Student Debt Investment Fund (SDIF): A Preliminary Proposal for Addressing the Student Debt Crisis

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The Progressive Policy Institute proposes the creation of a new, private sector Student Debt Investment Fund ("SDIF") that would address the student debt crisis. The proposed SDIF would act as a secondary market for student loan debt, capitalized by corporate profits currently held abroad. In return, participating U.S. corporate entities would receive tax credits. The SDIF would purchase existing student loans, apply a discount to the loan amount, and restructure the loan through refinancing the debt.[1]

By matching need for financial relief with available investment funds, the proposed SDIF could be a private sector solution to a public problem. Without action, the student debt crisis will be the next financial disaster. One in five households is currently saddled with student debt, now over $1 trillion, which cannot be discharged in bankruptcy or refinanced at today's historically low interest rates. At the same time, multinational U.S.-based companies are sitting on an estimated $2 trillion in cash reserves, much of it profits held abroad. Companies are unwilling to repatriate these profits under current tax law for fear of excessive financial penalties.[2]

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Societal benefits of the proposed SDIF include: (1) deflating the student debt bubble slowly, (2) facilitating economic growth by freeing financial resources for millions of young Americans, (3) enabling more young people to invest in their human capital, and (4) providing a way for U.S. corporate entities to invest their excess funds in America strategically and promote public well-being. The benefits to business include tax credits issued annually over the term of the investment and the potential for an annual return on investment depending on the success of the SDIF. The benefits to government include transferred risk to the private sector from reduced student loan exposure and potential tax revenue that would not have been received otherwise.

This preliminary proposal is intended to be a guiding framework for a secondary student loan market fund. It is not intended to cover every detail and we welcome comments. We note the proposed SDIF would address the issue of student debt, not the excessive rise in college tuition. There is also the possibility that more

loans could be discharged from bankruptcy under this proposal, so we included this assumption in the proposed structure.

Background

In some ways the student debt bubble is worse than the subprime mortgage crisis.

The student loan bubble will be the next to burst. Tuition is rising too fast, up 72 percent since 2000. Low interest rates and the availability of federal financial aid have enabled the increasing number of college students to keep up with higher costs. Average debt per graduating student with loans reached $26,600 in 2011, up 17 percent since 2008.[3] But real annual earnings for young college graduates working full-time are falling, down 15 percent since 2000.[4] At some point they will no longer be able to repay this debt—already the student loan delinquency rate is 11 percent and rising.[5]

In some ways this bubble is worse than the subprime mortgage crisis. You can't reclaim education like you can reclaim a house. You can't discharge the bad debt, especially for-profit loans, in bankruptcy. The federal government has little choice but to be on the hook for all of $850 billion in student debt it holds that goes unpaid. And even though a debt crisis looms, it cannot stop providing low-cost funding for higher education because that would go against equal access and opportunity. Education at its core is a social good, a public good, not a market benefit for those who can afford it. Nonetheless, the economic benefits of higher education are well-documented.[6]

When this bubble bursts, it will have a different impact than the 2007 subprime mortgage bust. Instead of hitting Wall Street first and taxpayers second it will hit taxpayers directly, since most student debt is already owned by the government. However, the pace of economic growth will be negatively affected just as in 2007, as people are unable to spend. The education sector—especially higher education—will have to undergo extensive restructuring and consolidation, and tuition and acceptance policies will have to adjust.

The biggest immediate risks of a student loan bubble burst are:

- A drag on economic growth through reduced domestic spending
- Reduced flexibility for government response to economic contraction from additional debt
- Capital market dysfunction, especially in fixed assets, if U.S. debt is downgraded
- Unequal access to higher education for those who cannot afford college without aid
- Lower standard of living for debt holders and for future generations if they are not able to obtain the education they need to be globally competitive

Student Debt Investment Fund ("SDIF") Structure

NOTE: This preliminary proposal is intended to be a guiding framework. As such it is illustrative of how such a fund could be structured and is not final or comprehensive. We welcome comments and suggestions.

The Fund: The proposed SDIF would be created as an independent Special Purpose Vehicle (SPV) licensed and registered with the U.S. government, capitalized by corporate profits current held abroad, and perhaps by excess corporate cash reserves.

Model Fund: The Private Export Funding Corporation[7] ("Pefco"—owned by banks and U.S. companies) sets the precedent and acts as a model for how the proposed SDIF could be structured and successfully function. Pefco is a secondary market "fund" (for U.S. government-backed assets), and serves a specific public policy purpose (to increase U.S. exports).

The Private Export Funding Corporation (Pefco) sets the precedent and acts as a model for how the proposed SDIF could successfully function.

Equity Investors: The participating U.S. financial and nonfinancial companies that invest a share of their corporate profits held abroad. Participation would be completely voluntary.

Equity Investment: Corporate profits currently held abroad. In return, participating entities would receive an annual tax credit over the term of the investment. The amount of equity investment (capital) required will depend on the target size of the fund. Investment can either be restricted to repatriated profits or broadened to all excess corporate cash reserves.

Tax Credits: The process for issuing investment tax credits would be similar to existing process utilized by the Low-Income Housing Tax Credits (LIHTCs).[8] The Consumer Financial Protection Bureau (CFPB) will be responsible for issuing the eligible tax credits at their discretion. The amount of available credits will depend on the targeted amount of equity investment. Tax credit availability will be re-established annually depending on the SDIF's level of equity investment.

Terms:

1) Investors would make a minimum $10 million equity investment from profits currently held abroad.
2) Investment would be in place for minimum of 10 years, with tax credits issued annually.
3) An annual dividend may be issued, depending on success of the SDIF.
4) Investment would be standard equity and not be returned if the SDIF uses reserve capital.
5) Investors would not have the ability to select which loans get purchased by the SDIF.

Capital Reserve Requirements: We anticipate a rise in the number of modified loans potentially discharged in bankruptcy once the proposed SDIF purchases the loan. To ensure there is enough equity capital to cover any losses, the SDIF could impose higher risk-weight and leverage ratio capital reserve requirements

than current rules dictate. Risk-weighting for any given note, or tranche of notes, would be determined by borrower's repayment history and current financial situation.

> Debt to Equity (Leverage) Ratio – For example, the proposed SDIF could have a target debt to equity ratio of 20 (or a non-risk weighted leverage ratio of 5 percent). Current banking rules dictate a 3 percent leverage ratio; Sallie Mae had a debt to equity ratio of 35 in 2012 but their assets were mostly government guaranteed.[9]

Student Debt Financing: Funding for the student loans would come from notes issued by the proposed SDIF. We propose the SDIF be allowed to issue notes that are tax-exempt and of varying term lengths. Any financial or non-financial entity may purchase SDIF issued notes.

Eligible Student Debt: Any individual with student loans could apply to the SDIF, but initial participation may be tiered in the beginning stages of SDIF capitalization. Loans will be consolidated by the individual. Initial eligibility may consider the following tiers:

1) Employees at companies of initial equity investors
2) Undergraduate debt, public and private
3) Either public debt or private debt only (Fund may be tranched)
4) Priority to debt issued since 2000
5) Priority to Perkins loan recipients / loans with demonstrated financial hardship
6) As Fund grows pool of loans can expand (perhaps an eventual priority to STEM degrees)

Process: The SDIF would purchase approved individuals' student debt from government/private lenders, restructure the debt through refinancing, and discount a portion of the outstanding amount per note. The SDIF will hold the note. Debt holders would receive a notice of new loan amount and new payment information.

Loan Discount: In addition to transferring the loan into a restructured note that is potentially dischargeable, the proposed SDIF would also discount each loan—reduce the current outstanding principal balance—by no more than 15 percent. The discount amount per loan could be determined by the borrower's repayment history. This feature could be eliminated if necessary.

Student Loan Interest Rate: Stafford loans currently have fixed interest rates while private loans are typically floating. The proposed SDIF would honor the lower of either the current interest rate or the restructured interest rate, and could allow a one-time fixed-floating rate conversion at time of purchases.

Legal Recourse: The proposed SDIF (and third party servicing agent) would have the authority to take legal action against non-payment or default, through lawsuit of individual assets or garnishing of wages. SDIF investors assume risk of education as a non-tangible, non-collateralized asset.

SDIF Administration: The proposed SDIF or a third party loan servicing partner would be paid a reasonable fee by the loan holders to continue loan servicing. Employees of the SDIF would produce publicly available annual and quarterly accounting reports that are independently audited with complete transparency.

SDIF Oversight: The Consumer Financial Protection Bureau (CFPB) would have primary oversight authority.

SDIF Ownership: The equity investors would share ownership of the proposed SDIF; ownership would be allocated by the share of total capital from each company.

Dept. of Education "Buy-in": The Department of Education must be willing to sell student loans to the private fund, on the basis that students will be better off with smaller debts that are restructured through refinancing (and take advantage of today's historically low interest rates). The department will continue to originate student loans, as the proposed SDIF is just a secondary market.

Hypothetical Example

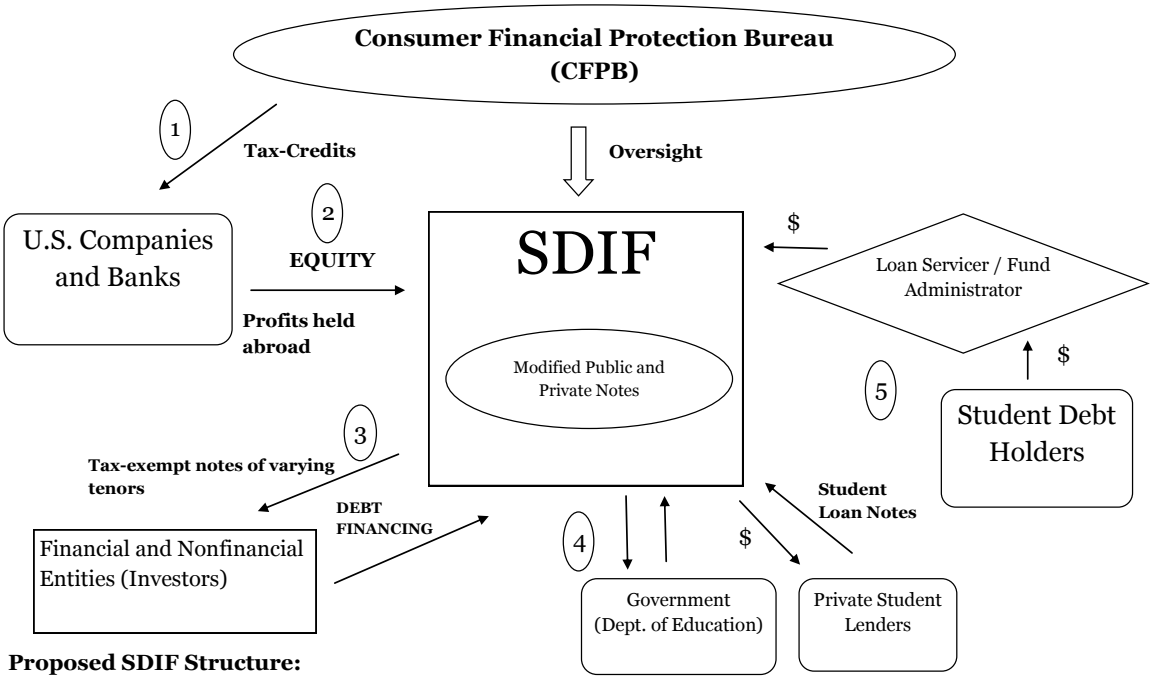
Suppose the proposed SDIF targets the purchase $500 billion in student debt, paid for by SDIF note issuances. At a debt to equity ratio of 20, the proposed SDIF would need $25 billion in standard equity. If the eligible tax credits are capped at 10 percent, the total tax credit issuance could not be greater than $2.5 billion in a given year.

Suppose company X invests $1 billion at once into the proposed SDIF from corporate profits held abroad. Then for each year of the 10-year investment, the company is eligible to receive 10 percent of the capital value in tax credits. In the first year, this translates to a $100 million tax credit. That means company X is paying an effective tax rate of 25 percent on this $1 billion in repatriated profits, instead of the 35 percent dictated by current rules.

Moreover, company X is eligible to receive additional annual tax credits for the remaining 9 years of their investment in the proposed SDIF that could be applied toward other earnings. The value of these credits will depend on the size of the investment, as equity could be lost to loans that default. So if the investment lost 5 percent annually to cover defaults, tax credits over 10 years would total $802.5 million. In addition, it would get any annual dividends issued by the SDIF over those 10 years based on earnings and at the end of 10 years company X would get back the remaining $630 million of its investment.

The company benefits from investing in the SDIF because it still gets a positive return on their investment. The government benefits because it transfers a substantial amount of risk to the private sector and it receives revenues it may not have otherwise. Finally, student loan holders benefit from restructured loans that potentially have lower interest rates and discount a share of the outstanding loan amount.

Student Debt Investment Fund (SDIF): Preliminary Proposed Structure



Proposed SDIF Structure:

1. CFPB Issues tax-credits to SDIF equity funders
2. U.S. companies & banks provide SDIF equity
3. SDIF issues tax-exempt notes to pay for student debt
4. SDIF purchases, converts, and discounts existing student debt notes
5. SDIF notifies student debt holders and establishes new payment channel

Endnotes

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