

Testimony of

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"Keeping College Within Reach:  
Examining Opportunities to Strengthen Federal Student Loan Programs"

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Thank you, Chairman Kline and Congressman Miller. To all the members of the committee, I appreciate the opportunity to testify on opportunities to strengthen the Federal student loan programs. My focus will be on four programmatic changes that are seemingly technical in nature, but which are likely to yield significant benefits to students and taxpayers, and that could increase the stability and transparency of budgetary costs.

#### Market-Indexed Student Loan Rates

A critical issue is to revisit the rule for how the interest rates on student loans are determined. Student loan interest rates are set in statute. The statutory rules have been changed numerous times throughout the history of the programs, including shifting between fixed interest rates and variable interest rate formulas. Since 2006, new Stafford loans have carried a fixed interest rate of 6.8%. The rate on subsidized loans is fixed at 3.4%, but that rate is scheduled to increase to 6.8% for loans made on or after July 1, 2013. The rates on other types of loans also are fixed in legislation.

The current practice of setting fixed interest rates that extend many years into the future--rather than linking them by formula to prevailing market interest rate conditions--has adverse consequences for students, for taxpayers, and for the stability and control of budgetary costs.

- For students, the current policy creates large swings in the value of government assistance from year to year. Similar students that attend the same school but in different years receive very different amounts of support: Subsidies will be small when market interest rates are low and large when rates are high. As well as raising fairness concerns, the volatility makes it more difficult for prospective students to assess the affordability of pursuing a higher education.

- At the same time, the variability in year-to-year subsidies creates potentially large and uncertain liabilities for taxpayers.
- From a budgeting and control perspective, the uncertain size and volatility of subsidies over time is detrimental to budgetary planning, and it has the effect of reducing the control that Congress exercises over the allocation of scarce budgetary resources.

The volatility in federal subsidies caused by fixing the interest rates on student loans is illustrated in Table 1, which shows the subsidy rates estimated by OMB for loans originated between 2006 and 2011. The pattern of sharply lower subsidies starting in 2009 reflects that the rates charged to students remained constant even as Treasury interest rates fell to historically low levels.

Table 1:

**Subsidy Costs for Federal Direct Student Loans**

Fiscal Year	Subsidy Rate
2006	5.12
2007	1.48
2008	-0.80
2009	-14.96
2010	-7.66
2011	-13.91

The subsidy rate is the percentage cost of a loan per dollar of principal. For example, a subsidy rate of -10 means that the reported budget deficit was reduced by 10 cents per dollar of loans disbursed.

Source: Federal Credit Supplement 2013

Adopting the alternative of market-indexed rates would reduce the volatility of subsidies for borrowers and taxpayers, and also help to stabilize the budgetary costs of the programs. Under that approach, the interest rate charged on new loans each year would be linked to a market rate, for instance, to a Treasury security with a similar duration to the student loans. The interest rates could still be fixed over the life of each individual loan, but that fixed rate would change year to year.

The notion that allowing interest rates to vary with market conditions would create greater stability and fairness than fixing interest rates by statute may at first seem

unintuitive. However, market-linked interest rates can be beneficial because they result in more stable *real* (or inflation-adjusted) loan payments. High nominal interest rates generally coincide with periods of high expected inflation rates. Market rates increase with inflation because investors need more compensation just to maintain the purchasing power of the loan repayments they receive. Wages also grow more quickly during periods of higher inflation, making higher nominal payments more affordable to borrowers. Furthermore, low nominal interest rates tend to be a symptom of a weak economy and job market, as is the situation today. Fixing the interest rate by law tends to shrink government subsidies at just those times when students would benefit from them most.

With market-indexed interest rates, the generosity of subsidies could be controlled by choosing an appropriate “interest rate spread”--a number which could be specified in legislation in place of a fixed interest rate. For example, Stafford borrowers could be charged a 3 percent spread over the 10-year Treasury bond rate (which would translate to an interest rate of 5 percent under current interest rate conditions of 10-year rates at about 2 percent). Lower rate spreads could be specified for subsidized loans.

If rates are indexed, policymakers may want to protect borrowers from unusually high interest rate conditions by setting an interest rate cap that limits the maximum rate charged. For example, the cap on consolidation loans is currently 8.25%. However, the lower is the cap that is chosen, the higher the cost and volatility that would be reintroduced. It is worth noting that even without a cap, borrowers would have some protection against unusually high interest rates because student loans can be prepaid without penalty.

### Fair Value Accounting for Costs

Because of the way student loans are budgeted for, indexing student loan interest rates would have the effect of lowering the volatility of their budgetary costs over time. Specifically, under the Federal Credit Reform Act of 1990 (or FCRA), credit programs are budgeted for on an accrual basis that records the lifetime cost of the loans disbursed each year. Specifically, costs are calculated by discounting to the present the expected cash flows over the life of the loan using current, maturity-matched, Treasury interest rates as the discount factors.

With interest rates on student loans that are fixed by statute, when Treasury rates go up the value of projected future payments fall and the budgetary cost of the loans increases; and conversely when market rates fall. Indexing the interest rates on student

loans would largely eliminate that source of volatility. (Subsidies would still vary over time with changes in projected default rates, program participation, and other factors.)

The move to accrual accounting for federal credit represented a significant improvement over the cash accounting that preceded it in terms of accuracy and transparency. The use of Treasury rates as discount factors, however, fails to account for the full costs of the risks associated with government credit assistance. Those costs must ultimately be borne by taxpayers, just as they must be borne by the equity holders (owners) of private lenders that make private loans.

A consequence of that incomplete accounting for risk is that in recent years student loans have appeared to be quite profitable for the government. For example, OMB reported that the government earned 14 cents per dollar on student loans made in 2011, even though the rates charged were significantly lower than those offered by private lenders, and despite the heightened risk of defaults caused by the still weak job market.

A policy change that could alleviate the understatement of costs in the budget and increase transparency would be to replace FCRA subsidy costs with so-called “fair” or market-based cost estimates in the budget. That change would eliminate the artificial appearance that the student loan programs are highly profitable for the government. To illustrate, Table 2 reproduces CBO’s 2010 estimates of the hypothetical effect of switching from FCRA to fair-value estimates of program cost.

**Table 2:**  
**Projected Fair-Value and FCRA Subsidy Rates for Representative Loans and Borrowers, by Fiscal Year**

(Percent)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average, 2010– 2020
<b>Fair-Value Estimates</b>												
(Using risk-adjusted discount rates and including administrative costs)												
Direct Loan Program	13	13	11	7	9	11	12	13	13	13	13	12
<b>FCRA Estimates<sup>a</sup></b>												
(Using Treasury discount rates and excluding administrative costs)												
Direct Loan Program	-18	-14	-13	-12	-10	-7	-6	-4	-4	-4	-4	-9

Source: Congressional Budget Office, “Costs and Policy Options for Federal Student Loan Programs,” March 2010.

As well as improving transparency about program costs, moving to fair value estimates would have the salutary effect of putting credit and non-credit assistance to students on a more level playing field in the budgetary process. In particular, the budgetary disadvantage of offering Pell grants as compared to student loans would be reduced by using a more comprehensive approach to estimating of the cost of credit assistance.

### Income-Based Repayments

Proposals have been put forward to move to a more income-based repayment system, under which borrowers' payments would depend on their earnings after they graduate. Such policies would benefit students in several ways: It would help them avoid unmanageable debt levels, and it would make it easier to pursue careers in lower paying fields such as the military, public service, or teaching. It could be especially beneficial to low-income students whose prospects after graduation are less predictable and who are therefore more wary of taking on debt.

The costs and risks to the government of an income-based repayment scheme would depend critically on the details of how the policy is structured. In principle it would be possible to set up the system in a way that did not increase overall program costs. However, because the savings that would be anticipated from lower default rates are unlikely to fully make up for the higher costs associated with reducing or extending the payments of students who get relief but would not have defaulted under the old system, overall costs would tend to be higher unless the average interest rates charged were also increased.

### Restructure the Consolidation Option

Finally, modifying the consolidation option to eliminate borrowers' ability to convert a floating rate loan to a fixed rate loan with the same interest rate could potentially save the government a significant amount of money in the event that Congress ever decides to return to fully floating interest rates. My academic work on the consolidation option suggests that between 1998 and 2005, a period when student loans carried a variable interest rate tied to 3-month Treasury rates, the cumulative cost of consolidation to the government was about \$27 billion.<sup>1</sup> The greatest benefits accrue to cohorts who happen to graduate when interest rate conditions are favorable to consolidation, to professional students with the largest loan balances, and to borrowers with the sophistication to manage their loans efficiently. As such, the option is unlikely to be an efficient way to subsidize higher education. The benefits of allowing students to combine all their loans into a single loan could be preserved, but the costs of consolidation reduced, by

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<sup>1</sup> Deborah Lucas and Damien Moore, "The Student Loan Consolidation Option," manuscript, MIT, January 2013

charging a rate on floating-to-fixed conversions that is linked to a current long-term Treasury rate.