STATEMENT OF

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BEFORE THE

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to testify today on the arbitrage issues raised by tax-exempt student loan bonds.

CBO recently published a study entitled State Profits on Tax-Exempt Student Loan Bonds, which explains how these profits are generated and the options that are available to the Congress for reducing them. In my testimony today, I will briefly summarize that study, concentrating on the relevant tax issues. In addition, I will review pending education legislation that could alter the guaranteed student loan program in general and the student loan bond program in particular.

Currently, 18 states, some local nonprofit agencies in Texas, and the District of Columbia have issued student loan bonds. About 10 other states are now considering whether to issue such bonds. Because of a special exception to the arbitrage rules, these governments may earn profits from student loan bonds. CBO has estimated that such profits could amount to between $300 million and $450 million over fiscal years 1980-1985.

How Profits Are Generated From Student Loan Bonds

State and local governments issue student loan bonds in an effort to give college students better access to loans. States and localities raise money by issuing bonds at low, tax-exempt interest rates. They then use the proceeds of these issues either

to make federally guaranteed student loans directly or to buy guaranteed loans that have been made by banks. The interest rate on these loans is 7 percent, which is paid by the recipient after he or she has left school and by the federal government while the student is still in school. In addition to this interest payment, the lender receives a special allowance from the government that changes every quarter according to the rate on 91-day Treasury bills. The yield on the loans – the interest rate plus the special allowance -- is designed to compensate the lender for the costs of raising capital in private credit markets.

The yield on student loans held by state and local bond authorities is the same as the yield on student loans held by commercial banks, even though the banks must raise money at higher interest rates. This would not cause a problem if student loan bonds were subject to the usual arbitrage rules, under which the bond proceeds could not be invested at a yield high enough to produce profits for the issuer. The arbitrage rules are designed to prohibit state and local governments from profiting from the difference between taxable interest rates and lower tax-exempt interest rates. In general, they restrict the difference between the interest rate on tax-exempt bonds and the yield on invested bond proceeds to 1.5 percentage points. In the Tax Reform Act of 1976, however, the Congress made an exception to those rules by excluding part of the yield on student loans -- the special

allowance portion – when determining compliance with the arbitrage rules.

When this legislation was enacted, the special allowance was capped under the education laws at 3 percent. Subsequent higher education legislation changed the way the special allowance is calculated and removed the ceiling. Hence, the special allowance rate rose to 9 percent in the last quarter of 1979 and to almost 11 percent in the first quarter of 1980. Its exclusion from arbitrage yield calculations is thus no longer an insignificant issue.

Reducing the Profit on Student Loan Bonds

The Congress could reduce the profitability of these bond programs in a number of ways. One of the most straightforward ways would be to set the special allowance rate for tax-exempt-bond-financed loans at a lower level than for other student loans. This could be done in the legislation the Congress is now considering to reauthorize the guaranteed student loan program and other higher education assistance programs due to expire on October 1, 1980.

The prospects for significant change along these lines are not certain. The House has completed action on H.R. 5192, which would make some minor changes in the guaranteed student loan program. The bill would not, however, change the basic structure of the program, or the 7 percent interest rate charged students,

or the formula for the special allowance. Nor would the bill affect tax-exempt bond financing of student loans, other than to direct a commission to study the appropriate role of tax-exempt bonds in higher education finance.

S. 1839, which was reported out by the Senate Labor and Human Resources Committee and passed by the full Senate, would restructure federal assistance for postsecondary education. It would greatly expand the National Direct Student Loan (NDSL) program into a needs-based loan program financed directly with federal funds. The bill would also transform the present guaranteed student loan program into a supplemental program, with loans continuing to be financed as they are now, mostly by commercial banks and tax-exempt bond programs. Like the House bill, S. 1839 would institute a program of loans to parents.

For commercial lenders, the Senate bill would leave unchanged the total yield on guaranteed student loans, but would change the composition of the yield. Students would pay 9 percent interest, instead of the current 7 percent, and the federally paid special allowance would be reduced by 2 percentage points. Loans financed with the proceeds of tax-exempt bonds would also carry 9 percent interest paid by students, but would receive only one-half of the special allowance received by commercial lenders, subject to a floor of one-half of one percent per year.

CBO has not yet completed its analysis of the impact of S. 1839. It appears likely, however, that S. 1839, if adopted into law, would reduce the profits earned by state and local governments from student loan bonds from the levels they may be expected to reach under a continuation of current law, because:

- Even though states would issue tax-exempt bonds to finance guaranteed parent loans as well as guaranteed student loans, they would issue fewer bonds in total than under an extension of current law. This would be due to the big shift in lending from the GSL to the NDSL program.
- The special allowance received by these governments would be half of that given to commercial lenders.

The significant differences between the House-passed and Senate-passed bills must now be worked out in conference. These differences include the treatment of loans financed with tax-exempt bonds.

If the education legislation does not lower the special allowance on these loans, or does not lower it significantly, the Committee on Ways and Means may want to consider changing the arbitrage rules to prevent states from making profits from the bonds. Imposing the standard arbitrage rules on student loan bonds could pose two difficulties. First, the standard 1.5-percentage-point spread allowed between the bond interest rate and the yield on invested bond proceeds may not be large enough to

cover the costs of administering a student loan bond program. Making collections on student loans is costly, compared to collections on other types of loans. The average size of a student loan, $2,000, is much smaller than the average size of other loans, and it is often difficult to keep track of the whereabouts of former students during the ten years or so of their indebtedness.

The existing arbitrage rules do permit a spread larger than 1.5 percentage points if the bond issuer has demonstrated that a higher amount is necessary to cover costs. In order to get a higher amount, however, a state would have to obtain a private letter ruling from the Internal Revenue Service (IRS) in advance of bond issuance. To avoid the administrative burden this process would impose on the IRS and on issuers of student loan bonds, the Congress could change the arbitrage rules to allow these bonds a specified spread of more than 1.5 percentage points. The size of the allowable spread in excess of 1.5 percentage points could be set to reflect the additional costs of servicing student loans compared to the costs of servicing other loans financed with tax-exempt bonds that are subject to the 1.5-percentage-point spread.

A second difficulty with imposing the usual arbitrage rules on student loan bonds arises because the yield on the loans floats up and down with the changes in the special allowance, while the

interest rate on nearly all student loan bonds is fixed at the time the bonds are issued. The permissible spread under the arbitrage rules is defined as the spread "which may be reasonably expected at the time of issuance" between the bond interest rate and the yield on invested bond proceeds. However, the issuers of student loan bonds may not be able, at the time of bond issuance, to make a reasonable prediction about the size of this spread, unless they structure their bonds so that the interest rate on the bonds floats up and down with the yield on the loans.

Rather than implementing a rule that would in effect require student loan bonds to have floating interest rates, the Congress could write a separate arbitrage rule for these bonds. Compliance with the arbitrage rule could be assessed once each quarter, so that states could not, in any quarter, accept a special allowance that would bring the total yield on their loans to a rate that would violate the arbitrage rule. If the rule allowed a spread of 2 percentage points between the loan yield and the bond interest rate, for example, a state that issued bonds at 8 percent interest could not receive a yield of more than 10 percent on its loans. If the interest rate on the loans was 9 percent, the state could apply for a special allowance no greater than 1 percent.

States might have problems with this rule if the allowable yield differential was set exactly at the level that would cover reasonable administrative costs. In this case, states could not

accumulate a profit cushion in quarters when the special allowance was high to use if the special allowance dropped below the level needed to cover their costs.

To overcome this potential problem the Congress could set the allowable yield differential slightly above the amount needed to administer a student loan bond program. If the Congress determined that a spread of 1.75 percentage points should be sufficient to cover administrative costs, for instance, it could set the allowable spread at 2 percentage points, allowing states to accumulate small surpluses when the special allowance was high to use if the special allowance subsequently fell. If states nonetheless still ran into trouble meeting costs, their state legislatures might be willing to appropriate emergency operating funds.

Because of the practical difficulties in limiting profits on student loan bonds, whether through tax or education legislation, the Congress might also want to place restrictions on the use of these profits. One option would be to require that surplus funds be used only for additional student loans.

Section 103(e) of the Internal Revenue Code now states that residual income earned by private nonprofit student loan corporations acting at state or local request must either be used to purchase additional student loans or be paid to the state or one of its political subdivisions. The Code imposes no