ESTIMATED BUDGETARY EFFECTS OF THE REGULATION TO REDUCE DIRECT STUDENT LOAN INTEREST RATES BY 25 BASIS POINTS FOR THOSE REPAYING THROUGH ELECTRONIC WITHDRAWALS

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The Secretary of Education recently proposed to offer borrowers participating in the direct student loan program the option to receive a 25-basis-point interest rate reduction if they were to repay their loans through automatic electronic withdrawals from their bank accounts. The regulation became effective on November 1, 1999. The Congressional Budget Office (CBO) estimates that this regulation will increase federal costs by $69 million in 2000 and by $123 million over the 2000-2004 period.

BACKGROUND

Under current law, the interest rate paid by borrowers under the direct student loan program is set by formula. For loans disbursed after July 1998 it is the bond-equivalent rate of the 91-day Treasury bill plus either 1.7 percent (while the borrower is in school, during the six-month grace period after he or she leaves school, and during any authorized deferment periods such as when the borrower is in graduate school or experiencing economic hardship) or 2.3 percent (while the borrower is repaying the loan). The statutory interest rate under the guaranteed student loan program is identical, but lenders have the option of charging a lower interest rate. Many private lenders now offer lower interest rates for certain students, such as those with a record of on-time payments or those who pay though automatic electronic withdrawals, which are also referred to as electronic debit accounts (EDAs).

Using the authority provided under subsection 455(b)(7) of the Higher Education Act (HEA) of 1965, the Secretary of Education published a notice of proposed rulemaking to provide a repayment incentive to borrowers participating in the federal direct student loan program. (The notice was published in the Federal Register on June 16, 1999.) Under the rule, which became effective on November 1, 1999, borrowers who opt to repay their loans through EDAs would receive an interest rate reduction of 0.25 percentage points (i.e., 25 basis points).

Subsection 455(b)(7) of the HEA requires that, before publishing the regulation, the Director of the Office of Management and Budget (OMB) must certify that the proposed repayment incentive would be cost-neutral. On August 12, 1999, OMB released a report that concluded that the proposed 25-basis-point incentive would result in a $7 million savings over the 2000-2004 period.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

CBO estimates that the regulation offering lower interest rates to borrowers who choose to repay their direct student loans through automatic withdrawals will increase federal outlays by $69 million in 2000 and $123 million over the 2000-2004 period. The estimated budgetary impact of the regulation is shown in the following table.

	By Fiscal Year, in Millions of Dollars				
	2000	2001	2002	2003	2004
Estimated Budget Authority	69	14	14	13	13
Estimated Outlays	69	14	14	13	13

BASIS OF ESTIMATE

Electronic Debit Accounts have not yet been fully implemented for direct loans and, consequently, no program data exist on this option. However, lenders in the guaranteed student loan program have been using EDAs in recent years. In September 1999, CBO conducted a telephone survey of private lenders and loan servicers in the guaranteed student loan program as well as other industry representatives to assess EDA usage. The majority of lenders and servicers surveyed were currently offering guaranteed student loan borrowers the option to make loan payments through electronic debiting, and most of those also offered an incentive of a 25-basis-point reduction in the interest rate on the loan.

Subsidy Costs

Based on information from private lenders, CBO estimates that about 10 percent of all borrowers would opt for EDAs if the interest rate was reduced by 25 basis points. The demand for EDAs without an economic incentive would be somewhat less—perhaps around 5 percent of borrowers. The data gathered also indicated that there was little change in the overall repayment time for borrowers who chose EDAs compared to those who send in monthly payments. Repayment time seemed to increase about two months on average for EDA users. Increases in repayment time tend to occur because borrowers who choose EDAs are less likely to make an occasional additional monthly payment on their loan.

Program costs associated with the proposed repayment incentive are assessed under the requirements of the Federal Credit Reform Act of 1990. As such, the budget records all the costs and collections associated with newly issued loans on a present-value basis in the year the loan is obligated. The costs of the change to currently outstanding loans are displayed in the year the regulation takes place—in this case 2000.

CBO estimates that the loss of interest income from borrowers who would receive the 25-basis-point reduction in interest rates would cost the federal government a total of $135 million in subsidy costs over the 2000-2004 period. That cost is partially offset by an estimated increase in interest income from the additional 5 percent of borrowers who choose the EDA because the 25-basis-point interest reduction was included. The increase in interest income results from the two-month average increase in the repayment time for the borrowers choosing EDAs, which reduces costs by $5 million over the 2000-2004 period. Of the estimated net change in subsidy costs—$130 million over the 2000-2004 period—CBO estimates that costs for currently outstanding (pre-2000) loans will be about $60 million (all recorded in 2000), and the costs for new loans will increase by about $10 million in 2000 and nearly $15 million a year for 2001 through 2004.

Administrative Costs

Federal administrative costs for credit programs are recorded on a cash basis. CBO's survey of lenders found that, while it was not the major reason for offering EDAs, some administrative cost savings were realized. The savings amounted to roughly 25 cents per month per borrower. On that basis, CBO estimates that the additional savings in administrative costs for the 5 percent of borrowers assumed to participate in EDA as a result of the 25-basis-point incentive will total $7 million over the 2000-2004 period.

COMPARISON WITH THE ADMINISTRATION'S ESTIMATE

CBO's estimate of the cost of this regulation is $130 million higher than OMB's for the 2000-2004 period. The OMB estimate reflects an assumed 5 percent participation rate in EDAs with an interest rate incentive and an increase in the repayment time by an average of

1.5 years for many borrowers. Under those assumptions, the present value of additional interest income from longer repayment periods more than offsets the loss of interest income because of the lower interest rate offered borrowers.

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