Insight

When in a Hole—Stop Digging: Direct Lending's $2 Trillion Hole

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An often-overlooked document issued by the Treasury Department every month should be raising alarms over the federal direct student loan program.

In the *Final Monthly Treasury Statement* for fiscal year 2012, issued at the end of September, the Treasury Department highlights spending by federal agencies and borrowing required to pay all of Uncle Sam's bills. September's statement summarizes just how deep the country went into the red for the previous fiscal year.

Among the highlights of last month's report are some expected headlines, such as the total deficit exceeding $1 trillion for the fourth consecutive year. Less publicized, however, is a data point that should be quite concerning for deficit-conscious policymakers and proponents of the direct loan program.

According to Treasury, the direct loan program borrowed $155 billion in fiscal year 2012. That's an interesting figure, considering that the Department of Education only expected to originate $112 billion in new loans, leaving a $43 billion gap between new loans originated and what was borrowed from Treasury.

To understand why this number is so troubling, it's important to understand how the direct loan program works. Every year, the Department of Education issues new direct loans to students by borrowing from Treasury (who borrows from all kinds of investors, including China). The IOU is complete with a principal and interest obligation, much like a consumer loan.

When ED calculates what they need to borrow, they take future repayments into account and come up with a subsidy cost estimate, which reflects the cost of ownership for the loan, including interest. In the case of direct loans, the subsidy cost has been negative, suggesting that the government makes money by issuing direct loans. Simple arbitrage accounting where spreads between interest owed and interest paid suggests that the Department of Education should be making more than enough money to pay back the Treasury and fund obligations like the Pell grant program, which expanded its reliance on mandatory money in 2009 as a result of the Affordable Care Act.

Except that's not what's happening. The Department of Education is falling farther behind its obligations to Treasury, for a variety of reasons. One is that direct loan subsidy costs have historically underestimated the cost of direct lending. Another is the slow repayment on the part of borrowers is causing the Department of Education to borrow more money to finance the shortfall between expected interest payments and what's actually received.

In the Historical Tables of the President's Budget for fiscal year 2013, the Department of Education shows where the gap between receipts and obligations is accelerating. Borrowers paid $3.8 billion in interest payments to the Department of Education in fiscal year 2011, but the Department of Education owed $10.8 billion to Treasury in interest payments – a $7 billion gap. For fiscal 2012, the gap was projected to expand to $12.9 billion.

The inconvenient reality is that the Department of Education borrowed $43 billion more than new originations in fiscal year 2012; the hole is getting substantially bigger than the Historical Tables of the President's budget forecast. The path to repayment doesn't begin by digging an even deeper hole, it depends on the direct loan assets performing as expected, which to date, they have not.

Proponents of the direct loan program will accurately point out that under the Federal Credit Reform Act, any losses due to credit reestimates or slower borrower repayments aren't counted against the direct loan program. That's true. That's also missing the point.

Using current performance as a guide, the direct loan program is on track to reach a $1 trillion debt mark far sooner than expected, perhaps as early as fiscal year 2015. By fiscal year 2020, 10 years after the direct loan program became the only loan program in town, the total debt would grow to $1.8 trillion, assuming that the shortfall is arrested and the poor performance doesn't get any worse.

However, the likelihood that interest rates will rise at the same time direct loans continue their lackluster performance will create additional borrowing pressure on the Department of Education. This increases the probability that the true debt obligation to finance direct lending will be much higher.

If it sounds like the story of the man-eating plant in the play "Little Shop of Horrors," it's because it's a very similar story. What should be a harmless, even desirable program, providing low-cost loans to borrowers is actually becoming a very problematic debt burden for taxpayers, requiring greater sacrifices to maintain. And

it’s about to get worse.

Under rules recently released by the Department of Education a larger number of borrowers will be able to participate in income-based-repayment (IBR) programs. These programs extend the life of a borrower’s loan and limit monthly repayment amounts to 10 percent of a borrower’s discretionary income. They also add substantially more in interest payments to the borrower’s total obligation and they flip the federal government’s position from a negative subsidy cost to a positive one. In other words, the borrower pays more in the long run, and taxpayers pay substantially more.

In addition to troubling findings that the IBR program will benefit wealthier borrowers, the Department’s changes compound the debt problem already facing the direct loan program. Rather than saving billions of dollars by capitalizing on low-cost interest rates to create favorable arbitrage spreads, the Department of Education is now in the position of losing ground every time a borrower switches to IBR. Moreover, the Department of Education has to come up with the money to pay back the Treasury on previous loans it took out, in order to make new direct loans at a time when borrowers were going to be paying more of the loan up front. Where the original repayment structure may have had a chance of offsetting the need to borrow to fill a gap between receipts and obligations, the Department of Education now faces an unresolvable gap for every new IBR loan. It’s creating a hole the Department of Education can’t possibly get out of, and it’s undermining the entire argument behind direct lending, which was that a switch to 100 percent direct lending would save billions of dollars.

One of the reasons for this growing debt spiral is the failure to use fair-value accounting to measure federal credit programs. Despite claims from the Congressional Budget Office that fair-value accounting is a better form of managing risk for federal credit programs, the direct student loan program continues to rely on flawed FCRA estimates that ignore the reality of the program’s failures. If the Department of Education were compelled to use fair-value accounting when making borrowing estimates, the direct loan program would still be borrowing the same amount, but at least it would be out in the open for public inspection. As it stands, the Department of Education is quietly adding what will ultimately be trillions of dollars to the national debt, and things are about to get much worse with the changes to IBR.

Somewhere underneath the Department of Education a very large plant is consuming borrowed Treasury dollars by the billions. It’s only a matter of time until people start a
sking what happened to those dollars and why there’s a $2 trillion hole under 400 Maryland Avenue, NW. Hopefully, those questions are asked before it’s too late.