THE GRACCHI INSTITUTE

DRAFT WORKING PAPER, STUDENT DEBT REFORM, 20140520

I. Description of Program

A proposal to apply anti-stacking rules to reduce the interest rate payable on student debt, and apply the savings generated by such rule toward the acquisition of "qualifying appreciable assets".

II. Summary of Program

Situation Report

- According to the Federal Reserve, the total aggregate student debt, as of the date of this working paper, exceeds $1.25 trillion.
- The current figure represents a dramatic increase from the total of $250 billion just 10 years ago.
- The explosion in student debt does not appear to be slowing, and if current trends continue some experts are projecting that the total could exceed $2 trillion by 2020, and that most of it will be privately-held by 2030.
- The latest research has shown that student debt impairs young people from getting on with their lives, and carries broad and lasting repercussions throughout the broader economy.
- The most immediate problem posed by student debt is the tight cash-flow problem, but the most enduring problem is the opportunity cost of delaying major investments such as a home, etc.

Overview of Proposal

- Student debt should be made subject to an anti-stacking rule (a doctrine borrowed from patent royalty contracts to reduce the burden of multiple royalty payment obligations).
- Application of the anti-stacking rule will be optional for the debtor; if the debtor does not utilize this program, whatever terms were originally negotiated with the lender will apply.
- The anti-stacking rule will reduce the original negotiated interest payable on student debt.
- The original interest rate on all current debt will be reduced: (a) by 50%; or (b) to the then-current "risk free rate" (10-year Treasury) plus 1.5%, whichever is better for the lender.
- The original interest rate on all future debt will be priced according to market conditions.
- All savings created by the anti-stacking rule will be diverted toward the acquisition of certain categories of "qualifying appreciable assets", as discussed below.

Qualifying Appreciable Assets

- The only permissible use of the anti-stacking rule is to divert funds toward the acquisition of a "qualifying appreciable asset", or QAA.
- The following categories of assets qualify as QAAs: (a) primary residences; (b) mutual funds; (c) closed-end funds; (d) ETFs; (e) REITs; (f) CDs; (g) permanent life insurance policies; (h) municipal bonds; and (i) sovereign funds or securities.
- Debtors may exchange and roll over on a tax-free basis investments made in one category of QAA into another category of QAA, subject to special rules for primary residences.
- Debtors may not liquidate or encumber the QAA until the underlying debt is fully discharged.
- The QAA will collateralize the student debt from which its purchase proceeds are derived.

III. Rationale for Program

- This program is preferable to a program that only reduces or prolongs debt, because it requires and enables the borrower to invest the savings, rather than simply increase discretionary income.
- Student debt is generally bankruptcy proof, which means it is less risky for the lender than most categories of debt, which in turn justifies the implementation of a modest interest rate.
- Bankruptcy protection combined with collateralization of the student debt with the QAA further reduces the lender's risk, which further justifies the application of a nominal rate.
- Student debt is more compulsory than other categories of debt, including mortgage debt, because pursuing higher education is regarded as essential to obtain higher wages.
- Student debt is the first major debt that a young person usually incurs, and its position as first-in-time makes it the most natural and proper category of debt for subsequent adjustment.

IV. Benefits of Program

- Debtors benefit because this gives them a chance to build an asset base and a better future.
- Educational institutions benefit because it avoids the need to compromise educational quality or plunder their endowments.
- State and local governments benefit because they have less funding slack to pick up for the educational institutions, and also because they may obtain additional liquidity through bond sales.
- The federal government benefits for similar reasons.
- The taxpayers benefit because this reduces their exposure to subsidize student debt relief.
- Homeowners benefit because the housing market improves.
- Mortgage lenders benefit because they will get more business.
- Fund managers benefit because they will get more business.
- Life insurance companies benefit because they will get more business.
- The public markets benefit because they get a liquidity infusion.
- Student lenders benefit because this gives them secured creditor rights, reduces their risk through the collateralization of their loans, and avoids harsher alternatives that do not provide these benefits, such as outright repudiation of bankruptcy protection, partial forgiveness of debt, or coerced refinancing at a lower rate for no additional benefit.

V. Terms and Conditions [*subject to further review and analysis*]

Lender Remedies

- Lenders will obtain a first-priority security interest in all non-mortgage-financed QAAs which may be perfected with UCC-1 financing statements.
- In the event of a student loan default, lenders may foreclose on and retain or liquidate, at their discretion, the entire QAA (which will offset the indebtedness owed) along with all appreciation thereon, with any surplus amounts being refunded as noted below.
- Lenders will retain bankruptcy protection over the debtors, and may pursue their existing garnishment order remedy if the QAA does not discharge the remaining indebtedness.
- The requirements to obtain a garnishment order will be standardized to proving: (a) the existence of the debt; (b) that a default exists; (c) that notice was received by the debtor; and (d) that such debt remained in default for at least 360 calendar days after such notice was received.
- If a debtor makes additional contributions to the QAA, and the QAA is later foreclosed upon, the lender may apply the principal amount of such contributions along with appreciation thereon to the debt payoff, with any surplus thereon being refunded.

Debtor Rights

- Debtors may make additional contributions to the QAA or accelerate payment of the student debt in their sole discretion.
- In the event of a foreclosure of the QAA, debtors will be entitled to offset any outstanding indebtedness with the entire then-current nominal/face value of such asset.
- In the event of a foreclosure of the QAA, debtors will be entitled to a refund of any surplus amounts derived from their contributions, and appreciation thereon, after satisfaction of the debt.
- The default runway will be extended to 360 calendar days after receipt of notice of delinquency from the lender, up from the current standard 270-day period.
- Debtors will not be prohibited from participating in the program by delinquency, provided that such delinquency does not continue unabated for at least 270 calendar days after receipt of notice of such delinquency from the lender, in which case the debtor may be subject to disqualification from the program as discussed below.
- Debtors will retain all existing defenses and mitigation against garnishment orders.

Additional Conditions

- The first dollars paid by a debtor in each monthly payment will be allocated toward the repayment of the student debt; no scheduled payments or additional contributions will be allocated toward investment in the QAA in any monthly period unless the applicable monthly debt payment has first been made.
- In the event there is an ongoing delinquency or the debt otherwise falls into arrears, the cumulative amount of the arrears must be repaid before funds are invested in the QAA.
- It will constitute an event of default under the student loan to intentionally fail to make the scheduled QAA payment in any monthly period.
- Debtors who remain delinquent for at least 270 calendar days, even if they cure such delinquency before 360 calendar days thus avoiding default, will be thereafter be disqualified from further participation in the anti-stacking program without lender consent.
- Debtors can also be disqualified for uncured non-payment-related defaults.

Special Primary Residence Terms

- Mortgage lenders may be incentivized to create a new loan product to enable debtors that have a sufficiently large debt load, and will thus incur significant savings through the anti-stacking program, to obtain a primary residence through this program.
- This new product could involve two separate amortization schedules over a 30-year term: (a) one that is developed in conjunction with the student debt amortization schedule, possibly up to a 15-year period, that features mortgage payments that decrease incrementally as the student loan payments correspondingly increase, subject to a minimum monthly payment; and (b) another that is spring-loaded to take effect on the date that the student loan is scheduled to be repaid, that amortizes any remaining mortgage indebtedness according to a standard fixed-rate schedule for the remainder of the 30-year term.
- The debtor may find it desirable to arrange for refinancing before the second amortization schedule is triggered to achieve a smoother transition to fixed-rate payments, although such refinancing will not be mandatory.
- This new product could also offer 100% loan-to-value financing, possibly including all or a portion of closing costs, so that debtors do not have to save a down payment.
- Lenders of student debt will be permitted to obtain a second lien on the primary residence, subordinate to the mortgage lender.

Student Debt Re-amortization Methodology

- The effective interest rate is first converted into a decimal ratio, by dividing the original interest rate by the effective interest rate.
- The inverse of that ratio is determined by subtracting that ratio from 1.
- The interest component of each monthly payment computed according to a standard amortization schedule, using the original interest rate, is multiplied by the inverse ratio, and the product of that operation becomes the effective interest payment.
- The anti-stacking rule in effect "lops off" part of the scheduled interest payments.
- The consequence of this method of re-amortization is that savings are front-end loaded, which: (a) reduces the total debt burden; and (b) maximizes QAA growth potential.

<u>VI. Examples</u> [*computations subject to confirmation*]

$30,000 principal @ 6.8% with 10-year amortization/5-year QAA growth period @3.0% growth rate

AGGREGATE DATA

Initial Principal Amount	$30,000.00
Original Total Interest	$11,428.92
Effective Rate	4.04%
Adjusted Total Interest	$6,790.12
Percentage Savings	40.59%
Savings (Diverted to QAA)	$4,638.80

MONTHLY DATA

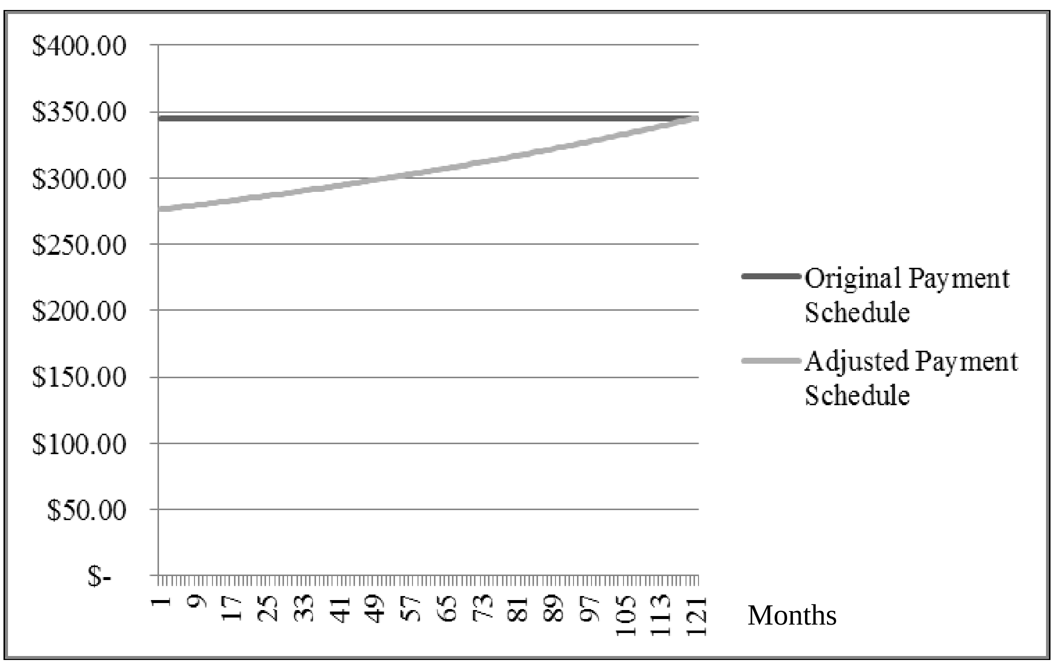
Original Monthly Payment	$345.24
Adjusted Avg. Monthly Payment	$306.58
First Monthly Payment	$276.24
Last Monthly Payment	$345.24

QAA INVESTMENT DATA

QAA Growth Period (Years)	5
QAA Growth Rate	3.00%
Additional Annual Contributions	$0.00

QAA PERFORMANCE OUTCOMES

QAA Base Value	$4,638.80
Total Additional Contributions	$0.00
Total QAA Contributions	$4,638.80
QAA Appreciation Amount	$738.84
QAA Appreciation Percentage	15.93%
QAA End Value	$5,377.64



$133,000 principal @ 9.0% with 15-year amortization/8-year QAA growth period @5.0% growth rate

AGGREGATE DATA

Initial Principal Amount	$133,000.00
Original Total Interest	$109,815.42
Effective Rate	4.50%
Adjusted Total Interest	$54,907.71
Percentage Savings	50.00%
Savings (Diverted to QAA)	$54,907.71

MONTHLY DATA

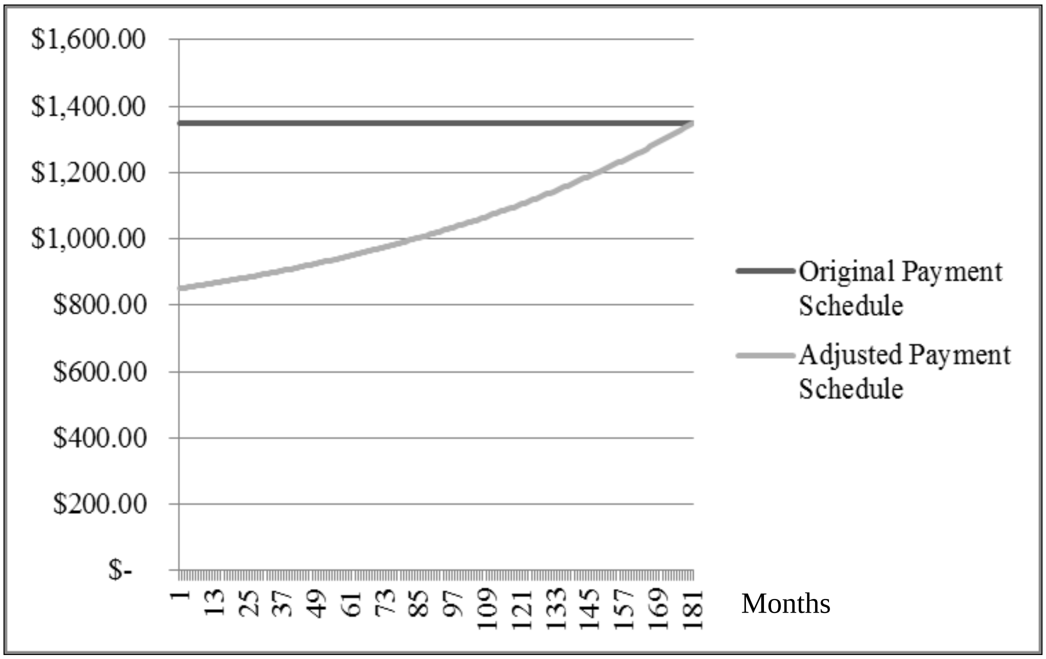
Original Monthly Payment	$1,348.97
Adjusted Avg. Monthly Payment	$1,043.93
First Monthly Payment	$850.22
Last Monthly Payment	$1,348.97

QAA INVESTMENT DATA

QAA Growth Period (Years)	8
QAA Growth Rate	5.00%
Additional Annual Contributions	$0.00

QAA PERFORMANCE OUTCOMES

QAA Base Value	$54,907.71
Total Additional Contributions	$0.00
Total QAA Contributions	$54,907.71
QAA Appreciation Amount	$26,215.99
QAA Appreciation Percentage	47.75%
QAA End Value	$81,123.70



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