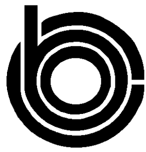

CONGRESSIONAL BUDGET OFFICE
PAY-AS-YOU-GO ESTIMATE

January 30, 2002

S. 1762
An act to amend the Higher Education Act of 1965 to establish fixed interest rates for student and parent borrowers, to extend current law with respect to special allowances for lenders, and for other purposes

As cleared by the Congress on January 24, 2002

SUMMARY

S. 1762, would amend the Higher Education Act of 1965 by:

- Extending until July 2006 the variable interest rates for borrowers of student and parent loans in effect since 2000 and due to expire in June 2003;
- Establishing as of July 2006 fixed interest rates for borrowers of student and parent loans;
- Extending permanently the method used to determine the interest rate on consolidation loans that is due to change in July 2003; and
- With one exception, extending permanently the current lender yield rates in effect prior to July 2003.

CBO estimates that the act would have a net cost of $8.2 billion over the 2002-2011 period. It would save $180 million in 2002 and cost $3.0 billion through 2006.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

CBO's estimate of the budgetary impact of S. 1762 is shown in the following table. Only the estimated changes through fiscal year 2006 are counted for pay-as-you-go purposes. The costs of this legislation fall within budget function 500 (education, training, employment, and social services).

	By Fiscal Year, in Millions of Dollars									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Changes in outlays	-180	345	875	1,005	995	1,000	1,000	1,025	1,050	1,075
Changes in receipts	Not applicable									

DESCRIPTION OF PROPOSED CHANGES

Borrower Interest Rates

Under current statute, until July 2003, the borrower interest rates on both federally guaranteed and federal direct student and parent loans are annually adjusted, variable rates based on the 91-day Treasury bill (T-bill) rate. The formula for student loans is the 91-day T-bill rate plus 1.7 percentage points capped at 8.25 percent while the borrower is in school, or the loan is in a grace period or deferment; and the 91-day T-bill rate plus 2.3 percentage points capped at 8.25 percent while the loan is in repayment. The parent loan formula is the 91-day T-bill rate plus 3.1 percentage points capped at 9.0 percent.

Beginning in July 2003, the current-law formula for establishing the annually adjusted, variable interest rates for student and parent loan borrowers will be based on a "comparable maturity" rate (assumed to be a blended rate for 10-year and 20-year government securities). That formula for student loans is the comparable maturity rate plus 1.0 percentage point capped at 8.25 percent. The parent loan formula is the comparable maturity rate plus 2.1 percentage points capped at 9.0 percent.

S. 1762 would forgo the rate change scheduled for July 2003. Instead, until July 2006, the formulas in effect prior to July 2003 would be used. Then, beginning in July 2006, the variable interest rate formulas would be eliminated and the borrower rates for both federally guaranteed and federal direct student and parent loans would become fixed. The student rate would be fixed at 6.8 percent. The parent loan interest rate would be fixed at 7.9 percent.

Consolidation Loan Interest Rates

Until July 2003, the formula used to establish a fixed interest rate for both the guaranteed and direct consolidation loans is based on the weighted average rate on all the loans consolidated by the borrower rounded upward to the nearest 1/8th percent and capped at a maximum of 8.25 percent.

Under current law, beginning in July 2003, the borrower interest rate on guaranteed consolidated loans will be fixed at the weighted average rate on all the loans being consolidated, rounded up to the nearest whole percent. For direct consolidated loans, the rate will be determined by the Secretary and is assumed to be an annually adjusted, variable rate based on the blended rate for 10-year and 20-year government securities plus 1.0 percentage point capped at 8.25 percent.

S. 1762 also would forgo the July 2003 scheduled change for consolidated loans. Instead, the formulas in effect prior to July 2003 would be used to determine the fixed interest rate on both the guaranteed and direct consolidation loans.

Lender Yields

Under current statute, until July 2003, the quarterly supplemental interest allowance payments (SAP) to lenders participating in the guaranteed loan program are based on the 3-month commercial paper (CP) rate. These payments combined with interest paid by or on behalf of borrowers guarantees lenders a statutory minimum yield. For student loans the guaranteed lender yield is the 3-month CP rate plus 1.74 percentage points while the borrower is in school, or the loan is in grace period or deferment; and the 3-month CP rate plus 2.34 percentage points while the loan is in repayment. Lender yields on parent and consolidated loans are the 3-month CP rate plus 2.64 percentage points. Lenders do not receive a quarterly federal SAP on parent loans until the 91-day T-bill rate plus 3.1 percentage points (set annually for the parent loan interest rate) exceeds 9.0 percent.

Under current statute, beginning in July 2003, quarterly SAP would be based on the comparable maturity rate plus 1.0 percentage point for student loans and the comparable maturity rate plus 2.1 percentage points for parent loans. Lenders would not receive a SAP on parent loans until the comparable maturity rate plus 2.1 percentage points (set annually for the parent loan interest rate) exceeds 9.0 percent.

S. 1762 would forgo the July 2003 yield change. With one exception, lender yields on guaranteed loans would become the formulas in effect prior to July 2003. The exception would be that as of July 2006, a lender would not receive a payment on parent loans until the 3-month CP plus 2.64 percent exceeds 9.0 percent.

BASIS OF ESTIMATE

Consistent with rules for baseline projections, as specified in the Balanced Budget and Emergency Deficit Control Act, CBO's baseline reflects the projected costs of the student

loan programs through 2011. In addition, the provisions affecting the student loan programs 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 a new loan on a present-value basis in the year the loan is obligated. The costs of all changes affecting outstanding loans are displayed in the year a bill is enacted—in this case 2002. CBO estimates that enacting S. 1762 would decrease program costs by $180 million in 2002 but increase costs by $8.2 billion over the 2002-2011 period.

Under current law, the Department of Education is expected to guarantee or issue about 100 million loans totaling $430 billion over the 2002-2011 period. The act would not change the conditions of eligibility for loans but would increase the government's cost of ensuring that sufficient loan capital is available to students and parents.

The changes made by S. 1762 would not take effect until July 2003. However, this act would save $180 million in 2002 because, under credit reform rules, future changes to the federal costs of pre-2003 loans would be recorded in the year the changes became law. Approximately, $50 billion of outstanding loans are expected to be consolidated after July 2003. The loan terms for consolidation loans are those in effect when the several individual loans are consolidated into one loan. Thus, the interest rate and lender yields on these loans would be changed by this act. CBO estimates that the new loan terms would increase the cost of the guaranteed consolidated loans by approximately $110 million as supplemental interest payments to lenders would be increased under the new rates and formulas. We estimate that the cost of the direct consolidated loans would decrease by $290 million because the interest rates on those loans would be increased, thus increasing interest income to the government.

CBO estimates costs of $3.2 billion over the 2003-2006 period, reflecting the cost of extending from June 2003 until July 2006 the borrower interest rate and lender yield formulas that have been in place since 2000. In 2004, the first full year of implementation, the overall federal cost of providing loan capital to students and parents would be increased by about 2.5 percentage points per dollar loaned from an estimated 6.8 percent to 9.3 percent. The increased cost is associated both with extending the approximate 50-basis-point spread between the borrower interest rate and the lender yield that is paid by the government and with the increased exposure of the federal government to interest rate subsidies when rates rise sufficiently to cause the borrowers' interest rates to be constrained by the statutory caps. The new interest rate structure would move the interest rates closer to the caps. Moreover, the 91-day T-bill is a more volatile instrument than the blended rate for 10-year and 20-year government securities. These costs are partially offset by higher interest payments by borrowers in the direct loan program.

CBO estimates additional costs of $5.2 billion over the 2007-2011 period, reflecting the cost of establishing the new fixed-rate loans to borrowers. In 2007, the first full year of implementation, the overall federal cost of providing loan capital to students and parents would be increased by about 2.3 percentage points per dollar loaned from an estimated 7.3 percent to 9.6 percent. This increase reflects the fact that the new fixed rates for borrowers are lower than what the variable interest rates would yield based on the CBO forecast. This increases the lender SAP payments in the guaranteed loan program and reduces interest income in the direct loan programs. These costs are offset by eliminating the costs associated with the interest rate caps on a variable-rate yield structure.

CBO used a vector autoregressive model to simulate the costs of the variation in interest rates around CBO's baseline forecast. The model provided probabilities of how often and by how much the simulated rates exceeded the 8.25 percent interest rate cap. We used these calculations in CBO's model of the student loan program to estimate changes in subsidy costs.

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