate average spread in the futures market since the end of May). For 1999, an alternative assumption for the 3-month T-bill rate is that the rate will be closer to the DRI estimate of 5.13 percent than the *Mid-Session Review* estimate, and the spread is 1.68 percentage points, which is the historical average spread since 1981. Our alternative assumptions for **student loan interest rates**, therefore, are 7.8 percent (5.40+1.4+1.0) for 1998/99, and 7.81 percent (5.13+1.68+1.0) for 1999/00.

- The next key variable is the lenders' **matched funds** rate. The general assumption is that lenders borrow at the 3-month T-bill rate plus some amount of basis points above that rate. Sallie Mae estimates their all-in cost to finance loans is 30 basis points above the 3-month T-bill rate.¹⁰ The Congressional Research Service (CRS) estimates that the spread for Sallie Mae is about 14 basis points. This may be too low. A private guarantor of student loans has told us they would estimate the spread for a traditional bank to be 75 basis points. This probably is too high. PNC Bank assumes an average bank can borrow at 3-month LIBOR, which is approximately equal to 3-month T-bills plus 40+ basis points.¹¹

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 of 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.

⁹ A 5.40 3-month T-bill rate based on the futures market is about 13 basis points higher than the projected 3-month T-bill rate for the *Mid-Session Review*. As of August, there have not been any quotes in the futures market for a June, 1998 3-month T-bill.

¹⁰ Financial experts at the PNC Bank of Pittsburgh believe that 30 basis points for Sallie Mae may be too high.

¹¹ For the past year, the average spread between 3-month LIBOR and 3-month T-bills has been 48 to 56 basis points. Since 1988, the average spread has been 43 basis points.

For this analysis, we assume the spread over the 3-month T-bill is 40 basis points, which is what PNC Bank estimates and close to the spread over the past year and since 1988. Our assumption is perhaps conservative, therefore. For our initial estimates, we assume a matched funds rate of 5.27 percent plus 40 basis points or 5.67 percent for 1998/99 and 5.10 percent plus 40 basis points or 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 5.8 percent in 1998/99 and 5.53 percent for 1999/00.

- **Servicing/overhead costs** are another variable that has a significant impact on lenders' net return. Sallie Mae has quoted us 30 basis points for overhead expenses. This estimate may be high if their administrative costs are bloated because of high salaries and other excessive expenses.¹² A private guarantor of student loans quoted us 15 basis points for overhead. We assume the latter figure is closer to the mark.

Estimates of servicing costs are more difficult to make. Sallie Mae told us their cost for servicing loans is 100 basis points, which seems high to us. A 1993 CRS study noted that Sallie Mae reported their servicing costs were 66 basis points but appeared to be rising since 1992. 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. The difference between this Sallie Mae figure and their 100 basis points apparently is that the latter is the average cost to service an additional loan over the expected life of that loan,¹³ whereas the 60 basis points reflects 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. We think the latter concept is the appropriate one. Assessing all these estimates, we assume servicing costs are 60 basis points.¹⁴

In the last section of this paper where we examine Sallie Mae's risk adjusted net return,

¹² Sallie Mae announced on September 5, 1997 that it has cut its executive staff to 66 from 106. This is part of the staff and cost reductions that were proposed by a dissident group that led a successful proxy fight to gain control of the company.

¹³ The 100 basis points estimated by Sallie Mae is derived by comparing annual service costs for a loan to the remaining amount of the loan principle outstanding each year. Sallie Mae assumes service costs are low during the in-school years, rise during the early years of repayment and then level-off. Because the amount of an outstanding loan declines over time, service costs as a percent of outstanding principle rises over time. The relative cost during the years 5-14 far outweigh the lower relative cost during first four in-school years. Average service costs for the life of a loan are relatively high, therefore.

¹⁴ 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.

we adjust downward their estimate of servicing costs.

- Finally, the last major factor to be estimated which affects lenders' costs under the new formula is **hedging costs**. We have talked with Goldman Sachs about this because they made an estimate of hedging costs for Sallie Mae, which Sallie Mae has shared with us. Goldman Sachs 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 quarterly 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 quarterly for a series of short term assets, say LIBOR or something similar. One could argue, of course, that the 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.

We have talked with Goldman Sachs on several occasions about their methodology for estimating hedging costs. We have also talked with financial experts at PNC Bank¹⁵ who agree with Goldman Sachs 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. PNC Bank 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, if they can't be assured they can sell the loan after about seven years, which is about as long as they hold such assets in their investment portfolio. The lack of assurance of capital market liquidity for future student loans will make it costly to offer them to borrowers.

At our request, Domestic Finance tried to price the swap described in the Goldman Sachs letter by using the Bloomberg data, but they were unable to do so because the Goldman Sachs swap is very specialized. In addition, the Bloomberg swap curves require estimates of forward LIBOR for a 10 year period, which Domestic Finance thinks is difficult to make. Although they said they can't price the swap as described by Goldman Sachs, Domestic Finance was able to use the Bloomberg generic swap curves as of August 21 to

¹⁵ PNC Bank was the 10th largest FFEL originator in FY1996, up from the 14th largest in 1995 and the 17th largest in 1994. In FY 1996 PNC originated nearly \$335 million of FFEL loans. In FY 1995, it held about \$1.4 billions in their investment portfolio, which made them the 8th largest holder.

determine generic swap rates for 5 and 10 year terms. Those rates are 6.51 percent and 6.77 percent, which is 34 basis points and 44 basis points over Treasury 5 and 10 year CMTs.

These amounts are less than Goldman Sachs' estimate of about 60 basis points for the cost of a swap for student loan assets and a PNC Bank estimate of between 60 and 70 basis points. Because the Domestic Finance estimate is not for an asset that is strictly comparable with the assets underlying the other two estimates, we have assumed, initially, that hedging costs are 65 basis points, the average for Goldman Sachs and PNC Bank. As an alternative assumption, we assume that hedging costs are about 50 basis points, or somewhat between the Goldman Sachs estimate and Domestic Finance. } 1

- 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. Sallie Mae estimates 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. — all (costs?)
- 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 sharing.

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.

Sallie Mae estimates their prepayment costs are 4 basis points. Goldman Sachs thinks that prepayments are a much greater risk than this, 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, whereas the interest on a student loan is not. The home equity tax deduction feature reduces the effective cost of a student loan to the borrower. PNC Bank assumes that prepayment costs are closer to the Sallie Mae estimate, about 4 to 5 basis points.

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.

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.¹⁶ 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.¹⁷ 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 Sallie Mae and some others do not think prepayment is a major problem, we assume the cost for lenders is 4 basis points. This is consistent with the cost estimated by Sallie Mae and PNC Bank.

¹⁶ Because of this logjam, the Department of Education has suspended temporarily the privilege of switching to the direct loan program.

¹⁷ 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.

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 1997/98,¹⁸ 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 a range for a normal pre-tax return for banks of between 1.67 percent and 2.1 percent.¹⁹ and with the return on other Government guaranteed loans. Because student loans are 98 percent 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, PNC Bank indicated that if loans are risk-weight adjusted, a 98 percent Government guaranteed student loan could earn as low as 1.00 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.²⁰ Furthermore, we have already noted

72 basis
1.3 high

¹⁸ Data for 1997 interest rates are actual rates for the last week in May, 1997 prior to June 1, 1997.

¹⁹ The range for a "normal" after-tax rate of return for banks is about 1.0 percent to 1.3 percent. Assuming that the average total income tax rate for a bank is 40 percent, the range for a normal before-tax rate of return is 1.67 percent to 2.1 percent.

²⁰ 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: 1.17 percentage points in 1998, 1.40 percentage points in

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 inaccurate. For example, our estimate for hedging costs may be too high (or too low), although two of the three estimates we received suggest that we are not. Certainly, interest rates in 1998 and 1999 could well be higher than the estimates in the *Mid-Session Review*, for example. For 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.

Plugging these revised assumptions into Table 2, lenders' net returns in 1998/99 and 1999/00 are 0.77 percent and 1.05 percent, respectively. These results are more positive than those in Table 1. The average weighted pre-tax return to lenders under the new student formula is still less than profitable in 1998/99, but appears to be marginally competitive in 1999/00.

However, this is correct only if an acceptable rate of return is 1.0 percent. But, a 1.0 percent 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 returns might be half-way between 1.0 percent and 1.67 percent, or 1.3 percent. Thus, the estimated net return of 1.05 percent for 1999/00 probably would not be adequate.

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.²¹ 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.

- The final section of this paper examines the policy implications of unprofitable returns to lenders participating in the student loan program. The section also includes a discussion of a proposal for changing the scheduled student loan formula that could benefit borrowers and lenders alike, and possibly reduce Federal outlays in the longer-run.

Recommendations

- As noted previously, during recent years, there has been a growing concentration of student loan originations among fewer and larger financial institutions, as some lenders have abandoned the student loan program. There has also been a growing concentration of purchases in the secondary market. The largest purchaser of student loans in the secondary market is Sallie Mae. Sallie Mae's annual student loan purchases are a substantial proportion of FFEL program loans and they hold a large proportion of outstanding FFEL program dollars. Between 1994 and 1996, annual Sallie Mae student loan purchases represented approximately one-third of the FFEL program dollar amount, and they held about the same share of the outstanding loan dollars.
- If the results of our analysis of the impact of the new student loan formula on lenders' net returns are accurate, many additional lenders could decide to drop out of the program, as they have done in the past, unless they can reduce their costs of operation substantially below what they are now, or they decide to continue making student loans for nonprofit motives. This could force the Federal Direct Student Loan Program to provide a greater share of the funding for guaranteed student loans. As discussed below, it even may be doubtful that Sallie Mae could survive if they had to operate under the provisions of the new student loan formula.
- Even if the Federal Government has to originate a larger share of student loans directly, it would still need private institutions to do the origination and servicing functions for it. One can disagree whether or not the Federal Government should be in the direct student loan business at all. But it is probably correct to say that the Government is not as efficient as the private sector in administering a loan program. If so, any increase in the actual cost of operating the student loan program would have to borne by taxpayers.
- The cost of the student loan program to the Federal Government depends on two factors:

²¹ 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.

*Logic
understanding
of 02.11*

(1) whether loans are made by private lenders and are subsidized and guaranteed by the Federal Government, or whether loans are subsidized but made directly by the Federal Government, and (2) the rate of interest that lenders can charge a borrower and the rate of interest at which the Budget assumes the Department of Education borrows.

It true that the Government doesn't have to earn a profit. However, there are some costs the Government incurs for a direct student loan that it doesn't incur for a guaranteed loan and vice-versa. The following is a step by step accounting of the pluses and minuses of an all-direct versus an all-guaranteed program.

All Guaranteed Program:

1. For a subsidized guaranteed loan, the Government pays to lenders the interest cost during the period a student is in school. This is a cost to the Government.
2. After graduation, the Government incurs no costs for a guaranteed loan, except for the possibility of default. That cost of default is the same whether it is a guaranteed loan or a direct loan. However, the Government receives from lenders an origination fee, which is like an offset against the Federal cost of the loan guarantee.
3. During the life of a guaranteed loan, the Government has to pay a fee to the State guaranty agencies for administering loan guarantees.
4. Finally, the Government makes a Special Allowance Payment (SAP) to lenders. The SAP is a fixed margin added to the 3-month T-bill rate, and paid by the Government whenever the student borrowing rate rises above the ceiling rate, which is 8.25 percent. The Government doesn't have to make this payment for a direct loan, because it doesn't have to pay itself. However, the Government still incurs a cost because its cost of funds also rise. If the Government doesn't take this cost into account, it understates the true cost of the loan. In effect, however, the SAP is a subsidy to the borrower, because the loan interest rate the borrower pays is capped. In one case the amount of the subsidy is paid to a lender; in the other case the Government pays the amount to itself. Therefore, if the Government budgets properly, the two transaction are a wash.

All Direct Loan Program.

1. The Government doesn't receive any payments of interest on a direct loan while the student is in school; but, at the same time the Government doesn't have to make a payment to a lender on behalf of the student. This is a cost-saving to the Government. During the period a student is in school, the Government must pay interest to holders of the public debt that financed the loan payment to the student. This is a cost that will be compensated by a stream of payments from the student after he/she graduates.

2. During the repayment period, the Government receives from the student this stream of payments consisting of interest and principle. For guaranteed loans these payments are made by the student to the private lender. Because the student will be paying the Government interest at the 10-20 year rate plus 1.0 percent, the 1.0 percentage point is a financial gain to the Government, because the assumption is the Government's cost of money is only the 10-20 year Treasury rate.

3. At the same time, however, the Government has to pay a fee to a third party that originates and services the direct loan for the Government. This fee is a cost to the Government and is over and above the administrative costs for civil servants who work for the student loan program. . At the same time, for a direct loan the Government does not have to pay a fee to State guaranty agencies, which is a cost saving.

The CBO maintains that when you take all these factors into consideration, the pluses and minuses wash so that the Government doesn't make a profit from the direct loan program. The Department of Education, however, thinks the Government makes a small profit. I believe the bottom line depends on just how efficient (or inefficient) the Government is and whether it can hold down its administrative costs. I don't think OMB is confident that the Department of Education is sufficiently efficient to balance the (cost) scales in favor of the Government.

There is one benefit that does accrue to the direct loan program that is not very likely in the guaranteed program. When the President promoted the direct loan program, he didn't necessarily think the Government could offer loans cheaper than the private sector.

However, he wanted to help students. One way to help them was to charge them a lower rate, and the new loan formula would do that. Unfortunately, the way the lower rate is achieved, it creates a problem for lenders because of the hedging cost they have to incur. Another way to help students, however, is to allow them to repay their loans at a pace that is contingent on their incomes after graduation. While the Government can allow students to repay it back under such an arrangement, the Government doesn't think it can require private lenders to make students' repayment streams contingent on their future income. To do this, loans would have to be made under a direct loan program.

The bottom line of this analysis is that I am not convinced the Government would come out ahead under a direct loan program. I don't think OMB thinks so either. I do know that Frank Raines is putting pressure on the third party contractors who provide the origination and servicing for direct student loans to hold down their costs and therefore the Governments costs.

- Based on the *Mid-Session Review* estimates to 2007, the Government would save money every year on student loans made by private lenders if the new loan formula is used rather than the current formula. The average 10-20 year Treasury rate plus 1.0 percentage point for the new formula is projected to be less than the 3-month T bill rate plus 2.5 percent, hence the Government's payment to lenders for in-school loans is less.

weird
logic-

?

?

Dr. Raines
Q

- One approach for dealing with the possibility that the new formula would be detrimental to the student loan program next year is to repeal the statutory requirement mandating the change and leave the formula as it is. After all, changing the formula from the 3-month T-bill rate to the 10-year rate is only an artifact for the calculation of the Department of Education's cost of financing the student loan program. As we have already noted, because of the reset provision of the law, student loans are not basically long-term loans but a series of loans with the rate reset quarterly for lenders and annually for students. OMB
=

Reverting to the current formula, by itself, would not necessarily reduce the cost of borrowing for students. It would, however, eliminate the risk to lenders because of the mismatch between their source of funding and the maturity of student loans. Eliminating this risk would reduce substantially the added costs to lenders of making student loans and allow them to continue their participation in the program. me

The President is committed to reducing the cost of borrowing to students, however. A reasonable remedy to this situation is to retain the structure of the current loan formula but reduce the spread between the 3-month T-bill and the cap. The spread could be reduced to a level that would assure lenders a competitive net return and a rate reduction for borrowers. This change in the formula would virtually eliminate the risk to lenders from a mismatch between the source of funding and the maturity of a student loan and, all other things being equal, reduce their costs, thereby making it likely that they would continue to participate in FFEL.

- Table 3 illustrates the impact of an alternative formula that revises the current formula so that it is still profitable for lenders and also permits a lower rate for borrowers. Assuming that lenders need a net pre-tax return of at least 1.0 percent to continue participating in the student loan program next year,²² the current formula could be revised to 3-month T-bills plus 1.9 for in-school loans, and 3-month T-bills plus 2.0 for loans in repayment. These changes would provide a 1.05 percent return to lenders in 1998/99 and a 1.09 percent return in 1999/00. These estimates assume that the rate for 3-month T-bills is 5.4 percent (a futures market estimate) in 1998/99 and 5.13 percent in 1999/00 (a DRI estimate). Using the current student loan formula next year would, for all practical purposes, eliminate the need for lenders to hedge their student loans. At the same time, the student loan interest rate could be reduced and lenders' net returns could be increased in the next two years from what they would be under the scheduled formula for next year. This should satisfy most interested parties.

If, for political reasons, a change in the formula would have to be based on Administration

²² Presumably, reverting to the structure of the current loan formula eliminates the potential problem of loan liquidity facing lenders under the new loan formula. Therefore, we can assume 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.

economic assumptions, such as those used in the *Mid-Session Review*, this proposal would still work, as indicated in Table 4.

- Another possible remedy is to change next year's formula from the average rate for 10-year Treasury securities to the 1-year Treasury bill or 1-year CMTs. This would be consistent with the notion that student loans are similar to a series of one-year loans with a reset provision. A formula using the 1-year Treasury bill rate is still used for Federal Plus and SLS loans.

Using DRI assumptions for the 1-year CMTs, the current formula could be revised to 1-year CMT plus 1.5 percent for in-school loans, and 1-year CMT plus 2.0 percent for loans in repayment. The student loan interest rate next year would be 7.63 percent for in-school loans and 8.13 percent for loans in repayment (see Table 5). In 1999/00 the comparable loan rates would be 6.93 percent and 7.13 percent. This change would provide a 1.40 percent return to lenders next year and a 1.06 percent return in 1999/00. These estimates assume that the rate for 3-month T-bills is 5.4 percent (a futures market estimate) in 1998 and 5.13 percent in 1999 (a DRI estimate). Again, the student loan interest rates in the next two years could be reduced from what they would be under the current formula, and lenders' net returns could be increased from what they would be under the new formula for next year.

If the Administration's economic assumptions must be used for policy purposes, the proposal would again work, as indicated in Table 6.

Sallie Mae Net Return

- As noted, Sallie Mae is the largest purchaser of student loans in the secondary market. By law, they are prohibited from originating student loans, but presumably this restriction will be lifted now that they have decided to privatize. Until the restriction is lifted, however, Sallie Mae continues to operate with Chase Manhattan Bank in a joint venture that originates student loans.
- The Table below shows data provided to us by Sallie Mae. The data in the second column are an estimate of their pre-tax net return under the current formula for student loans. The third column is our estimate of what their net return would be under the new formula. The starting point for the third column is our estimate of what Sallie Mae's gross return would be under the new formula. It assumes that the spread between the 3-month T-bill rate and 10-year Treasury notes is 168 basis points, which is our assumption based on historical experience since 1981. Under the new formula, this provides a gross return of 2.68 percent (1.68 plus 1.0 percentage point).

Sallie Mae's data suggest they are only marginally profitable (0.94 percent pre-tax return) under the current formula for student loans. It appears, however, that Sallie Mae would

not be profitable (0.52 percent pre-tax return) under the new student loan formula, if their estimates of costs are correct. But, we think some of their estimated costs are too high. For example, their estimate for servicing costs is high because it should be no higher than for a traditional bank, perhaps even lower since they are so specialized. As we noted, we think their estimate for servicing costs is high because of the way they choose to measure these costs. If we adjust for this, their servicing costs would be about 60 basis points and could be even lower.

Also, they
grad to
cut serv
costs in
half.

PNC Bank thinks Sallie Mae's funding costs are less than 3-month T-bills plus 30 basis points. For illustrative purposes, let's assume they are 3-month T-bills plus 20 basis points.

As we suggested earlier, their estimate for overhead costs is probably bloated by high salaries and the number of staff they employ, and unnecessary administrative expenses. We will assume their overhead costs are 15 basis points.²³

Taking these three factors into account, Sallie Mae's reestimated pre-tax net return using the new formula might be 1.59 percent in 1997/98 and 1.17 percent in 1998/99.

Since Sallie Mae will be a private corporation in the future, the 30 basis point offset fee that is imposed only on them should be removed. At the same time, they presumably would be charged an origination fee, assuming they choose to originate student loans directly instead of indirectly through their joint venture with Chase Manhattan Bank. This would add 5 basis points to their costs. The net of these two items would raise Sallie Mae's adjusted pre-tax net return by 25 basis points, to 1.42 percent.

If Sallie Mae has to operate under the new student loan formula, however, they would face the same risks that banks face from a mismatch between the source of their borrowing and the maturity of the loans they acquire. The risk may not be quite as high because the average remaining maturity of the loans they buy in the secondary market is about six years (Sallie Mae's estimate) rather than 11 years for loans when they enter repayment status. Nevertheless they would still have to hedge some risk. Let's assume their hedging costs would be about 40 basis points, the low end of the Domestic Finance estimates.

- Taking all these factors into consideration, a rough estimate of Sallie Mae's pre-tax net return next year would be about 1.02 percent, which is considerably less than what their net return appears to be today. Since the recommendations described above for traditional banks would apply to Sallie Mae, an alternative formula would strengthen their bottom line considerably. This probably would satisfy the minimum pre-tax return that Sallie Mae needs to continue its secondary market operations for assets that are Government-guaranteed.

²³ See footnote 12.

STUDENT LOAN YIELD, SALLIE MAE OWNED LOANS
(Percent)

	1997/98	1998/99
Gross Return	T-Bill + 3.10	T-bill + 2.68
Less Costs:		
Funding Costs	T-Bill + 0.30	T-Bill + 0.30
Offset Fee	0.30	0.30
Subtotal	2.50	2.08
Default Risk	0.07	0.07
Servicing Costs	1.00	1.00
Overhead	0.30	0.30
Origination Support	0.15	0.15
Prepayment Risk	0.04	0.04
Pre-tax Net Yield	0.94	0.52
Adjustments (Add):		
Funding Costs	0.10	0.10
Servicing Costs	0.40	0.40
Overhead	0.15	0.15
Subtotal	1.59	1.17
Origination fee/Offset (net)	0.00	0.25
Subtotal	1.59	1.42
Hedging Costs	0.00	-0.40
Net Pre-Tax Return After Adjustments	1.59	1.02

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	8.25	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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.65</u>	<u>0.65</u>	<u>0.65</u>	<u>0.65</u>	<u>0.65</u>	<u>0.65</u>
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. Interest rates for 1998/99 and 1999/00 are based on the economic assumptions for the 1997 Mid-Session Review.

STULOANS

M. COMIEZ

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	7.80	7.80	9.00	7.81	7.81	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.80	5.80	5.80	5.53	5.53	5.53
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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.50</u>	<u>0.50</u>	<u>0.50</u>	<u>0.50</u>	<u>0.50</u>	<u>0.50</u>
Subtotal	5.98	6.48	7.53	6.71	7.21	8.26	6.44	6.94	7.99
Net return	<u>1.69</u>	<u>1.77</u>	<u>1.47</u>	<u>1.09</u>	<u>0.59</u>	<u>0.74</u>	<u>1.37</u>	<u>0.87</u>	<u>1.01</u>
Weighted Average Net Return		<u>1.71</u>			<u>0.77</u>		<u>1.05</u>		

Note: Table is for new student loan formula. Interest rates for 1998/99 are based on the futures market; rates for 1999/00 are from DRI.

STULQAN8

M. COMIEZ

TABLE 3. ALTERNATIVE FORMULA FOR FFEL STUDENT LOANS, 1998 AND 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	7.30	7.70	9.00	7.03	7.43	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.80	5.80	5.80	5.53	5.53	5.53
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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Subtotal	6.98	6.48	7.53	6.21	6.71	7.76	5.94	6.44	7.49
Net return	<u>1.69</u>	<u>1.77</u>	<u>1.47</u>	<u>1.09</u>	<u>0.99</u>	<u>1.24</u>	<u>1.09</u>	<u>0.99</u>	<u>1.61</u>
Weighted Average Net Return		<u>1.71</u>			<u>1.05</u>			<u>1.09</u>	

Note: Interest rates for 1998/99 are based on the futures market; rates for 1999/00 are from DRI. The formula spread above the 3-month T-bill rate is 1.9 for in-school loans and 2.3 for loans in repayment. Formula is based on 3-month T-bill rate.

STULOAN8

M. COMIEZ

TABLE 4. ALTERNATIVE FORMULA FOR FFEL STUDENT LOANS, 1998 AND 1999

(Percent)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99			7/1/99 to 6/30/2000		
	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	7.17	7.57	9.00	7.00	7.40	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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Subtotal	5.98	6.48	7.53	6.08	6.58	7.63	5.91	6.41	7.46
Net return	<u>1.69</u>	<u>1.77</u>	<u>1.47</u>	<u>1.09</u>	<u>0.99</u>	<u>1.37</u>	<u>1.09</u>	<u>0.99</u>	<u>1.54</u>
Weighted Average Net Return		<u>1.71</u>			<u>1.07</u>			<u>1.09</u>	

Note: Formula is based on 3-month T-bill rate. Interest rate data are from the Mid-Session Review. The spread over the 3-month T-bill is 1.9 percent for in-school loans and 2.3 percent for loans in repayment.

STULOANS

M. COMIEZ

TABLE 5. ALTERNATIVE FORMULA FOR FFEL STUDENT LOANS, 1998 AND 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	7.63	8.13	9.00	6.93	7.43	9.00
Less costs:									
Matched funds	5.57	5.57	5.57	5.80	5.80	5.80	5.53	5.53	5.53
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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Subtotal	5.98	6.48	7.53	6.21	6.71	7.76	5.94	6.44	7.49
Net return	1.69	1.77	1.47	1.42	1.42	1.24	0.99	0.99	1.51
Weighted Average Net Return		1.71			1.40			1.06	

Note: Table is for formula based on 1-year CMT. One-year CMT estimates are from DRI; 3-month T-bill rates are from the futures market (1998) and DRI (1999). The spread over the 1-year Treasury CMT is 1.5 percent for in-school loans and 2.0 percent for loans in repayment.

STULOAN8

M. COMIEZ

TABLE 6. ALTERNATIVE FORMULA FOR FFEL STUDENT LOANS, 1998 AND 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	7.20	7.70	9.00	6.94	7.44	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	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Subtotal	5.98	6.48	7.53	6.08	6.58	7.63	5.91	6.41	7.46
Net return	<u>1.69</u>	<u>1.77</u>	<u>1.47</u>	<u>1.12</u>	<u>1.12</u>	<u>1.37</u>	<u>1.03</u>	<u>1.03</u>	<u>1.54</u>
Weighted Average Net Return		<u>1.71</u>			<u>1.15</u>		<u>1.09</u>		

Note: Formula is based on 1-year T-bills. Data are from the Mid-Session Review. The spread over the 1-year T-bill is 1.5 percent for in-school loans and 2.0 percent for loans in repayment.

STULOAN8

M. COMIEZ



Nancy.Coolidge @ ucop.edu

09/18/97 11:11:00 PM

Record Type: Record

To: Daniel J. Chenok, S. A. Noe, Robert M. Shireman, Daniel I. Werfel

cc:

Subject: Re: 1998 student loan interest rates and Pell independent stude

Dear John:

I very much appreciate your explanation and the faxed material -- I am quite impressed that you took the time to provide so much commentary in the note below! I also appreciate the frustrations associated with an e-mail debate, and so will not use this opportunity for that purpose with my e-mail clipping service readership, although I'm happy to share your message with them, if you feel you'd prefer it be out there to counter the PIRG piece and if you believe that it would not provoke unwanted e-mail responses -- always an issue. So, unless you say so, I won't share your note with that large and varied population. As I'm sure you are well aware, some of the financial aid community is already trading information and opinions on this topic, so a version of such a debate is taking place, irrespective of our exchange. Obviously, few of us are well informed, or comfortable with this issue.

I think that I understand your point that the CBO cost analyses are highly volatile and that the assumptions PIRG used in its analysis may exaggerate the most likely outcomes. I believe that I could be persuaded that subtle or complex issues are being glossed over and that important, but difficult-to-portray-as-simple points are being obscured by snappy rhetoric (how often I have believed myself to be in that very position -- in fact, I would suggest that the student and higher education community are frequently so entrapped!)

Still, John, I cannot feel I'm doing justice to the integrity of this larger issue if I shy away from sharing with you the underlying problem that I believe the private capital providers are struggling with this time: a substantial portion of the higher education community just doesn't trust you any more.

The parable that is being whispered about in my circles is that of the "Boy Who Cried Wolf."

This time you may, in fact, be facing a real and substantial impediment to participation in the guaranteed student loan programs. The bankers and economists who decide whether their financial institutions can make enough profit with the July 1, 1998 interest rate benchmarks will not be the friendly folks who market us and who negotiate alongside the school community for more reasonable administrative rules for these valuable programs.

But you've threatened us with this prospect before. In most cases, the power of this threatened withdrawal has been sufficient to leverage what you wanted; the community's bowing and scraping to defend and accommodate you has lingered in memory. In only one case has the community really taken on chance on confronting you -- when a small group walked off into an uncertain future with Direct Lending. You predicted cataclysm and you fought a pitched battle, the scars of which are palpable for many. And, when some of the dust settled (I'll agree, this sort of thing is an evolving story...), we realized that most of the important capital providers were still players, that service to institutions and students was improving, that some reliable populations of students were getting credit at more reasonable rates, that the speed of automation increased exponentially, and that guarantee agencies didn't provide the same value-added to the mix that they had when they were "invented" before technology reduced the need for a more local "federal face." We all grew up.

If the private student loan capital starts drying up, some schools may be forced to participate in direct lending, even if that's not their first choice. If we in the higher education community ever want to see in sharp relief the students (and their institutions) that the actuarial world views as "high risk" and for whom University of California (for example) students are paying insurance premiums, this is the moment. Forcing such risky students and schools to apply to participate in direct lending or to participate in the "lender of last resort" maize, could be a very good thing for consumer protection. Some students should not be borrowing and some "educational" or "vocational" offerings are not worth borrowing for! Pressure on the availability of less-enhanced capital could provide the sort of market-driven, hardnosed reality check that the Department of Education's institutional oversight efforts have struggled to impose all these years.

But if there was ever a time in history when it was in higher education's interests to force the cost of credit down by taking a chance on student loan capital becoming scarce, now is that time. If we ever want to determine where the real edges of profitability are, we cannot duck this opportunity.

I think that is why your carefully-hewn and possibly quite legitimate arguments are not being taken seriously, even by all those who are analytical enough to comprehend them.

This response does not address your points, John, because we can't get past the trust issue. Your arguments are admittedly "Daedalian -- but," as the quotation goes, "unpersuasive."

I'm a great admirer of yours, so I hope we're still speaking! Your friend, Nancy

At 10:13 AM 9/18/97 -0400, you wrote:

>Nancy: I will be forwarding you by regular fax the ED Budget Office
>prepared analysis of the projected increased cost to student loan borrowers
>of repealing the ten year bond based borrower interest rates on FFEL and
>FDSL loans scheduled to go into effect on July 1, 1998. The numbers are
>dramatic and surprised many in D.C. because they were almost twice previous
>estimates. We are trying to ED to explain to us how they reached the
numbers.

>

>There is no question that under the economic assumptions currently being
>used by both the Congressional Budget Office(CBO) and OMB that borrowers are
>likely to pay more interest on their student loans than under the 91 day
>to-bill rates currently used in the interest rate formula in both programs.

>

>As is well known throughout the community, the banking industry has been
>working hard to persuade Congress that the 1998 interest rates should be
>repealed. Here's our thinking:

>

>1) The ten year bond based rates were not enacted (in 1993 as part of the
>Direct Loan legislation) to reduce borrower interest costs, but to "match
>fund" Direct loan funding with the borrower's interest rate. The thinking
>was that the OMB presumed cost of funds in FDSL was ten year treasury debt
>and the 1 percent is a presumed cost of servicing. When a compromise was
>hammered out to provide for continuation of both programs, nobody considered
>whether a ten year bond based interest rate worked in the FFEL program.

>

>2) Importantly, the history of the ten year bond suggests that had the ten
>year bond plus one interest rate been in effect for past ten years,
>borrowers would have paid more in six of those years. Three of those years
>are '92, '93, and '94. On the basis of this history, we have been
>comfortable in saying that lower borrower interest costs are in no way
>certain under the ten year bond based rate. We also point out that the CBO
>projections are "straightlined" after the year 2000--CBO is not attempting
>to say what rates will be that far into the future.

>

>Since CBO was created, it has ALWAYS changed its economic assumptions every
>six months. Six months from now CBO may tell us that borrowers may pay even
>less under the ten year treasury bond, but they may also tell us that the
>borrowers will pay more. Given the very low treasury debt assumptions
>currently in place and the fact that in low inflationary times the
>difference in rates between the 91-day treasury bill and the 10 year
>treasury bill narrows, any increase in inflation will likely mean lower
>projected savings or even additional costs.

>

>3) Knowing that nobody in Congress wants to increase the cost of student
>loans for borrowers, FFEL interests suggested that all savings from
>repealing the ten year bond based rates should go to reducing the cost of
>loans to students. The budget savings of over \$1 billion made possible a
>one percent reduction in the borrower origination fee. We called this "a
>bird in the hand" and suggested it was better than "two birds in the bush,"
>hanging our hat on the speculative nature of the lower costs to students
>under the ten year rates. (Please note that the \$1 billion in "savings"
>comes from the presumed higher interest costs paid by borrowers in the FDSL

>program---Some have questioned whether it is "fair" to have additional
>interest costs paid by borrowers in FDSL go to reduce the borrower paid
>origination fee in FFEL (as well as FDSL). We were not troubled by this,
>thinking that this issue should not be about the "competition" between the
>two programs and that any reduction in origination fees to any borrowers was
>a good thing).

>

>4) FFEL interests have been called "stupid" by some for pursuing the repeal
>or modification of the 1998 interest rates, given the keen interest in the
>issue on the part of students. The fact of the matter is that if the new
>rates go into effect, and if the CBO is right, even in the short term, FFEL
>lenders would not be able to make loans. Please understand that nobody is
>saying they will quit promptly at 12:01 on July 1, 1998, but rather that
>over the next 12 to 18 months there would be virtually complete abandonment
>of the program.

>

>The problems are two fold: There is "interest rate risk" inherent in
>funding loans tied to the ten year treasury bond with short term financing.
>(Please note that lenders understand that the borrower's interest rate would
>be reset annually based on prevailing ten year bond rates) Lenders,
>consulting with firms like Smith Barney, Paine Webber, Goldman Sachs, and
>Sallie Mae have indicated that they can "hedge" against this interest rate
>risk, but doing so could cost as much as 1.2 percent. (The hedge is
>relatively simple: By contract an outside party agrees to guarantee the
>lender a return on the student loans corresponding to the lenders cost of
>funds---If the borrower paid interest rate is much less than the amount
>corresponding to the lenders cost of funds, a payment is made to the
>borrower. If the borrower's rate proves higher, no payment is made. Thus
>the "hedge" is in essence an insurance policy). Bob Shireman, now of the
>White House National Economic Council has said that our estimated cost of
>between .8 and 1.2 percent is too high. He has not offered any evidence to
>substantiate his claim, saying that "economists" told him the hedge cost is
>lower than we claim.

>

>The second issue is yield. Even without the "hedge" cost added to the mix,
>lender return on loans would drop by at least .6 percent. (As noted above,
>in some years, lenders would actually get a higher return, but bankers want
>predictability. They are not willing to gamble making nothing on their
>student loans for several years in exchange for the possibility of making a
>higher return in future years).

>

>Frankly, the reason why the FFEL interests haven't come to an agreement with
>student and other groups (Mr. Barmak Nassirian of AASCU has been very active
>on this issue) is because the yield is not there to modify the 91 day rate
>to equalize the POSSIBLE reductions to student loan borrowers. This
>situation, frankly, is what has stopped an agreement from taking place.

>

>Please note that the Gordon bill did include what used to be considered a
>large cut in FFEL lender yield and that FFEL interests do expect that some
>sort of a cut will occur in lender yield. It is impossible, unfortunately,
>to cut much more.

>

>

>All of the above has led us to consider the 1998 interest rate issue as one
>about whether FFEL will remain viable. We note, using EDs own numbers that
>when the projected savings to students are translated into a change in the
>monthly payment amount, the added possible cost to students is much lower
>(we know that many in the community find ANY increase troubling). For
>example, ED suggests that on a subsidized Stafford of \$3,431 to a student
>attending a 4 year school, the net cost of the FFEL industry proposal is
>only \$71 dollars. When translated as a difference in the monthly loan
>repayment amount of a borrower on a ten year repayment schedule, the
>arithmetic shows an increase of 59 cents per month.

>

>We have seen the material being put out by the U.S. Public Interest Research
>Group and find it troubling. US PIRG is suggesting Lenders will "Gain \$7
>Billion Windfall" when actual lender return on student loans would decline
>from the rates they are currently receiving. US PIRG apparently also
>totally rejects any acknowledgement that the savings they portray as real
>are in fact only possible.

>

>The 1998 interest rate problem has real issues in it on which people can
>disagree, but it is not about some sort of a FFEL lender grab for cash.
>FFEL interests believe FFEL itself is in jeopardy and that students,
>schools, ED and the Department should be working together to figure out a
>way to address the problem. Nobody wants borrowers to pay more on their
>student loans, but if the 1993 legislation is viewed as a legislative
>mistake, the consequences of which were not appreciated, then maybe progress
>can be made on this issue.

>

>Nancy, I am not interested in entering into some sort of an e-mail debate on
>this issue with parties that I expect are not interested in the other side
>of this difficult, esoteric issue. I don't think that helps either side on
>this issue. If the FFEL concerns are credible, we should be figuring out a
>fix.

>

>John Dean
>Special Council,
>Consumer Bankers Association
>deandbm@jdbm.com

>

>

>

Clinton Presidential Records Digital Records Marker

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

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

STUDENT LENDING UPDATE

An Independent Newsletter on Education Lending Policy and Practice

This issue features the latest outlook for a change in the 1998 interest rate problem, including an interview with Mark J. Weadick of Smith Barney Inc.

Volume 2, No. 9
September 16, 1997

OMB to Bar ED from Buying New Computer Equipment

CONGRESSIONAL DEVELOPMENTS

No Fix to 1998 Interest Rate in Labor-HHS-ED Appropriations Bill (p. 2)

INDUSTRY NEWS

FFEL 1998 Interest Rate Problem Arguments Unconvincing (p. 2)

Lenders Voice Current Concerns: NCHelp Convention Review (p. 4)

Delivery System Debate at NCHelp (p. 7)

DEPARTMENT OF EDUCATION AND OTHER FEDERAL AGENCIES

OMB to Bar ED from Buying New Computer Equipment (p. 1)

INTERVIEW

Mark J. Weadick
Vice President
Debt Origination Group
Smith Barney Inc. (p. 5)

NEWS IN BRIEF (p. 8)

PEOPLE (p. 9)

REGULATORY AND ADMINISTRATIVE NEWS (p. 10)

The Office of Management and Budget (OMB) will bar the Department of Education from buying new computer equipment this week until they can update their current systems to address the year 2000 computer glitch. OMB sent a report on the problem to the Hill late in the day on September 15, 1997.

ED has 24 critical systems. Seven of these are being repaired. "Of the seven needing repair, three of the four systems directly relating to student financial aid delivery have been assessed or are undergoing assessment. The remaining student financial aid system needing repair and three other systems, had not begun assessment as of the August report," reported the OMB.

According to ED's General Management Office, they hope to complete all, if not most, of the work in 1998. Five of ED's mission critical systems are two months behind schedule, ED reported to the OMB. ED needs "to realize that the year 2000 must be the No. 1 priority for them at this point," said an administration official.

Student Lending contacted the Department of Education to find out how this bar would affect the loan consolidation center. ED, however, had not yet been informed of the bar and was unable to comment at the time.

In a hearing related to the problem, Chairman Stephen Horn of the Subcommittee on Government Management, Information and Technology gave ED a grade of "F" for its efforts to date. Only two other federal agencies received similar failing grades.

The OMB hopes increased oversight will get ED back on track to meet the January 1, 2000 deadline.

SallieMae

SALLIE MAE
1050 Thomas Jefferson Street, N.W. Washington, D.C. 20007
202-298-3053 Fax 202-298-4802

Rose M. DiNapoli
Assistant Vice President
Market/Relations

September 18, 1997

TO: Bob Shireman

FROM: Rose DiNapoli



Thanks for your time on Tuesday.
It was good to see you.

When I got back to the office and checked with my colleagues, I learned that the attached chart was provided to Treasury on August 1. We discussed it with Gene Reynolds, Maynard Comiez and James Girola. I believe we assumed Treasury provided a copy to the NEC. I apologize if it didn't reach you.

Attachment

The Chronicle of Higher Education

Academic Today

GOVERNMENT & POLITICS

September 26, 1997

Lenders Thwarted in Effort to Block Change in Interest Rates on Student Loans

By STEPHEN BURD

WASHINGTON

Lenders have been thwarted again in their effort to persuade Congress to block a change that they say could threaten the survival of the guaranteed-student-loan program.

For the second time in four months, Congressional supporters of the loan program declined at the last minute to offer legislation that would halt a scheduled change to the formula that is used to calculate the interest rate borrowers pay on student loans. Staff members for those lawmakers said privately that they were reluctant to take such action because they knew it would prompt heated opposition from the Clinton Administration, the higher-education associations, and student-aid advocates who say that blocking the change will cost students billions of dollars.

On July 1, 1998, the index used to determine the interest rate on federal student loans will change from the 91-day Treasury bill to the 10-year Treasury note. That change will result in a lower interest rate for students. The transition was required as part of a 1993 law that created the federal government's direct-loan program. It was intended to reduce costs for students as the government expected to replace the guaranteed-student-loan program with direct lending after five years.

But that has not happened. In its fourth year, direct lending has captured only a third of the student-loan volume.

Bankers complain that switching to the 10-year Treasury note will make it extremely difficult for them to raise the

[Search The Chronicle](#)

[The current Chronicle](#)

[Copyright & reprints](#)

[Feedback](#)

money they need to make student loans. They said that investors are hesitant to take risks on such long-term financial instruments because the longer the investment, the less predictable their return will be.

"We are facing an impending crisis," said John Dean, counsel to the Consumer Bankers Association. "This has got to be fixed one way or another, or else guaranteed-student loans will no longer be available."

Mr. Dean has helped try to persuade lawmakers to block the rate change. But student-aid advocates have been equally vocal, complaining that the solution the lenders are promoting -- to block the rate change and keep the status quo -- would be extremely costly to student-loan borrowers. They charge that the lenders want to stop the rate change simply because it will cut into their profits. The current interest rate on guaranteed student loans is 8 per cent; using the 10-year Treasury note, it would fall to 7.1 per cent.

When word spread last week that lawmakers were preparing amendments to a House appropriations bill that would block the rate change, Ivan Frishberg sprang into action.

Mr. Frishberg, who directs the Higher Education Project at the U.S. Public Interest Research Group, sent a message to a electronic mailing list widely read by financial-aid directors, publicizing an Education Department report that halting the change would cost students \$9-billion over five years.

"Congress should be acting to reduce the cost of student loans, not the opposite," he wrote.

Mr. Frishberg's e-mail message was picked up by the American Association of State Colleges and Universities, the United States Student Association, and the National Association of Graduate and Professional Students, who forwarded it to their members.

Soon after, aides to the Congressmen who had considered sponsoring the amendments -- Representative William F. Goodling, the Pennsylvania Republican who heads the House Committee on Education and the Workforce, and Representative Bart Gordon, a Tennessee Democrat -- announced that the lawmakers had reconsidered.

Advocates for student aid had dissuaded members of the House panel in June from attaching a similar provision to a bill to cut federal spending on the student-loan programs.

Copyright (c) 1997 by The Chronicle of Higher Education

<http://chronicle.com>

Date: 09/26/97

Section: Government & Politics

Page: A38

[Front page](#) | [Guide to the site](#) | [Today's news](#) | [Information technology](#) | [Colloquy](#) | [Washington](#) | [New grant competitions](#) | [This Week's Chronicle](#) | [Chronicle archive](#) | [Information Bank](#) | [Jobs](#) | [Advertisers](#) | [About The Chronicle](#) | [Help](#)
