

March 15, 2010

Honorable Judd Gregg
Ranking Member
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Senator Gregg:

As you requested, the Congressional Budget Office (CBO) has prepared two estimates of the budgetary impact of the President's proposal to eliminate the federal program that provides guarantees for student loans and to replace those loans with direct loans made by the Department of Education. One of CBO's estimates follows the methodology delineated by the Federal Credit Reform Act (FCRA), which specifies how most credit programs are to be treated in the federal budget and which CBO is required to use in cost estimates for proposed changes to such programs. CBO's other estimate was done on a so-called "fair-value basis" that incorporates what a private entity would need to be paid to assume the costs and risks to the government from providing such loans or guarantees. The estimates in this letter were constructed relative to CBO's most recent set of baseline budget projections, which were issued on March 5, 2010.

Using the methodology specified in FCRA, CBO estimates that the President's proposal would produce savings in mandatory costs of \$68 billion over the 11 years from 2010 through 2020.¹ Adjusting for the projected increase in annual discretionary administrative costs in the direct program, the net budgetary cost savings over that period is about \$62 billion. Using an alternative methodology that evaluates the fair value of providing credit assistance to students and that includes the cost of market risk and the present value of future administrative costs, CBO estimates that the President's proposal would reduce the government's costs by about \$40 billion over the same period.

1. The 2010–2020 period includes the current year plus the 10 years that begin with the budget year.

Direct and Guaranteed Student Lending

The Federal Family Education Loan (FFEL) Program provides federal guarantees on loans for higher education that are administered and funded by private lenders. The guarantee ensures that lenders will receive almost all of the principal and accrued interest owed to them if borrowers default. The William D. Ford Direct Loan Program offers eligible borrowers nearly identical loans that are administered by the Department of Education and funded through the U.S. Treasury. Under a proposal included in the President's budget request, all federal student loans made after July 1, 2010, would be made by the direct loan program.

Historically, the guaranteed loan (FFEL) program has been the main source of federal credit assistance for higher education. It accounted for an average of 78 percent of the total dollar amount of federal student loans originated between 2005 and 2008. By 2009, the FFEL program's share had fallen to 69 percent, as difficulties experienced by private lenders during the financial crisis and uncertain prospects for the guaranteed loan program led many schools to switch to the direct loan program.² Since that time, the number of schools participating in the FFEL program has continued to decline. CBO projects that under current law, guaranteed loans will account for 55 percent of all new federal student loans in 2010 and smaller shares thereafter, leveling off at about 40 percent in 2013.

Under current law, combined new borrowing by students through the direct and guaranteed loan programs will total about \$1.4 trillion over the 2010–2020 period, in CBO's estimation. CBO expects that the President's proposal would not affect the total amount of federal student loans but would shift loans that would otherwise have been made through the guaranteed loan program to the direct loan program.

Estimating Subsidies According to the Federal Credit Reform Act and on a Fair-Value Accounting Basis

Under FCRA, the cost of new federal loans and loan guarantees is recorded in the year that the loans are disbursed. That cost, known as a credit subsidy, is calculated as the net present value (as of the year of disbursement) of the government's expected cash flows over the lifetime of a loan or guarantee, using interest rates on Treasury securities of comparable maturity to discount the estimated cash flows.³ FCRA specifies that the subsidy calculation exclude administrative expenses (including the costs of originating, servicing, and collecting on loans); instead, such costs are recorded separately in the budget year by year on a cash basis.

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2. The Ensuring Continued Access to Student Loans Act of 2008 (Public Law 110-227) authorized the Department of Education to purchase guaranteed loans made by FFEL lenders. FFEL loans purchased under that authority effectively become direct loans and entail a lower budgetary cost than other FFEL loans. That authority expires on July 1, 2010, and does not affect the estimates of cost savings in this letter.
 3. See title V of the Congressional Budget and Impoundment Control Act of 1974 (2 U.S.C. 661). FCRA was enacted in 1990 and incorporated as title V of the Congressional Budget Act.

Although the FCRA methodology accounts for the average losses from defaults on loans, it does not include the cost of all of the risks that loans and loan guarantees impose on taxpayers. In particular, it does not include the cost of market risk—the risk that losses from defaults will be higher during periods of market stress, when resources are scarce and hence most valuable.⁴ The cost of market risk is excluded from estimates under FCRA because the law dictates that expected future cash flows be discounted at Treasury borrowing rates rather than at the higher rates that private investors would require to make the loans or guarantees.

Fair-value estimates provide a more comprehensive measure of the cost of loan and loan guarantee programs because those estimates include administrative costs and the cost of risk. The fair value of an asset or liability corresponds to its market value under normal market conditions (or, in the absence of such conditions, to an approximation of what the value would be in an orderly private transaction). In general, a fair-value subsidy arises when the government accepts terms on the financing or services it provides that are less stringent than the terms that participants in private markets would require to take on comparable obligations and risks.

FCRA Estimate of the Budgetary Effects of the President's Proposal

Following the methodology specified in the Federal Credit Reform Act, CBO's March 2010 baseline projections show net budget receipts from new direct and guaranteed student loans of about \$25 billion between 2010 and 2020 (see Table 1). As estimated under FCRA, and as the programs are operated under current law, guaranteed student loans have a total subsidy cost of \$22 billion over that period, whereas direct student loans show a gain to the government of \$68 billion. The latter result—an estimate of a *negative* subsidy—arises because the interest rates on most direct loans exceed the rates on Treasury securities of comparable maturity, so discounting future interest payments at Treasury rates produces an estimated net gain for the government. Including discretionary and mandatory administrative costs of \$21 billion, which are estimated on an annual cash basis, produces the \$25 billion figure for total net receipts.⁵

CBO estimates that replacing new guarantees of student loans with direct lending would yield gross savings in mandatory spending of about \$68 billion over the 2010–2020 period according to the FCRA methodology. That figure represents the

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4. Federal direct and guaranteed student loans also entail prepayment risk—the risk that students will pay back loans more rapidly if future interest rates fall and more slowly if future rates rise, reducing the value of the government's claims. That source of risk is less important than market risk for student loans. CBO takes into account both market risk and prepayment risk in its fair-value estimates.
 5. Some additional administrative costs associated with the FFEL program are reflected in the program's subsidy cost. This occurs because periodic federal payments to FFEL lenders, which are recorded in the budget as interest payments, include compensation for lenders' administrative costs.

estimated savings in mandatory costs that would be shown in a CBO cost estimate for legislation under consideration by the Congress. However, CBO estimates that the expanded direct loan program would incur about \$6 billion in additional discretionary administrative costs during that period. As a result, the net reduction in federal costs from the President's proposal would be about \$62 billion over the 2010–2020 period, CBO estimates.

Fair-Value Estimate of the Budgetary Effects of the President's Proposal

When evaluated on a fair-value basis, the student loan programs have a very different estimated budgetary impact under both current law and the President's proposal.

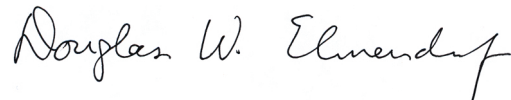
Using the fair-value methodology, CBO estimates that under current law, the net budgetary costs of new direct and guaranteed student loans during the 2010–2020 period would total about \$158 billion, as compared to a net savings of \$25 billion using the FCRA methodology (see Table 1). Because the fair-value methodology explicitly incorporates an assessment of the cost of risk, it indicates that the direct and guaranteed loan programs receive significant federal subsidies: \$52 billion and \$105 billion, respectively. Those estimates are quite sensitive to projections of interest rates and estimates of discount rates. But the findings that, on a fair-value basis, both programs incur costs for the government and those costs are lower for the direct loan program are consistent with a reasonable range of market conditions and other assumptions. The main reason for the higher fair-value (and FCRA) cost to the government of the guaranteed loan program is that payments to FFEL lenders are set by law at an average level that exceeds the cost to the government of administering and funding direct loans.

CBO estimates that on a fair-value basis, replacing new guarantees of student loans with direct lending would yield gross savings of about \$40 billion in mandatory spending over the 2010–2020 period. That estimate is \$22 billion less than the FCRA estimate of net savings adjusted for future appropriated administrative costs. The primary reason for that \$22 billion difference is that certain payments from the government to lenders in the guaranteed loan program are risky—they terminate when a borrower defaults on or prepays a loan. Those payments are less valuable to lenders and less costly to the government when the cost of that risk is taken into account, so terminating those payments by eliminating the guaranteed loan program yields smaller savings for the government.

Honorable Judd Gregg
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I hope this information is helpful to you. If you have further questions, we would be happy to address them. The CBO staff contacts for this analysis are Deborah Kalcevic and Damien Moore.

Sincerely,

A handwritten signature in black ink that reads "Douglas W. Elmendorf". The signature is written in a cursive style with a large initial 'D' and 'E'.

Douglas W. Elmendorf
Director

Attachment: Table 1

cc Honorable Kent Conrad
Chairman

Table 1.

Costs of Federal Student Loan Programs Under Current Law and the President's Proposal

(Outlays by fiscal year, in billions of dollars)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total, 2010– 2020
FCRA Estimates												
Under Current Law												
Loan programs ^a												
Guaranteed loans ^b	-7	*	1	2	3	3	4	4	4	4	4	22
Direct loans	-8	-9	-10	-9	-8	-6	-5	-3	-3	-3	-3	-68
Administrative costs ^c	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>21</u>
Total^d	-13	-8	-7	-6	-4	-1	1	3	3	3	3	-25
Under President's Proposal^e												
Loan programs ^f	-16	-15	-15	-14	-12	-9	-7	-5	-4	-4	-5	-108
Administrative costs ^g	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>21</u>
Total	-14	-13	-14	-13	-11	-8	-5	-3	-2	-2	-2	-87
Change in Outlays	-1	-6	-7	-7	-7	-6	-6	-5	-5	-6	-6	-62
Fair-Value Estimates												
Under Current Law												
Loan programs ^a												
Guaranteed loans ^b	2	10	11	9	9	10	10	11	11	11	12	105
Direct loans	<u>1</u>	<u>3</u>	<u>3</u>	<u>2</u>	<u>2</u>	<u>4</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>8</u>	<u>8</u>	<u>52</u>
Total	3	13	14	11	11	14	16	18	19	19	20	158
Under President's Proposal^{e,f}	2	10	9	6	6	9	12	14	15	16	16	118
Change in Fair Value	*	-3	-4	-5	-5	-4	-4	-4	-3	-3	-4	-40

Source: Congressional Budget Office.

Notes: FCRA = Federal Credit Reform Act of 1990; * = between -\$500 million and zero.

Numbers may not sum to totals because of rounding.

- a. Figures for 2010 do not include credit reestimates, which are adjustments to the subsidies for prior loans.
- b. For 2010, costs include the purchase of guaranteed loans by the Department of Education under the authority of the Ensuring Continued Access to Student Loans Act of 2008 (Public Law 110-227).
- c. The total of CBO's baseline projections for both mandatory and discretionary administrative costs, which are used for both the guaranteed and direct loan programs. (Discretionary costs are funded through annual appropriation acts.) Baseline projections for administrative costs include funding to service both new and old loans and loan guaranties.
- d. Total outlays do not include receipts from loans made before the enactment of FCRA.
- e. The President's proposal is to eliminate the federal program that provides guarantees for student loans made by private lenders and to replace those loans with direct loans made by the Department of Education.
- f. Under the proposal, there would be no guaranteed loan program, so all new loans would be direct loans.
- g. For this analysis, CBO assumes that administrative costs would not change under the proposal, although some of the administrative costs that are now mandatory would become discretionary.