



Treasury Borrowing Advisory Committee

November 4, 2014

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Charge to the Committee: Please provide an update on the trends in the student loan market over the last several years. What issues, if any, should Treasury consider with regard to student loans?

Topics to discuss:

1. A brief history of the student lending program and key elements today, including an update on trends since the July 2012 TBAC presentation on the topic
2. Default trends and implications
3. Key factors driving growth in student loans
4. Broader implications of student lending growth
5. How the Committee expects the student loan market to develop, including potential reform proposals
6. Main risks associated with student lending, including the funding implications for Treasury under the status quo versus alternate potential scenarios

Executive Summary

- In July 2012, TBAC addressed the topic of student lending, providing a broad review of the program, its growth, benefits and risks. Notably for TBAC, the Student Aid and Fiscal Responsibility Act (SAFRA) of 2010 ceased the origination of federal student loans by private lenders and as of July 1, 2010, all federal student loans are made directly by the Department of Education and funded by the U.S. Treasury Department.
 - As a result of this shift, the liability management task of Treasury has a new expanding dimension, moving from a focus on financing the deficit, toward an increasing share of overall issuance supporting the funding needs of financial assets owned by Treasury, some purchased during the financial crisis, but future growth primarily driven by direct student lending.
- Since the 2012 report, student loan balances and default rates have increased.
 - The balance of student loans outstanding has grown from \$1.0 trillion as of YE2011 to \$1.3 trillion as of 2Q2014.⁽¹⁾ The government represents more than 85% of origination volume. There are four key factors that continue to drive growth:
 - More people choosing to consume more years of higher education, in part reflecting demographic change with growth in the 20-34 year cohort and in part due to the weak economy with students staying in school longer.
 - A greater proportion of students are taking out Federal student loans (48% as of 2012, up from 33% in 2002).⁽²⁾
 - The increasing cost of higher education exacerbated by reduced subsidies from state governments to in-state schools.
 - Outstanding balances declining more slowly than originally anticipated due to both increased volume of loans in deferral and forbearance as well as longer loan tenors.
 - The growth in for-profit schools, which accounts for the majority of growth in higher education students and has broadened the use of student financing.
 - Default rates are high and rising, with the two-year cohort default rate increasing to 10.0% vs. 8.8% as of the 2012 TBAC report.⁽³⁾
 - Notably, “default” in the context of federal student loans is generally defined as 270 days without payment.⁽⁴⁾ Loans in default represent 9% of the stock of outstanding federal student loans.
 - Behind the default rate is a shadow book of potential future defaults, reflected in the volume of loans in deferment and forbearance. Those loans add 23% to the 9% that are already listed in default (see slide 12).
 - Additionally, the growing volume of seriously delinquent loans (90+ days) indicate further potential defaults on the horizon. Student loan delinquency rates are the highest among any consumer debt product.⁽⁵⁾

Notes

1. Based on data released by the Federal Reserve on October 7, 2014 for 2011 and 2Q14. Including student loans originated under FFELP and Direct Loan Programs; Perkins loans; and private student loans without government guarantees.
2. U.S. Department of Education, National Center for Education Statistics.
3. Department of Education two-year cohort default rates, which refer to the percentage of borrowers entering repayment during one fiscal year and defaulting by the end of the next fiscal year. The 2-year cohort default rate for 2011 was 10.0% (the most recent available) and for 2009 was 8.8% (the most recent available at the time of the 2012 TBAC presentation).
4. Department of Education. Varies by type of loan, date of origination and processing time.
5. Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit (August 2014).

Executive Summary (Continued)

- A key concern is that students are taking on student loans because historically an education has been correlated with economic mobility; however, today an average of 40% of students at four-year institutions (and 68% of students in for-profit institutions) do not graduate within six years,⁽¹⁾ which means they most likely do not benefit from the income upside from a higher degree yet have the burden of student debt.
 - Unlike all other indebtedness, student debt cannot be extinguished in bankruptcy in almost all cases and the government can offset income tax refunds, Social Security and other federal benefits.
- This outcome contrasts to the goal behind the Federally subsidized student loans which has been to ensure access to higher education, economic opportunity and social mobility.
 - As first commented by President Johnson at the inception of the program, the act should be “a way to deeper personal fulfillment, greater personal productivity, and increased personal reward.”⁽²⁾
- CBO calculations indicate that the student loan program delivers a \$135Bn profit to taxpayers over the next decade.⁽³⁾
 - However, as the CBO acknowledges, there are substantial potential liabilities that are hidden by required government accounting that calculates the cost of the program based on the program as mandated and without factoring in market risk.
 - According to the CBO, under fair value accounting (incorporating market risk) the program will cost taxpayers \$88 billion.⁽³⁾
- In addition, the estimate does not include the potential cost or benefit associated with recent proposals to redesign elements of the student lending program, including: (i) reducing the interest rate; (ii) increasing repayment options; and (iii) addressing the pace of origination with a focus on qualifying institutions eligible for such programs.
 - Nor does it reflect potential efficiency benefits by addressing disparities in the quality of student loan servicing.
 - For example, the gross cost of maturity extension in order to increase the probability of repayment would be approximately \$220 billion, although before factoring in the economic and social costs / benefits.
- Due to the relatively recent growth in both origination volume and default rates, it is premature to conclude the extent to which student lending is crowding out other forms of credit creation and thus acting as a drag on other parts of the economy. However, credit availability could be a problem as this age group bears the brunt of increased student debt.⁽⁴⁾
- While this presentation will attempt to identify important characteristics of the basic features of some of the more common loans offered directly by the federal government, clearly a more exhaustive analysis, including the collection and availability of important data about the performance and borrower trends is needed to complete a full assessment of the funding strategy for these loan programs.

Notes

1. National Center for Education Statistics. Based on graduation rates of Bachelor's Degree-Seeking Students at 4-Year Postsecondary Institutions (cohort entry year: 2006).
2. President Lyndon Johnson, "Remarks at Southwest Texas State College Upon Signing the Higher Education Act of 1965" (November 8, 1965).
3. Congressional Budget Office, "Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024" (May 2014).
4. Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit (August 2014).

Section 1: Overview of the Student Lending Program and Key Elements Today

History of the Student Lending Program

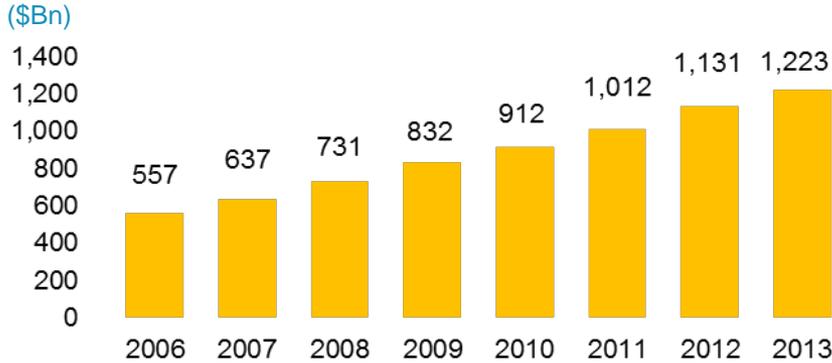
- Student loans are used to finance post-secondary education, which is typically targeted for undergraduate and postgraduate education but also can include eligible vocational or trade schools.
- The U.S. government began offering Federal financing for Institutions of Higher Education (IHE) in 1965 with Title IV of the Higher Education Act (HEA).
 - HEA is re-authorized every five years, although the re-authorization process can take years to get through Congress: HEA's reauthorization has been temporarily extended beyond its December 2013 expiry as Congress negotiate changes.
- Key elements of the Federal student loan financing in the last 25 years:
 - 1990: IHEs were given restrictions on eligibility for federal student loan financing, based on **Cohort Default Rates (CDRs)**. Today, an institution loses its eligibility for the FFELP and Direct Loan programs if the most recent 3-year CDR is greater than 40% and / or if the three most recent 3-year CDRs are each **30% or greater**.⁽¹⁾
 - 1998: Federal **student loan debt cannot be discharged in personal bankruptcy**. Private sector student loans cannot be discharged in bankruptcy after 2005.
 - 2008: Federal student loans could be discharged for permanently disabled people who have “no substantial gainful activity” (similar to the Social Security definition for disability)
 - 2010: The Student Aid and Fiscal Responsibility Act (SAFRA) of 2010 ceased the origination of federal student loans by private lenders, and as of July 1, 2010, **all federal student loans are made directly by the Department of Education and funded by the U.S. Treasury Department**. Newly originated federal student loans since July 1, 2006 are fixed rate loans.
 - 2013: Introduction of **Income-Based Repayment (IBR) alternative repayment schemes**

Note

1. Federal Pell Grants are subject to the three most recent 3-year CDR restriction.

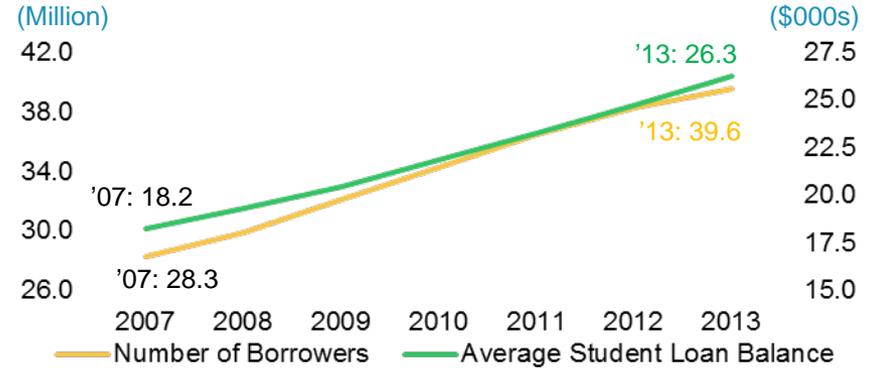
Student Debt Outstanding Is Growing Rapidly, With >85% Backed by the Federal Government

Student Debt Outstanding Has Doubled Since 2007



Source: Federal Reserve, Department of Education

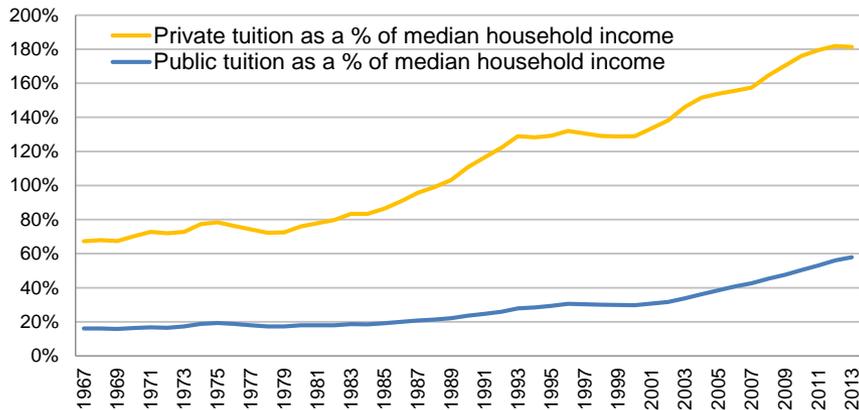
Reflecting Increases in Both Borrowers and Balances



Source: National Student Loan Data System (NSLDS) Federal Student Aid Portfolio Summary

And the Rising Cost of Education

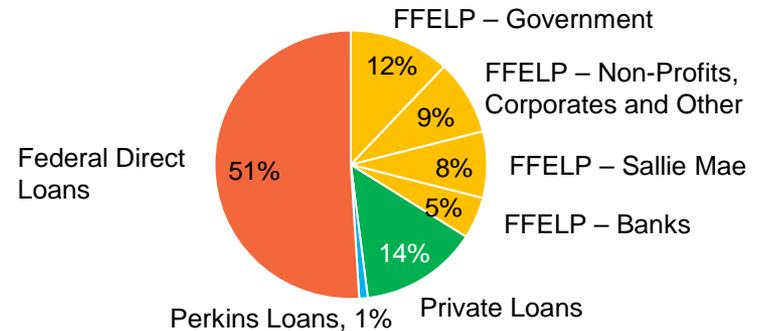
Cumulative 4Y Tuition Relative to Median Household Income (25Y to 34Y)



Source: U.S. Department of Education, National Center for Education Statistics, Haver

With Sizeable Taxpayer Exposure, Given the Percentage Backed by the Government

Outstanding Student Loans by Type as of Dec. 31, 2013

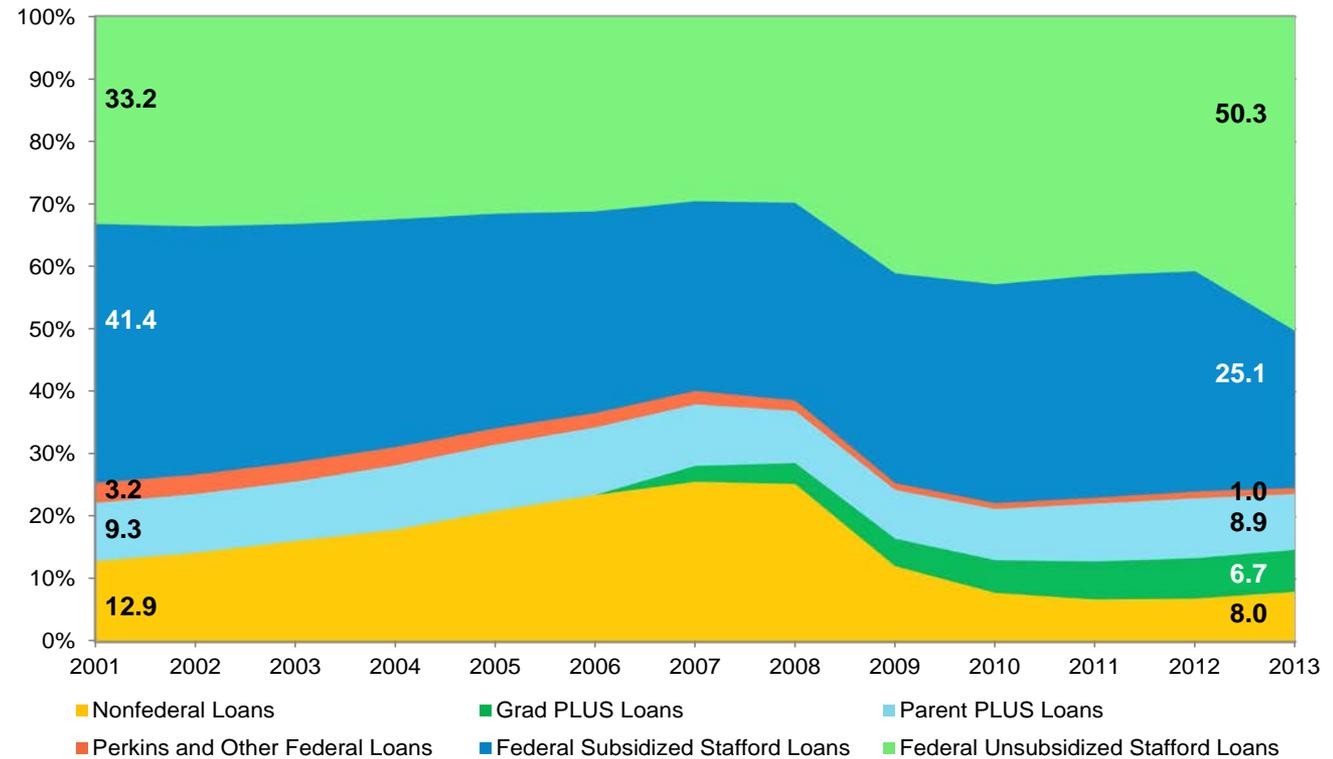


Source: Department of Education, Consumer Financial Protection Bureau, Federal Reserve

More Than 75% of Federal Student Loans Are Originated With No Credit Underwriting

- Approximately 76% of student loans, all government programs, were originated in AY 2012 – 2013 with no credit underwriting
- **Federal loans made with no credit underwriting**
 - Federal Unsubsidized Stafford Loans (50.3%)
 - Offered to undergraduate and graduate students; interest accrues while in school
 - Federal Subsidized Stafford Loans (25.1%)
 - Offered to undergraduate students; federal government pays the interest while enrolled in school
 - Perkins Loans (1%)
 - Low interest loans offered to undergraduate and graduate students with exceptional financial need
- Federal loans made with limited credit underwriting
 - Parent PLUS Loans (8.9%)
 - Loans to parents with dependent children
 - Requires credit check (limited)
 - Grad PLUS Loans (6.7%)
 - Loans offered to graduate students
 - Requires credit check (limited)
 - Private Student Loans ⁽¹⁾ (8%)
 - Comprehensive credit underwriting

Percentage Share of Federal and Non-Federal Student Loans Originations ⁽¹⁾
 (Annual Student Loan Originations, %)



Source: College Board, "Trends in Student Aid, 2013." <http://trends.collegeboard.org/sites/default/files/student-aid-2013-full-report.pdf>

Note

1. Data for academic year ending in years shown above. Nonfederal loans include loans to students from states and from institutions in addition to private loans by banks, credit unions, and Sallie Mae.

Unlike Other Credit, Can't Extinguish Student Loans in Bankruptcy

Default Consequences:

- **Tax Refund Offsets:** IRS can offset the borrower's income tax refund until the defaulted loan is paid in full. A number of states also have laws that authorize state guaranty agencies to take state income tax refunds.
- **Federal Benefits Offsets:** The government can offset certain Social Security benefits to collect government student loans. Just as with other types of student loan collection, there is no time limit on Social Security offsets, according to a 2005 Supreme Court Case.
- **Wage Garnishments:** The government can also garnish wages as a way to recover money owed on a defaulted student loan. The United States Department of Education or a Student Loan Guarantor can garnish 15% of disposable pay⁽¹⁾ per pay period without a court order.
- **Effect on Credit History:** Adversely affects credit for many years. If borrower defaults, loan will be listed as a current debt that is in default. The default will also be listed in the historical section of borrower's credit report, specifying the length of the default.
- **License Revocations:** A number of states allow professional and vocational boards to refuse to certify, certify with restrictions, suspend or revoke a member's professional or vocational license and, in some cases, impose a fine, when a member defaults on student loans.

Source: National Consumer Law Center; Finaid.org

Note

1. Disposable pay is the pay remaining after deduction of any amounts required by law to be withheld. The maximum for student loan and all other garnishments is 25% of disposable income. Wage garnishment amounts may be lower, as the borrower must be left with weekly earnings after garnishment that are at least 30 times the Federal minimum wage (\$7.25 an hour since July 24, 2009).

Section 2: Default Trends and Implications

Sizeable Loan Growth: Assessing Default Risk

- In attempting to gauge the potential future cost of the program, it is important to consider not only the volume of loans in default, but also the volumes in three other categories that could indicate difficulty repaying: deferment, forbearance, and serious delinquency.
- **Default:** “Default” in the context of student loans is generally defined as 270 days without payment.⁽¹⁾
 - For each group of loans maturing in a given federal fiscal year, the Department of Education publishes default rates occurring through the end of the following fiscal year (2-year Cohort Default Rate, or CDR) and the second following fiscal year (3-year CDR).
 - An institution loses its eligibility for the FFELP and Direct Loan programs if the most recent 3-year CDR is greater than 40% and / or if the three most recent 3-year CDRs are each 30% or greater.⁽²⁾
 - For reference, the most recent national 3-year cohort default rate was 13.7% (the national 2-year cohort default rate was 10% as of the last published mark for FY2011, up 300 bps from 2008 and 550 bps from the trough of 4.5% in 2003).
 - Universities that lose eligibility may appeal the decision, meaning they may not lose federal financing for a long period, if ever.
 - Default trends are weaker at for-profit institutions, nearly 400 bps above the national two-year CDR as of the most recent mark published for 2011.
 - Based on this threshold, 21 institutions of 6,100+ schools which qualified for Title IV funding lost eligibility in the most recent year.
- **Deferment:** Payments have been postponed as a result of certain circumstances such as returning to school, military service, or economic hardship.
- **Forbearance:** Payments have been temporarily suspended or reduced as a result of certain types of financial hardships.
- The ability to defer or forbear on loans distinguishes student lending from other credit. During deferment or forbearance, the principal and interest of the loans capitalize, making balances larger for students and exacerbating repayment potential.
- **Serious Delinquency (90+ Days):** Classified as in repayment, but given the high volume relative to historical levels, some portion can be considered at risk of default.
- **Result:** There are nearly \$100Bn in defaults (or an average of \$14,100 per borrower), which is 9% of the stock of federal student loans, with default rates differing meaningfully for the various types of institutions.⁽³⁾

Notes

1. Department of Education. Varies by type of loan, date of origination and processing time.

2. Federal Pell Grants are subject to the three most recent 3-year CDR restriction.

3. U.S. Department of Education, Default Coordination Team, Operations Performance Division. Default Management Database. <http://ifap.ed.gov/DefaultManagement/DefaultManagement.html>

Default, Defined as Loans That Are 270+ Days Delinquent, And Three Other Categories Are Potential Risks

- The following table outlines the current status of the outstanding stock of Federal student loans. The blue-shaded areas show the total stock of Federal student financing. The pink-shaded area outlines the portion of the stock that is in deferment or forbearance.

Breakdown of U.S. Federal Student Financing by Repayment Status, Type (As of June 2014)

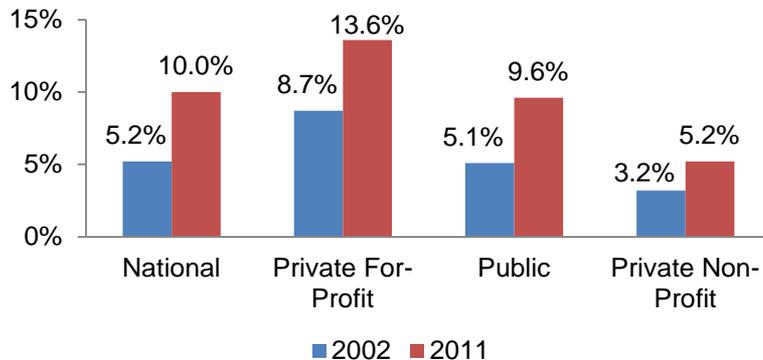
	In Grace		Repayment	Deferment	Forbearance	Default	Other	Total
	In School	Period						
Direct (Student Borrower)	\$136	\$43	\$300	\$89	\$75	\$37	\$5	\$686
<i># of borrowers (millions)</i>	7.6	1.8	12.3	3.4	2.5	2.6	0.2	30.4
FFEL (Family Borrower)	\$6	\$3	\$243	\$39	\$44	\$62	\$6	\$403
<i># of borrowers (millions)</i>	0.4	0.2	12.2	2.0	1.7	4.4	0.2	21.1
Total Fed Student Lending	\$142	\$46	\$543	\$128	\$119	\$99	\$11	\$1,088
<i># of borrowers (millions)</i>	8.0	2.0	24.5	5.4	4.2	7.0	0.4	51.5
% of notional US\$Bn	13%	4%	50%	12%	11%	9%	1%	100%

At risk of default

Source: U.S. Department of Education, National Center for Education Statistics

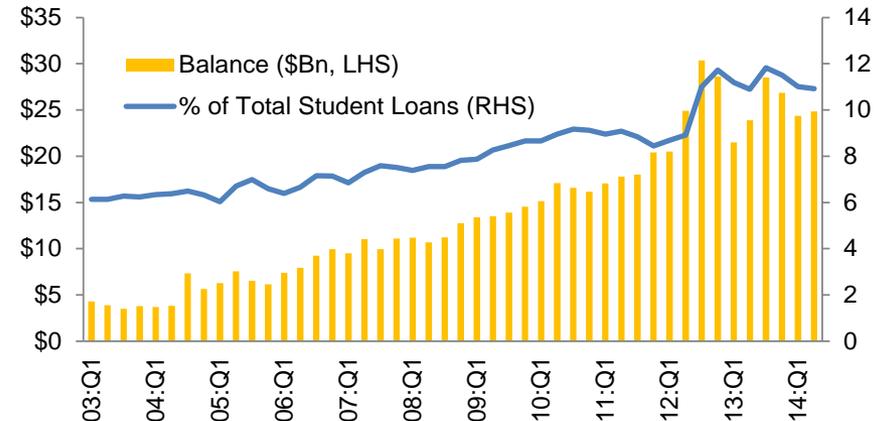
Default Rates Vary by Type of Institution

2-Year Cohort Default Rates by Type of Institution (%)



Source: U.S. Department of Education

Amount of 90+ Days Delinquent Loans has Grown Significantly



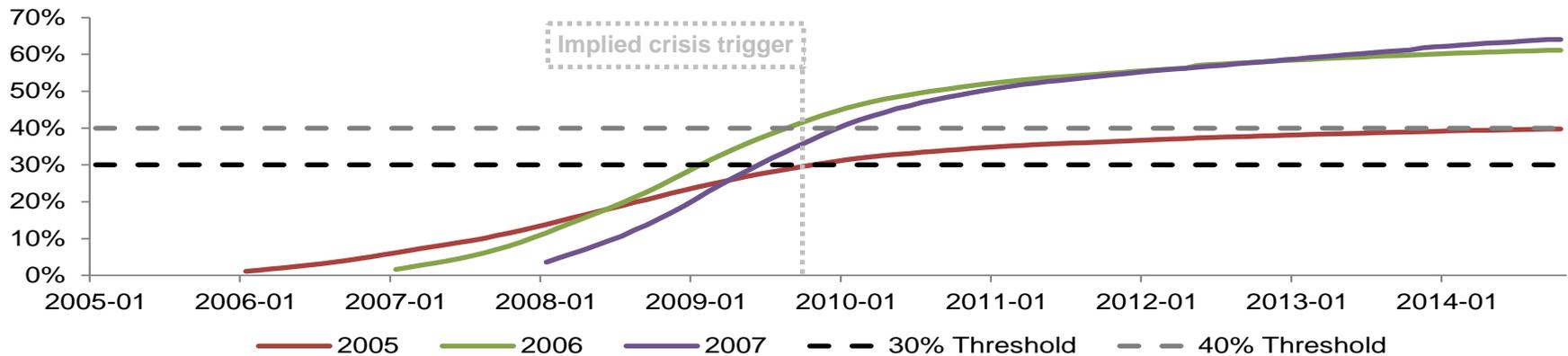
Source: Federal Reserve Bank of New York

Some Parallels to the Subprime Mortgage Market Pre-Crisis

- To the extent it is appropriate to draw parallels to the subprime mortgage market, although clearly substantial differences exist, one can look at the rate of serious delinquencies as a percent of the balance of total subprime loans originated leading up to the crisis. The market experienced a balance of 90+ day delinquencies greater than 30% and 40% only in mid/late 2009, suggesting that a 30% or 40% threshold as a trigger would be too generous.
 - It is important to note the subprime mortgage data is for delinquency versus default, and there are differences in the markets for subprime loans and student loans. However, in an attempt to calibrate the appropriate threshold, we find the data instructive.

Subprime Mortgages – Percentage of Seriously Delinquent (90+ Day) Loans Originated Between 2005-2007

Balance of Loans that Ever Reached 90+ Day Delinquency / Total Loans Outstanding, By Vintage (%)



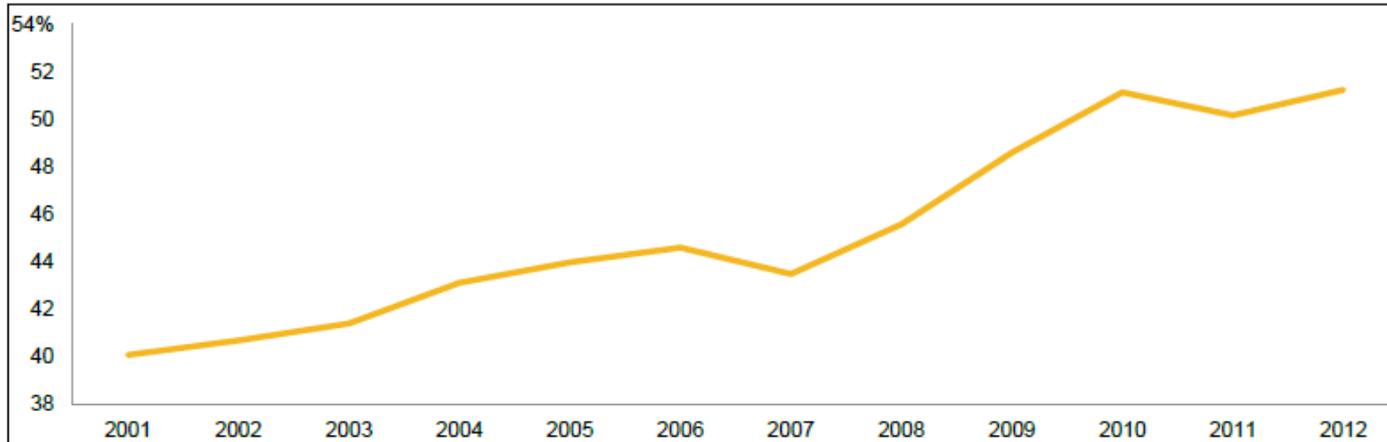
Source: Loan Performance Database

Section 3: Key Factors Driving Growth in Student Loans

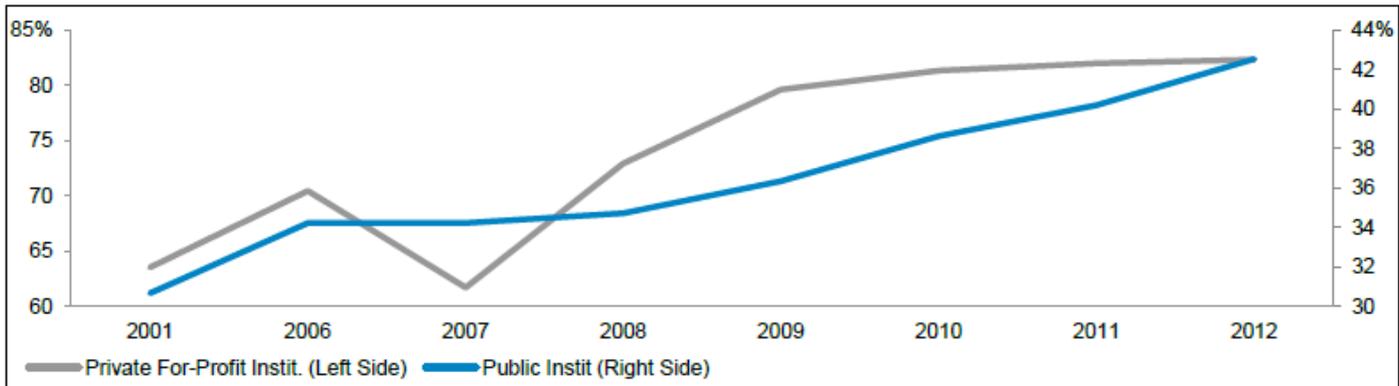
Growing Number of Students Receiving Student Loans

Percentage of Undergraduate Students Receiving Loans: 2001 - 2013 (1)

All Undergraduate Students(2)



Public and Private for-Profit Undergraduate Students



Source: U.S. Department of Education National Center for Education Statistics "Digest of Education Statistics," 2013, Table 331.20, 2013.

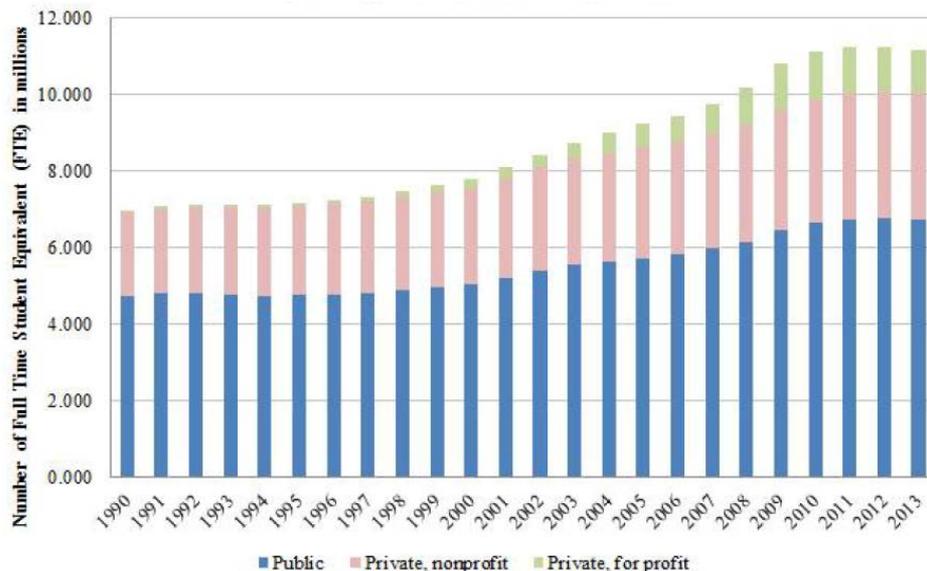
Notes

1. Data for academic year ending in years shown above.
2. Full-time, first time degree/certificate seeking undergraduates enrolled in all private or public degree-granting institutions. Student loans include only those made directly to students and do not include parent loans.

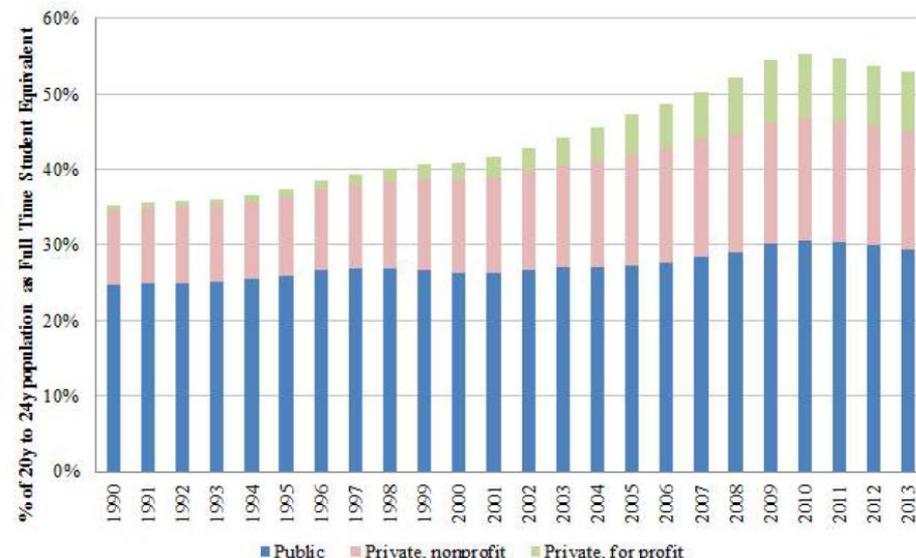
More People Are Consuming More Years of Higher Education

- *There are more college-aged people...* The US population cohort aged 20y to 24y has grown +9.4% over the last 10y.⁽¹⁾ This is the baby-boom 'echo' that should begin to slow noticeably from 2015 onward.
- *...And more of them are pursuing college degrees...* College enrollment has grown +19% over the last 10y.⁽²⁾
 - Graph 1 shows the growth of full time students in 4y universities of different types – public, non-profit private and for-profit private. Graph 2 shows the rising proportion of the US population aged 20y to 24y that attend different types of 4y universities.
 - Not only do both graphs show absolute and proportionate increase, but both graphs show that the Great Financial Crisis appears to have accelerated the growth in students attending school.
 - Equally important, both graphs show that the bulk of the increase in students was driven by 'for profit' universities.

Graph 1: Growth of Full-Time Students in Four-Year Universities, By Type



Graph 2: Proportion of U.S. Population Aged 20Y-24Y Attending Four-Year Universities, by Type



Source: U.S. Department of Education, National Center for Education Statistics

Source: U.S. Department of Education, National Center for Education Statistics

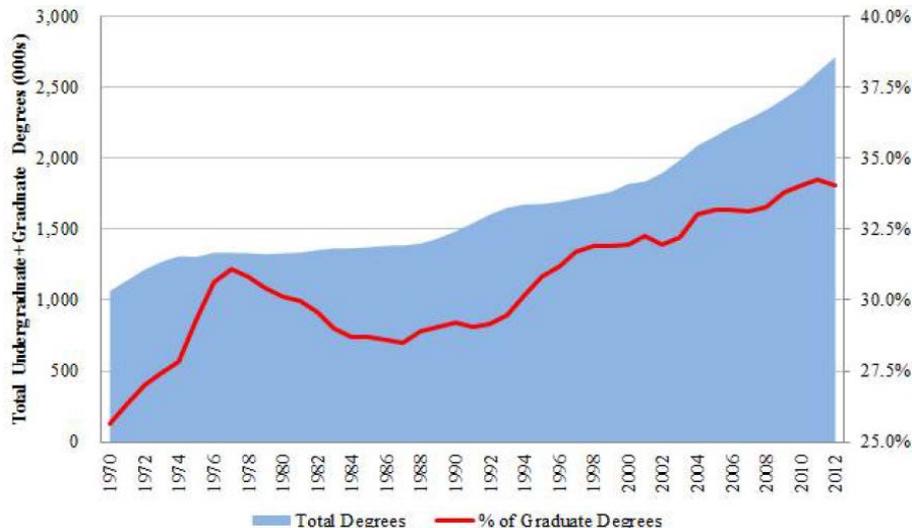
Notes

1. Haver / US Census Bureau.
2. US Department of Education, National Center for Educational Statistics, Digest of Education Statistics – 2012 and Digest of Education Statistics – 2013. <http://nces.ed.gov/programs/digest/>

More People Are Consuming More Years of Higher Education (Cont'd)

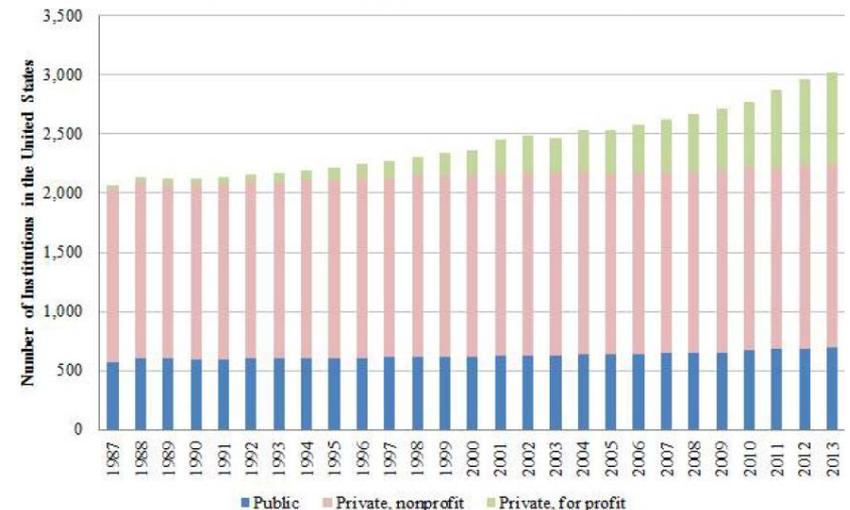
- ...And even more people are going to university for longer, in part pursuing post-graduate degrees and in part taking longer to graduate... Anecdotally, this is evident as a consequence of the Great Financial Crisis and spike in unemployment. Factually, it is also evident in the data as shown in Graph 3, which details the proportion of degrees granted in each that are above undergraduate/college degrees – i.e. Masters, Doctorate or Specialist (MD, MBA, etc...). Graph 3 shows a similar trend – more people are pursuing post-graduate degrees since the mid-1980s and this trend accelerated post-2008.
- ...And there are more universities to service them. There was a significant rise in the number of institutes of higher education (IHE) since 1992, as ‘for profit’ universities saw rapid growth. Graph 4 details the absolute number of IHEs by type that are eligible to receive students with Federal student aid.
 - Again, the bulk of the growth in the last 15y was driven by ‘for profit’ universities.
- These three trends mean that the absolute stock of student loan debt should increase – **a rising share of a growing population are choosing to consume more years of higher education.**
 - Even if we assume that the same proportion of this education expense was debt-financed (it is now a higher proportion) and that the cost of higher education remain constant (it has grown), the absolute stock of student financing would increase. In fact, a greater proportion of students are taking out Federal student loans (48% as of 2012, up from 33% in 2002).

Graph 3: More Students + More Students Getting Graduate Degrees



Source: U.S. Department of Education, National Center for Education Statistics

Graph 4: Growth in the Number of Degree-Granting Four-Year Institutions



Source: U.S. Department of Education, National Center for Education Statistics

Recent Growth in ‘For Profit’ Schools Has Broadened the Use of Student Financing

- *Simply put: “for profit” universities have grown rapidly in number and in enrollment, and students at “for profit” universities are twice as likely to utilize Federal student financing.*
- To give some context as to why ‘for profit’ schools have grown and consolidated, as well as to why they are very much a factor in the growth in student loan financing, Table 3 below is a snapshot for average four-year undergraduate university income statement as well as the average cumulative source of financing for the student.
 - The financial metrics are broken down as revenues and costs per student per year.
- Note the two boxes highlighted: the pink box shows the average operating profit per student at a ‘for profit’ university, while the yellow box shows that student financing covers roughly all public university tuition over the course of four years (which presumably was the design).

TABLE 3: Snapshot of Average Four-year Undergraduate Education
as of 2010-11 school year

<i>per Full Time Student equivalent</i>	Public	Private Nonprofit	Private For Profit
Tuition & fees	1,410	6,018	13,019
Investment & endowment income	297	3,100	0
Govt. grants, contracts, appropriation	3,265	2,735	1,001
Other revenues	<u>2,449</u>	<u>6,382</u>	<u>286</u>
Total Revenues	7,421	18,235	14,307
Instruction	7,239	15,321	3,017
Research	3,756	5,887	8
Student services & academic support	<u>5,190</u>	<u>14,128</u>	<u>8,310</u>
Total expenses	16,185	35,336	11,335
Differential	-8,764	-17,101	2,972
Scholarship or grant	6,931	16,037	4,832
<i>as % of 4y cumulative tuition</i>	123%	67%	9%
Student financing	6,063	7,466	9,641
<i>as % of 4y cumulative tuition</i>	108%	31%	19%

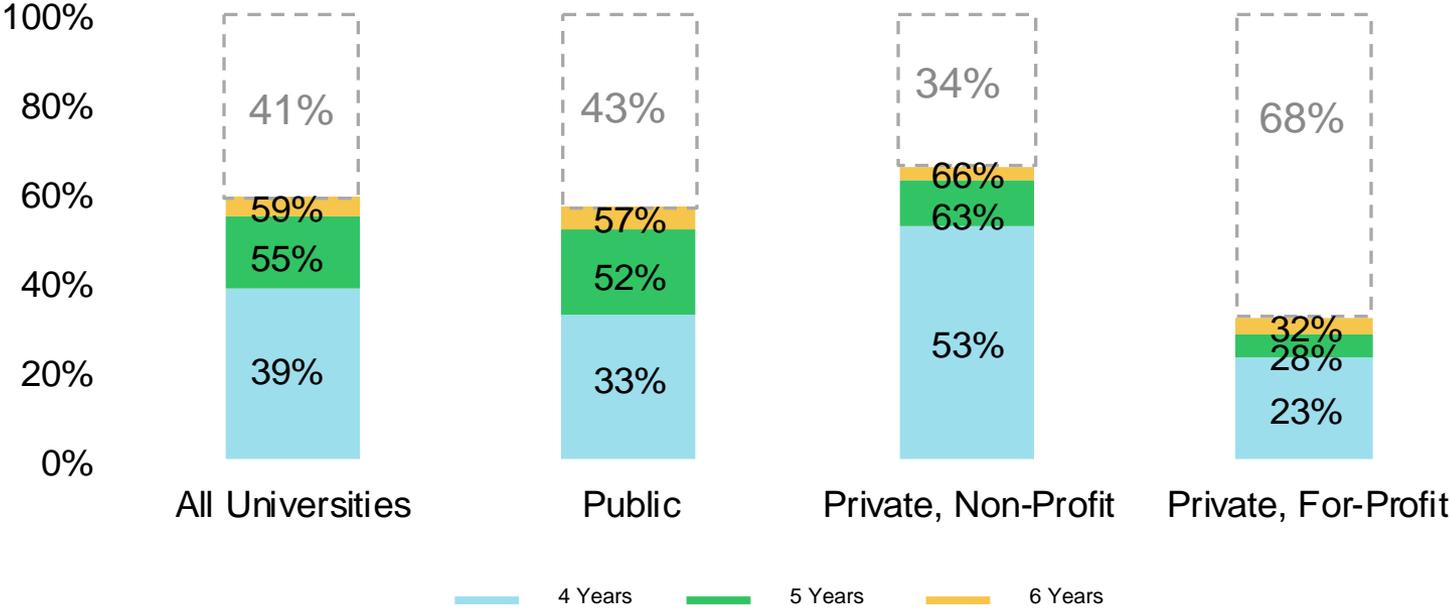
Source: US Department of Education, National Center for Education Statistics

Section 4: Broader Implications of Student Lending Growth

One of the Key Drivers for Default is Failure to Graduate...

Graduation Rates Raise Questions about the Value of Loans for Most Borrowers

Graduation Rates of Bachelor's Degree Seeking Students at 4-Year Postsecondary Institutions
(Cohort Entry Year: 2006)



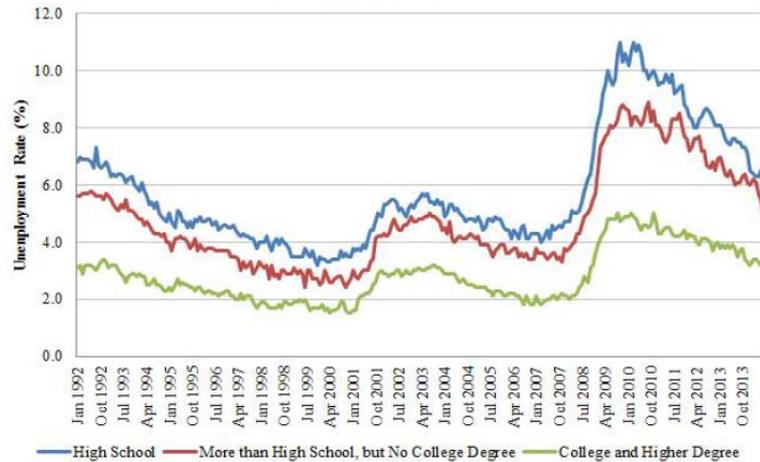
Source: Department of Education, National Center for Education Statistics

...Failure to Graduate Exacerbates Already Weak Labor Market Outcomes

- Failure-to-graduate remains the most deadly of traps for higher education. As shown in the following Graphs 8, 9 and 10, the marginal benefit of higher education is clear in terms of lifetime earnings and better employment stability. Failure-to-graduate combined with leverage is a poor mix: the debt burden remains but very little of the economic benefits accrue. Whatever the reasons that the student failed-to-graduate, he or she is left with all of the downside and limited upside.

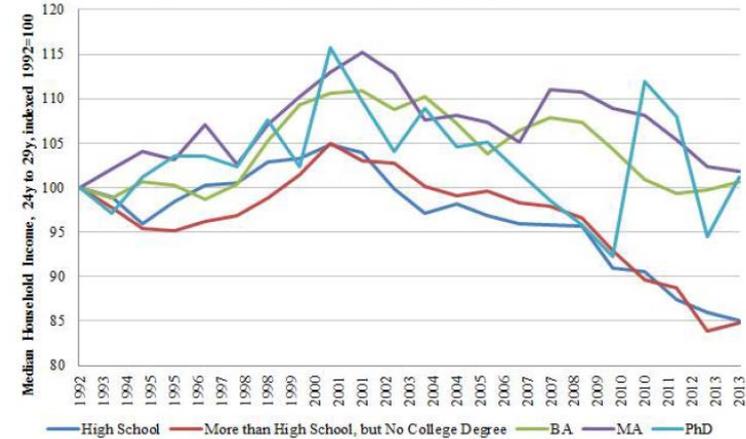
Graph 8: Higher Education Benefit: Better Job Security

Source: US Bureau of Labor Statistics, Haver



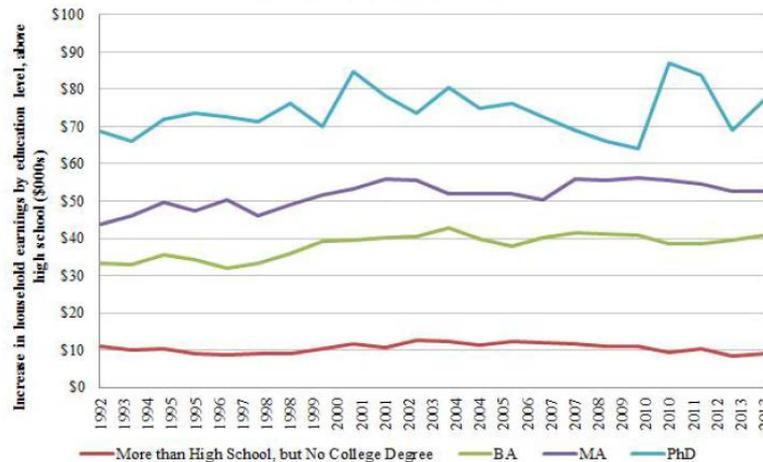
Graph 9: Higher Education Benefit: Absolute Higher Earnings

Source: US Bureau of Labor Statistics, Haver



Graph 10: Higher Education Benefit: Relative Higher Earnings

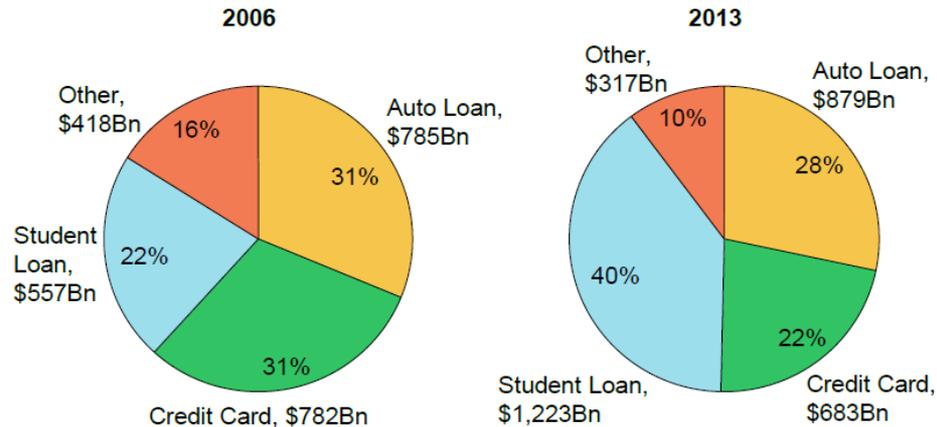
Source: US Bureau of Labor Statistics, Haver



Student Loan Debt Could Affect Credit Formation

Student Loan Debt Has Surpassed Auto Loans for the First Time

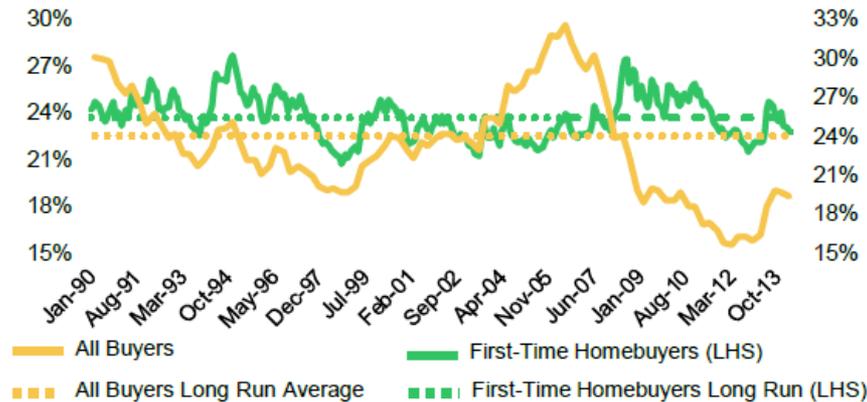
Consumer Debt Market Size by Type – Excluding Mortgages



Source: Federal Reserve, Federal Reserve Bank of New York

First Time Homebuyers Face Affordability Issues

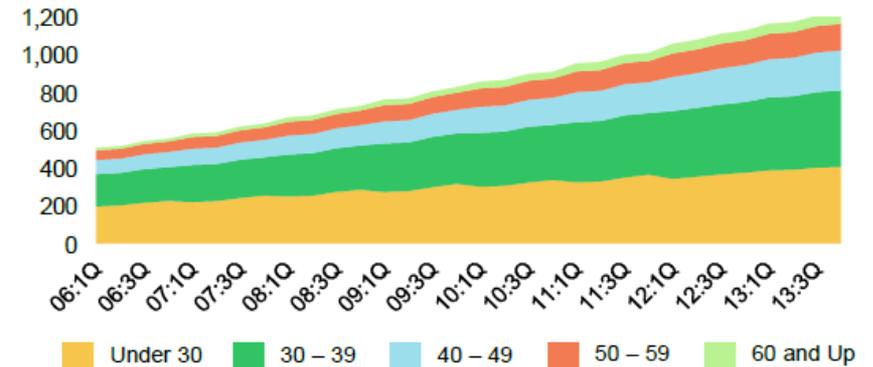
Monthly Payments as a % of Income



Source: Freddie Mac, Case Schiller, Census Bureau

Credit Availability Could be a Problem as This Age Group Represents a Large Portion of Student Debt Expense

Outstanding Student Loan Debt (\$Bn)

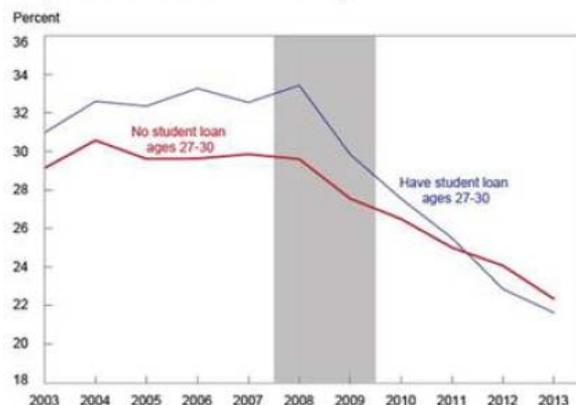


Source: Federal Reserve (total figures), Federal Reserve Bank of New York (age distribution)

The Increase in Student Loan Debt Shows Some Impact on Willingness to Purchase Housing

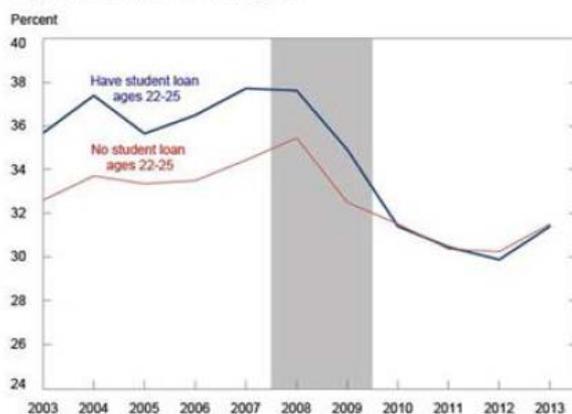
- There has been much debate as to whether the growth in student loan debt is crowding out other financing for post-graduates aged 24y to 34y. The academic and policy literature is mixed on the topic, primarily because there is limited data that is appropriated sliced by student loan debt level, income level and housing-secured debt.
- Federal Reserve Bank of New York analysis:

Proportion with Home-Secured Debt at Age 30



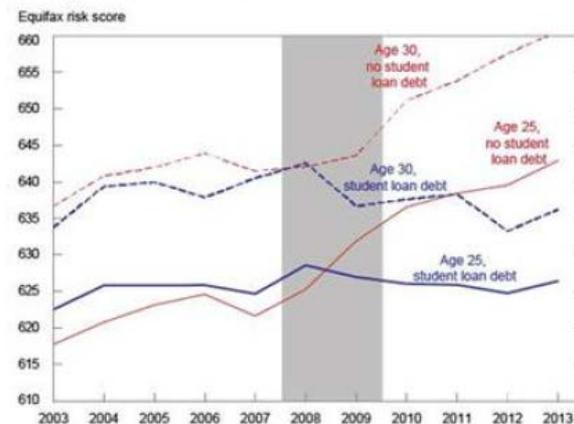
Source: FRBNY Consumer Credit Panel/Equifax.

Proportion With Auto Debt at Age 25



Source: FRBNY Consumer Credit Panel/Equifax.

Average Risk Scores at 25 and 30



Source: FRBNY Consumer Credit Panel/Equifax.

- The first panel shows that post-Great Financial Crisis, those with student-loan debt are marginally less likely to have mortgage debt and suffered a larger fall in mortgage debt. The second panel suggests there's no difference in utilization of auto-loan debt between those with and without student loans; however, like with mortgage debt, those with student-loan debt suffered a larger fall in auto debt. The final panel shows that the difference in credit/FICO scores for those with and without student loan debt has widened, either because FICO scores are more accurate or credit standards are more stringent.
- In addition to the potential spillovers to other credit, various academic studies show that there's a correlation between higher student debt burden and (a) lower propensity to pursue graduate education, (b) reduced retirement savings, (c) higher propensity to live with parents, (d) delayed age of marriage, and even (e) lower reported satisfaction of marriage.
- Correlations could be related to higher student debt but more broadly to the extreme stress on employment prospects, volatility in asset markets and housing markets, and meaningful structural change across several industries in the post-Great Financial Crisis.

More Households Have More Student Debt; Significant Burden For Those With Lowest Income

Graph 11: More Households Have More Student Debt

Source: Brookings Institute (May '14)

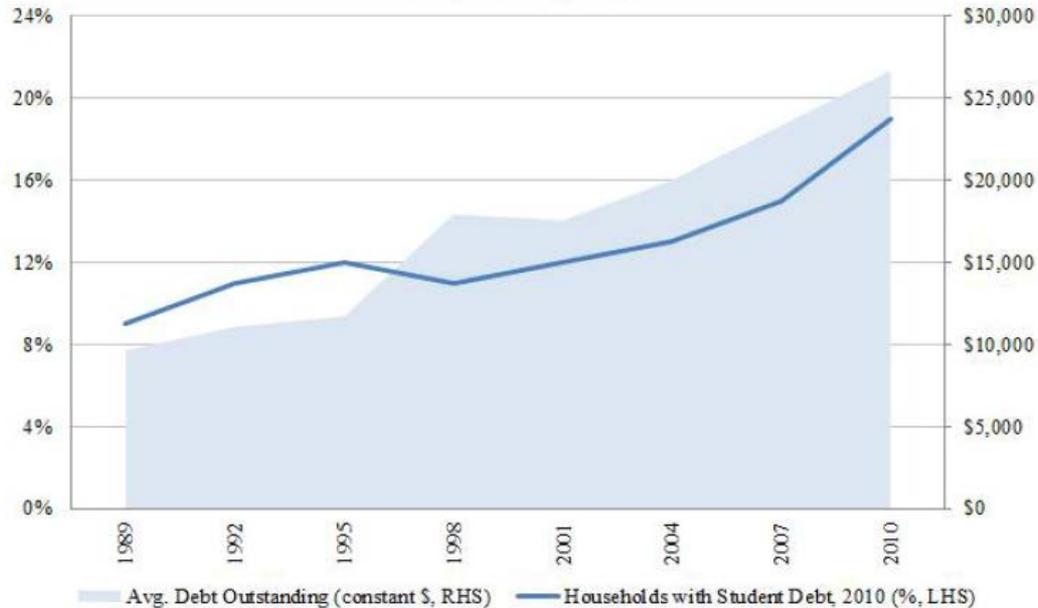


TABLE 8: Outstanding Student Loan Debt as % of Household Income

%			2010	2007
Lowest Quintile	Up to	\$21,044	24%	15%
Second Quintile	\$21,044 to	\$36,723	10%	7%
Middle Quintile	\$36,724 to	\$59,623	12%	7%
Fourth Quintile	\$59,624 to	\$97,585	7%	6%
Upper Quintile	\$97,586 to	\$146,791	7%	4%
Upper 10%	\$146,792 or more		2%	1%
All Households			6%	4%

Source: Fry (2012), Brookings Institute (May '14)

Note

1. Brookings Institute. Is a Student Loan Crisis on the Horizon? June 2014. Beth Akers and Matthew Chingos

Section 5: How the Committee Expects the Student Loan Market to Develop, Including Potential Reform Proposals

Current Trends Imply Continued Loan Growth and CBO Budget Savings Projections Do Not Factor in Market Risk or Shifts in Macroeconomic Conditions

As currently designed, the federal student loan programs are projected to grow significantly over the next ten years

- The CBO estimates that the government's four largest student loan programs will increase by \$1.2 trillion on a gross basis from FY2015 through FY2024.
 - Annual growth is expected to be \$103Bn in FY2015, increasing to annual growth of \$133Bn in FY2024 (also on a gross basis).

CBO estimates that the program as currently designed yields budget savings of \$135Bn from FY15 to FY24 ⁽¹⁾

- Based on the current accounting methodology as prescribed by the Federal Credit Reporting Act of 1990 (FCRA).

However, under fair-value accounting, the program results in an \$88Bn cost to taxpayers ⁽¹⁾

- FCRA discounts expected future cash flows of the loan program using current UST rates, without accounting for market risk.
- In contrast, under the alternative fair-value accounting approach analyzed by the CBO, “estimates are based on market values...which more fully account for the cost of the risk the government takes on.”
 - The CBO explains: “Market risk... arises from shifts in macroeconomic conditions, such as productivity and **unemployment**, and from changes in expectations about future macroeconomic conditions. The government is exposed to market risk when the economy is weak because borrowers default on their debt obligations more frequently and recoveries from borrowers are lower. When the government extends credit, the associated market risk of those obligations is effectively passed along to taxpayers, who, as investors, would view that risk as having a cost. **Therefore, the fair-value approach offers a more comprehensive estimate of federal costs.**”

Source: Congressional Budget Office, "Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024" (May 2014).

Note

1. Excluding administrative costs.

Potential Reform Proposals Could Alter Economics of Program

Overview

- Given the social and economic cost of default, it is important to note various ideas for reform that have been proposed.
- The primary reform proposals, described below, address: (i) cost of the program to students; (ii) options available for repayment; and (iii) volume of loan origination.
- The cost/benefit analysis of the program is beyond the scope of this presentation. The approaches to reform complement one another in the aggregate, with the focus on origination fulfilling the mandate of the student lending program by ensuring the completion of a quality education.

Cost

- Would allow borrowers with certain types of student loans issued before 2010 to refinance at lower interest rates offered to new borrowers as of July 2013.

Repayment and Servicing

- Income-based repayment: Several income-driven plans exist that focus on capping repayments at a percentage of discretionary income (e.g., 10%) and forgiving remaining balances after a period of qualifying payments (e.g., 20 years).
- Forgiveness: The Public Service Loan Forgiveness program allows individuals working in full-time public service jobs to qualify for forgiveness for the remaining balance of their federal direct loans after making 120 qualifying payments after October 1, 2007. The first forgiveness of loan balances will not be granted until October 2017.
- Servicing: Continued reform by the federal loan service providers to take advantage of income-based repayment programs as well as minimize defaults and delinquencies.

Volume and Pace of Origination

- Risk sharing:
 - Would develop a college ratings system that takes into account both affordability and outcomes.
 - The Department of Education recently finalized plans for a “gainful employment rule” that would put career training programs at risk of losing their ability to participate in taxpayer-funded federal student aid programs if the estimated annual loan payment of a typical graduate exceeds 20% of his or her discretionary income or 8% of his or her total earnings.
- CFPB: The CFPB’s student loan ombudsman has implemented numerous programs to enhance financial literacy for students, parents and universities; increase transparency about student loan practices; analyze trends in the market; and make policy recommendations for a variety of areas, especially improvements in loan servicing.

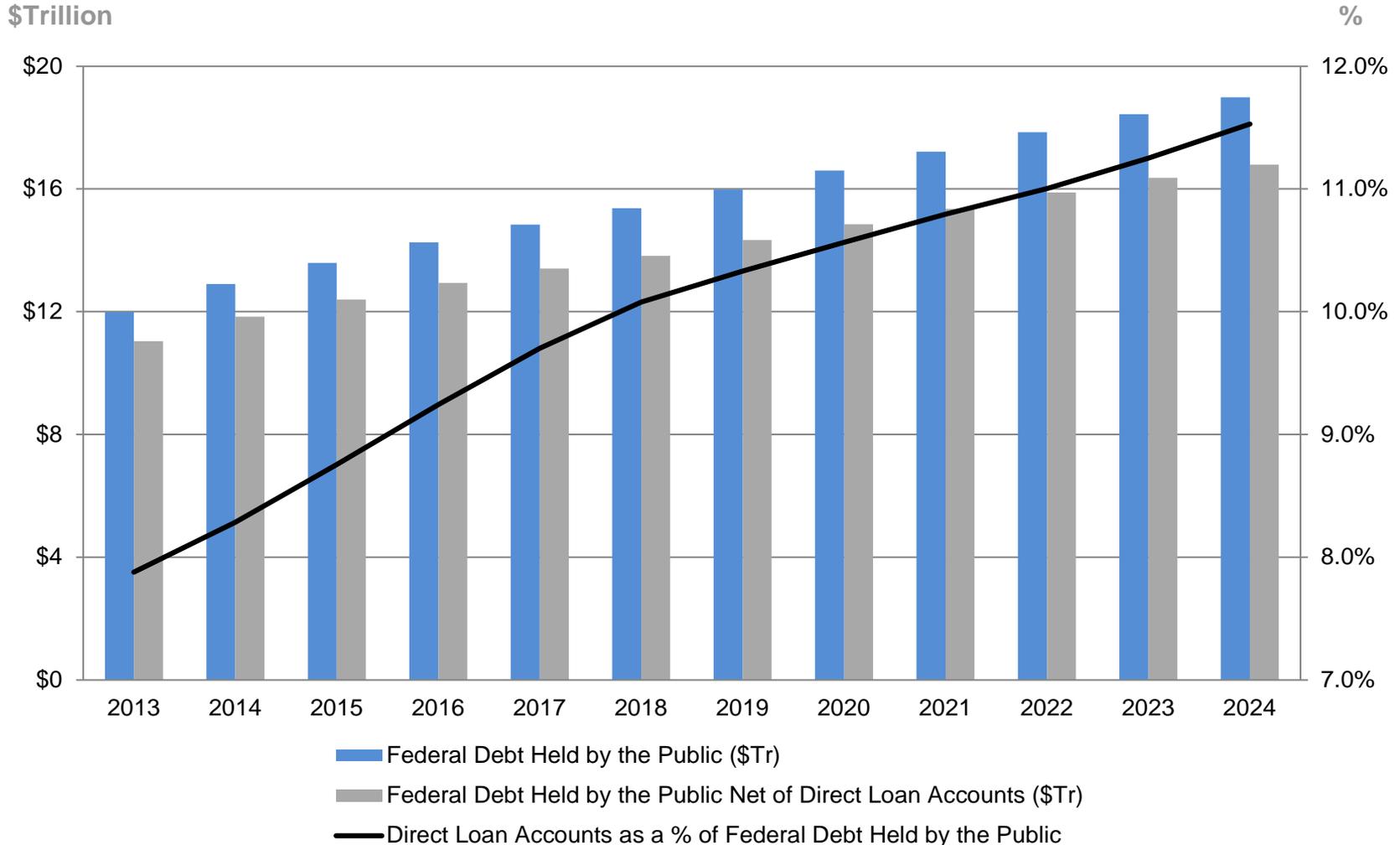
Other

- Market segmentation: The federal program, which represents >85% of the market, uses the same terms for all borrowers. Programs are developed with no ability to create tools that meet the specific needs of different types of borrowers. Market segmentation could help facilitate the development of loan products and loan terms to do so, for example through public-private partnerships.

Section 6: Main Risks Associated with Student Lending, Including the Funding Implications for Treasury Under the Status Quo Versus Alternate Potential Scenarios

Direct Loan Accounts Are Expected to Continue to Grow and Represent a Growing Portion of the Federal Debt Held by Taxpayers

U.S. Total Debt Held by the Public and Total Debt Held by Public Net of Direct Loan Accounts: FY2013 – FY2024

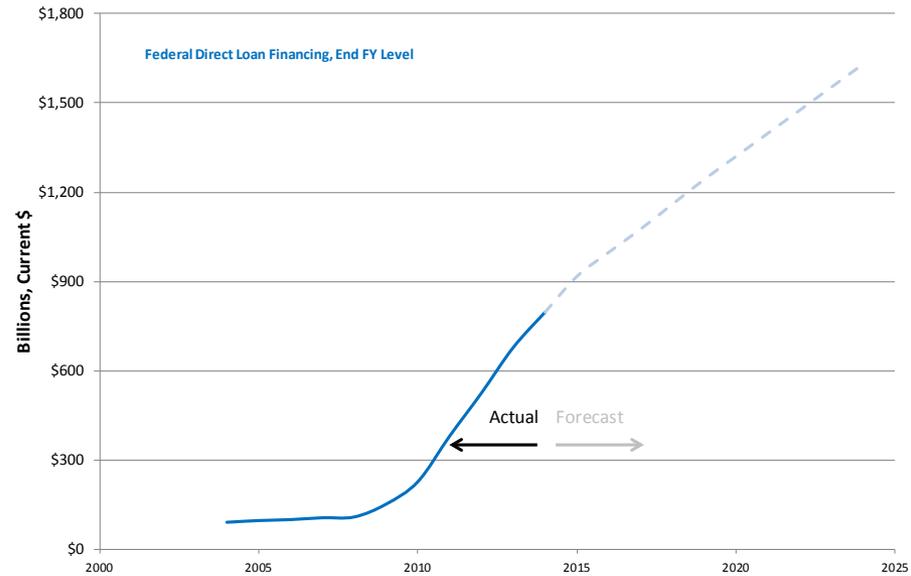
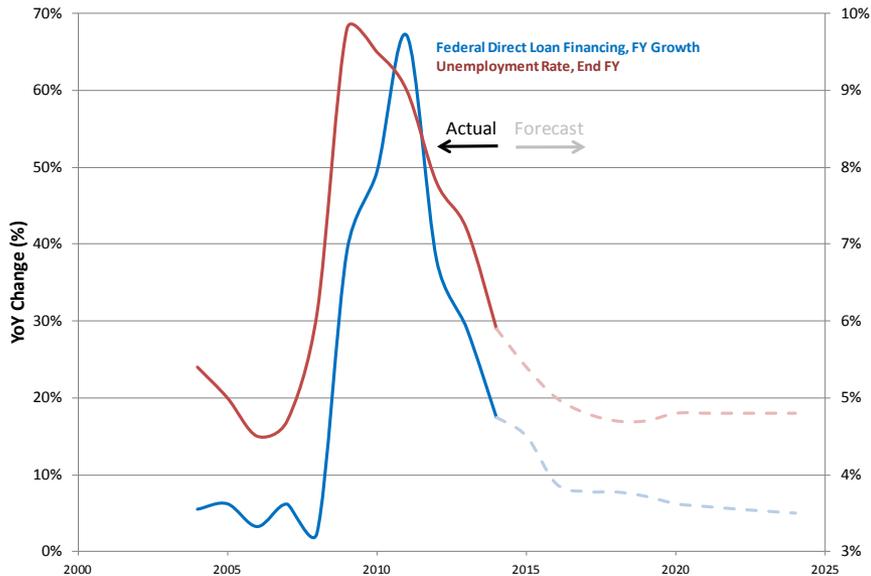


Source: Office of Management and Budget: Budget of the United States Government, Fiscal year 2015.

Direct Lending Expected to Expand Significantly

- Primary drivers of direct lending growth are demographics (population aged 16y-24y), unemployment and underemployment (U-6).
 - Demographics hold down direct loan growth as the baby-boom 'echo' ages.
 - As the labor market improves, growth should decelerate from a peak of 67% year-over-year growth in 2011 to 5% year-over-year growth in 2024 (net of amortization)
- Panel 1 plots the unemployment rate along with our model-based forecast of the growth rate of loan financing.
- Panel 2 shows that although the growth rate of loan financing is expected to slow significantly, the *level* of direct lending may still double over the next 10 years.
- Such forecasts are highly uncertain and depend on modeling choices and variables that we can know little about, such as recession odds (upside risk), regulatory action (downside risk), and inflation in education (two-way risk).

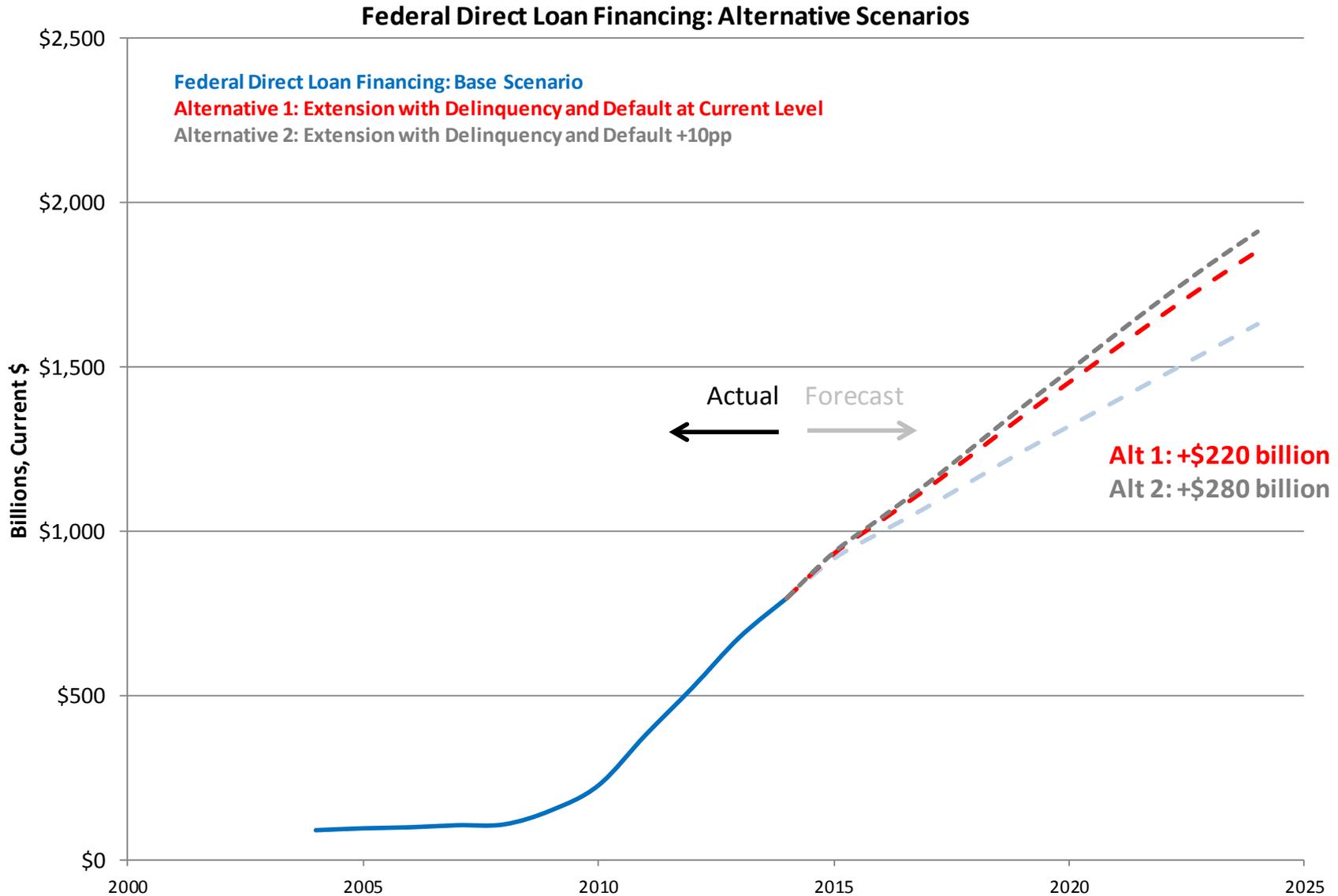
Federal Direct Loan Financing and the Unemployment Rate



Cost of Dealing with Legacy Debt: Maturity Extension

- Regardless of the pace of new lending, existing direct loans are of questionable creditworthiness
 - As of FY Q3:2014, 37.6% of Federal direct loan balances were tied up with borrowers who were delinquent, in default or in similar categories including forbearance, deferment, non-defaulted bankruptcy or disability (hereinafter called “delinquency and default rate” for simplicity)
 - In the same period, 37.5% of indirect (FFELP) loan balances were in default, forbearance, deferment, non-defaulted bankruptcy or disability
- While fixed-rate student debt is insulated from interest rate risk, given the consequences of default discussed earlier, political pressure may nevertheless mount to forgive or extend student debt
 - Debt forgiveness would reduce direct lending balances, while incurring a current-year expense for the Department of Education
 - Maturity extension would cost less upfront to the taxpayer than debt forgiveness and provide some breathing room for at-risk borrowers. However, by keeping loans on the balance sheet for longer, maturity extension would increase direct lending balances at the Treasury.
- Alternative scenario: all borrowers who are in default, delinquency, or similar categories are allowed to defer payment for 10 years, at which point the remaining balance becomes a 10-year loan
 - Assume in alternative (1) current delinquency and default rate, and in alternative (2) that the rate increases by 10pp (i.e., 37.6% to 47.6%)
- With maturity extension, total direct lending balances at the end FY2024 will be higher than the base case by +\$220 billion with delinquency and default unchanged, and +\$280 billion if delinquency and default increases 10pp to 47.6%
 - Balances affected more by maturity extension than by further erosion in creditworthiness
- We can consider a similar thought experiment for the contingent liability of the outstanding stock of indirect lending. Take the stock of FFELP loan balances (\$402.5 bn as of FY Q3:2014) and multiply by the delinquency and default rate (37.5%). Then the contingent liability is \$150.7 billion, if the Federal government is assumed to be the ultimate backstop for indirect loans.
- These calculations do *not* provide a complete cost/benefit analysis of maturity extension. This exercise quantifies the potential consequences of such a re-profiling of debt in terms of the consequences for Treasury’s debt management. A holistic assessment of such a program would have to consider the benefits of doing so, which could well be economically significant.

Cost of Dealing with Legacy Debt: Maturity Extension

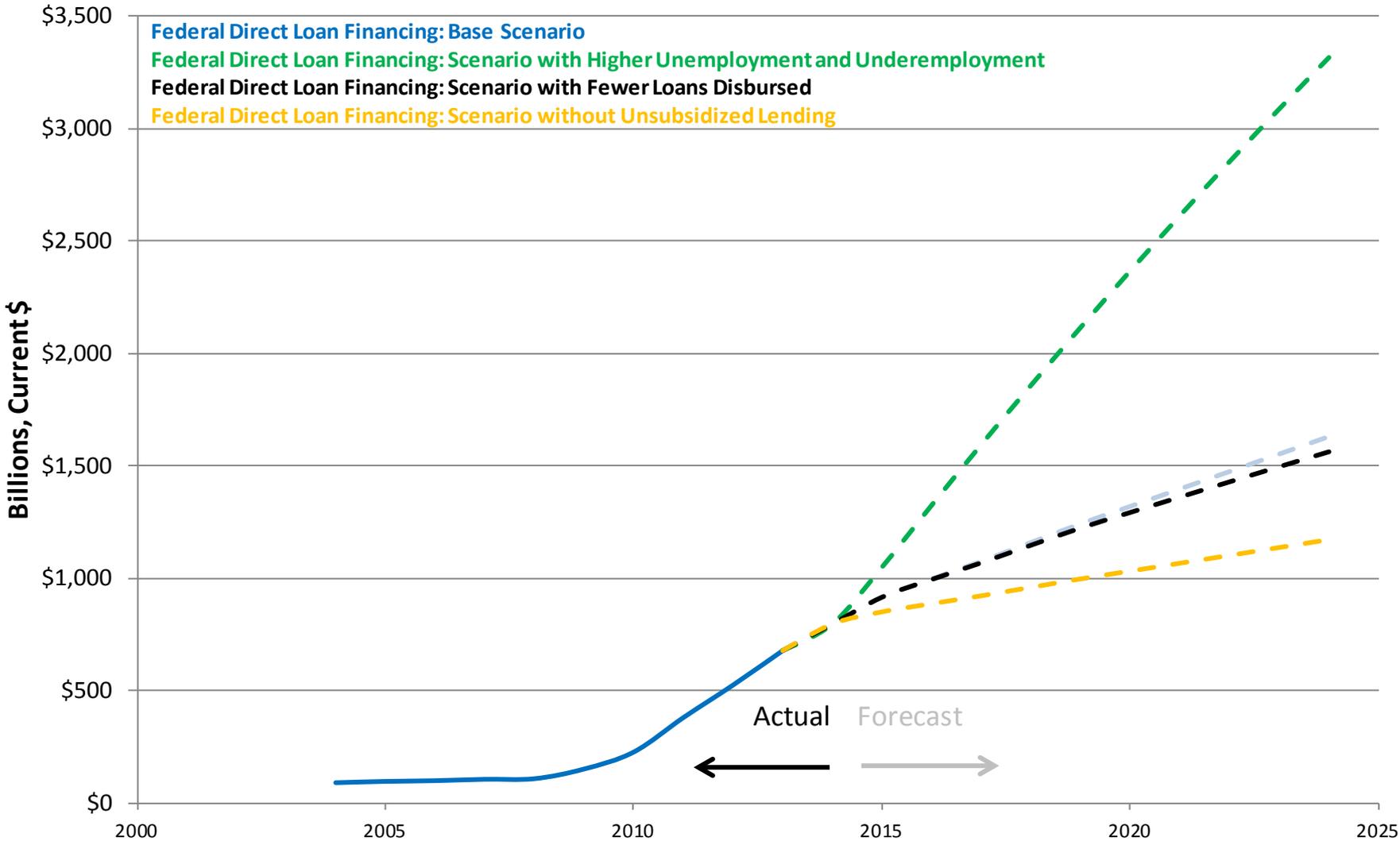


Appendix

For Illustrative Purposes Only: Alternative Paths of Loan Balances

- **Higher Unemployment and Underemployment:** Given the relationship between employment conditions and loan growth, a higher unemployment or underemployment (U-6) rate would be likely to cause lending to grow substantially more than the base case.
 - Specifically, if the unemployment rate were to edge up after reaching a trough in two years and the gap between U-6 and unemployment remains as wide as it is today – in excess of historical norms – the size of the program would be expected to reach roughly \$3.3 trillion in 2024, \$1.7 trillion more than in the base case.
- **Fewer loans are disbursed:** The CBO expects the number of new loans to grow at roughly 2% annually, even in years when the 16-24 year-old population is expected to decline, consistent with the base case presented here. While the number of loans is unlikely to turn negative due to increasing demand for years of higher education and cost, the pace may slow further than expected.
 - The effect of a slower pace of loan disbursements is likely to be small: if the rate of growth in the number of loans were to fall to 1%, the reduction in total balances would be expected only to amount to \$68 billion less over ten years than the base case.
 - The CBO's and our base case already assumes nominal growth in the average size of each loan to undershoot expected long-run inflation, so slower growth is unlikely to come from a deceleration in the cost of education – it is already baked into the model.
 - Under the program's current parameters, it is much easier to envision an upward surprise in lending relative to the base case than a downward surprise.
- **Government ends unsubsidized lending:** Roughly half of current lending is classified as “unsubsidized”. In theory, an “unsubsidized” product should be delivered at roughly the same price by the private sector, as any subsidy should be equal to the difference between the market's price and the government's price. Regardless of whether or not this concept is true in practice, it could serve as a rationale to reduce the government's obligations in student lending by discontinuing unsubsidized lending. Doing so would have a large impact on lending balances.
 - If the Federal government were to stop making “unsubsidized” loans, growth in direct student lending over the next ten years would be reduced by an estimated \$458 billion, roughly 55% of total growth in the base case.

For Illustrative Purposes Only: Alternative Paths of Loan Balances (Continued)



Types of U.S. Federal Student Loans

- Direct, Subsidized Loans. Loan is directly administered by the Federal government and offered only to undergraduate students based on financial need. Interest does not accumulate while the borrower remains in school. The interest rate (2014-15) is 4.66% and the maximum loan balance is \$23,000.
- Direct, Unsubsidized Loans. Loan is directly administered by the Federal government and offered to both undergraduate and graduate students regardless of need. Interest accumulates while the borrower remains in school. The 2014-15 interest rate for undergraduates is 4.66% and for graduate students is 6.21%. For undergraduate students, the maximum loan balance is \$31,000 for dependent students (i.e. supported by parents) and the maximum combined balance of subsidized and unsubsidized Federal loans is \$57,500 for independent students. Graduate and professional students have a hard cap of \$138,500 balance.
- Direct PLUS Loans. Loan is directly administered by the Federal government and offered to graduate students and the parents of undergraduate students up to the cost of tuition and living expenses, at an interest rate (2014-15) of 7.21%.
- Perkins Loans. Loan is administered by the IHE/university. Interest does not accumulate while the borrower remains in school. The 2014-15 rate is 5.0%. The aggregate limit is \$27,500 for undergraduate and \$60,000 for graduate students (inclusive of the \$27,500 as an undergraduate).

Terms of U.S. Federal Student Loans

- Pay rate – Interest rates are fixed over the life of the loan, but are based upon the UST10y rate and a fixed spread – 205bp for undergraduate loans, 360bp for graduate loans and 460bp for PLUS loans. The rates are capped at 8.25% (undergraduate), 9.50% (graduate) and 10.50% (PLUS).
- Maturity – The maturity of student loans is typically 10y but can extend to 25y.
- Repayment – For the most part, Federal student loans are similar to auto loans, with a fixed monthly payment of principal and interest over a ten year term.
 - However, the repayment of Federal student loans can be tied to the borrower’s discretionary income for the term of the loan. At present, 11% of Federal student loans are structured this way. The borrower’s discretionary income is the reported taxable income less 150% of the Federal poverty guideline for the household size. The paydown rate can be 10% to 15% (in some cases 20%) of the calculated discretionary income, determined at the time of the loan agreement. Upon maturity (either 20y or 25y), any remaining balance of the loan is forgiven (although the forgiven balance does count as taxable income). If the borrower’s discretionary income increases, the monthly loan payment will never be more than the standard payment under a 10y amortization.
 - For example, the 2014 Federal poverty threshold for a household of one person is \$11,670. For an individual earning \$30,000 after graduation and a loan paydown rate of 10% of discretionary income, the monthly payment would be \$104 ($\$30,000$ less $1.5 * \$11,670 = \$1,250 / 12 = \$104$).
 - Various amendments over the years have allowed forgiveness of Federal student loans if you work for a qualifying non-profit agency or government agency for ten years.

Definitions for Direct Loan and Federal Family Education Loan Portfolio by Loan Status

Field Name	Definition
In-School	Includes loans that have never entered repayment as a result of the borrower's enrollment in school.
Grace	Includes loans that have entered a six-month grace period after the borrower is no longer enrolled in school at least half-time. Borrowers are not expected to make payments during grace.
Repayment	Includes loans that are in an active repayment status.
Deferment	Includes loans in which payments have been postponed as a result of certain circumstances such as returning to school, military service, or economic hardship.
Forbearance	Includes loans in which payments have been temporarily suspended or reduced as a result of certain types of financial hardships.
Default	Includes loans that are more than 360 days delinquent.
Other	Includes loans that are in non-defaulted bankruptcy and in a disability status.
Dollars Outstanding	Includes the outstanding principal and interest balance of loans in the specified status.
Recipients	Includes the number of recipients in the specified loan status. The recipient is the student that benefits from the federal student loan. In most cases, the recipient is the borrower, but in parent PLUS loans, the parent is the borrower and their child is the recipient.

FCRA Versus Fair Value Accounting: \$223 Billion Differential

Estimated Total Budgetary Costs Under FCRA and Fair Value: 2015 to 2024

	Type of Credit	Obligations or Commitments (Billions of dollars)	Subsidy Cost (Billions of dollars)		
			FCRA	Fair-Value	
Department of Education					
Subsidized Stafford Loans (Undergraduate Students)	Direct loan	314	26	80	
Unsubsidized Stafford Loans (Undergraduate and Graduate Students)	Direct loan	647	-86	40	
PLUS Loans (Graduate Students)	Direct loan	107	-38	-13	
PLUS Loans (Parents of Dependent Students)	Direct loan	106	-38	-19	
Total, Department of Education^a		1,174	-135	88	

Cost to taxpayers under "more comprehensive" fair-value approach

Budget savings under current approach

Estimated Budgetary Costs of Selected Federal Credit Programs Under FCRA (\$Bn)

Program Name	FCRA Subsidy Cost											Total, 2015-2024
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2024	
<i>Department of Education</i>												
Subsidized Stafford Loans (Undergraduate Students)	1	2	2	3	3	3	3	3	3	3	3	26
Unsubsidized Stafford Loans (Undergraduate and Graduate Students)	-10	-9	-8	-8	-8	-8	-8	-9	-9	-9	-9	-86
PLUS Loans (Graduate Students)	-3	-3	-3	-3	-4	-4	-4	-4	-4	-4	-5	-38
PLUS Loans (Parents of Dependent Students)	-4	-4	-4	-3	-4	-4	-4	-4	-4	-4	-4	-38
Total, Department of Education^a	-16	-15	-13	-12	-12	-12	-13	-14	-14	-14	-14	-135

Source: Congressional Budget Office, "Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024" (May 2014).