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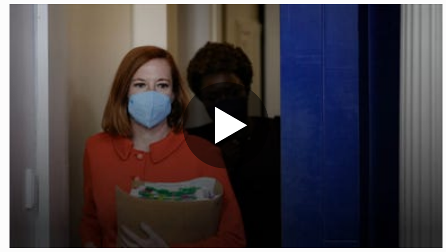

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Interview With Student Loan Activist Alan Collinge - **Fair** Value In An Un**fair** System ?

Peter J Reilly Contributor

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is the founder of StudentLoanjustice.org. He has appeared here several times. He and I have recently been corresponding about the application of **fair** value accounting to federal student loan programs. Alan thinks that there is something sinister going on there. Here is our discussion on the issue followed by my brief closing comment.

PR: So how are things going with StudentLoanJustice.Org these days?

AC: Relatively well. We have 50 state chapters up on Facebook now, so hopefully these will be catching wind soon. Donations are still urgently needed, but that seems to be a constant.

PR: Any movement on the push to return Bankruptcy protections?

AC: Nothing to speak about currently. The national conversation is being distracted badly by people content to re-arrange deckchairs, I would say.

PR: Any comments on the interest rate debate that is currently raging?

AC: That's the largest deckchair, actually. It's not the interest

AC: That's the largest deckchair, actually. It's not the interest rate that people care about, it's the sticker price, and as bankruptcy continues to be neglected, this will continue to be the case.

PR: You've voiced strong concerns recently about the use of fair value accounting for federal student loans. What's that all about?

AC: Glad you asked. DC based think tanks including the Heritage Foundation(Jason Richwine), the New America Foundation (Jason Delisle), and others are expending significant efforts currently to legitimize the use of so-called "fair value accounting" for establishing budgetary costs of the federal student loan program. These efforts largely rely upon recent and compelling work by the Congressional Budget Office to compare historical accounting cost estimates for federal student loans with fair value estimates. While there are some questions about the appropriateness of FVA for valuing assets on the government books, for the purposes of this discussion, we'll ignore them. As such, the method, which discounts the value of a lending instrument based on future risk projections, is a worthwhile approach in principle, and the CBO's cost estimates change dramatically as a result of employing it-turning a surplus of $45 billion into a loss of $11 billion for federal student loans and guarantees that were issued in 2013.

One has to be impressed with the dramatic increase in cost that this model predicts for federal student loans. Equally impressive is the extent to which Delisle defends this method (See here, here, and here) and the passion Richwine exudes as he condemns big-government for using such an "accounting trick" to hide the true costs of the program.

Upon cursory examination, however, it becomes obvious that the method being championed by these two analysts-even by Fair Value Principles- is blatantly inappropriate, uses grossly and demonstrably incorrect inputs on at least two fronts, and generates unbelievable results that even laymen with no particular accounting expertise would likely reject out of hand. Harsh characterizations, I realize, but certainly not thrown up lightly.

PR:How are FVA accounting principles being violated?

AC: In evaluating the value of a lending asset, Fair Value Accounting principles require, first, that actual, historical market data on sales of similar assets be used as a benchmark for determining the fair value assets if available. For federal student loans, such data exists, since federal loans have been securitized and traded for years, and except for a brief period following the financial crisis in 2008, the market has been active, healthy, and relatively stable. Therefore, any competent fair value accountant would and should use this data as the primary benchmark, and look no further. The CBO, however, does not do this! The CBO, Delisle, Richwine, et. al choose to ignore federal loan sales data, and instead choose private loans as their relevant benchmark. These loans have much higher interest rates, are far riskier, come with none of the guarantees or collection powers attached to federal loans, and the private student loan market is far smaller (less than a fifth the size of the federal market), more volatile, and far more difficult to find reliable data on generally (private lenders tend to consider data like default rates, collection costs, recovery rates, and so forth as proprietary). Based upon this, there should be no disagreement that private loans are ill suited for valuation of federal loans.

What is worse, however: The private loan market has always been highly dependent upon the federal loan system in many ways. One example: many if not most borrowers turn to private loans only as a last resort because they could not get federal loans. The lenders know this well, and raise their prices accordingly. There are other dependencies, but this alone should disqualify private loans from serious consideration as benchmarks for valuing federal loans.

For these reasons, it should be overwhelmingly clear that the private lending market is grossly inapproriate for use as a pricing benchmark for federal student loans. In fact, I cannot imagine that any competent analyst would attempt to use private loans as a stand in...even as a poor second choice.

PR: Don't you agree that taking in the future cost of defaults is an appropriate thing to do? This seems to be the thrust of why fair value accounting is being promoted.

AC: Again, thanks for asking! Delisle points to the cost of defaults as a critical reason for using fair value, but years of presidential budget data show that for defaulted FFELP loans, the government's recovery rate is 122%, a rate far higher than any loan, public or private could ever claim (this is directly attributable to unprecedented collection powers, and the removal of bankruptcy and other protections). For Direct loans, this rate has been about 110%, but I estimate that with FFELP ended, this rate is about 115% . Even discounting generously for collection costs (using cost data for generalized bank loans which typically involve seizure of property, significant court costs, etc.), and factoring in the government's cost of money leaves a hefty profit on defaults, and in fact shows that the government makes more money on defaults than loans which remain in good stead (a defining hallmark of a predatory lending system).

But Delisle points to the same, flawed "fair value" costing reasoning to claim that in fact the government loses money on defaults. This is analogous to Exxon pointing to a guy selling biodiesel out of his garage for $8/gallon, and using this to justify writing off $4 for every gallon the corporation sells. The "costs" are not only completely fictitious, there is ZERO chance that they will ever occur based on all available data.

PR: So, what are the implications of all this, Alan?

AC: A governmental entity having a preference for its loans to default is something like the epitomy of bad governance, and explains well the Department

of Education's reluctance to crack the whip on the schools to contain their costs, warn the public about the true risk they are taking, or advise congress to decrease federal lending limits. Certainly the Department's institutional budget has soared under these conditions as well. This makes it both bad government, and big government.

The New America Foundation used to do meaningful work pushing for good government, yet here their expert is protecting just the opposite. Similarly, the Heritage foundation has historically championed smaller government, but their staff protects its growth here, whether wittingly or not. Delisle, if not Richwine, has published voluminously and in great detail on the general concept, but for all his analysis, has never explained or even acknowledged the departure from sound FVA principles. I think he really must in the public interest, and frankly, in the interest of preserving the integrity of his professional reputation, if nothing else.

There are serious policy considerations as well. For example: If this methodology is accepted and used by Congress in its decision making, then

we'll have a "tail wagging the dog" scenario where the private lending industry will be able to make the federal program "look" far, far more expensive by simply raising their interest rates! While this is something the private lenders like Sallie Mae clearly would like to do for a number of reasons, it threatens millions of borrowers, the federal lending system and the public interest generally.

PR: So, eventually, the real facts about default recovery should catch up to this method over time, right? Doesn't this allay your concerns?

AC: We don't have 3-4 years to let this sort of dishonest accounting fraud prove itself as such. Google "Enron" and "Fair Value Accounting", and you will understand the urgency of my concern.

PR: Anything you'd like to add?

AC: Congress members, their staff, and other decision makers should consider these comments very seriously, and see if they don't come to the same conclusions based on their own careful, unbiased analysis. Clearly there are serious errors that, if accepted without question, will inevitably lead to horrible decisions for which they will be responsible.

In my discussions with Alan, I have sometimes frustrated him with my view that this whole thing is perhaps less sinister than he thinks. One of the ironies of being a CPA in tax is that you lose track of what your licensing by states is all about - rendering opinions on financial statements. The great state of Florida, I learned much to my chagrin, expects its CPAs to continue to maintain some knowledge of accounting. Go figure. I could have taken care of it by going to a few day long seminars and sleeping through them, but I am kind of a cheapskate so I recently spent longer than I wanted to wrestling with Wiley GAAP 2013 in order to take an on-line exam. One of the things that was reinforced as I slogged through that stuff is that there is a general trend to the use of fair value accounting, particularly when it comes to financial instruments.

The one quibble that I have with Alan's analysis is that I don't think the federal government can use data from the securtitized student loan market to do fmv analysis, since those loans were enhanced by a federal guaranty.

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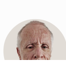

Peter J Reilly

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