Invest in Kids / PAES Update:
Sheldon Presentation of Early Care and Education Finance
October 2006

Most early care and education (ECE) programs are paid for on a short-term pay-as-you-go basis by families and state and federal governments. It is believed that due to limited resources, the strong long-term economic growth, job creation and fiscal sustainability potentials of increasing ECE program spending are not fully realized. To fully obtain these economic benefits, ways need to be found to pay for ECE programs with long-term financing. This was the challenge Paul Sheldon, Managing Director and Co-Head of the Student Loan Group at Citigroup, took on in the October Invest in Kids Working Group meeting. Paul explained the existing approaches to financing higher education and how they might be used to finance ECE programs. His presentation can be found at http://www.ced.org/docs/ivk/iikmeeting_slides200610sheldon.ppt.

Our next working group meeting will be Monday, November 20, at 3:00. We will continue our enquiry into ECE finance policy. George Overholser, founder and managing director of NFF Capital Partners, will present a framework for funding non-profit ECE providers that utilizes many of the concepts of modern investment finance.

At our October 16 working group meeting, Paul Sheldon began by stressing that his presentation should be viewed as only an initial discussion of this topic and that he was in no sense proposing that young children be burdened by debts as college students are. His purpose was to explain how modern financial market techniques could be used to tap a vast pool of global savings to pay for ECE programs. He also emphasized that the debates in higher education finance over "direct" versus "guaranteed" lending may have counterparts in ECE financing, but these are issues that can and should be considered separately.

Paul proposed that because early care and education spending is an capital formation expenditure, like building a home, an optimal way for society to pay for ECE costs would be to match the repayment of cash to the time when benefits are received, in a way that is analogous to how home mortgage payments are made as the benefits of home ownership are received. He proposed this might be accomplished via a financing mechanism similar to the federal government's student loan program. Paul indicated that under such an arrangement, the same entities (parents, federal and state governments) that currently pay for early education would be responsible to pay under the proposal he laid out. The range of current state and federal funding for ECE is very large. For a full discussion of just the federal government's commitments to education generally, see http://www.whitehouse.gov/omb/budget/fy2007/pdf/appendix/edu.pdf.

Paul described the federal student loan program and lessons that policy-makers and lenders learned from its development. In general student loans are originated by banks and other lenders and sold to institutions that pool the loans into bonds that are attractive to global investors such as pension funds, insurance companies, and other institutions with medium-term investment needs. The loan program combines (1) the ability to lend to specific students in specific circumstances and to service the loans thereafter, (2) state and federal guarantees and (3) the ability to access global sources of savings. These elements combined vastly increased the amount of money available to finance the higher education of American students. The current Federal Student Loan Program (FFELP) now provides funds totaling almost $100 billion to finance the education costs of over 14 million students between the ages of 18 and 24.

Paul then explained that ECE programs, such as preschool, could be financed in ways comparable to higher education by providing students with "scholarships" financed through the issuance of bonds sold in worldwide capital markets. As is done in higher education, special corporations could be organized to make ECE scholarships to parents and ECE providers. Though most likely such institutions would be regional government sponsored non-profit entities, they could take many forms including being private non-profit or for-profit institutions. The financing corporations would then issue bonds to gather the funds needed to take advantage of available attractive long-term financing.

Properly structured the bond issuances could raise more money for ECE programs than is now available via current pay-as-you-go systems. This would enable such programs to be operated at a level justified by their long-term economic growth, job creation, and fiscal sustainability potentials.

Paul stressed that repayment of the bonds issued to fund the scholarships would most likely be the responsibility of the same public and/or private institutions and families, which now pay for early care and education. Scholarships for the children of low income families, for instance, would probably be covered by the same state, federal, and foundation entities, and in a needs-based manner comparable to the frameworks that now support early care and education for such families. Differences would arise most likely from the fact that larger sums of money could be tapped for ECE program spending, and within an expanded funding framework ECE provider eligibility standards would probably be increased along with resources and technical assistance to increase them.

Paul explained that student loan-backed debt is sold worldwide by a group of Wall Street companies as agents for student loan originators, and offered his judgment that these same companies would be eager to finance ECE programs. These same companies sell US government securities to investors around the world and could easily sell ECE debt in a similar way. He explained that though these asset-backed financing approaches are straightforward and widely understood, an "Early Education Act" would need to be drafted to establish the parameters for administering the program (similar to the role of the Higher Education Act in student lending). He emphasized the importance of developing a framework that Wall Street can easily understand and suggested that establishing a government sponsored enterprise like Sallie Mae for ECE programs would not be needed because of the sophistication of today’s capital markets, and because with the proper structure lenders can interact directly with the asset-backed securities market. Paul explained that not only would the market be receptive, but raising amounts as large as $30 to $50 billion for ECE programs would be quite feasible.

Questioning and lively discussion took place during and after Paul's presentation. Topics raised included:

Does the financing approach presented improve the case for increasing public spending on early care and early education? No. The approach described does not improve the case for increasing public spending on quality ECE services. If that case can be made by sound economic analysis, this financing approach could be used to pay for it. But economic analysis is just the first step. Sufficient political support needs to be obtained to legislatively provide for the spending.

A key component of this approach is that it would involve a constant review by many independent long-term investors. Several levels of review are implied. There would need to be sound quality assessments and publicly available rating frameworks to make sure eligible ECE providers are providing truly quality services. See the summaries of working group presentations by Mark Ginsberg, NAEYC, and Doug Price, Qualistar, on service accreditation and ratings at http://www.partnershipforsuccess.org/?id=03. Students would need to be monitored to confirm that the services provided actually improve cognitive and social performance in later years and generate the expected economic benefits. If these are in place and effective, the approach Paul presented could contribute to transparency, performance evaluation, quality assurance, and business soundness – all of which are needed for a scale-up of ECE spending to achieve the desired economic benefits.

The financing approach illustrates a way to raise the money to pay for much of the spending by increasing the participation of a wide variety of finance and commercial interests. Their involvement would enable large volumes of funds to be raised at low cost for ECE spending and provide a market test of the idea that spending on quality ECE programs creates economic value. Assuming economic growth, job creation and fiscal strength are higher as a result of the ECE spending, by an amount that exceeds its financing costs, the approach would affirm that quality ECE is in fact a sound national investment.

Are there any advantages to the public sector using this program over just issuing bonds? This question in a sense mirrors the debate over direct lending versus the current Federal Family Education Program (FFELP) debate in higher education. Governments can certainly borrow at cheaper rates, but in the higher ed debate the central question was how the contact with individual education institutions and borrowers would be handled and which approach would be most efficient and least costly longer-term. The current higher ed lending framework reflects a judgment made some years ago that private companies could handle servicing at a lower cost over the long-term. Whether this would be the case for ECE programs is not clear yet. For a full review of federal higher ed financing see pp. 360-373, http://www.whitehouse.gov/omb/budget/fy2007/pdf/appendix/edu.pdf.

The nature of many small ECE providers suggests that some involvement by private non-profit and for-profit companies in assessing program quality and effectiveness and handling "servicing" would be desirable, and perhaps especially in assisting small ECE providers to conduct their accounting and related business operations in a sound and efficient manner. How questions like this are answered is crucial ultimately to how attractive ECE bonds are to worldwide investors. However, the specifics of the balance of public and private involvement are unclear at this point, and even when it is clear, it may differ from region to region. The main thing to keep in mind is this: the overall financing framework should provide for an ECE service provision framework that maximizes economic growth, job creation, and fiscal sustainability. A further need will be to convince policy-makers that ECE spending is an investment in capital goods, much like highways and healthcare, rather than current spending. If viewed this way, bond financing is the logical way to finance the spending.

<u>What percentage of people would have their ECE "scholarships" paid back by the state or federal government?</u> The answer to this is unclear because state and federal legislators have not held hearings and weighed the economic benefits and costs of significantly increasing ECE spending. A significant portion of ECE spending on economically disadvantaged children is currently paid for out of general revenues by state and federal governments. This would almost certainly remain the case even if ECE spending on all children increased. The experience of higher education finance is not necessarily a good guide. While 70% of higher education students have education loans of one kind or another, the students themselves are the borrowers. No one is anticipating that small children would become borrowers under an expanded ECE finance program. Moreover, because ECE financing is based on the expectation that ECE programs have high long-term economic returns to the entire economy, it is reasonable to expect the economy generally to bear ECE financing costs – most of the costs in the case of low-income children and at least some of the costs for moderate and middle income children. Scientific findings about the economic returns on ECE spending will guide decision making on how the costs should be distributed between families and society generally. The central concern will be to maximize the net benefit in terms of longer term GDP growth and fiscal sustainability.

<u>What is "servicing" a loan?</u> Servicing involves the administrative work needed to help people pay back their loan. For example, if borrowers make loan payments electronically the bank has to do very little administrative servicing of the loan. However, if loan payments do not come in on time, the servicing institution must take a variety of administrative actions to make sure the loan does not go into default.

<u>How is "Wall Street" involved in financing a loan?</u> When the higher education loans system began, most banks placed the debt on their balance sheet. Now several secondary markets buy packages of debt. These savings rich institutions include institutional investors, pension funds, insurance companies, and other worldwide public and private investment institutions.

<u>Why has there been an increase in student loans in higher education?</u> The number of student loans has been rising due to the increase in school tuition, the increase in the student population, and the reduction in grants. For example, 20 years ago students

financed their higher education with a combination of 60% grants and 40% loans, today those ratios have reversed. Furthermore, many students reconsolidated their loans when interest rates went down. This reconsolidation allowed students to benefit, while the government lost money on interest.

What type of activities would ECE program scholarships finance? The financing described could benefit children from 0- to 5-years-old in any full- or part-time programs that meet the funding criteria (i.e. accreditation, quality measures, etc.)

What are the regulatory hurdles involved in issuing debt? The issuer would have to comply with state and federal lending laws. State and federal agencies would have to specify the procedures and criteria that scholarship providers would follow, describe how lenders would make provide scholarships, and establish the guidelines for determining what qualifies as an eligible program.

Would family/friends/neighbors who take care of children be able to participate? The government would have to enact legislation that describes eligible institutions. This legislation would include a laundry list of organizations that may include family/friends/neighbors arrangements.

What criticisms might face an ECE program financing framework? The federal higher education agency was criticized by states and private lenders when the federal government told states how to administer loans. In addition, to disagreements between the states and federal government, an ECE financing program might be susceptible to fraud and abuse criticisms if accredited programs lack of overall quality standards or demonstrate an inability to manage funds. These criticisms might raise more questions such as: Since programs remain small (colleges have large infrastructure) will corporations need to build more infrastructure (like a clearinghouse)? Program administrators think that they save money by not hiring financial manager, should the first priority be to make programs efficient in handling their own money?

What would be the threshold of debt that would entice investors? International investors would need a familiar structure – bonds and other financial instruments that are comparable to existing securities and that can be bought and sold easily -- and \$10 to \$20 billion per year of flows for a sustained period.

Are there any financial instruments that could now be used by people (if the government stepped in to guarantee them and assured the ECE programs were high quality)? Private firms may have instruments that could be used to provide ECE funding. However, until the net economic benefits are estimated and legislators decide on the portions to be paid by society generally and by families of different economic circumstances, financial experts and economists will be unable to conduct market studies to determine what instruments governments and parents would prefer.