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Changes to financial aid rules would spur savings, too A fairer way to pay for college

Martin and Kathleen Feldstein

THE CLINTON ADMINISTRATION IS considering an important change in federal college financial aid rules that would make the system fairer, simpler, and more honest. It would also eliminate the strong bias against saving that exists under current rules, and make it easier for families to provide for future college costs. While we often disagree with Clinton administration proposals, this is one time when we are enthusiastic supporters. The White House should resist the opposition coming from defenders of the status quo.

Most families with college-bound children are eligible for financial assistance in the form of scholarships or low-interest loans. The amount of assistance now depends on the family's assets as well as its income, with financial aid declining rapidly as income and assets rise. Certain assets are excluded from the calculation; specifically, the family's house and retirement savings in company pension plans, 401(k) accounts, and IRAs. Colleges and universities generally follow the federal rules.

Although these exclusions may at first seem reasonable, they actually make the system grossly unfair in practice. And that's what the Clinton administration would remedy by basing financial aid on income rather than the combination of income and assets.

To see how this unfairness arises, consider the Smiths and the Joneses, each with two college-bound children, who are alike in every way except that the Smiths own their home while the Joneses are renters. The Smiths have a \$200,000 house with a \$120,000 mortgage, implying a net value of \$80,000. The Joneses are equally wealthy with \$80,000 in the bank, but do not own their home. Under the current scholarship rules, the Jones family could receive about \$45,000 less in financial aid over eight years than the Smiths, even though both were originally equally well off. The asset part of the scholarship rules would thus cause the Joneses to use up more than half of their initial assets.

A similar unfairness arises if one family has \$80,000 saved in a company-sponsored 401(k) plan while another has savings of \$80,000 in an ordinary mutual fund. The scholarship rules ignore the 401(k) savings, but could take away more than half of the mutual fund assets.

Some people are tempted to "game" the system to avoid the heavy penalties that the scholarship rules now impose on those who have accumulated ordinary financial assets. Because of the rule that excludes house values, a homeowner could increase his child's financial aid simply by temporarily paying down the outstanding mortgage. If the home-owning Smiths had \$50,000 in a bank account in addition to the value of their home, they could "hide" those dollars in a perfectly legal way by reducing their mortgage from \$120,000 to \$70,000 before their children start college. While the renting Joneses

would not have that option, a well-advised renter might use his financial assets to buy a "retirement annuity," knowing that the annuity can actually be cashed in after his children have graduated.

Because not everyone understands the rules or the opportunities to "game" the system, the scholarship rules hit some families much harder than others. There are also families who rebel against the rules by simply lying about their assets. While tax returns are used to verify reported income, there is no similar way to verify assets. As a result, the honest families get less in financial aid than those who cheat.

The Clinton administration's proposal to eliminate assets in the calculation of scholarships would end the current unfair advantage enjoyed by homeowners and by families with their assets in retirement accounts. It would also take away the advantage enjoyed by those who learn how to game the system and by those who are willing to cheat.

Although it's tempting to think that the problems of the current system could be solved by taking all assets into account, including the family house and retirement savings accounts, that wouldn't work. A house's value is

hard to estimate or verify, let alone turn into ready cash for tuition bills. And including 401(k) or similar defined contribution plans would drive employers to substitute traditional defined benefit pensions, which are virtually impossible to value before retirement occurs. That's why the Clinton plan to focus on income is the best alternative.

The new rules would also encourage parents to save for their children's college education, knowing that every dollar would be available for college bills. That's a

great improvement over the current system, in which saving in advance actually increases the amount a family is expected to pay out of pocket. The new rules would make it easier for families to meet college obligations without going into debt or drastically cutting their other spending.

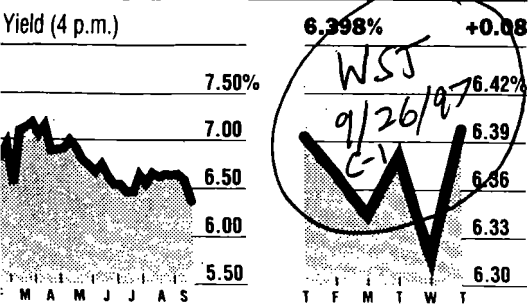
As economists we would also welcome the proposal's favorable effect on the incentive to save. Statistical research has shown that the current asset rule substantially reduces saving among families that expect to be subject to the so-called "scholarship tax." The proposed reform would no longer deter families from saving, since they would no longer fear losing a large part of those savings in the form of reduced financial aid. The extra national saving would result in faster economic growth and a higher standard of living.

Let's hope that this good idea for reform doesn't get sabotaged by those who are trying to protect the status quo.

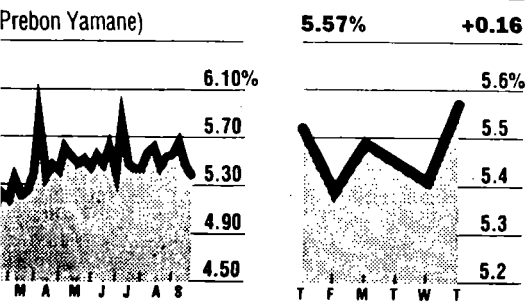
Martin Feldstein, the former chairman of the Council of Economic Advisers, and his wife, Kathleen, also an economist, write frequently together on economics.

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— make it easier for
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obligations without
going into debt.

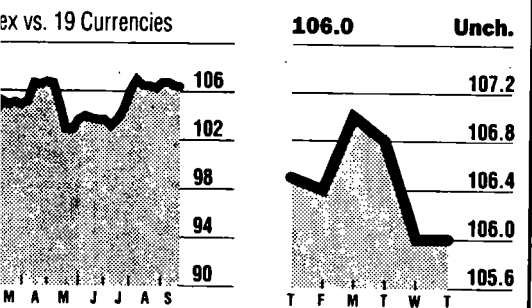
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THUR YIELD	WED	WED YIELD	12-MO HIGH	12-MO LOW	YTD %CHG
6.45%	7239.73	6.38%	7239.73	6344.45	+ 8.01
7.01	104.19	7.03	104.70	101.09	+ 0.25
7.00	774.64	6.97	774.94	704.46	+ 6.68
5.62	121-13	5.56	122-29	113-1	+ 2.90
6.79	913.16	6.72	913.16	818.31	+ 7.24



LOSE	WED	YEAR AGO	12-MO HIGH	12-MO LOW
4.89%	4.88%	4.87%	5.30%	4.77%
5.24	5.24	4.90	5.36	4.87
5.51	5.51	5.46	5.77	5.37
5.72	5.72	5.53	5.88	5.44
5.72	5.72	5.56	5.91	5.50



DATE	LATE NY	LATE WED	DAY'S HIGH	DAY'S LOW	12-MO HIGH	12-MO LOW
285	1.6138	1.6295	1.6102	1.7125	1.5617	
595	1.7725	1.7590	1.7785	1.4930	1.8820	
80	120.37	119.98	121.52	110.68	127.09	
128	0.7203	0.7231	0.7222	0.7520	0.7139	

Maughan could wind up with the higher billing because the merged firm may need them was there when Jessica Bibliowicz left," says Michael Holland, a former

Mr. Maughan says Mr. Weill responded "Co-CEOs," and "I said: 'Co-

Mr. Dhillon vested \$425, Please

YOUR MONEY MATTERS: WEEKEND REPORT

Saving for College Gets More Complex, But '97 Law Offers Intriguing Choices

By JONATHAN CLEMENTS

Staff Reporter of THE WALL STREET JOURNAL

Child's play, isn't it.

The 1997 tax law makes saving for college a lot more complicated. But with the complexity also come some intriguing investment opportunities.

Here are three suggestions from experts on how college savers can take advantage of the new tax law:

■ Make the most of the education IRA.

Starting in 1998, you can put \$500 a year into a new education individual retirement account for any child under age 18, providing you are single with adjusted gross income of \$95,000 and less or filing jointly with income of \$150,000 and below. Eligibility phases out above these income thresholds.

"Even if the parents aren't eligible to contribute, the grandparents may be," notes Minneapolis financial planner Ross Levin.

Some people sneer at these tax-sheltered savings accounts because of the low contribution cap. But after socking away \$500 a year for, say, 15 years with an annual return of 10%, your kid's education IRA would be worth some \$15,900, which you could then withdraw tax-free to pay college expenses.

That's a nice chunk of change. But the accounts don't make sense for everyone. In particular, there are three drawbacks.

First, in any year that you fund an education IRA for a kid, neither you nor anybody else can put money into a prepaid-tuition plan for the same child. Under the 1997 tax law, prepaid-tuition plans have been expanded, so now they can be used to pay for room and board, as well as tuition. But Mr. Levin says he would still favor the education IRA over a tuition plan.

Second, if you expect financial aid, you may want to pass on the education IRA, because these accounts will probably

crimp your aid eligibility. "I wouldn't put any money into an education IRA until the middle of next year, when we should know how the Department of Education will assess these accounts for financial-aid purposes," says Kalman Chany, author of "Paying for College Without Going Broke."

Finally, once your child is in college, you can't claim the new Hope Scholarship or Lifetime Learning credit in any year you withdraw money tax-free from an education IRA. These credits

are fully available to joint filers with adjusted gross income of \$80,000 and less.

The Hope Scholarship can be used in your child's first two years of college and is worth a maximum \$1,500 in annual tax savings. The Lifetime Learning credit, which can be used in subsequent years, is worth as much as \$1,000 a year through 2002 and \$2,000 a year thereafter. If you qualify, "the credits will be more valuable than the education IRA," Mr. Chany reckons.

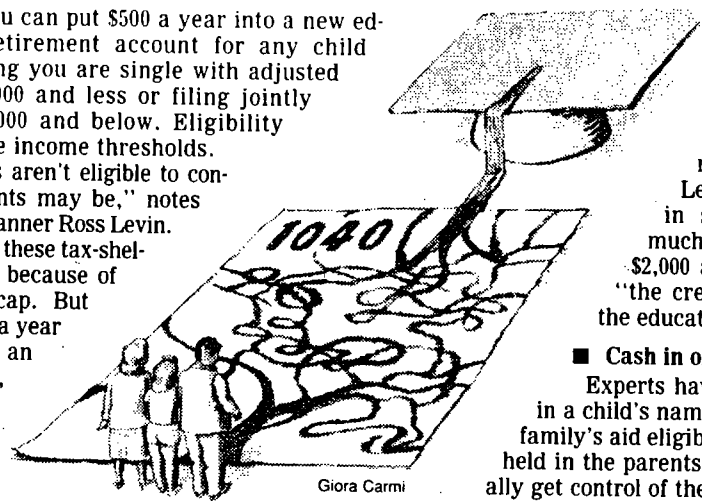
■ Cash in on lower capital-gains rates.

Experts have long warned against investing in a child's name. A kid's savings count against a family's aid eligibility far more heavily than money held in the parents' names. Moreover, children usually get control of their custodial accounts at age 18 or 21, depending on state law.

Despite these problems, plunking money into a custodial account for a child suddenly looks much more attractive, thanks to the cut in the capital-gains tax rate. For instance, if your children are in the 15% income-tax bracket and they hold an investment for more than 18 months, any capital gain is taxed at 10%.

But if you really want to skimp on taxes, possibly the most intriguing opportunity lies in the rock-bottom capital-gains rate on assets owned five years or more. If you are in the 28% income-tax bracket or above, the five-year capital-gains rate of 18% doesn't kick in until 2006 for investments held since

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Giora Carmi

Blue-Chip Stocks Fall 58.70

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Tax Law and Saving for College

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2001. But for those in the 15% bracket, the new five-year rate makes an earlier debut. Starting in 2001, those in the 15% bracket can sell investments held for at least five years and pay taxes at just 8%.

How can you take advantage of this? If you invest in a child's name and the kid is under age 14, the first \$650 of investment earnings is tax-free and the next \$650 is taxed at a maximum 15%. Above \$1,300, all gains are taxed at the parents' rate.

But the real tax break comes once your youngsters turn 14. Your children can then earn far more than \$1,300 and still be in the 15% income-tax bracket. Consider hanging onto your children's stocks and mutual funds until 2001. If, at that point, your children are at least age 14 and have held their investments for five years, you can sell the securities and pay taxes at 8%.

What if you want to keep control of the money? Mr. Levin suggests holding investments in your own name until your children turn 14. At that juncture, if your children seem responsible and you are confident you won't be eligible for financial aid, you and your spouse can each gift as much as \$10,000 of mutual funds or stocks to each of your children every year and have them sell the investments at their 8% or 10% capital-gains tax rate.

"An 8% tax rate is pretty darn attractive," says David Foster, a financial planner in Cincinnati. "That seems to me like a slam-dunk."

The 1997 tax law also makes home sales far less taxing. For instance, if you file jointly and your gain from selling your home is \$500,000 or less, you now avoid all capital-gains taxes. That opens up the possibility of tapping your home's value to pay for college.

"You could trade down and take equity out of your home tax-free," Mr. Levin says. "That especially works for older parents," who might be looking to buy a smaller home once their children head off to college.

• Stuff college savings into your IRA.

Starting next year, you can use your retirement IRA to pay a child or grandchild's college expenses and avoid the usual 10% tax penalty on withdrawals before age 59½. But the costs involved can still be hefty.

"If you withdraw from your IRA, you will raise your income and reduce your aid eligibility," Mr. Chany notes. "For people who are in the 28% tax bracket, every \$1 they pull out of a regular IRA might cost them 58 cents in taxes and reduced aid eligibility."

Nonetheless, if you are unsure whether you will be eligible for aid, putting college money in a retirement IRA may make more sense than stashing money in a child's name or funding an education IRA.

Under the federal financial-aid formula, your retirement IRA won't hurt your aid eligibility, providing you don't dip into the account. Thus, if you turn out to be eligible for aid, you can either leave your IRA untapped or use the account to pay for your child's senior year, at which point you should have finished applying for aid.

To pay for college, you can also make penalty-free withdrawals from the new Roth IRA. But tapping the Roth is a little trickier.

When you put money in a Roth, you don't get an upfront tax deduction. But everything pulled out of the account is tax-free, providing the account has been open for five years and you are at least age 59½.

The problem is, you may be younger than 59½ when your child enters college, which means that — while you may avoid tax penalties — you will have to pay income taxes on your Roth's investment earnings. To get around this problem, consider withdrawing just your Roth contributions, which you can pull out tax-free at any time. Meanwhile, leave your Roth's investment earnings to continue growing until retirement.

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Quotations as of 4 p.m. Eastern Time Thursday, September 25, 1997

Volume \$24,135,000

SALES SINCE JANUARY 1		(000 omitted)		1995	
1997	1996	1997	1996	1995	1994
\$3,967,276	\$4,233,089	\$5,525,565			

Dow Jones Bond Averages

1996		1997		1997		1998	
High	Low	High	Low	Close	%Yld	Close	Chg.
106.09	100.99	104.70	101.09	104.04	-0.15	101.18	+0.22
102.43	97.46	102.38	97.64	101.73	-0.35	98.91	+0.08
109.94	104.06	107.23	104.54	106.36	+0.05	105.45	+0.36

CORPORATION BONDS				Cur			
Volume, \$23,455,000				Yld. Vol. Close			
Bonds	Cur	Yld.	Vol.	Close	Chg.	Net	Chg.
ADT Op 2r10	...	...	...	105	...	...	...
AMR 8.10598	8.0	25	101 1/2	+	1/4	...	...
AMR 9516	7.9	5	114 1/2	...	...	...	...
ATT 4599	4.5	1	97 1/2	...	...	...	...
ATT 6800	6.0	102	99 1/2	...	...	...	...
ATT 5101	5.3	10	96 1/2	...	...	...	...
ATT 7102	6.9	46	103 1/2	...	...	...	...
ATT 6104	6.6	30	102 1/2	...	...	...	...
ATT 7505	6.8	8	103 1/2	...	...	...	...
ATT 8205	7.7	10	106	+	1/4	...	...
ATT 7106	7.1	13	105 1/2	...	...	...	...
ATT 8422	7.7	7	105 1/2	...	...	...	...
ATT 8424	7.8	10	104 1/2	...	...	...	...
ATT 85525	7.7	1	108 1/2	...	...	...	...
ATT 8511	8.0	20	108 1/2	...	...	...	...
Aames 10102	10.1	3	103 1/2	...	...	...	...
AcmeM 12102	11.5	1	109	...	...	...	...
AlePw 9121	8.8	5	104 1/2	...	...	...	...
AlskAr 6114	cv	62	105 1/2	...	...	...	...
AlidC 2r99	...	...	...	88 1/2	...	...	...
AlidC 2r2000	...	...	...	181	82 1/2	...	...
AlidC 2r07	...	...	...	15	50 1/2	...	...
AlidC 2r09	...	...	...	15	43 1/2	...	...
AlidC 2r10	cv	21	100 1/2	...	...	...	...
Alza 2r14	...	...	...	100	44 1/2	...	...
AREtire 5102	cv	11	99 1/2	...	...	...	...
Ametek 9104	9.0	14	107 1/2	...	...	...	...
Amresco 8109	8.6	45	101 1/2	...	...	...	...
Amresco 10503	9.7	39	103 1/2	...	...	...	...
Amresco 10504	9.5	40	105 1/2	...	...	...	...
Anhr 8116	8.4	29	102 1/2	...	...	...	...
Anntaylr 8100	8.8	173	100	...	...	...	...
Argosy 12501	cv	74	102	...	...	...	...
Argosy 12104	12.2	162	100 1/2	...	...	...	...
Armi 92500	9.2	18	100 1/2	...	...	...	...
AuburnHI 12102	...	...	...	1177	159	...	...
AufDI 2r12	...	...	...	1	61 1/2	...	...
BkrHigh 2r08	...	...	...	5	83	...	...
BarBks 10103	9.1	17	119	...	...	...	...
Barnet 8107	7.5	25	113	...	...	...	...
BellPa 7112	7.1	12	100	...	...	...	...
BellsoT 8100	6.4	100	101 1/2	...	...	...	...
BellsoT 8103	6.2	50	101 1/2	...	...	...	...
BellsoT 8104	6.4	5	99 1/2	...	...	...	...
BellsoT 7505	6.8	50	103 1/2	...	...	...	...
BellsoT 5109	6.2	63	95	...	...	...	...
BellsoT 7132	7.4	70	104 1/2	...	...	...	...
BellsoT 7133	7.4	40	102	...	...	...	...
BerkHath 1501	cv	2	135 1/2	...	...	...	...
BstBuy 8100	8.6	376	100 1/2	...	...	...	...
BethSI 8101	8.3	10	100 1/2	...	...	...	...
BethSI 84505	8.3	11	101 1/2	...	...	...	...
Bevrly 7103	cv	1	101	...	...	...	...
Bevrly 9006	8.5	100	105 1/2	...	...	...	...
Borin 8114	8.1	40	103	...	...	...	...
BorgWS 9103	9.0	246	102	...	...	...	...

NEW YORK EXCHANGE

Bonds				Cur			
Yld. Vol. Close				Yld. Vol. Close			
Chg.				Chg.			
Gerrill 11104	10.9	15	107 1/2	...	...	...	...
GrandCas 10103	9.6	40	106	...	...	...	...
GNOR 9110	9.4	7	65 1/2	...	...	...	...
Hawd 7500	7.4	63	94 1/2	...	...	...	...
Hawd 10113109	...	...	...	...	...	...	...
Hawd 10113109C	...	...	...	...	...	...	...
Hawm 7102	7.5	3	101 1/2	...	...	...	...
Hills 12103	15.1	1358	83	...	...	...	...
Hilton 5506	cv	53	116 1/2	...	...	...	...
Hollinger 9106	6.9	4	103 1/2	...	...	...	...
HomeDep 3101	10.6	68	111	...	...	...	...
HomePl 11104	cv	3	215	...	...	...	...
ICN Ph 8109	7.5	100	98 1/2	...	...	...	...
ITT Co 7115	7.5	43	101 1/2	...	...	...	...
IIIBel 7106	7.9	3	99 1/2	...	...	...	...
IndSII 7107	7.9	3	99 1/2	...	...	...	...
IntHil 6503	cv	8	105	...	...	...	...
IBM 6109	6.4	60	99 1/2	...	...	...	...
IBM 6100	6.3	193	100 1/2	...	...	...	...
IBM 7102	7.0	185	103 1/2	...	...	...	...
IBM 7113	7.3	20	114 1/2	...	...	...	...
IBM 8119	6.3	5	81 1/2	...	...	...	...
IPacDcs 112	8.8	24	102	...	...	...	...
IntShip 9103	7.1	5	99 1/2	...	...	...	...
JCLP 7104	7.5	20	100	...	...	...	...
JCLP 7123	cv	24	68	...	...	...	...
JumboSp 4100	9.0	150	103 1/2	...	...	...	...
KaufB 9103	cv	44	100 1/2	...	...	...	...
KentE 4104	cv	10	103 1/2	...	...	...	...
Kidmrg 8109	8.4	59	100 1/2	...	...	...	...
Koppers 8104	cv	6	130	...	...	...	...
LibPro 8501	7.7	5	109 1/2	...	...	...	...
Lilly 8106	cv	6	102	...	...	...	...
Loews 3107	8.4	10	102 1/2	...	...	...	...
LoisL 8104	8.3	20	102 1/2	...	...	...	...
LoisL 8106	8.4	125	105 1/2	...	...	...	...
LoisL 7107	7.4	75	101	...	...	...	...
LoisL 8109	9.1	55	112 1/2	...	...	...	...
LoisL 9121	9.4	21	102 1/2	...	...	...	...
LoisL 9124	8.2	5	100 1/2	...	...	...	...
MacNS 7104	cv	197	103 1/2	...	...	...	...
MacNS 7104	cv	55	102 1/2	...	...	...	...
MarO 7502	6.9	25	101 1/2	...	...	...	...
Masco 5112	cv	6	114	...	...	...	...
Mascotch 03	cv	78	92	...	...	...	...
Maxus 8108	8.4	9	101	...	...	...	...
McDerm 9106	9.0	1	104	...	...	...	...
McDerm 9106	9.0	80	115 1/2	...	...	...	...
McDerm 9109	9.4	15	105 1/2	...	...	...	...
MichB 7111	7.6	15	102 1/2	...	...	...	...
MindAm 12103	11.9	2	107	...	...	...	...
MPac 55451	...	...	...	82	65 1/2	...	...
Mobil 8101	7.8	6	107 1/2	...	...	...	...
Motria 2r13	...	...	...	17	83 1/2	...	...
NabIs 8109	8.1	71	102 1/2	...	...	...	...
NatDate 5503	cv	44	101	...	...	...	...
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NETel 6106	6.4	1	96	...	...	...	...
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OreSI 11503	9.9	65	101 1/2	...	...	...	...
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OutBm 7502	cv	130	90	...	...	...	...
NYTel 8104	7.7	2	102 1/2	...	...	...	...
PacBell 6105	6.4	27	98 1/2	...	...	...	...
PacBell 6105	7.2	10	95 1/2	...	...	...	...
PacBell 7123	7.0	28	101 1/2	...	...	...	...

GOVERNMENT

Thurs Over-the-Counter transactions, usually asked quotes represent. All yields are call quote. * Call quotes callable prior to earliest call date for the maturity date for Source: Bear, Stearns & Co. Inc.

TREASURY BONDS, NOTES & BILLS

Thursday, September 25, 1997
Representative and Indicative Over-the-Counter quotations based on \$1 million

Rate Mat. Bid Ask
5.35 10-97 100:00 100:00
6.05 11-97 100:02 100:00
6.55 11-97 100:10 100:10

Executives Reap Rewards From Nonprofit Loan Firm's Success

Second of three parts

By Valerie Strauss
Washington Post Staff Writer

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By all accounts, Catherine B. Dunlevy helped turn a small, nonprofit company into a national leader in the booming business of providing college students with tuition money. From her Washington and Herndon offices, Dunlevy oversees a firm that has lent \$1.5 billion to 250,000 students since it was founded 11 years ago.

The company has been profitable for Dunlevy. As chairman and chief executive of Edu-

Cap Inc., she makes almost \$600,000 annually, drives a company-leased Mercedes, rents a company-owned luxurious town house and racked up nearly \$100,000 in business expenses in one year recently.

Six-figure salaries and executive perks were nonexistent when EduCap—known until recently as University Support Services—was founded by a local Catholic priest to make loans to struggling students. Exempted from federal taxes, its avowed charitable purpose was—and still is—to help “make education affordable for American families,” according to the firm’s promotional materials.

But over the years, the company has fallen out of favor with some college financial aid officers who assert that its mission now seems to be not just making loans but also making money to support extravagant salaries and administrative costs. In 1992, it plunked down \$462,000 to buy the town house that Dunlevy now rents. Its top officers also hold stock in a for-profit company that draws almost all its business from EduCap without competitive bidding.

Experts ask the same question of EduCap hat surrounds the multilayered federally guar-

See LOANS, A8, Col. 1

LOANS, From A1

anteed student loan programs: If costs were kept down, couldn't interest rates for students be lower? They also question whether, given the growing number of for-profit companies offering alternative loans, EduCap should still enjoy tax-exempt status.

EduCap's evolution reflects changes in the college loan industry during a time when soaring tuitions have families scrambling for fresh sources of financial aid beyond the federal grant and guaranteed loan programs established three decades ago. EduCap makes so-called alternative loans, a type of student financing that has grown into a \$1.2 billion-a-year business. It is still a small segment of the more than \$100 billion students will need this year to pay for their educations. Unlike federally backed student loans, alternative loans are not guaranteed by the government if the borrower fails to repay. Interest rates are substantially higher to cover the risks of lending to students with no credit history. Alternative loans are sought mostly by families who need more cash than they can secure from federal programs.

Once virtually alone in the alternative loan industry, EduCap eventually faced competition from dozens of other lenders. But its interest rates and origination fees remained among the highest. EduCap responded to the competition with aggressive marketing, including arrangements with the National Rifle Association and the U.S. Chamber of Commerce, which received fees from EduCap for promoting its loans to their members.

EduCap's attempts to lure potential borrowers at times also has meant ignoring campus financial aid advisers.

“They go directly to the customer, who really doesn't have the wherewithal always to evaluate,” said Ellen Frishberg, financial services director at Johns Hopkins University, which does not recommend EduCap's loans because of their high interest rates. “I actually came out to my car one day last month and found under my windshield wipers an ad for them. Under every car in the parking lot at Hopkins. . . . I can understand there is a market imperative to do that, but coming to the school without stopping into the aid office?”

EduCap has also shown itself to be innovative in the way the nonprofit's loans are serviced. Dunlevy and some other EduCap officers partly own the profit-making affiliate called Servus Corp., which now handles much of the paperwork for EduCap. Servus last year made a profit of nearly \$3 million, according to company documents.

“The motivation of people going into the student loan industry is to make money,” said Mark Kantrowitz, a well-known financial aid analyst in New York. “When you talk about for-profit or nonprofit, it is pretty much the same motivation. The difference is whether the company that issues the loans is using their nonprofit status to fool people into thinking they are not getting rich off this.”

EduCap officials concede their rates are higher than some competitors but say that is the price for features they offer, such as allowing students to take out loans to pay old tuition bills and a speedy system that lets customers know in as little as five minutes whether they qualify. Furthermore, EduCap says it offers philanthropic programs, including scholarships to disadvantaged students.

Dunlevy said she is proud of her accomplishments and believes EduCap performs a vital service. She said she does not want to discuss details of her salary, which is set by the board of directors, or her financial interest in Servus.

EduCap's growth benefits students, Dunlevy added. “It's a story about addressing the needs of the public for funding education, having confidence that they will pay the money back and utilizing state-of-the-art technology and world-class customer service standards,” she said.

Booming Loan Demand

Paying for education has never been easy, but climbing college costs, which have increased at more than twice the inflation rate since the early 1980s, created a boom market for banks and other lenders. The demand for financing beyond what students could secure in federally guaranteed programs had to be met with home-equity and personal bank loans or credit card financing.

Then, in the mid-1980s, the Rev. John Whelan, who headed the Washington area consortium of universities, hit on a novel

concept for helping local students: have the District issue municipal bonds on behalf of area colleges and use the proceeds to make low-cost loans.

After winning D.C. Council approval, the initial \$50 million bond offering provided low-interest loan money for several thousand students. Whelan soon created University Support Services, a nonprofit firm, to offer the concept nationally. USS sold bonds to Wall Street investors. The revenue was used to make student loans. Students repaid their loans with interest, which provided USS with enough money to pay off the bond buyers. The nonprofit status granted to USS by the Internal Revenue Service offered a substantial benefit, since the company did not have to pay federal income taxes.

“The program began growing exponentially from Day One,” said Dunlevy, who was hired in 1988, along with Pierre Escandar, EduCap's executive vice president and chief operating officer.

EduCap now calls itself the nation's “largest provider of affordable, credit-based education financing.” It will issue \$300 million in loans this year, up from \$225 million in 1996, officials said. Essentially, EduCap follows Whelan's original formula: sell bonds; use the proceeds for loans; use the interest paid on the student loans to repay the bond investors and underwrite EduCap's operations.

EduCap's annual default rate—which Dunlevy cited as an indicator of sound lending practices—is less than 1 percent. The rate for federal student loans is about 11 percent.

As loan volume grew, so did executives' salaries. Whelan initially ran USS without compensation, tax filings show, but by 1993, the year before he retired, he was paid \$237,500 as board chairman.

Whelan said he was never interested in personal financial rewards but took a salary that was set by the board without his input.

Dunlevy, a Vanderbilt University graduate and former controller of a Virginia entertainment company, made \$375,000 in 1993. Today, she makes \$597,968 a year, she said. Federal tax returns for 1995 show that she received \$94,113 in business expense reimbursements.

She lives in a Falls Church town house that the nonprofit purchased in 1992 to try to entice a top job prospect, Dunlevy and Escandar said. Dunlevy moved in shortly after the purchase and pays \$2,000 a month in rent.

Escandar makes \$482,505 a year. He was reimbursed \$44,060 for expenses in 1995, the last year for which company tax returns are available. Both Escandar and Dunlevy said they reimburse EduCap for any personal use of their leased Mercedes sedans.

A 1995 survey by the Chronicle of Philanthropy, a Washington-based journal, showed that the median salary for chief executives of major U.S. nonprofit organizations was \$188,686.

Donald Kummerfeld, who sits on EduCap's board and is president of the New York-based Magazine Publishers of America, said the board sets executive salaries after examining what corporate and nonprofit executives make.

“If we did not pay what the market requires in order to get competent management, would that serve the nonprofit corporation?” Kummerfeld asked.

After several years of growth, EduCap “got so large, that it was taking just about every resource that this small nonprofit corporation had simply to originate and service the loans,” Whelan said.

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Whelan, Dunlevy and Escandar created the for-profit company Servus in 1993 to handle much of the paperwork involved in tracking loans—sending bills to borrowers, collecting payments and other tasks. EduCap bought 49 percent of Servus's stock, tax records show. The three executives bought equal shares of the rest and sit on Servus's board of directors, according to Dunlevy and financial documents. Whelan said he still holds Servus stock but does not know its value or attend board meetings.

Their part ownership of Servus is not widely advertised. Documents circulated on Wall Street last year to sell \$204 million in bonds for more EduCap loans do not mention the financial interests the EduCap officers have in Servus. Officials at Smith Barney Inc., which handled the bond offering, said the investment firm's legal adviser did not consider it necessary to disclose that information.

After Servus was formed, virtually overnight about 85 of EduCap's 100 employees

went to Servus, Dunlevy said. EduCap's Herndon offices and equipment were taken over by the for-profit company.

EduCap now has 17 employees in a small downtown Washington office, while Servus has about 180 employees who mainly do the computer work that is at the heart of the firm's loan servicing.

Last year, EduCap paid Servus \$15.4 million. Servus's profit last year was \$2.9 million, according to financial documents.

Cost of Borrowing

Footing the bill for EduCap's administrative costs have been student borrowers, who have absorbed higher-than-average interest rates and fees, according to numerous school financial aid directors.

When EduCap dominated the alternative market in the late 1980s, it charged 10.45 percent annual interest on a loan that was paid back over 12 years, Whelan said. That interest rate exceeded government-backed loans, which charged 8 percent to 10 percent, but it was cheaper than unsecured consumer loans offered by banks. As college costs rose and more students needed cash, other lenders jumped into the alternative loan business.

"We were hearing more and more from schools that a growing percentage of their students needed funding beyond what the federal [loan] programs could offer," said Barbara Faculjak, director of private credit, products and operations at Sallie Mae Inc., a government-sponsored student loan agency that was recently privatized.

EduCap's competitors offer rates that many financial aid directors prefer. For example, a \$5,000 EduCap PLATO loan would cost \$10,843 to repay in 15 years, given the current annual interest rate of 12.21 percent; that sum includes an 8 percent supplemental fee charged by EduCap. Another alternative loan, the Sallie Mae Signature loan, for the same amount and under the same conditions as the PLATO loan, can be had for 9.17 percent annual percentage rate, which includes a 6 percent origination fee. That loan

would cost \$9,310 over 15 years—a savings of more than \$1,500 on the \$5,000 loan.

"We certainly wouldn't put this [EduCap loans] at the top of our list, because generally speaking, their product has been outcompeted in recent years," said Nancy Coolidge, a financial aid expert for the University of California system, which includes about 166,000 students on nine campuses.

One factor contributing to loan costs is a "processing fee" often added to the loan's total. EduCap's charges are among the industry's highest, according to financial aid officers, sometimes more than 8 percent. With each new loan, a new fee is tacked on.

Officials at many area schools said they do not recommend EduCap products. Two that do are American University and Howard University. Howard's financial aid director, Avon Dennis, described PLATO loans as the "loan of choice." Dennis said he was not aware of alternative loans available at lower interest rates.

"Students seemed to get a fair shake from PLATO processing," Dennis added.

EduCap's continued success in the face of cut-rate competition is partly a consequence of dealing directly with businesses and persuading them to distribute information about the loans through personnel offices. EduCap, for example, paid the NRA nearly \$10,000 in fees last year to promote loan programs to its members, according to IRS documents. EduCap's biggest alliance was with the U.S. Chamber of Commerce, which helped the company expand its operations nationally after Whelan persuaded the Chamber to participate in 1988. "The chamber sort of felt it was part of our mission," said Frank Coleman, a chamber spokesman.

Employers who belonged to the chamber promoted EduCap's "ConSern" student loans to employees, at interest rates identical to those available on the open market. More than 30,000 companies eventually signed up, each paying EduCap a service fee. The chamber, in turn, got 10 percent of each fee

paid—a total of \$2.4 million in eight years, according to IRS documents.

The arrangement was discontinued last year after chamber executives concluded that interest among members had waned. But many companies continue to promote EduCap's loans.

Many borrowers praise EduCap's easy loan processing and swift customer service as reasons to use the company, regardless of interest rates.

Richard Curtin, a telecommunications worker from Sterling, took out five EduCap loans totaling \$30,000 to send his two sons to area universities. "I don't even want to look at how much interest I'll pay," Curtin said.

Carri Ann Angrisani, of Northern Virginia, who returned to school at George Mason University last year after working for 10 years, said she was drawn to EduCap's ConSern loan by its 7.9 percent introductory interest rate. Angrisani said she does not know what the rate will be in future years.

EduCap officials said interest on that particular loan will jump 3 percentage points after the first year.

ABOUT THIS SERIES

☐ **MONDAY** — College costs over the past 15 years have risen 10 times faster than median family income in the United States, forcing millions of students to borrow tuition money—and giving the loan industry an opportunity to earn billions.

☒ **TODAY** — A local nonprofit company and its officers thrive on the demand for "alternative" loans.

☐ **WEDNESDAY** — How some colleges and trade schools find a lucrative windfall in federal student aid.

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Draft of 5/15/98

Pilot Program for Auction of FFELP Loans

I. Principal Objective

To test whether the sale by auction of loans made under the Federal Family Education Loan Program (FFELP) would minimize the cost of those loans to the Government

A portfolio of existing loans should theoretically have a greater value to a lender than the right to originate a portfolio in the expectation that it will have the same characteristics as the actual portfolio. The loan-auction pilot, in conjunction with a contemporaneous rights-auction pilot, would be designed to test and quantify that theory.

II. Subsidiary Objectives

A. To test whether auctions of balanced (heterogeneous) parcels would be cost-effective

B. To test whether facilitation of separate loan management and loan ownership would be cost-effective

C. To test whether changes in the current allocation of risk (interest rates and/or nonpayment) between lenders and the Department of Education (ED) would be cost-effective

III. Pilot Design

ED would be authorized to make voluntary agreements with eligible lenders for up to 10 percent of total new FFELP volume, under which the lenders would sell at public auction FFELP loans owned by them, with price guarantees from ED. Auctions would be subject to minimum acceptable bids (reserves) set by ED. Loans that failed to attract bids at least equal to the reserves would continue to be serviced by the sellers until they could be re-auctioned. It might be necessary to provide Federal funding to hold the loans in the meantime. Other auction terms would be determined by ED. The distribution of any premiums over the guaranteed prices would be subject to agreements between the seller and ED.

Loans would be auctioned in balanced (heterogeneous) parcels.

Loans would be auctioned servicing-retained, but ED would only establish such relationships with lenders with quality servicing operations. Sellers would establish trustee-lender facilities to broaden the universe of potential bidders.

The loans auctioned would have standard FFELP borrower terms, which could not be changed. ED would be authorized to experiment with changes in lender terms, such as lender interest rate, special allowance and scope of guaranty. At the very least, ED would experiment with the auction of non-guaranteed loans that the holder was entitled to resell to ED if the borrower elected income-contingent repayment (ICR) and provided the same information about his/her income that is required under DL. Since the lender would assume all risk of nonpayment by a borrower with sufficient income, due diligence regulations for lenders could be relaxed/removed.

IV. Issues To Be Addressed for Pilot

- A. Administrative resources
- B. Funding of pilot expenses and interim holding of auctioned loans that failed to meet the reserve prices
- C. Effect of changes in lender terms on competition between pilot and other lenders
- D. Mechanism for administration of ICR loans
- F. Auction procedures

V. Additional Issues To Be Addressed for Full-Scale Program

A. Loan Origination

Because of time constraints, the pilot would solely utilize on a voluntary basis the existing system for loan origination in FFELP: private lenders selected by schools/borrowers. A full-scale program could also be devised on that system: The current FFELP origination system could remain in place, but a mechanism could be established by which private originating lenders would be required to subject their loans to public auction on an individual or combined basis at some point after origination. Although FFELP lenders have made great strides since the advent of Direct Lending (DL) in reducing the complexities for schools in dealing with multiple lenders, they have not yet achieved the single (at any one time) point of contact for schools offered by DL. In formulating a full scale program, consideration should be given to mandating the creation of a virtual single originator through systems such as Project

ELM or Project EASI or the creation of a single governmental or non-governmental originator.

B. Loan Management

DL also offers borrowers a single point of contact, subject to the possibility of the same change of servicer for all loans of that borrower. Such combined loan management also affords substantial economies in servicing costs to lenders. Again because of time constraints, the pilot would designate the selling lender as the manager for all loans that were auctioned, thereby achieving these advantages for loans made in the pilot. If the current origination system is maintained for the full-scale program, that arrangement could also be maintained. Not all originating lenders manage their own loans for their full lives, however; and such an arrangement would make it unlikely that all loans to a student attending multiple schools would come under common management. The situation would be substantially complicated further if it was decided to have a single loan originator and multiple servicers. In that case it would be necessary to devise a procedure to accumulate under common management loans to a single borrower that were under multiple ownership. In addition, although a mechanism under which the owners of all loans by a single borrower may change the single servicer for that borrower is too complex for pilot testing, it is probably necessary for a full-scale program.

C. Role of guaranty agencies

5/15/98 2:30 p.m.

Technical drafting assistance [auction mechanisms alternative]
[page and line numbers refer to the reported version of S. 1882]

Page 458, insert immediately after line 2 the following (and renumber accordingly):

“MARKET-BASED DETERMINATIONS OF LENDER RETURNS

“SEC. 425. Part B of title IV is further amended by inserting immediately after section 427A the following new section:

“MARKET-BASED DETERMINATIONS OF LENDER RETURNS

“SEC. 427B. (a) FINDINGS.--The Congress finds that--

“(1) Federal subsidies to lenders making, or holding, loans made, insured, or guaranteed under this part should not exceed the level necessary to ensure that all eligible borrowers have access to loans under this part;

“(2) setting the level of lender returns necessary to achieve the objective described in paragraph (1) in statute is inexact and insufficiently flexible to respond to market forces, and therefore lender returns should be determined through the use of market-based mechanisms;

“(3) alternative market-based mechanisms must be tested before a final selection is made as to the particular mechanism to be used for all loans made, insured, or guaranteed under this part,;

“(4) the results of testing of alternative market-based mechanisms should be evaluated independently; and

“(5) if the independent evaluation concludes that the testing of alternative market-based mechanism has been successful, a market-based mechanism to determine lender returns on all loans made, insured, or guaranteed under this part should be implemented as expeditiously as possible.

“(b) JOINT PLANNING STUDY TO SELECT AUCTION-BASED MECHANISMS FOR TESTING.--(1) The Secretary of Education and the Secretary of the Treasury shall jointly

conduct a planning study, in consultation with the Office of Management and Budget, the Congressional Budget Office, the Congressional Research Service, and the General Accounting Office, to--

“(A) select for testing two or more auction-based mechanisms to determine lender returns on loans made, insured, or guaranteed under this part; and

“(B) determine what related administrative and other changes would be required in order to ensure a successful implementation of auction-based determinations of lender returns for all loans made, insured, or guaranteed under this part.

“(2) Any auction-based mechanism selected for testing in the planning study required by this subsection shall be designed to minimize Federal cost when fully phased in. Any such mechanism shall also be designed to--

“(A) ensure loan availability under this part to all eligible students at all participating institutions;

“(B) minimize administrative complexity for borrowers, institutions, lenders, and the Federal Government;

“(C) maintain the participation of a broad spectrum of lenders and ensure healthy long-term competition in the program under this part.

“(3) In carrying out the planning study, the Secretary of Education and the Secretary of the Treasury shall, to the extent they determine practicable within the time allotted for the study, consult with experts on auction-based mechanisms and current and potential program participants whose participation may be affected by the use of an auction-based mechanism.

“(4) A report on the results of the planning study, together with a plan for implementing two or more pilot programs using promising auction-based approaches for determining lender returns, shall be transmitted to Congress not later December 31, 1998.

“(b) PILOT PROGRAMS.-- (1)(A) Notwithstanding any other provision of this part,

beginning not less than 60 days after the study report described in subsection (a) has been transmitted to Congress, the Secretary is authorized, in consultation with the Secretary of the Treasury, to carry out pilot programs meeting the requirements of this subsection in accordance with the implementation plan included in the study report.

“(B) The Secretary shall commence the implementation of the pilot programs under this subsection not earlier than the first full academic year beginning after the date of enactment of the Higher Education Amendments of 1998, and not later than the second full academic year beginning after such date.

“(C) The pilot programs under this subsection shall be not more than two academic years in duration, and the Secretary may use the pilot programs to determine the lender returns for not more than exceed 20 percent of the annual loan volume under this part during such period.

“(2) In carrying out pilot programs under this subsection, the Secretary--

“(A) shall use auction-based approaches, in which lenders bid competitively for such loans under this part, or rights to originate such loans, as the Secretary shall determine;

“(B) shall examine--

“(i) whether it is most appropriate to auction existing loans under this part, the right to originate such loans, or a combination thereof;

“(ii) whether it is preferable to auction parcels of such loans, or rights, that are similar or diverse in terms of loan or borrower characteristics;

“(iii) whether it would be appropriate to facilitate separate management and ownership of such loans, and what administrative and other procedures would best do so; and

“(iv) what is the appropriate reallocation of risk between the Federal Government and the owners of such loans with respect to interest rates and nonpayment

of loans;

“(C) shall determine which of the auction-based approaches tested in the pilot programs best meets the purposes described in subparagraphs (A), (B), and (C) of subsection (a)(2);

“(D) may determine the stated interest rate for lenders, other payments to lenders, and the terms, applicable to lenders, of the rights or loans, as the case may be, for which the lenders bid; and

“(E) shall include loans of different amounts and loans made to different categories of borrowers, but a representative sample of loans or borrowers shall not be required for each auction of rights or loans under a pilot program.

“(3) Participation in a pilot program under this subsection shall be voluntary for eligible institutions, eligible lenders, and States.

“(4) The Secretary shall--

“(A) obtain an independent evaluation of the pilot programs that shall be completed, and the results of the evaluation submitted to the Secretary, the Secretary of the Treasury, and Congress, by no later than 120 days after the end of the pilot programs under this subsection; and

“(B) consult with a broad range of program participants, pilot program participants, and other interested parties concerning their views on the success of the pilot programs, and their suggestions for improvements.

“(5) Notwithstanding any other provision of law, the Secretary may waive the application of any procurement statute or regulation to the pilot programs under this subsection if the Secretary determines that such waiver is necessary for the successful implementation of the pilot programs.

“(c) IMPLEMENTATION OF MARKET-BASED SYSTEM.--Notwithstanding any other provision of this part, for the first full academic year beginning not less than 120 days after

the independent evaluation described in subsection (b)(4)(A) has been transmitted to Congress, and succeeding academic years, the Secretary is authorized to implement for all loans made under this part (other than loans made under section 428C), a program-wide, auction-based system to determine returns to all lenders as the Secretary determines appropriate, provided that--

“(1) the Secretary of the Treasury, in consultation with the Secretary of Education, has certified that the auction-based system that the Secretary of Education intends to implement on a program-wide basis will ensure loan availability under this part to all eligible students at all participating institutions;

“(2) the Secretary has promulgated regulations establishing the structure of the auction-based system; and

“(3) the Secretary has notified the Congress of the Secretary’s intent to implement a program-wide auction-based system, and provided a description of the structure of the auction-based system, at least 120 days before implementing such system.

“(d) **[funding].’.**” .

Page 456, lines 6-7, strike out “clauses (ii), (iii) and (iv) of this subparagraph,” and insert in lieu thereof “clauses (ii), (iii), (iv) and (v).”.

Page 456, line 17, strike out “2.8 percent” and insert in lieu thereof “2.5 percent”.

Page 457, lines 2-3, strike out “2.2 percent” and insert in lieu thereof “1.9 percent”.

Page 457, insert immediately after line 22 the following (and redesignate accordingly):

“(c) **SMALL LENDER ORIGATION SUBSIDY PAYMENT.**--Part B of title IV is further amended by adding immediately after section 438 the following new section:

“**SMALL LENDER ORIGATION SUBSIDY PAYMENT**

“SEC. 438A. (a) In order to maintain the participation of a broad spectrum of lenders and long-term competition in the program under this part, the Secretary shall pay, to each eligible lender that meets the requirements of subsection (b), a one-time payment equal to 0.20 percent of the principal amount of each loan made under this part (other than loans made under section 428C) by such lender. The Secretary shall make such a payment on each such loan that is made by such lender during the period beginning [October 1, 1998?] and ending when the Secretary implements a program-wide, auction-based system to determine returns to all lenders, as described in section 427B(c), except that such program-wide auction-based system shall include such other provisions as the Secretary determines appropriate to encourage the continued participation in the program of lenders meeting the requirement of subsection (b).

“(b) An eligible lender shall receive the payment described in subsection (a) if the eligible lender made **[not more than \$1,000,000 in new loans (other than loans made under section 428C)in the preceding fiscal year/an average of not more than \$1,000,000 in new loans (other than loans made under section 428C for each of the three preceding fiscal years].’**”.

Page 457, line 23, strike out “The” and insert in lieu thereof “Except as the Secretary may otherwise provide under section 427B, the”.

Page 505, strike out line 5 through page 506, line 16.



Don Feuerstein @ ed.gov (Don Feuerstein)
05/19/98 03:02:04 PM

Record Type: Record

To: Kathryn B. Stack/OMB/EOP, TStan77346 <TStan77346 @ aol.com >
cc: See the distribution list at the bottom of this message
Subject: Re[2]: Auctions Technical Working Group

Perhaps I should take some comfort from the fact that Tom thinks that the proposed loan-auction pilot does too little, and Robin thinks that it does too much. I shall stake out my claim for the middle ground by trying to answer all three e-mails of yesterday here.

Tom's Credit-Management Auction:

Tom has done the Department a great service with his report analyzing the inefficiencies of relying upon uniform prescriptive rules in loan-servicing contracts, rather than economic incentives, to maximize service to students and minimize default and other costs to taxpayers. (Some {not I} may argue that policy reasons for uniform treatment of borrowers override considerations of inefficiency. At the very least, we should not decide for overriding policy reasons to pay the cost of inefficiency without having some idea of its magnitude.) Whether performance-based servicing contracts are structured as partial equity sales or as penalty/bonus fee structures is largely a matter of form rather than substance. Once the arrangement is properly structured, it also probably does not make much difference whether it is arranged through procurement or auction. A competently crafted RFP/parcel-description is necessary for both, and I am unaware of the Department's being faulted for paying too much in its servicing procurements.

To the extent that the Department retains substantial nonpayment risk in an auction system for FFELP loans, Tom's analysis would be highly pertinent. Whether a pilot is necessary to test performance-based servicing, and whether any such pilot should be an add-on to auction pilots or run separately are questions that should be addressed for any program structure in which the Department bears such risk. Although it is not clear whether the Department currently has statutory authority to "auction servicing," I know of no reason why it could not write performance-based servicing contracts through the procurement process.

In the proposed loan-auction pilot, the only nonpayment risk borne by the Department would be the borrower's failure to achieve an income level that would preclude ICR. In such case, the loan would be repurchased by the Department and would need to be serviced. The FFELP servicing contract for repurchased loans could, and probably should, be performance-based. The remaining risk of nonpayment would be borne by

private lenders, and they can write their own performance-based servicing contracts in any final system. In the proposed loan-auction pilot, however, servicing would be retained by the selling lender. Absent a costly up-front premium guarantee, it is hard to envision why lenders would voluntarily sell their loans in a pilot auction servicing-released. Since our agreements with sellers in the proposed pilot program would be on a servicing-released basis, we could negotiate performance-based servicing contracts on behalf of the ultimate purchasers. I believe that the proposed legislative language would allow us to do so.

In the current version of the proposed rights-auction pilot the loans would retain the current full Federal guarantee. That would be a more fertile testing ground for Tom's concept.

I am not sure of the rationale behind the new financial structure that Tom has suggested in his e-mail to Nabeel to implement the concept. If I understand it correctly, FFELP loans would be originated by private lenders, with the permanent servicers to be determined at later auctions run by the Department. Presumably the loans would fully be guaranteed by the Department, since the lenders would have no control over the management of the loans. Purchasers of servicing rights would make interest-bearing deposits with the Department, which would use them to fund the first level of nonpayment risk. Presumably the servicing rights would come with some stream of fee income to give them value above the right to get part of the deposits back. Any unused portions of the deposits would be returned to the servicers with interest. Why would an investor want to own a loan whose management is determined solely by fee level without regard to relative quality of service (other than presumably the presence of the servicer on some list of eligible entities)? What incentive would the servicer have to maximize its performance once default claims are likely to exceed the deposit? If loan owners bear a substantial portion of nonpayment risk themselves, why cannot the Department rely on them to make their own performance-based servicing arrangements? If Tom believes that this financial structure is consistent with our two auction-pilot models, he needs to address questions such as these.

Robin's comments on the loan-auction pilot:

1. Serial loans. Selling an existing loan with the right and/or obligation to make future loans to the same borrower would be a hybrid, probably closer to the rights-auction model than the loans-auction model, particularly for students who attend school for more than two years. The relative advantages/disadvantages are those for the two models.
2. Servicing retained. Account fragmentation (lack of common management of all loans of a single borrower) inconveniences borrowers and increases the cost of servicing, thereby increasing the need for Government subsidy of lenders. A loans auction servicing-released would likely increase the current level of account fragmentation. A loans auction servicing-retained with a mechanism to choose a single manager

for all loans of a borrower would eliminate account fragmentation. If Sallie Mae or any other servicer offered superior performance, loan owners bearing substantial risk of nonpayment would presumably choose it. For reasons stated above in my response to Tom's e-mail, it is probably not feasible to displace the selling lender as servicer in the pilot. The proposed pilot does not recommend any procedure for choosing among potential multiple servicers in the final program. In the mortgage market there is a procedure for qualifying servicers. The rating agencies would be a good source of input for any list of qualified servicers in the student-loan market. See my response to Tom above with respect to auctions of loan servicing.

3. Although the proposed legislation would require the sale of all types of loans in the pilot programs, it expressly provides that each auction parcel does not have to be a "representative sample." Since it does not seem feasible to test the sale of balanced packages in a rights-auction pilot and still maintain the entitlement to obtain a loan, I propose that we do so in the loans-auction pilot. We have discussed extensively the advantages and disadvantages of the two approaches: They basically involve specialization, critical mass and "transparency."

4. There is an inconsistency between this and the second question, since "auctions of servicing" (performanced-based servicing) are a form of risk-sharing. Although it might be feasible to conduct auction pilots with no changes in risk-sharing, doing so would miss a real opportunity to develop new structures in as part of an auction that would reduce the cost to the Government without diminishing student benefits. Since we are already proposing to test two different auction characteristics (rights vs. loans and homogeneous v. heterogeneous) in probably only two pilots, and uncertainty, informal boycotts, delays in attracting new entrants and the limited size and duration of the pilots will likely affect auction results, unambiguous information may prove an elusive goal anyway. Whatever change in lender terms were necessary to experiment with changes in risk-sharing could be made as part of the agreements with the selling lenders or as part of the auction terms.

5. The drafter of the loans-auction pilot may have a personal vision, but the pilot is designed to be as flexible as possible. Although fortuitously consistent with that vision, the origination and servicing structure proposed for the pilot is driven primarily by considerations of feasibility and the need at least not to increase the current school and account fragmentation in FFELP. As indicated by the attacks from lenders, the notion of moving the choice of loan originators from schools to auctions is hardly noncontroversial.

Author: TStan77346 <TStan77346@aol.com> at Internet
Date: 05/18/98 4:11 PM

Here is another straw person to consider, in the form of an auction to manage credit risk. The attachment is in Word 97. The idea also follows in text:

Discussion Draft
May 18, 1998

Credit Management: Another Type of Auction

As we develop our proposed auctions, it may be useful to include authority to auction the rights to manage the government's credit risk exposure on outstanding FFEL (and ultimately FDLP) loans. Consider how such an auction might work for a portfolio of FFEL loans:

- " The government would compile information about a specified pool of outstanding FFEL loans;
- " The government would auction the function of managing credit risk on the government's guarantee of those loans;
- " The government could, for example, structure the auction to be similar to sales of catastrophic event bonds by some insurance companies;
- " The bidders would purchase government obligations at a rate of return fixed by the auction. The government would pay claims on its FFEL guarantee from the paid-in principal received from sale of the bonds;
- " Upon maturity of the obligations, holders would receive their paid-in principal minus the aggregate cost of claims that the government paid for the FFEL loans in the portfolio. Note that this model could be adjusted to take account of the cost of delinquencies as well as defaults.

The benefit of this form of auction would be that it creates an incentive for the private bondholders to assure that a financially qualified private party capably manages the credit risk on FFEL loans. This sale of obligations could be used to supplement the other auctions (of loans and rights) that we are developing.

All comments are cordially invited.

This email message and attachments have been scanned and found
to be free of all known viruses.

Message Copied To:

John_Kane @ ed.gov (John Kane)
William_Graham @ ed.gov (William Graham)
Barry White/OMB/EOP
jonathan.gruber @ treas.sprint.com
Robert M. Shireman/OPD/EOP
Wayne Upshaw/OMB/EOP
robins @ cbo.gov
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Maureen_McLaughlin @ ed.gov (Maureen McLaughlin)
Pauline_Abernathy @ ed.gov (Pauline Abernathy) }

To: Members of H. Education & Workforce Committee
& S. Labor & Human Resources Committee

1

Dear 2:

As you know, current law mandates a new interest rate formula for government-guaranteed and direct student loans after July 1, 1998, that will substantially reduce students' interest costs. Virtually everyone agrees that this law must be changed to prevent many private lenders from leaving the guaranteed loan program, and I am encouraged by the recent bipartisan and productive discussions concerning how best to protect the interest of students, lenders, and taxpayers.

Nevertheless, I am also concerned that some lenders have indicated that, unless resolved soon, the mandated changes may lead their organizations to leave the guaranteed loan program. Therefore, I urge you and your Congressional colleagues to resolve the student loan interest rate issue soon enough to ensure that there is no reason for lenders to withdraw their support for this valuable program.

As Secretary of Education, however, I have a statutory responsibility to ensure uninterrupted access to student loans. It is only prudent to prepare for the unlikely but possible circumstance that some lenders might withdraw from the program. To avert any possible problem in access to student loans, Congress has given me the authority to require the Student Loan Marketing Association (Sallie Mae) and the 36 guaranty agencies to serve as "lenders of last resort."

I have attached a summary of the Department's plan for implementing a lender-of-last-resort program. In the unlikely event that such a program is necessary, the information we have received from Sallie Mae and the guaranty agencies shows that, together, they could meet the entire nationwide demand for student loans in a cost-effective manner. Although I believe that our mutual efforts to resolve this issue will prevent any loan access problem from occurring, we must begin implementing this plan now in order to ensure that last-resort loans are available to students on July 1, if needed. Therefore, I have asked my staff to begin implementing a lender-of-last-resort program immediately.

Finally, although I remain optimistic that this law will be amended before July 1, I am legally obligated to determine the new student loan interest rate on June 1 and publish a notice of it soon thereafter. Unless the law is changed, I will have no choice but to base the calculation of the new

Page 2

interest rate upon the formula in current law. However, the student loan interest rate may still be changed by an act of Congress at any time before it becomes effective on July 1. Our notice in the Federal Register will reflect the possibility of such Congressional action.

I am certain you can appreciate the need to take these steps. Again, I look forward to working with you to resolve this important issue as quickly as possible.

Yours sincerely,

Richard W. Riley

Enclosure

The Clinton Administration's Plan for Ensured Access to Student Loans

Summary

In the unlikely event that some private lenders participating in the guaranteed student loan program substantially reduce their activity after July 1, the Clinton Administration will use the tools that Congress has provided to ensure that all eligible students continue to have uninterrupted and timely access to student loans through the guaranteed loan program.

The Administration has requested the Student Loan Marketing Association (Sallie Mae) and each of the 36 guaranty agencies to meet their statutory obligation to act as "lenders of last resort" if eligible students cannot obtain loans through normal channels to attend eligible schools. According to their responses, Sallie Mae and the guaranty agencies could together provide many more loans than would be necessary under any scenario.

A lender-of-last-resort program would deal with any loan access problem within the government-guaranteed loan program in a cost-effective manner.

Background

Under the Higher Education Act of 1965, as amended (HEA), the interest rate on new student loans made through the Federal Family Education Loan (FFEL) program and the Direct Loan program is scheduled by law to be changed on July 1, 1998, reducing student costs of borrowing for higher education by hundreds, in some cases even thousands, of dollars.

Under current law for both the FFEL and Direct Loan programs, the interest rate for student loans is 2.5 percentage points above the rate for 91-day Treasury bills while students are in school and 3.1 percentage points above the 91-day T-bill during repayment. As part of the 1993 student loan reform, Congress added subsections 427(A) and 455(b)(3) to the HEA to change these rates to a single rate of 1.0 percentage point above the rate for "securities of a comparable maturity" -- which is anticipated to be an index of 10- to 20-year government securities -- for new loans disbursed after July 1, 1998. This new interest rate formula is projected to reduce the weighted interest rate from about 7.8 percent to about 7.0 percent -- reducing students' interest costs by roughly one-tenth.

The Clinton Administration has proposed a reasonable solution that would enable the scheduled interest rate reduction to go into effect while changing the interest rate instrument and making other improvements in the program to provide lenders with a profit sufficient to continue to participate in the program. The Administration has also proposed a small subsidy to lenders as part of a move toward setting lender returns through a market-based mechanism, rather than by statute.

The House and Senate committees have offered a proposal to preserve the savings for students, but it would force taxpayers to pay an additional subsidy of \$2.7 billion over five years to lenders to give them higher returns.

Nonetheless, some lenders have threatened to discontinue making at least some student loans unless they receive an interest rate that is still higher than specified by either proposal.

It is not yet clear how this issue will be resolved. Because some lead time is necessary to implement the lender-of-last-resort provisions for very large volumes, it is only prudent for the Department to prepare now for the unlikely possibility of substantial lender withdrawal from the student loan program. Regardless of lender participation, the Department will ensure students uninterrupted and timely access to FFEL loans.

Demand for Loans

There is a wide range in the profitability of government-guaranteed student loans for lenders. The least profitable loans are generally those made to students attending two-year or shorter term institutions, including community colleges and proprietary schools, who generally have smaller loans with higher proportionate servicing costs. But even within this category of loans, which totaled roughly \$3.2 billion in academic year 1996-97, there are many loans that have relatively high loan balances and therefore are relatively more profitable for lenders.

The Department is designing a safety net capable of providing more than \$3 billion in last-resort loans. We believe that this capacity is more than sufficient to ensure loan access under any likely scenario, but this volume could be expanded if that is necessary.

Capacity Exists to Ensure Loan Access

In March, the Department surveyed Sallie Mae and the 36 guaranty agencies to determine their ability to provide loans to students who are otherwise unable to get them. According to their responses, Sallie Mae and the guaranty agencies could together provide enough loans to ensure uninterrupted access to FFEL loans under any scenario.

Upon the request of the Secretary of Education, Sallie Mae is required under section 439(q) of the HEA to serve any eligible students who cannot otherwise obtain student loans. There is no specific provision for the advance of federal funds to Sallie Mae.

In addition, guaranty agencies are required by Section 428(j) of the HEA to act as lenders of last resort or to arrange for other entities to act as lenders of last resort on their behalf. Under sections 422(c)(7) and 428(j)(3) of the HEA, the Secretary has the authority to advance federal funds to guaranty agencies, on appropriate terms and conditions, to be used to make loans as a

lender of last resort. A guaranty agency serving as a lender of last resort would be paid a fee established by the Secretary for making such loans in place of the traditional interest payments made to lenders.

Some guaranty agencies requested federal advances to fund the student loans, while others indicated that they did not need federal advances.

Sallie Mae's Participation

Founded by Congress as a "government-sponsored enterprise" to serve students, Sallie Mae has a legal obligation to make loans to all eligible students who cannot otherwise get them. In 1993, Congress imposed this responsibility in exchange for the many economic benefits that it had conferred on Sallie Mae. Under that law, if Sallie Mae fails to meet this legal obligation, the Secretary may -- among other remedies -- increase the 0.30 percent offset fee to 1.0 percent, potentially costing Sallie Mae hundreds of millions of dollars.

Long before lenders threatened to leave the FFEL program because of the scheduled July 1, 1998 interest rate change, Sallie Mae contractually committed itself to allocate \$200 million for lender-of-last-resort loans. This agreement did not limit Sallie Mae's legal responsibility. Sallie Mae now serves as a lender of last resort for students in Texas and Puerto Rico under this agreement.

The Department informally asked Sallie Mae to agree to provide up to 350,000 loans with its own capital during academic year 1998-99, only half of which would be made between July 1, 1998, and December 31, 1998. Based on Sallie Mae's own numbers, Sallie Mae is easily capable of making these loans with its current infrastructure.

It has become apparent from the Department's communications with Sallie Mae, however, that Sallie Mae is refusing to prepare to fulfill its statutory obligations as requested by the Department, beyond the existing \$200 million arrangement, unless it can dictate to the Department the terms of such participation. Because of the need for advance preparations, Sallie Mae's recalcitrant conduct could jeopardize the development of an effective and timely lender-of-last-resort plan to be ready in the unlikely event of a loan access problem.

The Department's primary responsibility is to ensure that students have continued timely access to government-guaranteed student loans. We have decided, at least for the present, to establish the necessary safety net by working primarily with the guaranty agencies, which have acknowledged and willingly agreed to meet their statutory obligation.

However, in addition to requiring Sallie Mae to fulfill its existing \$200 million commitment -- a critical component of the safety net -- the Department reserves the right to require Sallie Mae to increase its lender-of-last-resort lending should circumstances change, and to take whatever action against Sallie Mae is appropriate if it fails to comply with a formal request to make lender-of-last-resort loans in excess of \$200 million.

We regret that although Sallie Mae is fully realizing the benefits resulting from its special status as a government-sponsored enterprise, it is refusing to fulfill its concomitant statutory obligations, at the expense of the taxpayers.

Nationwide Network of "Backstop" Lenders

Three large guaranty agencies -- Pennsylvania Higher Education Assistance Agency (PHEAA), United Student Aid Funds, Inc. (USAF), and Great Lakes Higher Education Guaranty Corporation (Great Lakes) -- have informed us that, together, they have the capacity to make more student loans than we believe will be necessary under any likely scenario.

Consequently, the Department has asked PHEAA, USAF, and Great Lakes to be "backstop" lenders in addition to Sallie Mae. Together, these four organizations will ensure that students nationwide have uninterrupted access to student loans in the event that other guaranty agencies are unable to provide last-resort loans to students in their own states. The Department has assigned one or more of these organizations to each state to serve as the backstop lenders if the state's guaranty agency is unable to provide or arrange for a last-resort loan.

Obtaining Last-Resort Loans

Under the Administration's plan, a school that is unable to locate a lender willing to provide loans to its students must notify its state's designated guaranty agency and certify that its students have been unable to obtain loans. The guaranty agency will review the school's certification of need for last-resort loans, and then:

- provide those loans itself, if necessary with federal advances,
- provide them through an agreement with a third-party lender, if necessary with federal advances, or
- ask the state's assigned backstop lender to provide them.

To allow schools to take advantage of pre-existing relationships without unduly complicating this process, a school may locate its own source for last-resort loans by agreement with the guaranty agency for its state.

Fee Structure

Lenders of last resort will be compensated differently from lenders making regular FFEL loans:

- The federal government would reimburse lenders for 100 percent of defaulted loan balances, while it pays for only 98 percent of default costs on regular FFEL loans;
- Lenders who make last-resort loans with federal funds would be paid a fee set by the Secretary in lieu of special allowance payments and interest payments, and any interest paid by borrowers would be turned over to the Secretary of Education; and

- Sallie Mae would not be required to pay the 0.30 percent offset fee on last-resort loans it makes.

This plan would deal with any student loan access problem in a cost-effective manner.

The Department's Accounting and Financial Management Service has begun designing and establishing the financial accounts and monitoring and reconciliation processes necessary to make federal advances to guaranty agencies for the purpose of last-resort loans. These systems will be fully implemented before July 1.

The Direct Loan Program

The Direct Loan program does not rely on private lenders and therefore does not have the potential loan access problem that exists in the FFEL program. However, we do not envision using Direct Loans to ensure loan access if lenders reduce their participation in the FFEL program.

The Administration is committed to maintaining access to student loans through the FFEL program. As always, the Direct Loan program will remain available to schools who choose to participate in it.

Draft of 5/15/98

Pilot Program for Auction of FFELP Loans

I. Principal Objective

To test whether the sale by auction of loans made under the Federal Family Education Loan Program (FFELP) would minimize the cost of those loans to the Government

A portfolio of existing loans should theoretically have a greater value to a lender than the right to originate a portfolio in the expectation that it will have the same characteristics as the actual portfolio. The loan-auction pilot, in conjunction with a contemporaneous rights-auction pilot, would be designed to test and quantify that theory.

II. Subsidiary Objectives

A. To test whether auctions of balanced (heterogeneous) parcels would be cost-effective

B. To test whether facilitation of separate loan management and loan ownership would be cost-effective

C. To test whether changes in the current allocation of risk (interest rates and/or nonpayment) between lenders and the Department of Education (ED) would be cost-effective

III. Pilot Design

ED would be authorized to make voluntary agreements with eligible lenders for up to 10 percent of total new FFELP volume, under which the lenders would sell at public auction FFELP loans owned by them, with price guarantees from ED. Auctions would be subject to minimum acceptable bids (reserves) set by ED. Loans that failed to attract bids at least equal to the reserves would continue to be serviced by the sellers until they could be re-auctioned. It might be necessary to provide Federal funding to hold the loans in the meantime. Other auction terms would be determined by ED. The distribution of any premiums over the guaranteed prices would be subject to agreements between the seller and ED.

Loans would be auctioned in balanced (heterogeneous) parcels.

Loans would be auctioned servicing-retained, but ED would only establish such relationships with lenders with quality servicing operations. Sellers would establish trustee-lender facilities to broaden the universe of potential bidders.

The loans auctioned would have standard FFELP borrower terms, which could not be changed. ED would be authorized to experiment with changes in lender terms, such as lender interest rate, special allowance and scope of guaranty. At the very least, ED would experiment with the auction of non-guaranteed loans that the holder was entitled to resell to ED if the borrower elected income-contingent repayment (ICR) and provided the same information about his/her income that is required under DL. Since the lender would assume all risk of nonpayment by a borrower with sufficient income, due diligence regulations for lenders could be relaxed/removed.

IV. Issues To Be Addressed for Pilot

- A. Administrative resources
- B. Funding of pilot expenses and interim holding of auctioned loans that failed to meet the reserve prices
- C. Effect of changes in lender terms on competition between pilot and other lenders
- D. Mechanism for administration of ICR loans
- F. Auction procedures

V. Additional Issues To Be Addressed for Full-Scale Program

A. Loan Origination

Because of time constraints, the pilot would solely utilize on a voluntary basis the existing system for loan origination in FFELP: private lenders selected by schools/borrowers. A full-scale program could also be devised on that system: The current FFELP origination system could remain in place, but a mechanism could be established by which private originating lenders would be required to subject their loans to public auction on an individual or combined basis at some point after origination. Although FFELP lenders have made great strides since the advent of Direct Lending (DL) in reducing the complexities for schools in dealing with multiple lenders, they have not yet achieved the single (at any one time) point of contact for schools offered by DL. In formulating a full scale program, consideration should be given to mandating the creation of a virtual single originator through systems such as Project

ELM or Project EASI or the creation of a single governmental or non-governmental originator.

B. Loan Management

DL also offers borrowers a single point of contact, subject to the possibility of the same change of servicer for all loans of that borrower. Such combined loan management also affords substantial economies in servicing costs to lenders. Again because of time constraints, the pilot would designate the selling lender as the manager for all loans that were auctioned, thereby achieving these advantages for loans made in the pilot. If the current origination system is maintained for the full-scale program, that arrangement could also be maintained. Not all originating lenders manage their own loans for their full lives, however; and such an arrangement would make it unlikely that all loans to a student attending multiple schools would come under common management. The situation would be substantially complicated further if it was decided to have a single loan originator and multiple servicers. In that case it would be necessary to devise a procedure to accumulate under common management loans to a single borrower that were under multiple ownership. In addition, although a mechanism under which the owners of all loans by a single borrower may change the single servicer for that borrower is too complex for pilot testing, it is probably necessary for a full-scale program.

C. Role of guaranty agencies

5/15/98 2:30 p.m.

Technical drafting assistance [auction mechanisms alternative]
[page and line numbers refer to the reported version of S. 1882]

Page 458, insert immediately after line 2 the following (and renumber accordingly):

“MARKET-BASED DETERMINATIONS OF LENDER RETURNS

“SEC. 425. Part B of title IV is further amended by inserting immediately after section 427A the following new section:

“MARKET-BASED DETERMINATIONS OF LENDER RETURNS

“SEC. 427B. (a) FINDINGS.--The Congress finds that--

“(1) Federal subsidies to lenders making, or holding, loans made, insured, or guaranteed under this part should not exceed the level necessary to ensure that all eligible borrowers have access to loans under this part;

“(2) setting the level of lender returns necessary to achieve the objective described in paragraph (1) in statute is inexact and insufficiently flexible to respond to market forces, and therefore lender returns should be determined through the use of market-based mechanisms;

“(3) alternative market-based mechanisms must be tested before a final selection is made as to the particular mechanism to be used for all loans made, insured, or guaranteed under this part,;

“(4) the results of testing of alternative market-based mechanisms should be evaluated independently; and

“(5) if the independent evaluation concludes that the testing of alternative market-based mechanism has been successful, a market-based mechanism to determine lender returns on all loans made, insured, or guaranteed under this part should be implemented as expeditiously as possible.

“(b) JOINT PLANNING STUDY TO SELECT AUCTION-BASED MECHANISMS FOR TESTING.--(1) The Secretary of Education and the Secretary of the Treasury shall jointly

conduct a planning study, in consultation with the Office of Management and Budget, the Congressional Budget Office, the Congressional Research Service, and the General Accounting Office, to--

“(A) select for testing two or more auction-based mechanisms to determine lender returns on loans made, insured, or guaranteed under this part; and

“(B) determine what related administrative and other changes would be required in order to ensure a successful implementation of auction-based determinations of lender returns for all loans made, insured, or guaranteed under this part.

“(2) Any auction-based mechanism selected for testing in the planning study required by this subsection shall be designed to minimize Federal cost when fully phased in. Any such mechanism shall also be designed to--

“(A) ensure loan availability under this part to all eligible students at all participating institutions;

“(B) minimize administrative complexity for borrowers, institutions, lenders, and the Federal Government;

“(C) maintain the participation of a broad spectrum of lenders and ensure healthy long-term competition in the program under this part.

“(3) In carrying out the planning study, the Secretary of Education and the Secretary of the Treasury shall, to the extent they determine practicable within the time allotted for the study, consult with experts on auction-based mechanisms and current and potential program participants whose participation may be affected by the use of an auction-based mechanism.

“(4) A report on the results of the planning study, together with a plan for implementing two or more pilot programs using promising auction-based approaches for determining lender returns, shall be transmitted to Congress not later December 31, 1998.

“(b) PILOT PROGRAMS.-- (1)(A) Notwithstanding any other provision of this part,

conduct a planning study, in consultation with the Office of Management and Budget, the Congressional Budget Office, the Congressional Research Service, and the General Accounting Office, to--

“(A) select for testing two or more auction-based mechanisms to determine lender returns on loans made, insured, or guaranteed under this part; and

“(B) determine what related administrative and other changes would be required in order to ensure a successful implementation of auction-based determinations of lender returns for all loans made, insured, or guaranteed under this part.

“(2) Any auction-based mechanism selected for testing in the planning study required by this subsection shall be designed to minimize Federal cost when fully phased in. Any such mechanism shall also be designed to--

“(A) ensure loan availability under this part to all eligible students at all participating institutions;

“(B) minimize administrative complexity for borrowers, institutions, lenders, and the Federal Government;

“(C) maintain the participation of a broad spectrum of lenders and ensure healthy long-term competition in the program under this part.

“(3) In carrying out the planning study, the Secretary of Education and the Secretary of the Treasury shall, to the extent they determine practicable within the time allotted for the study, consult with experts on auction-based mechanisms and current and potential program participants whose participation may be affected by the use of an auction-based mechanism.

“(4) A report on the results of the planning study, together with a plan for implementing two or more pilot programs using promising auction-based approaches for determining lender returns, shall be transmitted to Congress not later December 31, 1998.

“(b) PILOT PROGRAMS.-- (1)(A) Notwithstanding any other provision of this part,

beginning not less than 60 days after the study report described in subsection (a) has been transmitted to Congress, the Secretary is authorized, in consultation with the Secretary of the Treasury, to carry out pilot programs meeting the requirements of this subsection in accordance with the implementation plan included in the study report.

“(B) The Secretary shall commence the implementation of the pilot programs under this subsection not earlier than the first full academic year beginning after the date of enactment of the Higher Education Amendments of 1998, and not later than the second full academic year beginning after such date.

“(C) The pilot programs under this subsection shall be not more than two academic years in duration, and the Secretary may use the pilot programs to determine the lender returns for not more than exceed 20 percent of the annual loan volume under this part during such period.

“(2) In carrying out pilot programs under this subsection, the Secretary--

“(A) shall use auction-based approaches, in which lenders bid competitively for such loans under this part, or rights to originate such loans, as the Secretary shall determine;

“(B) shall examine--

“(i) whether it is most appropriate to auction existing loans under this part, the right to originate such loans, or a combination thereof;

“(ii) whether it is preferable to auction parcels of such loans, or rights, that are similar or diverse in terms of loan or borrower characteristics;

“(iii) whether it would be appropriate to facilitate separate management and ownership of such loans, and what administrative and other procedures would best do so; and

“(iv) what is the appropriate reallocation of risk between the Federal Government and the owners of such loans with respect to interest rates and nonpayment

of loans;

“(C) shall determine which of the auction-based approaches tested in the pilot programs best meets the purposes described in subparagraphs (A), (B), and (C) of subsection (a)(2);

“(D) may determine the stated interest rate for lenders, other payments to lenders, and the terms, applicable to lenders, of the rights or loans, as the case may be, for which the lenders bid; and

“(E) shall include loans of different amounts and loans made to different categories of borrowers, but a representative sample of loans or borrowers shall not be required for each auction of rights or loans under a pilot program.

“(3) Participation in a pilot program under this subsection shall be voluntary for eligible institutions, eligible lenders, and States.

“(4) The Secretary shall--

“(A) obtain an independent evaluation of the pilot programs that shall be completed, and the results of the evaluation submitted to the Secretary, the Secretary of the Treasury, and Congress, by no later than 120 days after the end of the pilot programs under this subsection; and

“(B) consult with a broad range of program participants, pilot program participants, and other interested parties concerning their views on the success of the pilot programs, and their suggestions for improvements.

“(5) Notwithstanding any other provision of law, the Secretary may waive the application of any procurement statute or regulation to the pilot programs under this subsection if the Secretary determines that such waiver is necessary for the successful implementation of the pilot programs.

“(c) IMPLEMENTATION OF MARKET-BASED SYSTEM.--Notwithstanding any other provision of this part, for the first full academic year beginning not less than 120 days after

the independent evaluation described in subsection (b)(4)(A) has been transmitted to Congress, and succeeding academic years, the Secretary is authorized to implement for all loans made under this part (other than loans made under section 428C), a program-wide, auction-based system to determine returns to all lenders as the Secretary determines appropriate, provided that--

“(1) the Secretary of the Treasury, in consultation with the Secretary of Education, has certified that the auction-based system that the Secretary of Education intends to implement on a program-wide basis will ensure loan availability under this part to all eligible students at all participating institutions;

“(2) the Secretary has promulgated regulations establishing the structure of the auction-based system; and

“(3) the Secretary has notified the Congress of the Secretary’s intent to implement a program-wide auction-based system, and provided a description of the structure of the auction-based system, at least 120 days before implementing such system.

“(d) [funding].”

Page 456, lines 6-7, strike out “clauses (ii), (iii) and (iv) of this subparagraph,” and insert in lieu thereof “clauses (ii), (iii), (iv) and (v).”

Page 456, line 17, strike out “2.8 percent” and insert in lieu thereof “2.5 percent”.

Page 457, lines 2-3, strike out “2.2 percent” and insert in lieu thereof “1.9 percent”.

Page 457, insert immediately after line 22 the following (and redesignate accordingly):

“(c) SMALL LENDER ORIGINATION SUBSIDY PAYMENT.--Part B of title IV is further amended by adding immediately after section 438 the following new section:

“SMALL LENDER ORIGINATION SUBSIDY PAYMENT

“SEC. 438A. (a) In order to maintain the participation of a broad spectrum of lenders and long-term competition in the program under this part, the Secretary shall pay, to each eligible lender that meets the requirements of subsection (b), a one-time payment equal to 0.20 percent of the principal amount of each loan made under this part (other than loans made under section 428C) by such lender. The Secretary shall make such a payment on each such loan that is made by such lender during the period beginning [October 1, 1998?] and ending when the Secretary implements a program-wide, auction-based system to determine returns to all lenders, as described in section 427B(c), except that such program-wide auction-based system shall include such other provisions as the Secretary determines appropriate to encourage the continued participation in the program of lenders meeting the requirement of subsection (b).

“(b) An eligible lender shall receive the payment described in subsection (a) if the eligible lender made [not more than \$1,000,000 in new loans (other than loans made under section 428C) in the preceding fiscal year/an average of not more than \$1,000,000 in new loans (other than loans made under section 428C for each of the three preceding fiscal years)].”

Page 457, line 23, strike out “The” and insert in lieu thereof “Except as the Secretary may otherwise provide under section 427B, the”.

Page 505, strike out line 5 through page 506, line 16.

URGENT

Total Pages: 5

LRM ID: CJB214

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
Washington, D.C. 20503-0001

Tuesday, April 28, 1998

LEGISLATIVE REFERRAL MEMORANDUM

TO: Legislative Liaison Officer - See Distribution below *Connie O'Garra for*

FROM: Janet R. Forsgren (for) Assistant Director for Legislative Reference

OMB CONTACT: Constance J. Bowers

PHONE: (202)395-3803 **FAX:** (202)395-6148

SUBJECT: EDUCATION; TREASURY Report on HR6 Higher Education Amendments of 1998 -- Student Loan Interest Rate Proposals

DEADLINE: *5:30*
~~2:00~~ p.m., today Tuesday, April 28, 1998

In accordance with OMB Circular A-19, OMB requests the views of your agency on the above subject before advising on its relationship to the program of the President. **Please advise us if this item will affect direct spending or receipts for purposes of the "Pay-As-You-Go" provisions of Title XIII of the Omnibus Budget Reconciliation Act of 1990.**

COMMENTS: Since the student loan interest rate proposals are now being considered by the House, this letter must be transmitted today. Therefore, this deadline is firm. If we do not hear from you, we will assume you have no objection.

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LRM ID: CJB214 SUBJECT: EDUCATION; TREASURY Report on HR6 Higher Education Amendments of 1998 -- Student Loan Interest Rate Proposals

**RESPONSE TO
LEGISLATIVE REFERRAL
MEMORANDUM**

If your response to this request for views is short (e.g., concur/no comment), we prefer that you respond by e-mail or by faxing us this response sheet. If the response is short and you prefer to call, please call the branch-wide line shown below (NOT the analyst's lino) to leave a message with a legislative assistant.

You may also respond by:

- (1) calling the analyst/attorney's direct line (you will be connected to voice mail if the analyst does not answer); or
- (2) sending us a memo or letter

Please include the LRM number shown above, and the subject shown below.

TO: Constance J. Bowers Phone: 395-3803 Fax: 395-6148
Office of Management and Budget
Branch-Wide Line (to reach legislative assistant): 395-7362

FROM: _____ (Date)
 _____ (Name)
 _____ (Agency)
 _____ (Telephone)

The following is the response of our agency to your request for views on the above-captioned subject:

Concur

No Objection

No Comment

See proposed edits on pages _____

Other: _____

FAX RETURN of _____ pages, attached to this response sheet

Dear

We are writing to express our concern about impending Congressional actions affecting the viability of the government guaranteed student loan program (FFEL). In particular, we are concerned about proposals to change the calculation of ceiling interest rates for student loans after July 1st of this year. As you know, current law mandates a new formula, scheduled to take effect on July 1, that will provide a substantial reduction in interest rates for students. As part of this change, the formula would shift to a different index for determining student loan rates. Because this index would be a longer-term yield, it would raise the cost to lenders, who finance themselves on a short-term basis. The Administration recognizes this problem for lenders and seeks to correct it.

In the spirit of balancing a competitive student lending market with students' access to an affordable education, the Vice President proposed on February 25th a plan that would deliver to students their full expected savings under scheduled law, while shifting back to a short-term index to provide a competitive rate of return for lenders. The Treasury Department's analysis of the student loan program indicated that the rate of return under this proposal would meet competitive criteria for maintaining the participation of private lenders in the FFEL program. Other proposals also might meet our three key principles: maintaining student access to private loan capital, and providing the lowest possible rate for borrowers, while being fully funded. Unfortunately, the current proposals under consideration in Congress only meet the first two goals, while imposing an unacceptable burden on the taxpayers, who would subsidize high profits for lenders.

By maintaining the scheduled interest rate cut, the proposal reported by the House and Senate committees does deliver substantial savings to students. However, it also provides FFEL lenders with a 50 basis points subsidy above what students would pay, with the taxpayers financing the difference. Such an approach subsidizes excessive bank profits at the expense of scarce taxpayer resources, and threatens other domestic programs that would be cut in the Congressional budget process or by a sequester.

Two recent analyses, one by the Treasury Department and the other by the Congressional Budget Office (CBO), bolster the notion that lenders now earn a rate of return on equity from their student loans that substantially exceeds their overall rate of return, even in recent years of peak profits. Indeed, the CBO reported a rate of return on equity for lenders that securitize their loans of *almost double* the overall average rate of return to the banking sector in recent years. Lenders reap these high profits on an asset that is much safer (in terms of both credit and interest rate risk) than the typical bank loan, and that banks should be willing to acquire at a *lower* than average rate of return. As CBO stated in their recent report, "In summary, banks do not require the same returns on FFELs that they require overall, since federally guaranteed student loans are less risky than the average bank asset".

2

The House-Senate committee bills lock in these high rates of return. Treasury estimates that the proposed rates to be paid to lenders would yield an after-tax rate of return of 16 percent, a rate of profit above the recent high, banking industry average and one third above the average for the past 30 years. The CBO estimates that, for banks that securitize, the after-tax rate of return will be 19 percent, or almost one-third above the recent high profit levels. Thus, the House-Senate proposal provides returns substantially higher than banks' recent surging overall profit levels, on loans which they should be willing to make at rates of return below the average for their portfolios.

The costs of subsidizing these high levels of bank profits would be borne by the taxpayers under the House-Senate proposal. The Office of Management and Budget estimates these costs to be \$2.7 billion over the next five years. If these costs are not fully paid for, under Administration scoring, a sequester could be triggered with far-reaching consequences both for students and for other beneficiaries of mandatory programs. We should not be threatening other high priority programs, or jeopardizing the surplus that has been reserved for Social Security, in order to subsidize an excessive level of bank profitability.

The Administration supports an objective, market-based determination of appropriate lender returns under the FFEL program. The difficulty of the current debate highlights the value of letting the market determine the appropriate rate of return. A number of different auction-based mechanisms have the potential to achieve this outcome, and we are eager to work with Congress to find the right approach. We recognize the concerns of small lenders who worry about being excluded from the FFEL program under an auction model. One important feature of an acceptable market-based approach will be a viable mechanism to allow the continuation of small lender participation in this program.

In summary, the Administration opposes the proposal now before the Congress, and hopes Congress will continue its search for a true compromise, one that provides a low rate to students, maintains lender participation, minimizes taxpayer subsidies, and sets in motion a process for developing a market-based mechanism to determine lenders' returns on student loans. We can continue to have a healthy FFEL program without expensive bank subsidies. We look forward to working with you in developing such a plan.

Sincerely,

Robert E. Rubin
Secretary of the Treasury

Richard W. Riley
Secretary of Education

cc: The Honorable James M. Jeffords
 The Honorable Edward M. Kennedy
 The Honorable Pete V. Domenici
 The Honorable Frank R. Lautenberg
 The Honorable Ted Stevens
 The Honorable Robert C. Byrd
 The Honorable William F. Goodling
 The Honorable William L. Clay
 The Honorable John R. Kasich
 The Honorable John M. Spratt, Jr.
 The Honorable Bob Livingston
 The Honorable David Obey

Office of Economic Policy

Department of the Treasury
Washington, D.C. 20220

FAX

Date: 2/19/98Number of pages including cover sheet: 14

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To: Mr. Shireman	456-2223	456-2803
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Mr. White	395-7752	395-6150
Mr. Edlin	395-6870	395-5614
From: Jon Gruber	202-622-2633	622-0563

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

Folks -

Here is the latest revision of the key sections of the paper - the executive summary and the discussion of results, along with a revised set of tables.

This has not yet been approved by the secretary - this should not affect results but may affect wording choice.

Jon

The Financial Viability of the Government-Guaranteed Student Loan Program Executive Summary

The current student loan formula, which sets the ceiling rate for the government guaranteed student loan program and also for the direct loan program, is based on the bond equivalent yield for 3-month T-bills plus a spread of 2.5 percentage points for loans to students who are in school, and a spread of 3.1 percentage points for loans that are being repaid, with the rate reset annually for borrowers. The rate that the student pays on loans is capped at 8.25 percent and the Government pays any excess above this rate in the form of a Special Allowance Payment (SAP); SAPs also reimburse lenders on a quarterly basis for increases in the index interest rate within the year.

The Student Loan Reform Act of 1993 (SLRA) scheduled a change in the formula determining the rate that borrowers would pay for new student loans finalized beginning July 1, 1998. The SLRA requires that lenders' gross yield on new loans be based on "the bond equivalent rate of the securities with a comparable maturity as established by the Secretary of Education", in consultation with the Secretary of the Treasury, plus 1.0 percentage point, with the rate reset every 12 months. For the purposes of the government credit budget, the comparable maturity would be a 10-20 year average annual rate (simple interest). However, most observers have assumed that the comparable maturity that will be chosen will be the 10-year Treasury constant maturity yield.

Lenders under the guarantee program (Federal Family Education Loans, or FFEL) are concerned that loans under the new formula will not be profitable. Part of the reason is the cut in the markup from 2.50/3.10 percentage points over the benchmark rate to 1.0 percentage point; in today's interest rate environment, this results in a large implicit reduction in the interest rate on student loans. In addition, structurally, the move from a system which closely matches interest flows to financing costs (both short-term) to one which imposes a timing mismatch (with interest flows tied to a long term rate) exposes lenders to a new risk, with resultant costs and uncertainties.

This paper provides estimates of lenders' costs (including servicing, default and pre-payment costs as well as cost of funds) and of the return from student loans, under the current student loan formula and under the formula scheduled to become effective on July 1, 1998. We also provide an estimate of the "target" rate of return to which this return will be compared by banks deciding whether to participate in this program. Although we recognize the diversity of participants in student loan origination, our analysis is focused on large, for-profit bank originators. These institutions span the markets in which other lenders operate, and we believe that the economic forces at work on these lenders are the leading edge of developments that are likely unfold in this complex market. Our estimates of costs and target rates of return reflect this choice of focus. We have based our analysis on a review of the existing literature, financial data from loan originators, and discussions with many experts in this area.

Our results show that under the current formula, lenders are earning a pre-tax rate of return on student loans that exceeds a reasonable range of assumed target rates. Switching to the

scheduled student loan formula would reduce lenders' net return to a level below this target range. Such a reduction need not imply an immediate crisis in the market for guaranteed student loans, but it could be problematic in the longer term.

We also consider the implications of moving back to short-term interest rates as a basis for determining the student loan rate while holding borrowers harmless -- i.e., pegging the student loan rate at the same level as it would be under the new formula, using the 10-20 year average Treasury rate. We find that pursuing this approach for next year would result in a return to banks which is slightly below the range of estimated target rates of return; but, averaging over the next five years, such an approach can meet the lower end of this target range.

Our analysis may be summarized in the following points. First, unless our assumptions are substantially in error, the new formula will provide a rate of return on student loans that is below the target rate of return of for-profit bank lenders in the government-guaranteed student loan program, under current financial market circumstances. Second, there are inefficiencies associated with the mismatch of (long-term) student loan interest rates and (short-term) bank financing under the proposed formula, and joint benefits could be realized to students and lenders from moving back to a short-term index. Third, an alternative rate setting formula could be devised, linked to a short-term rate, that would maintain bank participation in the government-guaranteed student loan program at little or no net cost to students, relative to their expectations about the formula now scheduled to become effective in July. Fourth, preserving the existing differential between the mark-up for loans while the student is in school and loans during the in-repayment period would better track gross returns to costs.

Our confidence in the qualitative conclusions of the following analysis is high. Nevertheless, the uncertainties involved in this exercise points out the difficulties with regulatory determination of student loan interest rates. An alternative approach would be to use a more market-based mechanism for determining these rates. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans. The experience of the Health Education Assistance Loan (HEAL) program using an auction system for allocating the insurance authority for HEAL loans suggests that an auction could be considered for the Federal Family Education Loan program.

Summary Results and Some Empirical Evidence

As shown in Table 2, our estimate of the pre-tax weighted net return to lenders in 1997/98, for in-school loans and loans in repayment, is about 1.63 percent. It appears that, under the current student loan formula, lenders are earning more than their targeted rate of return for student loans. Student loans, however, may yield a slightly lower rate of return than the average return in recent years on banks' total portfolios.

As noted above, this return does not allow for discounts from the maximum student loan rate that banks may charge. For example, Sallie Mae offers a "Great Rewards Program" that allows borrowers who have made 48 consecutive loan payments on time a 2 percentage point discount of the loan rate. Other lenders have similar concessions. For Sallie Mae, the discount translates to about a 10-15 basis point reduction in return for their entire portfolio.¹ If this discount is the competitive standard for the industry, then banks' net returns are actually 1.48 to 1.53 percent after the cost of the discounts. We also did not allow for costs of marketing and promotional activity that would further reduce lenders returns.

On the other hand, this return also does not consider the fact that the interest rate for loans to parents (PLUS) is higher than the current rate for subsidized student loans: this rate is the one-year T-bill rate plus 3.1 percent, which is currently about 100 basis points higher than the rate for subsidized loans. This differential will be reduced somewhat by the costs of hedging this one-year instrument into a shorter term instrument, but it nevertheless provides excess returns to banks who are providing both subsidized and PLUS loans. Since PLUS loans are roughly 10 percent of loan volume, this implies at most a 10 basis point increase in net returns for the average bank, so it once again does not greatly affect our calculations.

In addition, we do not consider in our basic calculations the effect of loans in consolidation, although these are examined in some detail in Table 4. Until recently, the loan interest rate for loans in consolidation was the weighted average of the interest rates on all outstanding loans being consolidated, rounded up to the nearest whole percent; this figure is currently 9.0 percent. Under the Emergency Student Loan Consolidation Act, passed in October, 1997, the rate for consolidation loans will be the T-bill rate plus 3.1 percent until October, 1998 (capped at 8.25 percent). Under the system that existed before last October, the net return on loans in consolidation roughly mirrored the average return on loans in-school and in repayment. Under the current system, the net return on loans in consolidation is much lower. The impact on future profitability depends critically on whether the current treatment of loans in consolidation is extended or not.

The financial statements for 1996 for two major student loan originators are very consistent with our estimates. For one wholly student loan subsidiary, the annual pre-tax rate of return for 1996 was 1.65 percent; for another bank, their internal calculation of the implied rate of return to their student loan department was 2 percent. For the first bank, partial data for 1997

¹ Sallie Mae estimates that on the basis of current experience, less than 20 percent of borrowers qualify for a discount under these terms.

indicates a reduction in the rate of return to 1.3 percent.² The decline in returns for 1997 likely reflects, in part, the fact that the structure of interest rates in the short-term market became less favorable to lenders for a while last year than our assumptions allow. In particular, the Treasury bill rate, to which the short-term cost of funds is pegged in the assumptions used to analyze the current formula, tended to decline relative to other short-term rates (such as LIBOR) during the past year. In this situation, our assumptions will under-estimate the cost of matched funds for lenders. But this phenomenon appears to have been a temporary initial reaction to the financial disturbances in Asia (a "flight to quality"), and more recent data suggest that this trend has been reversed. We have assumed that banks will continue to be able to fund in a variety of markets with the spreads among rates similar to those that prevailed in the earlier part of 1997, before the Asian difficulties emerged.

Another source of profit data is Sallie Mae. Of course, this secondary market agency is not a loan originator, but its joint ventures and pre-purchase agreements bring it close to the origination market. Its rate of return on assets for 1997 (from partial data once again) is similar to that reported above for the student loan subsidiary: 1.2 to 1.3 percent. Their slightly lower return than our calculation may reflect, in part, premiums that it pays on loans acquired in the secondary market rather than aspects of its costs that are directly relevant to originators. Furthermore, its rate of return on capital is higher than would be implied for banks because, as a Government Sponsored Enterprise, Sallie Mae can operate now with a lower capitalization. Thus, for the present, it too seems to be earning at least an adequate rate of return. In the future, Sallie Mae can be expected to continue to operate a high-volume, low-margin activity as long as costs in the market for securitizations permit it to move a considerable volume of assets off its books fairly quickly. Sallie Mae's situation will change in an important respect, nonetheless, because of its transition to privatization. As a private entity, the holding company can be expected to be required by credit rating agencies to have higher capitalization than it now has; this will be relevant for its required return on assets which could become somewhat more similar to that of banks.

The return to lenders would fall significantly if the new student loan formula were changed from the 3-month T-bill rate plus 2.5/3.1 percentage points to a longer rate (either for 10-year Treasury notes, or to 10-20 year interest rates) plus 1.0 percentage point, in part because of the new risk associated with this change which raises the all-in cost of funding as a result of hedging. Table 2 shows that switching to the new student loan formula for loans in-school and in-repayment could reduce the weighted average pre-tax return to lenders from 1.65 percent under the current formula in 1997/98 to 0.38 percent to 0.55 percent under the new formula next year, if the 1999 Budget assumptions are borne out. These estimates, if correct, would be below the minimum target rate of return for lenders.

² For the first three quarters of 1997, this financial institution reported a net interest margin of 2.41 percent and operating expenses of .96 percent of average insured student loans. Assuming that its other costs were about .16 percent of its student loan assets, its pretax rate of return is 1.29 percent ($2.41 - .96 - .16 = 1.29$)

It may be noted, however, that these findings are somewhat sensitive to substantial interest rate movements within a year, i.e., between the time (end of May) when the student loan rate is determined by formula and the time when a lender actually makes a loan and finances it. For example, if the new formula were in place for the current school year, using the 10-year CMT rate, the risk-adjusted net return on assets for student loans in-school and in-repayment would be 1.1 percent. This is in the range of providing a satisfactory rate of return. However, this rate of return would have been achievable only because yields fell significantly after mid-1997, lowering the cost of funds relative to the second quarter of 1997 when the formula sets the student loan rate.

The fact that the yield curve historically has been much steeper than is currently projected was the reason in 1993 for expecting that the new formula would be financially acceptable. Adjusting the data for the years when the loan formula rate exceeded the 8.25 percent cap on the student loan interest rate, the 10-year rate plus 1.0 percentage point has been less than the 3-month T-bill rate plus 3.1 percentage points by an average of only 30 basis points since the early 1960s. The 1999 Budget assumptions project this difference to be 140 basis points in 1998, 130 basis points in 1999, and 120 basis points from 2000 through 2007 (with the T-bill based index higher); other projections have a similar contour. As noted above, swap dealers have documented to us that the all-in cost of funds for student loans tied to a long-term index (with an quarterly reset) would be substantially sensitive to the yield curve; that is, with the historically much steeper yield curve, banks would have earned a much higher profit on their student loans.

This historical pattern documents the difficulties with tying student loan interest rates to a long term index, when banks finance themselves on a short-term basis. This approach introduces a substantial risk into the banks portfolio, which is mitigated by swapping for a given loan but is not mitigated over time as the yield curve changes. The difficulty of using a long-term index for student loans should be seen not as a matter of betting on future yield curves but rather in light of the joint uncertainties for students and lenders that is implied by the experience between 1993 and 1998. The slope of the yield curve is notoriously uncertain, and mis-judgements about it have played a role in problems of lenders including the thrift institution difficulties of a decade ago. Making the profitability or the availability of guaranteed student loans dependent on such uncertainties seems to entail risks for both the users and the providers of student loans.

Regardless of this point, however, it is fairly clear that given average non-interest costs (averaging across in-school and in-repayment) of 87 basis points, a 100 basis point mark-up of the student loan rate over an index rate leaves very little room for profits except under favorable spreads between long-term indexed income and short-term indexed borrowing costs. And, as **Table 3** illustrates, this point is true looking forward over the next five years of projected interest rates as well. The first rows of Table 3 show that the rate of return to the banks would remain high if the current system were maintained. But the next rows show that the rate of return under the new legislation will remain below the target rate into the future as well as in the current environment.

Returning to a T-bill Index

The results in **Tables 2 and 3** imply that lenders will not receive a reasonable estimate of their target rate of return in the government-guaranteed student loan program if the scheduled change of formula takes place this July. As shown in Table 3 (second block of rows), the five year average return under the new formula would be 34-51 basis points, given the administration's economic assumptions. It should be noted that there is some variation in returns from one student loan year to the next in the table that arises largely from projected changes in the level of interest rates within each year; as noted above, in a year when the cost of funds falls relative to the level of interest rates in the second calendar quarter, which sets the student loan rate, the student loan becomes more profitable for the lender.³

As an alternative formula, we have calculated the returns to banks of returning the basis for student loans to a short-term rate, while holding borrowers harmless so that the total cost to a student next year would be no higher than under the new formula. Holding borrowers harmless over the next year would require that the student loan interest rate for 1988/99 is reduced to 3-month T-bill plus 1.73 percent to T-bill plus 1.98 percent, depending on whether the 10 year or 10-20 year rate is used (see **Table 3**). This appears to provide returns to lenders, in the range of 50-75 basis points, which fall just below their target rate of return. But, averaged over the coming five years, the rate which holds borrowers harmless rises to T-bill plus 1.83 percent to T-bill plus 2.11 percent. The latter figure provides a rate of return which meets the lower bound of the range of target rates of return.

Another possible formula would involve allowing lenders the minimum rate of return that would make student loans profitable according to a target rate of return criterion. We calculate that the loan rate under this approach would range from T-bill plus 2.1 percentage points to T-bill plus 2.45 percentage points; this uses the second quarter interest rate for each year to set the appropriate markup. All of these loan rate would be somewhat higher than would prevail under the formula now scheduled to go into effect at mid-year. Any of the rates would represent, however, a significant reduction in the cost relative to the current system (roughly 45-80 basis points from the current markup of 2.9, using a weighted average of the rates in-school and in repayment). The savings to students would be roughly that projected when the SLRA scheduled this rate change for July 1, 1998.

While the discussion thus far has been phrased in terms of a single markup over the

³For example, note that from 2000/01 to 2000/02, the spread between the 91 day and 10 year rates is unchanged, while the rate of return to banks falls by 5 basis points. The reason for this seeming discrepancy is that short-term interest rates are projected to be falling after the second quarter of 2000, boosting lenders' profitability in that year. Interest rates are projected to be flat after the second quarter of 2001, so that bank profitability is lower. Thus, movements in interest rates after the second quarter can affect bank profitability, even while constant year-year second quarter interest rates imply the same rate to borrowers.

interest rate index, our research has confirmed the significant differences in lenders costs for loan in-school and in-repayment, as is recognized by the current 60 basis point differential. Continued recognition of these cost differences in the formula setting returns would help to even out returns across types of lenders.

Market-Based Mechanisms

The uncertainties involved in this exercise points out the difficulties with regulatory determination of student loan interest rates. An alternative approach would be to use a more market-based mechanism for determining these rates. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans.

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

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

The success of the HEAL auction, however, does not necessarily imply that an auction will guarantee large savings for FFEL. The successful bidders for the HEAL program generally have been not-for-profit State agencies. As such, their debt is not taxable, which allows them to borrow at rates that are well below the cost of funds for others who are not exempt from taxes. If an adjustment is made for the difference between the interest rates for a tax-exempt and a taxable security, the effective student loan interest rate might not be much, if any, different between the

HEAL and FFEL programs. Moreover, the HEAL program involves only \$85 millions currently and probably less than \$400 million if an authorization/appropriation is enacted by next fall. The experience with this small program may not be completely transferable to a \$20-25 billion program that has a 98 percent guarantee rather than 100 percent and whose borrowers are more diverse and do not have the same risk characteristics as HEAL borrowers.

Concluding Remarks

The results presented in this paper rest on a number of assumptions about the cost structure of the student loan program, projections of the term structure of interest rates and the costs of hedging loans tied to long-term interest rates, and estimates of the target rate of return for lenders. These results therefore have a degree of uncertainty that is not necessarily reflected in our tables. Nevertheless, most of our conclusions are fairly robust to variations in assumptions.

Our analysis may be summarized in the following points. First, unless our assumptions are substantially in error, the new formula will provide a rate of return on student loans that is below the target rate of return of for-profit bank lenders in the government-guaranteed student loan program, under current financial market circumstances. Second, there are inefficiencies associated with the mismatch of (long-term) student loan interest rates and (short-term) bank financing under the proposed formula, and joint benefits could be realized to students and lenders from moving back to a short-term index. Third, an alternative rate setting formula could be devised, linked to a short-term rate, that would maintain bank participation in the government-guaranteed student loan program at little or no net cost to students, relative to their expectations about the formula now scheduled to become effective in July. Fourth, preserving the existing differential between the mark-up for loans while the student is in school and loans during the in-repayment period would better track gross returns to costs.

Our confidence in the qualitative conclusions of the following analysis is high. Nevertheless, the uncertainties involved in this exercise points out the difficulties with regulatory determination of student loan interest rates. An alternative approach would be to use a more market-based mechanism for determining these rates. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans. The experience of the Health Education Assistance Loan (HEAL) program using an auction system for allocating the insurance authority for HEAL loans suggests that an auction could be considered for the Federal Family Education Loan program.

TABLE 1: INTEREST RATE ASSUMPTIONS
(Percent)

SOURCE	1997	1998	1999	2000	2001	2002	5-year ave.
OMB ('99 Budget)							
3-month T-bill	5.17	5.13	5.01	4.91	4.81	4.81	4.93
10-year note	6.75	5.86	5.80	5.80	5.70	5.70	5.77
Spread	1.58	0.73	0.79	0.89	0.89	0.89	0.84
memo: 10-20 simple a/	6.77	6.11	6.03	6.03	6.03	6.03	6.05
Blue Chip (Feb.98)							
3-month T-bill	5.17	5.24	5.24	—	—	—	—
10-year note	6.75	5.80	6.00	—	—	—	—
Spread	1.58	0.56	0.76	—	—	—	—
CBO (Jan'98)							
3-month T-bill	5.17	5.45	5.34	4.93	4.82	4.82	5.07
10-year note	6.75	6.00	6.10	6.00	5.90	5.90	5.98
Spread	1.58	0.55	0.76	1.07	1.08	1.08	0.91
DRI (Jan'98)							
3-month T-bill	5.17	4.95	4.53	4.21	4.2	4.22	4.422
10-year note	6.75	5.64	5.78	5.63	5.47	5.33	5.57
Spread	1.58	0.69	1.25	1.42	1.27	1.11	1.15
Implicit Forward Rates b/							
3-month T-bill	—	5.17	5.40	5.33	5.64	5.33	5.374
10-year note	—	5.67	5.80	5.92	6.03	6.14	5.912
Spread	—	0.50	0.40	0.59	0.39	0.81	0.54

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1; all other OMB data are for the second calendar quarter while data from other sources are for calendar years, as published. All bill rates are converted to a bond equivalent basis.

a/ The average simple annual interest rates for 10 to 20 year Treasury bonds, as used in credit budget scoring.

b/ Forward rates for June of each year, as of February 10, 1998.

n.a. Not available.

02/17/98

TABLE 2: INTEREST SPREAD AND COST ASSUMPTIONS
(Percent or Basis Points)

Income or Cost Category	Current Policy		Future Policy: 10-year CMT		Future Policy: 10-20 year	
	In-School	Repayment	In-School	Repayment	In-School	Repayment
Loan income, after hedging if needed a/	Bills + 2.50	Bills + 3.10	Bills + 1.60	Bills + 1.60	Bills + 1.77	Bills + 1.77
Lenders' cost of matched funds b/	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70
For 1997/8 & 98/9	5.85	5.85	5.77	5.77	5.77	5.77
Interest spread	1.80	2.42	0.96	0.96	1.13	1.13
Grossed-up interest spread c/	2.11	2.71	1.25	1.25	1.42	1.42
Servicing and other costs d/	0.41	1.13	0.41	1.13	0.41	1.13
Net income on assets before tax, '97/8 &	1.70	1.58	0.84	0.12	1.01	.29
Weighted average net income on assets e/	1.63		0.38		0.55	

Note: Costs are representative of large for-profit lenders who both originate loans and hold loans in-repayment in their portfolios.

a/ For current policy, loan income is the formula determination, based on Q2 interest rate; for future policy, loan income is determined under the formula and then reduced by the cost of hedging the loan to convert it into a short-term denominated asset.

b/ All-in costs are the cost of matched funds, which are assumed to be essentially the same whether raised in a T-bill denominated securitization of borrowed in the LIBOR market, possibly entailing a T-bill/LIBOR swap.

c/ Interest spread is grossed up here and in following tables; interest costs are reduced by 5 percent of the total, because that amount is assumed financed by equity.

d/ Includes servicing and overhead costs, origination fees, default risk and prepayment risk (for detailed component separately, see Table 4).

e/ Weights are 36.8% in school and 63.92% in repayment.

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

Administration Economic Assumptions

Formula or Net Rate of Return	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	5-yr. ave.
1 Current Formula:							
1a. 3-month T-bill + 2.50/3.10	7.67/8.25	7.63/8.23	7.51/8.11	7.43/8.01	7.31/7.91	7.31/7.91	7.43/8.03
1b. Estimated net return to lender	1.63	1.66	1.64	1.64	1.59	1.59	1.62
2 Future Formula:							
2a. 10-year CMT + 1.00	n.a.	6.86	6.80	6.80	6.70	6.70	6.77
2b. Estimated net return to lender	n.a.	0.38	0.36	0.36	0.31	0.31	0.34
2c. 10-20 year, simple interest + 1.00	n.a.	7.11	7.03	7.03	7.03	7.03	7.05
2d. Estimated net return to lender	n.a.	0.55	0.52	0.51	0.53	0.53	0.53
3 Alternative Formulas:							
3a. To hold student harmless, CMT	n.a.	Bills + 1.73	Bills + 1.79	Bills + 1.89	Bills + 1.89	Bills + 1.89	Bills + 1.83
3b. Estimated net return to lender	n.a.	0.51	0.55	0.65	0.60	0.60	0.58
3c. To hold student harmless, 10-20	na.	Bills + 1.98	Bills + 2.02	Bills + 2.12	Bills + 2.22	Bills + 2.22	Bills + 2.11
3d. Estimated net return to lender	n.a.	0.76	0.78	0.88	0.93	0.93	0.85

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

Net rates of return to lender are before-tax returns on assets.

n.a. Not applicable

2/17/98

TABLE 4: RISK-ADJUSTED PRE-TAX NET RETURN for FFEL STUDENT LOANS, 1997 and 1998
(Percent, Administration Economic Assumptions))

	7/1/97 to 6/30/98			7/1/98 to 6/30/99		
	In-school or Deferment	Repayment	Consolidation	In-school or Deferment	Repayment	Consolidation g/
Student Loan Interest Rate	7.67	8.25	9.00	6.86	6.86	9.00
Loan income, net a/	7.67	6.27	9.00	6.73	6.73	8.87
Less Costs:						
All-in cost of funds b/	5.85	5.85	5.85	5.77	5.77	5.77
Adjusted cost c/	5.58	5.58	5.56	5.48	5.48	5.48
Origination/holding fee d/	0.06	0.04	1.10	0.06	0.04	1.10
Servicing costs/overhead e/	0.32	0.95	0.47	0.32	0.95	0.47
Default risk	0.00	0.07	0.07	0.00	0.07	0.07
Prepayment risk	<u>0.03</u>	<u>0.07</u>	<u>0.07</u>	<u>0.03</u>	<u>0.07</u>	<u>0.07</u>
Subtotal	5.97	6.69	7.27	5.89	6.61	7.19
Net Return	1.70	1.58	1.73	0.84	0.12	1.68
Weighted Average Net Return f/		1.64			0.54	

Note: OMB estimates for interest rates are from the 1999 budget. Loan rates are determined in Q2 of calendar year, costs of funds are determined by the average interest rate from Q3 of first year through Q2 of following year.

a/ Loan income takes account of SAP payments and of hedging costs when the formula is tied to a long-term index.

b/ Assumes all-in cost of funds is T-bill + 70 basis points.

c/ All-in cost of funds, reduced by 5%; only 95% of the loan principal is assumed to be financed by debt.

d/ Fee is amortized over life of loan; part of it becomes a prepayment cost in the case of default or other early loan payoff. Consolidation loans involve an extra fee.

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

f/ Weights are 31.53%, 55.88%, and 12.58% for loans in school, in repayment, and in consolidation, respectively.

g/ For loans already consolidated before 1998-99.

**TREASURY COMMENTS RE EDUCATION REVISED DRAFT BILL
HIGHER EDUCATION ACT REAUTHORIZATION--TITLE IV, PART G--GENERAL**

Comments from the Office of the Assistant Secretary (Tax Policy):

Our comments relate to the information disclosure provisions of this bill (section 483(b), pages 14-16).

The proposed disclosure provisions are unacceptable. In particular, Treasury has repeatedly advised the Department of Education of our objection to allow "agents" (i.e., contractors) to receive tax data. This is a government-wide issue: IRS cannot monitor contractors' compliance with the 6103 protections, and we have uniformly prevented contractors from gaining access to tax information, and been backed up on that by OMB. The proposed changes to IRC section 6103(l)(10) and (l)(13) should be removed from this bill.

Next, the new proposed section 6103(l)(15) (actually, there already is a paragraph (l)(15)) is also contrary to Treasury's and the Administration's policy. While we fully support the idea of reducing errors by verifying eligibility, we thought it had been settled during passage of the Debt Collection Improvements bill that the New Hire Database was to be the source of the verifying information in future, not the IRS. The specific information requested would also be useless. We have no idea why "the amount of federal taxes paid" is relevant to determining eligibility for educational assistance.

The rest of page 16 is devoted to conforming amendments for these changes, which are obviously unnecessary and should also be deleted.

Finally, the description of these provisions (page 6 of the section-by-section analysis) is extremely misleading. These significant changes to 6103 are mentioned only as "comparable" changes; reading this analysis one would think they're just conforming amendments.

TABLE 1: INTEREST RATE ASSUMPTIONS

	(Percent)						
	1997	1998	1999	2000	2001	2002	5-year ave.
OMB ('99 Budget)							
3-month T-bill	5.17	5.13	5.01	4.91	4.81	4.81	4.93
10-year note	6.75	5.86	5.80	5.80	5.70	5.70	5.77
Spread	1.58	0.73	0.79	0.89	0.89	0.89	0.84
Blue Chip (Feb.98)							
3-month T-bill	5.17	5.24	5.24	--	--	--	--
10-year note	6.75	5.80	6.00	--	--	--	--
Spread	1.58	0.56	0.76	--	--	--	--
CBO (Jan'98)							
3-month T-bill	5.17	5.45	5.34	--	--	--	--
10-year note	6.75	6.00	6.10	--	--	--	--
Spread	1.58	0.55	0.76	--	--	--	--
DRI							
3-month T-bill	5.17	5.19	4.83	--	--	--	--
10-year note	6.75	5.8	5.82	--	--	--	--
Spread	1.58	0.61	0.99	--	--	--	--
Implicit Forward Rates							
3-month T-bill	--	5.16	n.a.	n.a.	n.a.	n.a.	n.a.
10-year note	--	5.67	n.a.	n.a.	n.a.	n.a.	n.a.
Spread	--	0.61	n.a.	n.a.	n.a.	n.a.	n.a.

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1;
all other data are for the second calendar quarter. Bill rates are converted to a
bond equivalent basis.

n.a. Not available.

a/ Forward rates for June, 1998 as of February, 1998.

newtab1

02/10/98

TABLE 2: COST ASSUMPTIONS
(Percent or Basis Points)

	Current Policy		Future Policy	
	In-School	Repayment	In-School	Repayment
All-in costs a/	T-bills + .70	T-bills +.70	CMT + .12	CMT+.12
For 1997/8 & 98/9	5.85	5.85	5.95	5.95
Adjusted costs	5.56	5.56	5.65	5.65
Servicing/overhead b/	0.32	0.95	0.32	0.95
Default risk	0.00	0.07	0.00	0.07
Prepayment risk	0.04	0.08	0.04	0.08
Origination fee	0.05	0.05	0.05	0.05

a/ For current policy, all-in costs include only the cost of matched funds;
for future policy, all-in costs include the cost of financing plus the cost of a swap.
Costs to banks are adjusted in the third line above and following tables, reducing them by
5 percent of this total, because that amount is assumed to be financed by equity.

b/ Includes both servicing and overhead costs.

newtab2

2/11/98

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS

Administration Economic Assumptions

Formula or Net Rate of Return	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	5-yr. ave.
Current Formula:							
3-month T-bill + 2.50/3.10	7.67/8.25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Estimated net return to lender	1.61	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Future Formula:							
10-year CMT + 1.00	n.a.	6.86	6.80	6.80	6.70	6.70	6.77
Estimated net return to lender	n.a.	0.32	0.30	0.34	0.29	0.29	0.31
Alternative Formulas:							
To hold student harmless	n.a.	T-bill + 1.73	T-bill + 1.79	T-bill + 1.89	T-bill + 1.89	T-bill + 1.89	T-bill + 1.83
Estimated net return to lender	n.a.	0.50	0.54	0.64	0.59	0.59	0.57
To maintain lenders minimum required net rate of return:							
80 basis points	n.a.	T-bill + 2.09	T-bill + 2.09	T-bill + 2.09	T-bill + 2.09	T-bill + 2.09	T-bill + 2.09
100 basis points	n.a.	T-bill + 2.29	T-bill + 2.29	T-bill + 2.29	T-bill + 2.29	T-bill + 2.29	T-bill + 2.29
115 basis points	n.a.	T-bill + 2.44	T-bill + 2.44	T-bill + 2.44	T-bill + 2.44	T-bill + 2.44	T-bill + 2.44

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

n.a. Not applicable

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

(In Percent, Administration Economic Assumptions)

Formula or Net Rate of Return	1997/98	1998/99
Current Formula:		
3-month T-bill + 2.5/3.10	7.67/8.25	n.a.
Estimated net return to lender	1.61	n.a.
Future Formula:		
10-20 year simple interest + 1.00	n.a.	7.11
Estimated net return to lender	n.a.	0.32
Alternative Formulas:		
To hold student harmless	n.a.	T-bill + 1.98
Estimated net return to lender	n.a.	0.75
To maintain lenders minimum required net rate of return:		
80 basis points	n.a.	2.09
100 basis points	n.a.	2.29
115 basis points	n.a.	2.44

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

n.a. Not applicable

Assumptions:

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

2/11/98

TABLE 5: SWAP ESTIMATES (IN BASIS POINTS)

SWAP	Dealer A 11/14/97	Deaer B 11/14/97	Dealer C 11/14/97	Dealer D 11/21/97	Dealer E 11/14/97
3-month T-bill for LIBOR (weekly reset, quarterly pay)					
4 year	T-bill + 69	T-bill + 70	T-bill + 68	T-bill + 70	T-bill + 75
7 year	T-bill + 68	T-bill + 70	T-bill + 66	T-bill + 69	T-bill + 73
10 year	T-bill + 67.5	T-bill + 69	T-bill + 66	T-bill + 69	T-bill + 73
10 year CMT (annual reset) for LIBOR					
4 year	CMT + 9.5	CMT + 26	CMT + 27	CMT + 31	CMT + 15
7 year	CMT + 7.5	CMT + 21	CMT + 26	CMT + 27	CMT + 11
10 year	CMT + 5.5	CMT + 16	CMT + 24	CMT + 25	CMT + 9

Note: spot market yeilds on November 14, the date of most of these swap quotes, were around: 3-month T-BILL, 5.26%; 3-month LIBOR, 5.88%;
10-year CMT, 5.81% to 5.86% (all quotes on bond-equivalent basis).

swapest

2/11/98

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

(Percent, Administration Economic Assumptions))

	7/1/97 to 6/30/98			7/1/98 to 6/30/99		
	In-school or Deferment	Repayment	Consolidation	In-school or Deferment	Repayment	Consolidation e/
Student Loan Interest Rate	7.67	8.25	9.00	6.86	6.86	9.00
Less Costs:						
All-in cost of funds a/	5.85	5.85	5.85	5.95	5.95	5.95
Adjusted cost b/	5.56	5.56	5.56	5.65	5.65	5.65
Origination/holding fee	0.05	0.05	1.10	0.05	0.05	1.10
Servicing costs/overhead c/	0.32	0.95	0.47	0.32	0.95	0.47
Default risk	0.00	0.07	0.07	0.00	0.07	0.07
Prepayment risk	<u>0.04</u>	<u>0.08</u>	<u>0.04</u>	<u>0.04</u>	<u>0.08</u>	<u>0.04</u>
Subtotal	5.97	6.71	7.24	6.06	6.80	7.33
Net Return d/	1.70	1.56	1.76	0.80	0.06	1.67
Weighted Average Net Return		1.63			0.49	

Note: OMB estimates for interest rates are for the 1999 budget. Blue Chip estimate is for February 1998.

a/ Assumes all-in cost of funds for 1997/98 is T-bill + 70 basis points; for 1998/99 the all-in cost is CMT +12 basis points.

b/ All-in cost of funds, reduced by 5%; only 95% of the loan principal is assumed to be financed by debt.

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

d/ For loans in repayment in '97-98, loan income is 5.17 (T-bill +3.10) because SAP would be received.

e/ For loans already consolidated before 1998-99.

Principles to Guide Resolution of the Student Loan Interest Rate Problem

[For Administration purposes, analyses needed are identified under each Principle.]

- **Minimize costs to students**
 - Analysis of other factors affecting student costs, such as origination fee reductions or reward of on-time repayment, needs to be combined with interest rate options to derive overall policy options.
- **Every qualified student should continue to have access to loan capital**
 - Analysis of the magnitude of risk of lender withdrawal, and development of options to have in hand for using (1) the Secretary's lender-of-last-resort, Sallie Mae, and advances to guaranty agencies authorities, and (2) Education's capacity to meet needs through expansion of Direct lending contracts.
 - Analysis to identify costs of options, including use of Federal capital and Federal contractors, and development of a financial plan to meet those costs, including, any necessary budget offsets if costs exceed current budgetary resources.
- **Cost neutrality in the Federal Budget**
 - Cost neutrality is required using Administration assumptions. Cost effects should also be calculated, as best as possible, under CBO's probabilistic scoring approach.
 - If costs would reduce the net savings in the FY 1999 budget from student loans, additional savings proposals are required to make up the difference.
- **Use of a benchmark instrument that does not impose unnecessary costs on lenders nor raise Federal costs unnecessarily**
 - Analysis of alternative benchmark instruments should consider volatility (which carries a significant cost under future CBO scoring); and Administration willingness to use a debt instrument other than a government security as the benchmark.
- **Introduction of market processes and streamline systems to lower student, lender and Federal budget costs.**
 - Analysis should consider of effects of price competition on different types of schools and economic classes of students, and examine the effects of authority to the Secretary to lower Direct Loan interest rates on guaranteed loan rates.

**Principles and Implementation Options for Scheduled Change in
Interest Rates on Student Loans**

Principles

- I. Minimize cost to students**
- II. Assure critical mass of private loan capital**
- III. Minimize cost to Government**
- IV. Facilitate long-run fundamental improvement of loan programs**

* * *

Implementation Options

I. Permanent Solution

Positives

- (1) Elimination of divisive issue
- (2) Possible acceleration of improvements that might otherwise await reauthorization¹
- (3) Avoidance of tendency of temporary solution to become permanent (only if temporary solution not acceptable as permanent solution)

Negatives

- (1) Fewer opportunities for offsetting student benefits than in reauthorization
- (2) Loss of potential leverage for two-stage process to achieve long-term structural reform in reauthorization
- (3) Lack of information on banks that originate and sell loans (more than 50 percent of all originations) and tax-exempt secondary markets (more than 20 percent of all loan holdings)
- (4) Short time period for resolution (probably late

¹Assumes reauthorization later and not on accelerated schedule of House authorizing committee

April)

A. Implement Scheduled Change

Positives

(1) Creation of urgent need for major structural reform in reauthorization (for example, fully functional FDSLSP as sole program, FFELP lenders as loan managers for Federal funding or hybrid program)

(2) Substantial reduction in student costs

Negatives

(1) Possible loss of critical mass of lenders in FFELP

(2) Risk of potential program failure

(3) Loss of opportunity for substantial net decrease in baseline cost to Government (higher interest income in FDSLSP minus higher interest subsidy in FFELP)

B. Repeal Scheduled Change

Positive

(1) Elimination of risk of potential program failure

(2) Substantial net decrease in baseline cost to Government

Negative

(1) Substantial increase in student costs over their current expectations

(2) Elimination of current impetus for long-term structural reform of loan programs

Positive and/or Negative

(1) Maintenance of current status quo (including substantially equal interest rates for all students with no substantial access problems) ("cross-subsidy")

C. Set Same New Fixed Rate for Both Programs

Positive

- (1) Elimination of competitive disadvantage of FDSL

Negatives

- (1) Difficulties in governmentally determining "correct" interest rates, particularly for extremely heterogeneous universe of lenders
- (2) Elimination of existing theoretical opportunities for student savings through competition

Positive and/or Negative

- (1) Requirement of exactly equal interest rates for all borrowers

1. At Level Attractive for Most Current Bank Lenders

Positives

- (1) Minimum likelihood of access problems
- (2) Substantial reduction in baseline cost to Government
- (3) Maintenance of support for loan programs from large, diverse group of lenders

Negatives

- (1) Probable equivalence to repeal in terms of cost to students
- (2) "Excessive" returns to efficient and/or highly leveraged lenders
- (3) Elimination of current impetus for long-term structural reform of loan programs
- (4) Administrative inefficiency in large number of lenders

2. At Level Attractive for Efficient Bank Lenders

Positives and/or Negatives

- (1) Blend of I(C)(1) and I(C)(3)

3. At Level Attractive for Efficient Leveraged Lenders

Positives

- (1) Substantial reduction in cost to students
- (2) Elimination of "excessive" returns to lenders
- (3) Administrative efficiency in small number of lenders

Negative

- (1) Reduction in political support for loan programs from small number of lenders

D. Rely on Price Competition To Set Subsidy Level

Positive

- (1) More accurate mechanism to achieve "correct" interest rates than governmental determination

Negatives

- (1) Regulatory difficulties if large economies of scale in servicing (and possibly, although to a lesser extent, in funding) lead to program dependence on one or a handful of lenders
- (2) Consequences of competition highly dependent on surrounding regulatory structure
- (3) Increase in unpredictability of result with increased magnitude of structural change
- (4) Difficulty in implementing structural change by scheduled date for change in interest rates

1. Set Lower Maximum Rate in FFELP at Same Level as FDSLPRate

Positive and/or Negative

- (1) Absence of significant competition in interest rates under current maximum; lesser likelihood at lower maximum

2. Set Lower Maximum Rate in FFELP and Implement

Scheduled Change in FDSLSP

Positive and/or Negative

- (1) Need for FFELP lenders to compete with FDSLSP in interest rates likely to start significant competition among themselves, possibly leading to:
 - (a) Differential interest rates by school/socioeconomic status of borrower
 - (b) Inability of FDSLSP to compete for most economically desirable loans
 - (c) "Redlining" by FFELP lenders
 - (d) Uncoupling of highly desirable unsubsidized loans
 - (e) Differential borrower constituencies for FFELP and FDSLSP
 - (f) Change in relative budgetary costs and performance measures of FFELP and FDSLSP

3. Auction Rights To Make Loans on Basis of Interest Rates

Positives and/or Negatives

- (1) Experience of substantial rate reductions in HEAL program with no access problems (in relatively homogeneous borrower universe)
- (2) Likelihood of "redlining" in highly heterogeneous borrower universe
- (3) Passing on to students of excess subsidy rather than elimination

4. Auction Rights To Make Loans on Basis of Cash Payments to Government

Positives and/or Negatives

- (1) Likelihood of "redlining" in highly heterogeneous borrower universe
- (2) Elimination of excess subsidy rather than passing on to students (but potential availability to fund other student benefits)

5. Auction Loans Made to All Eligible Borrowers at Same Interest Rate

Positives and/or Negatives

- (1) Universal access

(2) Elimination of excess subsidy rather than passing on to students (but potential availability to fund other student benefits)

(3) Same interest rate for all borrowers

(4) Some relevant positive experience in Keystone Program of Pennsylvania guaranty agency

II. Temporary Solution

Positive

(1) Some continued leverage for long-term structural reform in reauthorization in a two-stage process

Negative

(1) Reduction of leverage for long-term structural reform in reauthorization

(2) Tendency of temporary solution to become permanent (only if temporary solution not acceptable as permanent solution)

A. Defer Scheduled Change for One Year

Positives

(1) Same as I(B) on interim basis

Negatives

(1) Same as I(B) on interim basis

B. Set Interim Rate(s) for One Year

Positives

(1) Same as I(C) on interim basis

Negatives

(1) Same as I(C) on interim basis

Principles and Implementation Options for Scheduled Change in
Interest Rates on Student Loans

Principles

- I. Minimize cost to students
- II. Assure critical mass of private loan capital
- III. Minimize cost to Government
- IV. Facilitate long-run fundamental improvement of loan programs

* * *

Implementation Options

- I. Permanent Solution
 - A. Implement Scheduled Change
 - B. Repeal Scheduled Change
 - C. Set Same New Fixed Rate for Both Programs
 - 1. At Level Attractive for Most Current Bank Lenders
 - 2. At Level Attractive for Efficient Bank Lenders
 - 3. At Level Attractive for Efficient Leveraged Lenders
 - D. Rely on Price Competition To Set Subsidy Level
 - 1. Set Lower Maximum Rate in FFELP at Same Level as FDSLSP Rate
 - 2. Set Lower Maximum Rate in FFELP and Implement scheduled Change in FDSLSP
 - 3. Auction Rights To Make Loans on Basis of Interest Rates
 - 4. Auction Rights To Make Loans on Basis of Cash Payments to Government
 - 5. Auction Loans Made to All Eligible Borrowers at Same Interest Rate

II. Temporary Solution

- A. Defer Scheduled Change for One Year
- B. Set Interim Rate(s) for One Year

Interest Rate (and other issues) Meeting
2/13/98

I. Income verification problem (brief)

II. Treasury Study

--review draft

--timing

III. Principles for a Resolution

IV. Preliminary discussion of Options

V. Asset imputation in need analysis

Straw Men and the Student Loan Interest Rate

All numbers are rounded to the closest 10 basis points.

Comparison rates, i.e., the equivalent rates from the students' perspective, based on Administration projections:

<i>Increment above T-bill</i>	In-School	Repayment
10-20 year instrument	1.60	2.20
10-year instrument	1.40	2.00

Straw Man 1a: Low Rate

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed	1.70	2.30

This is the lowest rate that could be justified for for-profit lenders, based on the Treasury study. To make this a better offer, this rate could be combined with proposals aimed at reducing lender costs, e.g. the government's willingness to use an even more efficient instrument (such as LIBOR), or streamlining the guarantee and due diligence procedures. (Combined, these changes could reduce lender costs by 20 basis points, bringing profitability to the mid-point level of Treasury's analysis).

Advantages:

- ☐ Justifiable.
- ☐ Very close to the "hold students harmless" rate.
- ☐ Leaves room for further negotiation (e.g. fee reductions could be brought up later).

Disadvantages:

- ☐ Because it is so close to the bottom of Treasury's range, it will be easy for the industry to reject.
- ☐ Imposes a cost on students without compensating them, a possible slippery slope.

Straw Man 1b: Mid-Point Rate

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed	1.90	2.50

This is roughly the mid-point of the range identified by Treasury. It also approximately "splits the difference" between the current rate and the rate anticipated by lenders (based on the 10-year instrument). *Since this rate is considerably higher than the rate now projected for students on July 1, it should certainly be combined with a reduction in borrower-paid loan fees.*

Advantages:

- ☐ Would be seen as a reasonable offer, based on the Treasury analysis. Chairman McKeon himself has been rumored to be considering "splitting the difference."
- ☐ Is approximately the interest rate reduction that was projected when the decision to change the rate was made in 1993.

Disadvantages:

- ☐ A better end-point for negotiations than starting point. (If the goal is to achieve at least the reduction intended in 1993 -- 60 basis points in repayment -- it does not leave any further room for negotiation).

Straw Man 2: Split Rate

<i>Increment above T-bill</i>	In-School	Repayment
Government-Guaranteed	1.90	2.50
Direct Loan Program	1.90	2.20

The lower in-repayment rate in the Direct Loan Program is intended to provide lenders with an incentive to offer borrowers lower rates. By having the same in-school rate, the incentive for *schools* to switch from the guaranteed to the direct program is minimized: as is true today, if students don't like the terms they are offered in the guarantee program, they can consolidate into direct loans when they are finished with school. (Student and higher education organizations are suggesting an option similar to this.)

Advantages:

- ☐ Provides students with an in-repayment rate *as low as projected for July 1* (in the Direct Loan Program).
- ☐ Spurs price competition by lenders, to meet or beat the Direct Loan rate.

Disadvantages:

- ☐ Price competition will lead some schools to be frozen out of the guarantee program, while other (elite) schools are offered the best deals.
- ☒ Direct Loans will be left with the less profitable portfolio, affecting its image and perhaps its political support.

☐ *Not clear that segmentation increases*

Straw Man 3: Interest rate-based Auction

Lenders would bid for a particular volume of loans, at a particular interest rate. The lowest-rate lenders would be selected until sufficient volume is available. All the selected lenders could then offer loans at or below the rate of the last-selected lender (which would also be the Direct Loan rate?). There would be an overall maximum rate.

Advantages:

Students could consolidate to better

- ☐ Efficient method of ensuring students the lowest-possible price.
- ☐ As efficiencies lower lender costs, students continue to benefit by even lower interest rates.

Disadvantages:

- ☐ Strong incentives for lenders to compete for the high-balance, high-income borrower, leaving direct loans with the remnants.
- ☐ Need interim solution until auction can be implemented.

Universal Access

Straw Man 4: Cash Payment-based Auction

Interest rate would be set, but lenders would name a price for offering a particular volume of loans to eligible students. The government would accept bids until a sufficient volume is assured.

Advantages:

- ☐ Beyond the low interest rate, savings accrue to taxpayer.
- ☐ Could auction loans without the guarantee, to reduce need for continued government involvement.
- ☐ More compatible with possible directions for Direct Loan Program.

Disadvantages:

- ☐ Need interim solution until auction can be implemented.
- ☐ Many unanswered questions about ensuring universal access, how students/school would choose lenders, etc.

Agenda
2/18/98

- I. Treasury Study content and timing
- II. Options
 - Rate
 - Timing and relationship to HEA
- III. DL and LOLR capacity
- IV. Other issues (Hill activity, etc.)

ISSUE I: Interest Rate Policy

Goals:

- Lowest possible interest rate for students.
- Lower fees for students.
- A more efficient and accountable system.
- Recognition that competition would be better than Congress at setting loan rates and subsidies: a study and possible future implementation of better approaches (such as an auction).

Approaches to getting there:

- **A** Straw Man: Hold students harmless.
- **B** Straw Man: Split the difference.
- **C** Straw Man: Direct/Guaranteed differential.

All of the options would include the fee reductions that are proposed in the FY 1999 Budget and the Administration's proposal for reauthorization of the Higher Education Act.

A Straw Man: Hold students harmless

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed	1.60	2.20

Proposal: Reduce lender costs by cutting regulations, streamlining the guarantee approach, and using the most efficient instrument (for banks) available [and allow broader range of lenders with lower capitalization requirements?]. *This makes it possible for lenders to afford the low rate that students are projected to be paying on July 1.*

Advantages:

- A strongly pro-student opening position.
- Leaves room for further negotiation (*e.g.* when negotiations move to higher rates, then out-year reductions pegged to auction approaches would be added).

Disadvantages:

- Because it is below Treasury's range, the industry will argue that it is not a serious offer.
- Some Democrats are getting nervous about this issue, and this position may not satisfy them.

B Straw Man: Split the difference

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed July, 1998	1.90	2.50
July, 2000	1.60	2.20

This is roughly the mid-point of the range identified by Treasury. It also approximately “splits the difference” between the current rate and the rate anticipated by lenders (based on the 10-year instrument). A lower, “hold students harmless” rate would go into effect in two years, after a study of market-based approaches to setting the rate/subsidy, including auctions. (The Secretary could be authorized to implement an approach).

Advantages:

- Would be seen as a reasonable offer, based on the Treasury analysis. Chairman McKeon himself has been rumored to be considering “splitting the difference.”
- Is approximately the interest rate reduction that was projected when the decision to change the rate was made in 1993.

Disadvantages:

- A better end-point for negotiations than starting point. (If the goal is to achieve at least the reduction intended in 1993 -- 60 basis points in repayment -- it does not leave any further room for negotiation).
- More complicated than simply “holding students harmless.”

C Straw Man: Direct/Guarantee differential

<i>Increment above T-bill</i>	In-School	Repayment
Government-Guaranteed	1.90	2.50
Direct Loan Program	1.90	2.20

This is the type of approach being pursued by the higher education associations. They are asserting that “this is a guarantee problem, not a direct loan problem.” So they are suggesting that the guarantee program interest rate can be changed, but the direct loan rate should stay the same. Lenders could meet or beat the direct loan rate, but wouldn’t have to. This would inject more price competition into the student loan market.

Advantages:

- Provides students with an in-repayment rate *as low as projected for July 1* (in the Direct Loan Program).
- Spurs price competition by lenders, to meet or beat the Direct Loan rate.

Disadvantages:

- Price competition may lead to more discrimination on the basis of schools, with students at some schools offered only the highest rate (if banks offer them loans at all), while others at elite schools are offered the best deals.
- Direct Loans will be left with the less profitable portfolio, affecting its image and perhaps its political support.

ISSUE II: Vehicle for Interest Rate Change

Should we insist that any deal on the interest rate be included in a larger HEA reauthorization bill?

Yes:

- It makes it easier to include related items like GA reform and student fee reduction in the negotiations.
- If we need a 30-45 day delay it would not cost students much.
- Authorizers of both parties will be incensed if we take away the driver from the reauthorization. Make them happy by making a firm statement.
- We will be a player, helping us on issues like Title V and High Hopes.

No:

- Lenders need a fix by late April, and it is impossible to get the whole HEA done by that time.
- Including it in HEA does not give us significant leverage over non-interest rate items in HEA, because we would be accused of using the issue to get unrelated things.
- Any delay in the interest rate change is a capitulation that risks a further delay at a large cost to students.

Subject: In case you missed it, from Congress Daily: 2/17/98 pm
----- Message Contents -----

EDUCATION

Kanjorski Turns To Greenspan On Student Loan Question

House Banking Capital Markets Subcommittee ranking member Paul Kanjorski, D-Pa., late last week sent a letter to Federal Reserve Chairman Greenspan asking him for recommendations on how to handle the new student loan interest rate cut scheduled to take effect July 1. "In light of the Federal Reserve's economic expertise, and the potential adverse impact this change could have on member banks, I would appreciate receiving your analysis on this issue," Kanjorski wrote. While the student loan interest rate issue is the province of the House Education and the Workforce Committee, Democrats and Republicans on the Banking Committee are prodding the Education and the Workforce panel to move quickly enough to address the change by July 1. But Education and the Workforce Committee aides say they are working on the issue, and will make a proposal as part of the Higher Education Act reauthorization.

A little noticed provision in the 1993 budget deal cuts the interest rate private lenders can charge for new guaranteed student loans. Banks currently are allowed to charge student borrowers an interest rate equal to a 91-day Treasury bill plus 3.1 percent. But after July 1, banks can only charge a rate for new loans equal to a 10-year Treasury bill plus 1 percent. The interest rates for 10-year T-bills are far lower than those for 91-day T-bills. The banking industry and other student loan lenders consider the rate change a "ticking time bomb" that, if allowed to take effect, will cause banks to flee the student loan business in droves. That could leave many families and students in limbo this summer as they arrange their college financing for the fall semester. The Clinton administration defends the scheduled rate change, arguing private lenders should not charge higher rates than the direct loan program run by the Education Department, which uses cheaper government capital.

In his letter to Greenspan, Kanjorski wrote: "This change would have a dramatic impact on the ability of lenders to originate and invest in guaranteed student loans safely and soundly. The new index will cause a mismatch between the rate and maturity on the securities and deposits lenders used to finance student loans and the rate and maturity of the loans themselves. While it may be possible to use complicated hedging techniques to offset this interest rate risk, the costs would be prohibitive. Even without the hedging costs, lender yields in many interest rate environments could be negative." Kanjorski also asked Greenspan to outline how lenders fund student loan capital, and whether creating assets that yield long-term rates in a program financed through the use of shorter-term obligations "would generate interest rate risk."

wilkes - Barre

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From: <i>Shymon</i>	To: <i>Bob Shymon</i>
Co. <i>SBC</i>	Co. <i>N/C</i>
Phone #	Dept.
Fax #	

Congress of the United States
Washington, DC 20515

February 9, 1998

Spare Students and Parents the 'Pain'
Assure the Continuation of a Reliable Source of Student Loan Funds

Dear Colleague:

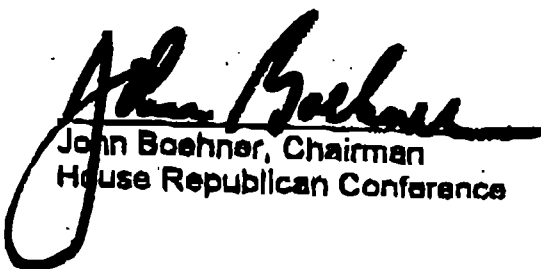
The attached column by Albert Crenshaw from the February 1 *Washington Post* reports on an impending change in the formula governing interest rates in the federal student loan program, scheduled to take effect on July 1, that will disrupt the fall's student education finance market if not modified very soon.

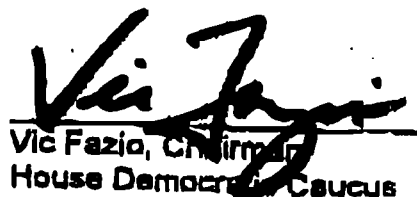
According to analyses by the Congressional Research Service (CRS) and others, if the index is converted from the old formula, which is based on the 91-day Treasury Bill, to the new formula, which will be based on the 10-year Treasury note, the private capital markets will not be able to continue to support the student loan lenders and secondary markets that provide students loans under the Federal Family Education Loan Program (FFELP). This could, in turn, lead some lenders to withdraw from the FFELP program making the market more volatile for students. This concerns us greatly, especially considering reports from the U.S. Department of Education that the direct loan program is not in a position to handle an extensive increase in loan volume.

While the Congressional Budget Office (CBO) projects lower interest rates under the new formula, historical interest rate patterns show borrowers are just as likely to receive no benefit over time from the scheduled interest rate formula change.

We support modification of the upcoming change in the student loan interest rate formula and the use of any resulting savings to permanently reduce borrowing costs for students. With the financial aid application process already underway for next Fall, Congress and the Administration must move quickly to resolve this matter and avoid a potential crisis in education funding.

Sincerely,


John Boehner, Chairman
House Republican Conference


Vic Fazio, Chairman
House Democratic Caucus

EDUCATION

Student Loan Program May Break the Bank

Lenders say changes in interest rates and federal direct-lending program could leave students without funds to borrow

Congress is caught in a political dilemma that could become a financial crunch — whether to proceed with a cut in student loan interest rates or back off under pressure from bankers threatening to pull out of the college lending business.

The quandary comes at a time when lawmakers had hoped to be unveiling new initiatives to slow the rising cost of college. Instead, they are faced with the unhappy prospect of having to roll back a 1993 law that would lower interest rates on federally backed student loans, beginning July 1.

If Congress does not alter the law, commercial banks, which account for 70 percent of the college loan market, say they will cut back on lending, possibly upending the higher education finance market and leaving students who depend on loans without access to college funds.

Student groups, however, insist Congress must make lower interest rates a top priority this year as it considers reauthorizing the Higher Education Act, which governs tens of billions of dollars in annual grants and loans.

The predicament is a textbook example of how unforeseen economic developments can derail policy objectives years after they are made. Two unexpected changes are now colliding five years after Congress planned the interest rate change.

One is the failure of President Clinton's direct government lending program to capture a majority of the student aid market. The other is a major change in interest rates, with short-term interest rates rising and long-term rates falling, that bankers say have rendered the planned formula unprofitable.

"There's no question there's a problem... and it's everybody's problem," said Senate Labor and Human Re-



McKeon

sources Committee Chairman James M. Jeffords, R-Vt.



Kildee

Direct Lending Gone Awry

The controversy has its roots in the 1993 fight over the Clinton administration's push to scrap commercial, guaranteed student loans in favor of direct government lending. The direct loans were designed to cut out banks, secondary markets and guaranty agencies. Government lending was expected to save billions of dollars by eliminating subsidies to private-sector lenders. (1993 Almanac, p. 410)

Congress refused to move entirely to direct lending by the government, worried that the Education Department could not administer such a massive program. Instead the 1993 budget-reconciliation law (PL 103-66) allowed the government to gradually phase in the program over five years.

The legislation assumed that direct loans could account for at least 60 percent of new student loans. The Clinton administration had hoped the government would eventually take over all student lending.

In the same law, Congress enacted a change in the formula the federal government uses when it sets student loan interest rates.

For nearly 20 years, student loan interest rates have been based on the 91-day Treasury-bill rate. The current formula is the 91-day rate, plus 2.5 percent

while the borrower is in school and 3.1 percent during repayment. The new formula would set rates at the 10-year Treasury bond rate plus 1 percent. Overall, interest to students would still be capped at 8.25 percent.

The new formula could cut interest rates to students by more than a full percentage point.

While that may be good news for students, bankers say it would decrease the returns they receive on those loans to the point where the \$25 billion-a-year commercial student loan market would be unprofitable for them. The new formula, they said, would also create unpredictability because banks would have to pay higher short-term interest rates to attract deposits but would be forced to lend at long-term rates that are often lower.

"The way the formula is configured... does not provide sufficient returns to lenders to entice them to stay in the program," said Scott Miller, director of government relations for the Sallie Mae, which purchases student loans from banks.

Lenders say the decision to link student loan rates, which run a standard 10 years, to the 10-year bond rate was made to address bookkeeping problems that arose from having them linked to the 91-day T-bills. They point out that if the new formula had been used in 1993 and 1994, interest rates would have increased.

Democrats say the change was always intended to reduce interest rates to students, based on projections that the gap between interest rates on long- and short-term Treasury obligations would change.

"The information they [banks] are throwing out is an effort to confuse and deceive," said a White House official who is working on the issue but who asked not to be identified. "It's clear that it was intended as a reduction."

But even administration officials skeptical about the bankers' claims ad-

By Sue Kirchhoff

mit that the changes in interest rates over the past five years are greater than expected, causing a problem.

The Treasury Department is analyzing the situation. Administration officials say they expect the department will recommend that Congress move away from 10-year notes.

According to Sallie Mae officials, when the law was written in 1993, interest on 10-year Treasury notes was 5.75 percent. Adding 1 percentage point would have resulted in a student interest rate of 6.75 percent. At the same time, the 91-day Treasury bill rate of 3.11 percent plus 3.1 percent would have produced a 6.21 percent rate.

Using Jan. 7 data, Sallie Mae officials said the 10-year rate was 5.55 percent. Adding 1 percentage point produced an interest rate of 6.55 percent. That compares with the current formula using the 91-day T-bill carrying a 5.25 percent rate and the 3.1 percent add-on, for a 8.35 percent interest rate. However, student rates are capped at 8.25 percent.

A recent report by the Congressional Research Service said that the new formula increased the odds that the loan program would be unprofitable for banks and could be "sufficient to remove some of them from the program."

At the same time, direct loans have captured only 30 percent of the student aid market. Administration officials say the government would not be able to pick up the slack if commercial banks back out. Already, congressional critics point out, the Department of Education is having a hard time managing the current direct loan volume, and Congress in 1997 was forced to approve special legislation making it easier for students to consolidate loans taken out under the direct lending program. (*1997 Weekly Report*, p. 2412)

Student Worries

Lining up against the bankers are students and colleges who would benefit, at least initially, from a cut in interest rates under the new system.

They say they are willing to alter the formula to guarantee banks a slightly larger return — but insist the bottom line must be a reduction in interest.

"We won't condone a bank fix that does so at the expense of the interest rate reduction," said Becky Timmons, director of congressional relations for the American Council on Education, representing colleges and universities.

The battle comes against the backdrop of growing student reliance on loans to finance college education. The College Board, which tracks higher education trends, said in a September

1997 report that student loans now account for 60 percent of federal aid, compared with 40 percent in 1980-81.

The Education Department estimates that students and their families will take out nearly \$32 billion in new loans for college in fiscal 1998.

"This is one of the top priorities for students," said Erica Adelsheimer, legislative director of the U.S. Student Association. "We are taking on overwhelming debt and the debt levels continue to rise with no end in sight."

"There's no question there's a problem . . . and it's everybody's problem."



Senate Labor and Human Resources Committee Chairman
James M. Jeffords, R-Vt.

She estimated the new interest rate formula could mean \$1,000 in savings to the average student who takes on \$14,000 in college debt.

Bankers respond that while students may profit now, historic data shows that the relationship between long- and short-term rates is unpredictable. They warn that students in the future could end up paying higher rates under the proposed formula.

"For people to suggest that students are going to be benefiting from this is absolutely a mistake," said Bill Hansen, executive director of the Education Finance Council, which represents not-for-profit organizations that purchase student loans from banks.

The issue has been simmering for months but is reaching a crisis point, with colleges and lenders saying they need a decision by this spring when they must put together aid packages for students for the 1998-99 school year.

Congress Tries To Respond

"I'm not convinced, I'm open-minded," said Rep. Dale E. Kildee, D-Mich. "I want to make sure I take care of the legitimate needs of lenders, if there are needs, but also the needs of borrowers."

House and Senate lawmakers have been talking to banks, student groups and colleges for months to determine the depth of the problem and find a possible solution. Some suggested the sketchy outlines of a possible deal.

Rep. Howard P. "Buck" McKeon, R-Calif., chairman of the House Education and the Workforce Subcommittee on Postsecondary Education, Training and Life-Long Learning, said he was open to finding an alternative that would ensure a higher return to banks.

"I'm not coming from a love for banks, I'm talking about a concern for students," McKeon said. "If [banks] stop making loans, that's bad for everybody."

To make an expected increase in interest rates palatable to students, McKeon and other lawmakers hoped to reduce a 4 percent federal fee now levied on students when they take out loans. The fiscal 1999 White House budget also calls for reducing such fees, at a cost of about \$1.4 billion over five years.

Congress had expected to have money to pay for such a reduction. That is because the Congressional Budget Office had estimated that blocking the July 1 interest rate change would save about \$1.3 billion over five years.

The savings would occur because if the government keeps the formula, based on short-term Treasury bills, it would collect higher interest for the government's direct loan program.

However, CBO's most recent budget baseline, released last month, changed the forecast for student aid spending. The new baseline assumes that the government will have to make special payments, required by law, to compensate banks for making loans at the capped rate of 8.25 percent even though commercial interest rates may exceed that.

Partly because short-term interest rates are more volatile, under its new methodology CBO now estimates that blocking the 1993 formula change would cost \$2 billion over five years.

The turnabout leaves lawmakers suddenly without the money needed to soften the blow for students. They must either persuade congressional budget committees not to include the projections in the fiscal 1999 budget resolution or find spending cuts elsewhere.

The Clinton administration has begun to cautiously weigh in on the issue. Acting Deputy Secretary of Education Marshall S. Smith said Feb. 2 that he wanted to resolve the matter by April.

Treasury Secretary Robert E. Rubin told the Senate Budget Committee that he hoped to have a final report in "a month or two."

"I trust you and I don't want to hear later on that somebody held that report up," said committee Chairman Pete V. Domenici, R-N.M. "There's going to be nothing left for those who are not direct loan people."

TUSSLING OVER STUDENT LOAN RATES

EDUCATION

BY SHAWN ZELLER

What a difference even a fraction of a percentage point can make. For recent college graduates these days, struggling under an average of \$14,500 in debt, a pending July 1 reduction in the student loan interest rate seems like manna from heaven. To lenders such as the Student Loan Marketing Association (Sallie Mae) and Citibank Corp., however, the reduction is more like 40 years wandering the desert, and they are lobbying fiercely to prevent it.

Lawmakers of both parties are in a quandary. President Clinton in his State of the Union address pledged to make higher education affordable for all Americans. And the Republican leadership is eager to appear equally committed to education issues. But both the Administration and the political conservatives are taking the concerns of these private lenders seriously.

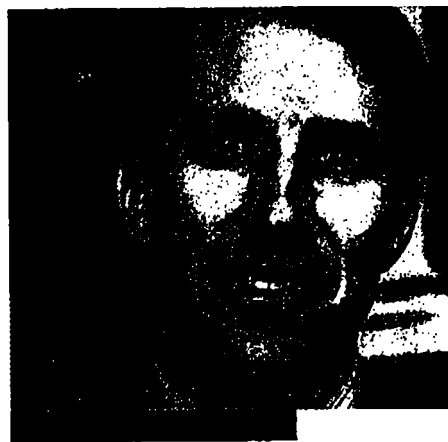
The debate, simmering for months, centers on a provision in the 1993 Student Loan Reform Act that shifts the student loan interest rate from its present index, the three-month Treasury bill rate, to the 10-year T-bill rate. That change, set for July 1 of this year, will reduce interest rates on Stafford loans—loans made under the largest student loan program—by 1.35 percentage points, from 8.25 per cent to 6.9 per cent. The new rate, like the old, will vary over time. But even if the T-bill rates crept above 8.25 per cent, students would still have to pay only what they do now, thanks to a congressionally mandated 8.25 per cent cap.

The federal government, which makes a third of all student loans in its direct-lending program, is set to move ahead with the rate change, both for the direct-lending program and for the Family Education Loan Program (FELP), which insures the remaining two-thirds of student loans. FELP loans are federally backed but are made by private-sector lending institutions.

Private lenders, anxious to block the rate reduction and avoid a reduction in profits, have floated various compromise solutions. They want student loans tied to the commercial paper index or to LIBOR, short-term London interbank rates, which lenders say reflect their costs more accurately. Each of those solutions would give

students a reduction of about 0.2 percentage point.

To be sure, private lenders have a lot to lose. Though the federal government began extending direct lending to students in 1993, nongovernmental institutions still provide the bulk of all student loans, and they say the new rate could put them out of business. "A 30-year history of private lending, in which \$225 billion has been provided to help students, could be



ROBERT SCHIREMAN: "We've been hearing deceptive arguments from the lending industry for a long time. It's hard to determine when the complaints are well-founded."

seriously damaged," said Bill Hansen, president of the Education Finance Council, which represents many private lenders. Hansen said that shifting to the 10-year rate would cut lenders' profit margins dangerously close to the bone. He cites a July Congressional Research Service report that concludes that the scheduled interest rate shift "adds a cost to the program for private lenders who make student loans; the cost may be sufficient to remove some of them from the program."

The lenders tried to forge a compromise over the summer that would still have given students the same 0.2 percentage point reduction. But firebrand student groups, led by the United States Students Association and the Public Interest Research Group (PIRG), torpedoed the settlement. Ivan Frishberg, who directs the PIRG's higher-education group, said the

students are incensed that lenders didn't complain about the imminent rate reduction until three years after passage of the Student Loan Reform Act, and that their sudden objections could cost student borrowers \$11 billion in interest repayments. Frishberg said the average student, saddled with a \$14,500 debt on a 10-year repayment plan, would save more than \$1,200 dollars with the scheduled shift.

After the summer compromise failed, lenders unsuccessfully tried to include a provision in the balanced budget bill, but Rep. Howard P. (Buck) McKeon, R-Calif., who chairs the House Education and the Workforce Postsecondary Education, Training and Lifelong Learning Subcommittee, shot down the lenders' amendment and told the banks they had to have student support in order to change the rules.

Getting both sides to the table again, however, has proved difficult. McKeon and Robert Schireman, who is the Clinton Administration's point man on higher education, remain hesitant to move forward without the agreement of both students and bankers.

The banking industry has been vocal for years about the downside of student lending. "We've been hearing deceptive arguments from the lending industry for a long time," Schireman said. "It's hard to determine when they are crying wolf and when the complaints are well-founded." Schireman said the Administration would seek to secure a lower repayment rate for students, but it wouldn't necessarily push for the scheduled rate change.

Sallie Mae president Paul Carey said that his group, while concerned with the rhetoric of the student groups, was still working on a compromise. "It would be crazy for us to try to hurt students," Carey said. "They're our customers."

In any case, tough decisions lie ahead, said Terry Hartle of the American Council on Education. "Ultimately someone will have to pay—lenders, students, or the American taxpayer. Those are not decisions anyone wants to make, politically." As a result, Hartle doesn't expect any change until very close to July 1, when battle lines will be drawn around the pending reauthorization of the Higher Education Act.

Straw Men and the Student Loan Interest Rate

All numbers are rounded to the closest 10 basis points.

Comparison rates, i.e., the equivalent rates from the students' perspective, based on Administration projections:

<i>Increment above T-bill</i>	In-School	Repayment
10-20 year instrument	1.60	2.20
10-year instrument	1.40	2.00

Straw Man 1a: Low Rate

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed	1.70	2.30

This is the lowest rate that could be justified for for-profit lenders, based on the Treasury study. To make this a better offer, this rate could be combined with proposals aimed at reducing lender costs, *e.g.* the government's willingness to use an even more efficient instrument (such as LIBOR), or streamlining the guarantee and due diligence procedures. (Combined, these changes could reduce lender costs by 20 basis points, bringing profitability to the mid-point level of Treasury's analysis).

Advantages:

- Justifiable.
- Very close to the "hold students harmless" rate.
- Leaves room for further negotiation (*e.g.* fee reductions could be brought up later).

Disadvantages:

- Because it is so close to the bottom of Treasury's range, it will be easy for the industry to reject.
- Imposes a cost on students without compensating them, a possible slippery slope.

Straw Man 1b: Mid-Point Rate

<i>Increment above T-bill</i>	In-School	Repayment
Direct & Guaranteed	1.90	2.50

This is roughly the mid-point of the range identified by Treasury. It also approximately "splits the difference" between the current rate and the rate anticipated by lenders (based on the 10-year instrument). *Since this rate is considerably higher than the rate now projected for students on July 1, it should certainly be combined with a reduction in borrower-paid loan fees.*

Advantages:

- Would be seen as a reasonable offer, based on the Treasury analysis. Chairman McKeon himself has been rumored to be considering "splitting the difference."
- Is approximately the interest rate reduction that was projected when the decision to change the rate was made in 1993.

Disadvantages:

- A better end-point for negotiations than starting point. (If the goal is to achieve at least the reduction intended in 1993 -- 60 basis points in repayment -- it does not leave any further room for negotiation).

Straw Man 2: Split Rate

<i>Increment above T-bill</i>	In-School	Repayment
Government-Guaranteed	1.90	2.50
Direct Loan Program	1.90	2.20

The lower in-repayment rate in the Direct Loan Program is intended to provide lenders with an incentive to offer borrowers lower rates. By having the same in-school rate, the incentive for *schools* to switch from the guaranteed to the direct program is minimized: as is true today, if students don't like the terms they are offered in the guarantee program, they can consolidate into direct loans when they are finished with school. (Student and higher education organizations are suggesting an option similar to this.)

Advantages:

- Provides students with an in-repayment rate *as low as projected for July 1* (in the Direct Loan Program).
- Spurs price competition by lenders, to meet or beat the Direct Loan rate.

Disadvantages:

- Price competition will lead some schools to be frozen out of the guarantee program, while other (elite) schools are offered the best deals.
- Direct Loans will be left with the less profitable portfolio, affecting its image and perhaps its political support.

Straw Man 3: Interest rate-based Auction

Lenders would bid for a particular volume of loans, at a particular interest rate. The lowest-rate lenders would be selected until sufficient volume is available. All the selected lenders could then offer loans at or below the rate of the last-selected lender (which would also be the Direct Loan rate?). There would be an overall maximum rate.

Advantages:

- Efficient method of ensuring students the lowest-possible price.
- As efficiencies lower lender costs, students continue to benefit by even lower interest rates.

Disadvantages:

- Strong incentives for lenders to compete for the high-balance, high-income borrower, leaving direct loans with the remnants.
- Need interim solution until auction can be implemented.

Straw Man 4: Cash Payment-based Auction

Interest rate would be set, but lenders would name a price for offering a particular volume of loans to eligible students. The government would accept bids until a sufficient volume is assured.

Advantages:

- Beyond the low interest rate, savings accrue to taxpayer.
- Could auction loans without the guarantee, to reduce need for continued government involvement.
- More compatible with possible directions for Direct Loan Program.

Disadvantages:

- Need interim solution until auction can be implemented.
- Many unanswered questions about ensuring universal access, how students/school would choose lenders, etc.

The Chronicle of Higher Education

Academic Today

GOVERNMENT & POLITICS

February 20, 1998

Backers of Direct Lending Fight an Effort to Halt Impending Change in Interest Rates

By STEPHEN BURD

Supporters of direct lending are fighting efforts by lenders to halt an impending change in the formula for calculating the interest rate paid by borrowers in the direct-student-loan program.

Advocates of direct lending say that if the change in the interest-rate formula threatens the collapse of the guaranteed-loan program, as lenders have warned, then Congress should stop the change. However, the advocates say, the new formula poses no threat to the survival of direct lending, and so lawmakers should allow the new, lower rates to take effect in the program. Direct lending provides federal loan funds directly to students through their colleges, bypassing the banks that dominate the traditional student-loan system.

"This is not a direct-loan problem," said Thomas A. Butts, director of federal relations at the University of Michigan and a member of the National Direct Student Loan Coalition, which is made up of officials of colleges in the direct-lending program. "This is simply a problem for the loan industry."

Officials of the leading higher-education associations and advocates for students agree. Making the change, they say, would save students in the direct-loan program about \$3-billion and would force lenders to charge the lowest interest rates possible, in order to compete with the new, lower rates in the direct-loan program.

So far, the Clinton Administration has been silent on the debate, but college leaders and lenders alike believe that the White House is quietly backing the position of the direct-loan coalition.

Lenders argue that direct-loan supporters are simply trying to give their program a "competitive advantage" at a time when the guaranteed-loan program is threatened with collapse. "Everybody has been working toward a level playing field between the two loan programs," said Paul Carey, executive vice-president at Sallie Mae, a company that purchases student loans from banks.

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As of July 1, the formula used for calculating the interest rate on student loans will be based on the rate for 10-year Treasury notes rather than on that for 91-day Treasury bills, as it is now. The change will result in a lower interest rate for student loans. The current rate is 8.1 per cent; using the 10-year Treasury note, it would fall to 6.6 per cent.

The transition was required as part of a 1993 law that created the federal government's direct-loan program. It was intended to reduce costs for students as the government replaced the guaranteed-loan program with direct lending, which it is expected to do after five years. But direct lending, now in its fourth year, has captured only a third of the total student-loan volume.

Bankers say they will be forced to flee the guaranteed-loan program if the change in interest rates is made, because the loans will no longer be profitable.

Sallie Mae officials traveled to San Francisco last week for the American Council on Education's national convention to try to convince the council's members that the company had found a solution to the interest-rate problem. But Terry W. Hartle, the council's senior vice-president for government and public affairs, said he preferred the direct-loan coalition's plan.

Under Sallie Mae's proposal, the government would change not to the 10-year Treasury notes, but to the index used for commercial paper, which are short-term loans by major corporations. That index is preferable, the company said, because it is a short-term index like the 91-day T-bill but is more stable, because of its wider use.

Sallie Mae officials say their proposal would lower the interest rate by two-tenths of a percentage point, bringing the current interest rate down to 7.9.

Mr. Hartle said Sallie Mae's plan was unattractive to students, who would see a drop of 1.5 percentage points under the Treasury-note proposal. All students would benefit if Congress chose to allow the rate change in direct lending, he said, because banks would be forced to keep their rates down to compete with direct loans.

"I think that the cost of guaranteed loans will not be significantly greater than direct loans, because the banks will respond aggressively," he wrote in a letter to the council's Board of Trustees, expressing his support for the direct-loan coalition's plan. "Thus, treating the programs differently is the best way to protect students and assure the continued availability of bank-based loans at the lowest possible cost."

That idea is opposed not only by lenders but also by some student-aid directors at colleges in the guaranteed-loan program, who think that all student borrowers should be

charged the same interest rate.

Cathy Thomas, associate dean of admissions and financial aid at the University of Southern California, said that if the direct-and-guaranteed-loan programs used different formulas for determining interest rates, colleges would have to keep switching between the two, depending on which one had the lower interest at a given time.

Such an argument is likely to be persuasive to Republican Congressional leaders, who ultimately will decide what formula will be used to calculate interest rates in both loan programs. They are unlikely to approve any change that would make direct lending seem more attractive than the guaranteed-loan program.

But advocates for the direct-loan coalition's plan said they would fight hard to keep the new, lower rates in direct lending.

"The biggest advantage of the proposal is that it will begin to give us a concrete, market-tested idea about the subsidy that lenders need to make student loans and still make an acceptable profit," Mr. Hartle wrote.

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The Financial Viability of the Government Guaranteed Student Loan Program

Executive Summary

The current student loan formula, which sets the ceiling rate for the government guaranteed student loan program and also for the direct loan program, is based on the bond equivalent yield for 3-month T-bills plus a spread of 2.5 percentage points for loans to students who are in school or for loans that are temporarily deferred, and a spread of 3.1 percentage points for loans that are being repaid, with the rate reset annually for borrowers. The rate that the student pays on loans is capped at 8.25 percent and the Government pays any excess above this rate in the form of a Special Allowance Payment (SAP); the government also reimburses lenders on a quarterly basis for increases in the interest rate within the year.

The Student Loan Reform Act of 1993 (SLRA) scheduled a change in the formula determining the rate that borrowers would pay for new student loans finalized beginning July 1, 1998. The SLRA requires that lenders' gross yield on new loans be based on "the bond equivalent rate of the securities with a comparable maturity as established by the Secretary of Education", in consultation with the Secretary of the Treasury, plus 1.0 percentage point, with the rate reset every 12 months. For the purposes of the government credit budget, the comparable maturity would be a 10-20 year average annual rate (simple interest). However, most observers have assumed that the comparable maturity that will be chosen will be the 10-year Treasury constant maturity yield.

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

This paper provides estimates of lenders' costs (including servicing, default and pre-payment costs as well as cost of funds) and the gross return from student loans under the current student loan formula and under the formula scheduled to become effective on July 1, 1998. We also provide an estimate of the "target" rate of return to which this return will be compared by banks deciding whether to participate in this program. Although we recognize the diversity of participants in student loan origination, our analysis is focused on large, for-profit bank originators because these institutions span the markets in which other lenders operate. Our estimates of costs and target rates of return reflect this choice of focus; they are offered not in the belief that "one size fits all" very well but because we believe that the economic forces at work on these large, for-profit lenders are the leading edge of developments that are likely unfold in this complex market. We have based our analysis on a review of the existing literature, financial data from loan originators, and discussions with many experts in this area.

Our results show that under the current formula, lenders are earning a pretax rate of return on student loans that exceeds a reasonable range of assumed target rates, but that switching to the

new student loan formula would reduce lenders' net return substantially, to a level below this target range. Such a reduction need not imply an immediate crisis in the market for guaranteed student loans but it would be an untenable long-term situation and would perpetuate inefficient uncertainties in the industry. Moreover, only part of this substantial reduction in lender margins arises from the need to hedge. That is, moving back to short-term interest rates as a basis for determining the student loan rate while holding borrowers harmless -- i.e., pegging the student loan rate at the same level as it would be under the new formula -- does not appear to produce a competitive rate of return on the banks' investments in these loans.

In particular, holding borrowers harmless could be achieved by keeping the current T-bill basis for indexing student loans but reducing the current weighted-average rate paid by students from 3-month T-bill plus 2.88 percentage points to 3-month T-bill plus 1.73-1.98 percentage points (depending on which instrument would have been chosen by the Secretaries of Education and Treasury). In order to assure that lenders receive a competitive rate of return, however, we estimate the formula would have to be 3-month T-bill plus a range of 2.08 to 2.43.

Several conclusions are apparent from our analysis. First, unless our assumptions are substantially in error, the new formula will provide a rate of return on student loans which is below the target rate of return of lenders in the guaranteed student loan program. Second, there are large inefficiencies associated with the mismatch of student loan interest rates and bank financing under the proposed formula, and substantial joint benefits could be realized to students and lenders from moving back to a short-term index. Third, while there is some range of uncertainty reflected in these numbers, it is clear that an alternative rate setting formula could be devised, linked to a short-term rate, that would maintain bank participation in the government-guaranteed student loan program over the long-term. Fourth, the new formula should preserve a differential between the mark-up for loans while the student is in school and loans during the in-repayment period; this differential allows gross returns to better track costs and thus help to even out returns among different types of lenders. Finally, it appears from our analysis that attention should be given to the advantages -- and, of course, any possible disadvantages -- of alternative short-term index rates. Although a T-bill rate seems natural for a government program, a program that is dependent on the participation of sophisticated private sector lenders might benefit from their greater efficiency in raising funds indexed to an alternative short-term rate.

Our confidence in the qualitative conclusions of the following analysis is high. Nevertheless, setting student loan interest rates by fiat is a highly uncertain proposition, which is unlikely to result in exactly the minimum rate that lenders need to participate in the student loan program. One way to assure the loan rate is not too high or too low is to allow the market to set the loan rate directly. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans. The experience of the Health Education Assistance Loan (HEAL) program using an auction system for allocating the insurance authority for HEAL loans suggests that an auction could be considered for the Federal Family Education Loan program.

with respect to ?

*Students
hedging costs*

THE FINANCIAL VIABILITY OF THE GUARANTEED STUDENT LOAN PROGRAM

Introduction

The current formula for calculating student loan interest rates -- the ceiling rate for government guaranteed loans and the rate on the direct loan program -- applies to new loans made between July 1, 1994 and June 30, 1998. Under this formula, lenders receive the bond-equivalent yield of 3-month T-bills¹ plus 2.5 percentage points for in-school loans and loans in deferment, or the 3-month T-bill rate plus 3.1 percentage points on loans in repayment. Loans are reset annually for borrowers, with an 8.25 percent cap on the borrower's rate. A lender of guaranteed loans receives a Special Allowance Payment (SAP) in any quarter in which the average rate for 3-month T-bills auctioned during the quarter plus 2.5/3.1 percentage points is greater than the borrower's interest rate (either the formula interest rate established at the last annual re-set or the cap of 8.25 percent). The SAP is the difference between the quarterly re-set rate from the formula and the rate the student pays, divided by four (for a quarterly payment). Until recently, the loan interest rate for loans in consolidation was the weighted average of the interest rates on all outstanding loans being consolidated, rounded up to the nearest whole percent; this figure is currently 9.0 percent. Under the Emergency Student Loan Consolidation Act, passed in October, 1997, the rate for consolidation loans will be the T-bill rate plus 3.1 percent until October, 1998 (capped at 8.25 percent).

The Student Loan Reform Act of 1993 (SLRA) scheduled a change in the formula determining the rate that borrowers would pay for new student loans finalized beginning July 1, 1998. The SLRA requires that lenders' gross yield on new loans be based on "the bond equivalent rate of the securities with a comparable maturity as established by the Secretary of Education", in consultation with the Secretary of the Treasury, plus 1.0 percentage point, with the rate reset every 12 months.² For the purposes of the government credit budget, the comparable maturity would be a 10-20 year average annual rate (simple interest).³ However, most observers have assumed that the comparable maturity that will be chosen will be the 10-year Treasury constant maturity yield. This yield is a commonly used benchmark in financial markets, within the appropriate maturity range, is regularly published in official sources, and is forecast in private as well as government budget analyses.⁴ Based on the assumption for either of these rates, 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 As noted later in this paper, in all likelihood the formula change also would reduce the net return to lenders.

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

In principle, the legislated interest rate is a ceiling, below which lenders can compete to offer the most attractive interest rates to students. In practice, direct price competition of this form has been very limited. Many schools have "preferred provider" lists of lenders to whom they direct students and these lists seem to play the dominant role in students' choices⁶. Competition to be on such a list takes place largely in terms of services -- mostly directed to the schools themselves -- rather than taking the form of direct price competition, and there is considerable variation among schools in their procedures. At some schools, for instance, preferred providers may have other connections to a school and its community, and offer nothing more than customer-relations at the bank; at other schools, however, competition may be keen among providers to offer quick payments to schools, ease in billing, and assured follow-up on delinquencies. Lenders may send representatives to campuses at enrollment time to help with loan processing, may coach students on loan consolidation options, and may provide the school with substantial computer support for financial processing. There appear to be substantial economies of scale in basic loan servicing and it may, therefore, be worthwhile for large servicers to expend additional resources on essentially promotional activities. (As will be noted below, our cost estimates have not attempted to capture such promotional costs.)

Overall, it appears that for a top tier of schools that are attractive to major national lenders, the loan market is "imperfectly competitive" with loan providers likely able to establish reputations and maintain market share for a time at prices above a purely competitive level. For this tier, however, it is likely that the drive to maintain market share and realize economies of scale at least assures effective competition in service provision. For schools relying on local providers, competition may not be very effective, and local loan providers may well be able to obtain extra returns from sale of loans in the secondary market as they reach the "in repayment" stage where scale economies for servicing become especially important. For schools whose programs lack the characteristics that appeal to private lenders, the role of not-for-profit public agencies in providing a secondary market is especially important.

Competition among lenders has become more keen since the inception of the full-scale federal direct loan program, which does offer some directly financial incentives, such as income-contingent repayment options and loan-write offs under certain special circumstances. Nevertheless, although lenders are not required to charge borrowers the full rate of interest authorized by the student loan formula, our understanding is that direct competition on a loan interest rate basis is rare. Direct interest rate competition seems to be viewed with unease, as subject to criticism for being discriminatory and as socially divisive --even when, in the secondary market, loans from schools with better repayment records will sell for a higher price than loans from other schools. An important but small exception is the Sallie Mae formula -- the "Great Rewards Program" -- for reducing the loan rate in repayment, based on a borrower's good payment performance over a period of time. We understand that other lenders, particularly some of the major institutions in the national market, have followed Sallie Mae's lead in this respect with similar types of incentives. (The effect of such programs on our profit calculations will be noted below.)

The new loan formula introduces another dimension of cost for lenders, because of the

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

The cost of this swap agreement will detract from the overall profitability of the loan contract from the banks' perspective. Moreover, because this particular swap contract is somewhat unusual, substantially boosting the demand for such swaps could raise the cost of obtaining such swaps. The critical policy issue for the loan program is whether lenders offering student loans currently have a profit margin that is sufficiently large to absorb this and any additional costs, so that the return on educational loans is still favorable.

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

Assumptions for Lenders' Costs

The following discussion attempts to describe the costs of a for-profit lender big enough to have achieved scale economies in its operations while both originating loans and holding loans in repayment in its portfolio. We realize that analyzing the situation for any one type of lender may not describe accurately the cost structure all lenders or loans in this diverse market. Indeed, only 41 percent of outstanding student loans are held by banks, while not-for-profit institutions (essentially state government agencies) hold 26 percent and Sallie Mae, the currently government sponsored enterprise, holds the remaining 31 percent. Student loan originations are very much more concentrated among banks because the origination business is legally limited, with a few exceptions, to banks. Bank originators, however, range considerably in size and funding sources and may experience cost differentials depending on the parts of the student population that they most readily serve.

Our choice of focus was dictated by three considerations. The first, and most important, is trends in financial markets towards consolidation, with the implicit realization of scale economies and specializations of function. This trend has been illustrated in the case of student loans, where from 1994 to 1996 the top 25 originators increased their market share from 55 to 60 percent [CAN WE GET LONGER HISTORICAL PERSPECTIVE?] In view of these trends, it made most sense to us to examine the part of the market where expansion has tended to occur and where the cutting edge of the formula change might first have an effect.

Second, non-profit entities should experience similar pressures on the return from their loans as a result of the change in the mark-up in the formula over the index interest rate, and the evolution of substantially narrower spreads between long-term and short-term interest rates since 1993. In a relatively tranquil financial environment, public sector entities might not feel that they needed to hedge the basis risk imposed by the new formula. Thus, their costs might not be as severely impacted as banks' costs in the short-term and the availability of loans from these agencies might respond slowly -- or even be positive if they moved to pick up some short-run fall out from the for-profit sector. Over time, of course, failure to hedge basis risk could prove costly for these institutions if financial markets changed abruptly. The emergence of different funding costs than anticipated could impose budget pressures on the parent state governments and, ultimately, affect the rating given by rating agencies to a public sector agency. In this respect, the pressures implied on the not-for-profit sector would parallel those discussed below for commercial banks.

Finally, we have chosen to focus primarily on institutions that are formally loan originators, since without origination there would be no secondary market. The lines between the primary and secondary markets are not hard, and it has become increasingly clear that the secondary market plays a very important role in allowing smaller originators to sell loans profitably at the point in their life cycle when servicing costs could become prohibitive without greater scale economics. Given that there are large banks that span both loan origination and secondary market activities, however, analysis of their profitability should assure the profitability of the student loan market overall. That is, given arbitrage in the secondary market for student loans, the analysis should be the same whether banks originate and hold these loans or whether they sell them to secondary holders at a premium; if, for example, there are regular excess returns to selling over holding, there would be no banks engaged in both activities.

Of course, even the for-profit market need not be expected to respond instantly or massively to adverse changes in profitability. A 1992 study of the student loan market suggested that a 25 basis point reduction in payments to lenders could lead growth of loan volume to be about 1 percentage point lower than it would have been in the absence of the reduction, and a 50 basis point reduction could lower the growth rate by about 2 percent -- amounts that could be accommodated by the not-for-profit guarantee agencies.⁷ This report notes, however, that its conclusions should not be extended beyond the range of variables examined historically and, as will be noted below, the reduction in profitability from the impending formula change could be larger than the changes this report examined.

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

- The 1999 Budget projections for **interest rates** are shown in Table 1, along with some other projections for comparison. All of these projections suggest that the yield curve will remain relatively flat, consistent with the structure of current market rates. The projected yield curve is somewhat steeper under administration projections for 1998 than in projections from other sources, but for 1999 the projections are more similar. Interest

rate levels are projected to change rather little and the spread between long-term and short-term rates is projected to remain well below average historical experience since 1962, consistent with a favorable inflation outlook and expectations of federal deficit reduction that adds to national saving.

- Under the new formula, the need for **hedging** affects lenders' returns. Lenders would be expected to swap -- i.e. give up -- their long-term income to obtain a short-term-index-linked income flow that would parallel their cost of funds. We talked with several major financial institutions, which provided estimates of the cost of swaps between a fixed 10-year Treasury yield, reset annually, and LIBOR. We were unable to obtain swap estimates for the case of a 10-20 year maturity instrument, which is not currently traded on a regular basis. We therefore assume that banks swap the 10-year portion of the risk in this case, and bear themselves (at a cost) the additional variation of this particular index.

We emphasize that the swap quotes we obtained are for a contract that is currently used only to a limited extent. The market for swapping between a fixed 10-year Treasury yield and LIBOR is a deep market, but swap brokers have no natural counter-parties for a floating rate long-term yield and are likely, therefore, to need to hedge themselves on this side of the market through a basket of fixed rate transactions. The need for the swap dealer to hold one side of the contract may imply that a liquidity premium would develop in this market if the swap were demanded in volume. We assume that swaps would be available and chose a representative estimate of the costs of hedging from quotes provided to us by swap dealers.

Using this estimate of hedging costs, we translated lenders' returns from the long-term indexed formula into a short-term rate of return after the hedge. It should be noted that the cost of these floating rate hedges are, we are told, quite sensitive to the shape of the yield curve. Consequently, our estimates of the future returns from the hedged asset are sensitive to the underlying economic assumptions, which show very little change in the shape of the yield curve by historical standards.

- The **lenders' cost of matched funds** is assumed to be the 3-month T-bill, or the 1-or-3-month LIBOR rate plus a given spread. The size of the spread for an individual lender will depend on its size and creditworthiness and on the exact structure of the financing --e.g., whether warehousing loans or raising new funds by actually selling a package of loans in a securitization. Large lenders will move around among sources in the short-term financial markets seeking the lowest costs. In general, arbitrage will tend to keep costs fairly closely in line. For example, we obtained quotes for swapping T-bills into LIBOR, a highly liquid market in which banks do much marginal funding. These quotes plus a slight mark-up over LIBOR for banks actual funding yielded roughly similar costs to those associated with typical securitizations done in the first half of last year. We have assumed a short-term funding cost in the range of these securitizations.
- The **all-in cost of funds** used in the calculations below is the short-term matched fund

cost, as discussed above. These costs are then **adjusted** (fourth row of Table 2) to allow for a small fraction of a loan asset to be counter-balanced on the balance sheet of a bank by capital rather than debt; thus, a student loan is not assumed to be 100 percent debt financed by the originator.

- Given the cost of funds and an estimate of lenders' return after hedging, we calculate the **net interest margin** earned on the loan asset (see Table 2)
- **Servicing and overhead costs** (an estimate of the total seems likely to be more accurate than estimates of the separate pieces) include a share of expenses such as general management, legal, accounting, human resources, and marketing costs plus direct costs for servicing the loan such as expenses for collections, borrower correspondence, reporting and account maintenance, and filing guarantee claims. Servicing costs seem to vary among lenders depending on the size of lenders and the efficiency of their operations. Larger lenders probably are more efficient owing to economies of scale. Costs may differ also among parts of the student population depending, e.g., on whether or not the students typically complete four or more years of schooling possibly at an expensive school, thus accumulating a large total loan for given costs of billing.
- The possibility of **default** on loans in repayment also implies some small cost to lenders.. Recent data suggest that default rates may be declining. The probability of default on in-school loans, and to a lesser extent loans in consolidation, generally has been small. The Federal Government pays the interest cost on a subsidized student loan while a student is in school. Most important, the Government guarantees 98 percent of a student loan, thereby reducing substantially the cost of default to the lender. (Currently, a borrower pays a guaranty agency a loan insurance premium of 1.0 percent of the loan amount to help defray default costs; the lender may pick up part of this cost to the borrower in order to reduce the overall loan rate but is not required to do so nor assumed here to do so.)
- Another cost for lenders is the one-time 50 basis point **origination fee** paid by loan originators to the Department of Education. This fee cannot be passed on to borrowers, who already pay a separate 3 percent origination fee to the Federal Government to help offset the cost of the Federal subsidy. In addition to this origination fee, holders of consolidation loans must pay to the Federal Government a **rebate fee**, calculated on an annual basis, equal to 1.05 percent of the loan principal plus interest, which is then added to the 50 basis point origination fee.
- Lenders offering student loans face a risk of prepayment of loans attributable to defaults, loan consolidation, and advance payments from borrowers. Prepayment reduces the life of a loan, thereby increasing the over-the-life cost of certain fixed expenses, e.g., origination support. Consequently, lenders may face a **prepayment risk** that results in a cost to them. Many financial experts, however, think that prepayment costs are not large for student loans because there is little evidence of prepayment on these loans being interest rate sensitive; the absence of interest sensitivity seem reasonable as most

borrowers would have accumulated other credit with higher rates that would be more important to prepay when interest rates decline. (This absence of interest sensitivity distinguishes student loans from mortgages for which prepayment means that lenders forego a highly profitable asset in an environment where they cannot make a new loan at as high a rate.)

Table 2 provides a summary of the interest margin cost assumptions used for this paper. The two major costs for lenders are their all-in cost of funds and servicing/ overhead costs; the former is then adjusted for counter-balancing as noted above. For the former, the rates are 5.56 percent (5.15 bond-equivalent average yield on the 3-month T-bill +0.70 spread, net of adjustment) for 1997/98 and 5.48 percent (5.07 T-bill plus .70, net of adjustment) for 1998/99. The estimated servicing/overhead cost for loans in repayment status is 95 basis points. For in-school loans, the estimated cost is one-third the cost for loans being repaid, or 32 basis points. All other costs combined are 9 basis points for in-school loans and 20 basis points for loans in repayment. The net interest margin for a swapped loan tied to a long-term index in 1998/99 or thereafter is assumed to reflect a swapped return of T-bill plus 1.60 (given swap quotes plus the 1.0 markup over the long-term index in the new loan formula).

For the future policy environment, **Table 2** shows two scenarios: interest rates tied the 10-year CMT rate, and interest rates tied to the bond equivalent of the 10-20 year rate. As noted earlier, the latter is the actual cost of these loans in the government credit budget, while the former is the commonly assumed index for the loans. We compute our results using both rates throughout the report. **Table 4** breaks out the underlying costs in more detail, and shows the effects of considering as well the case of consolidation.

Target Rate of Return for Student Loans

The viability of various student loan formulae depends on the appropriate target rate of return for the lender for this particular asset. The ultimate criterion that a financial institution must meet is a competitive rate of return on its capital. The return on its capital and the return on its assets are related by the ratio of capital to assets.

Banking regulations in fact require that two conditions be met for capital adequacy: One condition requires a ratio of capital to *risk-adjusted* assets. The required ratio is 8 percent but recent history shows ratios well above that. The industry -wide average currently stands at around 12.5 percent, down from 13.2 percent in 1994.

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

The second requirement (the leverage ratio requirement) is for a minimum amount of capital equal to 4 percent of assets regardless of risk weight. As with the risk-based capital standard, banks have tended to have more than required capital in recent years (the average ratio

has been above 7 percent). Although these years may mark an historically peculiar period, it is important to note that to achieve standing as a "well capitalized bank" (which 98 percent of banks now have), capital must be at least 5 percent of assets without risk weighting.

Clearly, banks' circumstances may vary considerably with a bank having excess capital after an exceptionally profitable year permitted large retained earnings, and vice versa. Some banks may be bound at times by one capital requirement and, at other times, by the other required ratio. For a low-risk loan category, however, it seems more likely that the target for overall capital would be controlling rather than the risk-based standard. Some financial market participants (non-bankers) share this view.

If banks had a target rate of return on capital of 12 percent (after-tax, or 20 percent before-tax) -- about the average since 1970 -- a 5 percent target capitalization, on the margin, for fairly safe assets would imply a target return on those assets of 1 percent before tax. Note that this is considerably below the average return that banks have been receiving on their overall portfolios during the recent period of high bank profits. Alternatively, if banks had a target rate of return after tax of 13.7 percent, the average for the last five years for the 10 largest banks, and a target capitalization of 5 percent, their target before tax rate of return would be 1.15 percent. With a target rate of return of 12 percent and only 4 percent capitalization, their target rate of return would be 80 basis points. Alternatively, if banks viewed student loans more as "loss leaders" for community relations and future business, they might accept an after-tax rate of return of about 10 percent with 5 percent capitalization, also implying about 80 basis points as a minimum target return on these assets. We believe that these assumptions span a relevant range for assessing the prospects for returns to student loans. Thus, *we use a range of estimates for our target rate of return of 80 to 115 basis points.*

We recognize that efficient lenders could choose to operate at the margin with lower capitalization, generally meeting the risk-based standards with more differentiation in the assumed capitalization and target rates of returns across asset types in their portfolios. Whether enough banks would, in fact, be willing to make such fine distinctions with regard to asset categories that were only small parts of their total portfolios (in the aggregate student loans are only about 2 percent of banks' assets) is an open question. Assuming an excessively high capitalization in estimating banks' target rate of return implies giving the banks a subsidy in the student loan formula. On the other hand, assuming an unrealistically low capitalization and target rate of return would imply eventual exodus of lenders from the industry. We have chosen a middle ground by using the overall leverage ratio requirements, but by relying on the minimal regulatory level of those requirements, and not the current (much higher) average level of capitalization. But we recognize the potential efficiencies that could emerge, and the resultant lower target rate of return, if loans were concentrated in institutions with lower marginal capitalization requirements.

Our choice of a reasonable range of target returns can be interpreted relative to two frames of reference. The first is the current rate of return to the banking sector. The average pre-tax return on all bank assets (averaged across all banks) was roughly 1.75 percent over the 1993-96 period (latest available comprehensive data). Some financial analysts have told us that,

because these average returns on all assets had been calculated after allowances for defaults and loan-loss reserves, they were already risk-adjusted and represented the appropriate standard to which to compare a risk-adjusted return on a safe asset such as student loans. Others analysts, however, seemed inclined to think that a government-guaranteed asset with a fairly stable interest rate and cash flow profile possibly could receive a pre-tax return far below 1.75 percent although they did not present firm frameworks for determining how much below average a student loan return should be. Even accounting for loss reserves, the facts on risk and non-risk adjusted capitalization presented above imply most bank assets are much riskier than student loans, and therefore require a much higher capitalization and return. Thus, it is reasonable to assume that the target rate of return on student loans is much lower than the current average return on assets.

The second criterion for judging the target rate of return is the rate of return on alternative, comparable, assets. A 1997 paper by the CRS9 on the student loan program presented estimated returns on a couple of alternative assets as a frame of reference for judging returns on student loans. This approach keys on the idea that no profit-maximizing bank would allocate part of its portfolio to an asset that was dominated by other available assets. CRS estimated returns on Ginnie Mae securities¹⁰ at 1.20 percentage points and estimated the return on adjustable-rate mortgages to be 1.25 percentage points; these rates are slightly above the upper end of our range of target rates of return. Although this is an attractive approach in principle, however, it runs into important difficulties in practice. The usefulness of the adjustable rate mortgage return for comparison may be questioned because it does not take account of "teaser rates", which have become a very important feature of this market and could significantly lower the rate of return. The Ginnie Mae comparison also may be problematic because the spread between yields on this instrument (even after adjustment for systematic prepayment risks) and other open market rates such as Treasuries appears to be quite volatile. These instruments are held by banks in their investment portfolios more for trading purposes, implying use for liquidity and interest rate plays, than in their long-term loan asset portfolios.

Summary Results and Some Empirical Evidence

As shown in Table 2, our estimate of the pre-tax weighted net return to lenders in 1997/98, for in-school loans and loans in repayment, is about 1.63 percent. It appears that, under the current student loan formula, lenders are earning more than an adequate rate of return on student loans compared with a reasonable range for the minimum target rate of return. Student loans, however, may yield a slightly lower rate of return than the average return in recent years on banks' total portfolios.

As noted above, this return does not allow for discounts from the maximum student loan rate that banks may charge. For example, Sallie Mae offers a "Great Rewards Program" that allows borrowers who have made 48 consecutive loan payments on time a 2 percentage point discount of the loan rate. Other lenders have similar concessions. For Sallie Mae, the discount translates to about a 10-15 point reduction in return for their entire portfolio.¹¹ If this discount is the competitive standard for the industry, then banks' net returns are actually 1.48 to 1.53 percent after the cost of the discounts. Costs of marketing and promotional factivity that we did

not allow for would also reduce lenders returns. Nevertheless, even after factoring in these competitive discounts and costs of service competition, there is a large excess return in this sector.

On the other hand, this return also does not consider the fact that the interest rate for unsubsidized student loans is higher than the current rate for subsidized loans: this rate is the one-year treasury interest rate plus 3.1 percent, which is currently about 100 basis points higher than the rate for subsidized loans. This differential will be reduced somewhat by the costs of hedging this one-year instrument into a shorter term instrument, but it nevertheless provides excess returns to banks who are providing both subsidized and unsubsidized loans. Since subsidized loans are roughly 10% of loan volume, this implies at most a 10 basis point increase in net returns for the average bank, so it once again does not greatly affect our calculations [TO BE RECHECKED].

The financial statements for 1996 for two major student loan originator are very consistent with our estimates. For one wholly student loan subsidiary, the annual pre-tax rate of return for 1996 was 1.64 percent; for another bank, their internal calculation of the implied rate of return to their student loan department was 1.99 percent. For the first bank, partial data for 1997 indicates a reduction in the rate of return to 1.29 percent.¹² The decline in returns for 1997 likely reflects, in part, the fact that the structure of interest rates in the short-term market also became less favorable to lenders for a while last year than our assumptions allow. In particular, the Treasury bill rate, to which the short-term cost of funds is pegged in assumptions used to analyze the current formula, tended to decline relative to other short-term rates, such as LIBOR, during the past year, increasing the cost of matched funds for lenders. But this phenomenon appears to have been a temporary initial reaction to the financial disturbances in Asia (a "flight to quality"), and more recent data suggests that this trend has been reversed. We have assumed that banks will continue to be able to fund in a variety of markets with the spreads among rates similar to those that prevailed in the earlier part of 1997, before the Asian difficulties emerged.

Another source of profit data is Sallie Mae. Of course, this secondary market agency is not a loan originator but its joint ventures and pre-purchase agreements bring it close to the origination market. Its rate of return on assets for 1997 (from partial data once again) is similar to that reported above for the student loan subsidiary: 1.2 to 1.3 percent. Their slightly lower return than our calculation may reflect, in part, premiums that it pays on loans acquired in the secondary market rather than aspects of its costs that are directly relevant to originators. Furthermore, its rate of return on capital is higher than would be implied for banks because, as a Government Sponsored Enterprise, Sallie Mae can operate now with a lower capitalization. Thus, for the present, it too seems to be earning at least an adequate rate of return. In the future, Sallie Mae can be expected to continue to operate a high-volume, low-margin activity as long as costs in the market for securitizations permit it to move a considerable volume of assets off its books fairly quickly. Sallie Mae's situation will change in an important respect, nonetheless, because of its transition to privatization. As a private entity, the holding company can be expected to be required by credit rating agencies to have higher capitalization than it now has; this will be relevant for its required return on assets which can be expected to become more similar to that of banks.

The return to lenders would change dramatically if the new student loan formula were changed from the 3-month T-bill rate plus 2.5/3.1 percentage points to a longer rate (either for 10-year Treasury notes, or to 10-20 year interest rates) plus 1.0 percentage point, in part because of the new risk associated with this change which raises the all-in cost of funding as a result of hedging. Table 2 shows that switching to the new student loan formula for loans in school and in repayment could reduce the weighted average pre-tax return to lenders from 1.63 percent under the current formula in 1997/98 to 0.38 percent to 55 percent under the new formula next year if the 1999 Budget assumptions are borne out. Clearly, these estimates, if correct, would not be acceptable to lenders.

It may be noted, however, that these findings are somewhat sensitive to substantial interest rate movements within a year, i.e., between the time (end of May) when the student loan rate is determined by formula and the time when a lender actually makes a loan and finances it. For example, if the new formula were in place for the current school year, using the 10-year CMT rate, the risk-adjusted net return on assets for student loans in-school and in-repayment would be 1.08 percent. This is in the range of providing a satisfactory rate of return. However, this rate of return would have been achievable only because yields fell significantly after mid-1997, lowering the cost of funds relative to the second quarter of 1997 when the formula sets the student loan rate.

The fact that the yield curve historically has been much steeper than is currently projected was the reason in 1993 for expecting that the new formula would be financially acceptable. Adjusting the data for the years when the loan formula rate exceeded the 8.25 percent cap on the student loan interest rate, the 10-year rate plus 1.0 percentage point has been less than the 3-month T-bill rate plus 3.1 percentage points by an average of only 28 basis points since the early 1960s. The 1999 Budget assumptions project this difference to be 137 basis points in 1998, 131 basis points in 1999, and 121 basis points from 2000 through 2007 (with the T-bill based index higher); other projections have a similar contour. As noted above, swap dealers have documented to us that the all-in cost of funds for student loans tied to a long-term index (with an annual reset) would be substantially sensitive to the yield curve; that is, with the historically much steeper yield curve, banks would have earned a much higher profit on their student loans.

But this very historical pattern documents the difficulties with tying student loan interest rates to a long term index, when banks finance themselves on a short-term basis. This approach introduces a substantial risk into the banks portfolio which is not mitigated by swapping, due to the annual reset provision. The difficulty of using a long-term index for student loans should be seen not as a matter of betting on future yield curves but rather in light of the risk to lenders that is implied by the experience between 1993 and 1998. The slope of the yield curve is notoriously uncertain, and mis-judgements about it have played a significant role in problems of lenders including the thrift institution difficulties of a decade ago. Making the profitability or the availability of guaranteed student loans dependent on such uncertainties seems like unwise policy.

Regardless of this point, however, it is fairly clear that given average non-interest costs

(averaging across in-school and in-repayment) of 87 basis points, a 100 basis point mark-up of the student loan rate over an index rate leaves very little room for profits except under favorable spreads between long-term indexed income and short-term indexed borrowing costs. And, as Table 3 illustrates, this point is true looking forward over the next five years of projected interest rates as well. The first rows of Table 3 show that the rate of return to the banks would remain high if the current system were maintained. But the next rows show that the rate of return under the new legislation will remain below the target rate into the future as well as in the current environment.

Is there a Remedy ?

The results in Tables 2 and 3 imply that lenders will not receive a reasonable rate of return in the government-guaranteed student loan program if the scheduled change of formula takes place in July, 1998. As shown in Table 3 (second block of rows), the five year average return under the new formula would be 34-53 basis points, given the administration's economic assumptions. It should be noted that there is some variation in returns from one student loan year to the next in the table that arises largely from projected changes in the level of interest rates within each year; as noted above, in a year when the cost of funds falls relative to the level of interest rates in the second calendar quarter, which sets the student loan rate, the student loan becomes more profitable for the lender.¹³

One possible remedy would involve returning the basis for student loans to a short-term rate, while holding borrowers harmless so that the total cost to a student next year would be no higher than under the new formula. This alternative, however, does not appear sufficient to provide a competitive rate of return to banks. Holding borrowers harmless would require that the student loan interest rate for 1998/99 is reduced to 3-month T-bill plus 1.73 percent to T-bill plus 1.98 percent, depending on whether the 10 year or 10-20 year rate is used (see Table 3). However, we estimate that a formula which holds borrowers harmless would provide lenders only a 0.51 percent to 0.76 percent rate of return next year, using 1999 Budget assumptions (which have a small decline in short-term rates, and hence borrowers' costs during the student year). This rate of return is below the target rates described above. But, in the case of the 10-20 year rate, it is very close.

Another possible remedy would involve allowing lenders the minimum rate of return that would make student loans profitable according to a target rate of return criterion. We calculate that the loan rate under this approach would range from T-bill plus 2.08 percentage points to T-bill plus 2.43 percentage points; this uses the second quarter interest rate for each year to set the appropriate markup. All of these loan rates would be somewhat higher than would prevail under the formula now scheduled to go into effect at mid-year. Any of the rates would represent, however, a significant reduction in the cost relative to the current system (roughly 45-80 basis points from the current markup of 2.88, using a weighted average of the rates in-school and in repayment). Thus, a new formula which allowed banks and students to "split the difference" could provide a competitive rate of return to banks, while maintaining much of the projected savings to students from the scheduled interest rate change.¹⁴ Indeed, the savings to students would be roughly that projected when the SLRA scheduled this rate change for July 1, 1998, or

even a bit higher.

In addition to considering an alternative T-bill based formula, our research into hedging emphasized for us the importance of alternative short-term indexes, such as LIBOR or commercial paper, for the financial community. The possibility of achieving economies for lenders by using such an index should be explored; using these alternative instruments could save 10 or more basis points for banks, which could additionally be passed on to students in the form of lower rates. The inefficiencies of a T-bill based formula are not nearly as large as the inefficiencies of a 10-year or 10-20 year based formula. But there are inefficiencies nonetheless, and serious consideration should be given to reducing them.

Additionally, any new formula should probably also revert to recognizing the significant differences in lenders costs for loan in-school and in-repayment, as is recognized by the current 60 basis point differential. Our research has suggested real underlying cost differentials between these two states, and recognition of these cost differences in the formula setting returns would help to even out returns across types of lenders.

Why Set the Rate Administratively?

The difficulty of this exercise points out the fundamental problems with regulatory determination of student loan interest rates. Setting these rates by fiat is a hit or miss proposition, which only by chance will result in the minimum rate lenders need to participate in the student loan program. One way to assure the loan rate is set appropriately would be to *allow the market to set the rate directly*. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans.

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

The experience of the Health Education Assistance Loan (HEAL) program suggests that such an auction can work. HEAL is a federally-insured loan program for graduate students in schools of medicine and other health professions. The interest rate for both borrowers and lenders is reset quarterly, but rates on HEAL loans are capped at the rate for 3-month T-bills plus 3.0 percentage points. Since FY 1993, there has been an auction system for allocating the insurance authority for HEAL loans and the interest rate spread over the T-bill rate has been well

below the cap and declining every year. The lowest rate bid in the first auction was T-bill plus 2.4 percentage points. For the most recent auction in February, 1997 (for the school year 1997/98), the successful bid was T-bill plus 1.5 percentage points.

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

Concluding Remarks

The results presented in this paper rest on a number of assumptions about the cost structure of the student loan program, projections of the term structure of interest rates and the costs of hedging loans tied to long-term interest rates, and estimates of the target rate of return for lenders. These results therefore have a degree of uncertainty that is not necessarily reflected in our tables. Nevertheless, four conclusions seem clear.

- Unless our assumptions are substantially in error, the new formula will provide a rate of return on student loans which is below the target rate of return of lenders in the guaranteed student loan program.
- There are large inefficiencies associated with the mismatch of student loan interest rates and bank financing under the proposed formula, and substantial joint benefits could be realized to students and lenders from moving back to a short-term index.
- While there is some range of uncertainty reflected in these numbers, it is clear that an alternative rate setting formula could be devised, linked to a short-term rate, that would maintain bank participation in the government-guaranteed student loan program over the long-term.
- The new formula should preserve a differential between the mark-up for loans while the student is in school and loans during the in-repayment period; this differential allows gross returns to better track costs and thus help to even out returns among different types of lenders.
- Finally, it appears from our analysis that attention should be given to the advantages --

and, of course, any possible disadvantages -- of alternative short-term index rates. Although a T-bill rate seems natural for a government program, a program that is dependent on the participation of sophisticated private sector lenders might benefit from their greater efficiency in raising funds indexed to an alternative short-term rate.

Our confidence in the qualitative conclusions of the following analysis is high. Nevertheless, setting student loan interest rates by fiat is a highly uncertain proposition, which is unlikely to result in exactly the minimum rate that lenders need to participate in the student loan program. One way to assure the loan rate is not too high or too low is to allow the market to set the loan rate directly. For the student loan program, this could mean using some form of auction system to determine who would receive the rights to originate student loans. The experience of the Health Education Assistance Loan (HEAL) program using an auction system for allocating the insurance authority for HEAL loans suggests that an auction could be considered for the Federal Family Education Loan program.

TABLE 1: INTEREST RATE ASSUMPTIONS
(Percent)

SOURCE	1997	1998	1999	2000	2001	2002	5-year ave.
OMB ('99 Budget)							
3-month T-bill	6.17	5.13	5.01	4.91	4.81	4.81	4.93
10-year note	6.75	5.86	5.80	5.80	6.70	5.70	5.77
Spread	1.58	0.73	0.79	0.89	0.89	0.89	0.84
memo: 10-20 simple	6.77	5.11	6.03	6.03	6.03	6.03	6.03
Blue Chip (Feb. 98)							
3-month T-bill	5.17	5.24	5.24	-	-	-	-
10-year note	6.75	5.80	6.00	-	-	-	-
Spread	1.58	0.56	0.76	-	-	-	-
CBO (Jan'99)							
3-month T-bill	5.17	5.45	5.34	4.83	4.82	4.82	5.07
10-year note	6.75	6.00	6.10	6.00	5.90	5.90	5.88
Spread	1.58	0.55	0.76	1.07	1.08	1.08	0.91
ORU (Jan'98)							
3-month T-bill	5.17	4.85	4.53	4.21	4.2	4.22	4.422
10-year note	6.75	5.84	5.78	5.83	5.47	5.33	5.57
Spread	1.58	0.69	1.25	1.42	1.27	1.11	1.15
Implicit Forward Rates b/							
3-month T-bill	-	5.17	5.40	5.33	5.64	5.33	5.374
10-year note	-	5.67	5.80	5.82	6.03	6.14	5.912
Spread	-	0.50	0.40	0.59	0.39	0.81	0.54

Note: Data for 1997/98 are actual data for the last week in May, 1997 prior to June 1; all other OMB data are for the second calendar quarter while data from other sources are for calendar years, as published. All bill rates are converted to a bond equivalent basis.

a/ The average simple annual interest rates for 10 to 20 year Treasury bonds, as used in credit budget scoring.

b/ Forward rates for June of each year, as of February 10, 1998.

n.s. Not available.

02/17/98

TABLE 2: INTEREST MARGIN AND COST ASSUMPTIONS
(Percent or Basis Points)

Income or Cost Category	Current Policy		Future Policy:10-year CMT		Future Policy:10-20 year	
	In-School	Repayment	In-School	Repayment	In-School	Repayment
Loan income, after hedging if needed a/	Bills + 2.50	Bills + 3.10	Bills + 1.60	Bills + 1.60	Bills + 1.77	Bills + 1.77
All-in cost of funds b/	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70	Bills + 0.70
For 1997/8 & 98/9	5.85	5.85	5.77	5.77	5.77	5.77
Adjusted costs c/	5.56	5.56	5.48	5.48	5.48	5.48
Interest margin	2.11	2.71	1.25	1.25	1.42	1.42
Servicing and other costs d/	0.41	1.13	0.41	1.13	0.41	1.13
Net income before tax, 1997/8 & 98/9	1.70	1.58	0.84	0.12	1.01	.29
Weighted average net income e/	1.63		0.38		0.55	

Note: Costs are representative of large for-profit lenders who both originate loans and hold loans in-repayment in their portfolios.

- a/ For current policy, loan income is the formula determination, based on Q2 interest rate; for future policy, loan income is determined under the formula and then reduced by the cost of hedging the loan to convert it into a short-term denominated asset.
- b/ All-in costs are the cost of matched funds, which are assumed to be essentially the same whether raised in a T-bill denominated securitization of borrowed in the LIBOR market, possibly entailing a T-bill/LIBOR swap.
- c/ Costs to banks are adjusted, in the fourth line above and following tables, reducing them by 5 percent of this total, because that amount is assumed financed by equity.
- d/ Includes servicing and overhead costs, origination fees, default risk and prepayment risk (for detailed component separately, see Table 4).
- e/ Weights are 36.8% in school and 63.92% in repayment.

TABLE 3: SUMMARY TABLE OF STUDENT LOAN PROGRAM RESULTS
Administration Economic Assumptions

Formula or Net Rate of Return	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	5-yr. ave.
1 Current Formula:							
1a. 3-month T-bill + 2.50/3.10	7.67/8.25	7.63/8.23	7.51/8.11	7.43/8.01	7.31/7.91	7.31/7.91	7.43/8.03
1b. Estimated net return to lender	1.63	1.68	1.64	1.64	1.59	1.59	1.62
2 Future Formula:							
2a. 10-year CMT + 1.00	n.a.	6.88	6.80	6.80	6.70	6.70	6.77
2b. Estimated net return to lender	n.a.	0.38	0.36	0.36	0.31	0.31	0.34
2c. 10-20 year, simple interest + 1	n.a.	7.11	7.03	7.03	7.03	7.08	7.05
2d. Estimated net return to lender	n.a.	0.55	0.52	0.51	0.53	0.53	0.53
3 Alternative Formulas:							
3a. To hold student harmless, CM	n.a.	T-bill + 1.73	T-bill + 1.79	T-bill + 1.89	T-bill + 1.89	T-bill + 1.89	T-bill + 1.83
3b. Estimated net return to lender	n.a.	0.51	0.65	0.65	0.60	0.60	0.58
3c. To hold student harmless, 10-2	n.a.	T-bill + 1.98	T-bill + 2.02	T-bill + 2.12	T-bill + 2.22	T-bill + 2.22	T-bill + 2.11
3d. Estimated net return to lender	n.a.	0.76	0.78	0.88	0.93	0.93	0.85
To maintain lenders' minimum target net rate of return:							
3f. 80 basis points	n.a.	T-bill + 2.08	T-bill + 2.08	T-bill + 2.08	T-bill + 2.08	T-bill + 2.08	T-bill + 2.08
3g. 100 basis points	n.a.	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28	T-bill + 2.28
3h. 115 basis points	n.a.	T-bill + 2.43	T-bill + 2.43	T-bill + 2.43	T-bill + 2.43	T-bill + 2.43	T-bill + 2.43

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

n.a. Not applicable

2/17/98

TABLE 4: RISK-ADJUSTED PRE-TAX NET RETURN for FFEL STUDENT LOANS, 1997 and 1998
(Percent, Administration Economic Assumptions)

	7/1/97 to 6/30/98			7/1/98 to 6/30/99		
	In-school or Deferment	Repayment	Consolidation	In-school or Deferment	Repayment	Consolidation g/
Student Loan Interest Rate	7.67	8.25	9.00	6.88	6.88	9.00
Loan income, net a/	7.67	8.27	9.00	6.73	6.73	8.87
Less Costs:						
All-in cost of funds b/	5.85	5.85	5.85	5.77	5.77	5.77
Adjusted cost c/	5.56	5.58	5.58	5.48	5.48	5.48
Origination/holding fee d/	0.06	0.04	1.10	0.06	0.04	1.10
Servicing costs/overhead e/	0.32	0.95	0.47	0.92	0.95	0.47
Default risk	0.00	0.07	0.07	0.00	0.07	0.07
Prepayment risk	0.03	0.07	0.07	0.03	0.07	0.07
Subtotal	5.97	6.69	7.27	5.89	6.61	7.19
Net Return	1.70	1.58	1.73	0.84	0.12	1.68
Weighted Average Net Return f/		1.64			0.54	

Note: OMB estimates for interest rates are from the 1999 budget. Loan rates are determined in Q2 of calendar year;
costs of funds are determined by the average interest rate from Q3 of first year through Q2 of following year.

a/ Loan income takes account of SAP payments and of hedging costs when the formula is tied to a long-term index.

b/ Assumes all-in cost of funds is T-bill + 70 basis points.

c/ All-in cost of funds, reduced by 5%; only 95% of the loan principal is assumed to be financed by debt.

d/ Fee is amortized over life of loan; part of it becomes a prepayment cost in the case of default or other early loan payoff. Consolidation loans involve an extra fee.

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

f/ Weights are 31.53%, 55.88%, and 12.58% for loans in school, in repayment, and in consolidation, respectively.

g/ For loans already consolidated before 1998-99.

Appendix A

This Appendix provides details and sources related to the assumptions used in this paper.

1. Table 1 shows that several different *forecasts of interest rates* project a relatively flat yield curve for coming years. Although the *Blue Chip Economic Indicators* consensus forecast for the next two years reflects such a flat yield curve, the levels of their projected rates are slightly higher than those forecast by the Administration in the *FY 1999 Budget*, as are CBO's forecast rates, which also are shown in the Table. A recent DRI forecast, on the other hand, has interest rates close to or slightly below the Administration's projections, but with the emergence of a somewhat steeper yield curve in 1999 and 2000. The differences among these forecasts are small by historical standards and not large enough to change the qualitative conclusions presented in the subsequent tables.

Using the latest budget economic assumptions for 10-year Treasury notes, the student loan interest rate under the new formula would be 6.86 percent ($5.86 + 1.0$) for 1998/99, and 6.8 percent ($5.8 + 1.0$) for 1999/00. If OMB assumptions for 10-20 year average Treasury security yields on a simple interest basis are used, the comparable rates would be 7.11 percent ($6.11 + 1.0$) for 1998/99 and 7.03 percent ($6.03 + 1.0$) for 1999/00.¹

2. Lenders have several options for obtaining *funds to finance their portfolio* of student loans. One, they can finance their loans by using the bank deposits of their customers. Two, they can sell new debt, which many lenders opt to do. Three, lenders can securitize some of their loan portfolio by a public issuance of student loan asset-backed securities. And four, lenders can roll-over or reduce their financing costs by selling their student loans to a secondary market institution; in some cases, lenders receive a premium for selling their loans.

We consulted a number of financial experts about lenders' cost of financing through new debt issues or securitizations. We did not consider the alternative of financing issuance through drawing on existing bank deposits. Larger banks, in particular, not only may have some instability in their deposit base but also will be rationing deposit funds among many loan departments that are claimants for financing. Consequently, at the margin, these institutions are likely to impose an internal cost of funds that would be closer to an external borrowing cost in short-term markets (so called "managed liabilities") than to yields on customer deposit accounts.

An analysis of actual public debt financing for 1997 indicates a significant amount of securitizing. Nearly all of these securitizations were based on T-bills. This may be because student loans are indexed to T-bills, which would preclude a basis risk and the need to hedge by

¹ The 10-year CMT estimates are based on the second calendar quarter rate for 10-year Treasury notes for 1998 and 1999 plus 1.0 percentage point. The 10-20 year average simple interest rates are based on the estimated market yield as of October 1 of the budget year.

arranging a swap agreement. Another explanation could be that lenders expected the spread between T-bills and LIBOR to narrow but were taking advantage of "cheap" T-bill financing during 1997.

Based on a sample of actual public financings, the average cost of matched funds for the first 11 months of 1997 was T-bills plus about 65 basis points, but the more recent offerings were as high as T-bills plus 85-89 basis points. These new higher cost estimates, as noted in the text, presumably reflect the flight to quality that led to a historically large spread between T-bills and LIBOR. This spread reverted much closer to normal in the first month and a half of 1998, but we have been told by some dealers that technical aspects of the bill market could cause it to be a bit volatile in the next few months. *For our analysis, we assume the cost of matched funds is T-bills plus 70 basis points. This would translate to LIBOR plus about 5 points.* Using FY1999 budget assumptions, the estimated cost of matched funds for 1997/98 is 5.85 percent ($5.15 + 0.70$), based on the average projected T-bill rate for the "student loan year" from the third quarter of 1997 through the second quarter of 1998 (see Table 2).

3. When there is a basis risk between lenders' assets and liabilities, the net interest margin between the interest rate on student loans and the cost of funds through debt issues is affected by the *cost of a swap*. The basis risk between T-bill indexed assets, such as student loans under the current student loan formula, and LIBOR-based liabilities that are a common alternative for banks is not great because it is not subject to yield curve risk. The risk between 10-year CMT-indexed assets (reset annually), or assets indexed to the 10-20 year average rate, and LIBOR-based liabilities is substantial because of the possibility of disparate movements of long-term and short-term yields. It is this newly increased basis risk that must be taken into account in estimating the net interest margin under the new formula.

Recent estimates provided to us of the cost of swapping T-bills for LIBOR fall within a relatively narrow range. This is not surprising because this is an active and efficient market.² Most of the cost estimates to swap T-bills for LIBOR centered around 65 basis points. When the cost of matched funds is factored in, total all-in costs would be about 70 basis points, assuming that the cost of matched funds in 1997 is LIBOR plus 5 basis points. Note that this swap cost is centered around the same level as the securitization costs discussed above.

² A swap agreement will be for several years during which both the levels and the relationships between various interest rates may be expected to change. Swap dealers formulate their bids based on models that reflect the historical patterns in these relationships, as well as the current spreads between different yields and the future evolution of these yields that seems to be implicit in current market quotes (futures rates and forward rates implicit in the shape yield curve at the present time). Actual swap quotes will also be influenced by supply and demand considerations at any point in time as well as by transactions costs of the dealers and counter-party risks.

Under the new loan formula, lenders presumably would continue actually to raise funds at a rate near, or closely correlated to, LIBOR but would enter into a long-term (amortizing) swap to hedge against basis risk. Lenders financing their student loan portfolio by this option would issue LIBOR-indexed securities and simultaneously enter into a swap where they would agree to pay the swap counter-party the 10-year CMT plus or minus some spread in exchange for LIBOR.

Since they would be both paying LIBOR on their original financing and receiving LIBOR on the swap, fluctuations in their short-term cost of funds would be canceled out. But this reduction in risk comes at a cost since the lenders would be giving up the 10-year CMT part of their return and would be left with the spread over the 10-year CMT (or the 10-20 year average interest rate index) in the student loan formula, plus or minus the spread in the swap contract. If the student loan originator wanted to borrow in a T-bill based instrument (securitizations being the instrument that is likely to come in this form), the lender might swap LIBOR back to bills and that swap spread would also have to be taken into account in calculating the net interest margin. *Indeed, this is the assumption used in the presentation in Table 2 above, where the swap margin of CMT plus 5 for LIBOR and the reverse swap of LIBOR for bills plus 65 converts the formula return on the student loan from CMT plus 100 to a return in terms of bills of T-bill plus 160.* If the student loan rate were indexed to average annual simple interest rate on 10-20 year Treasury securities, banks would have a more complex problem in hedging their yield because there is no market for directly swapping this yield index. We have assumed that one third of the surplus yield from the 10-20 year index over the 10-year CMT would be absorbed in additional transactions and swap costs.

The estimated costs of swapping CMTs for LIBOR were obtained from a number of major swap dealers. These dealers told us that such a market, with the CMT reset quarterly (consistent with the lender receiving SAP payments) does exist because it has been useful for mortgage servicers. *These dealers generally provided quite similar swap spreads, with such a contract quoted at about CMT plus 5 basis points for LIBOR. As noted above, this is the swap spread that we have assumed.* Some dealers did mention that a substantial increase in the demand for these swaps could affect the quotes because there is not a natural counter-party to take up the opposite side of the contract from the student loan originator. Therefore, the dealer must carry that side of the contract, hedging it in turn with a sequence of transactions in the forward market.

Swap estimates, we also were told, will be heavily influenced by the term structure of interest rates at the time the swap contract is executed. This means that a lender is able to insulate his net return on any given loan from short-term fluctuations in his funding costs, but that this net interest margin may vary considerable among loans made in different financial market circumstances. Because the interest rate assumptions in the FY 1999 Budget imply little change in the yield curve over the next few years, we have assumed that the estimated cost of a swap for the current interest rate environment remains applicable over the forecast horizon.

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

5. There are two approaches that lenders may use to estimate their *servicing costs*. One is to view these costs as the ratio of all such costs incurred in any given time period to the total value of the loan portfolio for that period. Alternatively, servicing costs could be thought of in terms of the average annual cost over the life of a single loan as a percent of the average annual remaining principal of the loan. Looking at servicing costs the latter way, the ratio rises sharply over the life of the loan because the loan principal declines from year to year while servicing cost rises sharply during the in-school period and then levels off during the repayment and consolidation periods until close to final repayment. Obviously, both of these approaches for estimating servicing costs depend on the average maturity of a lenders portfolio: a lower average maturity will be influenced by the lower relative cost of servicing the portfolio and a higher average maturity will be influenced by the higher costs relative to the remaining principal.

A 1993 CRS study³ noted that Sallie Mae reported their servicing costs were 66 basis points. A private guaranty agency estimates that servicing costs are about 60 basis points for a traditional bank. A similar figure is also cited in the latest Sallie Mae annual financial report as the cost of servicing Sallie Mae's entire portfolio over the course of a year, i.e., total servicing costs as a percent of total loans.

A later (1997) CRS study⁴ estimated Sallie Mae's in-school servicing costs are 35 basis points, but their costs for the repayment period are much higher, about 100 basis points. This latter figure apparently was based on the average annual servicing cost of a loan over the life of the marginal loan as a percent of the remaining principal of the loan outstanding. We think this approach of using averages of large numbers to estimate servicing costs overstates servicing costs.

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

³ Barbara Miles and Dennis Zimmerman, "Federal Family Educational Loans: Reduced Costs, Direct Lending, and National Income," Congressional Research Service, February 22, 1993, PP. CRS-18 and 19.

⁴ Miles and Zimmerman, 1997, *op. cit.*

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

If we consider servicing and overhead costs as one cost in order to avoid the problem of allocating these costs to the correct category. *Our assumption for total servicing/overhead costs is 95 basis points for loans in repayment. It costs lenders less to service student loans when students are in school and when loans are consolidated. Thus, we assume overhead and servicing costs for loans in the in-school status are one-third of the cost of loans in repayment and loans in consolidation are one-half of the cost of loans in repayment. (Details of the servicing and other operational expenses borne by lenders are summarized in Table 4; these costs are cumulated in the "servicing and other costs" line of Table 2.)*

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

7. Loan originators are required to pay a 50 basis point *origination fee* to the Department of Education. Although this is a one-time fee paid when the loan is originated, we have assumed that the cost of the fee is amortized over the average lifetime of a student loan, which has fallen in recent years to about 9 years (3 years in-school and 6 years of repayment). *Thus the annual amortized cost of the origination fee is about 6 basis points for over the full life of the loan.* However, since some of these loans will default, or otherwise be paid early, a part of these costs, in repayment, are shifted to the prepayment cost line discussed below. For consolidation loans, the 5 basis points origination fee is added to the 1.05 percent rebate fee, for a total fee of 1.10 percent.

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

In addition, prepayments may occur because of consolidations -- indeed, there have been reports in the past that some lenders may have been offering price incentives to discourage students from consolidating or prepaying their loans and moving into the direct loan version of the program -- but this source of prepayments has become much less important recently. Consolidation have been reduced because of the logjam of applications and the temporary suspension of the program that allows borrowers to consolidate their guaranteed loans into a consolidated direct loan. Moreover, in the future, the squeeze on lenders' net return because of the new student loan formula may make it impossible for lenders to continue offering these price incentives. And finally, the Emergency Student Loan Consolidation Act of 1997 (LCA), enacted in October, 1997, could discourage many lenders from offering to consolidate students loans for borrowers.

The LCA makes it too costly for lenders to offer students the option to consolidate their loans, because it changes the formula for determining consolidation loan rates. The LCA also makes consolidation less attractive to lenders, because the law is only temporary and because the start up costs to configure computer programs will be expensive. Sallie Mae, which had been handling about 40 percent of all consolidations, has indicated it will not continue to participate in this part of the student loan program because it may no longer be profitable for them.⁵ Furthermore, it is possible that if lenders are concerned about prepayments, they may sell their student loans to avoid this problem. Overall, then, it is not clear what the impact of the Act will be. Because it is effective only until October 22, 1998, it should have limited impact in any event.

Estimates of prepayment costs appear to be somewhat arbitrary. The CRS estimated that lenders prepayment costs are high.⁶ But various lenders have told us that they do not view prepayment as a major cost. One clear cost associated with prepayment is that there are fewer years over which to amortize origination fees. If the typical prepayment happens when there are about 4-1/2 years remaining in the life of the loan, then this is about 25 basis points of increased costs in that year (since the lender was typically going to have the extra years over which he was amortizing 5-to-6 basis points per year). Given typical default rates, this is an expected cost over all loans of about 5 to 7 basis points. Although the costs of prepayment are higher if a student prepays in school (since the student is "un-amortizing" more years), the number of students who do so is much smaller. *We assume the prepayment cost for lenders is 3 basis points while students are in school, and 7 basis points in repayment.* These estimates are consistent with the cost estimated by several sources before the enactment of LCA.

⁵ Student Loan Corporation, which is a subsidiary of Citibank and is the largest originator of student loans, has indicated they will continue to offer consolidation loans.

⁶ Miles and Zimmerman, 1993, *op. cit.* Subsequent conversations with Barbara Miles confirm that their prepayment cost estimate was too high.