



July 27, 2009

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

Dear Senator:

This letter responds to your request for an estimate of the change in federal costs, adjusted for the cost of market risk, that might result from enactment of the President's proposal to prohibit new federal guarantees of student loans and to replace those guarantees with direct loans made by the Department of Education.¹ The Federal Family Education Loan Program (FFELP) provides federal guarantees for loans made to students by private lenders and is the predominant source of loans for higher education; the Congressional Budget Office (CBO) projects that, under current law, guaranteed loans will account for 70 percent of all new direct and guaranteed student loans made over the next 10 years. Under the President's proposal, the Department of Education, through the William D. Ford Direct Loan Program, would provide federal support for student loans only by lending money directly to students.

In its July 24, 2009, cost estimate for H.R. 3221 (the Student Aid and Fiscal Responsibility Act of 2009, as approved by the House Committee on Education and Labor), which would incorporate the President's proposal, CBO estimated that replacing new guarantees of student loans with direct lending would yield gross savings in federal direct (or mandatory) spending of about \$87 billion over the 2010–2019 period.² (Mandatory spending is governed by existing provisions of law and does not require future appropriations.) About \$7 billion of those savings would represent a reduction in the administrative costs of the guaranteed loan program, which are recorded in the budget as mandatory spending. In contrast, most of the administrative costs for the direct loan program are funded in appropriation bills and recorded as discretionary spending. Thus, of the \$87 billion reduction in direct spending, roughly \$7 billion would be offset by an increase in future appropriations for administrative costs, for an estimated net reduction in federal costs from the President's proposal of about \$80 billion over the 2010–2019 period.

¹Conventional budget estimates of the cost of loan and guarantee programs incorporate an estimated default rate. However, there is a risk that defaults will exceed the estimated rate, especially at times of market stress. The compensation for accepting that risk is referred to as the "cost of market risk."

²CBO's cost estimate is available at <http://www.cbo.gov/ftpdocs/104xx/doc10479/hr3221.pdf>.

Those estimates follow the standard loan-valuation procedure called for in the Federal Credit Reform Act of 1990 (FCRA).³ The law specifies that the cost of federal loans and loan guarantees be estimated as the net present value of the federal government's cash flows, using the Treasury's borrowing rates to discount those flows;⁴ that calculation does not include administrative costs, which are recorded in the budget year by year on a cash basis (that is, undiscounted). The FCRA methodology, however, does not include the cost to the government stemming from the risk that the cash flows may be less than the amount projected (that is, that defaults could be higher than projected). CBO found that after accounting for the cost of such risk, as discussed below, the proposal to replace new guaranteed loans with direct loans would lead to estimated savings of about \$47 billion over the 2010–2019 period—about \$33 billion less than CBO's estimate under the standard credit reform treatment.

Estimating Subsidy Costs Using Credit Reform Procedures

To determine whether a proposal to change the federal student loan programs would lead to budgetary savings requires comparing the federal government's costs for the subsidies that the two programs provide. Those subsidy costs depend on the various cash flows of the direct loan and guaranteed loan programs, the interest rates used to discount those cash flows, and the programs' administrative costs.

FCRA calls for using a present-value subsidy concept—in what is otherwise a largely cash budget—to better compare the strikingly different patterns of federal cash flows under the two programs. In the direct student loan program, the federal government makes a large, one-time outlay for the amount of the loan (net of various fees) and then receives a stream of principal and interest payments over time. In the guaranteed student loan program, the federal government faces a more complicated set of payments. It does not disburse a principal amount (loans are disbursed by private lenders) but instead receives some up-front fees, makes a stream of subsidy payments (known as special-allowance payments) to lenders, partially compensates lenders for loans that go into default, and pays certain borrower benefits, in addition to various other receipts and payments.

FCRA facilitates the comparison of the budgetary effects of direct loans and loan guarantees by converting the net outlays for each program into a single lump-sum estimate of net costs (that is, the discounted present value of all cash flows). Those cash flows are discounted using the government's costs of borrowing—that is, the interest rates it pays on Treasury securities of comparable maturities. The resulting subsidy estimate is recorded in the federal budget in the year of a loan's disbursement. Subsidies computed under FCRA do not include the government's

³The Federal Credit Reform Act of 1990 became Title V of the Congressional Budget and Impoundment Control Act (see 2 U.S.C. 661).

⁴The present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. The present value depends on the rate of interest used—that is, the discount rate. For example, if the government makes a one-year loan of \$100 to someone on January 1 at an annual interest rate of 5 percent, it will receive \$105 in a year if the borrower does not default. If the government's cost of borrowing is 3 percent, the present value of \$105 payable a year from today is about \$102.

costs for administering the loans; those administrative costs are recorded separately, on a cash basis.⁵

Under the FCRA accounting rules, the guaranteed loan and direct loan programs have very different subsidy rates, and thus different budgetary costs, even though the programs result in very similar loans to borrowers. CBO estimates that over the 2010–2019 period, the subsidy cost for each dollar of a guaranteed loan will exceed the subsidy cost for each dollar of a direct loan by between 10 cents and 20 cents. Generally, in CBO’s estimation, the direct loan program will have a negative subsidy rate (that is, the net receipts to the government on a present-value basis are projected to be greater than its disbursements), whereas the guaranteed loan program will have a positive subsidy rate (that is, a net cost on a present-value basis). The difference in subsidy rates under FCRA for direct and guaranteed loans occurs primarily because of certain payments made for the latter—in particular, interest payments made on behalf of borrowers for subsidized loans and special-allowance payments to lenders. The latter are made by the government to lenders in the guaranteed loan program to ensure that they receive a specified interest rate on their student lending. The difference in the programs’ subsidy rates led to CBO’s estimate that under the procedures specified in FCRA, enactment of the President’s proposal (as included in H.R. 3221) would yield net budgetary savings of approximately \$80 billion (representing \$87 billion in mandatory savings and \$7 billion in discretionary costs) over the 2010–2019 period.

Adjusting for Risk

The full value of the subsidy provided by the government’s student loan programs depends on what students would have to pay to obtain loans in the private market without federal support. That cost depends on the riskiness of the loans. Estimates of subsidies that are made using the techniques specified by FCRA do not provide a comprehensive picture of the costs of loan programs, mainly because they do not fully account for the riskiness of the loans. That methodology, which uses yields on Treasury securities as discount rates, tends to understate the subsidy provided under each program; but it generally understates the subsidy costs of the direct loan program to a greater degree than it does those of the guaranteed loan program. Alternative estimates of the value of the programs’ subsidies that might better reflect the costs they represent for the government would incorporate the estimated cost of the market risk that taxpayers bear through such lending—a cost analogous to the higher returns that private investors expect for making risky investments.

When conditions in the financial markets are relatively benign, as CBO assumes will be the case after the first few years of the 2010–2019 projection period, the private sector’s pricing of student loans that do not carry a federal guarantee suggests that the cost of raising capital for such loans will be 2 to 3 percentage points more per year than the interest that the government pays on Treasury securities with comparable maturities. That difference reflects the risk involved in extending long-term, unsecured credit to an individual consumer; participants in private-sector

⁵ In previous years, the budget and CBO’s baseline projections incorporated most of the administrative costs of the guaranteed loan program in the subsidy value. Currently, CBO’s baseline, and its cost estimate for H.R. 3221, present those costs on a cash basis.

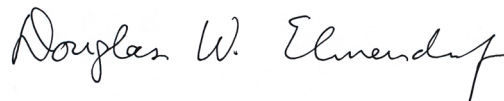
loan markets generally demand a higher rate of return for bearing that risk. (Put differently, the cost of capital for the firms that make such loans will be higher than the rates on Treasury securities.) A private entity that issued or insured student loans would recognize that higher cost of capital by discounting its expected cash flows from the loans at that higher rate. (A private entity would also approach administrative costs somewhat differently, but administrative costs account for little of the difference between the costs of the direct and guaranteed loan programs.)

Applying a set of risk-adjusted discount rates to the cash flows from the government's student loans would raise the subsidy rates for both student loan programs, but the rate for the direct loan program would increase by more than the rate for the guaranteed loan program because of differences in the timing and riskiness of the estimated cash flows. CBO estimates that if projected savings for the President's proposal were calculated using risk-adjusted discount rates, those savings would be \$47 billion over the 2010–2019 period—a difference of \$33 billion relative to CBO's cost estimate for H.R. 3221 issued on July 24.

Although the use of subsidy rates that have been adjusted for the cost of risk generally improves the ability to compare the costs of financial programs, the approach does raise some concerns. As the recent financial turmoil has shown, risky assets, including student loans, can fluctuate wildly in value. Those fluctuations can lead to large changes in market-based estimates of subsidy rates for student loans from one year to the next. Quite similar assets may trade at widely divergent values for reasons that are difficult to establish. Nevertheless, CBO believes that risk-adjusted subsidy rates provide useful information about the cost of federal programs in terms of the value of the economic resources that are devoted to those programs. The Congress adopted the approach of incorporating the cost of market risk into budget estimates for the 2009 enactment of the Troubled Asset Relief Program (TARP). That approach requires that the costs of assets purchased under the program be estimated using a present-value approach that, except for its requirement of an adjustment for the cost of market risk, is similar to the way loans and loan guarantees are evaluated under the Federal Credit Reform Act.

I hope this information is helpful. If you have further questions, we would be happy to address them. The CBO staff contact for this analysis is Sam Papenfuss.

Sincerely,



Douglas W. Elmendorf
Director

cc: Honorable Kent Conrad
Chairman

Honorable Judd Gregg

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Honorable John M. Spratt Jr.
Chairman
House Committee on the Budget

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Ranking Member

Honorable George Miller
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