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[Student Loan Programs] : 10 Year Bond / Treasury Bill

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- 69 - Spafford + Unsub
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6/13/97

Rever

CARCO

- will Street Corp -

Agreed
- equity is $T + 180 - 200$

5 loss p/b @ \$1 billion

1 ~~1990~~ m/b @ \$20 billion

we agreed - early

3 mo. and be more effective -

but yield is diff. issue.

Must be conceded a spread issue.

(-Treasury id be the counterparty in the swaps)

8/4/97

rdx account
slo by
BRI Rachel

= ~~reset~~ risk or yield spread?

- what purpose?

91-day's asset worth is more efficient

WILLIAM M.E. RACHAL, JR.
Vice President
Corporate Finance

11600 Sallie Mae Drive
Reston, Virginia 20193
Tel: 703-810-7702, Fax: 703-810-7655

Leads indifferent German

T-Bill + 180
and

low T-Bond + 100

That addresses the hedging problem.

- all, the size of the market.

- varies over time

- #s sensitive - 10 yr - reset

- Close hedge is perfect hedge

- Sell 10 yrs short g.m/y...

x - 10 yr + 1 - reset only } 

↳ knows market not to hedge

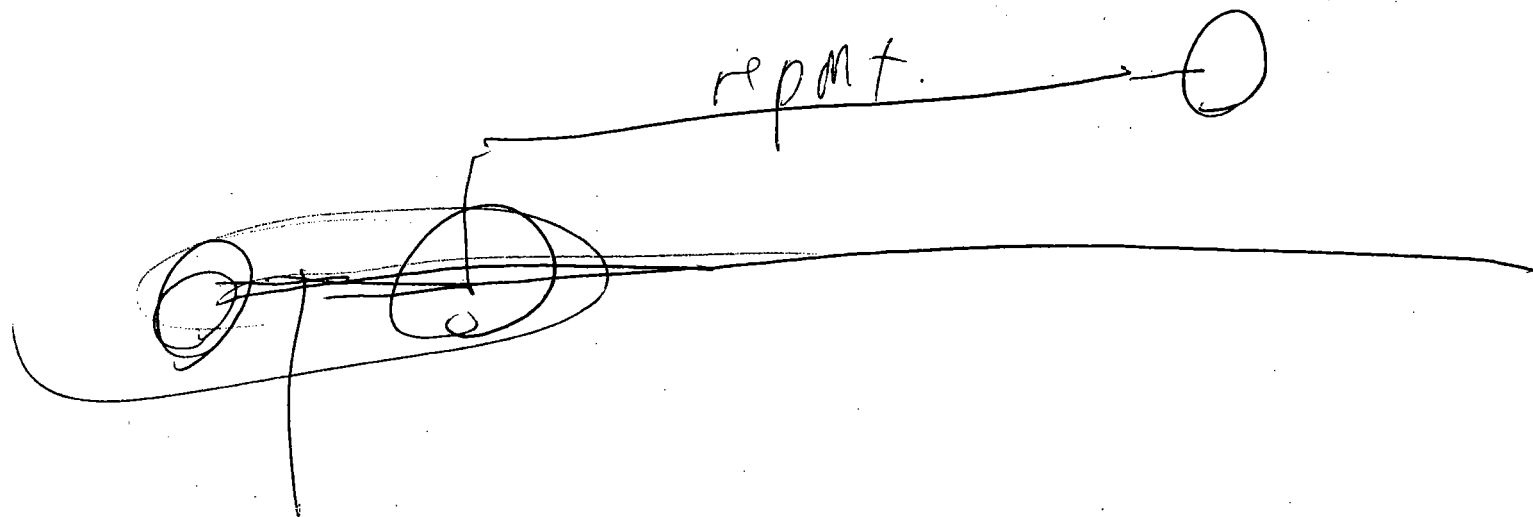
⇒ 1) Trade 4 diff. categories...
Bonds + Futures

2) sensitivity of perfection of the hedge.

(→ earnings variability → rating agencies)

- receive acc't in the secured trnsf. (1.5% ll

3) neutrality expansion



T-Gill

Discaet

- half rates is. May 1985 projections...

$\frac{1}{2}$ of the debt gone by 97-98

- 'Tougher budget is. possible...'

- making one boom

SallieMae

JUDY KENNEDY

Assistant Vice President, Government Relations

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An Analysis of the Scheduled Recalibration of Student Loan Interest Rates

Prepared by PaineWebber

On July 1, 1998, the index used to determine the interest rate on federal student loans is scheduled to be recalibrated from the 91-Day Treasury Bill to the "bond equivalent rate of the securities with a comparable maturity," which has been determined to be the 10-Year Treasury Note. Ostensibly, the motivation behind this change is to offer students lower interest rates and to parallel more closely the Department of Education's Borrowing Rate ("DBR").

As the implementation date for this change nears, PaineWebber has performed extensive analyses of the impacts of the conversion in rate. We conclude that the use of the DBR does little to improve the program for borrowers or to encourage lenders to remain in the FFEL Program.

The replacement of the existing Treasury bill rate system with a DBR based system is a needless change to a pair of programs that delivers 7.5 million loans to borrowers annually. The FFEL and Direct Loan Programs originated over \$250 billion of loans, which have a Treasury bill-based return and/or statutorily fixed interest rate, over the past 20 years. The success of these systems relative to their predecessor, the defunct Federally Insured Student Loan Program (FISL), can be attributed to the establishment of market interest rate-based loans and the development of an adequate secondary market for these loans.

Legislation passed in 1972 and 1976 was instrumental in developing the infrastructure of a secondary market in student loans to encourage lenders to participate in the program, thereby expanding student access to postsecondary education. A shift today to a DBR-based system would be a significant departure from the mechanism that has provided the high degree of liquidity that exists in the system today and under which all loan servicing systems have been developed.

The major drawback to the DBR is that it is not representative of the funding costs that loan holders face in the marketplace to finance their loan portfolios. Indeed, it is not a true market rate to the Department either, but rather a rate assigned to the Department by the Treasury Department. Further, the rate assessed by Treasury is established as a matter of policy, rather than a reflection of any direct or indirect financing activity to finance the Department of Education's direct loan portfolio. The Treasury's borrowing program and government financing schedule is in no way related to or dependent upon the volume or timing of Direct Loans originated by the Department.

In contrast, banks, financial institutions, and secondary markets finance their student loan holdings primarily through the issuance of a variety of debt instruments whose maturity or interest rate reset period is generally not longer than 90 days. The reason for this is that this is the most liquid sector of the market. The existing Treasury bill-based special allowance payment

structure supports the secondary market for loans, in that there is no mismatch between the establishment of the loan rate (shortly before June 1 of each year) and the date of actual loan origination. Lenders do not have to raise money in June in order to lock in interest rates in anticipation of financing a loan's second disbursement the following January. Sales of loans from lenders to secondary markets could also be affected by the staleness of the loan and SAP rates.

Before addressing other issues that may arise from such a radical change in the interest rate reset mechanism, it is useful to review what impact the proposed change may have on borrowers and the federal government. This may determine whether there are sufficient benefits to warrant the significant cost that would be imposed on lenders to modify servicing systems to accommodate the proposed reset methodology.

Borrowers

Borrowers would benefit from a DBR mechanism if the resulting loan rate were lower than the rate determined by the existing reset feature. To determine how each reset mechanism would have performed (i.e. which method was better) over time through a variety of market environments, a pro forma analysis was undertaken from 1975 to present. The results were as follows:

<i>Borrowers' rate in repayment was lower:</i>	<i># of Years</i>	<i>Avg. Size of Benefit (%)</i>
As a result of the DBR Formula	2	0.49%
As a result of the Treasury Bill Formula	4	1.03%

Hence, borrowers would have fared better, more often and by a wider margin, with the Treasury bill-based formula rather than the DBR Formula.

Federal Government

The federal government currently pays SAP to holders and reinsures the interest on defaulted loans to guaranty agencies. Any change in the method of computing these rates could affect federal outlays. Once again, a pro forma analysis from 1983 forward was performed for the two rate-setting mechanisms. Although the two rates fluctuated wildly in a cyclical fashion, the average spread differential between them over the past 14 years was only 10 basis points (0.10%). For the most recent five-year period, the Treasury bill-based formula would have resulted in a lower overall interest rate by 13 basis points. Indeed, the attached graphs show that the moving average spread between these two formulae are rarely far from zero. A look at a polynomial trend analysis shows a high degree of cyclicity with the current trend indicating the Treasury bill formula will result in lower future interest rates than the DBR. For different periods of time the differential is as follows:

*Observed Period**Amount DBR Formula Exceeds The T-Bill Formula*

January 1992 - December 1996	0.13%
January 1987 - December 1996	-0.23%
January 1983 - December 1996	-0.10%

It appears then that the existing Treasury bill-indexed borrower interest rates and SAP rates provide better execution for borrowers, the federal government and lenders. More importantly, Congress and the Administration have agreed to operate both the Direct Loan and FFELP programs and to permit "individual educational institutions to choose which program best meets their needs and the needs of their students."

The underlying premise of the Direct Loan Program is that it is publicly financed, and the underlying premise of the FFELP is that loan capital is provided by private lenders. It would seem counter to these premises to convert the subsidy mechanisms of the market-based FFELP system to the non-market based, internal cost allocation structure of the public Treasury.

Goldman Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-6376

Thomas D. Lasersohn
Managing Director

Goldman
Sachs

May 16, 1997

William M.E. Rachal, Jr.
Vice President
Student Loan Marketing Association
11600 Sallie Mae Drive
Reston, VA 20193

Dear Bill:

As you requested, we have reviewed the financial impact of the scheduled change of the interest rate on FFELP student loans from the quarterly average of the weekly auctions of three month Treasury Bills (3M T-Bill) plus 310 basis points (in repayment) to the yield of a "security with a comparable maturity" plus 100 basis points. In the absence of authoritative guidance on exactly how the new rate will be calculated, we have assumed that the new rate will be the yield of the then current ten year Treasury Note (10 Yr UST) at the beginning of each calendar quarter plus 100 basis points (bp). We have the following observations.

Historical Data

We reviewed data from the first quarter of 1982 through the fourth quarter of 1996. Over that period, 3M T-Bills + 310 bp exceeded the 10 Yr UST + 100 bp by an average of 6 bp. The accompanying charts graph the data over time (Chart 1 shows the spread between the two series; Chart 2 shows the values of the two series). The greatest positive difference was 219 bp, and the greatest negative difference was 238 bp. The standard deviation of the quarterly observations is 108 bp. By factoring in the borrower interest rate cap of 8.25%, one can compare the approximate rate that would have been paid by student borrowers under the two indices. This comparison shows that the Treasury Note based series exceeded the T-Bill based series by an average of 7 basis points.

Discussion

The significant volatility of the difference between the two interest rates suggests that a holder of student loans who funds them so as to minimize swings in net interest income would have to adjust its current funding strategy if the 10 Yr UST became the new index for student loans. Two ways to do this would be to (1) issue securities indexed to the yield of the 10 Yr UST with a quarterly reset or

Student Loan Marketing Association
 May 16, 1997
 Page Two

(2) hedge the rate risk attributable to the difference between 3M T-Bills and the 10 Yr UST quarterly reset.

Issuing 10 Yr UST Quarterly Reset Securities

The closest market to a 10 Yr UST quarterly reset is the market for floating rate securities indexed to the 10 Yr Constant Maturity Treasury (10 Yr CMT). Although 10 Yr CMT floaters are issued from time to time, there are few natural buyers of that index, and the volume of issuance is quite limited. A significant expansion of that market, such as would be required to support large scale issuance to fund student loans, would require the unearthing of a substantial new group of investors.

Hedging

Because few natural buyers of 10 Yr UST quarterly reset exist, hedging requires establishing positions in the Treasury bond market (cash or futures) and short term market (T-Bills or Eurodollar). The cost of this hedge is reflected in the quotes for 10 Yr CMT vs. 3M T-Bill interest rate swaps. We have priced this "swap" for different trade dates assuming the notional balance of the swap matches the balance of a student loan that does not amortize for two years and then is paid back over ten years. The following table sets out the spread (or cost) at which a swap counterparty would agree to receive 10 Yr CMT reset quarterly and pay 3M T-Bill weekly reset quarterly.

Receive 10 Yr CMT vs. Pay 3M T-Bill + Spread	
<u>Pricing Date</u>	<u>Spread</u>
December 31, 1996	77 bp
August 22, 1996	79 bp
June 20, 1996	72 bp
January 25, 1996	87 bp
January 25, 1995	51 bp
December 23, 1993	141 bp

Student Loan Marketing Association
May 16, 1997
Page Three

This indicates that, although a swap would eliminate the interest rate risk between student loans and their funding, the effective gross yield of the student loans before expenses (including costs of financing, origination, servicing, offset fees and taxes, etc.) would be reduced from 3M T-Bills + 310 bp to a range of 3M T-Bills + 151 bp to 3M T-Bills + 241 bp. Today's yield would therefore be reduced by between 69 bp and 159 bp.

As mentioned above, there are few natural receivers of 10Yr CMT. As a result, most counterparties willing to receive 10 Yr CMT are dealers. This limits the liquidity and capacity of the market as dealers reach balance sheet and risk exposure limits. Trades of several hundred million dollars notional amount would increase the cost of hedging only slightly, with billion dollar volumes having a more substantial impact. Thus, it is possible that the effective yield reduction would be larger than those described in the preceding paragraph.

Alternatives

As an alternative to trying to match the yield on assets and liabilities, a holder of student loans could simply accept the interest rate mismatch. This would reduce the predictability of earnings and increase the riskiness of their business. Access to financing in this case would be more expensive for substantially all student loan originators.

Conclusion

It is not possible to know whether the data we analyzed or current market conditions are representative of future relationships. Nevertheless, if historical and current relationships do prevail, the scheduled change of index for FFELP loans will both increase the volatility of earnings of student loan lenders and decrease the expected return on FFELP loans.

Sincerely,



Thomas D. Lasersohn

Chart 1

Yield Spread Quarterly Avg. of the 3M TBILL(BEY) +310bp vs.
Yield of 10YR UST +100bp (Beginning of Quarter)

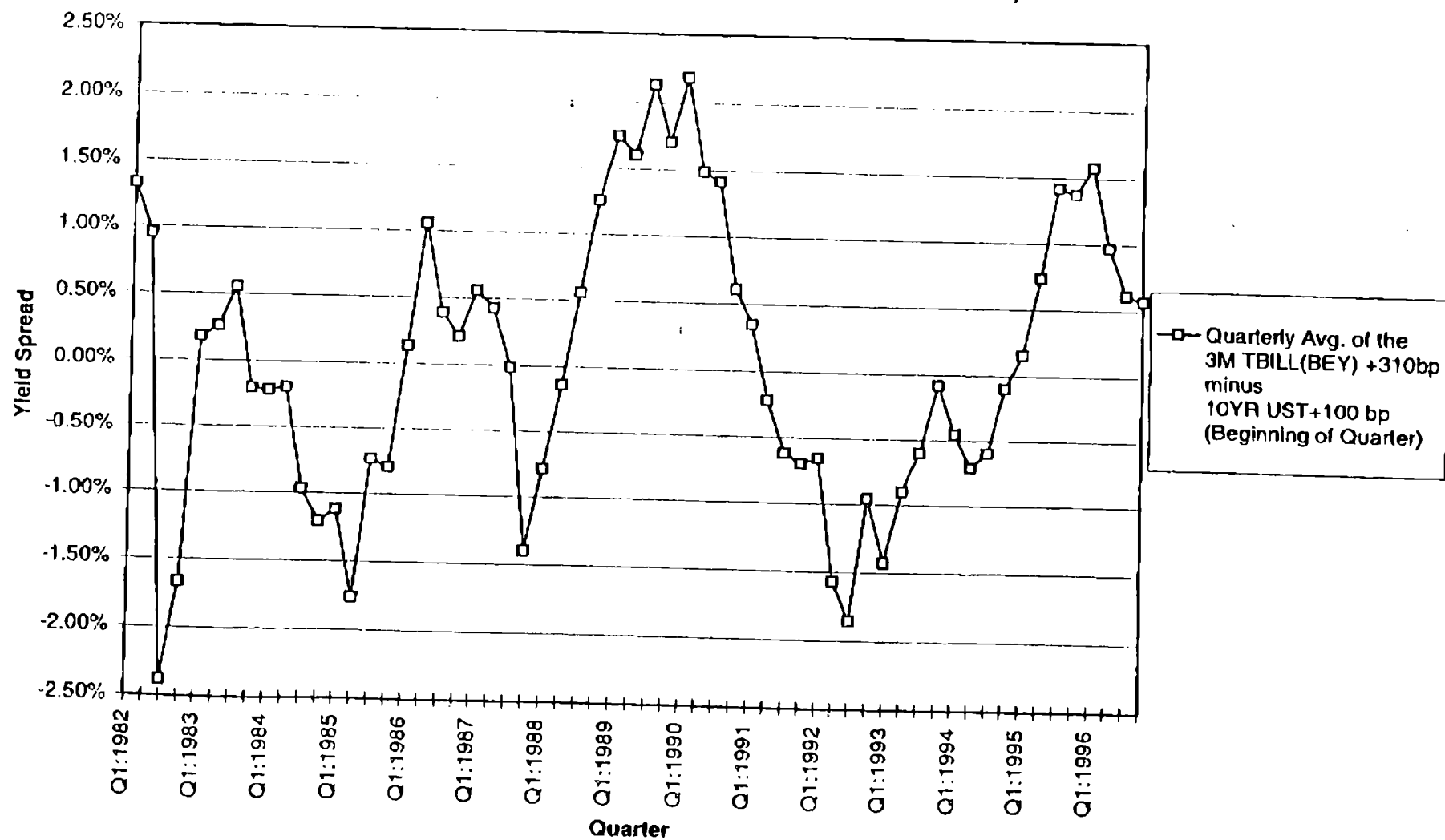
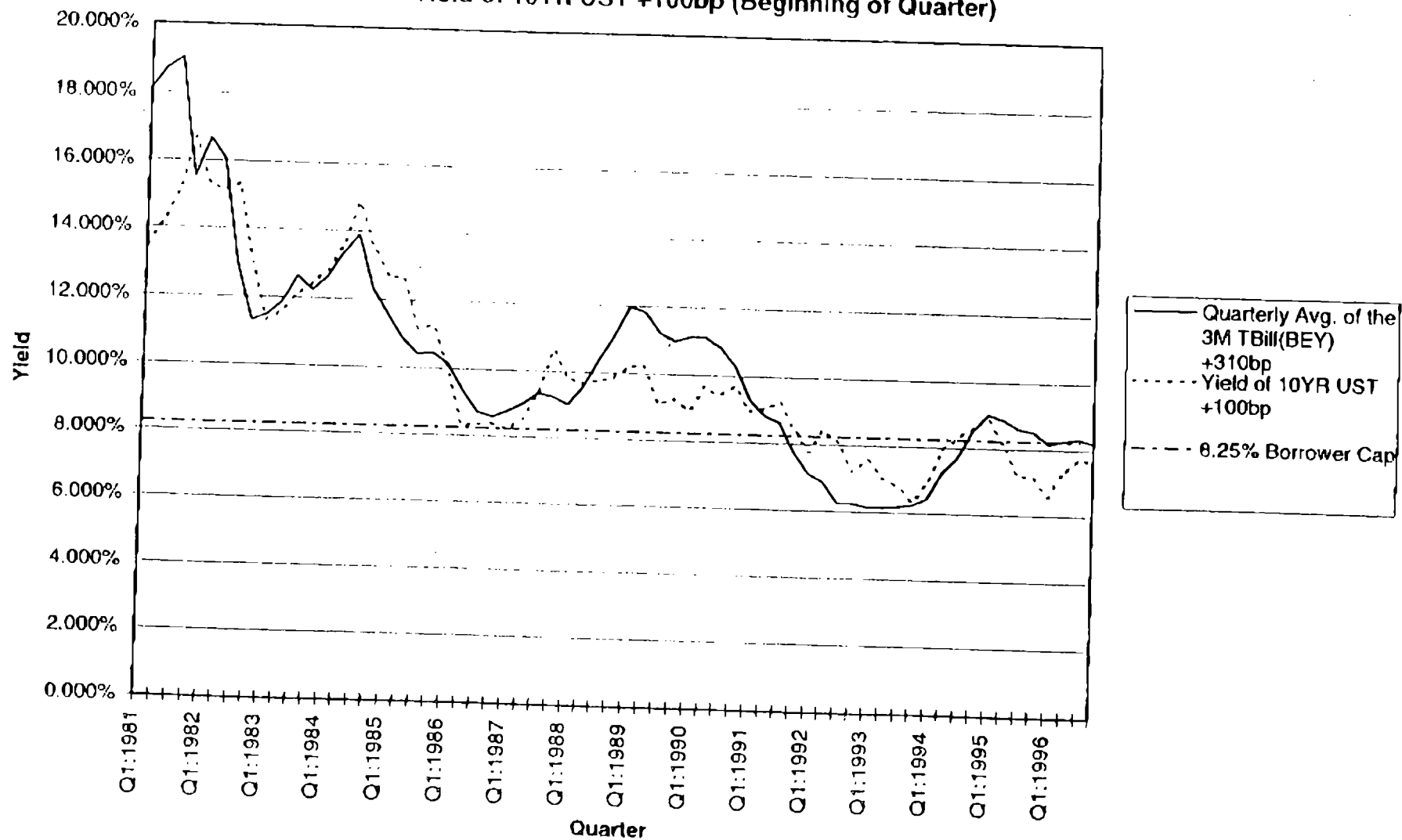


Chart 2

Quarterly Avg. of the 3M TBILL(BEY) +310bp vs.
Yield of 10YR UST +100bp (Beginning of Quarter)



Paul Sprauas

SWAPS

Monitor

(trade newsletter)

~~transaction~~ cost — max
= excess cost of the hedge

212-254-9500

= 10 CMT (annualized) trade for 91-day =

91-day T + 155 basis pts.

- 40 of last 48³ yrs - students and
have been better off.

* - most profitable line of biz in
RMB - 35%

Company - 25%



Jon_Oberg @ ed.gov
06/06/97 05:13:00 PM

Record Type: Record

To: Robert M. Shireman, Patricia A. Smith

cc:

Subject: Goodling Sponsored Meeting for Sallie Mae

Quick summary of the Hill meeting set up by Goodling to hear the Sallie Mae pitch for eliminating the current-law-scheduled July 1, 1998, interest rate change from 91 Day T-bill rates plus 3.1% to bonds with comparable maturities plus 1.0%:

Present at the meeting:

Lender interests: Bill Rachal, SM; Shelly Repp, SM, Sara Davis, SM; Paul Wozniak, Paine Webber; John Dean, CBA; Bill Nelson and Barbara Benison, secondary market agencies.

Higher Ed community: Barmak Nassirian, AASCU; Terry Hartle, ACE.

Congressional Staff: Vic Klatt, Sally Stroup, George Conant (Goodling); Mark Zuckerman, Marshall Grigsby (Clay); David Evans (Kildee) Scott J., Jenny Smulson (Jeffords); Marianna Pierce (Kennedy); Margot Schenet (CRS)

Department of Education: Jon Oberg (OLCA)

Vic Klatt chaired, asking for Sallie Mae to make its presentation, to be followed by reaction from the Higher Ed community and the Department of Education. Shelly Repp said reconciliation was a good vehicle to solve their problem, to use the savings identified to return to the current formula; Barbara Benison said that would be consistent with the legislative history; Paul Wozniak had charts comparing 91 day and 10 year bond interest rates, saying it was the volatility of the longer term bonds that was the problem.

Barmak N. said AASCU wanted to fix the problem if there was a problem. He said he couldn't understand the presentation very well. He said it was difficult to determine if this was a financial instrument problem or a yield problem, and it would be advisable for Sallie Mae to sort this out. Terry H. did not speak.

I said we had not previously been brought into this. I asked if they had a specific legislative proposal (they do not). I asked if the volatility issue could be solved by the usual means of hedging to limit risks inherent in volatility. Bill Rachel and Paul Wozniak said even with hedging, they have a 130 basis points problem. I asked for a write-up of their analysis as to why there would be a failure of the

capital markets that would preclude hedging as a solution.

Vic asked what the Administration's position was. I said as far as reconciliation is concerned, we have a budget agreement and a budget instruction to which we are all bound, and it does not provide for this issue.

David Evans said, as a Democrat, he would be delighted to have the majority try to push this through, since it would increase interest costs to students and we would have a repeat of the 104th Congress. He chastized the lender interests for not having long ago prepared a proposal with offsets that CBO could score within the budget agreement. John Dean replied that a crisis was coming, that loan availability would be cut back, that Texas and California already were relying on Lenders of Last Resort, and that he didn't care much for what CBO scoring dictated for budget reconciliation.

Vic halted the meeting after about 75 minutes by saying that there was no point in continuing. He said he was under instructions from his Chairman to solve the problem quickly, but that it was obvious that this meeting had identified no solution. There were no instructions given to anyone and no further meetings scheduled. I have the handouts.

FAX

American Association of State Colleges and Universities
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phone 202/293-7070 • fax 202/296-5819

☐ Urgent FAXDate: 6/6/97To: Bob ShickmanAffiliation: NEG

Fax #: _____

From: Bacman (857-1831 office / 744-7339 cell phone)

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(COMMITTEE PRINT)

**LEGISLATIVE RECOMMENDATIONS FOR
REAUTHORIZATION OF THE
HIGHER EDUCATION ACT
AND RELATED MEASURES**

Part 3

Title IV, Stafford

**COMMITTEE ON EDUCATION AND LABOR
Subcommittee on Postsecondary Education
HOUSE OF REPRESENTATIVES**

May 1991

U.S. GOVERNMENT PRINTING OFFICE: 1991

STAFFORD

CBA

SUGGESTED AMENDMENT

EXPLANATION

Section 427A of the Act is amended by redesignating subsections (f) and (g) as subsections (g) and (h) and by inserting after subsection (e) the following:

(f) **INTEREST RATES FOR NEW BORROWERS AFTER SEPTEMBER 30, 1991.**—(1) Notwithstanding subsections (a), (b) and (d) of this section with respect to any loan (other than a loan made pursuant to sections 423A, 428B, and 428C) guaranteed on or after September 30, 1991, to any borrower who, on the date of entering into the note or other written evidence of the loan, has no outstanding balance of principal or interest on any loan made, insured, or guaranteed under this part, the applicable interest rate shall be—

"(A) 8 percent per year on the unpaid principal balance of the loan during the period described in division (II) of section 428(a)(3)(A)(i) of this Act, relating to the payment of the interest subsidy; and

"(B) the applicable rate of interest determined under paragraph (2) for any 12-month period beginning on July 1 and beginning after the period described in subparagraph (A) ending on June 30 during the remainder of the repayment period, except that such rate shall not exceed 10 percent.

"(2) **DETERMINATION OF VARIABLE RATE.**—(A) for any 12-month period beginning on July 1 and ending on June 30, the rate determined under this subparagraph is determined on the preceding June 1 and is equal to—

(i) the bond equivalent rate of 52-week Treasury bills auctioned at the final auction held prior to such June 1; plus

(ii) 3.25 percent.

"(B) The Secretary shall determine the applicable rate of interest under subparagraph (A) after consultation with the Secretary of the Treasury and shall publish such rate in the Federal Register as soon as practicable after the date of determination."

Section 427A(d) of the Act is amended by inserting "(1)" after the subsection designation and by redesignating paragraphs (1) and (2) as subparagraphs (A) and (B) and by adding at the end thereof the following:

"(2) Notwithstanding subparagraph (B) of paragraph (1), after July 1, 1988, borrowers with loans with applicable interest rates subject to this section as in effect on January 1, 1991, shall not be subject to paragraph (2) of that section as in effect on January 1, 1991."

The amendment makes all regular Stafford Loans to new borrowers carry a variable interest rate at the bond equivalent rate of 52-week Treasury bills as determined by the final auction held prior to June 1st plus 3.25 percent. The current in-school interest subsidy to borrowers is continued in the in-school period.

The amendment removes the 8-10 interest rate structure requirement from all loans currently subject to the 8-10 interest rate structure (see section 427A (d) and (e)). The interest rate on all loans affected by the amendment is set at 8 percent for the life of the loan.

balance of the
of the disburse-
commencement

ipal balance of
period.

Interest Rates 1953-1996

	3-Month T-Bill	10-Year Bond	3-Month T-Bill + 3.1%	10-Year Bond + 1%
1953	1.93%	2.85%	5.03%	3.85%
1954	0.95%	2.40%	4.05%	3.40%
1955	1.75%	2.82%	4.85%	3.82%
1956	2.66%	3.18%	5.76%	4.18%
1957	3.27%	3.65%	6.37%	4.65%
1958	1.84%	3.32%	4.94%	4.32%
1959	3.41%	4.33%	6.51%	5.33%
1960	2.93%	4.12%	6.03%	5.12%
1961	2.38%	3.88%	5.48%	4.88%
1962	2.78%	3.95%	5.88%	4.95%
1963	3.16%	4.00%	6.26%	5.00%
1964	3.55%	4.19%	6.65%	5.19%
1965	3.95%	4.28%	7.05%	5.28%
1966	4.88%	4.92%	7.98%	5.92%
1967	4.32%	5.07%	7.42%	6.07%
1968	5.34%	5.65%	8.44%	6.65%
1969	6.68%	6.67%	9.78%	7.67%
1970	6.46%	7.35%	9.56%	8.35%
1971	4.35%	6.16%	7.45%	7.16%
1972	4.07%	6.21%	7.17%	7.21%
1973	7.04%	6.84%	10.14%	7.84%
1974	7.89%	7.56%	10.99%	8.56%
1975	5.84%	7.99%	8.94%	8.99%
1976	4.99%	7.61%	8.09%	8.61%
1977	5.27%	7.42%	8.37%	8.42%
1978	7.22%	8.41%	10.32%	9.41%
1979	10.04%	9.44%	13.14%	10.44%
1980	11.51%	11.46%	14.61%	12.46%
1981	14.03%	13.91%	17.13%	14.91%
1982	10.69%	13.00%	13.79%	14.00%
1983	8.63%	11.10%	11.73%	12.10%
1984	9.58%	12.44%	12.68%	13.44%
1985	7.48%	10.62%	10.58%	11.62%
1986	5.98%	7.68%	9.08%	8.68%
1987	5.82%	8.39%	8.92%	9.39%
1988	6.69%	8.85%	9.79%	9.85%
1989	8.12%	8.49%	11.22%	9.49%
1990	7.51%	8.55%	10.61%	9.55%
1991	5.42%	7.86%	8.52%	8.86%
1992	3.45%	7.01%	6.55%	8.01%
1993	3.02%	5.87%	6.12%	6.87%
1994	4.29%	7.09%	7.39%	8.09%
1995	5.51%	6.57%	8.61%	7.57%
1996	5.02%	6.44%	8.12%	7.44%

~~[MEMO from Pat Smith to OMB, April 30, 1997]~~

As part of the reconciliation debate, Shireman and the higher education associations have heard that the lenders and SLMA are again proposing repeal of the scheduled change.

Borrowers will receive a reduction of almost 1% in student interest for new student loans made beginning July 1998 under current CBO and OMB interest rate projections because of a scheduled change in the borrower interest rate, which was mandated by the Student Loan Reform Act of 1993 (SLRA). At that time, the Administration anticipated moving rapidly to 100% direct lending.

Borrower rate in FY 1998 under --

Current lender yield

8.02% (91-day T-bill plus 3.1%)

New lender yield

7.11% (10-20 yr. T-note plus 1%)

*John G. Baker
Exec. Director*

The Administration proposed the language in the SLRA that benchmarks student loan interest to a security of comparable maturity, replacing the existing language benchmarking to a 91-day T-bill, to avoid Federal interest rate risk, that is, insure that borrower interest in the Direct Loan program would cover the interest ED pays Treasury. (OMB Circular A-129) ED borrows from Treasury at the rate of a 10-20 year T-note on funds for capital and subsidy.

Student loans have carried variable interest rates since 1992, with interest reset annually, and are capped at 8.25%. To guarantee their yield, lenders receive a Federal special allowance when their guaranteed yield exceeds the borrower cap.

Lender objections.

Lenders are asserting that they cannot afford to raise capital for guaranteed student loans under the scheduled change in lender yield. Since the current policy is continued competition between both student loan programs, lenders believe the scheduled interest rate change, which was established to protect the Federal government from interest rate risk in the direct loan program, is no longer appropriate and propose repeal. They contend --

FFEL loans would no longer be profitable because the spread between 91-day T-bill rate, which lenders use in financing guaranteed loans, and the rate for 10-yr. Treasury notes is extremely volatile and lenders would incur significant interest rate risk.

Repeal would achieve budget savings of \$1.1 billion (CBO estimate) by increasing borrower interest in the Direct Loan program. [ED estimates that FFEL borrowers would pay an additional \$2 billion over that period to lenders since CBO estimates that FFEL will continue to have about 2/3 of loan volume. Total additional cost to borrowers: \$3 billion.]

When asked why they cannot hedge to "insure" against such risk, lenders replied in an April 22 meeting with NEC staff that it is too expensive.

Orszag and Shireman pressed whether the issue is the instrument or the yield. Lenders were asked whether they would make loans with a lower yield if the borrower rate were to remain pegged to the 91-day T-bill, for example, 91-day T-bill plus 2.3 rather than 3.1, which would be roughly comparable to 10-yr. note plus 1, and thereby not raise borrower interest. Lenders said they will come back to the Administration with a proposed solution soon. Orszag's preliminary discussions with New York financiers indicate that the instrument and cost of hedging are probably not the issue -- it is the yield itself.

Subsequent to the April 22 meeting, SLMA has asked me why OMB does not discount at the 91-day T-bill rate, and thereby resolve the disagreement.

Discount rate.

Current OMB policy designates the discount rate, or the security of comparable maturity, for student loans to be the 10-20 yr. Treasury note. Whether a different policy is needed on variable rate loans, including student loans, has been the subject of discussion within the Administration for several years.

In meetings between Education, Treasury, CEA, and OMB in 1995, Education and the Office of Federal Finance at Treasury supported the use of the interest reset period, which would be a 1-yr. note. OMB has taken the position that this is not possible under current law.

Barry Anderson wrote in a November 3, 1995, memo that it is necessary to base the Federal discount rate on the actual cost to government and not on private sector practices, such as use of the interest reset period. The use of the market value in discounting loans was considered and explicitly rejected as the approved method for calculating the subsidy cost of loans under the Federal Credit Reform Act. "Since lenders have the Federal guarantee providing complete assurance of 98% of loan repayment, they can, without risk, borrow short and lend to students at the higher interest rate defined in the statute."

OMB's focus should be the underlying cash flows and the cost to government, for which he believes ED has not yet provided an adequate analysis.

Impact on program cost/deficit.

The current discount rate policy has a major impact on the cost of the Direct Loan program. If the discount rate were based on the reset period, that is, the 1-year Treasury note, but the borrower interest remained the same, ED estimates that the program cost estimate would decrease approximately \$5.5 billion over FY 1998-2002, and thereby reduce baseline by that amount, whether or not savings were scored from the change.

Policy options:

1. Stay with current law.

Many do not believe that the large lenders will withdraw over the issue, even though they exert great pressure on Congress.

Large lenders may be reluctant to lend to high risk schools/students under the new formula.

If many small lenders withdraw from FFEL, institutions can participate in direct lending or shift to larger lenders.

2. Cancel the scheduled change and revert to the 91-day T-bill +3.1% as borrower interest for both the guaranteed and direct loan programs, as suggested by the lenders.

This would increase student interest payments above baseline by \$3 billion in both programs.

It would address lender concern about the volatility of the spread.

It would leave the Administration subject to the interest rate risk to which the lenders object.

The Committees on the Hill will probably try to accomplish some version of this prior to or in reauthorization to address lender concerns.

3. Revert to the 91-day T-bill as the benchmark but reduce the additional increment to roughly 2.3% in both programs to eliminate the volatility but avoid raising student interest.

This would address lender concern regarding the instrument to which interest is benchmarked, but would not satisfy them if their concern is primarily yield, not the instrument.

It would leave the Administration subject to interest rate risk.

4. Define security of comparable maturity in the student loan programs, either by legislation or regulation, as the 1-yr. T-note, that is, the reset period, and set borrower interest at 1-yr. T-note plus some supplement that would approximate the rate scheduled to go into effect July 1998.

This would reduce the baseline by over \$5 billion over 5 yrs. whether or not savings were scored, and protect the government from interest rate risk since the borrower interest would be benchmarked to the Federal discount rate.

ED would have to satisfy BRD that their cash flows using this discount rate are a reasonable estimate of Federal costs.

Lenders would not probably not be satisfied if their primary concern is yield.

It would have to be done in consultation with the Committees, which are opponents of direct lending and would probably therefore oppose it, claiming that the Administration is trying to obscure the true cost of direct lending.

5. Cancel the scheduled change, and reduce student fees to minimize or eliminate the impact on student costs.

Even if all origination fees were eliminated, borrowers under the unsubsidized loan programs would pay more interest.

All fees would have to be eliminated to have to avoid increasing costs for borrowers with subsidized Stafford loans attending 4 years of college.

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

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

— assumes 100%
closed repay.

← ??

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

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

Appendix A

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

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

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

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

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

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

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

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

Patricia A. Smith

05/30/97 01:04:18 PM

Record Type: Record

To: Kathryn B. Stack/OMB/EOP

cc: Barry White/OMB/EOP, Robert M. Shireman/OPD/EOP

Subject: Student Loan Interest Rate and Lender Yield: preliminary analysis/options regarding the scheduled change

As part of the reconciliation debate, Shireman and the higher education associations have heard that the lenders and SLMA are again proposing repeal of the scheduled change.

Borrowers will receive a reduction of almost 1% in student interest for new student loans made beginning July 1998 under current CBO and OMB interest rate projections because of a scheduled change in the borrower interest rate, which was mandated by the Student Loan Reform Act of 1993 (SLRA). At that time, the Administration anticipated moving rapidly to 100% direct lending.

Borrower rate in FY 1998 under --

<u>Current lender yield</u>	<u>New lender yield</u>
8.02%	7.11%

91-day T-bill plus 3.1%

10-20 yr.T-note plus 1%

The Administration proposed the language in the SLRA that benchmarks student loan interest to a security of comparable maturity, replacing the existing language benchmarking to a 91-day T-bill, to avoid Federal interest rate risk, that is, insure that borrower interest in the Direct Loan program would cover the interest ED pays Treasury. (OMB Circular A-129) ED borrows from Treasury at the rate of a 10-20 year T-note on funds for capital and subsidy.

Student loans have carried variable interest rates since 1992, with interest reset annually, and are capped at 8.25%. To guarantee their yield, lenders receive a Federal special allowance when their guaranteed yield exceeds the borrower cap.

Lender objections.

Lenders are asserting that they cannot afford to raise capital for guaranteed student loans under the scheduled change in lender yield. Since the current policy is continued competition between both student loan programs, lenders believe the scheduled interest rate change, which was established to protect the Federal government from interest rate risk in the direct loan program, is no longer appropriate and propose repeal. They contend --

- FFEL loans would no longer be profitable because the spread between 91-day T-bill rate, which lenders use in financing guaranteed loans, and the rate for 10-yr. Treasury notes is extremely volatile and lenders would incur significant interest rate risk.
- Repeal would achieve budget savings of \$1.1 billion (CBO estimate) by increasing borrower interest in the Direct Loan program. [ED estimates that FFEL borrowers would pay an additional \$2 billion over that period to lenders since CBO estimates that FFEL will continue to have about 2/3 of loan volume. Total additional cost to borrowers: \$3 billion.]

When asked why they cannot hedge to "insure" against such risk, lenders replied in an April 22 meeting with NEC staff that it is too expensive.

Orszag and Shireman pressed whether the issue is the instrument or the yield. Lenders were asked whether they would make loans with a lower yield if the borrower rate were to remain pegged to the 91-day T-bill, for example, 91-day T-bill plus 2.3 rather than 3.1, which would be roughly comparable to 10-yr. note plus 1, and thereby not raise borrower interest. Lenders said they will come back to the Administration with a proposed solution soon. Orszag's preliminary discussions with New York financiers indicate that the instrument and

cost of hedging are probably not the issue -- it is the yield itself.

Subsequent to the April 22 meeting, SLMA has asked me why OMB does not discount at the 91-day T-bill rate, and thereby resolve the disagreement.

Discount rate.

Current OMB policy designates the discount rate, or the security of comparable maturity, for student loans to be the 10-20 yr. Treasury note. Whether a different policy is needed on variable rate loans, including student loans, has been the subject of discussion within the Administration for several years.

In meetings between Education, Treasury, CEA, and OMB in 1995, Education and the Office of Federal Finance at Treasury supported the use of the interest reset period, which would be a 1-yr. note. OMB has taken the position that this is not possible under current law.

Barry Anderson wrote in a November 3, 1995, memo that it is necessary to base the Federal discount rate on the actual cost to government and not on private sector practices, such as use of the interest reset period. The use of the market value in discounting loans was considered and explicitly rejected as the approved method for calculating the subsidy cost of loans under the Federal Credit Reform Act. "Since lenders have the Federal guarantee providing complete assurance of 98% of loan repayment, they can, without risk, borrow short and lend to students at the higher interest rate defined in the statute." OMB's focus should be the underlying cash flows and the cost to government, for which he believes ED has not yet provided an adequate analysis.

Impact on program cost/deficit.

The current discount rate policy has a major impact on the cost of the Direct Loan program. If the discount rate were based on the reset period, that is, the 1-year Treasury note, but the borrower interest remained the same, ED estimates that the program cost estimate would decrease approximately \$5.5 billion over FY 1998-2002, and thereby reduce baseline by that amount, whether or not savings were scored from the change.

Policy options:

1. Stay with current law.
 - Many do not believe that the large lenders will withdraw over the issue, even though they exert great pressure on Congress.
 - Large lenders may be reluctant to lend to high risk schools/students under the new formula.
 - If many small lenders withdraw from FFEL, institutions can participate in direct lending or shift to larger lenders.
2. Cancel the scheduled change and revert to the 91-day T-bill +3.1% as borrower interest for both the guaranteed and direct loan programs, as suggested by the lenders.
 - This would increase student interest payments above baseline by \$3 billion in both programs.
 - It would address lender concern about the volatility of the spread.
 - It would leave the Administration subject to the interest rate risk to which the lenders object.
 - The Committees on the Hill will probably try to accomplish some version of this prior to or in reauthorization to address lender concerns.
3. Revert to the 91-day T-bill as the benchmark but reduce the additional increment to roughly 2.3% in both programs to eliminate the volatility but avoid raising student interest.
 - This would address lender concern regarding the instrument to which interest is benchmarked, but would not satisfy them if their concern is primarily yield, not the instrument.
 - It would leave the Administration subject to interest rate risk.
4. Define security of comparable maturity in the student loan programs, either by legislation or regulation, as the 1-yr. T-note, that is, the reset period, and set borrower interest at

1-yr. T-note plus some supplement that would approximate the rate scheduled to go into effect July 1998.

- This would reduce the baseline by over \$5 billion over 5 yrs. whether or not savings were scored, and protect the government from interest rate risk since the borrower interest would be benchmarked to the Federal discount rate.
- ED would have to satisfy BRD that their cash flows using this discount rate are a reasonable estimate of Federal costs.
- Lenders would not probably not be satisfied if their primary concern is yield.
- It would have to be done in consultation with the Committees, which are opponents of direct lending and would probably therefore oppose it, claiming that the Administration is trying to obscure the true cost of direct lending.

5. Cancel the scheduled change, and reduce student fees to minimize or eliminate the impact on student costs.

- Even if all origination fees were eliminated, borrowers under the unsubsidized loan programs would pay more interest.
- All fees would have to be eliminated to have to avoid increasing costs for borrowers with subsidized Stafford loans attending 4 years of college.



Kirk_Slegwarth @ ed.gov
04/17/97 08:55:00 AM

Record Type: Record

To: Patricia A. Smith

cc:

Subject: - no subject (01IHT3QQ0U4Y0028L5) -

Pat --

Four case studies.

Option A: continue current law of student interest rate equal 10 year
+ 1

Option B: In-school rate equal 91-day T plus 2.5%, in repayment rate
equal 91-day plus 3.1%

Assume: loans originated July, 1998

Case 1: Stafford borrowers in school 4 years

Loan amount: \$3236

Origination fee: \$129

Additional interest payments from moving to Option B(NPV): \$120

Additional interest payments from moving to Option B(Cash): \$207

Analysis(NPV Basis): Students would need to reduce ALL fees to be
indifferent to Option B

Case 2: Unsubsidized Stafford borrowers in school 4 years

Loan amount: \$3312

Origination fee: \$132

Additional interest payments from moving to Option B(NPV): \$203

Additional interest payments from moving to Option B(Cash): \$347

Analysis(NPV Basis): Students would always pay more under Option B,
even if all origination fees were revoked

Case 3: Stafford borrowers in school 2 years

Loan amount: \$3236

Origination fee: \$129

Additional interest payments from moving to Option B(NPV): \$103

Additional interest payments from moving to Option B(Cash): \$162

Analysis(NPV Basis): Students would need to reduce fees by 3% to be
indifferent to Option B

Case 4: Unsubsidized Stafford borrowers in school 2 years**Loan amount: \$3312****Origination fee: \$132****Additional interest payments from moving to Option B(NPV): \$135****Additional interest payments from moving to Option B(Cash): \$216****Analysis(NPV Basis): Students would always pay more under Option B,
even if all origination fees were revoked**

		1996	1997	1998	1999	2000	2001	2002	98-02
		Actual							Avg
71-day Treasury Bill Interest Rate (%)									
Administration	(Jan)'97	5.0	5.0	4.7	4.4	4.2	4.0	4.0	4.26
Administration	MSR (July)'96		4.5	4.3	4.2	4.0	4.0	4.0	4.10
CBO	(Jan)'97		5.0	5.0	4.6	4.2	3.9	3.9	4.32
CBO	(May)'96		4.8	4.3	3.9	3.7	3.7	3.7	3.86
Blue Chip	(Mar)		5.2	5.2	5.0	5.0	5.2	5.2	5.12
10-year Treasury Note Interest Rate (%)									
Administration	(Jan)	6.4	6.1	5.9	5.5	5.3	5.1	5.1	5.38
Administration	MSR (July)		5.6	5.2	5.0	5.0	5.0	5.0	5.04
CBO	(Jan)		6.2	6.1	5.8	5.5	5.5	5.5	5.68
CBO	(May)		5.5	5.3	5.3	5.3	5.3	5.3	5.30
Blue Chip	(Mar)		6.5	6.5	6.4	6.4	6.5	6.5	6.46
Corporate profits (w/IVA & CCA)									
Administration	(Jan) <1>	8.8	8.6	8.7	8.7	8.7	8.5	8.5	8.62
Administration	MSR (July)		8.9	8.9	8.9	9.0	8.9	8.7	8.88
CBO	(Jan)		8.4	8.3	8.1	8.1	8.1	8.1	8.14
CBO	(May)		8.0	8.0	7.9	7.8	7.7	7.7	7.82
Wage & Salary Disbursements									
Administration	(Jan)	47.9	47.9	47.9	47.8	47.8	47.8	47.7	47.80
Administration	MSR (July)		47.8	47.9	48.0	48.0	48.0	48.0	47.98
CBO	(Jan)		48.0	47.7	47.6	47.4	47.3	47.3	47.46
CBO	(May)		47.3	47.3	47.2	47.2	47.2	47.1	47.20
Non-Wage Personal Income									
Administration	(Jan)	21.3	21.2	21.0	20.8	20.6	20.5	20.5	20.68
Administration	MSR (July)		20.7	20.2	19.7	19.2	18.8	18.5	19.28
CBO	(Jan)		21.3	21.4	21.5	21.4	21.2	21.1	21.32
CBO	(May)		20.6	20.4	20.3	20.3	20.2	20.1	20.26
Taxable Income Share									
Administration	(Jan)	77.9	77.7	77.6	77.3	77.1	76.8	76.7	77.10
Administration	MSR (July)		77.4	77.0	76.6	76.2	75.7	75.2	76.14
CBO	(Jan)		77.7	77.4	77.2	76.9	76.6	76.5	76.92
CBO	(May)		75.9	75.7	75.4	75.3	75.1	74.9	75.28
<1> In order to facilitate comparison, these are NIPA corporate profits with inventory valuation and capital consumption adjustments. The Administration's published forecasts are for before tax profits.									

5/3/97

04/06/97		1996	1997	1998	1999	2000	2001	2002	98-02
		Actual							Avg
Real GDP (Fisher Chain, Yr/Yr)									
Administration	(Jan)	2.4	2.2	2.0	2.2	2.3	2.3	2.3	2.22
Administration	(Jan) (Q4/Q4)	3.1	2.0	2.0	2.3	2.3	2.3	2.3	2.24
Administration	MSR (July)		2.4	2.3	2.3	2.3	2.3	2.3	2.30
Administration	MSR (July) (Q4/Q4)		2.3	2.3	2.3	2.3	2.3	2.3	2.30
CBO	(Jan)		2.3	2.1	2.2	2.2	2.2	2.1	2.16
CBO	(May)		2.0	2.1	2.2	2.2	2.2	2.2	2.18
Blue Chip	(Mar)		2.6	2.1	2.1	2.5	2.4	2.3	2.28
GDP Price Index (chain price index, Yr/Yr)									
Administration	(Jan)	2.1	2.5	2.6	2.6	2.6	2.6	2.6	2.60
Administration	(Jan) (Q4/Q4)	2.1	2.5	2.6	2.6	2.6	2.6	2.6	2.60
Administration	MSR (July)		2.6	2.8	2.7	2.7	2.7	2.7	2.72
Administration	MSR (July) (Q4/Q4)		2.7	2.7	2.7	2.7	2.7	2.7	2.70
CBO	(Jan) [revised]		2.3	2.5	2.6	2.6	2.5	2.6	2.56
CBO	(May)		2.8	2.7	2.7	2.7	2.7	2.7	2.70
Blue Chip	(Mar)		2.2	2.5	2.6	2.6	2.7	2.7	2.62
Nominal GDP % change (Yr/Yr)									
Administration	(Jan)	4.4	4.8	4.7	4.9	5.0	5.0	5.0	4.92
Administration	(Jan) (Q4/Q4)	5.0	4.6	4.7	5.0	5.0	5.0	5.0	4.94
Administration	MSR (July)		5.1	5.1	5.1	5.1	5.1	5.1	5.10
Administration	MSR (July) (Q4/Q4)		5.0	5.1	5.1	5.1	5.1	5.1	5.10
CBO	(Jan)		4.6	4.6	4.9	4.9	4.8	4.8	4.80
CBO	(May)		4.8	4.9	4.9	4.9	4.9	4.9	4.90
Blue Chip	(Mar)		4.8	4.6	4.8	5.1	5.3	5.0	4.96
CPI-U, % change, Yr/Yr									
Administration	(Jan)	2.9	2.7	2.7	2.7	2.7	2.7	2.7	2.70
Administration	(Jan) (Q4/Q4)	3.2	2.6	2.7	2.7	2.7	2.7	2.7	2.70
Administration	MSR (July)		2.8	2.8	2.8	2.8	2.8	2.8	2.80
Administration	MSR (July) (Q4/Q4)		2.8	2.8	2.8	2.8	2.8	2.8	2.80
CBO	(Jan)		2.9	2.9	3.0	3.0	3.0	3.0	2.98
CBO	(May)		3.1	3.0	2.9	2.9	2.9	3.0	2.94
Blue Chip	(Mar)		2.9	3.0	3.0	3.0	3.2	3.1	3.06
Unemployment Rate (%)									
Administration	(Jan)	5.4	5.3	5.5	5.5	5.5	5.5	5.5	5.50
Administration	MSR (July)		5.7	5.7	5.7	5.7	5.7	5.7	5.70
CBO	(Jan)		5.3	5.6	5.8	5.9	6.0	6.0	5.86
CBO	(May)		6.0	6.0	6.0	6.0	6.0	6.0	6.00
Blue Chip	(Mar)		5.4	5.5	5.9	5.9	5.7	5.5	5.70

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NOTES ON MEETING APRIL 22, 1997 ON STUDENT LOAN BORROWER INTEREST RATES WITH BOB SHIREMAN AT REQUEST OF LENDER REPRESENTATIVES

Attendees:

Bob Shireman, Peter Orszag (NEC), Jason Furman (CEA), Gene Reynolds (Treasury), Pat Smith (OMB), John Dean (Consumer Bankers), Steve Biklen (Citibank), Bill Hansen and Barbara Bennison (Education Finance Council), Paul Wozniak (Paine Webber), Robert Levine (SLMA V-P and Treasurer), Judy Kennedy and Scott Miller (SLMA Government Relations)

Background: In both loan programs, borrowers are currently charged 91-day T-bill plus 3.1%, not to exceed 8.25%, during the repayment period. Under current law, that formula will change for new loans to "bond equivalent rate of the securities with a comparable maturity" plus 1%, with the 8.25% limit. OMB has interpreted that equivalent rate to be the average of the 10-20 yr. Treasury note, which is the rate at which the Department of Education borrows from Treasury to finance both loan programs.

Discussion: Bob Shireman asked whether the concern of the lenders is the instrument (91-day T-bill vs. 10-yr. Treas. note) to which borrower interest is pegged, or the yield produced by current rate vs. the new rate scheduled for July 1998.

Wozniak asserted that (1) there much volatility in the spread between 91-day T-bills and 10-yr. bond rates, (2) historically, there would not have been much difference in interest charged to borrowers under either formula, but (3) the volatility would be damaging to lenders in raising funds for student loans.

Bob pointed out that in 1993 when the Student Loan Reform Act was passed, the formula of 10-yr. bond plus 1% was better for students under CBO projections, and it still is. Peter Orszag noted that historical data may not be as insightful as the best available economic projections, even though both are imperfect guides to what will actually transpire in the future. More specifically, he raised an objection about Wozniak's presentation, because it focused primarily on the 1980's -- an era of relatively large structural budget deficits -- and excluded the 1960's -- which was much more similar to today's economic environment, with relatively small budget deficits and low inflation. He was also puzzled by the assertions made about volatility, since the 10-year bond yield series presented by Wozniak did not seem any more volatile than the 3-month bond equivalent yield series. Wozniak and others explained that the volatility they were concerned about was in the spread between the 10-year and the 3-month yields -- not the volatility of the 10-year yield by itself. Orszag registered some skepticism about the costs of that volatility.

Biklen from Citibank asserted that if banks had to fund under the scheduled formula change, they would lose money. The volatility in spread between 91-day T-bills and 10-yr. bonds would kill them. Banks have to fund short.

Bob asked why is hedging not a solution. Biklen answered that it is costly to "take out the volatility" with hedging. Banks will not agree to this.

The SLMA V-P stated that access to student loan capital would remain available if lenders can stick to financing with 91-day T-bills.

Orszag replied that if the objective is to match the duration, the law could tie borrower payments to 91-day T-bills but not add 310 basis points -- perhaps to be comparable to 10-year bond plus 1%, the borrower interest could be 91-day T-bills plus 230 basis points.

Bob asked whether there is a problem -- will loans not be made under the scheduled change in interest rates? if so, what are the solutions? The Administration and CBO have interest rate projections through FY 2002 on which the Budget is based. We cannot use one set of interest rate projections in order to balance the budget, and then claim that those rates are not good enough to project the cost to students in the student loan programs. Under the CBO rates, student interest would be increased \$3 billion for the FY 1998-2002 cohorts if the scheduled change was canceled (\$1 billion in Federal "savings" from increased student interest payments, and \$2 billion in increased interest payments to banks under the FFEL program, which have no Federal budget impact.)

The SLMA V-P said that they could not not finance using a 10-yr. bond rate plus 1% because their servicing and financing costs would be higher than 1% over the 10-yr. rate. On the other hand, if SLMA lends long and finances short, but the borrower pays 10-yr. bond plus 1%, SLMA is subject to inflationary risk.

Bob asked whether the industry is willing to wait until reauthorization for a law change. Consumer Bankers replied no -- that this rate must be fixed as soon as possible. They will come back to the Administration with a proposal for a solution -- presumably short of just not implementing the July 98 change in formula.

John Dean

Steve Bollen

Scott Miller + Andy Kennedy + Peter Leone

Bill Foster, Bob Denney

Paul Wozniak - P-W

Jason Funnell - CEA

Peter Grezay

Pat Smith

Gene Reynolds - Treas.

Rosen Formula

- hedging above / below.

- liq. rate is an accompanying
index.

- short-term inflation.

OMB/CIA

APR: Govt. hedge + def.

Hedging?

- PLU resets actually based on 1 yr.
net gross in max $\rightarrow$ def.

- Var. rate mortgage - 3rd rate drops...

BUT ex. looks - all at once... (resul
dant)

Assess bank market

- 3.1?

market?

Reinvestment ? ?

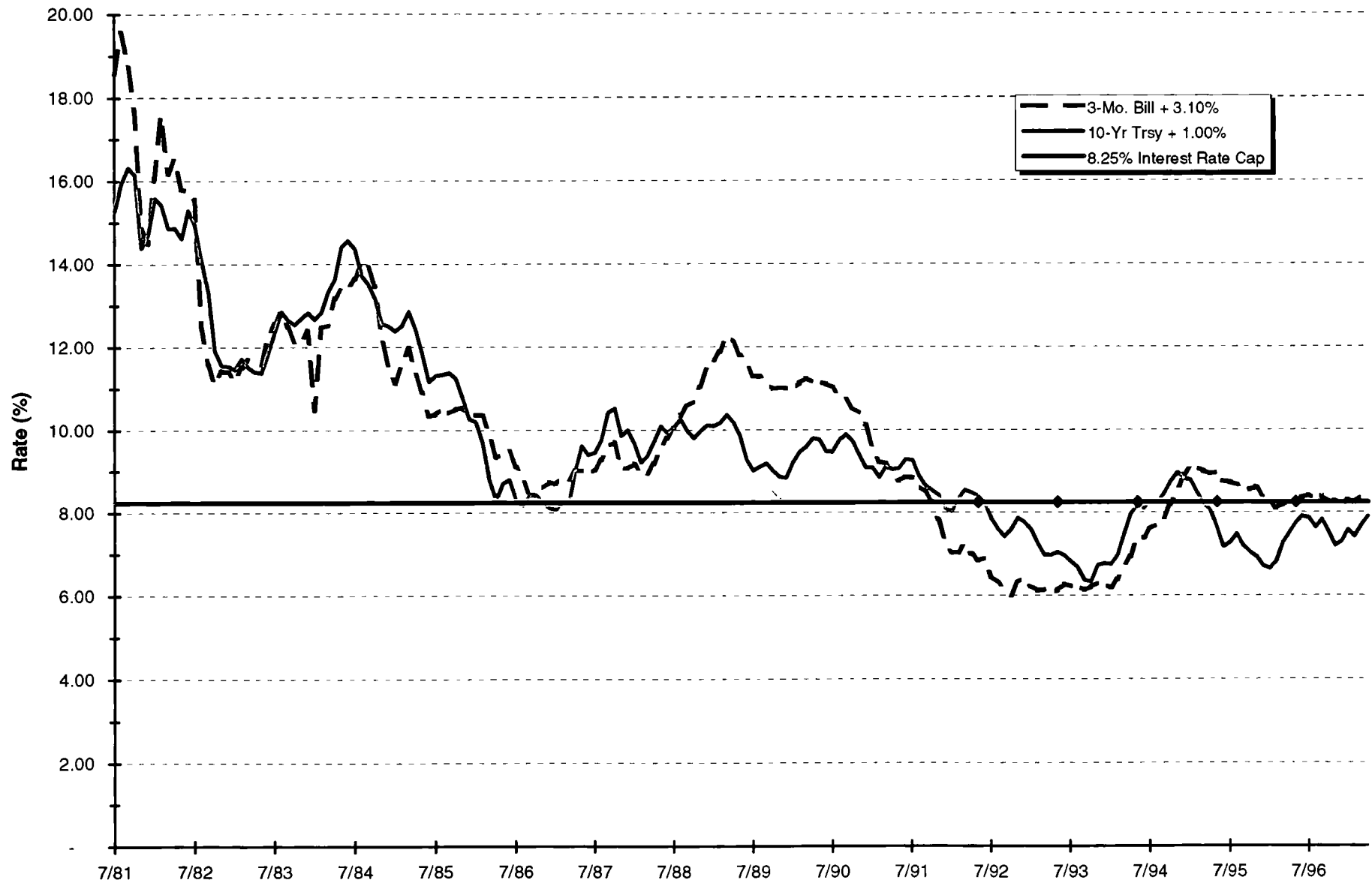
- ① Is there a problem
② What are solutions / impacts
on students

- cannot work - spread B
only 100 hours per

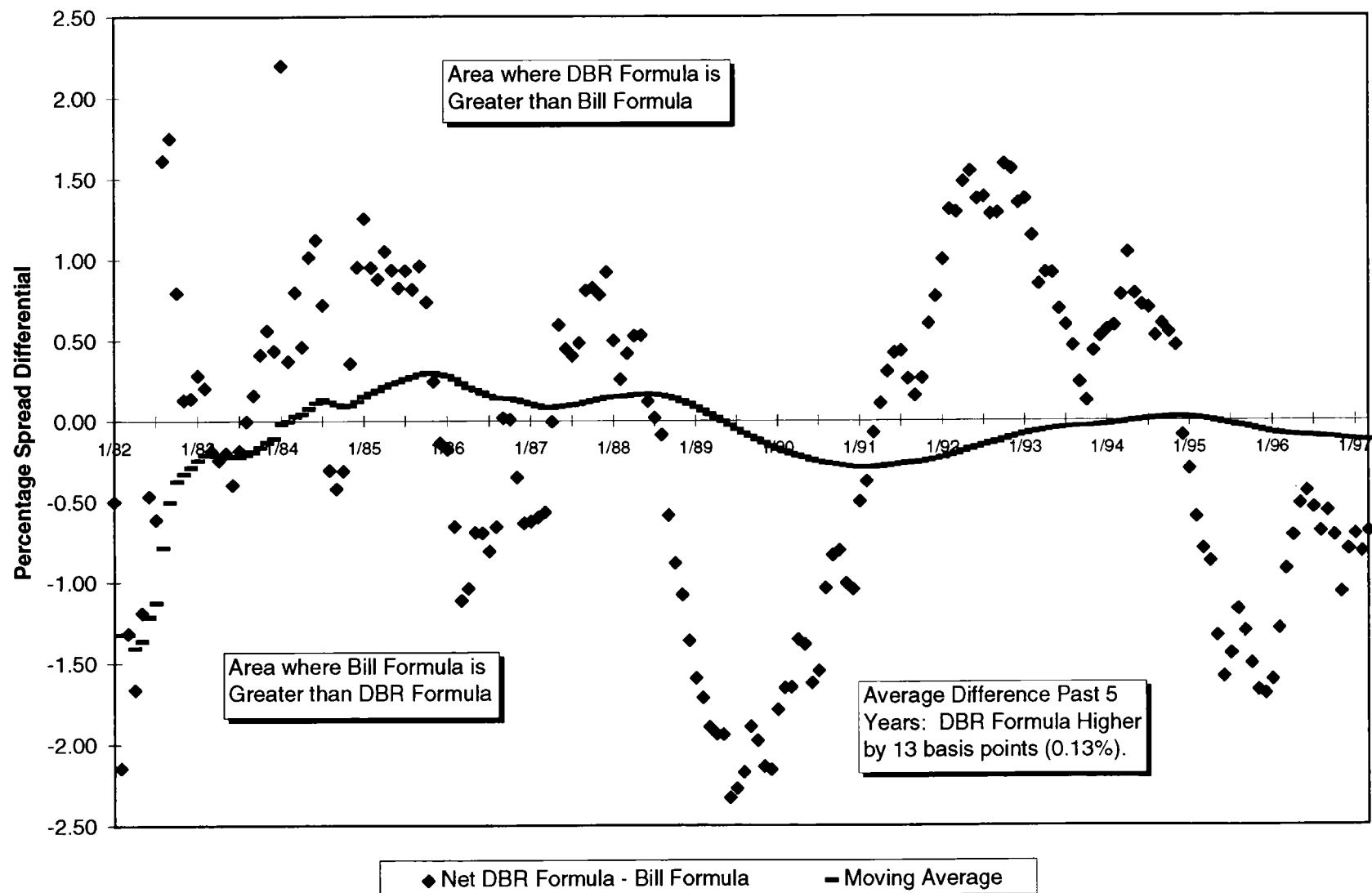
- not in budget (avg,
frequency short...

1 'perachilary / sea'

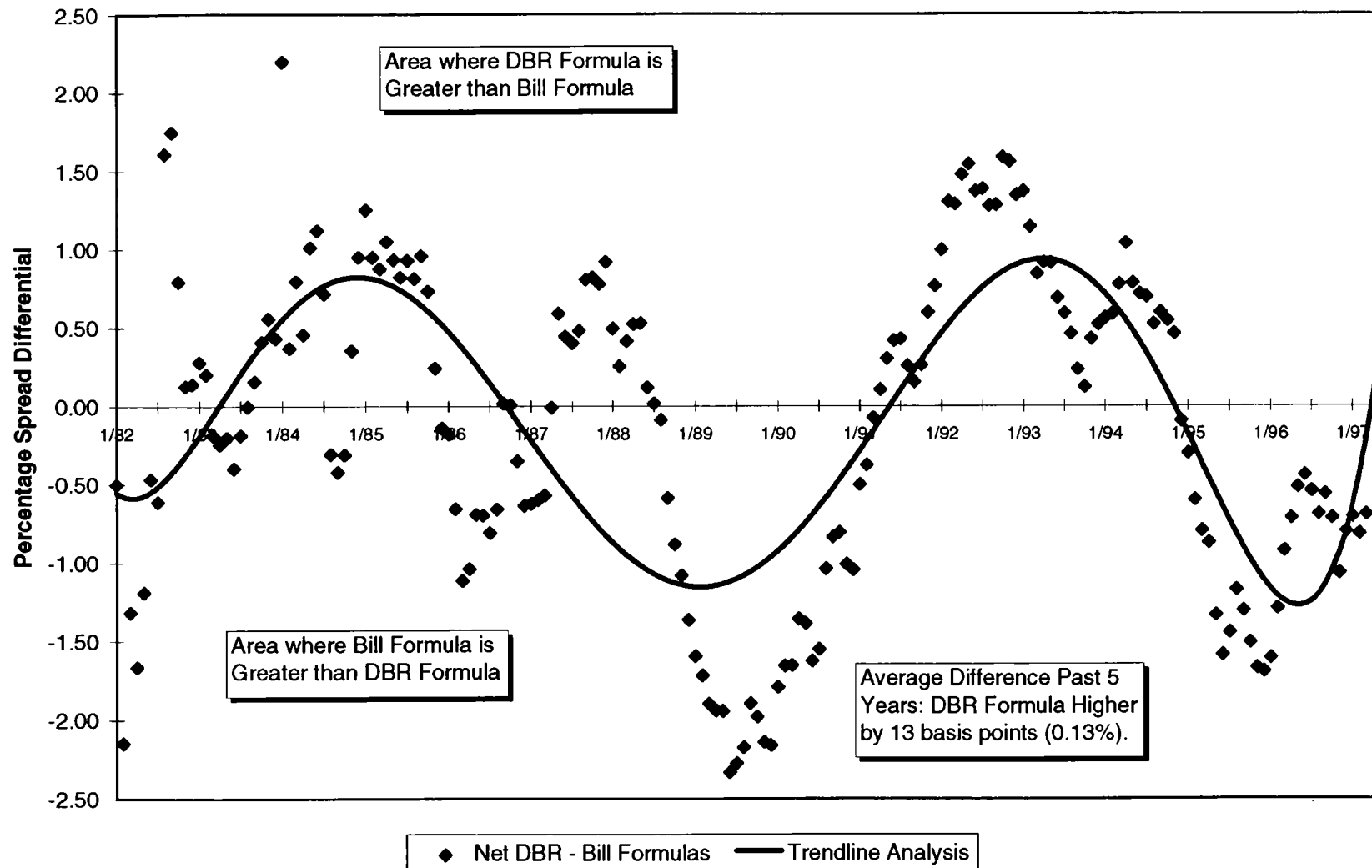
Interest Rate Comparison Between Two Treasury Formulae



Spread Differential Between Historical 3-Month T-Bill Rates + 3.1% and Historical 10-Year Treasury Rates + 1.0%



Spread Differential Between Historical 3-Month T-Bill Rates + 3.1% and Historical 10-Year Treasury Rates + 1.0%



COMPARISON OF THE STUDENT LOAN PROGRAM INTEREST RATES USING CBO'S PRE-POLICY AND POST-POLICY DECEMBER 1996 ECONOMIC ASSUMPTIONS

27-Feb-97

December Post-Policy	(by fiscal year)										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Discount Rate	6.23%	6.15%	5.88%	5.58%	5.50%	5.50%	5.58%	5.50%	5.50%	5.50%	5.58%
Pre 7/98 Loan Interest Rate:											
In-School	7.66%	7.63%	7.56%	7.19%	6.73%	6.49%	6.49%	6.49%	6.49%	6.49%	6.49%
In-Repayment	8.25%	8.23%	8.16%	7.79%	7.33%	7.09%	7.09%	7.09%	7.09%	7.09%	7.09%
Post 7/98 Loan Interest Rate:											
In-School	7.59%	7.18%	7.03%	6.73%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
In-Repayment	7.59%	7.18%	7.03%	6.73%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%

December Pre-Policy	(by fiscal year)										
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Discount Rate	6.23%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%	6.20%
Pre 7/98 Loan Interest Rate:											
In-School	7.66%	7.63%	7.61%	7.48%	7.30%	7.22%	7.22%	7.22%	7.22%	7.22%	7.22%
In-Repayment	8.25%	8.23%	8.21%	8.08%	7.90%	7.82%	7.82%	7.82%	7.82%	7.82%	7.82%
Post 7/98 Loan Interest Rate:											
In-School	7.59%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%
In-Repayment	7.59%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%	7.20%

Notes:

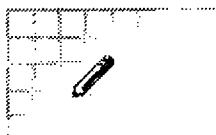
1. The Discount Rate used to discount program costs is the fiscal year average of the 10-year Bond Rate.
2. Pre-7/98 Loan Interest Rates are: 91-day Treasury Bill Rate + 2.5% In-School, and 91-day Treasury Bill Rate + 3.1% In-Repayment. The Loan Interest Rate is a variable rate set each year based on the rate for the last auction of May and effective beginning July 1.
3. Post-7/98 Loan Interest Rates are: 10-year Bond Rate + 1.0% both In-School and in In-Repayment. The Loan Interest Rate is a variable rate set each year based on the rate for the last auction of May and effective beginning July 1.

Comparison of Selected Interest Rates

(In percent)

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
91-day T-Bill					
OMB	4.92	4.60	4.37	4.18	4.14
CBO	5.00	4.60	4.20	3.90	3.90
91-day + 2.0%					
OMB	6.92	6.60	6.37	6.18	6.14
CBO	7.00	6.60	6.20	5.90	5.90
91-day + 2.5%					
OMB	7.42	7.10	6.87	6.68	6.64
CBO	7.50	7.10	6.70	6.40	6.40
91-day + 3.0%					
OMB	7.92	7.60	7.37	7.18	7.14
CBO	8.00	7.60	7.20	6.90	6.90
91-day + 3.1%					
OMB	8.02	7.70	7.47	7.28	7.24
CBO	8.10	7.70	7.30	7.00	7.00
10-year Bond					
OMB	6.11	5.72	5.44	5.25	5.20
CBO	6.10	5.80	5.50	5.50	5.50
10-year + 1.0%					
OMB	7.11	6.72	6.44	6.25	6.20
CBO	7.10	6.80	6.50	6.50	6.50
10-year + 1.5%					
OMB	7.61	7.22	6.94	6.75	6.70
CBO	7.60	7.30	7.00	7.00	7.00

Budget Service
4/17/97



To: Gene Reynolds

from Bob Shireman

Record Type: Record

To:

cc:

Subject: Meeting

A little preview on the 9:30 meeting Tuesday (room 231 OEOB):

Student loan interest rates are adjusted annually, and are set at 3.1 percentage points above an average of 91-day T-bills (up to a cap -- the government picks up anything above the cap). In the 1993 reconciliation, a decision was made to change the interest rate to one percentage point above the 10-year T-bond rate, still adjusted annually (technically, the law says it's one point above the rate on a security with a "similar maturity" -- i.e. the discount rate we use for the program, which is actually a melded 10/20 year rate, I believe). This new rate is scheduled to take effect in July 1998.

Under current interest rate projections, students will pay less with the new rate. Lenders are urging the Administration to cancel the rate change. (Doing so would save money because it would increase the spread, over baseline, in the direct loan program). They argue that it is too volatile, by which I gather they mean that the long-term rate does not track their short-term borrowing closely enough.

Below is further background from a staffer at the state college association.

----- Forwarded by Robert M. Shireman/OPD/EOP on 04/21/97 05:17 PM



nassirianb @ aascu.nche.edu

04/21/97 04:08:00 PM

Record Type: Record

To: Robert M. Shireman

cc:

Subject: Meeting

Bob:

Here are my quick observations about the meeting I had with CBA, EFC, and their PaineWebber consultant, Paul Wozniak:

1- Paul makes the argument that, based on historical data, the 91-day T + 310 formula is no worse for borrowers than the 10 year T + 100. The

data he uses to "prove" his case go back to the early 1980s. I agreed with his historical data, but asked him whether PainWebber's economists had any opinions on where short and long term rates were headed. He claims they don't, and that the differential between the two formulae will continue to be a sine curve. For my part, this strikes me as a bogus argument. Students will, in all likelihood, be better off with the 10-year formula than with the 91-day one, but lenders deny this.

2- He makes the argument that banks hedge their rate risk, and that hedging against the 10-year rates is prohibitively expensive, if not altogether impossible. I asked him about shorter-term indexing--say, 1-yr T--and he gave the same response. When I enquired about how mortgage lenders can do this, he answered that they securitized. I asked why, given the government guarantee on student loans, student loans couldn't be securitized. A: They could, but that the rates on mortgages were really 270 daily rates, whereas student loans would be exactly one rate. I asked whether resets could be used (I am not crazy about this idea at all), he said he hadn't thought about it, and would get back to me. Pat Smith correctly sums this up as coming down to whether one believes that student lending is as theoretically sound a business as these guys make it out to be. The idea that they all run their operations with matched books is a bit too neat for my comfort.

Short answer, I am unconvinced on both counts. The conversation I had with Paul really ought to have been between he and experts on our side of the issue. Someone with Wall Street expertise would be especially helpful.

I will fax you the charts he handed out.

Barmak

DRAFT June 2, 1997

MEMORANDUM FOR GENE SPERLING

FROM: Bob Shireman

SUBJECT: Student Loan Interest Rates & Reconciliation Rumors

I have received calls indicating that Sallie Mae lobbyists are working the Hill -- hard -- on the issue of the interest rate change scheduled to take effect next year. They still see reconciliation as their best chance to head off the change, since the Higher Ed reauthorization will not be completed in time.

As you know, under a provision that was part of the 1993 reforms, student and parent borrowers in the guaranteed and direct loan programs will benefit from a reduced interest rate scheduled to take effect for new loans made starting July 1998. *Lenders are arguing that it will not be profitable to make loans next year unless this change is repealed or changed.*¹ (See attached from OMB for more background).

I do not expect that lenders could accomplish outright repeal in reconciliation. The budget deal clearly states that there can be no reduced benefits or increased costs for borrowers. Repealing the interest rate change would cost students \$3 billion (NPV) over five years, more over ten. Compensating students would require *eliminating* fees, and more. But doing so increases the deficit. So, in addition, they would need to find far more savings than have already been agreed to.

My prediction is that one or both of the Chairmen will propose -- in Committee, or at the last minute of the Conference -- to delay the interest rate change for "just six months." This would open a large enough window so that the issue could be dealt with in reauthorization. To make the borrowers whole, they might reduce the fee by one percentage point or so (and they will either get a pass from Kasich and Domenici on the deficit reduction, find some way to hit the Department or direct lending, or propose a phony saver that affects guaranty agencies).

¹Lenders always claim they need more, and until direct lending, we have never been in a position to call their bluff. Both Peter and I think the numbers suggest that the new interest rates could be cutting close to the bone. But that is where the rate should be, and it is difficult to tell if it is going too far. Furthermore, if it does cut too deep, direct lending is there to fill in the gaps.

Clearly, we must take a firm position that we will not budge from the “do no harm to borrowers” agreement. Beyond that, I see three options:

1. Hard-line approach

In this approach, we would criticize the industry’s attempt to impose \$3 billion of costs on students to pad their own pockets, and firmly remind Congress that that would violate the budget agreement. We would further point out that even if students are made whole with changes to fees, any increase in the interest rate makes guaranteed loans more expensive to taxpayers than direct lending *even under the “fixed” Republican scoring rules.*² (Currently, CBO says the programs cost the same under directed scorekeeping). We would be able to claim that “With direct loans, we’ll charge students a lower rate, and still be better for taxpayers.” (We could even argue that the rate change could be repealed *only* for guaranteed loans, while direct loan will be at the lower rate).

The benefits of this approach are:

- Allows us to highlight the President’s support for lower-cost student loans, and remind the public of yet another benefit of the 1993 reconciliation bill.
- Allows us to crow about direct lending’s lower costs (although this can get complicated), and our ability to offer a lower interest rate than the banks say they can.
- If the Republicans back off and do nothing, Sallie will either find a way to cope with the new rates, or the cries of “crisis” will give reason for schools to move to (or stay in) direct lending.

The disadvantages of this approach are:

- Could upset some of our new Republican friends.
- Could box us in if we decide that we need to cut a deal of some sort.

2. A soft approach

We can wait for something to be proposed by a key Member of Congress. In response to other inquiries (Sen. Kennedy’s staff has already asked for our view on the bankers’ problem) our response could simply be “we don’t consider it a problem, but if someone

²To make matters worse (for the Republicans) the guaranty agencies are pushing for an entitlement to their administrative payment. This would put the payment into CBO’s “subsidy” calculation, making the guarantee program even more expensive.

has a proposal that is consistent with the the 'do no harm to students' policy of the budget agreement, we would be happy to look at it."

If someone does develop a proposal akin to the temporary fix, we could use that as an opportunity to equalize the fees in direct and guaranteed loans -- fixing one of the "discounting" problems that direct lending is currently having (some guaranty agencies have forgone the 1% insurance premium portion of loan fees, making the fee on guaranteed loans 3%, while it remains at 4% for direct loans).

Benefits of this approach:

- Retains a cooperative approach.
- Perhaps can address a problem currently faced by direct loan schools.

Disadvantages of this approach:

- Giving in on a six-month delay would make it more difficult to take a hard line in reauthorization.
- Missed opportunity to take credit for fighting for the right thing for students.

3, Seek a creative compromise

The attached OMB memo notes that the reason for the interest rate change (pegging it to the 10-20 year Treasury note) is to match the rate with what OMB uses the long-term rate for its own discount rate on student loans. If we were to take this as a cue to change the discount rate (or let Congress change it), the baseline cost of student loans would be reduced by \$5.5 billion according to ED's estimate. This would provide enough room to adjust the interest rate change, reduce or eliminate fees to make borrowers whole, and still meet the deficit reduction target. It is possible that we could also include long-term servicing costs in the direct loan subsidy, as Republicans have requested.

Benefits of this approach:

- Takes advantage of what may be our greatest leverage with Congress.
- Addresses three problems at once (bankers, discount rate, directed scorekeeping).
- Subsidy cost of direct loans would be dramatically reduced, even under CBO directed scorekeeping.

Disadvantages of this approach:

- Would require a change in OMB's discount rate policy.**
- More complicated. (Perhaps too much to do given the little time available?)**
- May give up more than we need to (*theoretically*, if we prevent the interest rate change from being repealed, we could make the discount rate change before reauthorization and eliminate fees, too -- bringing even greater benefits to borrowers. But it's a long shot).**