AMERICAN ACTION FORUM

A Demonstration Program: The Use of Private Capital in the Federal Direct Student Loan Program

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Executive Summary

The 2009 switch to direct student lending, billed as a means to bolster student financial aid spending by eliminating private sector 'middlemen,' has not only failed to produce the anticipated savings, it has cost taxpayers billions of dollars and shifted billions more onto the federal balance sheet, forcing the Department of Treasury to borrow money to keep the program afloat.

There is a better way. Currently, the government has precluded the use of the vast private capital markets willing to lend to students. Tapping into those markets would shift costs away from the federal government and generate billions in potential savings.

To evaluate this potential solution, Congress should develop a pilot program to determine if it is economically beneficial to utilize private capital in the long-term funding of Federal Direct Student Loans. A simple pilot program would provide all of the data necessary to make an informed policy decision. The basic outline of the pilot would look something like this:

- Authorize the Secretaries of Education and Treasury to conduct a pilot program that tests the use of private capital instead of Treasury borrowed funds to support the Federal Direct Loan Program (FDLP).
- The scope of the pilot program involves $150 billion in current student loan assets—loans will remain the property of the U.S. government.
- Qualified Private Capital Providers (QPCP's) would bid on portions of the package of loans in exchange for the cash flows derived from loans over time.
- QPCP's include public, private, and non-profit sector pension funds, credit unions and other depository institutions, investment funds, corporations, and individuals.
- All other aspects of the FDLP, including servicing, remain as they are—managed by the Department of Education.
- Require the government to use Fair Value Accounting (FVA) in lieu of the Fair Credit Reform Act (FCRA) model to evaluate true costs and benefits of the pilot program.
- Savings derived from the pilot program and/or a broader scale implementation may be directed by the Congress to purposes established by law.

The Problem

After taking over the student loan industry in 2009, the U.S. government now finds itself in the midst of a subprime problem with over $1 trillion in outstanding loan obligations. Federal budget projections suggest that obligation will grow by at least $110 billion per year for the next decade, with Treasury borrowing added to the growing volume to make up for repayment shortfalls that have perpetually plagued the direct loan

program. With the program losing billions of dollars against its projected savings many experts now question whether the Federal Direct Student-Lending Program (FDLP) is actually saving taxpayer dollars.

Relying on favorable subsidy cost estimates, the FDLP was estimated to generate some $86 billion in reduced outlays. However, Congressional Budget Office (CBO) reestimates have varied widely since the program's inception, reducing the projected savings, and in some cases, showing substantial costs. Rather than produce the expected savings, the switch away from private capital has created an unmet budgetary obligation that is silently adding billions of dollars to the national debt.

A Solution

Reinserting private capital into the original process could actually produce the savings Congress was expecting. Congress should develop a pilot program to determine if it is economically beneficial to utilize private capital in the long-term funding of Federal Direct Student Loans and evaluate the potential budget savings associated with a private capital solution.

Currently, the United States owns approximately $700 billion in direct loans (about 70 percent of the total outstanding volume)and it is anticipated that in the next ten years, more than $1.3 trillion in additional U.S. Treasury borrowing will be required to fund the student loans originated by the Department of Education. To reduce the National Debt and relieve borrowing burdens on the U.S., it may be feasible for the Department of Education to continue to operate the FDLP but substitute private market capital for U.S. Treasury capital. Disbursement, servicing, and delinquency and default management would continue to be managed by the Department of Education, through contracts or cooperative agreements, just as the program is managed today.

The pilot program could be conducted in Federal Fiscal Year 2014 and, if successful in demonstrating favorable budget outcomes compared to the direct loan program, could be expanded to include other value realization efforts such as, whole loan auctions and loan origination rights auctions.

Description of the Pilot Program

The Department of Education would implement a pilot program to demonstrate the economic and logistical efficacy of utilizing private market capital for the funding of FDLP. Specifically, the pilot program would be conducted during Federal Fiscal Year 2014 and entail the contractual assignment of irrevocable rights to the cash flows derived from a $150 billion pool of Federal Direct Student loans to one or more Qualified Private Capital Providers (QPCP's) in exchange for cash.

The price to QPCP's for the cash flows would be determined by auction. The Secretary of Education would review the cost effectiveness of the program using Fair Value Accounting (FVA) methodology. Funds projected to be derived from the pilot program could then be authorized and appropriated for purposes set forth in legislation.

Pilot Program Loan Pool

A pool of loans not less in par value than $150 billion would be identified by the Secretary of Education for use in this pilot program. The loans should have been in repayment for at least five years and representative of all loans held by the Department of Education in the FDLP.

Loans in the pool would be serviced in the same manner as all other loans in the FDLP and loan servicers would be required to service loans in the pool no differently from other loans in their FDLP servicing portfolio. Private capital providers entering into a cash flow assignment agreement with the Secretary of Education would be entitled to all performance and status reporting information received by the Secretary as part of the loan servicing program administered by the Department of Education.

In constructing the pilot program loan pool, the Secretary of Education would restrict the dollar value of loans where borrowers have elected an Income Based Repayment option to no more than five percent of the total par value of the pilot program loan pool.

Qualified Private Capital Providers

In order to ensure that the Secretaries of Education and the Treasury are able to obtain maximum value to the government through this pilot program and beyond, it is intended that the opportunity to participate in the pilot program and beyond is extended to as many QPCP's sources as feasible, including but not limited to:

1. Public, private, and non-profit sector pension and retirement funds,
2. Investment funds,
3. Credit unions, depository, and other financial institutions,
4. Public benefit corporations,
5. Private firms, and
6. Individuals.

The Secretaries of Education and the Treasury would ensure that a broad outreach effort to solicit private capital provider participation is undertaken to include announcements in various government solicitation and announcement publications, inclusion of information about the pilot program and contact information on Departmental websites, and through press releases to the media and various trade associations commonly used by federal agencies to communicate programs and events of interest to the general public and professional organizations.

As part of this pilot program, the Secretaries of Education and Treasury should be authorized to segment the pilot program portfolio in order to test whether smaller or larger size segments (as to dollar value) produce the most favorable outcomes for the federal government. The Secretaries of Education and Treasury would be authorized to offer participation opportunities based on risk-differentiated tranches if appropriate.

Method for Obtaining Bids and Congressional Reporting

The Secretary of Education, with the advice of the Secretary of the Treasury, would conduct a process to secure QPCP participation in the pilot program. The process selected would be one designed to obtain best economic value to the federal government and, accordingly, may involve sealed bids submitted in response to a request for proposals, an auction process, or other process identified by the Secretaries as being most advantageous to the federal government's fiscal interest.

The auction or bid process would be conducted within 60 days of the beginning of Federal Fiscal Year 2014 and initial status of the pilot program should be reported to Congress within 180 days after a participation contract is entered into by one or more QPCP's and the Secretary of Education. A final report on the pilot program should be delivered to the Congress by the Secretary of Education within 180 days following the end of Federal Fiscal Year 2014.

Criteria for Determining Entrance into a Participation Agreement

The Secretary of Education would enter into a pilot participation agreement with one or more QPCP's providers only if, upon evaluation of the economic proposals offered by one or more private capital providers, the Secretary determines that the economic value offered by the private capital provider or providers' offering exceeds the value of the pilot program pool, inclusive of all costs and subsidies as determined by the

Congressional Budget Office and after adjusting the discount rate for market risk, loan repayment program impact, and the reduction in Treasury borrowing costs.

Conclusion

Shifting the cost of student lending back to private sector offers an opportunity to create substantial budget savings for the federal government. The fact that the private sector would take on these assets not only promises to reduce the size and cost of the federal government, it will also create private sector jobs, increase the federal tax base, ensure innovation in student lending solutions, and provide a stable foundation for student borrowing.

While arguments in favor of direct lending succeeded against a beleaguered FFEL program in 2009, the reality is that today's budget situation demands more thoughtful solutions, particularly when private capital alternatives provide compelling advantages over the existing structure of FDLP. When compared against the potential options outlined here, together with the estimated budget savings that may come as a result, it is clear that direct lending through Treasury borrowing has outlived its potential and needs to be replaced with a more innovative solution to meet the growing needs of borrowers.