

Guide to Student Loan Issues

By Britta Anderson

March 2007



About the Author

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About USA Funds

USA Funds is a nonprofit corporation that works to enhance postsecondary-education preparedness, access and success by providing and supporting financial and other valued services. USA Funds links colleges, universities, proprietary schools, private lenders, students and parents to promote financial access to higher learning.

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USA Funds Briefing Paper

***Guide to
Student Loan Issues***

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FOREWORD

The purpose of this revised and updated briefing paper is to create a backdrop for student loan policy discussions by offering an objective and concise guide to:

- The Federal Family Education Loan Program.
- The William D. Ford Direct Loan Program.
- Private student loans.

The main focus of the paper is on the evolution of federal and private student loans with emphasis on program history, trends, loan terms and costs as well as selected policy issues.

To provide a more comprehensive perspective on borrowing, this edition also recapitulates the rationale for student aid, summarizes the latest research on student loan indebtedness and highlights some key postsecondary education statistics.

Finally, the appendices provide complementary information about federal student loan basics, the involvement of the U.S. Department of Education in student loans, the 2001 federal “Market Mechanisms” study, advances in student loan servicing, FFELP lender finances and the role of student loan guarantors.

Throughout this document, the terms “Stafford,” “PLUS” and “private loans” refer to federal and private loans used to pay for current educational expenses. In contrast, “consolidation loans” are used to refinance existing loans. This distinction is necessary because each type of loan serves very different purposes and constituencies, and consequently, generates different policy concerns.

Copies of this guide may be downloaded in Portable Document Format from www.usafunds.org/forms/school_lender/guide_student_loan_issue.pdf on the USA Funds Web site.

ACKNOWLEDGMENTS

I wish to express my sincere appreciation to Terry Muilenburg, Bob Murray, Henry Fernandez, Brenda Grady and Rick Buckingham of USA Funds for their valuable contributions to this briefing paper. They have provided indispensable content, editing and production assistance for this project. Special thanks also to Carl Dalstrom and USA Funds for funding and publishing this document.

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1. FRAMEWORK

To set the stage for the detailed discussions of student loans to follow, this chapter summarizes:

- The rationale for student financial assistance.
- Current studies pertaining to the adequacy of student aid.
- College enrollment trends.
- College cost trends.
- The economic and societal value of a college degree.

THE RATIONALE FOR STUDENT FINANCIAL ASSISTANCE

To understand the history of student loans, it is necessary to keep in mind the underlying goals of student assistance. At the signing of the Higher Education Act on Nov. 8, 1965, President Lyndon Johnson said:

In a very few moments, I will put my signature on the Higher Education Act of 1965. The President's signature upon this legislation passed by this Congress will swing open a new door for the young people of America. For them, and for this entire land of ours, it is the most important door that will ever open — the door to education. ...

A high school senior anywhere in this great land of ours can apply to any college or any university in any of the fifty states and not be turned away because his family is poor.¹

In a tribute to the major federal student aid programs on their 30th anniversary, a lawmaker summarized the national student aid objectives as follows:

The Higher Education Act, enacted in 1965 to provide disadvantaged students with greater educational opportunities, recognized the shared benefit of providing every American a chance to maximize his or her potential. As a result of the passage of this legislation, doors have been opened to millions of citizens who otherwise would not have had the access or the resources to obtain a higher education. Although the act has been amended over the years through the reauthorization process, the central purposes of the legislation have remained the same — to ensure access, choice and opportunity in higher education.²

¹ Lyndon B. Johnson, President, "Remarks at Southwest Texas State College Upon Signing the Higher Education Act of 1965," Nov. 8, 1965.

² *Congressional Record*, Senator Paul Sarbanes, "The 30th Anniversary of the Higher Education Act," Nov. 8, 1995, p. S16815.

In 2000, the College Board further elaborated on the purpose of federal student assistance:

Thirty-five years ago, Congress passed the Higher Education Act and committed the federal government to the goal of opening college doors to all, regardless of family income or wealth. Federal student aid has helped millions of people go to college who otherwise might not have had the chance. Federal, state, and private efforts combined have fueled a half century of explosive growth in college attendance and educational attainment. U.S. colleges and universities now enroll 15 million students: 1.5 times the number enrolled in 1965, 6 times the enrollment in 1950, and 10 times pre-World War II levels. The proportion of the population 25 to 29 years of age that has completed four years of college or more has quadrupled since 1940.³

SUFFICIENCY OF STUDENT AID

In recent years, several entities and individuals have expressed deep concern about the ability of the current financial aid system to provide the level of access to postsecondary education necessary to maintain the goal of equal educational opportunity. Below are synopses of a sampling of reports dealing with the topic.

Advisory Committee on Student Financial Assistance

2002 Report

In June 2002, the independent federal Advisory Committee on Student Financial Assistance published a report sharply pessimistic about the current status of postsecondary access:

Most Americans believe that all students have the opportunity to earn a college degree through hard work in high school and college. Yet, this year alone due to record-high financial barriers, nearly one-half of all college-qualified, low- and moderate-income high school graduates — over 400,000 students fully prepared to attend a four-year college — will be unable to do so, and 170,000 of these students will attend no college at all.⁴

To remedy this problem, the Advisory Committee proposed to:

Forge a new national partnership among the federal government, states, and colleges and private philanthropic groups to improve integration and coordination among existing programs and to implement a comprehensive strategy effectively

³ Lawrence E. Gladioux, Executive Director for Policy Analysis, The College Board, Washington, D.C., *Statement to the Committee on Governmental Affairs*, U.S. Senate Hearing on the Rising Cost of College Tuition and the Effectiveness of Government Financial Aid, Feb. 10, 2000.

⁴ Advisory Committee on Student Financial Assistance, *Empty Promises, the Myth of College Access in America*, Washington, D.C., June 2002, p. v.

aimed at all of the factors that determine access and persistence. The overall objective would be to provide low-income students with —

- Adequate grant aid to reduce work-loan burden;
- Early assurances of financial access to four-year institutions; and
- Incentives to increase participation in early intervention programs.⁵

2006 Report

The Advisory Committee reiterated its sobering warning in 2006:

America's global competitiveness depends on the ability of our high school graduates to earn at least a bachelor's degree. As in recent decades, financial barriers are a major factor in preventing large numbers of college-qualified students from earning a bachelor's degree, particularly those from low- and moderate-income families. These bachelor's degree losses are an unmistakable signal that our nation has yet to make the full investment in student aid necessary to secure our economic future — a dire warning that we are requiring millions of students to mortgage their future and ours as well.

We have failed to take accurate account of the impact of price barriers on our lowest income students, especially those who have prepared and planned for college:

- During the 1990s, between nearly 1 million and 1.6 million bachelor's degrees were lost among college-qualified high school graduates from low- and moderate-income families;
- During the current decade, between 1.4 million and 2.4 million more bachelor's degrees will likely be lost, as the number of high school graduates increases and academic preparation improves.⁶

To ameliorate the implications of these findings, the Committee recommended that:

To increase bachelor's degree attainment, the nation must —

- Reinvigorate the access and persistence partnership to increase need-based aid from all sources;
- Restrain increases in the price of college and offset necessary increases with need-based aid;

⁵ Advisory Committee on Student Financial Assistance, Presentation Prepared for NASSGAP Fall Conference 2005, San Francisco, CA, and Oct. 11, 2005.

⁶ Advisory Committee on Student Financial Assistance, *Mortgaging our Future: How Financial Barriers to College Undercut America's Global Competitiveness*, September 2006, p. iii.

- Moderate the trend — at all levels — toward merit-based aid and increasing reliance on loans;
- Reduce financial barriers to transfer from two-year to four-year colleges;
- Strengthen early intervention programs for low- and moderate-income middle school students; and
- Invest in efficient and productive remediation in college.⁷

The National Center for Public Policy and Higher Education

The National Center for Public Policy and Higher Education — an independent, nonprofit, nonpartisan organization — issues “National Report Cards” on postsecondary education. The 2006 report took a particularly dim view of the current status of college affordability:

As critical as it is, the college affordability problem does not exist in a vacuum. It is one of many symptoms of the underperformance of American higher education that signal the urgent need for a comprehensive and fundamental reexamination of higher education finance. This report card highlights these symptoms: flat college participation rates; lack of progress in extending college opportunity for low-income Americans; poor rates of completion of college programs; escalating costs and prices; and a financial aid system that is less focused on the nation’s need to improve college access and attainment. Current approaches to higher education finance, including some of the policy and practices described above, poorly address these symptoms and may, in fact, exacerbate the underlying condition of underperformance. Additional public investment is essential, especially in need-based student aid. However, if the nation and the states are to realize improvements commensurate with their investments, they must raise and answer critical questions of fairness, efficiency, effectiveness, incentives, and accountability.⁸

Commission on the Future of Higher Education

Also in 2006, The Secretary of Education’s Commission on the Future of Higher Education issued a report that expressed serious concerns about both educational access and financial aid. In terms of access, the document stated:

We found that access to American higher education is unduly limited by the complex interplay of inadequate preparation, lack of information about college opportunities, and persistent financial barriers. Substandard high school preparation is compounded by poor alignment between high schools and colleges,

⁷ Ibid., p. iv.

⁸ The National Center for Public Policy and Higher Education, *Measuring Up 2006, The National Report Card on Higher Education*, August 2006, p. 21.

which often creates an “expectations gap” between what colleges require and what high schools produce. Although the proportion of high school graduates who go on to college has risen substantially in recent decades, the college completion rate has failed to improve at anywhere near the same pace. Shortcomings in high schools mean that an unacceptable number of college students must take costly remedial classes. Moreover, there is a troubling and persistent gap between the college attendance and graduation rates of low-income Americans and their more affluent peers. Similar gaps characterize the college attendance rates — and especially the college completion rates — of the nation’s growing population of racial and ethnic minorities. While about one-third of whites have obtained bachelor’s degrees by age 25-29, for example, just 18 percent of blacks and ten percent of Latinos in the same age cohort have earned degrees by that time.⁹

The Commission’s stance on financial aid also reflected serious concerns about the current system:

We found that our financial aid system is confusing, complex, inefficient, duplicative, and frequently does not direct aid to students who truly need it. There are at least 20 separate federal programs providing direct financial aid or tax benefits to individuals pursuing postsecondary education. For the typical household, the Free Application for Federal Student Aid, or FAFSA, is longer and more complicated than the federal tax return. Moreover, the current system does not provide definitive information about freshman year aid until the spring of the senior year of high school, which makes it hard for families to plan and discourages college attendance. Unmet financial need is a growing problem for students from low-income families, who need aid the most.

We propose replacing the current maze of financial aid programs, rules and regulations with a system more in line with student needs and national priorities. That effort would require a significant increase in need-based financial aid and a complete restructuring of the current federal financial aid system. Our recommendations call for consolidating programs, streamlining processes, and replacing the FAFSA with a much shorter and simpler application.¹⁰

COLLEGE ENROLLMENT TRENDS

College enrollments in degree-granting institutions increased substantially from 1990 to 2004 and, according to the National Center for Education Statistics’ middle alternative projections, more than 2.5 million students are expected to be added to the roster between 2004 and 2015, resulting in a total enrollment of almost 20 million students.

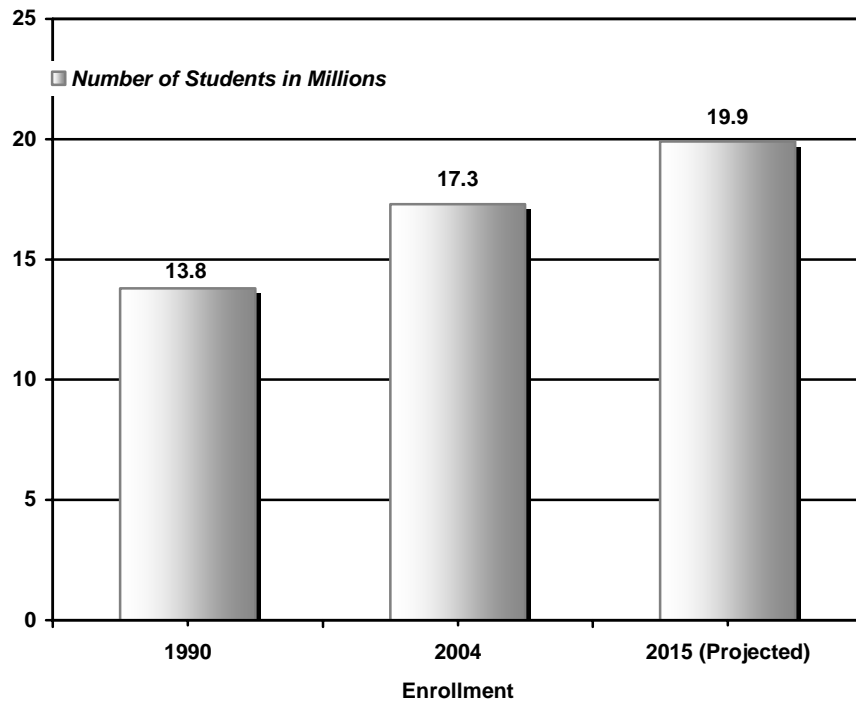
⁹ The Secretary of Education’s Commission on the Future of Higher Education, *A Test of Leadership, Charting the Future of U.S. Higher Education*, September 2006, p. 1.

¹⁰ *Ibid.*, p. 3.

According to NCES:

The enrollment projections do not take into account such factors as the cost of a college education, the economic value of an education, and the impact of distance learning due to technological changes. These factors may produce changes in enrollment levels.¹¹

FIGURE A. Actual and Projected Total Enrollment in Degree-Granting Institutions: 1990–2015¹²



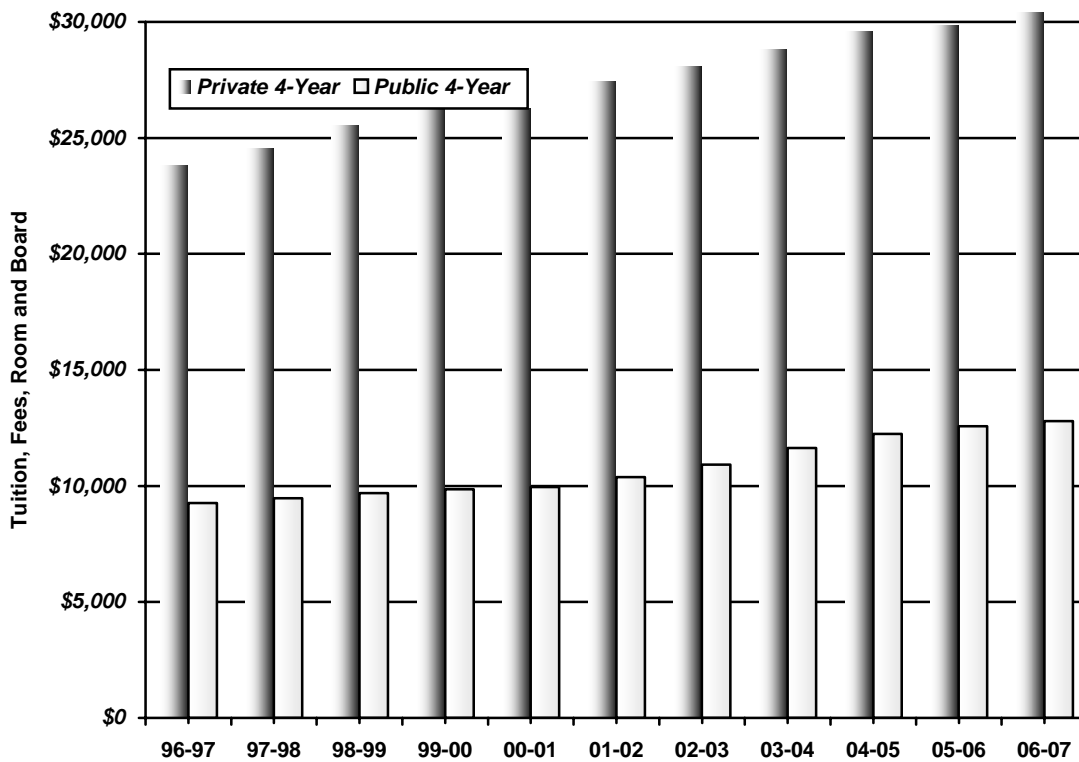
¹¹ U.S. Dept. of Education, NCES, *Projections of Education Statistics to 2015*, Thirty-Fourth Edition, SOURCE: Integrated Postsecondary Education Data System (IPEDS), “Fall Enrollment Survey,” various years; and *Enrollment in Degree-Granting Institutions Model*, September 2006, p. 8.

¹² Ibid.

COLLEGE COST TRENDS

The figure below captures the trend in tuition, fees, room and board for full-time students at four-year public and private institutions during the past decade, as published by the College Board. Measured in constant dollars, public four-year college costs increased from \$9,258 to \$12,798 during that period, while private four-year college costs grew from \$23,795 to \$30,367.¹³

FIGURE B. Trends in Tuition, Fees, Room and Board at Four-Year Schools (Constant Dollars)¹⁴



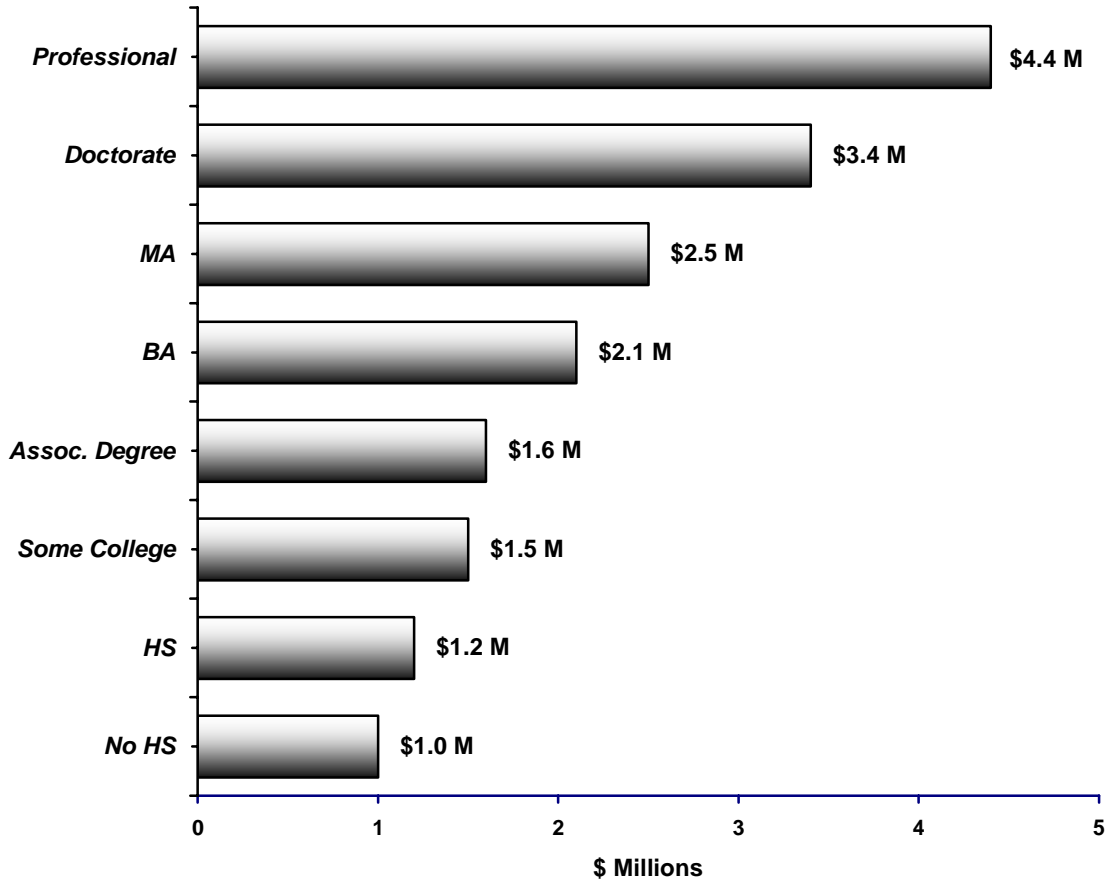
¹³ College Board, *Trends in College Pricing*, October 2006, p. 11.

¹⁴ Ibid.

EDUCATION AND LIFETIME INCOME

The Census Bureau has estimated that, over a lifetime, a bachelor degree recipient can expect to earn roughly twice the amount of someone with a high school diploma, and a professional degree holder will likely be paid twice that of a bachelor's degree recipient.

FIGURE C. Estimated Average Work-Life Earnings for Full-Time, Year-Round Workers by Educational Attainment. Based on 1997-1999 Work Experience (\$ in Millions)¹⁵



¹⁵ U. S. Census Bureau, Day, Jennifer Cheeseman and Eric C. Newburger, *The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings*, July 2002, p. 4.

SOCIETAL VALUE OF A POSTSECONDARY EDUCATION

Participating in an educational pursuit beyond high school generates not only monetary and cultural rewards for the individual, but society, as a whole, also stands to profit. The following passage from a report published by the Institute for Higher Education Policy illustrates the societal benefit:

A college education makes a big difference in our lives as Americans. This is true for individuals, but is especially true in terms of our shared economic, social, and cultural well-being as a nation. Student aid, particularly grants, is a critical part of the investment in higher education that leads to these public and private benefits.

While many policy-makers and education leaders cite the fact that a bachelor's degree has become worth more than \$1 million in lifetime earnings, the other economic and social benefits of college are even more important, though often unrecognized. These include:

- increased tax revenues,
- decreased reliance on public assistance programs,
- lower unemployment rates, and
- increased voting, volunteering, and other civic activities.

For example, the unemployment rate for those with bachelor's degrees was 2.9% in January of 2004, compared to 4.9% for those with a high school diploma and 8.8% for those with less than a high school diploma. Similarly, in the 2000 national elections, 77% of Americans with a bachelor's degree voted, compared to 54% of high school graduates and 38% of those with less than a high school diploma.¹⁶

¹⁶ Melissa Clinedinst, Institute for Higher Education Policy and Scholarship America, *Investing in America's Future, Why Student Aid Pays off for Society and Individuals*, May 2004, p. 1.

2. BACKGROUND

Borrowing for college is a necessity for most students. In 2004, 65.6 percent of graduating seniors had taken out a student loan at some time, and for those students, the average cumulative debt was \$19,200. This was a substantial increase from 11 years earlier when the comparable figures were 46.3 percent and \$9,300.¹⁷

For fiscal year 2006, new Stafford and PLUS loan volume for the Federal Family Education Loan Program was \$47.3 billion and \$12.7 billion for the Federal Direct Loan Program.¹⁸ Taken together, those figures were almost double the loan volume of FY 2000.¹⁹ Furthermore, at \$91.4 billion, new consolidation volume for FY 2006 far exceeded that of Stafford and PLUS loans combined.²⁰

Both the FFELP and Direct Loan Program are federally sponsored credit programs that **entitle** borrowers to loans and subsidies if they meet the eligibility criteria. In other words, any borrower who applies and qualifies for a loan has a **right** to receive one.²¹ Funding for student loan subsidies are considered to be mandatory spending in the federal budget.

This chapter places student borrowing in perspective by recapping the objectives and history of federal student loans.

THE OBJECTIVES OF FEDERAL STUDENT LOANS

During the early years of the federal student aid programs, grants were generally intended to provide access for low-income individuals, and loans were meant to give low- and middle-income students the ability to choose among institutions, according to the following description:

The original legislation creating the Higher Education Act of 1965 was the result of two competing ideologies for federal funding of higher education. The first was that of assisting higher education by funneling funds directly to institutions through an all-encompassing formula based on student counts. The second was that of assisting needy students directly through grants to the poorest students and subsidized loans to lower-middle class students. This alternative provided a system of portable aid that provided both access and choice to the student. Even though the 1965 legislation was indeed a compromise between these two competing interests, the primary objective was one of equalizing educational

¹⁷ National Center for Education Statistics (NCES), National Postsecondary Student Aid Study (NPSAS), 1993 and 2004 undergraduates, Data Analysis System (DAS), http://nces.ed.gov/das/library/tables_listings/nedrc_table.asp?sbj=student%20aid, Table 149, accessed Feb. 23, 2007.

¹⁸ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 58.

¹⁹ U.S. Department of Education, *Budget for Fiscal Year 2001, Appendix*, p. 368.

²⁰ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 58.

²¹ *Higher Education Act of 1965* (as amended). See, for example, Sec. 428(a)(1), Sec. 428H(b), and Sec. 452(b).

opportunity for socioeconomically disadvantaged students by providing equal access to higher education for all students.²²

Because the amount of grant funding has lagged behind the increases in the cost of education, loans have assumed an increasingly central role in postsecondary funding. Consequently, access and choice are now more intricately intertwined, as discussed in the following passage from an Association for the Study of Higher Education report:

Two recent shifts in student financial aid may also adversely affect future postsecondary education enrollments among minority groups. First, over the past twenty years, more financial aid has been provided in the form of loans instead of grants. According to the College Board (2001), in 1980–1981, 55 percent of all student financial assistance was provided in the form of grants, and 43 percent was in loans (the remainder was work-study). By 2000–2001, the share of aid from grants had fallen to just 41 percent, with the percentage from loans rising to 58 percent. This trend may harm college access for prospective students from low-income families generally and people of color specifically because they tend to be more averse to borrowing student loans than white students and those from higher income families (St. John, 2001).²³

Together with continuing to advocate for postsecondary access and choice, members of the student aid community generally agree that student loan programs should meet the following criteria:

- Be available at the lowest-possible cost to the borrower.
- Foster default avoidance.
- Enhance service delivery and service quality.²⁴

STAFFORD AND PLUS LOANS: A BRIEF HISTORY

The Higher Education Act authorizes three federally sponsored student loan programs:

- The Federal Family Education Loan Program was enacted in 1965 and originally was targeted to middle-income families and as a supplement to National Direct Student Loans. It is funded with private capital.²⁵

²² James Cofer, Ed.D, Vice President of Finance and Administration, University of Missouri System, Patricia Somers, Ph.D., Associate Professor of Higher Education, Division of Educational Leadership and Policy Studies, University of Missouri - St. Louis, "What Influences Student Persistence at Two-Year Colleges? A Multi-Year Comparison," Paper presented at the Council for the Study of Community Colleges, April, 2001, No Page Numbers.

²³ Association for the Study of Higher Education, ASHE-ERIC Higher Education Report: Volume 30, Number 2, Watson Scott Swail, with Kenneth E. Redd, Laura W. Perna, *Retaining Minority Students in Higher Education: A Framework for Success*, November 2003, p. ix.

²⁴ See, for example, American Council on Education, "Recommendations for Reauthorization of the Higher Education Act," Feb. 2003, various pages, and USA Group, *Student Loan Auctions: Issues and Implications, A Briefing Paper*, April 2000, pp. 9-11.

²⁵ Public Law No. 89-329, *The Higher Education Act*, Nov. 8, 1965.

- The Act defines the objective of the FFELP very concisely: Its central purpose is to encourage an adequate program of loan insurance for students at eligible institutions (and eligible parents of such students) and to provide interest subsidies for qualified students;²⁶
 - FFELP provides three types of loans: Stafford (for students), PLUS (for parents and some students) and consolidation loans.
- The William D. Ford Federal Direct Loan Program was established in 1993 and is funded through federal borrowing. It is administered by the U.S. Department of Education and its contractors and was initially intended to replace the FFELP.²⁷
 - The legislative goal for the FDLP also is succinct: To make loans to all eligible students (and the eligible parents of such students) in attendance at institutions that have elected to participate in the Direct Loan Program.²⁸
 - FDLP also provides three types of loans: Stafford (for students), PLUS (for parents and some students) and consolidation loans.
 - The Perkins Loan Program, a campus-based program, descended from the first federal student loan program, the National Defense Student Loan Program, which was enacted in 1958.²⁹ According to the Higher Education Act, the purpose of Perkins loans is to establish and maintain funding at institutions for low-interest loans to needy students.³⁰

This section outlines the history of the FFELP and Direct Loan Program.

The Evolution of Guaranteed Student Loans

The country's first privately guaranteed student loan was made in the spring of 1957 through the nonprofit Massachusetts Higher Education Assistance Foundation.³¹ The premise for the Massachusetts initiative was simple: Private lenders would provide student loan capital, and a nonprofit corporation would cover the risk of defaults with a reserve fund created from philanthropic contributions. This successful model was emulated by 16 other states and nonprofit organizations.³²

²⁶ *Higher Education Act of 1965* (as amended), Sec. 421(a) (1).

²⁷ Public Law No. 103-66, *Student Loan Reform Act of 1993*, Aug. 10, 1993.

²⁸ *Higher Education Act of 1965* (as amended), Sec. 451(a).

²⁹ Public Law No. 85-864, *The National Defense Education Act of 1958*, Sept. 2, 1958.

³⁰ *Higher Education Act of 1965* (as amended), Sec. 461(a).

³¹ Joseph Marr Cronin and Sylvia Quarles Simmons, *Student Loans: Risks and Realities*, Auburn House Publishing Company, Dover, Mass., 1987, p. xix.

³² Lumina Foundation for Education, Inc., *Dream, Recollections from 40 Years of Opening Doors to Higher Education for Students and Families*, 2001, p. 9.

The Guaranteed Student Loan Program

In 1965, the passage of the Higher Education Act built on these initiatives to create a nationwide **federally** guaranteed student loan program, later renamed the Federal Family Education Loan Program, based on the concept of private capital and decentralized guarantors.³³

The program initially was intended to supplement the National Defense Student Loan Program, which had been established seven years earlier as an institution-based, predominantly federally funded loan program.³⁴ The GSLP was very different from the NDSL, however. It was not institution-based; it did not rely on federal capital contributions; and it was available both to low-income borrowers, who received interest subsidies, and to higher-income borrowers, whose interest was **not** subsidized.³⁵

The GSLP's primary purpose was articulated by Congresswoman Edith Green, one of the principal authors of the legislation, who stated that "the Guaranteed Student Loan Program is designed primarily for those students who come from middle-income families — those students ... who have not up to this time been able to obtain loans under the National Defense Education Act."³⁶

The Federal Insured Student Loan Program

The 1965 enabling legislation also created a backup program of student loans guaranteed by the Department of Health, Education and Welfare.³⁷ This program was known as the Federal Insured Student Loan Program.³⁸

By 1966, just one year after passage of the Higher Education Act, each state had established a guaranteed loan program, but many quickly exhausted their federal seed monies and could no longer guarantee loans. Consequently, at the end of 1968 roughly half the states had requested FISL guarantees.³⁹

As guarantee volume expanded in the 1970s, the FISL program proved incapable of meeting increased demands for service and developed significant problems. According to a student loan analyst:

The ability of HEW to manage a guarantee program directly had been tested and found wanting. As a result, the Education Amendments of 1976 added incentives

³³ Public Law No. 89-329, *The Higher Education Act*, Nov. 8, 1965, and U.S. Department of Education, Office of Postsecondary Education, *FY 1988 Guaranteed Student Loan Programs Data Book*, p. 29.

³⁴ Public Law No. 85-864, *The National Defense Education Act of 1958*, Sept. 2, 1958.

³⁵ Common Manual Guarantors, *Common Manual, Unified Student Loan Policy*, Appendix H. p. 1, January 2007, p. 1.

³⁶ As quoted in the *Belmont Task Force Report, Congressional Record*, July 27, 1990, p. E2532.

³⁷ HEW oversaw student loans prior to the establishment of the Department of Education.

³⁸ Public Law No. 89-329, *The Higher Education Act of 1965*, Nov. 8, 1965.

³⁹ U.S. Department of Education, Office of Postsecondary Education, *FY 1988 Guaranteed Student Loan Programs Data Book*, p. 29.

to ensure that guarantee agencies were established or designated in every state, rendering FISL unnecessary.⁴⁰

Since the early 1980s, state and private nonprofit guarantors have been managing loan-guarantee functions in all states, and the FISL program has been defunct for more than 20 years.⁴¹

Parent and Supplemental Loans

Until 1980, only students were able to take out federally guaranteed education loans. The Higher Education Amendments of that year expanded the pool of eligible borrowers and extended borrowing eligibility to parents of undergraduate students by creating the Parent Loans for Undergraduate Students program.⁴² A year later the PLUS program was folded into the Auxiliary Loans to Assist Students program, which authorized loans for parents, independent undergraduates and graduate and professional students.⁴³ In 1986, ALAS was repealed, and PLUS re-emerged for parents with a companion program, entitled Supplemental Loans for Students, for independent and graduate and professional students.⁴⁴

In 1992, Congress enacted a new stand-alone unsubsidized Stafford loan program for students, which allowed virtually all students to borrow regardless of income if they were otherwise qualified.⁴⁵ SLS was officially repealed and merged into the new Unsubsidized Loan Program in 1993, with an effective date of July 1, 1994.⁴⁶

Until the passage of the Higher Education Reconciliation Act in 2006, PLUS loans were for parents only. HERA allowed graduate and professional students back into the program for the first time in 20 years.⁴⁷

Current FFELP Providers

In the course of the past 41 years, the FFELP has evolved from a somewhat narrowly targeted loan initiative to the largest student assistance program in the country. Each year, millions of students and parents borrow Stafford, PLUS and consolidation loans, and both for-profit and nonprofit education credit providers play a significant role in providing loan capital and supporting access to postsecondary education.

⁴⁰ David W. Breneman, *Guaranteed Student Loans: Great Success or Dismal Failure?* May 1991, p. 8.

⁴¹ U.S. Department of Education, *Federal Student Loan Programs Data Book FY94-FY96*, Glossary, <http://www.ed.gov/finaid/prof/resources/data/fslpdata94-96/glossary.html>, accessed Feb. 10, 2007.

⁴² Public Law No. 96-374, *Education Amendments of 1980*, Oct. 3, 1980.

⁴³ Public Law No. 97-35, *Omnibus Budget Reconciliation Act of 1981* (including the *Postsecondary Student Assistance Amendments of 1981*), Aug. 13, 1981.

⁴⁴ Public Law No. 99-498, *Higher Education Amendments of 1986*, Oct. 17, 1986.

⁴⁵ Public Law No. 102-325, *Higher Education Amendments of 1992*, July 23, 1992.

⁴⁶ Public Law No. 103-66, *Omnibus Budget Reconciliation Act of 1993*, Aug. 10, 1993.

⁴⁷ Public Law No. 109-171, *Higher Education Reconciliation Act of 2005*, Feb. 8, 2006.

A synopsis of the roles and responsibilities of FFELP participants follows.

During the 2006-2007 school year:

- Approximately 3,200 for-profit and nonprofit lenders were active in the FFELP, compared with 8,505 in 1990. They furnished the student loan capital and had responsibility for servicing the loans.^{48 49}
 - In fiscal year 2005, the 25 largest originating lenders accounted for 71.0 percent of all FFELP loans, compared with only 41.9 percent in fiscal year 1990.^{50 51}
- More than 5,000 postsecondary institutions participated in the FFELP. Fewer than 1,100 were active in the Direct Loan Program.⁵²
- A network of roughly 30 for-profit and nonprofit student loan secondary markets, in addition to Sallie Mae, issued taxable and tax-exempt bonds to underwrite lender liquidity and provide a market in student loans.⁵³
- Thirty-five active state or private nonprofit guarantors worked as administrators and insurers of student loans and served 54 jurisdictions, states and territories, several of them with “national” guarantee authority, as well as designation in a specific state or states. In 1990, there were 46 guarantors.^{54 55 56}
- The U.S. Department of Education reinsured the loans and monitored the duties of program participants.
- Numerous specialized private-sector third-party servicers and collection agencies facilitated the administrative responsibilities for lenders, secondary markets and guarantors.

These entities — lenders, guarantors, ED, secondary markets and servicers — each have responsibilities that complement each other to ensure that students and parents have ready access to loan capital.

⁴⁸ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 59.

⁴⁹ Department of Education, Office of Postsecondary Education, *FY 1991 Guaranteed Student Loan Programs Data Book*, p. 24.

⁵⁰ U.S. Department of Education, Office of Postsecondary Education, “Top 100 Originators of FFELP Loans — FY 2004 and FY 2005,” February, 2006, Excel Spreadsheet, <http://www.fp.ed.gov/PORTALSWebApp/fp/whatsnew.jsp>, accessed Feb. 11, 2007.

⁵¹ U.S. Department of Education, Office of Postsecondary Education, *FY 1991 Guaranteed Student Loan Programs Data Book*, p. 27.

⁵² U.S. Office of Management and the Budget, *Fiscal Year 2008 Budget of the U.S., Analytical Perspectives*, February 2007, p. 76.

⁵³ Education Finance Council, Membership List, http://www.efc.org/cs/root/membership/efc_members?key=memberType&val=Member, accessed Feb. 10, 2007.

⁵⁴ Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 59.

⁵⁵ U.S. Department of Education, Office of Postsecondary Education, *FY 1990 Guaranteed Student Loan Programs Data Book*, p. 43.

⁵⁶ As a result of the 1998 Higher Education Amendments, four guarantors entered into Voluntary Flexible Agreements with the Secretary. See *Higher Education Act of 1965* (as amended), Sec. 428A and Appendix E.

The Impetus for the Direct Loan Program

The emergence in the early 1990s of student loans funded by the federal Treasury can be attributed to two primary factors: **federal credit reform** legislation and **FFELP challenges**. Each element is discussed below.

Before Federal Credit Reform

During the 1970s and 1980s, some members of Congress periodically considered ways to fund student loans directly with federal dollars.⁵⁷ Under budget rules as they existed then, direct government funding of student credit was not a fiscally appealing option. The reason, as explained by the GAO was that:

Prior to the implementation of FCRA [the Credit Reform Act], credit programs were reported in the budget on a cash basis. Thus, loan guarantees appeared to be free in the budget year, while direct loans appeared to be as expensive as grants. As a result, costs were distorted and credit programs could not be compared meaningfully with other programs and with each other.⁵⁸

The Purpose of Credit Reform

The Federal Credit Reform Act of 1990 (Title V of the Congressional Budget Act of 1974, as amended by section 13201 of the Budget Reconciliation Act of 1990) significantly altered the manner in which costs were estimated for federal direct loans and federally guaranteed loans. For both types of loans, the intent was to estimate fully the lifetime cost to the government of loans made in a given fiscal year. This reform would “permit better cost comparisons both among credit programs and between credit and noncredit programs.”⁵⁹ The Act applies to all federal loans, not just student loans.

The Consequences of Credit Reform

The Credit Reform Act resulted in a reversal of the on-budget costs of student loans. Guaranteed loans now carried a steeper price tag because all subsidy costs, including estimated lender and guarantor payments paid out over the life of the loan, would be recorded as a cost in the **initial** year of the loan.⁶⁰

Conversely, Direct Loans appeared to cost less after Credit Reform. The assumption was that, except for defaults, funds provided by the Treasury for loan capital in a given year

⁵⁷ See, for example, Senator Edward Kennedy as quoted in Steven Waldman, *The Bill*, New York, Viking Penguin, 1995, p. 206.

⁵⁸ U.S. General Accounting Office, Report to Congressional Requesters, Department of Education, *Key Aspects of the Federal Direct Loan Program's Cost Estimates*, January 2001, p. 9.

⁵⁹ *Ibid.*

⁶⁰ General Accounting Office and U.S. Department of Education, paraphrased from *Final Report Regarding the Findings of the Study Group on the Feasibility of Using Alternative Financial Instruments for Determining Lender Yield Under the Federal Family Education Loan Program*, Jan. 19, 2001, p. 9.

together with subsidy costs would, in most cases, be repaid at an interest rate higher than that which the government paid its bondholders. Consequently, capital and most subsidy outlays for direct student loans would not constitute a budgetary expense.⁶¹

In addition, and of significant importance, federal **administrative** costs incurred over the life of the loans were not included for any type of loans in the calculation of student loan expenses under Credit Reform.⁶²

Credit Reform and Administrative Costs

Although the intent of the Credit Reform Act was to account for the cost of credit programs more accurately, the exclusion of federal administrative costs from the long-term expenditure estimates presented a conundrum.

Congress recognized that this omission might have significant fiscal consequences and provided directives to the Congressional Budget Office and the Office of Management and Budget to study the impact of the new scoring rules. These two entities were further instructed to furnish Congress with recommendations for “any changes if necessary, in the treatment of administrative costs under credit reform accounting.”⁶³

CBO and OMB Administrative Cost Reports

CBO issued its report in 1992, but made no recommendations to change the budgetary treatment of administrative costs due to the complexity and potential costs involved in getting accurate expenditure estimates. Nevertheless, the report stated that:

In particular, long term cost information is crucial to informed decisions in two situations: when considering a new credit program or a significant program expansion, and when considering substituting one program for another — for example, replacing a loan guarantee with a Direct Loan Program.”⁶⁴

The report further concluded that “only a small portion of the administrative costs of Direct Loans occur in the first year” and estimated that fully two-thirds of administrative costs, for both direct and guaranteed loans, occur after year five. “For this reason,” CBO stated, “it is analytically incorrect to predict savings from converting to a Direct Loan Program if administrative costs are treated on a present-value basis for loan guarantees but on a cash basis for Direct Loans.”⁶⁵

The OMB report, published later that year, essentially agreed that the complexities inherent in including administrative costs in the long-term cost estimates were daunting.

⁶¹ 2 U.S.C., Section 661(a)(5)(C).

⁶² 2 U.S.C., Section 661(a)(5)(B).

⁶³ 2 U.S.C., Section 661(f).

⁶⁴ Congressional Budget Office, *Budgeting for Administrative Costs Under Credit Reform*, January 1992, p.

⁶⁵ *Ibid.*, p. 25.

OMB did recommend that “a system be established for reporting on Federal administrative costs, including the development of a commonly accepted definition. Once a common definition has been established, these costs should be included in the subsidy.”⁶⁶

Credit Reform as a Catalyst for Direct Loans

The new scoring guidelines, with federal administrative costs omitted, produced CBO estimates indicating that replacing guaranteed student loans with direct loans would create budgetary savings of \$4.3 billion over five years.⁶⁷ Projected cost reductions of this magnitude significantly bolstered the arguments of those who favored a switch to direct student loans.

FFELP Problems as a Catalyst for FDLP

The second factor contributing to a favorable climate for direct student loans in the early 1990s was a FFELP program burdened by troubles stemming from:

- Frequent statutory changes.
- Lack of regulatory guidance.
- Lack of standardization.
- FFELP provider failures.
- Inadequate school-eligibility criteria.

Each of these contributory elements is discussed below.

Background

During the 1970s and early 1980s, the Guaranteed Student Loan Program rested on a solid base of lenders and guarantors. Schools and students generally were satisfied with both access and service, and there were few calls for fundamental program changes.

During those years, guarantors confined their activities to the states for which they had been designated. As a result of this framework, they possessed a high degree of autonomy in setting guidelines for lender and school participation. Furthermore, guarantors became adept at tailoring services to the unique needs of their institutions and geographic regions.

iii. ⁶⁶ Office of Management and the Budget, *Administrative Costs of Credit and Grant Programs*, May 1992, p.

⁶⁷ U.S. Congress, CBO, *Cost Estimate of the Conference Agreement on Title IV of the Omnibus Budget Reconciliation Act of 1993*, Aug. 3, 1993.

Frequent Statutory Changes

A profusion of legislative changes during the 1980s weakened the decentralized student loan community. Annual budget reconciliation directives cut billions of dollars from the program by changing borrower eligibility criteria and lowering lender and guarantor subsidies. The 1986 reauthorization changes further increased the financial and operational burdens on student loan providers.

The result was student loan statutes that were hampered by complicated provisions for borrowers and providers. Each layer of legislation created its own aftermath of confusing and often conflicting implementation issues.

Lack of Regulatory Guidance

Further exacerbating program complexity, the Department of Education provided private rulings and a profusion of “Dear Colleague” letters in lieu of formal regulations after both the 1980 and 1986 Reauthorization Amendments. Members of the House Committee on Education and Labor expressed their concern by stating that it was “unconscionable that a \$12 billion program is operating on a series of ‘Dear Colleague’ letters without final published regulations.”⁶⁸

Despite many exhortations, ED failed to promulgate final regulations for six years after the 1980 Amendments and for seven years after the 1986 reauthorization legislation. These delays prompted Congress to include language in the 1992 Amendments mandating a shutdown of the FFELP unless the Secretary of Education issued final regulations by June 1994.⁶⁹

Lack of Standardization

During the middle and latter part of the 1980s, the concept of “national guarantors” and “national lenders” took hold. As a result, some organizations indicated that they were willing, in the case of guarantors, to guarantee loans outside the confines of their designated states, and, in the case of lenders, to disregard state borders when making student loans.

This development prompted protests from those providers whose service areas were threatened. Interstate marketing advanced nonetheless, and competition for schools and student borrowers began in earnest. The ensuing rivalry provided benefits to customers in the form of lower fees and a quicker turnaround of loans, but also deterred efforts to promote administrative simplicity and standardization.

⁶⁸ U.S. House of Representatives, Committee on Education and Labor, *Higher Education Amendments of 1992*, Report No. 102-447, Feb. 27, 1992, pp. 41-42.

⁶⁹ *Higher Education Act of 1965* (as amended), Sec. 421(d) [repealed in 1998].

For example, national lenders that dealt with multiple guarantors had to set up data systems that incorporated each guarantor's administrative requirements, contributing to additional management burdens for the lender community.

Furthermore, borrowers and schools struggled with a profusion of guidelines and loan options depending on which guarantor and lender the borrower was using. Many postsecondary institutions became weary of managing the profusion of loan processes imposed by lenders and guarantors. As a consequence, some schools and trade associations channeled this discontent into support for replacing the FFELP with either the Perkins Loan Program or a new Direct Loan Program. Either approach had appeal because, once implemented, institutions would control the loan origination process and no longer be subject to dissimilar lender and guarantor requirements and oversight.

In the words of a Washington trade association:

Direct lending would bring (in most cases) all components of a student's financial aid package to the campus, expedite the flow of funds to eligible students, and simplify and improve the receipt and disbursement of funds functions. We firmly believe that institutional administrative efficiencies and improved controls can be achieved under a Direct Loan Program when compared with the overall current guaranteed student loan process.⁷⁰

And the American Council on Education, an umbrella organization for associations representing postsecondary institutions, stated in 1993:

It appears to us that this legislation [the Direct Loan legislation] would result in a student loan program that is simpler and more comprehensible for students and institutions than the current Family Federal Education Loan Program [sic].⁷¹

FFELP-Provider Failures

Further exacerbating program troubles, the Higher Education Assistance Foundation, the largest guarantor in the country, became insolvent in 1990. The HEAF bankruptcy occurred primarily as a result of its market focus on proprietary schools with high default rates. Because the insurance reimbursements by the federal government are much lower if a guarantor crosses a certain threshold on its default rate, HEAF had large insurance losses, which depleted its reserve fund and caused its downfall.⁷²

⁷⁰ Testimony by the National Association of College and University Business Officers, as quoted in *The Chronicle of Higher Education*, by U.S. Senator Paul Simon, "Direct U. S. Lending to Students: A Debate," May 12, 1993.

⁷¹ *Congressional Record*, Letter from Robert H. Atwell to Congressman William Ford, May 11, 1993, as inserted on May 19, 1993, p. E1297.

⁷² U.S. General Accounting Office, *Financial Problems in the Stafford Student Loan Program*, July 1990, Abstract.

Other difficulties followed. Sen. Sam Nunn, in describing the work of a Senate oversight committee commented that:

The subcommittee also examined perhaps the largest single fiasco involving the GSLP [Guaranteed Student Loan Program] — the collapse of the First Independent Trust Co. [FITCO] of Sacramento, CA, at one time the second largest lender of GSL's in the Nation. FITCO's failure directly affected other major GSLP financial players — for example, the now-defunct Higher Education Assistance Foundation — a guaranty agency — the California Student Loan Finance Corp: a secondary market organization —and United Education and Software — a loan servicer — and will result in hundreds of millions of dollars in losses to the taxpayers.

Finally, as part of its investigation, the subcommittee scrutinized the U.S. Department of Education's management of the GSLP, finding its performance to be grossly inefficient and ineffective in virtually every area of its GSLP-related responsibilities. Indeed ... virtually every witness that testified at the subcommittee's hearings described instances of gross mismanagement, ineptitude, and/or neglect on the part of the Department.⁷³

The effect of these problems was that Congress, in the 1992 Higher Education Amendments, modified the statute to mandate that the Secretary must take over the functions of a guaranty agency in the event of insolvency, thus holding lenders harmless from guarantor failure.⁷⁴

Inadequate School Eligibility Criteria

The absence of rigorous school eligibility standards also created serious difficulties for the FFELP, because many borrowers attending poor-quality schools were lured into debts that they could not repay and thus suffered the adverse consequences of default. Congress, meanwhile, was torn between providing universal access and ousting unprincipled participants from the loan program. There was, however, a growing awareness of the significance of the default problem, and in the late 1980s, congressional leaders began to call for more stringent default prevention measures.⁷⁵

These initial efforts were insufficient, however. Unscrupulous schools continued to abuse the public trust by taking advantage of statutory and regulatory loopholes. Default rates surged. Sen. Edward Kennedy said in 1992:

A third issue of serious concern is the fraud and abuse in the current student loan program. In the past 5 years, we have seen a massive increase in loan defaults.

⁷³ *Congressional Record*, U.S. Senate, "Statement on Introduced Bills and Resolutions," July 19, 1991, p. S10495.

⁷⁴ *Higher Education Act of 1965* (as amended), Sec. 432(o).

⁷⁵ For examples, see the *Stafford Student Loan Default Prevention and Management Act of 1989* (S. 568) and *Student Loan Default Prevention Act of 1989* (H.R. 2193).

Most of these defaults can be attributed to schools that fail to deliver on their promise to prepare students for the job market. The sad fact is that we have seen a proliferation of schools more interested in making a profit than training students. Students from these schools, often from low-income backgrounds, are then unable to find employment, and are saddled with a student loan debt, which they cannot repay.⁷⁶

To rectify these weaknesses, the 1992 Reauthorization Amendments contained robust new school eligibility requirements and stringent default prevention measures.⁷⁷

The Early Years of Direct Loans

The 1992 Direct Loan Demonstration Program

During the 1992 reauthorization process, the House passed legislation that called for a full-scale direct student loan program.⁷⁸ The Senate, however, did not approve such a sweeping mandate, and the final reauthorization compromise was limited to a Direct Loan Demonstration Program that was to take effect on July 1, 1994.⁷⁹

The 1993 Direct Loan Program

During the presidential election campaign in 1992, candidate Bill Clinton made student loan reform a central component of his higher education platform, initially focusing on income contingent repayment as the cornerstone of his student loan proposals.⁸⁰

After the new Administration took office in 1993, the campaign promise of income contingent repayment of student loans was attached to a proposal to replace the FFELP with a government-funded student loan program. Although Democrats controlled both houses of Congress, the Senate, unlike the House, was not in favor of a rapid transition to full-scale Direct Lending.

Following lengthy negotiations, a compromise was reached to phase in a new Direct Loan Program according to a timetable far less ambitious than that originally envisioned by the House.^{81 82} Although the enabling legislation did not absolutely mandate a switch to Direct Lending, it contained many specific references to a transition to Direct Loans, and the sponsors envisioned that it would quickly garner support and replace the FFELP.^{83 84}

⁷⁶ *Congressional Record*, Senator Edward M. Kennedy outlining provisions of the Higher Education Amendments of 1992, June 30, 1992, p. S9262.

⁷⁷ Public Law No. 102-325, *Higher Education Amendments of 1992*, July 23, 1992, Various Sections.

⁷⁸ U.S. House of Representatives, H.R. 3553. Report No. 102-447, Sec. 451, Feb. 27, 1992.

⁷⁹ Public Law No. 102-325, *Higher Education Amendments of 1992*, July 23, 1992, Section 451.

⁸⁰ Steven Waldman, *The Bill*, Viking Penguin, New York, 1995, p. 14.

⁸¹ *Ibid.*, pp. 234-236.

⁸² Public Law No. 103-66, *Omnibus Budget Reconciliation Act of 1993*, August 10, 1993, Section 4021.

^{83 84} *Congressional Record*, "National Service Trust Act of 1993 and Student Loan Reform Act of 1993 – Message from the President of the U.S.," House of Representatives, May 5, 1993, p. H2297.

To promote such a switch, the law provided that the Secretary could conscript schools into the program to meet the following targets:

- For academic year 1994-1995, Direct Loans must represent 5 percent of the new student loan volume;
- For academic year 1995-1996, Direct Loans must represent 40 percent of volume;
- For academic years 1996-1997 and 1997-1998, Direct Loans must represent 50 percent of volume; and
- For the academic year that begins in fiscal year 1998, Direct Loans must represent 60 percent of volume.⁸⁵

The 1995 Direct Loan Repeal Initiative

Barely a year after the FDLP was implemented, the political picture changed completely. In 1994, the Democrats lost control of the House of Representatives for the first time in 40 years. That same year, Republicans also took over Senate leadership, thus setting the stage for attempts to repeal the Direct Loan Program.

Several Republican lawmakers in both the House and Senate quickly introduced legislation to phase out FDLP.⁸⁶ The repeal sponsors argued that the program inappropriately would (1) supplant the private sector, (2) create an enormous bureaucracy, (3) be less efficient than FFELP loans, and (4) not achieve the promised savings.^{87 88}

Repeal advocates were temporarily successful in Congress. The final version of the Balanced Budget Act of 1995 essentially would have abolished the FDLP by limiting the number of participating schools to the original 102 Direct Loan institutions.⁸⁹ President Clinton vetoed this measure, and efforts to eliminate the Direct Loan Program came to a standstill.

Competition and Streamlining

1996-2000

The years before the 2000 election were characterized by intense competition between the two student loan programs. The rivalry spurred the private sector to invest heavily in

⁸⁴ See, for example, *Higher Education Act of 1965* (as amended), Sections 453(a)(2) and 458(a) prior to repeal in 1998.

⁸⁵ *Higher Education Act of 1965* (as amended), Sec. 453(a)(2) and (b)(2) prior to repeal in 1998.

⁸⁶ See the following legislative proposals from the 104th Congress: H.R. 1501, S. 1198, H.R. 530, S. 495.

⁸⁷ U.S. 104th Congress, H. R. 1501, April 7, 1995.

⁸⁸ *Congressional Record*, House of Representatives, the Honorable Ernest Istook, "Extension of Remarks," June 8, 1995, p. E1211.

⁸⁹ U.S. 104th Congress, H. R. 2491, Oct. 17, 1995, Sec. 4002.

borrower benefits, predominantly in the form of fee and interest rate discounting. FFELP partners also focused their efforts on technology enhancements, formed coalitions and developed new methods to streamline and standardize their program.⁹⁰

At the same time, the Clinton Administration abandoned the goal of a complete transition to Direct Lending in favor of a commitment to improving the efficiency of both programs and allowing postsecondary institutions to choose which program best met their needs and the needs of their students.⁹¹

Thus, without opposition from the Administration, the 1998 Higher Education Amendments repealed the FDLP volume requirements and all references to a transition to Direct Loans.⁹²

Despite these tacit acknowledgements of the political need to support both loan programs, the Secretary continued diligently to promote the FDLP and also took advantage of new authorities granted in the 1998 Higher Education Amendments to provide price benefits to FDLP borrowers under closely circumscribed conditions.^{93 94} In 1999, the Secretary announced the following borrower discounts:

- A 1-percentage-point reduction in the upfront loan fee, also called the origination fee. The fee was reduced from 4 percent to 3 percent of the total loan balance.
- A 0.25-percentage-point interest rate reduction for borrowers paying electronically.
- A 0.6-percentage-point interest rate reduction for Direct Loan borrowers who consolidated their loans while they were in school, or during the grace period before they entered loan repayment.⁹⁵

In 2000, the Secretary announced additional price benefits for Direct Loan borrowers:

- Beginning with the 2000-2001 academic year, students became eligible for an upfront rebate worth 1.5 percent, which they would get to keep if they made their first 12 loan payments on time. This benefit effectively lowered the origination fee to 1.5 percent.

⁹⁰ For example, FFELP providers created a *Common Manual* of loan policy; a Clearinghouse for data exchange; a public-benefit organization, known as ELM, to facilitate the loan process; as well as the Meteor Project to facilitate information dissemination. Additional information about these initiatives can be found in Appendix F.

⁹¹ U.S. Department of Education, *Budget for Fiscal Year 1998, Appendix*, p. 431.

⁹² Public Law No. 105-244, Various Sections, Oct. 7, 1998.

⁹³ See, for example, U.S. Department of Education, *Direct Loan Newsletter*, quote from Secretary Richard Riley: "Direct lending epitomizes what good government is all about," Volume III, Number 2, March/April 1997, March 3, 1997.

⁹⁴ *Higher Education Act of 1965* (as amended), Sections 455(b)(7) and 459.

⁹⁵ U.S. Department of Education, News Release, "ED Announces Lower Student Fees on Direct Loans," June 16, 1999.

- Students who consolidated their loans with the Direct Loan Program would receive an interest rate reduction of 0.8 percent. This lower rate applied to loans consolidated between Oct. 1, 2000 and Sept. 30, 2001.⁹⁶

Several FFELP providers and organizations questioned the Secretary's authority to provide some of these benefits and the manner in which statutory requirements were followed. In November 2000, these organizations filed suit against the Secretary, claiming that he had violated statutory constraints on his authority.⁹⁷

Congress, meanwhile, ensured the continued viability of the FFELP by rejecting repeated budget proposals from the Clinton Administration aimed at reducing FFELP subsidies for lenders and guarantors.⁹⁸ If those cuts had been enacted, they likely would have limited the FFELP's ability to compete effectively and might possibly have led to the demise of the program.⁹⁹

The 2001 Student Loan Studies

Congress set the stage for renewed scrutiny of student loan program finances by mandating two studies as part of the 1998 Higher Education Amendments. One study called for the examination of the feasibility of using alternative financial instruments for determining lender yields in the FFELP. The second study required a review of market mechanisms in the federal student loan programs.¹⁰⁰

Study of Alternative Financial Instruments

The study involving alternative financial instruments for determining lender yields was completed in January 2001, and a report, without consensus recommendations, was submitted to Congress at that time.¹⁰¹ Interestingly, this final report was submitted more than a year **after** Congress already had passed legislation changing the financial instrument used to calculate lender subsidies from the 91-day Treasury Bill to 3-month commercial paper.¹⁰² This change, in effect, made the report obsolete.

⁹⁶ U.S. Department of Education, News Release, "Education Secretary Riley Announces Lower Interest Rates on Direct Student Loans & Consolidations," Aug. 10, 2000.

⁹⁷ U.S. District Court for the District Of Columbia, Student Loan Finance Corp et al., vs. Richard Riley, Secretary of Education, *Complaint for Declaratory Relief*, Civ. No. 00-2660 (RWR).

⁹⁸ U.S. Department of Education, Annual Budgets, Fiscal Years 1997, 1998, 1999, 2000, 2001.

⁹⁹ See, for example, *Chronicle of Higher Education*, "Clinton Reopens Debate on Subsidies for Lenders in Guaranteed Loan Program," Feb. 12, 1999, p. A32.

¹⁰⁰ *Higher Education of 1965* (as amended), Sections 801 and 802.

¹⁰¹ General Accounting Office and the Department of Education, *Final Report Regarding the Findings of the Study Group on the Feasibility of Using Alternative Financial Instruments for Determining Lender Yield Under the Federal Family Education Loan Program*, Jan. 19, 2001.

¹⁰² U.S. Congress, *Ticket to Work and Work Incentives Improvement Act of 1999*, Public Law No. 106-170, Dec. 17, 1999, Sec. 409.

Study of Market Mechanisms in Federal Student Loan Programs

The second student loan study mandated by the 1998 Higher Education Amendments was far-reaching. Its main focus was to evaluate whether additional market forces could be applied to the student loan programs to promote better service and lower costs for borrowers and the federal government. Specifically, the legislation described the study as follows:

The study required under this section shall identify not fewer than 3 different market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the programs under parts B and D of such title IV, including the provision of loans to all eligible students. Consideration may be given to the use of auctions and to the feasibility of incorporating income contingent repayment options into the student loan system and requiring borrowers to repay through income tax withholding.¹⁰³

The 1998 Amendments called for the report to contain findings, but did not specify that any recommendations must be included.¹⁰⁴

A draft report was released in January 2001, just before President Clinton left office and the Bush Administration published a final report in December of that year. Both reports included evaluations of five different market-mechanism models, but neither recommended changes to the current FFELP system.¹⁰⁵ ¹⁰⁶ To date, no adjustments have been made to the FFELP as a result of the report, which is excerpted in Appendix D.

2001-2007

Bush Administration Activities

Since the President Bush took office in 2001, competition between FFELP and Direct Loans has continued. Although the Bush Administration has not promoted the FDLP as vigorously as did the Clinton Administration, the Secretary did continue to offer the 1 percent origination fee reduction until passage of the 2006 Higher Education Reconciliation Act of 2005. Furthermore, the 0.25-percent electronic payment discount and the FDLP 1.5-percent upfront loan rebate still are in effect.

The Bush Administration, like the Clinton Administration before it, has voiced support for both loan programs, and in 2007, re-inserted the following statement in the

¹⁰³ *Higher Education Act of 1965* (as amended), Sec. 801(b).

¹⁰⁴ *Higher Education Act of 1965* (as amended), Sec. 801(d)

¹⁰⁵ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Draft, January 2001.

¹⁰⁶ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Dec. 18, 2001.

president's budget, a variation of which has been included in previous budgets for at least the past nine years¹⁰⁷:

For 2007, the President is committed to improving the efficiency of both programs and allowing individual institutions to choose which of these two programs best meets their needs and the needs of their students."¹⁰⁸

A budget document from FY 2006 included a statement that expressed some ambiguity toward the Direct Loan Program:

The Administration is strongly committed to the lender-based FFEL program and expects it to continue as the primary source of loans to students in the years ahead. In addition, the Administration will continue to maintain a DL program to ensure that no eligible student is denied access to student loans in the event a student or school cannot find a suitable lender.¹⁰⁹

One of the Administration's FY 2006 and FY 2007 budget proposals with a direct impact on the FDLP was a recommendation to move the monies to administer the Direct Loan program from the mandatory side of the ledger to a discretionary spending account, thus subject to annual appropriations.¹¹⁰ That request was adopted as part of the Higher Education Reconciliation Act of 2005.¹¹¹

Co-Existence of FFELP and FDLP

As described previously, during the early years of FDLP there were numerous attempts by adherents of either FFELP or Direct Loans to eliminate the "other" program. In the late 1990s and early 2000s, however, policy-makers generally supported allowing the programs to co-exist and compete.

This bipartisan neutrality did not last. From 2003 onward, a number of members of Congress introduced legislation intended to provide incentives to schools for participating in the Direct Loan Program. The rationale for these proposals was that, according to budget data, participation in the FDLP would save substantial sums of money. These legislative initiatives, which were not enacted during the 108th and 109th Congresses and are pending in the 110th, are outlined in Chapter 4.

Higher Education Reconciliation Act of 2005

Reauthorization of the Higher Education Act was slated to occur in 2003, but had not yet been finalized as of February 2007. The student loan programs were reauthorized through

¹⁰⁷ See, for example, the FY 1998 Education Budget Summary posted at <http://www.ed.gov/offices/OUS/Budget98/BudgetSum/summary7.html>, no page numbers, accessed Feb. 11, 2007.

¹⁰⁸ U.S. Department of Education, *Fiscal Year 2008 Budget, Appendix*, p. 335.

¹⁰⁹ U.S. Department of Education, *Fiscal Year 2006 Budget Analytical Perspectives*, p. 96.

¹¹⁰ U.S. Department of Education, *Fiscal Year 2006 Budget, Appendix*, p. 364

¹¹¹ Public Law No. 109-171, Feb. 8, 2006.

the Higher Education Reconciliation Act of 2005, which was signed into law on Feb. 7, 2006.¹¹² Many non-budget loan program proposals were not included in the HERA because of prohibitions on considering purely “policy” issues in the budget reconciliation process.

The HERA included provisions that dealt with the following issues:

- Loan limits.
- Interest rates.
- Loan fees.
- Repayment options.
- School-as-lender.
- Lender yields.
- Guarantor financing.

The HERA changes are detailed in the relevant chapters of this paper.

CONSOLIDATION LOANS: A BRIEF HISTORY

FFELP Consolidation

1980-1986

Federal student loan consolidation had its genesis in a late-1970s student movement that called for longer repayment periods to ease the burden of high indebtedness and demanded that borrowers be given the ability to consolidate loans from multiple lenders or programs into one note.¹¹³

Congress was receptive to these concerns, and the Higher Education Amendments of 1980 included a program that allowed borrowers with at least \$7,500 in debt or with multiple loans to consolidate and extend the repayment period for up to 20 years, depending on level of indebtedness.¹¹⁴

The Student Loan Marketing Association, commonly known as Sallie Mae, which was originally established by statute as a secondary market in 1972, was given sole authority to consolidate loans, although that authority could be shared with other entities. Sallie Mae chose, however, to implement the program without allowing other organizations to participate. This exclusivity was opposed by many in the student loan community who claimed that Sallie Mae was creating a consolidation loan monopoly.¹¹⁵ The outcome of

¹¹² *Ibid.*, Sec. 8004.

¹¹³ U.S. House of Representatives, Committee on Education and Labor, Subcommittee on Postsecondary Education, *Reauthorization of the Higher Education Act*, Hearing, May 30, 1979, pp. 46–105.

¹¹⁴ Public Law No. 96-374, Oct. 3, 1980.

¹¹⁵ U.S. Senate, Committee on Labor and Human Resources, Subcommittee on Education, Arts and the Humanities, *Oversight of Student Loan Marketing Association*, Hearing, Aug. 12, 1982, pp. 72-90.

the conflict was that Congress, in 1983, rescinded Sallie Mae's authority to consolidate loans. For three years, a consolidation program was not offered to borrowers.¹¹⁶

During this interim, Congress continued to work toward consensus on a program that would enable virtually all loan holders to consolidate loans. The resulting compromise was enacted as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (which was passed in 1986) and the Higher Education Amendments of 1986.^{117 118}

Both the House and Senate versions of the 1986 consolidation legislation included provisions that would **increase** the borrower interest rate over time.¹¹⁹ The 1986 conference agreement mandated a fixed rate, based on the weighted average rates of the underlying loans, with a **minimum** rate of 9 percent. This was a full percentage point higher than the 8 percent rate in effect, at that time, for the first five years of repayment of an unconsolidated loan.¹²⁰

The 1986 FFELP consolidation program permitted only borrowers whose outstanding student loan debt was at least \$5,000 to consolidate.¹²¹

1986-1995

From 1986 until the advent of Direct Lending in 1995, the FFELP consolidation program grew at a modest pace: from less than \$300 million in annual volume in 1987 to about \$2 billion in 1994.¹²² Implementation was relatively uncomplicated, with banks, secondary markets and Sallie Mae all able to cooperate to get the program off to an auspicious albeit measured start.

A number of restrictions on borrower eligibility also contributed to the fairly limited initial scope of the program. For example, as noted above, interest rates were higher than those for Stafford loans until 1994, when the **minimum** rate of 9 percent was eliminated, but no interest rate cap was enacted.¹²³

In addition, borrowers were also subject to a minimum balance requirement that was raised to \$7,500 after enactment of the 1992 Amendments. Less than one year later, all minimum balance requirements for consolidation loans were eliminated. Borrowers with

¹¹⁶ Public Law No. 98-79, Aug. 15, 1983.

¹¹⁷ Public Law No. 99-272, *Consolidated Omnibus Budget Reconciliation Act of 1985*, April 7, 1986.

¹¹⁸ Public Law No. 99-498, Oct. 17, 1986.

¹¹⁹ *Higher Education Amendments of 1986*, "Conference Report to Accompany S. 1965," Sept. 22, 1986, p. 398.

¹²⁰ *Ibid.*, p. 399.

¹²¹ Public Law No. 99-272, *Consolidated Omnibus Budget Reconciliation Act of 1985*, April 7, 1986.

¹²² U.S. Department of Education, *Guaranteed Student Loan Programs Data Book FY 1988*, p. 18 and U.S. Department of Education, *Federal Student Loan Programs Data Book FY94-FY96*, Table 20.

¹²³ *Omnibus Budget Reconciliation Act of 1993*, "Conference Report to Accompany H.R. 2264," Aug. 4, 1993, p. 53.

a balance of less than \$7,500 could not extend their repayment period beyond 10 years, however.^{124 125 126}

It is also important to note, that from 1995 to 1997, FFELP borrowers were able to consolidate into FDLP, but Direct Loan borrowers were precluded, by law, from taking out a FFELP consolidation loan.

1996-2007

As a result of emergency legislation in 1997, both programs were authorized to consolidate each other's loans, and their interest rate formulas were aligned.¹²⁷

Accordingly, from 1997 to 1998, both programs operated under a **variable** interest rate, but the 1998 Amendments established a **fixed** rate, still in effect, based on the weighted average rates of the underlying loans, rounded up to the nearest one-eighth of 1 percent, with a cap of 8.25 percent.^{128 129}

Currently, if they are otherwise eligible, all borrowers can consolidate their loans, regardless of their loan balance. To extend the repayment period beyond 10 years, however, borrowers must owe at least \$7,500 on their loans.¹³⁰

Direct Consolidation Loan Program

1995-1997

The purpose of the Direct Consolidation Loan Program, which became operational in 1995, was the same as that of its FFELP counterpart: Borrowers were given the option of consolidating multiple loans from different loan programs, including FFELP loans and FFELP consolidation loans, or extending payments on large amounts of debt.¹³¹

The Direct Consolidation Loan Program initially was excluded from the statutory requirement that mandates parallel terms and conditions for FDLP and FFELP.¹³² Thus, from 1995 to 1997, the program carried a variable interest rate, capped at 8.25 percent, identical to the regular Direct Loan rate.¹³³ In contrast, the FFELP consolidation rate still was fixed, based on the weighted average of the underlying loans.

¹²⁴ Public Law No. 102-325, July 23, 1992.

¹²⁵ Public Law No. 103-66, Aug. 10, 1993.

¹²⁶ *Higher Education Act of 1965* (as amended), Sec. 428C(c)(2).

¹²⁷ Public Law No. 105-78, Nov. 13, 1997, Sec. 609(b).

¹²⁸ *Ibid.*, Sec. 609(e).

¹²⁹ *Higher Education Amendments of 1998*, "Conference Report to Accompany H.R. 6," Sept. 26, 1998, Sec.

416.

¹³⁰ *Higher Education Act of 1965* (as amended), Sec. 428C (c)(2)

¹³¹ *Higher Education Act of 1965* (as amended), Sec. 455(g).

¹³² *Higher Education Act of 1965* (as amended), Sec. 455(a).

¹³³ 34 CFR, 685.216(g).

Direct Consolidation Loans also offered in-school consolidation, income contingent repayment and the ability to re-consolidate a previously consolidated loan. Furthermore, Direct Consolidation Loan borrowers initially were not permitted to consolidate into FFELP, whereas FFELP borrowers could cross-consolidate under certain conditions. Many of these terms were not conferred by law. Rather, they were a result of FDLP regulations that had no equivalents under FFELP.¹³⁴

1997-2006

As mentioned above, during the early days of Direct Consolidation Loans, FFELP borrowers were eligible to consolidate their loans into the Direct Loan Program, but the Direct Loan borrowers could not consolidate into the FFELP.

This arrangement changed as a result of the Direct Consolidation Loan Program's collapse in 1997. During this time "the Department of Education was facing a backlog of more than 80,000 applications for Direct Student Loan consolidations, and had stopped accepting new applications for loan consolidations altogether," Congress incorporated emergency loan consolidation language into that year's appropriations bill. The new legislation permitted FFELP lenders, for the first time, to consolidate Direct Loans. This authority was made permanent in the 1998 reauthorization of the Higher Education Act, and as a result, borrowers from both programs were able to cross-consolidate.^{135 136 137}

Despite the statutory mandates for two-way cross-consolidation and identical maximum interest rates, significant differences remained between the two programs from the late 1990s until the passage of the HERA in 2006. For example, one such difference was the continuation of the FDLP in-school consolidation option, which was promoted vigorously in the late 1990s by the Department of Education based on claims that borrowers could save substantial sums if they consolidated while in school.^{138 139}

2006-2007

The HERA altered the statute to require that Direct Consolidation Loans must adhere to the requirement for parallel terms and conditions between the two programs, unless otherwise specified in law. As a result, except for the income contingent repayment option, all previous FDLP regulatory consolidation benefits are no longer available if they have no statutory FFELP counterpart.¹⁴⁰

¹³⁴ 34 CFR, 685.216.

¹³⁵ Congressional Record, *Emergency Student Loan Consolidation Act of 1997*, House of Representatives, Oct. 21, 1997, p. 8846.

¹³⁶ Public Law No. 105-78, Nov. 13, 1997, Sec. 609.

¹³⁷ *Higher Education Act of 1965* (as amended), Secs. 428C(a)(4) and 428C(b)(5).

¹³⁸ *Ibid.*

¹³⁹ U. S. Department of Education, "Dear Colleague Letter," GEN-99-17, June 18, 1999.

¹⁴⁰ Public Law No. 109-171, Feb. 8, 2006, Sec. 8009.

3. FFELP AND FDLP COST STUDIES

HIGHLIGHTS

Which student loan program is more cost-effective? After more than 10 years of Direct Loans, the answer continues to depend on the source of the response. Accordingly, a fervent debate continues on the question of student loan costs, and numerous reports published since 1991 have weighed in with attempted answers. These studies can be categorized as follows:

- Reports published by Direct Lending advocates.
- Reports commissioned by FFELP participants.
- Official reports published by independent government oversight entities.

Some government reports have maintained that there are no winners in the cost contest: For example, the Department of Education’s Inspector General concluded that, in terms of total costs (administrative and subsidy) **“in any given year, either student loan program may be more expensive than the other, depending on how economic conditions affect subsidy costs.”** [Emphasis supplied]¹⁴¹

The FFELP may be less expensive than the FDLP to **administer**, however. In 1999, the Inspector General estimated that the per-unit administrative cost of a Direct Loan was \$17 — \$4 higher than the projected \$13 cost of managing an FFELP loan.¹⁴²

Several other government entities also have attempted to assess the actual cost to the federal government of the loan programs, but have experienced difficulties amassing sufficient data for adequate analysis.

In 2005, both the General Accountability Office and the Congressional Budget Office reiterated that the Credit Reform Act subsidy estimates did not provide a complete picture of federal student loan costs. The GAO stated that:

While subsidy cost estimates include many of the federal costs associated with FFELP and FDLP loans, they do not capture all federal costs and revenues associated with the loan programs. Consideration of all federal costs and revenues of the loan programs would be an important component of a broader assessment of the costs and benefits of the two programs.¹⁴³

The Congressional Budget Office echoed the GAO caveat:

¹⁴¹ U.S. Department of Education, Office of Inspector General, *Study of Cost Issues, Federal Family Education Loan Program, Federal Direct Loan Program*, March 1999, CN S13-70001, pp. 1-2.

¹⁴² *Ibid.*

¹⁴³ General Accountability Office, Student Loans, *Federal Student Loans, Challenges in Estimating Federal Subsidy Costs*, GAO-05-874, September 2005, p. 35.

... The subsidy calculations under the Credit Reform Act are not designed to fully capture the economic costs to the government of the assistance that the student loan programs provide, nor do they capture all of the effects of the programs on federal spending and revenues.¹⁴⁴

On several occasions, congressional Republicans have asked for more definitive data in an attempt to shed light on some of the cost questions. Based on the language included in the FY 2006 joint statement of managers on the budget resolution conference agreement and in the House committee report accompanying the FY 2007 budget resolution, it is apparent that those questions have not yet been fully answered:

From the FY 2006 Conference Report:

Although the Congress strongly supports the Federal student loan programs, it is increasingly concerned that the subsidy estimates for the Ford Direct Loan Program do not reflect the program's true cost to the Federal Government.

For example, the President's 2006 budget reveals that although the program was expected to result in a net savings of \$2 billion from its inception through fiscal year 2004, the actual experience is that the program resulted in a net cost to taxpayers of \$3 billion over the same period. This represents a \$5-billion underestimate of the program's actual cost to taxpayers over roughly 10 years.

Accordingly, the Congress supports the administration's continuing efforts to direct the Department of Education to refine and improve its cost estimating techniques for this program.

The Congress believes it is important for estimates to be corrected for all known deficiencies so that the decision makers have sufficient information to compare the cost to taxpayers of competing policy options, and large-scale structural reform proposals, in the student loan programs.¹⁴⁵

From the FY 2007 House committee report:

Although the committee strongly supports the Federal student loan programs, members remain concerned that the baselines for student loans may not provide a sufficiently accurate indication of true economic costs. This concern was validated by the publication of reports last year by two different congressional support agencies. Both of the reports — one published by the Congressional Budget Office and the other by the Government Accountability Office — found

¹⁴⁴ Congressional Budget Office, *Subsidy Estimates for Guaranteed and Direct Student Loans*, November 2005, p. vii.

¹⁴⁵ U.S. House of Representatives, *Conference Report, House Report 109-062, Concurrent Resolution on the Budget for Fiscal Year 2006*, April 28, 2005, p. 42.

the subsidy cost estimates calculated under the Credit Reform Act do not fully capture all governmental costs associated with the Direct Loan Program.

The Budget Committee is committed to working with both the Committee on Education and the Workforce and the Congressional Budget Office to identify additional cost factors that could be incorporated into future baselines and subsidy estimates. Through the use of studies and other analyses, the committee looks forward to identifying and evaluating other quantifiable factors that might significantly contribute to the certainty and accuracy of student loan estimates.¹⁴⁶

Profiled below, in chronological sequence, are compendia of cost-comparison reports published by both governmental and private entities.

COST COMPARISON REPORTS

1991 and 1992 GAO Studies

In 1991, subsequent to the new scoring criteria mandated by the 1990 credit reform legislation, the General Accounting Office published its first comprehensive report on the feasibility of Direct Lending.

The report claimed that:

A Direct Loan Program operating in place of the Stafford Loan Program could save over \$1 billion — present value terms — assuming the loans are made in fiscal year 1992. Our baseline estimate of the budgetary cost for a 1-year cohort of loans is \$2.71 billion for Stafford loans as compared with \$1.55 billion for Direct Loans. Depending on the assumptions we made, our estimated savings ranged from \$620 million to \$1.47 billion. These savings result primarily from the absence of in-school interest and special allowance payments to lenders.¹⁴⁷

In 1992, the GAO released a follow-up report that also concluded, “A switch to direct student loans could save the federal government about \$4.8 billion — in present value terms — within the first five years of implementation.”¹⁴⁸

1993 CBO Estimates

The official CBO estimates accompanying the 1993 Budget Reconciliation Conference Agreement projected that implementation of the Direct Loan Program, according to the criteria in the legislation, would save \$4.3 billion in federal outlays during the fiscal year

¹⁴⁶ U. S. House of Representatives, House Budget Committee Report 109-402, *Concurrent Resolution on the Budget for Fiscal Year 2007*, March 31, 2006, pp. 36-37.

¹⁴⁷ General Accounting Office, Student Loans, *Direct Loans Could Save Money and Simplify Program Administration*, Sept. 27, 1991, p. 3.

¹⁴⁸ General Accounting Office, Student Loans, *Direct Loans Could Save Billions in First Five Years with Proper Implementation*, Nov. 25, 1992, p. 3.

1994-98 period.¹⁴⁹ These estimates conformed to the rules laid out by the Credit Reform Act, which did not recognize the long-term federal administrative costs of student loans.

1993 CRS Estimates

Opinions differed sharply among government officials about the validity of the 1992-93 cost estimates. A 1993 Congressional Research Service Report maintained that “if ... the current program structure provides lenders a competitive return, there are neither real budget savings nor national income increases from conversion to Direct Lending.”¹⁵⁰

Another CRS document examined the assumptions underlying CBO’s Direct Loan savings estimates and found that:

The essential problem here is that the budget accounting rules have forced the comparison of these alternative lending techniques into a context divorced from economic reality. Operating under budget accounting rules that force us to say that up is down does not make it so; unfortunately, it takes time (multiple years) for economic reality to become obvious to those who are required to make policy based on the current estimates.¹⁵¹

1995 Department of Education Direct Loan/FFELP Cost Update

The Administration proposed, in 1995, to expedite the phase-in of the Direct Loan Program. As justification, the Administration presented a new cost study, which concluded that such a policy would save an additional \$5.2 billion in outlays over the 1996-2000 period. Total savings attributed to the Direct Loan Program and the implementation of the 1993 Student Loan Reform Act would, as a consequence, increase to \$12 billion during the five-year period.¹⁵²

The conclusions drawn by this study echoed those of an earlier report published by the Administration, which estimated \$6.2 billion in outlay savings over the fiscal year 1994-1998 period as a result of the Student Loan Reform Act. These savings totaled \$1.9 billion more than estimates used at the time of the passage of the legislation.¹⁵³

1995 Barents Group Analysis

In 1995, former Congressional Budget Office Director Rudolph Penner, who previously had issued a report critical of claims of Direct Loan savings, prepared an analysis in

¹⁴⁹ U.S. Congress, Congressional Budget Office, *Cost Estimate of the Conference Agreement on Title IV of the Omnibus Budget Reconciliation Act of 1993*, Aug. 3, 1993.

¹⁵⁰ Congressional Research Service, Barbara Miles and Dennis Zimmerman, *Federal Family Education Loans: Reduced Costs, Direct Lending, and National Income*, CRS Report 93-247 E, Feb. 22, 1993, Summary.

¹⁵¹ Congressional Research Service, Memorandum from Barbara Miles and Dennis Zimmerman to the Honorable Bart Gordon, April 23, 1993.

¹⁵² U.S. Department of Education, *Direct Loan/FFEL Program Cost Update*, February 1995.

¹⁵³ U.S. Department of Education, *Direct Loan/FFEL Program Cost Update*, September 1994.

which he maintained that the Administration's budgetary documentation related to student loans greatly exaggerated the savings that could be gained from a shift to Direct Loans.¹⁵⁴

The analysis, which was commissioned by the pro-FFELP Coalition for Student Loan Reform, contended that, if administrative costs were factored into the costs of Direct Loans, "on average, 80 percent of the savings projected by the Administration over academic years 1996-2000 would disappear."¹⁵⁵

The review also asserted that:

Other factors, such as the economic consequences of the higher national debt that results from Direct Lending, place in serious doubt if any savings can be realized or whether the program will end up costing taxpayers more money in the long term.¹⁵⁶

1995 CBO Estimates

Republicans in Congress were concerned about the budgetary impact of the omission of the long-term federal administrative costs from Direct Loan cost estimates. Consequently, the fiscal year 1996 and 1997 budget resolutions (but not subsequent years' resolutions) mandated the inclusion of these costs in budget estimates.¹⁵⁷

The resulting CBO recalculations concluded that Direct Loans were **more** expensive than FFELP loans. This was a complete reversal of previous estimates, which had **not** included the administrative costs of Direct Loans. According to the Congressional Budget Office:

Incorporating the direct administrative costs of direct student loans in the subsidy calculation (under the assumptions of the budget resolution) brings the subsidy costs of Direct Loans to levels slightly above that for guaranteed loans in each of the next seven years except 1997. As a result, a shift to 100 percent guaranteed loans would reduce overall subsidy costs under the assumptions of the budget resolution. ...¹⁵⁸

¹⁵⁴ Dr. Rudolph G. Penner, "Budgetary Savings Exaggerated under the Direct Government Student Loan Program," Barents Group, March 1995, p. 1.

¹⁵⁵ Ibid.

¹⁵⁶ Ibid.

¹⁵⁷ U.S. 104th Congress, H. Con. Res. 67, Sec. 207 and H. Con. Res. 178, Sec. 303.

¹⁵⁸ Congressional Budget Office, Letter from June O'Neill to the Honorable William F. Goodling, July 26, 1995, p. 2.

1997 CRS Study

In 1997, after the Direct Loan Program had been operational for several years, the Congressional Research Service also concluded that Direct Loans might be more costly than FFELP loans:

A change in delivery systems from guaranteed to Direct Loans or the reverse [the FFELP] does not lower program costs unless the rules differ. The Direct Loan income contingent repayment plan (ICR) is a rule that appears to raise costs. Were ICR removed, the costs would not differ for FFEL and Direct Loans. Current limited use of ICR implies only marginally higher Direct Loan costs. Should ICR use increase, costs will rise accordingly.¹⁵⁹

1997 Study by Macro International, Inc.

Shortly after the enactment of the Direct Loan Program, the Department of Education signed a contract with Macro International, Inc. to undertake a five-year evaluation of the program. Macro was charged with:

Conducting a series of institutional case studies as part of the evaluation of the William D. Ford Federal Direct Loan Program. Commissioned by the U.S. Department of Education (ED), this evaluation is examining the overall effectiveness of the Direct Loan Program in terms of reduced cost to the federal government, simplified administration, and customer satisfaction.¹⁶⁰

Macro's initial plan was "to benchmark the two programs [FDLP and FFELP] at a particular point in time so that the changes in costs over time can be put into context." Macro further insisted that it was essential to have "an accurate and defensible allocation of administrative and contractor servicing costs between the two programs. ..."¹⁶¹

In 1997, the cost component of the Macro evaluation was abruptly terminated. In the words of the Evaluation Director:

During the summer of 1997 we were hard at work estimating the Federal costs of the loan programs when our work was stopped by the Department of Education. We were told to turn over all of our work documents and to provide a summary of our work-to-date, which we did on August 15, 1997.¹⁶²

¹⁵⁹ Congressional Research Service, *Reducing Federal Loan Costs: The Options Are Narrowing*, Barbara Miles and Dennis Zimmerman, Feb. 19, 1997, Summary.

¹⁶⁰ U.S. Department of Education, Office of the Under Secretary, Direct Loan Evaluation, *Case Study Summary Report Academic Year 1996-97, Volume One*, Study Findings, 1998.

¹⁶¹ U.S. Department of Education, *Direct Loan Evaluation*, Macro International Inc., Third Annual Report on Cost Issues, Vol. I, March 1997, p. 1.

¹⁶² U.S. House of Representatives, Subcommittee on Criminal Justice, Drug Policy and Human Resources, Committee on Government Reform, *Statement of Dr. Fred J. Galloway, formerly Project Director, Direct Student Loan Evaluation*, Macro International, Inc., July 17, 1999.

According to *The Chronicle of Higher Education*:

Macro International, a company hired by the Education Department to evaluate the Direct Loan Program, was forced in 1997 to scrap a study it had begun on the issue after department officials canceled that portion of Macro's contract. A department spokeswoman said the study had been canceled because officials felt that it would be "duplicative" of others being conducted. But some observers believe that the department took the action because it did not agree with Macro's early findings.¹⁶³

1999 Inspector General Cost Estimates

The termination of the Macro study prompted the Department of Education's Inspector General to take on the task of comparing the costs of the two student loan programs. The OIG reported:

We reached two principal conclusions. First, in any given year either FFELP or FDLP total costs (administrative and subsidy) may be greater, given the impact of prevailing economic conditions on subsidy costs. Since costs may be higher or lower at any one point in time, a total cost figure for any one year does not definitively answer the question of whether the FFELP or FDLP is more expensive.

Secondly, we concluded that inefficiencies likely affect the Department's administration of the two programs. To approximate the effect of these inefficiencies, we compared our estimate of the Department's cost to manage the FDLP — \$17 per loan — to the average cost that we estimated (based on US Treasury research) that large private lenders would have incurred to manage the FDLP — \$13 per loan. A significant portion of the \$4 difference may be due to inefficiencies; however, some of the difference may be due to other factors. We believe that the Department's inefficiencies affect its administration of the FFELP, but we were unable to estimate the extent because no private sector entity performs comparable oversight functions like the Department performs for the FFELP.¹⁶⁴

1999 Department of Education Cost Study

At the end of 1999, the Department of Education released a report claiming that overall costs for the Direct Loan Program were substantially lower than FFELP costs, even when federal administrative costs were taken into account. Specifically the report asserted that:

¹⁶³ *The Chronicle of Higher Education*, "Report Challenges Idea That Direct Lending Is Cheaper Than Guaranteed Program," April 2, 1999, p. A42.

¹⁶⁴ U.S. Department of Education, Office of Inspector General, *Study of Cost Issues, Federal Family Education Loan Program, Federal Direct Loan Program*, March 1999, CN S13-70001, pp. 1-2.

Federal subsidy expenses associated with making \$10,000 in loans total \$1,305 for FFEL and \$773 for Direct Loans. Corresponding Federal administrative costs total \$102 for FFEL and \$362 for Direct Loans.¹⁶⁵

The Chronicle of Higher Education paraphrased these findings as follows:

For every dollar of those loans [Direct Loans], the government will earn 4 cents, because borrowers' interest payments will offset the costs of running the program, the Education Department contended. For every dollar of federally guaranteed loans, meanwhile, the government will pay about 14 cents in special subsidies to private lenders and guarantors.¹⁶⁶

2000 Barents Group Review

In early 2000, the Barents Group, at the request of the Education Finance Council, a FFELP trade association representing nonprofit secondary markets, prepared a rebuttal to the Department's 1999 cost study. The Barents Group review concluded that the Department of Education's assumptions were flawed because:

- Cost estimates were based on optimistic interest rate projections.
- Estimates were based on unrealistic assumptions about Department of Education efficiency, default rates and other key cost drivers.
- Estimates did not permit direct "apples-to-apples" comparison of the two programs.¹⁶⁷

The review concluded that the Department's study should not be used "as a basis for reliable comparison of the relative efficiencies of these two programs, or for making public policy decisions about how they should be structured."¹⁶⁸

2001 GAO Cost Estimate Study

In 2001, the General Accounting Office issued a report that answered a series of questions raised by members of Congress related to the cost of the Direct Loan Program. These responses represent a marked change from earlier GAO reports that had attributed substantial cost savings to Direct Loans.

The GAO reiterated the Inspector General's assertion that the Direct Loan Program may experience negative or positive subsidy costs, depending on economic circumstances:

¹⁶⁵ U. S. Department of Education, *Incorporating Federal Administrative Costs into FFEL and Direct Loan Program Cost Estimates*, November 1999, p. 1.

¹⁶⁶ *The Chronicle of Higher Education*, "Direct-Loan Program Costs Less Than Its Rival, Education Department Claims," Dec. 10, 1999, p. A34.

¹⁶⁷ Barents Group, *Preliminary Review of Department of Education's Report on Student Loan Costs*, Jan. 17, 2000, p. 2.

¹⁶⁸ *Ibid.*

Because FDLP's subsidy costs are determined largely by interest rates — specifically the difference, or spread, between the borrower and discount rates [generally the rate at which Education borrows money from the Department of the Treasury to finance its loans] — and since interest rate fluctuations cannot be predicted with any certainty, it is uncertain that the current trend in negative subsidy costs for FDLP will continue. A change in interest rates, for example, can cause a negative subsidy to become positive. ...

Additionally, Education's current model for estimating FDLP subsidy costs does not directly take into account certain key factors, such as prepayments and consolidations. This limitation hinders Education's ability to determine the impacts of consolidation activities, which are increasing significantly. Also, Education was unable to provide actual data related to defaults, which are a key assumption. Finally, the fact that Education does not currently have the information readily available to make meaningful comparisons of estimated to actual cash flows, and, most important, to identify the reasons for differences, significantly impedes Education's ability to refine future estimates based on actual results.¹⁶⁹

Finally, in response to a specific question concerning ED's claim that every \$100 of Direct Loans made would save more than \$4, the GAO stated:

The projected savings will not necessarily occur with other cohorts and may not continue to occur for the fiscal year 2000 cohort, depending on future interest rate fluctuations. ... The total program cost could change from \$4.11 in cost savings for every \$100 in loans for the fiscal year 2000 cohort to 58 cents in costs for every \$100 in loans for the fiscal year 2001 cohort.¹⁷⁰

2004 GAO Cost Estimate Study

In 2004, the General Accounting Office issued a report as a follow-up to its 2001 study, which had identified the need for the Department of Education to improve its cost estimation process to provide more meaningful information about the Direct Loan Program. Although the GAO noted that progress had been made on some cost estimate items, the report noted that ED:

Has not taken action to fully resolve our recommendations to (1) formalize sensitivity analysis of its cash flow model assumptions to ensure that the most significant assumptions are identified, or (2) develop and implement a method of comparing detailed estimated and actual cash flows to more thoroughly assess loan performance estimates over time. Education officials agreed that additional procedures related to sensitivity analysis and comparing estimated and actual loan

¹⁶⁹ U.S. General Accounting Office, Report to Congressional Requesters, *Department Of Education, Key Aspects of the Federal Direct Loan Program's Cost Estimates*, January 2001, pp. 44-45.

¹⁷⁰ *Ibid.*, pp. 41-42.

performance would be beneficial and a recently formed working group will consider additional procedures related to these issues.¹⁷¹

As indicated in the table below, for the years 1995-2003 ED significantly underestimated cash flows in the Direct Loan Program in three out of four areas:

TABLE 1. Estimated and Actual Key Direct Loan Cash Flows for Fiscal Years 1995-2003¹⁷²

Key Cash Flows	Actual Cash Flows (millions)	Estimated Cash Flows (millions)	Difference (millions)	Percentage Difference
<i>Principal receipts</i>	\$38,991.7	\$36,259.4	\$2,732.3	7.0%
<i>Interest receipts</i>	\$9,113.0	\$15,237.0	\$(6,124.0)	(67.2)%
<i>Origination fees</i>	\$2,864.7	\$3,008.2	\$(143.5)	(5.0)%
<i>Default collections</i>	\$1,547.4	\$2,234.7	\$(687.3)	(44.4)%
Total	\$52,516.8	\$56,739.3	\$(4,222.5)	(8.0)%

The GAO summarized these cash flows as follows:

For fiscal years 1995 through 2003, total cash outflows exceeded total cash inflows by about \$10.7 billion, mainly because interest Education paid to Treasury was significantly greater than interest receipts from borrowers. This is primarily because Education is required to make interest payments to Treasury, even if borrowers are not making interest payments to Education, which could occur when borrowers are in school or in a grace or deferment period. Over this same period, FDLP’s actual key cash flows (principal receipts, interest receipts, origination fees, and collections on defaults) were less than estimated by about \$4.2 billion, primarily because Education overestimated interest receipts by about \$6.1 billion.¹⁷³

2004 Center for American Progress Study

In 2004, the Center for American Progress, an organization affiliated with the progressive movement, released a report asserting that a move to FDLP would generate savings that were twice as high as those claimed by ED in 1999. The report declared that:

Based on data provided in a 1999 U.S. Department of Education report on the administrative costs of each student loan program and the “subsidy” costs associated with each loan program contained in the Administration’s budget for

¹⁷¹ General Accounting Office, *Department of Education’s Federal Direct Loan Program , Status of Recommendations to Improve Cost Estimates and Presentation of Updated Cash Flow Information, Briefing to the Staff of the House Committee on the Budget*, Feb. 18, 2004, p. 6.

¹⁷² Ibid, p. 50.

¹⁷³ Ibid, p. 9.

fiscal year 2005, we can estimate that Direct Loans cost the government approximately 69 cents per every \$100 loaned or less than one penny per dollar loaned. In contrast, FFEL loans cost the government \$10.51 for every \$100 dollars borrowed or a little more than 10 cents on the dollar. So the savings affiliated with opting for a Direct Loan rather than a FFEL loan are approximately \$9.82 (\$10.51 - \$0.69) per \$100 borrowed, or more than 9 cents on the dollar.¹⁷⁴

2004 CBO Study

In 2004, the Congressional Budget Office released a study confirming that using the 1990 credit reform rules resulted in underestimating the cost of federal credit programs in two areas:

First, federal agencies' administrative expenses are not included in estimates of subsidy costs (though they appear elsewhere in the federal budget). Second, those estimates exclude the cost of market risk — the compensation that investors require for the uncertainty of expected but risky cash flows. The reason is that the FCRA requires analysts to calculate present values by discounting expected cash flows at the interest rate on risk-free Treasury securities (the rate at which the government borrows money). In contrast, private financial institutions use risk-adjusted discount rates to calculate present values.¹⁷⁵

2005 PriceWaterhouseCoopers Study

In early 2005, PriceWaterhouseCoopers released a Direct Loan cost study, sponsored by student loan industry associations, which maintained that budget scorekeeping biases are distorting the true costs of the student loan programs. The report stated that:

Proponents of the FDLP have argued the Direct Loan Program is more cost-effective because the Federal government can borrow more cheaply than the private sector and does not have to generate a profitable return. Federal budget estimates of the cost of the loan programs are often cited as evidence supporting this claim. These comparisons, however, are flawed in ways that bias scorekeeping in favor of the FDLP. This report analyzes some of these budget scorekeeping issues. ...

The first scoring bias examined by this report concerns interest rate assumptions. Projections of FDLP savings are crucially reliant on the projected relationship between short-term and long-term interest rates — the shape of the yield curve. Importantly, compared to historical experience, the Congressional Budget Office (CBO) and the Administration understate the steepness of the yield curve in their

¹⁷⁴ Center for American Progress, *Putting Students First, An Analysis of the Potential for Cost Savings and Increased Aid to Students Through Greater Participation in the Direct Loan Program*, April 29, 2004, no page numbers.

¹⁷⁵ Congress of the United States, Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August 2004, pp. 1-2.

interest rate projections. This reduces the estimated cost of the FDLP relative to the FFELP. And this bias continues going forward: long-run interest rate projections for FY 2005 by both the CBO and the Administration continue to show a flatter yield curve than has historically been experienced.

The second bias concerns tax revenues. As mentioned above, FDLP proponents believe direct lending is cheaper because FFELP must generate profits to lenders. These same profits, however, yield revenue to the Treasury in the form of tax payments. Importantly, these tax payments are not considered as an offset to the subsidy cost of the FFELP. We estimate that FFELP lenders alone generated \$651 million dollars of tax revenue last year. If all student loan volume were handled by the FDLP, on the other hand, total tax revenue from the loan programs would only have been \$20 million.

The third bias is the mandated exclusion of administrative costs under the Credit Reform Act of 1990, which artificially makes the Direct Loan Program appear less expensive than the FFELP, the cost of which includes most administrative costs. Any shift in loan volume to the FDLP would increase the administrative cost of the program, but this is not reflected in the scoring when comparing subsidy costs in the budget.

Each of these budgetary score-keeping considerations results in cost comparisons between the two programs that exhibit a bias that favors federal direct lending over federally guaranteed lending. Under certain economic circumstances, either program can be the more expensive of the two.¹⁷⁶

2005 GAO Study

In September 2005, the General Accountability Office published a report on federal student loans entitled “Challenges in Estimating Federal Subsidy Costs,” which restated the many impediments to comparing the costs of FFELP and Direct Loans previously identified by both public and private analysts. The GAO report stated that:

Both FFELP and FDLP subsidy cost re-estimates have differed from original estimates for loans made in fiscal years 1994 through 2004, reflecting the challenges inherent in estimating the actual costs of loans made under each of these federal loan programs. Re-estimated subsidy costs for FFELP loans were close to or lower than original estimates for loans made in fiscal years 1994 to 2002, but higher than originally estimated for loans made in fiscal years 2003 and 2004. FDLP re-estimated subsidy costs were generally similar to or higher than originally estimated for loans made in fiscal years 1994 through 2004.¹⁷⁷

¹⁷⁶ PriceWaterhouseCoopers, “The Limitations of Budget Score-Keeping in Comparing the Federal Student Loan Programs,” prepared for Consumer Bankers Association, Education Finance Council, National Council of Higher Education Loan Programs, March 3, 2005, pp. 1-2.

¹⁷⁷ General Accountability Office, *Student Loans, Federal Student Loans, Challenges in Estimating Federal Subsidy Costs*, GAO-05-874, Sept. 2005, p. 6.

FDLP subsidy costs per \$100 of loans disbursed have, in general, remained lower than those of FFELP. Nonetheless, if current assumptions correctly predict future loan performance and economic conditions, **the originally estimated gain to the government from FDLP loans made in fiscal years 1994 to 2004 will not materialize, and instead these loans will result in a net cost to the government.** [Emphasis supplied]¹⁷⁸

The complicating factors in determining the true federal subsidy costs were, according to the report:

- **Fluctuating Interest Rates.**
For FFELP, lower than expected interest rates have made the difference between the borrower interest rate and lender yield smaller than expected, resulting in lower special allowance payments paid to lenders, which in turn resulted in lower re-estimated subsidy cost estimates.
For FDLP, lower than expected interest rates contributed to higher re-estimated subsidy costs because the government received smaller interest payments from borrowers than originally anticipated and, in some cases, the rate paid by student borrowers fell below the government's fixed borrowing rate.¹⁷⁹
- **Unanticipated Loan Consolidation Volume.**
Higher than anticipated consolidation loan volume, resulting, in part, from low interest rates, contributed to differences between original and re-estimated subsidy costs for both programs.
In FFELP, it contributed to lower re-estimated subsidy costs for the underlying loan cohorts repaid by consolidation loans, because the length of time Education anticipated paying special allowance to lenders was shortened. Estimated subsidy costs for recently disbursed FFELP consolidation loans, which reflect costs associated with default risk and special allowance payments to lenders, are, however, quite large in comparison to previous years.
In FDLP, greater than expected prepayment due to consolidation decreased the anticipated interest payments on the underlying loans, which, in turn, contributed to higher re-estimated subsidy cost estimates of the underlying loan cohorts.¹⁸⁰
- **Additional Data Available for Modeling.**
Additional data for both FFELP and FDLP loans have enabled Education to refine its cash flow model when it re-estimated subsidy costs. For example, according to Education officials, data on FFELP and FDLP borrowers' use of deferment options that allow them to delay making payments on a loan when they return to school or are experiencing

¹⁷⁸ Ibid., p. 34.

¹⁷⁹ Ibid.

¹⁸⁰ Ibid., p. 7.

economic hardship only recently became available. Education refined its model to explicitly include assumptions about borrowers' use of deferment, which has improved its cash flow estimates.¹⁸¹

- **Federal Administrative Expenses.**

Under current law, federal administrative expenses are excluded from subsidy cost estimates. For the fiscal year 2005 loan cohort, Education estimated that cost estimates for FDLP would increase by \$1.45 and for FFELP by \$0.69 per \$100 in loans disbursed if federal administrative expenses were included. The large difference is because the federal government is primarily responsible for administering the FDLP while in FFELP lenders and guaranty agencies perform administrative tasks.¹⁸²

- **Interest Rate Risks.**

Subsidy cost estimates do not include all risk that the government incurs by lending money over time.

Subsidy cost estimates factor in anticipated cash flows from the loans, which incorporate some risks that the government incurs, such as credit risk represented by a default rate — the rate at which the government expects borrowers not to pay back their student loans.

However, some risks are not explicitly included in subsidy cost estimates, such as interest rate risk — unanticipated fluctuations in the interest rate due to changes in the economy that cause changes in the present value of the loans' cash flows.¹⁸³

- **Unaccounted for Tax Revenues.**

Both loan programs generate federal tax revenues from private sector companies and investors that are encompassed in the revenue portion of the budget but are not included in subsidy cost calculations. Estimating the amount of federal tax revenues generated by the loan programs would be difficult and was beyond the scope of our review.¹⁸⁴

2005 CBO Study

In late 2005, CBO released a study comparing the subsidy costs of FFELP and Direct Loans. CBO took pains to explain that its study was based on the Credit Reform Act and thus excluded a number of cost items, such as federal administrative costs.¹⁸⁵ The paper also did not include a discussion of past re-estimates of subsidy costs.

It is important to note that the 2005 CBO conclusions are very unlike the 1995 CBO study's results, which did include federal administrative costs. (See p. 36.)

¹⁸¹ Ibid.

¹⁸² Ibid.

¹⁸³ Ibid.

¹⁸⁴ Ibid.

¹⁸⁵ Congressional Budget Office, *Subsidy Estimates for Guaranteed and Direct Student Loans*, November 2005, p. viii.

CBO summarized the 2005 findings as follows:

Using the procedures specified in the Federal Credit Reform Act, the Congressional Budget Office (CBO) estimates that loans made under the FFEL program have higher budgetary costs to the government than Direct Loans do. According to CBO's estimates, the overall subsidy rate (that is, the net budgetary costs measured as a percentage of the amount lent) for loans originated in 2006 in the FFEL program is about 15 percent, whereas the rate for the Direct Loan Program is about -2 percent — meaning that for every \$1 in loans, the federal government incurs budgetary costs of \$0.15 in the FFEL program and realizes budgetary savings of \$0.02 in the Direct Loan Program.¹⁸⁶

That conclusion generated the following caveat, however:

The government does not really “make money” providing student loans — the subsidy calculations under the Credit Reform Act are not designed to fully capture the economic costs to the government of the assistance that the student loan programs provide, nor do they capture all of the effects of the programs on federal spending and revenues. This paper deals only with the subsidy estimates as currently calculated under the credit reform framework, which are the present values of estimated cash flows for the two types of loans.¹⁸⁷

2006 Study by America's Student Loan Providers

In May 2006, America's Student Loan Providers — an umbrella organization of more than 80 student loan entities — published a paper that asserted the FFELP costs the government less than the Direct Loan Program.

Below is an excerpt from the executive summary of the report detailing the ASLP arguments and conclusions:

After correcting for obvious flaws in current budget methodology, as well as others identified by government and non-partisan congressional agencies, ASLP found that the Federal Family Education Loan (FFEL) Program has cost taxpayers \$2.16 less per \$100 lent than the Federal Direct Loan Program. Specifically, FFEL program loans from 1994 to 2002 are estimated to have cost the government \$7.00 for every \$100 in loans, as compared to \$9.16 for Direct Loans.

The Office of Management and Budget (OMB), as well as the Congressional Budget Office (CBO), “score” the Direct Loan Program as being less expensive than the FFEL program. ASLP found that the official government score is incorrect — that the FFEL program actually costs the government less than the Direct Loan Program.

¹⁸⁶ Ibid, p. vii.

¹⁸⁷ Ibid.

ASLP has long argued that OMB's cost estimates are flawed, not only because they are based on overly optimistic interest rate projections far into the future, but also because they omit key program costs (e.g., administrative costs) and credits (e.g., tax revenues generated by both programs).

This analysis shows that if the cost estimates better reflected the risks associated with actual program performance and omitted costs and credits were counted, OMB (and CBO) would draw a far different conclusion.

Drawing on official government data found in the President's FY 2007 budget proposal, as well as reports by the U.S. Government Accountability Office (GAO), CBO, the Department of Education (ED) Office of the Inspector General (IG), and PricewaterhouseCoopers (PWC), among others, the ASLP analysis demonstrates that the FFEL program costs taxpayers less to operate than the Direct Loan Program.

ASLP came to these conclusions via the following methodology:

- **Confining Cost Comparison to Relevant Time Frame.** This is accomplished by comparing program costs for only the years in which loans (a) were made in both the FFELP and Direct Loan Program and (b) are mature enough to have actual performance histories.
- **Adding in Missing Costs and Credits.** This analysis adds in the administrative costs of the Direct Loan Program and the taxes paid by loan providers and servicers in both student loan programs.
- **Adding a Risk Premium to the Direct Loan Program.** Even though the costs of the Direct Loan Program are highly dependent on future interest and principal payments by borrowers, OMB scoring methodologies do not fully account for the risks of lending money over time, namely, the uncertainty of future cash flows resulting from deviations in projected defaults, consolidations or interest rates. These risks are accounted for by assigning a minimal risk premium of 0.25 percent, or 25 basis points.¹⁸⁸

¹⁸⁸ America's Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less Based on New FY 2007 Budget Data*, May 2006, pp. 1-2.

4. STAFFORD AND PLUS LOANS

This chapter examines trends in Stafford and PLUS volume and school participation. Also included are sections on student loan terms, borrower benefits, default rates and summaries of salient student loan policy issues.

TRENDS

According to the College Board, during the 2005-2006 school year, Stafford and PLUS loans accounted for about 51 percent of an estimated \$134.8 billion in federal, state and institutional student aid.¹⁸⁹

This total does not include private loans, which the College Board, reports provided an estimated \$17.3 billion in funding for that school year.¹⁹⁰ Private loans are becoming an increasingly important component of students' aid packages, as discussed in Chapter 6.

The FFELP, which relies on both for-profit and nonprofit lenders for capital, has provided \$575 billion in new Stafford and PLUS over the past 41 years. The Direct Loan Program, funded exclusively by the government, has provided \$142 billion in new Stafford and PLUS loans since its inception in 1994.¹⁹¹

Stafford and PLUS Loan Volume

For FY 2008, total Stafford and PLUS volume for both FFELP and Direct Loans is expected to exceed \$72 billion.

The FFELP is the dominant of the two programs, with a market share of almost 80 percent of Stafford and PLUS volume. As shown in Table 2, the FDLP's share hovered in the 35 percent range during the late 1990s, but has accounted for less than a quarter of new Stafford and PLUS student loans since 2004. For 2008-2009, the Department of Education projects that the Direct Loan volume share will decrease to 20.6 percent.¹⁹²

¹⁸⁹ College Board, *Trends in Student Aid*, October 2006, p. 8.

¹⁹⁰ *Ibid.*, p. 6.

¹⁹¹ U.S. Department of Education, Office of Postsecondary Education Policy, Planning, and Innovation, *Federal Student Loan Programs Data Book, FY 1997-FY 2000*, p. 28 and p. 31, and U.S. Department of Education, *Budgets for Fiscal Years 1995-2008*.

¹⁹² U.S. Department of Education, *Budgets for Fiscal Years 1995-2007 and Budget for Fiscal Year 2008, Appendix*, p. 335.

TABLE 2. Number and Volume of New Stafford and PLUS Loans (Excluding Consolidation Loans) 1994-2008¹⁹³

Fiscal Year	FDLP Stafford and PLUS			FFELP Stafford and PLUS		
	# of Loans (thousands)	Volume (millions)	% of Total Volume	# of Loans (thousands)	Volume (millions)	% of Total Volume
1994	210	\$915	3.8	6,740	\$23,053	96.2
1995	1,290	\$5,102	19.6	5,869	\$20,951	80.4
1996	2,616	\$9,372	32.2	5,336	\$19,728	67.8
1997	2,864	\$9,838	34.0	5,225	\$19,163	66.0
1998	3,018	\$10,400	34.2	5,378	\$20,003	65.8
1999	2,891	\$9,953	33.1	5,354	\$20,107	66.9
2000	2,739	\$10,347	31.3	5,879	\$22,711	68.7
2001	2,763	\$10,635	30.1	6,355	\$24,694	69.9
2002	2,908	\$11,689	29.0	7,274	\$28,606	71.0
2003	2,939	\$11,969	26.2	8,429	\$33,791	73.8
2004	3,001	\$12,840	24.6	9,550	\$39,266	75.4
2005	2,971	\$12,930	23.0	10,323	\$43,284	77.0
2006	2,841	\$12,677	21.1	10,982	\$47,307	78.9
2007 (est.)	2,839	\$13,596	20.6	11,496	\$52,402	79.4
2008 (est.)	2,935	\$15,050	20.6	11,906	\$57,845	79.4

School Participation

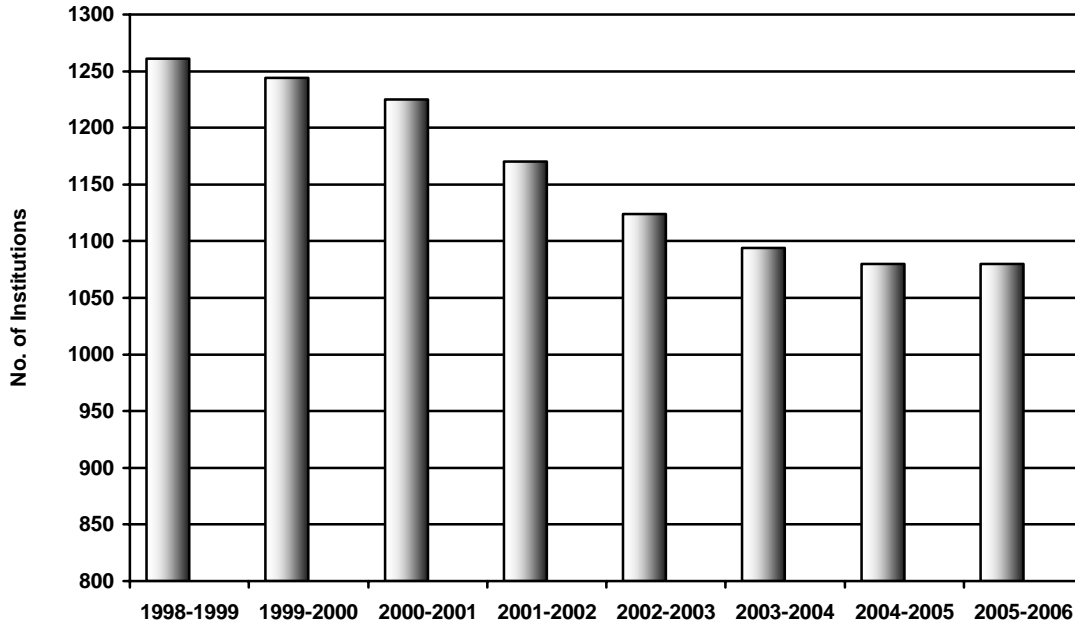
More than 5,000 institutions participate in the FFELP, and fewer than 1,100 are active in Direct Loans. Of those active in Direct Loans, about 750 schools participate exclusively in FDLP. The remainder of the FDLP schools participate in both programs.¹⁹⁴ ¹⁹⁵ As outlined in Figure D below, the number of FDLP schools has declined in tandem with the program's share of loan volume.

¹⁹³ Fiscal Year 1994, 1995, 1996: U. S. Department of Education, *Student Loan Data Book FY94-FY96*, Tables 4 and 5. Remainder of data: U. S. Department of Education, Budgets for Fiscal Years 1995-2008.

¹⁹⁴ U.S. Office of Management and the Budget, *Budget of the U.S., Analytical Perspectives*, February 2007, p.76.

¹⁹⁵ As documented in NCHelp, *Daily Briefing*, March 29, 2006, no page numbers.

FIGURE D. Number of FDLP Institutions by Academic Year ^{196 197}



TERMS AND CONDITIONS OF STAFFORD AND PLUS LOANS

Below are summaries of key student loan terms and conditions pertaining to Stafford and PLUS loans.

Loan Limits

Until passage of the HERA in early 2006, the loan limit for undergraduate freshmen (\$2,625) had not been increased since 1986. Limits for sophomores, juniors, seniors and graduate students had not changed since 1992.

In contrast, from 1986-87 to 2006-2007 the average cost of tuition and fees in **constant** dollars almost doubled, in the case of private four-year and public two-year colleges, and more than doubled, in the case of public four-year colleges.¹⁹⁸

HERA increased some annual loan limits as described in Table 3, but left aggregate limits intact. Please note that loan limits are identical for FFELP and FDLP.

¹⁹⁶ Education Finance Council, *EFC Weekly*, Nov. 18, 2002, p. 4, Oct. 24, 2003, p. 5, Jan. 28, 2005, p. 2 and NCHelp, *Daily Briefing*, March 29, 2006, no page numbers.

¹⁹⁷ For 2005-2006, estimate based on U.S. Office of Management and the Budget, *Budget of the U.S., Analytical Perspectives*, February 2007, p.76.

¹⁹⁸ College Board, *Trends in College Pricing 2006*, October 2006, p. 7.

TABLE 3. Stafford and PLUS Loan Limits for FFELP and FDLP Before and After HERA ^{199 200}

Current Limits			HERA Limits (Effective July 1, 2007 unless otherwise noted. New limits in bold.)		
<i>Current Subsidized Stafford Loan Limits</i>	Year 1	\$2,625	<i>New Subsidized Stafford Loan Limits</i>	Year 1	\$3,500
	Year 2	\$3,500		Year 2	\$4,500
	Subsequent Years	\$5,500		Subsequent Years	\$5,500
	Grad. or Prof.	\$8,500		Grad. or Prof	\$8,500
<i>All Borrowers</i>	Aggregate Undergrad	\$23,000	<i>All Borrowers</i>	Aggregate Undergrad.	\$23,000
	Aggregate Graduate	\$65,500		Aggregate Graduate	\$65,500
<i>Current Unsubsidized Stafford Loan Limits</i>	The amount of Subsidized and Unsubsidized Federal Stafford loans combined cannot exceed:		<i>New Unsubsidized Stafford Loan Limits</i>	The amount of Subsidized and Unsubsidized Federal Stafford loans combined cannot exceed:	
	Dependent Undergraduate			Dependent Undergraduate	
	Year 1	\$2,625		Year 1	\$3,500
	Year 2	\$3,500		Year 2	\$4,500
	Subsequent Years	\$5,500		Years 3-5	\$5,500
	Aggregate	\$23,000		Aggregate	\$23,000
	Independent Undergraduate			Independent Undergraduate:	
	Year 1	\$6,625		Year 1	\$7,500
	Year 2	\$7,500		Year 2	\$8,500
	Subsequent Years	\$10,500		Subsequent Years	\$10,500
	Aggregate	\$46,000		Aggregate	\$46,000
	(incl. Subsidized loans)			(incl. Subsidized loans)	
	Graduate/Professional			Graduate/Professional	
Annual	\$18,500	Annual	\$20,500		
(no more than \$8,500 can be subsidized)		(no more than \$8,500 can be subsidized);			
Aggregate	\$138,500	Aggregate	\$138,500		
(incl. Subsidized loans).		(incl. Subsidized loans).			
<i>Current PLUS Loan Limits for Parents</i>	Up to the total cost of their dependent children's undergraduate education, less financial aid received from other sources.		<i>New PLUS Loan Limits for Parents, Professional and Graduate Students</i>	For Parents:	
	No aggregate limit.			Up to the total cost of their dependent children's undergraduate education, less financial aid received from other sources. No aggregate limit.	
			<i>Effective July 1, 2006</i>	For Professional and Graduate Students:	
				Up to the total cost of education, less financial aid received from other sources. No aggregate limit.	

¹⁹⁹ Higher Education Act of 1965, (as amended), various sections.

²⁰⁰ Public Law No. 109-171, Feb. 8, 2006, various sections.

Among student aid stakeholders, there continues to be widespread disagreement about whether student loan limits should be increased further.²⁰¹

Maximum Interest Rates for New Student and Parent Loans

Until July 2006, the Stafford and PLUS loan interest rates were based on a **variable-rate** formula, subject to change each year. Stafford loan repayment rates were based on an annually adjusted 91-day T-Bill rate plus 2.3 percent, capped at 8.25 percent with lower rates for borrowers during the in-school and grace periods and during deferment. PLUS rates were based on an annually adjusted 91-day T-Bill rate plus 3.1 percent, capped at 9 percent.²⁰²

As a result of legislation enacted in 2002 with an effective date of July 1, 2006, the maximum interest rate on new FFELP and FDLP Stafford loans is now a **fixed** rate of 6.8 percent. This rate applies to all phases of the loan, in-school, grace, deferment and repayment. That same legislation also changed the variable PLUS rate for the two programs to a fixed maximum rate of 7.9 percent.²⁰³

The HERA left the fixed Stafford rates intact, but changed the maximum FFELP PLUS rate to 8.5 percent.²⁰⁴ HERA did not change the Direct Loan PLUS rate.

For Stafford borrowers, the maximum variable rates during the past several years have been well below the new fixed 6.8 percent rate. For the coming decade, however, CBO has projected that 91-day T-Bill rates will average approximately 4.4 percent. Consequently, borrowers with “old” variable-rate Stafford loans can expect an average repayment rate of 6.7 percent for the foreseeable future. In other words, current CBO projections yield approximately equivalent future rates for Stafford loans in repayment, be they variable or fixed rate.²⁰⁵

It is also noteworthy that, as shown in Table 4, new fixed-rate borrowers who took out loans in 2006-2007 — with 91-day T-Bills averaging 4.6 percent — currently have lower rates in repayment than do borrowers with “old” variable-rate loans.²⁰⁶ Lenders and the Secretary of Education may offer borrower benefits that result in an even lower rate for both FFELP and FDLP loans. (For an in-depth discussion of optional borrower benefits, see p. 63.)

The following table illustrates the **maximum** fixed and variable rates permitted for Stafford and PLUS loans for the period July 1, 2006, to July 1, 2007.

²⁰¹ See, for example, <http://charmandrigor.com/clips/chro-grants.html>, and the Coalition for Better Student Loans at <http://www.collegeparents.org/betterloans/aboutProposal.html>, accessed Feb. 11, 2007.

²⁰² *Higher Education Act of 1965*, (as amended), Sec. 427A.

²⁰³ Public Law No. 107-139, Feb. 8, 2002.

²⁰⁴ Public Law No. 109-171, Feb. 8, 2006.

²⁰⁵ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*, January 2006, p. xvi.

²⁰⁶ *Ibid.*

TABLE 4. Stafford and PLUS Loans: Maximum Interest Rates for the Period July 1, 2006. to July 1, 2007²⁰⁷

Date Disbursed	Type of Loan	In-School Rate	Repayment Rate
7/2006- (Fixed)	Stafford	6.8%	6.8%
	FFELP PLUS	8.5%	8.5%
	FDLP PLUS	7.9%	7.9%
7/1998-6/2006 (Var.)	Stafford	6.54%	7.14%
	PLUS	7.94%	7.94%
7/1995-6/1998 (Var.)	Stafford	7.34%	7.94%
	PLUS	8.34%	8.34%
7/1994-6/1995 (Var.)	Stafford	7.94%	7.94%
	PLUS	8.34%	8.34%

Statutory Interest Benefits for Subsidized Stafford Loan Borrowers

To decrease the cost of student loans for lower-income individuals, the federal government offers borrowers a subsidized Stafford loan. In the FFELP, the Department of Education pays interest to the lender on behalf of the subsidized Stafford borrower during the in-school and grace periods and during deferment.²⁰⁸ In FDLP, as in FFELP, the borrower is not charged interest during those periods, and thus the U.S. Treasury absorbs the cost.

Borrowers with subsidized Stafford loans are, however, responsible for paying all interest during the repayment period. In the case of a fixed-rate loan, the rate is a constant 6.8 percent. In contrast, a borrower with a variable-rate loan pays interest at the prevailing rate for a given year. That rate, however, can never exceed 8.25 percent.²⁰⁹

The cost to the Treasury of borrower interest benefits depends on prevailing interest rates and the volume of outstanding loans that qualify. When rates are high, the borrower subsidy per \$100 of loans will be higher. The opposite is, of course, true when rates are low. The table below details actual and projected FFELP borrower interest subsidy payments since FY 1995. The Department of Education does not publish comparable data for Direct Loans.

²⁰⁷ U. S. Department of Education, “Federal Stafford, Federal PLUS, Federal SLS, and Federal Consolidation Interest Rate Calculations for the Period July 1, 2006-June 30, 2007,” accessed at http://www.usafunds.org/forms/school_lender/ED_interest_rate_table.pdf, Feb. 12, 2007.

²⁰⁸ Higher Education Act (as amended), Sec. 428(a).

²⁰⁹ Higher Education Act (as amended), Sec. 427A.

TABLE 5. FFELP Borrower Interest Benefit Payments (FY 1995-FY 2008)²¹⁰

Fiscal Year	Interest Benefit
	Amount (billions)
1995	\$2.2
1996	\$2.5
1997	\$2.2
1998	\$3.2
1999	\$3.7
2000	\$1.9
2001	\$1.9
2002	\$2.1
2003	\$1.2
2004	\$1.5
2005	\$1.7
2006	\$2.7
2007 (est.)	\$3.4
2008 (est.)	\$4.0

Stafford and PLUS Loan Fees

FFELP Background

The FFELP **origination fee** was instituted in the early 1980s as part of a sweeping budget bill and the **guarantee fee** (now the federal default fee) has been in place since the inception of the program.²¹¹

Prior to passage of the Higher Education Reconciliation Act in 2006, Stafford borrowers could be charged a 3-percent origination fee and a 1-percent guarantee fee, both of which were deducted from the loan proceeds. Lenders and guarantors frequently waived some or all of the fees to borrowers. Federal law requires that the 3-percent origination fee be charged to borrowers. Only the guarantee fee could be waived for PLUS borrowers, although some lenders rebate the origination fee following disbursement of the loan.

Whether the lender subsidized the fees or collected them from the borrower, the lender was obligated to remit 3 percent of the loan proceeds to the federal government.²¹² If

²¹⁰ U. S. Department of Education, Fiscal Year 1997-2008 Budget Appendices.

²¹¹ *Higher Education Act* (as amended), Secs. 438(c) and 428(b)(1)(H).

²¹² *Higher Education Act* (as amended), Sec. 438(c).

guarantors waived the guarantee fee, the impact was a reduced income stream to the guarantor's Federal Reserve Fund.

FDLP Background

When the FDLP was enacted in 1993, the legislation required a single origination fee that totaled 4 percent and would thus be the equivalent of the two FFELP fees. The law explicitly stated that the Secretary "shall" charge all Direct Loan borrowers a 4-percent origination fee. The Clinton Administration interpreted the Higher Education Act to permit a lower fee of 3 percent, and the Bush Administration did not change that policy.²¹³

Fees Mandated by the Higher Education Reconciliation Act

Over the years, these fees have been criticized repeatedly and there have been many calls for their repeal or modification.²¹⁴ The concerns expressed by students and many associations prompted several members of Congress to sponsor proposals to eliminate or reduce student loan fees.²¹⁵

The Higher Education Reconciliation Act included the following changes to loan fees:

- The 3-percent maximum origination fee was gradually phased out in FFELP, and the 4-percent maximum origination fee was reduced to 1 percent in FDLP.
- A 1-percent mandatory federal default fee was required to be paid into guarantors' Federal Fund, either by charging the borrower, payment by the lender, or payment by the guarantor from non-federal resources. Although there is no federal default fee in the Direct Loan Program, because the program's origination fee is gradually reduced to 1 percent, there is statutory parity between the two programs.
- Both FFELP lenders and the Secretary for FDLP have the authority to lower the maximum origination fee for Stafford borrowers. The Secretary also can reduce it for FDLP PLUS borrower, but FFELP lenders must charge the fee for their PLUS borrowers. Some lenders rebate the fee at a later time, however.^{216 217}
- It is important to note that no fees are charged to borrowers on consolidation loans.

²¹³ *Higher Education Act* (as amended), Sec. 455(c)

²¹⁴ For examples, see proposals from ACE, NASFAA, Coalition for Better Student Loans, AASCU, USSA, PIRG and many other associations. Proposals are generally posted on the associations' respective Web sites.

²¹⁵ For example, see the 109th Congress, S. 371, S. 1293, H.R. 609.

²¹⁶ Public Law No. 109-171, Secs. 8008 and 8014, Feb. 8, 2006.

²¹⁷ For examples see, <http://www.elresources.org/elrebate.html>,
<http://www.chelastudentloans.org/Loans/BorrowerBenefits/FullFeeRebates.asp>,
<https://www.collegelenderlist.com/content/lenderlist.asp?lsid=1123&s=CA&n=Y>, accessed Feb. 27, 2007.

The following table below provides specifics about the new fee structure.

TABLE 6. HERA-Enacted Borrower Fees, Effective July 1, 2006 ²¹⁸

FFELP	FDLP
<p><u>ORIGINATION FEE</u></p> <p>Stafford Loans</p> <p>Decreases the statutory 3% maximum origination fee on FFELP Stafford loans to 0% by July 1, 2010, as follows:</p> <ul style="list-style-type: none"> • 2% for loans first disbursed on or after 7/1/06. • 1.5% for loans first disbursed on or after 7/1/07. • 1% for loans first disbursed on or after 7/1/08. • 0.5% for loans first disbursed on or after 7/1/09. • 0.0% for loans first disbursed on or after 7/1/10. <p>PLUS Loans</p> <p>The fee remains at a mandatory 3%, which must be paid by the borrower. There is no provision for statutory reduction of the fee, but some lenders rebate the fee at a later time.</p> <p><u>DEFAULT FEE</u></p> <p>Stafford and PLUS Loans</p> <p>Guarantors must collect 1 percent of the principal amount of the loan, either by deduction from the proceeds of the loan or by payment from other non-federal sources. Regardless of the source, the default fee must be deposited into the guarantor's Federal Fund.</p>	<p><u>ORIGINATION FEE</u></p> <p>Stafford Loans</p> <p>Decreases the statutory maximum 4% origination fee on FDLP Stafford loans to 1% by July 1, 2010, as follows:</p> <ul style="list-style-type: none"> • 3% for loans first disbursed on or after 7/1/06. • 2.5% for loans first disbursed on or after 7/1/07. • 2.0% for loans first disbursed on or after 7/1/08. • 1.5% for loans first disbursed on or after 7/1/09. • 1.0% for loans first disbursed on or after 7/1/10. <p>PLUS Loans</p> <p>The fee remains at a mandatory 4%, which must be paid by the borrower. There is, however, provision for statutory reduction of the fee, if the Secretary meets certain requirements.</p> <p><u>OTHER</u></p> <p>The Secretary is authorized to reduce the origination fee on all Direct Loans to encourage on-time repayment, but only if the Secretary determines the reduction is cost-neutral and in the best financial interest of the federal government.</p>

Repayment Options

FFELP and Direct Loans provide an array of repayment options based on two concepts: regular repayment plans and consolidation loan plans.

Under **regular repayment plans**, borrowers pay off their loans according to a schedule based on either a 10-year repayment period with equal monthly payments (the standard repayment plan), or based on a graduated, extended or income-based repayment scheme.²¹⁹

²¹⁸ Public Law No. 109-171, Secs. 8008 and 8014, Feb. 8, 2006. The information about fees also was adapted from the Department of Education's "Enactment of the Higher Education Reconciliation Act of 2005, Loan Issues," (Enclosure to DCL GEN-06-02 and FP-06-01), March 10, 2006.

²¹⁹ *Higher Education Act of 1965* (as amended), Sec. 428(b)(9).

Consolidation loan plans (discussed in detail in Chapter 5) are repayment options that allow borrowers to combine loans from different programs and extend the payment period, depending on level of indebtedness. Consolidation borrowers may choose from the full range of payment choices available under regular repayment plans: standard, graduated, extended and income-based.²²⁰

Prior to the passage of the HERA, there were substantial differences between the repayment plans of FFELP and FDLP. Effective July 1 2006, HERA eliminated most of those differences, with the notable exception of the unique income contingent repayment option in the Direct Loan Program.²²¹

The HERA changes affected only Direct Loans that went into repayment after July 1, 2006.²²² No statutory changes were made to FFELP repayment options or to the repayment plans for existing FDLP loans in repayment.

The following tables outline the old and new repayment terms for Stafford and PLUS loans.

TABLE 7. Repayment Terms for Loans in Repayment before July 1, 2006²²³

	FFELP	FDLP
<i>Repayment Options</i>	Standard, graduated, extended, income-sensitive, and consolidation.	Standard, graduated, extended, income contingent, alternative and consolidation.
<i>Length of Repayment</i>	Standard: 10 Years Graduated: 10 Years Extended: 25 Years Income-sensitive: 10 Years Consolidation: 30 Years	Standard: 10 Years Graduated: 30 Years Extended: 30 Years Income contingent (Except for PLUS): 25 Years Consolidation: 30 Years Alternative: 30 Years

²²⁰ Higher Education Act of 1965 (as amended), Sec. 428C and Sec. 455(g).

²²¹ Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²²² Ibid.

²²³ Higher Education Act of 1965 (as amended), Sec. 428(b)(9) and Sec. 455(d)(1).

TABLE 8. Repayment Terms : Loans Entering Repayment after July 1, 2006²²⁴

	FFELP	FDLP
<i>Repayment Options</i>	Standard, graduated, extended, income-sensitive, and consolidation.	Standard, graduated, extended, income contingent, alternative and consolidation.
<i>Length of Repayment</i>	Standard: 10 Years Graduated: 10 Years Extended: 25 Years Income-sensitive: 10 Years Consolidation: 30 Years	Standard: 10 Years Graduated: 10 Years Extended: 25 Years Income contingent (Except for PLUS): 25 Years Consolidation: 30 Years Alternative: 30 Years

TABLE 9. Details of FFELP and FDLP “Old” and “New” Repayment Terms

FFELP and “NEW” FDLP TERMS ²²⁵	TERMS	“OLD” FDLP TERMS	TERMS
<i>Standard</i> ²²⁶	Minimum Payment: Interest due or \$600/year, whichever is more. Maximum Term: 10 years.	<i>Standard</i> ²²⁷	Minimum Payment: \$600/year. Maximum Term: 10 years.
<i>Graduated</i> ²²⁸	Minimum Payment: Interest due, but no installment may be more than three times greater than any other installment. Maximum Term: 10 years.	<i>Graduated</i> ²²⁹	Minimum Payment: Interest due, but not less than 50% of the amount required under a standard plan, nor more than 150% of the payment amount required under the standard repayment plan. Maximum Term: 30 years. ²³⁰
<i>Extended</i> ²³¹	Minimum Payment: Interest due or \$600/year, whichever is more. Applies to borrowers with post-1998 debts greater than \$30,000. Maximum Term: 25 years.	<i>Extended</i> ²³²	Minimum Payment: \$600/year. Maximum Term: 30 years. ²³³

²²⁴ Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²²⁵ Ibid. Only these repayment plans will be available to Direct Loan borrowers who enter repayment on their loans on or after July 1, 2006. “Pre-HERA” plans will **NOT** be available for borrowers who enter repayment after that date.

²²⁶ Higher Education Act of 1965 (as amended), Sec. 428(b)(1)(L)(i).

²²⁷ 34 CFR, 685.208(b).

²²⁸ Higher Education Act (as amended), Sec. 428(b)(1)(L)(i) and 34 CFR, 682.209(a)(7)(ii).

²²⁹ Higher Education Act (as amended), Sec. 455(d)(1)(C) and 34 CFR, 685.208(d).

²³⁰ Applies only to loan balances equal to or greater than \$60,000, 34 CFR, 685.208(e).

²³¹ Applies only to new borrowers on or after Oct. 7, 1998, who accumulate outstanding loans under Part B totaling more than \$30,000 after that date, Higher Education Act of 1965 (as amended), Sec. 428C(b)(9)(A)(iv).

²³² Higher Education Act (as amended), Sec. 455(d)(1)(C) and 34 CFR, 685.208(d).

²³³ Applies to all Direct Loan borrowers with loan balances greater than or equal to \$60,000, 34 CFR, 685.208(e).

FFELP and "NEW" FDLP TERMS ²²⁵	TERMS	"OLD" FDLP TERMS	TERMS
<i>Income-Sensitive</i> ²³⁴ <i>Income Contingent Repayment still is available for post-HERA FDLP (Except for PLUS)</i>	Minimum Payment: Interest due. Maximum Term: 10 years	<i>Income Contingent</i> ²³⁵	Minimum Payment: No minimum. Allows negative amortization. Maximum Term: 25 years.
<i>Alternative Repayment</i> <i>Alternative is still available for post-HERA FDLP</i>	Not Available in FFELP.	<i>Alternative</i> ²³⁶	Minimum Payment: No minimum. Allows negative amortization. Maximum Term: 30 years.

Cost to Borrowers of Various Stafford Loan Repayment Plans

Table 10 illustrates the costs to borrowers of various non-consolidation repayment plans under FFELP and FDLP. Consolidation payment plans and their costs are discussed in Chapter 5.

As the following table illustrates, because a shorter repayment term results in lower total interest costs, the standard repayment plan is typically the least expensive student loan repayment option. Based on the assumptions in the table, the FDLP income contingent plan, which adds almost five years to the repayment term, carries the steepest price tag of all the available choices. On the other hand, income contingent repayment does offer the lowest monthly payments of all the plans, and also provides for write-off of the balance of the loan if it is not repaid after 25 years.^{237 238 239}

²³⁴ Higher Education Act (as amended), Sec. 428(b)(9)(A)(iii).

²³⁵ Higher Education Act (as amended), Sec. 455(e) and 34 CFR 685.209.

²³⁶ Higher Education Act (as amended), Sec. 455(e) and 34 CFR 685.208(g).

²³⁷ Indebtedness figure based on averages from Baum, Sandy and O'Malley, Marie, *College on Credit: How Borrowers Perceive Their Education Debt. Results of the 2002 National Student Loan Survey*, Washington, DC: Nellie Mae Corporation, 2003, p. v.

²³⁸ Salary data based on projected average starting salary for Liberal Arts Bachelor Degree recipients in 2007. See, for example, http://money.cnn.com/2007/02/08/pf/college/lucrative_degrees_winter07/index.htm?postversion=2007020813, accessed Feb. 14, 2007.

²³⁹ For FDLP Loans: U.S. Department of Education, Office of Student Financial Assistance, *Exit Counseling Guide for Borrowers*, <http://www.ed.gov/offices/OSFAP/DirectLoan/pubs/exitcounselguide.pdf>, pp. 12, 13, and <http://www.ed.gov/offices/OSFAP/DirectLoan/RepayCalc/dlentry2.html>, accessed Feb. 14, 2007. The data for income contingent repayment assume repayment at an interest rate of 8.25 percent and annual income growth of 5 percent. For FFELP Loans: USA Funds, *Online Calculators*, <http://www.usafunds.org/borrowers/index.html>, accessed Feb. 14, 2007.

TABLE 10. Projected Repayment Costs for a Borrower with \$20,000 in Stafford Subsidized Loans at an Interest Rate of 6.8% and an Initial Income of \$30,000 Under Various Repayment Options

Repayment Option	Length of Repayment	Monthly Payment	Total Amount Paid	Interest Paid
<i>Standard Repayment: FFELP and FDLP</i> ²⁴⁰	10 years	\$230	\$ 27,619	\$7,619
<i>Extended Repayment: FFELP and FDLP</i> ²⁴¹	N/A	N/A	N/A	N/A
<i>Graduated Repayment: FFELP and FDLP</i> ²⁴²	10 years	\$113, years 1-2. \$271, years 3-10	\$28,706	\$8,706
<i>Income-Sensitive Repayment: FFELP</i> ²⁴³	11 years	\$150, year 1. \$225, years 2-11	\$28,792	\$8,792
<i>Income Contingent Repayment: FDLP</i>	14 years 10 mos.	\$170 initial, \$194 final payments.	\$32,118	\$12,118

Details of Repayment Plans

Standard Repayment: FFELP and FDLP

From 1965 until the present, the primary student loan repayment option has been straight-line amortization over a period not to exceed 10 years. The length of the standard repayment period has not changed and is identical for FFELP and Direct Loans.²⁴⁴

Graduated Repayment: FFELP and FDLP

During the 1980s, average borrower indebtedness rose steadily and with this increase came a demand for more repayment flexibility. In 1992, Congress responded by providing additional repayment alternatives. One of these was an option to repay a loan by making smaller payments during the first years after leaving school, and then gradually increasing the payments during subsequent years.²⁴⁵

Graduated repayment flexibility is, however, constrained by a maximum repayment period of 10 years. Furthermore, the graduated repayment plan is hampered by a regulatory requirement that stipulates that no payment can be more than three times greater than any other payment (the “three-times rule”).²⁴⁶ This restriction, coupled with

²⁴⁰ Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²⁴¹ Not available for loan balances of less than \$30,000.

²⁴² Graduated Repayment – Two years reduced payments. (Numbers are rounded up.)

²⁴³ Income-Sensitive Repayment – Based on 6 percent of income allocated to repayment and 11 years of repayment, which includes one year of mandatory administrative forbearance as permitted by 34 CFR, 682.211(i)(5)(ii).

²⁴⁴ *Higher Education Act of 1965* (as amended), Secs. 428(b)(1)(D) and (b)(9).

²⁴⁵ *Higher Education Act of 1965* (as amended), Sec. 428(b)(1)(E).

²⁴⁶ 34 CFR, 682.209(a)(7)(ii).

the limited amortization period, has had a negative effect on borrowers' ability to take advantage of this option.

Effective July 1, 2006, the original Direct Loan graduated repayment options were repealed, and FDLP borrowers became subject to the FFELP graduated repayment terms.²⁴⁷ The "three-times rule" was not repealed, and both FFELP and FDLP borrowers now are subject to the limitations imposed by the regulation.

Extended Repayment: FFELP and FDLP

Until passage of the Higher Education Amendments of 1998, FFELP borrowers could not extend their loan-repayment term without consolidating their loans. The 1998 amendments included a very limited option that permitted borrowers with FFELP loans totaling more than \$30,000 to extend their repayment term to no longer than 25 years, provided that borrowers make monthly payments that cover at least the interest portion of their loans. The 1998 legislation applied only to borrowers who took out their first loan after the date of enactment of the amendments.²⁴⁸

Effective July 1, 2006, the original Direct Loan extended repayment options were repealed, and FDLP borrowers now are subject to the FFELP extended repayment terms.²⁴⁹

FDLP Alternative Repayment

The Direct Loan Program offers borrowers an "alternative" repayment option that has no equivalent in FFELP. This plan, which was established by statute, is reserved for borrowers who have exceptional circumstances that preclude their participation in any other FDLP repayment option. Eligibility is determined on a case-by-case basis.²⁵⁰ The plan provides for a repayment period of up to 30 years and allows negative amortization.²⁵¹ As of May 2000, the latest year for which information is available, nearly 11,000 borrowers were participating in the plan.²⁵²

FFELP Income-Sensitive Repayment

This repayment alternative was enacted in 1992, in conjunction with graduated repayment. Like that plan, the income-sensitive option suffers from lack of flexibility because the borrower must adhere to a repayment schedule that may not exceed 10 years,

²⁴⁷ Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²⁴⁸ *Higher Education Act of 1965* (as amended), Sec. 428b(9)(A)(iv).

²⁴⁹ Public Law No. 109-171, Feb. 8, 2006.

²⁵⁰ *Higher Education Act of 1965* (as amended), Sec. 455(d)(4).

²⁵¹ 34 CFR, 685.208(g).

²⁵² U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, December 2001, p. 83.

and is also subject to the stipulation that no payment can be more than three times greater than any other payment.²⁵³

To ease the difficulties involved in taking advantage of income-sensitive repayment under such confining criteria, regulations have been promulgated that allow borrowers up to an additional five years to amortize their loans through forbearance. This extension is limited to cases where the effect of decreased installment amounts paid under an income-sensitive repayment schedule would result in the loan not being repaid within the maximum 10-year repayment term.²⁵⁴

FDLP Income Contingent Repayment Program

Original Purpose

The original intent of ICRP was to radically alter student loan repayment by providing a repayment period of up to 25 years for Stafford loan borrowers during which payments would be tied to income levels, but would never exceed a certain proportion of earnings. Furthermore, the aim was that the Internal Revenue Service would be responsible for collecting the loans through payroll withholding.

According to former President Clinton:

Through cooperation with the IRS, the Act will improve collection and monitoring of student loans. And for those who are able to pay but do not, the Act will give the Secretary of Education authority to require payment on an income contingent basis.²⁵⁵

Despite the Clinton Administration's expectations, the IRS determined that it would not be feasible for the Service to collect student loans. In a letter to Rep. Christopher Shays, Education Secretary Richard W. Riley indicated that collecting student loans would be a prohibitively expensive venture for the IRS, and would be beyond its normal scope of operation.²⁵⁶

Lacking the IRS repayment component, the Clinton Administration still decided to move ahead with implementation of the ICRP.

ICRP Participation

Although the income contingent repayment option has been available since 1994, few borrowers with unconsolidated loans appear to be using the program. For example, for

²⁵³ 34 CFR, 682.209(a)(7)(ii).

²⁵⁴ 34 CFR, 682.211(i)(5)(ii).

²⁵⁵ Congressional Record, *Message From The President of The U.S.*, House of Representatives, May 5, 1993, p. H2297.

²⁵⁶ *The Chronicle of Higher Education*, "White House Rules Out IRS Role in Student Loan Collection," June 16, 1995.

FY 2004 (the latest year for which the Education Department's budget appendix included this information), ED projected that only 3.2 percent of FDLP Stafford loan borrowers would opt for ICRP. In contrast, 45 percent of Direct Loan consolidation borrowers were expected to repay via income contingent repayment.²⁵⁷

Details of the ICRP Criteria

The annual amount payable under the income contingent repayment plan is the lesser of the amount the borrower would repay annually over 12 years using standard amortization multiplied by a formula-derived income percentage factor, or 20 percent of discretionary income.

If a borrower has not paid off the entire principal amount after 25 years, any remaining debt will be forgiven. Under current law, the amount of debt forgiven is treated as taxable income to the borrower.

In addition to discharging the remaining balance at the end of 25 years, ICRP includes an interest-capitalization limitation. If payments do not cover interest due (known as negative amortization), the unpaid interest is capitalized (added to the principal) once a year. The amount that may be capitalized is limited to 10 percent of the original loan amount. Any additional unpaid interest continues to accumulate, but is not compounded.

OPTIONAL BORROWER BENEFITS

Background

As mentioned above, during the early and mid-1980s, some FFELP lenders and guarantors expanded their activities beyond their designated states and local service areas. For the most part, these efforts involved direct marketing of student loans to postsecondary institutions and prospective borrowers through the use of service or economic benefits.

Although certain "inducements" are prohibited by law, intra-FFELP price competition is possible because lenders and guarantors are permitted, by statute, to offer reduced interest rates and fees to borrowers.²⁵⁸ ²⁵⁹ With price rivalry already well established within FFELP, the launch of FDLP simply created another entity, the government, with which to compete. Thus, the practice of price discounting was widely used as a tool by FFELP providers to compete with Direct Loans because, until 1998, the Secretary had little latitude to offer price benefits to Direct Loan borrowers.²⁶⁰

²⁵⁷ U. S. Department of Education, *Fiscal Year 2004 Budget, Appendix*, p. 346.

²⁵⁸ *Higher Education Act of 1965* (as amended), Sec. 428(b)(3) and Sec. 435(d)(5).

²⁵⁹ See, for example, *Higher Education Act of 1965* (as amended), Sec. 428(b)(1)(H) and Sec. 427A(l).

²⁶⁰ *Higher Education Act of 1965* (as amended), Sec. 455(b)(8).

The 1998 Higher Education Amendments enabled the Secretary to reduce Direct Loan interest rates under tightly circumscribed conditions. This legislation, and the Secretary's interpretation of the statute governing origination fees, prompted several FDLP price-reduction initiatives.²⁶¹ The HERA codified Direct Loan pricing flexibility by permitting the Secretary to reduce the origination fee as long as the reduction is a repayment incentive and is deemed cost-neutral.²⁶²

Although targeted price benefits were not available to Direct Loan borrowers until the late 1990s, the FDLP, as structured then, offered other advantages not available to FFELP borrowers. For example, income contingent repayment, in-school consolidation and other repayment options gave the Direct Loan Program a degree of flexibility not found under FFELP repayment plans.²⁶³ Except for ICRP, these FDLP incentives were removed with the passage of HERA in 2006.²⁶⁴

FFELP and Direct Loan borrower-benefit programs are outlined in detail below.

Origination/Default Fee/Interest Rate Rebate Benefits

FFELP

As outlined on p. 54, Stafford borrowers may be charged an origination fee and a default fee, the sum of which may not exceed 3 percent of the total loan amount.

FFELP lenders must charge all PLUS borrowers the full 3-percent origination fee, which combined with the possible charge of the 1-percent federal default fee may result in a 4-percent upfront fee for the parent or graduate student PLUS borrower.²⁶⁵

Federal Default Fee Benefits

Many guarantors choose to pay the federal default fee on behalf of borrowers from the guarantors' non-federal sources, and some lenders pay the fee on behalf of their borrowers.²⁶⁶ Whatever the source, 1 percent of the principal amount of each loan must be deposited in a Federal Reserve Fund that belongs to the federal government, but is managed by the guarantor.²⁶⁷

²⁶¹ *Higher Education Act of 1965* (as amended), Sec. 455(b)(7).

²⁶² Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²⁶³ *Higher Education Act of 1965* (as amended), Sec. 455(e), Sec. 455(d) and *CFR*. 685.216.

²⁶⁴ Public Law No. 109-171, Sec. 8008, Feb. 8, 2006.

²⁶⁵ *Higher Education Act of 1965* (as amended), Sec. 438(c)(6).

²⁶⁶ See, for example, http://www.aessuccess.org/about/media/2006/March_24_06.shtml,
<http://www.collegezone.com/studentzone/8538.htm>,

http://www.usafunds.org/borrowers/resources/loan_fee_info/federal_default_fee_FAQ.htm, accessed Feb. 14, 2007.

²⁶⁷ *Higher Education Act of 1965* (as amended), Sec. 422A(c)(3).

Origination Fee Benefits

Many lenders offer origination fee benefits to their borrowers. A review of the Web sites of the top 10 student lenders reveals that most of them advertise a zero percent origination fee to Stafford borrowers.²⁶⁸

It is, however, important to mention that the 1998 Higher Education Amendments placed some constraints on origination fee reductions by mandating that lenders, in general, must reduce the fee equally for all borrowers. Furthermore, if a lender wishes to charge an even lower fee to a specific cohort of borrowers, those borrowers must demonstrate greater financial need, and the lender must apply the lower fee to all such borrowers.²⁶⁹

FDLP

Origination Fee Benefits/Interest Rate Rebate

For the FDLP, HERA provided that the Secretary “shall” charge Stafford borrowers a 3-percent origination fee until July 1, 2007, and that this fee will be reduced to 1 percent by 2010.²⁷⁰

The PLUS origination fee remains at 4 percent.

HERA also authorized the Secretary to reduce the origination fee on FDLP loans in order to encourage on-time repayment, but only if the Secretary determines the reduction is cost-neutral and in the best interest of the Federal Government.²⁷¹ The Secretary has taken no action to lower the origination fee based on this new authority.

In July 2000, however, the Clinton Administration announced an upfront interest rate rebate worth 1.5 percent of the original principal loan amount for Stafford and PLUS loans made through the Direct Loan Program, beginning with the 2000-2001 academic year. Although billed as an interest **rate** rebate, the actual effect of this benefit was to decrease the origination fee by 1.5 percentage points.²⁷²

²⁶⁸ See, for example, <http://www.chasestudentloans.com/loans/stafford.htm>, https://web.da-us.citibank.com/cgi-bin/citifi/scripts/prod_and_service/prod_serv_detail.jsp?BS_Id=FederalStaffordLoans&BV_UseBVCookie=yes, http://www.salliemae.com/get_student_loan/find_student_loan/undergrad_student_loan/compare_student_loans/, http://www.bankofamerica.com/studentbanking/index.cfm?template=stb_stafford_loans, accessed Feb. 14, 2007. Based on U.S. Department of Education, Office of Postsecondary Education, “Top 100 Originators of FFELP Loans — FY 2004 and FY 2005,” February 2006, Excel Spreadsheet, <http://www.fp.ed.gov/PORTALSWebApp/fp/whatsnew.jsp>, accessed Feb. 14, 2007.

²⁶⁹ *Higher Education Act of 1965* (as amended), Sec. 438(c)(8) and 34 CFR, 682.203(c)(2).

²⁷⁰ Public Law No. 109-171, Sec. 8008, Feb.8, 2006.

²⁷¹ *Ibid.*

²⁷² U.S. Department of Education, News Release, “Education Secretary Riley Announces Lower Interest Rates on Direct Student Loans & Consolidations,” <http://www.ed.gov/PressReleases/08-2000/0810b.html>, August 10, 2000, accessed Feb. 14, 2006.

To keep the benefit, borrowers must make their first 12 loan payments on time. If any of the first 12 payments are late — received more than six days after the scheduled payment date — the rebate will be added to the outstanding balance at the end of the first repayment year.²⁷³

This benefit remains in effect.²⁷⁴

Other Interest Rate Reductions

FFELP Stafford Loan Interest Rate and Principal Reductions

For FFELP, the interest rates prescribed by law are maximum rates because the statute explicitly permits lenders to charge a lesser rate for all types of loans, if they so choose.²⁷⁵ After implementation of Direct Lending, an increasing number of FFELP lenders opted to provide borrower benefits in the form of lower interest rates as a competitive measure.

Commonly, borrowers in repayment qualify for a variety of interest rate or principal reductions or “cash back” incentives if they make a certain number of payments on time or pay electronically.

As of February 2007, the 10 largest originators of subsidized Stafford loans all offered borrower benefits in the form of either interest rate reductions, principal amount reductions or “cash backs.”²⁷⁶ In the fall of 2002, 90 percent of 70 lenders surveyed by an industry publication offered an interest rate reduction for direct deposit repayment, and 93 percent provided on-time payment discounts.²⁷⁷

Electronic Debit of Student Loan Payments

In June of 1999, in the wake of the newly enacted authority to provide borrower repayment incentives in the form of reduced FDLP interest rates, the Secretary of Education announced that borrowers who chose to repay their loans through automatic debit from their bank accounts would be eligible for a 0.25-percentage point interest rate reduction.²⁷⁸

²⁷³ Ibid.

²⁷⁴ U.S. Department of Education, *Enactment of the Higher Education Reconciliation Act of 2005 Loan Issues*, March 2006, p. 16.

²⁷⁵ *Higher Education Act of 1965* (as amended), Sec. 427A(l).

²⁷⁶ See, for example, <https://www.chasestudentloans.com/benefits/naslmms.htm>, https://web.da-us.citibank.com/cgi-bin/citifi/scripts/prod_and_service/prod_serv_detail.jsp?BS_Id=FederalStaffordLoans&BV_UseBVCookie=yes, http://www.salliemae.com/get_student_loan/find_student_loan/undergrad_student_loan/federal_student_loans/staff_ord_loans/, http://www.bankofamerica.com/studentbanking/index.cfm?template=stb_stafford_loans, accessed Feb. 14, 2007. Based on U.S. Department of Education, Office of Postsecondary Education, “Top 100 Originators of FFELP Loans — FY 2004 and FY 2005,” January 2006, Excel Spreadsheet, <http://www.jp.ed.gov/PORTALSWebApp/jp/whatsnew.jsp>, accessed Feb. 14, 2007.

²⁷⁷ *The Greentree Gazette*, “FFEL Lender Directory,” November 2002, pp. 80-84.

²⁷⁸ U. S. Department of Education, News Release, “ED Announces Lower Student Fees on Direct Loans,”

The Secretary's authority to reduce interest rates is circumscribed by a statutory accountability requirement that mandates that the rate reductions must be cost-neutral and cannot be provided:

Unless an official report from the Director of the Office of Management and Budget to the Secretary and a comparable report from the Director of the Congressional Budget Office to the Congress each certify that any such reductions will be completely cost neutral.²⁷⁹

Although the Secretary did not obtain a certification of cost-neutrality from the Congressional Budget Office prior to implementing the rate reduction, he did claim that automatic-debit participation generated revenues for the federal government because borrowers who would otherwise have prepaid their loans would pay the Treasury an additional \$9.6 million in interest.²⁸⁰

This claim was challenged by House Education and the Workforce Committee Chairman William Goodling, who stated:

Congress granted that authority [the ability to charge lower rates] to the Education Department with the express limitation that any such reductions must be cost neutral. ... Last year, when the Education Department exercised this authority and reduced interest rates in the direct student loan program, it claimed the proposal would save taxpayers \$7 million from 2000-2004. When the Congressional Budget Office (CBO) examined the proposal, it disagreed with the department and estimated that the proposal would in fact cost taxpayers \$123 million over the same period.²⁸¹

Also questioning ED on this issue, the former chairman of the Senate Health, Education, Labor and Pensions Committee, James Jeffords, asked the Department to clarify its motivation in publicly claiming that borrowers would save money by using the electronic-debit option while, at the same time, stating that the program would generate additional federal revenue from borrowers who otherwise would have prepaid their loans. Sen. Jeffords' concerns engendered a request that the GAO review the electronic-debit program to ascertain whether this alleged borrower benefit actually was **increasing** rather than decreasing the cost of student loans for some borrowers.²⁸²

In the spring of 2002, the GAO published a report, which concluded that:

June 16, 1999, <http://www.ed.gov/PressReleases/06-1999/fees.html>, accessed Feb. 4, 2007.

²⁷⁹ Higher Education Act of 1965 (as amended), Sec. 455(b)(7)(B).

²⁸⁰ U.S. Senate, Letter from Senator James Jeffords to Comptroller General David M. Walker, Dec. 11, 2000, p. 1.

²⁸¹ U.S. House of Representatives, Committee on Education and the Workforce, Statement of Chairman Bill Goodling on the Clinton-Gore Administration's "New Initiatives Affecting Student Loans and New Teachers," Aug. 10, 2000.

²⁸² U.S. Senate, Letter from Senator James Jeffords to Comptroller General David M. Walker, Dec. 11, 2000.

Education lacks readily accessible data needed to determine whether and how EDA [Electronic Debit Account] borrowers changed their prepayment patterns. As a result, the extent to which EDA borrowers have been less likely to prepay is unknown.²⁸³

The GAO did suggest that some borrowers might be dissuaded from prepaying their loans if they use the electronic-debit option. To address this concern, the GAO recommended that:

... Education take steps to inform EDA borrowers about steps they can take to prepay their loans. Such steps could include modifying EDA applications to allow borrowers interested in prepaying their loans to designate withdrawal amounts in excess of their scheduled payments when they initially complete the EDA application.²⁸⁴

The FDLP electronic debit benefit remains in effect.

Differences Between FFELP and FDLP Optional Borrower Benefits

As noted above, with the passage in 2006 of the Higher Education Reconciliation Act, many components of FFELP and Direct Loans that had previously differed were brought into conformity through statutory mandates. The statute still provides some latitude for disparate terms, however. Consequently, some optional borrower benefits still differ between the two programs, as outlined in the table below.

TABLE 11. Differences between FFELP and FDLP Optional Borrower Benefits

ISSUE	DIFFERENCES BETWEEN FFELP AND FDLP	LEGAL BASIS
<i>Origination Fees</i>	<p>FFELP: Lenders may offer a lower fee upfront to Stafford borrowers, but not to PLUS borrowers.</p> <p>Currently, many lenders waive the fee completely or partially for Stafford loans.</p> <p>Some lenders rebate a portion of the fee for FFELP PLUS loans after the loan is disbursed or enters repayment.²⁸⁵</p>	<p>FFELP: FFELP Stafford benefits are permitted by the following clause in the statute: “each eligible lender under this part is authorized to charge the borrower an origination fee in an amount not to exceed [currently 2] percent.”²⁸⁶</p> <p>FFELP PLUS borrowers must pay the fee upfront according to this provision: “Each eligible lender under this part shall charge the borrower an origination fee of 3.0 percent of the principal amount of the loan ...”</p>

²⁸³ U.S. General Accounting Office, Report to the Honorable James M. Jeffords, U.S. Senate, *Direct Student Loans, Additional Steps Would Increase Borrowers’ Awareness of Electronic Debiting and Reduce Federal Administrative Costs*, March 2002, p. 4.

²⁸⁴ *Ibid.*, p. 13.

²⁸⁵ See for example: <http://www.nationaled.net/incentives.asp>, accessed February 14, 2007.

²⁸⁶ *Higher Education of 1965* (as amended), Sec. 438(c)(2).

ISSUE	DIFFERENCES BETWEEN FFELP AND FDLP	LEGAL BASIS
	<p>FDLP:</p> <p>The Secretary has the authority to reduce the origination fee for both PLUS and Stafford loans as part of repayment incentives. The impact of the reduction must be cost-neutral.</p> <p>ED currently provides an upfront interest rate rebate worth 1.5 percent of the original principal loan amount for Stafford and PLUS loans. Although billed as an interest rate rebate, the actual effect of this benefit is to decrease the origination fee by 1.5 percentage points. To keep the benefit, borrowers must make their first 12 loan payments on time.</p>	<p>There is no explicit prohibition in statute against a later rebate, however²⁸⁷</p> <p>FDLP:</p> <p>FDLP benefits for both Stafford and PLUS also are allowed by statute, as follows: "The Secretary is authorized to prescribe by regulation such reductions in the interest rate or origination fee paid by a borrower of a loan made under this part as the Secretary determines appropriate to encourage on-time repayment of the loan. Such reductions may be offered only if the Secretary determines the reductions are cost-neutral and in the best financial interest of the Federal Government."²⁸⁸</p>
<p><i>Federal Default Fee</i></p>	<p>FFELP:</p> <p>Although guarantors must deposit the 1-percent fee in their federal fund, it is not mandatory that they charge the fee to the borrower. The fee may be paid from other non-federal funds.</p> <p>Many guarantors and lenders are paying the fee on Stafford loans rather than passing it on to students.</p> <p>Some entities also are paying the fee on behalf of PLUS borrowers.</p> <p>FDLP:</p> <p>Although the default fee is a separate fee under FFELP, an equivalent origination fee is charged to Direct Loan borrower. That origination fee, as noted above, can be reduced by the Secretary under certain conditions.</p>	<p>FFELP:</p> <p>FFELP benefits permitted by statute as follows: Guarantors are required to collect and deposit: "A Federal default fee of an amount equal to 1.0 percent of the principal amount of the loan, which fee shall be collected either by deduction from the proceeds of the loan or by payment from other non-Federal sources."²⁸⁹</p> <p>FDLP:</p> <p>Please see above.</p>
<p><i>Interest Rate Benefit – Automatic Debit</i></p>	<p>FFELP:</p> <p>Commonly, a 0.25 percent reduction in the interest rate for payments via automatic debit. Some lenders offer a greater reduction.²⁹⁰</p> <p>FDLP:</p> <p>The Direct Loan Program offers a 0.25 percent reduction in the interest rate for</p>	<p>FFELP:</p> <p>FFELP interest rate benefits are in statute: "Nothing in this section or section 428C shall be construed to prohibit a lender from charging a borrower interest at a rate less than the rate that is applicable under this part."²⁹²</p> <p>FDLP:</p> <p>FDLP interest rate benefits are permitted by</p>

²⁸⁷ *Higher Education of 1965* (as amended), Sec. 438(c)(6).

²⁸⁸ *Higher Education of 1965* (as amended), Sec. 455(b)(8).

²⁸⁹ *Higher Education of 1965* (as amended), Sec. 428(b)(1)(H) and Sec. 428H(h).

²⁹⁰ See, for examples, http://www.uwrf.edu/financial-assistance/finaid_process/Preferred_Lenders.htm and <http://financialaid.syr.edu/lenderchart0607.htm>, accessed February 14, 2007.

²⁹¹ See "Billing Options," <https://www.dlsonline.com/borrower/QctrHelpIndex.do?SectionId=Faqu>,

ISSUE	DIFFERENCES BETWEEN FFELP AND FDLP	LEGAL BASIS
	payments via automatic debit. ²⁹¹	statute if cost-neutral, as shown above. ²⁹³
<i>Other Interest Rate Benefits</i>	<p>FFELP: Many lenders reduce interest rates after a certain number of on-time payments. Other lenders reduce principal as a reward for paying on time.²⁹⁴</p> <p>FDLP: The interest rebate offered is discussed above under the origination fee.</p>	<p>FFELP: FFELP interest rate benefits are allowed by statute as described above.²⁹⁵ FFELP principal reduction or cash back benefits are not explicitly permitted by statute.</p> <p>FDLP: FDLP interest rate benefits are permitted by statute if cost-neutral, as shown above.</p>

STAFFORD LOAN DEFAULT RATES

Stafford Cohort Default Rates

There are several ways of measuring Stafford loan defaults. Since the 1980s the most common yardstick has been the institutional cohort default rate, which is based on the following formula:

The percentage of a school's borrowers who enter repayment on certain Federal Family Education Loan (FFEL) Program and/or William D. Ford Federal Direct Loan (Direct Loan) Program loans during a particular Federal fiscal year (FY), October 1 to September 30, and default or meet other specified conditions prior to the end of the next fiscal year.²⁹⁶

Cohort default rates are important to institutions because rates of 25 percent or more over a period of three years, or a rate of greater than 40 percent for one year, likely will disqualify the school from participation in the student loan programs.²⁹⁷

Cohort Default Rate Trends

Since 1987, the Department of Education has been tracking the national institutional cohort default rates for FFELP. Rather than reporting a separate rate for FDLP, annual default rate data since 1995 has combined information for both programs.

accessed Feb. 26, 2007.

²⁹² *Higher Education of 1965* (as amended), Sec. 427(m).

²⁹³ *Higher Education of 1965* (as amended), Sec. 455(b)(8).

²⁹⁴ See, for examples, http://www.uwrf.edu/financial-assistance/finaid_process/Preferred_Lenders.htm and <http://financialaid.syr.edu/lenderchart0607.htm>, accessed Feb. 14, 2007.

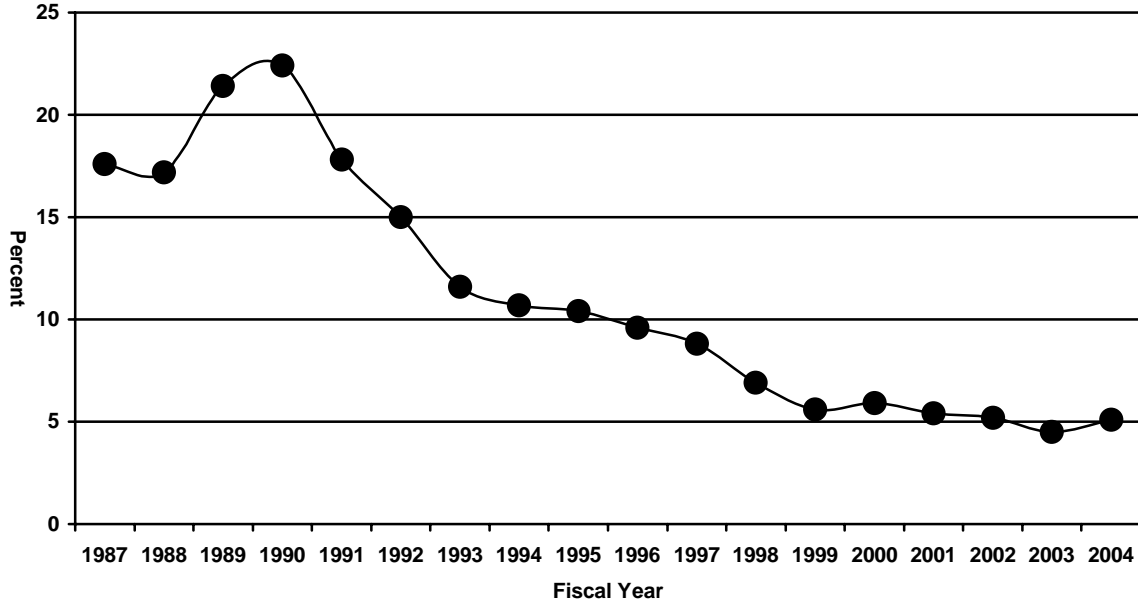
²⁹⁵ *Higher Education of 1965* (as amended), Sec. 427(m).

²⁹⁶ U.S. Department of Education, <http://www.ed.gov/offices/OSFAP/defaultmanagement/cdr.html>, accessed Feb. 14, 2007.

²⁹⁷ *Higher Education Act of 1965* (as amended), Sec. 435(a)(2).

As shown in Figure E, these combined default rates have fallen significantly during the past decade and had begun a sharp decline prior to implementation of Direct Lending.

FIGURE E. National Cohort Default Rate Percentages FY 1987-FY 2004²⁹⁸



There are several likely reasons for this decline. Among them:

- Defaults probably are lower as a result of 1990 legislation that removes schools with excessively high default rates from participation in the federal student loan programs.²⁹⁹ According to the Department of Education, 1,161 schools have lost student loan program eligibility since 1991.³⁰⁰
- Education Secretary Margaret Spellings has given credit to all student loan program participants for the lower rates, according to the following text from an ED news release:

There's a coordinated campaign among all partners in the federal loan programs to focus attention on student loan repayment — and it's working. ... Financial awareness outreach to students and families, and targeted intervention when needed have paid off, resulting in significant savings to taxpayers.³⁰¹

²⁹⁸ U.S. Department of Education, "National Student Loan Default Rates," Web Document published Sept. 2006, <http://www.ed.gov/offices/OSFAP/defaultmanagement/defaultrates.html>, accessed Sept. 19, 2006.

²⁹⁹ *Omnibus Budget Reconciliation Act of 1990*, Public Law No. 101-508, Nov. 5, 1990.

³⁰⁰ U.S. Department of Education, "Briefing on National Default Rates," Sept. 13, 2006, <http://www.ed.gov/news/pressreleases/2005/09/09142005.html>, accessed Sept. 19, 2006.

³⁰¹ U.S. Department of Education, *Press Release*, Sept. 14, 2005.

Cohort Default Rate Comparisons

In 2000, the GAO completed a narrowly focused study of institutional cohort default rates. According to the study:

The most recent student loan default rate statistics for schools — the 1998 cohort default rates — showed that overall, the direct and guaranteed student loan programs had similar default rates — 6.6 percent for FDLP and 6.7 percent for FFELP.³⁰²

Although these rates were almost identical, the GAO suggested that “considering that FDLP is a relatively new program, more time will be needed to tell whether this similarity in rates will continue.”³⁰³

The 1999 annual cohort default rate data (published in 2001) showed that the rate for Direct Loans was 6 percent, compared with a FFELP rate of 5.3 percent.³⁰⁴ The Deputy Secretary of Education indicated that “the Department did not view this difference as significant noting that it was primarily a function of the different cohort of schools in the Direct Loan program and could be related to better counseling in the FFEL program.”³⁰⁵

Data released by ED in a letter in response to questions from Rep. George Miller indicated a similar trend for 2000. For that year, the cohort rate for Direct Loans stood at 6.1 percent compared with 5.7 percent for FFELP. The Secretary of Education also maintained that the differences could be explained by the fact that, on average, schools that switched to Direct Lending have historically had higher default rates than was the case for FFELP schools.³⁰⁶

No official reports that compare cohort default rates between the two programs have been published since 2000.

Concerns about Understatement of Cohort Default Rates

The GAO and the Education Department’s Inspector General have questioned the adequacy of the current method of calculating the cohort default rate as well as some of the underlying policies that have an impact on the rates. These oversight entities have indicated, at various times, that:

- Cohort default rates do not appear to reflect general default trends.
- The method of calculating the cohort default rate is inadequate.

³⁰² U.S. General Accounting Office, Report to Congressional Requesters, *Student Loans, Direct Loan Default Rates*, October 2000, p. 7.

³⁰³ Ibid.

³⁰⁴ Education Finance Council, Inc., *EFC Exchange*, Sept. 19, 2001.

³⁰⁵ Ibid.

³⁰⁶ U.S. Department of Education, Letter from Secretary Roderick Paige to Congressman George Miller, October 29, 2002, p. 1, enclosure, as published in *EFC Exchange*, Oct. 30, 2002.

- Increased use of deferments and forbearances may mask defaults.
- Consolidating defaulted loans is not cost-effective and hides defaults.

Below are synopses of each of these reports.

Cohort Default Rates Do Not Appear to Reflect General Trends in Defaults

In 2003, the Department's Inspector General released a cohort default rate audit report, which claimed that:

Cohort default rates do not appear to provide decision makers with sufficient information on defaults in the Title IV loan programs. Cohort default rates do not capture information on defaults beyond the two-year cohort period, because the HEA specifies that cohort default rates only include defaults that occur during the FY in which the borrower enters repayment and in the following FY. Without information that reflects the general trend in defaults, schools may continue to participate in Title IV programs even though a significant percentage of their students may default. Defaulted student loans cost taxpayers money.³⁰⁷

The 2003 study also echoed an earlier study by the GAO in its finding that borrower deferments and forbearances have a significant impact on cohort default rates:

The percentage of borrowers with loans in deferment or forbearance more than doubled between the 1996 and 1999 cohorts, from 10.1 percent to 21.7 percent. If these borrowers were excluded entirely from the 1996 through 1999 cohort default rate calculations — because the borrowers were not making payments during the cohort default period, and could not default — the effect would be a material increase in cohort default rates for those years.³⁰⁸

The Method of Calculating the Cohort Default Rate Is Inadequate

According to the Department of Education's Inspector General:

Based on the Department of Education's longstanding interpretation and implementation of the default provisions of the Higher Education Act, official cohort default rates are understated. As a result, schools with high default rates are not being identified because not all of the borrowers who meet the statutory definition of a defaulter during the cohort period are included in the default rate computation. ...

The understated rates occur because the Department does not capture the default date or count reported defaults unless the claim is paid within the cohort period.

³⁰⁷ U. S. Department of Education, *Office of Inspector General, Audit to Determine if Cohort Default Rates Provide Sufficient Information on Defaults in the Title IV Loan Programs*, December 2003, p. 9.

³⁰⁸ *Ibid.* p. 2.

We are recommending that the Chief Operating Officer (COO) for Student Financial Assistance capture the default date in the NSLDS and use that date in calculating cohort default rates for schools.

We also are recommending that the Assistant Secretary for the Office of Postsecondary Education, with appropriate consultation with the public, modify the current cohort default rate computation method to include defaults that occurred within the cohort period but were subsequently paid during the first three months following the cohort period.³⁰⁹

Increased Use of Deferments and Forbearances May Mask Defaults

A 1999 General Accounting Office report cautioned that the published cohort default rates were understated because borrowers whose loans were in deferment or forbearance were included in the rate calculation.³¹⁰

The GAO found that:

Between 1993 and 1996, the percentage of borrowers with loans in deferment or forbearance more than doubled, from 5.2 percent of borrowers who had begun repaying to 11.3 percent. ...

According to Department of Education officials, the increase was attributable, in part, to provisions of the 1992 amendments to the Higher Education Act of 1965 that eased the requirements for obtaining deferments and forbearances as a way of helping minimize loan defaults.

Excluding borrowers with loans in deferment or forbearance entirely from the calculation of the cohort default rate would have had the effect of increasing the overall default rate from 9.6 percent to 10.9 percent for 1996, the most recent cohort year for which data are available. ...

For the 1996 cohort, excluding borrowers with loans in deferment or forbearance from the calculation would have increased the number of schools with rates exceeding the 25-percent threshold (for excluding schools from the loan programs) by 181 schools, from 352 to 533 — an increase of 51 percent. ... Most of the additional schools that would have exceeded the threshold under the alternative calculation method were proprietary schools, but 12 were 4-year colleges and universities and 57 were public or private schools with degree programs of less than 4 years. Because the number of borrowers with loans in deferment or forbearance has been growing, and because the exclusion of these

³⁰⁹ U.S. Department of Education, Office of Inspector General, *Change in the Computation of Cohort Default Rates Would Make Rates More Accurate*, Final Audit Report, March 2000, p.1.

³¹⁰ U.S. General Accounting Office, GAO Report to Congressional Requesters, *Student Loans, Default Rates Need to Be Computed More Appropriately*, July 1999, pp. 3-4.

borrowers from the calculation could have a substantial effect on schools' default rates, the Congress may want to consider requiring an alternative method for computing default rates.³¹¹

Consolidating Defaulted Loans Is Not Cost-Effective and Hides Defaults

In 1997, the Department of Education's Inspector General urged Congress to enact an across-the-board prohibition against consolidation of defaulted loans. As rationale for this policy recommendation, the OIG claimed that:

The Department as of June 10, 1996 paid \$23 million to consolidate into the William D. Ford Federal Direct Loan Program (FDLP) 29,431 defaulted loans previously held by the Department's Debt Collection Services (DCS). These consolidations resulted in the Department collecting \$8.53 less per month per loan in the FDLP than what was collected by DCS.³¹²

The OIG also based its suggestion on a 1996 audit of the consolidation process, which found that:

- The prospect of repayment of the new FDLP loans was low and the likelihood of re-default was high, given the poor payment history of the defaulted borrowers.
- There were high upfront costs, largely from collection agency and servicer fees, that [the OIG] believed would not be recouped. Defaulted borrowers who consolidate into new FDLP loans and repay their new loans under the income contingent repayment option may pay nothing or minimal payments too small to repay their loans.
- Revenues from involuntary collection methods, such as tax-refund offsets and wage garnishment, were lost because these methods are used only for defaulted loans.
- Defaulted borrowers who consolidate become eligible for additional student loans and grants and pose a significant risk of defaulting again.³¹³

Default Rates Used for Budgeting Purposes

The FFELP and Direct Loan default rates used for federal budgeting purposes are **not** the cohort default rates, but rates that are based on formulas, "which reflect projected defaults over the life of a loan cohort."³¹⁴

³¹¹ Ibid.

³¹² U.S. Department of Education, Office of Inspector General, *OIG Proposals for the 1998 Reauthorization of the Higher Education Act*, July 1997, p. 42.

³¹³ Ibid.

³¹⁴ U.S. Department of Education, *FY 2008 Budget Appendix*, p. 337.

Until recently, the Administration assumed, in cost estimates in its annual budgets, that FFELP and FDLP would experience comparable default rates over the life of each year's volume of loans. Thus, federal budget proposals, until the 2005 budget, asserted that, "within each risk group, it is assumed that borrowers choosing similar repayment plans will have similar default rates, regardless of whether they borrow under the FFEL or Direct Loan program."³¹⁵

The 2005 budget changed ED's previous methodology and incorporated new default forecasts. Table 12 shows that the projected rates for subsidized Stafford and PLUS loans are roughly similar for both programs. As illustrated in Table 17 on p. 130, FDLP **consolidation** loans are projected to experience much higher default rates than is the case for their FFELP counterparts.

TABLE 12. Projected Life-of-Loan Default Rates for FDLP and FFELP Subsidized Stafford and PLUS Loans — 2003-2008 ³¹⁶

Fiscal Year Cohort	STAFFORD SUBSIDIZED		PLUS	
	FFELP	FDLP	FFELP	FDLP
FY 2003	12.8%	11.5%	6.4%	5.6%
FY 2004	13.0%	11.6%	6.4%	5.5%
FY 2005	12.5%	11.9%	5.4%	5.5%
FY 2006	12.3%	12.4%	5.2%	5.5%
FY 2007 (est.)	12.5%	12.7%	5.2%	5.5%
FY 2008 (est.)	12.7%	12.8%	5.2%	5.5%

Default Collections

FFELP guarantors and FDLP collections contractors are able, over time, to recoup a substantial portion of defaulted loans. According to the *Federal Student Loans Programs Data Book*, for FFELP, defaults totaled about \$39 billion from 1986 to 2000. During the same period, collections on defaulted loans amounted to \$29.4 billion.³¹⁷ For FDLP, which has a relatively small outstanding loan portfolio, defaults from 1996 to 2000 amounted to \$1.3 billion, with collections of \$300 million.³¹⁸

The Department of Education has not published a *Data Book* since 2000, and the federal budget documents do not contain data on the amount of FDLP defaults because they are

³¹⁵ See, for example, U.S. Department of Education, *FY 2004 Budget Appendix*, p. 347.

³¹⁶ U.S. Department of Education, *FY 2005 Budget Appendix*, p. 367, *FY 2006 Budget Appendix*, p. 370 and *FY 2007 Budget Appendix*, p. 366, *FY 2008 Budget Appendix*, p. 337.

³¹⁷ U.S. Department of Education, Office of Postsecondary Education Policy, Planning, and Innovation, *Federal Student Loan Programs FY 1997-FY 2000 Data Book, FFEL Program and FDLP Defaults and Collections*, Table 49.

³¹⁸ *Ibid.*, Table 50.

considered fiscal “non-events”.³¹⁹ The budget documents do include information about FFELP defaults and collections. This information reveals that during the fiscal years 2001-2006, loan default costs totaled \$18.9 billion and collections on all outstanding FFELP defaulted loans totaled \$23.3 billion.³²⁰

POLICY ISSUES

School-as-Lender Issues

During the past several years, school-as-lender issues have given rise to much congressional activity as well as intensified scrutiny by the media and other entities. This section covers school-as-lender history, participation trends and loan volume.

Brief History of School-as-Lender

1965-1985

Educational institutions have had the authority to be FFELP lenders since the enactment of the Higher Education Act in 1965.³²¹ In the course of the following 20 years, the statute was modified to limit institutional loans to graduate and professional students. An exception permitted lending to undergraduate students who were unable to obtain loans from other lenders, but under no circumstances could a school-lender provide loans to more than 50 percent of its undergraduates.³²²

Thus, the intent of the schools-as-lender authority was limited. According to a student aid official:

The purpose of an institution becoming a lender for graduate programs was to provide loans for graduate students at a time when federal student loans were more difficult to obtain. The intent was to provide institutions with the opportunity to provide their own capital for loans. ... Some institutions used the process as a lender of last resort.³²³

In addition to targeting the types of students who could receive loans, early statutes (and current law as well) mandated that institutional lenders must employ at least one full-time financial aid person and that the school lender could not be a home-study school.³²⁴

³¹⁹ U. S. Department of Education, Fiscal Year 2005 Budget Appendix, p. 367.

³²⁰ U. S. Department of Education, *Fiscal Years, 2003, 2004, 2005, 2006, 2007, 2008 Budget Appendices*, p. 370, p. 347, p. 367, p. 371, p. 367, and p. 338 respectively.

³²¹ Public Law No. 89-329, *Higher Education Act of 1965*, Nov. 8, 1965, Secs. 433 and 435.

³²² See above and also P.L. 89-698, Sec. 204, Oct. 29, 1966; P.L. 90-575, Secs. 116, 118, Oct. 16, 1968; P.L. 94-482, Sec. 127(a), Oct. 12, 1976; P.L. 95-43, Sec. 1 (a)(35), (a)(36), June 15, 1977; P.L. 96-374, Secs. 412(e), 421(e)(2), 1391, Oct. 3, 1980.

³²³ *Student Lending*, “Interview with Dan Davenport, Director of Admissions and Student Financial Aid University of Idaho,” Sept. 3, 2003, p. 5.

³²⁴ *Ibid.*

Furthermore, 1970s legislation provided that institutional lenders would be disqualified from making loans if their default rates, as calculated then, were 15 percent or higher over a two-year period. Some mitigating circumstances and appeals processes existed then, as they do now.³²⁵

1985-2000

1989 Advisory Committee Report on Institutional Lending

In the 1980s, concurrently with the debate about Direct Lending, there was considerable debate in the school community about the feasibility of institutions becoming the sole lenders under FFELP. This debate was, in part, fueled by the fact that schools were concerned about the administrative burdens that resulted from having to do business with a multitude of lenders and guarantors with widely varying loan processing requirements.

Institutions reasoned, just as they did when advocating for Direct Loans, that since many of them were already lenders in the Perkins Loan Program, they simply would need a source of capital in order to be able to fully meet the loan needs of their students.

In the late 1980s, as the issue continued to brew, Congress tasked the Advisory Committee on Student Financial Assistance with conducting “a thorough study of institutional lender policy.”³²⁶

According to Brian Fitzgerald, at that time the staff director of the Advisory Committee, the group had a generally negative opinion about expanding the scope of institutional lending. Specifically:

The Committee’s analysis identified several major concerns with expanding the number of institutions acting as lenders. The Committee found that while expanding institutional lending would reduce complexity and burden for students and institutions, such expansion was potentially destabilizing to the program generally, especially to lenders and guaranty agencies, as a result of larger, more profitable loans — those from borrowers attending high-cost institutions — leaving the bank-based loan program. The Committee strongly recommended against expanding the institutions lending role in the FFEL program. ...

The Committee did explore the issue of whether institutional lending would generate revenues for institutions and whether such revenues could help to hold down prices or subsidize student aid. Committee research indicated that, as a result of relatively high defaults at some schools and the relatively low indebtedness of most students at the time, profitability most likely would be low at most institutions. The Committee found a fundamental problem: high-cost, selective institutions were more likely than other types of institutions (e.g.,

³²⁵ Ibid.

³²⁶ Public Law No. 100-50, Sec. 15(16)-(18), June 3, 1987.

community colleges) to engage in lending; thus the benefits of lending, in general terms, would not accrue to those institutions and students most in need of such revenue. ...

The Committee did examine the issue of “conflicts of interest,” as it related to the manner in which that issue was defined at the time. The Committee found that expansion of institutional lending held the risk of encouraging inducements by lenders, guaranty agencies and secondary markets to institutions in order to gain an institution’s business. ...

The Committee found that in 1989 creaming of low-risk, highly profitable loans from the portfolios of lenders and regional secondary markets could destabilize the loans program and reduce access to capital for low-income students.³²⁷

1992 School-as-Lender Amendments

The 1992 reauthorization legislation added two new stipulations to the school-as-lender section. Specifically, school lenders:

- Must not have a **cohort** default rate greater than 15 percent [the previous default rate calculation was not based on cohorts].
- Must use the proceeds from special allowance payments and interest payments from borrowers for need-based grant programs, except for reasonable reimbursement for their direct administrative expenses.³²⁸

1995 Department of Education School-as-Lender/Inducement Guidance

During the mid-1990s, the Department of Education issued guidance to schools and lenders warning that:

- (1) Schools must be careful how they use their authority to lend to students.
- (2) lenders must observe the inducements prohibitions.³²⁹

Specifically, the 1995 “Dear Colleague” letter provided that the statutory school-as-lender criteria:

May not be evaded by arrangements in which some other lender formally originates the loan and holds it for a short period of time, but the arrangements between that lender and the school allocate all but a small portion of the lender’s economic risk and profit to the school.³³⁰

³²⁷ *Student Lending*, “Interview with Brian Fitzgerald,” March 18, 2003, pp. 4-7.

³²⁸ *Higher Education Amendments of 1992*, Public Law No. 102-325, July 23, 1992, Sec. 427.

³²⁹ U. S. Department of Education, Dear Colleague Letter, “Limitations on lending by schools and prohibition on inducements to schools by lenders must be observed,” 95-L-178, March 1995.

³³⁰ *Ibid.*

The Department's directives pertaining to inducements are outlined in the "Prohibited Inducements" section later in this chapter.

1995 Dept. of Education School-as-Lender Lawsuit Against Sallie Mae

Shortly after issuing the 1995 "Dear Colleague" letter, the Department of Education filed suit against the Student Loan Marketing Association, commonly known as Sallie Mae, claiming that the school-as-lender arrangement that Sallie Mae had instituted with the Dr. Scholl School of Podiatry constituted an illegal inducement. In 1996, the judge in the suit ruled in favor of Sallie Mae as follows:

Section 435(d)(5)(A) of the HEA prohibits lenders from offering, directly or indirectly, "points, premiums, payments, or other inducements, to any educational institution or individual in order to secure applicants" for FFEL loans. The issue presented to this tribunal is whether Sallie Mae violated this provision of the HEA by entering into a contract with the Dr. William M. Scholl College of Podiatric Medicine (Scholl College) whereby the latter would make FFEL loans to its students with the understanding it would later sell these loans to Sallie Mae at a previously agreed upon price which was profitable to Scholl College. Furthermore, pursuant to another contract, Scholl College has a line of credit with Sallie Mae which is used to fund these FFEL loans to its students. SFAP alleged that these contracts violate Section 435(d)(5)(A) because they provide Scholl College with an improper financial inducement to solicit more FFEL loan applications from its students than they would have solicited without such an inducement. After analyzing the evidence presented during the hearing and applying it to the law, I find Sallie Mae has not violated the statute and its eligibility to participate in the FFEL Program should not be limited.³³¹

After a remand by ED, the judge further ruled in 1997 that (quoted in part):

There are no secret deals between Sallie Mae and Scholl College, and Scholl College had no obligation to contract with Sallie Mae. It could have chosen any number of other financial competitors which were capable of providing the same services as Sallie Mae. Regardless of which financial operation Scholl College chose to associate with, the college would still be characterized as the originating lender of the FFEL program loans it extended to its students.

In reaching this conclusion, SFAP's argument to the contrary, one cannot ignore the many contractual arrangements between the two parties which clearly label Sallie Mae as the lender to Scholl College and Scholl College as the borrower from Sallie Mae and the lender to its students, and these contracts clearly set out the specific responsibilities of each party. Following Sallie Mae's performance of

³³¹ Judge Richard F. O'Hair, Docket No. 96-23-SL "United States Department of Education, In the Matter of Student Loan Marketing Association (Sallie Mae), Respondent," Student Financial Assistance Proceeding, Sept. 26, 1996.

its student loan processing, submission to the guaranty agency, and servicing arrangements, Scholl College becomes the holder of all student loans consummated pursuant to these agreements and it remains as such until the student loans enter the repayment stage and are sold to Sallie Mae. Sallie Mae does not consider itself to be the creditor of those student loans, in either a book keeping sense or as assets, until it purchases the loans at prescribed times. During the interim, Scholl College holds these loans and accepts all risks of loss, regardless of how insignificant they may be. More importantly, the Department also considers Scholl College to be the lender/creditor/holder of those loans.³³²

The Department of Education did not appeal this ruling.³³³

2000-2007

2002 Student Aid Groups' School-as-Lender Proposals

While the Bush Administration decided not to address the school-as-lender issue in its legislative proposals, other entities continued to feel that the practice was controversial and should be taken up as part of the anticipated 2003 reauthorization deliberations. CBA, the Direct Student Loan Coalition, NASFAA and the student loan community all submitted recommendations to Congress on the issue. Below are synopses:

- The student loan community, consisting of the major student loan organizations, decided to remain neutral on the issue and stated that:

Current law permits limited participation by schools in the lender role. The past few years have seen a continued and growing increase in this activity. Because questions have been raised about some of the lending practices in the school as lender model, we believe Congress and the Administration should carefully review the school as lender model as part of reauthorization.³³⁴

- Separately, the Consumer Bankers Association proposed that “the “school-as-lender” provision be eliminated, because “there is more than adequate competition to provide loans to all students, and there is no need for a lender of last resort at the graduate level.” The group also recommended that schools currently acting as lenders be required to phase out their programs by not lending to any additional students or parents.³³⁵

³³² Judge Richard F. O’Hair, Docket No. 96-23-SL “United States Department of Education, In the Matter of Student Loan Marketing Association (Sallie Mae), Respondent,” Student Financial Assistance Proceeding, July 18, 1997.

³³³ As Reported in Dean, Blakey and Moskowitz, *Weekly Activities*, Oct. 6, 2000, Item #11.

³³⁴ Consumer Bankers Association, Education Finance Council, National Council of Higher Education Loan Programs, Sallie Mae, Student Loan Servicing Alliance, *Student Loan Community Reauthorization Recommendations*, May 23, 2003.

³³⁵ Consumer Bankers Association, “Additional Reauthorization Concepts,” Dec. 31, 2002.

- The Direct Loan Coalition proposed that “the school as lender program be totally eliminated based in part on the following rationale”:

If schools serving as lenders can realize \$1-2 million per annum in derived profits, it is arguable there are excessive funds within the FFEL program. While many in higher education collectively lobby for increased Pell Grant maximums and the elimination of loan fees, this blatant surplus of funds within the FFEL program is ignored. Such funds would be better directed to the benefit of all needy students — not just to those who happen to enroll at an institution serving as a lender. ...³³⁶

- In 2002, the National Association of Student Financial Aid Administrators, came out in favor of the school-as-lender status quo as follows:

NASFAA recommends maintaining this provision [school-as-lender] and clarifying that proceeds, after subtraction of administrative costs, be used exclusively for need-based student aid programs at the institution.³³⁷

In 2005, the NASFAA Board of Directors voted to rescind this proposal and oppose school-as-lender “because the provision does not support the premise of equal benefits for all students.”³³⁸

2004 School-as-Lender Legislative Proposal

An early House Republican reauthorization proposal, H.R. 4283, which was not enacted during the 108th Congress, recommended these changes to the school-as-lender provisions:

- Repeal of the authority for schools to lend to undergraduates under certain circumstances and a phase-out of the current authority to lend to undergraduates if they had already received a school-as-lender loan.
- A ban on making loans to students who were not enrolled at the institution.
- A stipulation that all earnings above administrative expenses, including the proceeds from sales of loans, must be directed to need-based aid.³³⁹

³³⁶ National Direct Student Loan Coalition, “Recommendations for Reauthorization of the Higher Education Act’s Federal Stafford Loan Program,” March 2003, no page numbers.

³³⁷ National Association of Student Aid Administrators, *Higher Education Reauthorization Recommendations*, Dec. 31, 2002, p. 33.

³³⁸ National Association of Student Aid Administrators, “NASFAA Board Reaffirms Reauthorization Recommendations and Takes New Action,” July 8, 2005, posting on www.NASFAA.org.

³³⁹ H. R. 4283, Sec. 428(i), *College Access and Opportunity Act of 2004*, May 5, 2004.

2004 Access Group Report

In late 2004, the Access Group, a nonprofit student lender, sponsored a report intended to be “an overview of the issues for institutions that are considering adopting the school-as-lender model.”³⁴⁰

Below are excerpts:

- Institutions must generally meet three threshold requirements if they expect to establish successful, attractive school-as-lender programs:
 - The average borrower indebtedness of their graduate and first-professional students must be high;
 - Their graduate and first-professional borrowers must have an exceptionally low default rate if they expect to receive higher premiums when loans are sold; and
 - The institutions must have a sizeable potential school-as-lender volume.
- The five most common types of risks posed by a school-as-lender programs are:
 1. Risk of principal loss;
 2. Risk of liquidity;
 3. Administrative risks;
 4. Risk of reputation; and
 5. Regulatory risks.

The first four risks can be minimized if the program is structured properly; the fifth generally cannot. The typical school-as-lender institution relies on a line of credit from its financial partner; contracts with its partner(s) to provide all origination, servicing, and other support; holds the loans only until they are fully disbursed and then sells them promptly for a premium. Consequently, school-as-lender institutions have minimal cost of funds or financial risks, minimal risk of loss from origination or servicing errors, minimal net interest and special allowance earnings, and rely primarily on premium income from loan sales for their program revenues. Regulatory risks, however, are an inherent feature of federal loan programs because fundamental program rules, terms, and conditions can and have been changed at any time through legislation or regulation.
- The two most commonly cited reasons for creating school-as-lender programs are to be able to:
 1. Reduce graduate and professional students’ borrowing costs;
 2. Generate revenue to provide institutional grants and scholarships or generate revenue for other institutional purposes. . . .

³⁴⁰ Access Group, Inc., *Annual Report 2005*, p. 5.

- The vast majority of institutions with school-as-lender programs attempt to maximize their graduate students' use of the program for their federal borrowing and rarely include other FFELP lenders on a preferred lender list.
- Many are conscientious about avoiding even the appearance of a conflict of interest by not interfering with their students' ability to take advantage of other loans if they have more favorable terms, but those institutions with non-competitive school-as-lender programs are often the least likely to do so. ...³⁴¹

2005 GAO Report

In response to requests from members of Congress to examine various school-as-lender issues, the Government Accountability Office issued a report in early 2005 that concluded that the Department of Education needed to improve its oversight responsibilities over institutional lenders. The GAO reasoned as follows:

A number of statutory and regulatory provisions applicable to all lenders and schools, and some applicable only to school lenders, exist to safeguard the interests of taxpayers and borrowers. FSA, however, has little information about how school lenders have complied with these requirements.

Under the HEA, FFELP lenders that originate or hold more than \$5 million in FFELP loans must submit annually audited financial statements and independent compliance audits to assist Education in detecting fraud, waste, abuse, and mismanagement potentially contributing to borrower defaults. Another provision in the HEA, commonly called the "anti-inducement provision" is designed to protect borrowers' interests by prohibiting any lender from offering gifts or other incentives to schools or individuals to secure FFELP applicants.

To address problems among school lenders in the 1970s, Congress added several provisions that apply only to them. For example, under the HEA, schools with high rates of borrower default are prohibited from participating in FFELP as lenders.

FSA, which is responsible for ensuring compliance with laws and regulations, has not provided timely and adequate oversight of school lenders. For example, in October 2004, FSA discovered that 10 of 29 school lenders required to submit a compliance audit for fiscal year 2002 had not done so. Furthermore, until 2004 FSA had not used its authority to conduct program reviews of school lenders, which supplement the information contained in audits and are intended to improve the integrity of the program. During the course of our review, FSA asked

³⁴¹ Kipp, Dr. Samuel M., III, *The FFELP School-as-Lender Model*, November 2004, pp. iv-vi.

31 school lenders about their compliance with the regulation pertaining to the use of interest income and special allowance payments.

In this report, we are recommending that FSA's Chief Operating Officer take the steps necessary to ensure that all school lenders are consistently complying with FFELP statutory and regulatory provisions intended to protect the interests of taxpayers and borrowers.³⁴²

2005-2006 School-as-Lender Legislation

As the 109th Congress began its activities, members of Congress introduced a number of legislative proposals that addressed a multitude of institutional lending issues. Below is an outline of these initiatives:

H.R. 555

Representatives Dale Kildee, D-Mich., Chris Van Hollen, D-Md., and George Miller, D-Calif., introduced the "School-As-Lender Reform Act of 2005," which added or altered numerous provisions to the statutory requirements and mandated that institutional lenders must:

- Award any contract for financing, servicing, administration, or administration of loans on a competitive basis.
- Offer loans that would carry a reduced origination fee, or a lower interest rate, or both, than authorized under the statute.
- Not have a cohort default rate (as defined in section 435(m)) greater than 10 percent.
- Use any proceeds from special allowance payments and interest payments from borrowers, and any proceeds from the sale or other disposition of loans, for need-based grant programs.
- Submit a compliance audit to the Secretary.
- Ensure that the proceeds from special allowance payments and interest payments from borrowers, and any proceeds from the sale or other disposition of loans, would be used to supplement, and not to supplant, non-Federal funds that would otherwise be used for need-based grant programs.³⁴³

This legislation was not acted upon on a stand-alone basis, but was later incorporated into the Democratic reauthorization bill, H.R. 2960, parts of which were included in H.R. 609, and subsequently enacted through HERA in 2006.³⁴⁴

³⁴² United States Government Accountability Office, GAO, Report to Congressional Requesters, *More Oversight Is Needed for Schools That Are Lenders*, GAO-05-184, January 2005, pp. 4-5.

³⁴³ H. R. 555, *School-As-Lender Reform Act of 2005*, Feb. 2, 2005, Sec. 2.

³⁴⁴ H.R. 2960, *College Opportunity for All Act*, June 17, 2005, Sec. 114.

H.R. 609

Also in early 2005, Congressman John Boehner, R-Ohio, and other Republicans introduced their second reauthorization bill, which included school-as-lender provisions that were essentially identical to those in the 2004 H.R. 4283 (summarized above).

As H.R. 609 went through the legislative process, it became a bipartisan vehicle for additional restrictions on school-lenders, and the bill that was reported out of committee in September had been amended by Congressman Kildee to incorporate all provisions of the Kildee/Van Hollen/Miller bills outlined above. In addition, the Republican bill also added “interest subsidies” to the sources of income that institutional lenders must use for need-based aid.³⁴⁵ Thus, the legislation that was reported out of the House Committee on Education and the Workforce tightened restrictions on schools that act as lenders by:

- Striking the authority to make loans to undergraduate students.
- Providing that the school may make only subsidized and unsubsidized Stafford loans to graduate students.
- Prohibiting the school from making loans to students who are not enrolled at the institution.
- Mandating that schools must award any contract for financing, servicing, or administration of loans on a competitive basis.
- Mandating that loans made must carry a lower origination fee or interest rate, or both, than the statutory maximum.
- Prohibiting a school from making institutional loans if the school’s cohort default rate is greater than 10 percent for the two most recent fiscal years.
- Requiring schools to undergo an annual compliance audit.
- Providing that proceeds from the following must be used for need-based grants:
 - Special allowance.
 - Interest payments.
 - Interest subsidies.
 - The sale and/or disposition of school-as-lender loans.
- Allowing the school to use a portion of the proceeds for reasonable and direct administrative expenses.
- Mandating that the proceeds used for grants must supplement and not supplant non-federal funds that would otherwise have been used for grants.³⁴⁶

The House Committee Report explained the added restrictions and requirements in the following manner:

³⁴⁵ H.R. 609, *College Access and Opportunity Act of 2005*, Feb. 8 and Sept. 22, 2005, Sec. 430.

³⁴⁶ *Ibid.*

The Committee believes that there is a need to clarify Congressional intent with respect to the school as lender program and put into place additional protections for students whose schools serve as the lender given the inherent conflict of interest that may exist with this arrangement.

According to the Government Accountability Office, schools receive a premium for the loans anywhere between two and six percent of the face value of the loans. Under current law, schools are permitted to use the premiums made off of selling the loans for their own purposes, but must use the borrower interest payments and special allowance payments from the government for need based grant programs. For students attending those institutions, the financial aid office is both their lender as well as their financial advisor.

The Committee views the school as lender program as an inherent conflict of interest in the school's role, which is, first and foremost, to educate the student and second, to ensure that the student is receiving the best financial aid package for his or her financial situation. H.R. 609 takes additional steps to reduce the role schools can play as a student's bank by permitting schools to only lend to graduate students, not parents or undergraduate students, and also further restricts where the profits the school is making can be spent.

If schools are making money from the program, the Committee believes it should be put back into the need based aid programs at the school. Through requiring that the schools' profits from its lending programs be put into the need based aid programs, H.R. 609 takes one more step to ensure that students receive the funding they truly need to attend college, without forcing the student to take out more costly private loans.³⁴⁷

S. 1614

In late summer 2005, Senators Michael Enzi, R-Wyo., and Edward Kennedy, D-Mass., introduced a bipartisan reauthorization bill, which included not only stringent restrictions on existing institutional lenders, but also a moratorium on new participants in the school-as-lender program. The legislation:

- Provided that proceeds from the following must be used for need based grant programs, but grants may not exceed the cost of attendance:
 - Special allowance payments.
 - Interest payments from borrowers.
 - Proceeds from the sale of a loan.
 - All other loan proceeds furnished to the eligible institution or any entity affiliated (directly or indirectly) with the eligible institution.

³⁴⁷ H.R. 609, *College Access and Opportunity Act of 2005*, Report of the Committee on Education and the Workforce, Sept. 22, 2006, pp. 200-201.

- Allowed the school to use a portion of the proceeds for reasonable administrative expenses.
- Placed a moratorium on any new schools entering into a school-as-lender arrangement after Aug. 31, 2005.
- Mandated that the school must hold the loan until the student enters grace period.
- Mandated that the proceeds must supplement and not supplant federal, state, and institutional aid.
- Prohibited alumni groups and foundations from being school-lenders.³⁴⁸

The Senate Committee Report explained these limitations as follows:

The committee has heard concerns from several sources about some of the practices of institutions that have become lenders. The committee directs schools acting as lenders to continue acting as the lender until the student completes the required coursework. In addition, schools acting as lenders must use proceeds from the special allowance payments, interest payments from borrowers and proceeds from the sale of the loan only for need based aid or for reasonable reimbursement for direct administrative expenses, including interest owed on funds used to make loans.

The committee believes all net revenues from Federal loans should be used to provide need based aid to students. The committee requires that this source supplement, not supplant, institutional, State, and local sources of support. The committee also recognizes that some institutions are already using some or all of the revenues for need based aid. In implementing this provision the Secretary should recognize current institutional efforts to help students and should apply the supplement, not supplant rule only to that portion of net revenues not currently being applied to need based aid.³⁴⁹

S. 1932: 2005-2006 Budget Reconciliation

Concurrent with the efforts to reauthorize the Higher Education Act, the 109th Congress also embarked on an expenditure-paring budget reconciliation process. After the Senate and the House had each agreed to their respective Budget Resolutions, the situation was as follows, according to a student loan publication:

... The Committees with jurisdiction over student loan programs were hit hard. The House Education and the Workforce Committee was instructed to cut \$12.651 billion over five years. The Senate Health, Education, Labor and Pensions Committee was instructed to reduce spending by \$13.651 billion over

³⁴⁸ S. 1614, *Higher Education Amendments of 2005*, Sept. 6, 2005, Secs. 429 and 1013.

³⁴⁹ *Higher Education Amendments of 2005*, Report of the Committee on Health, Education, Labor, and Pensions, United States Senate, to Accompany S. 1614, Feb. 28, 2006, p. 53.

five years. The discrepancy apparently relates to differing jurisdictions of the two Committees. The Committees are instructed to report out implementing legislation by mid-September. ...

The savings from the student loan programs would go towards deficit reduction and not be used to create a reserve fund for student benefits, as college officials and the student loan community had hoped.³⁵⁰

In the fall of 2005, Congress decided that the need to pass a budget reconciliation measure took priority over the need to pass comprehensive reauthorization bills. Accordingly, the House and Senate agreed to extract savings from the student loan programs by reauthorizing them via the reconciliation measures. Actions on all remaining reauthorization proposals, including some non-budget student loan issues, were postponed and were not addressed by the 109th Congress.

Meanwhile, the conferees on the budget reconciliation bills adopted the House H.R. 609 proposals on institutional lending, effective July 1, 2006, and also added the Senate S. 1614 provision that imposed a moratorium on new institutional lenders, albeit with a different effective date.

Thus, the school-as-lender provisions as enacted:

- Struck the authority to make loans to undergraduate students.
- Provided that the school may make only subsidized and unsubsidized Stafford loans to graduate students.
- Prohibited the school from making loans to students who are not enrolled at the institution.
- Mandated that schools must award any contract for financing, servicing, administration, or administration of loans on a competitive basis.
- Mandated that loans made must carry a lower origination fee or interest rate than the statutory maximum, or both.
- Prohibited a school from making school-as-lender loans if the institution's cohort default rate is greater than 10 percent for the two most recent fiscal years.
- Required schools to undergo an annual compliance audit of their FFELP portfolio, regardless of size.
- Provided that proceeds from the following must be used for need-based grants:
 - Special allowance.
 - Interest payments.
 - Interest subsidies.
 - The sale and/or disposition of school-as-lender loans.

³⁵⁰ NCHelp, *Morning Briefing*, May 29, 2005, pp. 1-2.

- Allowed the school to use a portion of the proceeds for reasonable and direct administrative expenses.
- Mandated that the proceeds used for grants must supplement and not supplant non-federal funds that would otherwise have been used for grants.
- Instituted a moratorium on new institutional lenders by requiring that school-lenders must “have met all school-as-lender statutory requirements in effect on the day before the date of enactment of the Higher Education Reconciliation Act of 2005, and made loans under this part, on or before April 1, 2006.”³⁵¹

This legislation was signed into law on Feb. 8, 2006, and became Public Law No. 109-171.

2006 Legislation to Close School-as-Lender Loophole

S. 3593

In June of 2006, following the revelation that institutions were using trustee relationships with lenders to circumvent the recently enacted moratorium on institutional lending, Senator Edward Kennedy introduced a bill, S. 3593, which included a requirement that, in the case of an eligible institution that used an eligible lender trustee for the purpose of qualifying as a school-lender, the trustee also must meet the newly enacted school-as-lender requirements as well as the “old” requirements under section 435(d) in the statute.³⁵²

In August 2006, Senator Kennedy communicated his concerns about the school-lender trustee relationships in a letter to the Secretary of Education. The letter stated in part:

As you know, in February, Congress established a moratorium on the entry of new schools into the school-as-lender program and enacted a number of specific obligations on institutions already in the program. Since the new restrictions were enacted, it has come to my attention that a growing number of schools are being advised by financial institutions that restrictions on the program can be circumvented through the use of an eligible lender trustee. I urge you to ensure that this loophole is not used to circumvent the law. ...

Prior to the moratorium on the program, schools in states with laws banning them from participating in the lending process were able to participate in the school-as-lender program through the creation of an eligible lender trust, as long as they abided by the statutory restrictions on the program. Creation of this type of arrangement is no longer relevant, since Congress has banned additional schools

³⁵¹ S. 1932, *Higher Education Reconciliation Act of 2005*, Feb. 8, 2006, Sec. 8011.

³⁵² S. 3593, *Student Debt Relief Act of 2006*, June 28, 2006, Sec. 9.

from becoming lenders. Nevertheless, members of the lending community are encouraging schools to use an eligible lender trust solely to circumvent the new federal restrictions.

The Department of Education recognized the potential for abuse and issued a “Dear Colleague Letter” in 1995 to clarify that arrangements intended to evade the restrictions on the school-as-lender program would not be tolerated. I urge you to continue this policy of preventing lenders from using loopholes to violate the law. ...³⁵³

H.R. 6138

In October 2006, Congress passed, and the President signed, a bill that extended the programs under the Higher Education Act. The legislation also included several permanent provisions, including a modified version of the Kennedy proposal on school-lender trustee relationships. Specifically, the bill:

- Prohibited new trustee relationships after the date of enactment of the legislation.
- Grandfathered existing trustee relationships.
- Effective Jan. 1, 2007, mandated that lenders that act as trustees must meet a number of the requirements that apply to institutional lenders, such as:
 - Not making loans to undergraduates.
 - Not making PLUS or consolidation loans.
 - Not making loans to students who are not enrolled at the institution.
 - Offering loans with lower origination fees and/or interest rates.
 - Complying with certain audit obligations on loans held for the institutional lender.³⁵⁴

2006 Legislative Proposal to Repeal School-as-Lender Authority

Concomitant with the passage of the lender-trustee clarifications, Sen. Charles Schumer, D-N.Y., introduced legislation that would repeal, with no grandfathering, all institutional lending.³⁵⁵

An industry publication provided the following assessment of the legislation:

Additional evidence that student loan marketing practices will remain a major issue appeared on Friday, shortly before the Senate recessed for the mid-year

³⁵³ Senator Edward Kennedy, “Letter to Secretary of Education, Margaret Spellings”, Aug. 1, 2006.

³⁵⁴ H.R. 6138, *Third Higher Education Extension Act of 2006*, Sept. 30, 2006, Sec. 3.

³⁵⁵ S. 4035, *To Amend the Higher Education Act of 1965 to Repeal the School as Lender Program*, Sept. 29, 2006.

elections. Senator Charles Schumer (D-NY) introduced a bill to repeal the school-as-lender program, S. 4035.

Throughout the summer, there were rumors that Senator Schumer was going to introduce a new bill relating to the school-as-lender program. Reportedly, Schumer has seen the MyRichUncle advertisements suggesting abuses in student loan marketing and believes that school-as-lender arrangements are a circumvention of the prohibition on FFEL lenders paying inducements to secure loan applications.

Schumer's bill goes beyond the provisions included in the most recent short term extension of the Higher Education Act and the Higher Education Reconciliation Act. Those measures cut off the entry of new schools to the school-as-lender program as of April 2006 and also imposed new restrictions on the use of proceeds earned by schools by acting as lenders.³⁵⁶

No action was taken on this bill in the 109th Congress.

Trends

Number of School-Lenders

The number of school-lenders has increased sharply over the past five years. Data published as part of a 2005 GAO study and data from news sources show that there were:

- Fewer than 20 institutional lenders in the late 1990s.
- Sixty-four in 2003-2004.
- At least 100 in 2005.
- An estimated 150 in 2006.³⁵⁷

Furthermore, *The Chronicle of Higher Education* reported that an additional "64 universities rushed to apply to become lenders shortly before a congressionally required moratorium on the 'school-as-lender' program went into effect."³⁵⁸

School-as-Lender Loan Volume

School-as-lender loan volume has grown in tandem with the increase in the number of school-lenders. In 1992-1993, school-as-lender loans amounted to less than \$200 million. That figure swelled almost eight-fold to more than \$1.5 billion in 2003-2004.³⁵⁹

³⁵⁶ Washington Partners, LLC, *Weekly Memorandum*, Oct. 6, 2006. Item #4.

³⁵⁷ United States Government Accountability Office, GAO, Report to Congressional Requesters, *More Oversight Is Needed for Schools That Are Lenders*, GAO-05-184, January 2005, pp. 8-11.

³⁵⁸ *The Chronicle of Higher Education*, "Colleges Find a Way to Keep Profiting From Loans," July 14 2006, p. A1.

³⁵⁹ United States Government Accountability Office, GAO, Report to Congressional Requesters, *More*

A year later, 15 school-lenders were represented among the top 100 FFELP originating lenders, and these schools originated almost \$1.5 billion in student loans among them, the same amount that **all** 64 school-lenders originated a year earlier. The table below outlines the FY 2005 volume for each of the top institutional lenders.³⁶⁰

TABLE 13. FY 2005 Loan Volume for Top 15 School Lenders³⁶¹

School Lender	Volume (Millions)
1. <i>Nova Southeastern University</i>	\$392.1
2. <i>University of Phoenix</i>	\$213.7
3. <i>Webster University</i>	\$103.2
4. <i>University of Pennsylvania</i>	\$93.8
5. <i>Michigan State University</i>	\$91.6
6. <i>Midwestern University</i>	\$81.4
7. <i>University of Missouri - Kansas City</i>	\$62.0
8. <i>University of Miami</i>	\$60.8
9. <i>Wayne State University</i>	\$60.4
10. <i>Kirksville Col. of Osteopathic Medicine</i>	\$59.8
11. <i>Western Univ. of Health Sciences</i>	\$58.9
12. <i>University of Chicago</i>	\$57.0
13. <i>American University</i>	\$54.6
14. <i>University of Denver</i>	\$51.6
15. <i>Palmer College of Chiropractic</i>	\$51.5
Total for Above Institutions	\$1,492.40

Oversight Is Needed for Schools That Are Lenders, GAO-05-184, January 2005, pp. 8-11.

³⁶⁰ U. S. Department of Education, Top 100 Originators of FFELP Loans -- FY05 and FY04. Available at <http://www.fp.ed.gov/PORTALSWebApp/fp/pubs.jsp>, accessed Dec. 1, 2006.

³⁶¹ Ibid.

Prohibited Inducements Issues

The topic of inducements in the student loan programs has taken on heightened importance in recent years. This section outlines the history of prohibited inducements and recent efforts to augment and change the policy guidelines.

Brief History of Prohibited Inducements

1986 Prohibited Inducements Legislation

As mentioned previously, in the 1980s, many student loan providers broadened their geographic focus and began competing for regional and national market-share. To acquire additional loan volume, some efforts involved intensive marketing of federal student loans directly to students and their parents, with a number of lenders offering cash or other incentives to attract customers.

Schools were also drawn into these marketing campaigns. Some of them accepted incentives, viewed by many as inducements, from student loan entities in return for steering student loan volume to certain providers.

In response to concerns about these tactics, the Higher Education Amendments of 1986 provided that all lenders, including institutional lenders, must submit to restrictions on the use of incentives and inducements. These statutory restrictions remain in effect and stipulate that lenders may not:

- Offer, directly or indirectly, points, premiums, payments or other inducements, to any educational institution or individual in order to secure applicants for FFELP loans.
- Conduct unsolicited mailings to students of student loan application forms, except to students who have previously received FFELP loans from the lender.
- Offer, directly or indirectly, FFELP loans as an inducement to a prospective borrower to purchase a policy of insurance or other product.
- Engage in fraudulent or misleading advertising.³⁶²

Similar legislation was enacted for guarantors.³⁶³

³⁶² *Higher Education Amendments of 1986*, “Conference Report to Accompany S. 1965,” Sec. 435(d)(5), Sept. 22, 1986, p. 149.

³⁶³ *Higher Education Act of 1965* (as amended), Sec. 428(b)(3).

1989 Department of Education Inducement Guidance

The Department provided its first guidance on the 1986 inducement legislation in 1989 by issuing a “Dear Colleague” letter that spelled out which activities were prohibited under the Act and which were permissible.

Examples of prohibited activities included:

- Canvassing individual students to persuade them to take out loans with a particular lender.
- Lenders paying another lender finder’s fees in excess of reasonable processing and advertising costs.
- Guarantors and/or lenders providing software and/or hardware to schools at prices below cost.
- Offering potential borrowers prizes if they apply for loans.
- Providing direct payments to schools in return for loan applications.
- Performing institutions’ federally required student loan administration functions free of charge to the schools or paying the schools to perform these functions.

Examples of permissible activities were:

- Activities allowed by the Act, such as providing lower interest rates or fees to student and parent borrowers.
- Providing superior service.
- Provision of training and counseling materials to the school.
- Toll-free numbers for schools and students.
- Non-exclusive meals, such as trade association luncheons for schools.³⁶⁴

1995 Department of Education School-as-Lender/Inducement Guidance

As noted above, ED issued additional guidance in 1995 warning that:

- (1) Schools must be careful how they use their authority to lend to students.
- (2) Lenders must observe the inducements prohibitions.³⁶⁵

³⁶⁴ U. S. Department of Education, *Dear Colleague Letter*, “Inducements Prohibited Under the Stafford Loan, Supplemental Loans for Students, PLUS and Consolidation Loan Programs,” 89-L-129, February 1989.

³⁶⁵ U. S. Department of Education, *Dear Colleague Letter*, “Limitations on lending by schools and prohibition on inducements to schools by lenders must be observed,” 95-L-178, March 1995.

In the matter of prohibited inducements, the guidance provided that “it does not matter whether the lender offers the monetary benefit to the school directly or simply arranges for the school to receive the benefit from a third party.”³⁶⁶

Furthermore, the letter stated that:

Although providing “inducements” to a school is not permitted for any lender, it becomes part of an improper activity for the school as well when it is structured to enable a school “lender” to evade the limitations of paragraph (d)(2) on an undergraduate loan. We have heard of situations, for example, in which the non-school lender itself originates the loan acting as “trustee” for the school and subsequently “buys” the loan from the school after the school has received substantial interest payments or in which the non-school lender that ultimately “buys” the loan arranges for some other “lender” to be the originator of record. Arrangements such as these put both the school and the non-school lender at risk of losing their eligibility under FFELP.³⁶⁷

1998 Amendments Regarding Prohibited Inducements

After the implementation of Direct Lending, FFELP lenders and guarantors recommended that the anti-inducement law be changed to allow them to provide the same benefits to their customers as the Secretary provided to FDLP schools. Consequently, the 1998 Higher Education Amendments added the following to the statutory inducement provisions:

It shall not be a violation of this paragraph for a lender to provide assistance to institutions of higher education comparable to the kinds of assistance provided to institutions of higher education by the Department of Education.³⁶⁸

A similar provision was added to the Act pertaining to guarantors.³⁶⁹

2003 Inducement Alert from the Inspector General

The issue of illegal inducements moved to the forefront in 2003 with a letter from the ED Inspector General to the Assistant Secretary, which read in part:

... The Department’s interpretive guidance to the community through Dear Colleague Letters has not been updated since 1995. Informal guidance provided in letters and e-mails has not resolved the concerns of the FFELP participants as to what constitutes an inducement. Formal administrative enforcement action has been limited to one case, involving Sallie Mae’s agreement with Dr. William M. Scholl College of Podiatric Medicine. Federal Student Aid has never performed

³⁶⁶ Ibid.

³⁶⁷ Ibid.

³⁶⁸ Public Law No. 105-244, “Higher Education Amendments of 1998,” Oct. 7, 1998, Sec. 429.

³⁶⁹ Ibid., Sec. 417.

reviews of lenders for the specific purpose of reviewing compliance with the anti-inducement provision. ...

Our review concluded there are bargaining practices between schools and lenders for FFELP referred loan status and private loan volume that should be addressed through statutory and regulatory changes or further Department guidance. Given the current marketing practices by schools and lenders, the Department should examine the roles and responsibilities of schools, as well as lenders and lender affiliates in the inducement issue.

We recommend that in recognition of the current market realities in the FFELP, the Assistant Secretary for OPE:

Provide guidance on the growing market for private loans by clarifying the application of the anti-inducement provision to private loans; and

Reevaluate the anti-inducement provision of Section 435(d)(5)(A) of the HEA and determine if statutory changes should be proposed in the upcoming reauthorization to include schools, lender affiliates and other necessary changes.³⁷⁰

2003 Department of Education Response to a Congressional Inducement Inquiry

In 2003, some Democratic members of Congress called for hearings, and others wrote to the Department to request action on the issue of inducements.³⁷¹ No steps were taken by ED to clarify current regulations, however. Instead, ED repeatedly expressed a desire for the industry to become self-regulating on the issue, as outlined in the following excerpt of a letter to Sen. John Edwards, D-N.C.:

We responded to the Department's Inspector General's report (ED/OIG 113C0003) that you mentioned by saying that a much more extensive analysis needed to be conducted before the Department takes action. Our main concern is that we could ultimately harm student borrowers by taking actions that may or may not clearly address any problems related to the inducement issue because we do not have a complete analysis of the purportedly problematic activities.

The student loan industry and higher education community are currently working to develop a joint statement on the inducements issue, and we understand that they have made significant progress. Rather than intervene at this time, we believe

³⁷⁰ United States Department of Education, Office of Inspector General, "Alert Memorandum to: Sally Stroup, Assistant Secretary, Office of Postsecondary Education, From: Cathy H. Lewis, Assistant Inspector General," Aug. 8, 2003.

³⁷¹ See, for example, press release from Congressman George Miller, "Miller Calls on House Education Committee Chairman and Federal Education Department to Stop Student Loan Scams," Oct. 24, 2003.

that it is preferable to wait to see whether these groups can reach consensus while we pursue a more extensive analysis of the issue.³⁷²

2004 Student Loan Provider and School Self-Regulation

As noted above, the Department of Education had endorsed community self-regulation in the area of inducements. To move this effort along, the National Association of Student Financial Aid Administrators in 2003 spearheaded an initiative to create provider consensus on guidelines for student lending practices. Below is the text of those guidelines, which were endorsed by CBA, EFC and NCHELP in 2004. As of February 2007, NASFAA had not formally endorsed the document.³⁷³

Guidelines for FFELP Industry Practices

The following guidelines were developed to provide guidance to postsecondary institutions and loan industry participants for compliance with the statutory provisions of the Higher Education Act. These guidelines were developed by institutional and lending representatives and are intended to supplement the Department of Education's existing guidance.

1. FFEL borrowers have the right to choose the eligible lender of their choice and institutions cannot intentionally delay or refuse to process the loan application based on the borrower's choice.
2. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to work with institutions, students, and others to help promote increased awareness of financial aid opportunities and generally to promote access to postsecondary education.
3. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to engage in philanthropic activities including providing scholarships or financial contributions; however, they should not be conditioned on the existence of, or the expectation of, an FFEL business relationship between the industry participant and the institution, nor should institutions or their related organizations request or accept philanthropic contributions based on such a relationship.
4. Lenders, guarantors, servicers, secondary markets, and their related organizations should not offer, directly or indirectly, nor should institutions or their related organizations request or accept private loan products in exchange for a specified dollar amount of FFEL loan or guarantee volume, a percentage of FFEL loan or guarantee volume, or FFEL exclusivity. Notwithstanding the above,

³⁷² U. S. Department of Education, "Letter from Assistant Secretary Sally Stroup to Senator John Edwards," Oct 17, 2003.

³⁷³ Washington Partners, LLP, *Weekly Memorandum*, Nov. 12, 2004, Item #6.

institutions may choose a single preferred FFEL lender or a single preferred FFEL service provider.

5. Institutions and their related organizations should not request or accept referral or marketing fees for FFELP loan applications. Institutions and their related organizations are encouraged to coordinate all matters related to student loans through the designated campus financial aid office.

6. Lenders, guarantors, servicers, secondary markets, and their related organizations should not offer referral or marketing fees for FFEL loan volume to educational institutions or other entities; however, they are permitted to offer reasonable referral and processing fees to other lenders and other non-institutionally-related entities for FFEL loan applications.

7. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to work with schools to implement new technologies and to offer training sessions and financial instructional materials that assist students and staff members; however, except as part of a philanthropic effort, lenders, guarantors, servicers, secondary markets, and their related organizations should not offer, nor should institutions or their related organizations request or accept equipment, commercially available software or funds to procure such.

8. Subject to applicable state law, lenders, guarantors, servicers, secondary markets, or their related organizations may provide reasonable financial reimbursement to institutional personnel for travel, lodging, meals, and miscellaneous expenses, associated with their participation in school advisory group meetings held by the sponsor.

9. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to sponsor approved activities open to all eligible attendees during regularly scheduled conference periods. Every effort should be made to conduct private functions during times that do not conflict with any portion of the scheduled conference program.

10. Institutional personnel should not request or accept, nor should lenders, guarantors, servicers, secondary markets, or their related organizations offer gifts, meals, or tickets to entertainment events if the value of such is greater than what would be offered in a normal business setting. Further, institutional personnel should be aware of state ethics laws to ensure they are in compliance.³⁷⁴

³⁷⁴ EFC, NCHelp, CBA, News Release, "Loan Associations Endorse Inducement Guidelines," Nov. 16, 2004.

2006-2007 Proposed “Student Loan Sunshine Act”

Following the 2006 election, Senator Kennedy announced his intention to bring up a “Student Loan Sunshine Act” that would mandate that colleges and lenders publicize their student loan arrangements and that also would require the GAO to undertake a study of inducements.³⁷⁵

In early 2007, Senate and House Democratic members, led by Senator Kennedy and Representative George Miller, D-Calif., followed through on that objective and introduced S. 486 and H. R. 890 respectively. These legislative initiatives were identical and would, as excerpted from the press release issued by Senator Kennedy:

- Prohibit lenders from offering any gift worth more than \$10 to a college employee, including free or discounted trips, meals, invitations to entertainment events or other form of hospitality.
- Prohibit lenders from offering services to financial aid offices that create a conflict of interest, such as lending staff during peak loan processing times.
- Prohibit lenders from entering arrangements with colleges that require the college to “brand” the lender’s loan product with the college’s emblem or logo.
- Require lenders to report to the Secretary of Education any special arrangements they have with colleges to make loans, including the terms of the arrangement related to marketing, recommending, endorsing student loans, and any benefit, direct or indirect, provided to or paid to any party in connection with the loan arrangement.
- Require the Secretary of Education, together with members of the higher education community and students, to develop a clear, easy-to-use model format for reporting the terms and conditions of student loans, similar to the APR disclosure required for other types of loans.
- Require colleges’ preferred lender lists to: include at least three non-affiliated lenders; clearly and fully disclose why the college has identified a lender as a preferred lender; and state that students do not have to borrow from the preferred lender list.
- Task the General Accountability Office with conducting a study of lender practices as they relate to securing loans at institutions with a focus on the use of inducements.
- Require all lenders of direct-to-consumer private educational loans to clearly and prominently state that borrowers may qualify for low-interest loans through the federal government’s loan programs.
- Require these lenders to clearly disclose: how the interest rate is determined; sample loan costs disaggregated by type; information on any

³⁷⁵ Washington Partners, LLC, *Weekly Memorandum*, Nov. 17, 2006. Item #1.

and all fees; information on collection in the case of default; and information on Better Business and state consumer agency or state attorney general complaints against the lender and their resolution.

- Before a direct-to-consumer lender can offer an education loan of more than \$1,000, the Act would require the lender to notify the borrower's college of the amount of the proposed loan, so the school can advise the borrower if the loan exceeds what's necessary to cover the student's cost of attendance after other aid sources are considered.
- Bar lenders from offering a private loan through a college (also known as an "alternative loan") until the college has informed students and parents of all their options for borrowing under the government's Title IV loan programs — including information on any terms and conditions of Title IV loans that are more favorable than the private loan.³⁷⁶

As of February 2007, the bills had not yet been debated and were awaiting action by the committees to which they had been assigned.

2006-2007 Negotiated Rulemaking

In December 2006, the Department of Education announced that it had established a negotiated rulemaking committee charged with addressing federal student loan issues. Among the issues on the committee's agenda were "Use of Preferred Lenders" and "Prohibited Inducements."³⁷⁷

In late January 2007, the Department published proposed regulations on these two issues. Below are summaries of the revised regulatory requirements recommended by ED.

Preferred Lenders

- A School may not provide or make available a list of recommended or suggested lenders for use by the school's students or their parents that—
 - Is used to deny or otherwise impede a borrower's choice of lender;
 - Contains fewer than three lenders who will make loans to students attending the school; and
 - Includes lenders that have offered, or have been solicited to offer, financial or other benefits to the school or its borrowers in exchange for inclusion on the list or any promise that a certain number of loan applications will be sent to the lender by the school or its students.
- A school that provides or makes available a list of recommended or suggested lenders must —

³⁷⁶ Excerpted from S. 486 and Senator Edward M. Kennedy's Press Release, "Kennedy, Durbin Introduce Bill to Prevent Exploitation of Students by Private Lenders," Feb. 1, 2007.

³⁷⁷ U. S. Department of Education Announcement, <http://www.ed.gov/policy/highered/reg/hearulemaking/2007/nr.html>, accessed Dec. 5, 2006.

- Disclose to prospective borrowers the method and criteria used by the school to choose the lenders that are recommended or suggested;
 - Provide comparative information to prospective borrowers about interest rates and benefits offered by the lenders;
 - Include a prominent statement in any information related to its list of lenders advising prospective borrowers that they are not required to use one of the school's recommended or suggested lenders;
 - Not assign, through award packaging or other methods, a borrower's loan to a particular lender; and
 - Not cause unnecessary processing delays for borrowers who use a lender that has not been recommended or suggested by the school.
- In certifying loans, a school—
 - May not refuse to certify, or delay certification, of a Stafford or PLUS loan based on the borrower's selection of a particular lender or guaranty agency;
 - May refuse to certify a Stafford or PLUS loan or may reduce the borrower's determination of need for the loan if the reason for that action is documented and provided to the borrower in writing, provided the determination is made on a case-by-case basis and the documentation supporting the determination is retained in the student's file.³⁷⁸

Prohibited Inducements

Proposed new regulatory requirements for lenders:

- The term "eligible lender" does not include any lender that the Secretary determines, after notice and opportunity for a hearing before a designated Department official, has, directly or through an agent, employee or contractor—
 - Offered, directly or indirectly, points, premiums, payments, or other inducements to any school or other party to secure applications for FFEL loans or to secure FFEL loan volume, which includes but is not limited to—
 - Payments or offerings of other benefits, including additional financial aid funds or prizes, to a prospective student, parent, or Consolidation Loan borrower in exchange for applying for or accepting a loan from the lender;

³⁷⁸ U. S. Department of Education, "Proposed Regulatory Language, Pre-Decisional Draft for discussion on February 5-7, 2007," Institutional Preferred Lenders Section, Jan. 29, 2007, no running page numbers.

- Payments or other benefits to a school or any organization directly or indirectly affiliated with the school in exchange for applications, application referrals, or application processing rights, a specified volume or dollar amount of loans made, or placement on a school's list of recommended or suggested lenders;
 - Payments or other benefits to a school or any organization directly or indirectly affiliated with the school not specifically tied to loan applications, application referrals, or application processing rights;
 - Payments or other benefits provided to a student at a school who acts as the lender's representative to secure loan applicants, or to a loan solicitor or sales representative who visits campuses to secure loan applicants;
 - Payment of referral or processing fees to another lender that exceed reasonable compensation for the administrative handling and marketing of loan availability by the referring or processing lender, or are based on loans made;
 - Payment of conference or training registration, transportation, and lodging costs for an employee of a school or an employee of an organization directly or indirectly affiliated with a school;
 - Payment of entertainment expenses for employees of a school or employees of an organization directly or indirectly affiliated with a school, including private hospitality suites, tickets to shows or sporting events, meals, alcoholic beverages, and any lodging, rental, transportation, and other gratuities related to lender-sponsored social activities; and
 - Providing below market terms of financing or below market rates for loan origination and servicing to a participating FFEL school lender.
- For these purposes, an organization that is, directly or indirectly, affiliated with a school is defined as a school-affiliated organization. Applications include the Federal Application for Financial Aid (FAFSA) and master promissory notes. Other benefits include, but are not limited to, preferential rates or access to the lender's other financial products, computer hardware or non-loan processing related computer software at below market rental or purchase cost, contributions to institutional scholarship funds, printing and distribution of college catalogs and other materials at reduced or no cost, and the placement of lender employees or contractors at the school, except on an occasional, short-term emergency basis.

- A lender may provide—
 - Assistance to a school that is comparable to assistance provided by the Department of Education to a school in the William D. Ford Direct Loan Program as identified by the Secretary in a notice in the Federal Register.
 - Staffing services to a school on an occasional, short-term, emergency basis;
 - Support of and participation in a guaranty agency's student aid related outreach activities;
 - The cost of meals, refreshments, and receptions that are scheduled in conjunction with meeting or conference events if those events are open to all meeting or conference attendees;
 - Toll-free telephone numbers for use by schools or others to obtain information about FFEL program loans, or for use by schools to electronically submit applicant loan processing information or student status confirmation data;
 - A reduced origination fee in accordance with §682.202(c);
 - A reduced interest rate as provided under the Act;
 - Payment of Federal default fees in a non-discriminatory manner;
 - Other benefits to a borrower under a repayment incentive program that requires, at a minimum, one or more payments to receive or retain the benefit; and
 - Items of a nominal value offered as a form of general advertising or creation of good will.³⁷⁹

Proposed new regulatory requirements for guarantors:

A guaranty agency may not—

- Offer, directly or indirectly, from any fund or assets any premium, payment, or other inducement to a student or a student's parents or an employee or an entity or individual affiliated with a school, to secure applicants for FFEL loans, which includes, but is not limited to—
 - Payments or offerings of other benefits, including additional financial aid funds or prizes, to a prospective student or parent borrower in exchange for processing a loan using the agency's loan guarantee;
 - Payments or other benefits, including additional financial aid funds under State or private programs, to a school based on the school's voluntary or coerced agreement to use the guaranty agency for processing loans, or a specified volume of loans, using the agency's loan guarantee;

³⁷⁹ U.S. Department of Education, "Proposed Regulatory Language, Pre-Decisional Draft for discussion on February 5-7, 2007," Prohibited Inducements Section, Jan. 29, 2007, no running page numbers.

- Payment or other benefits to a school or any organization directly or indirectly affiliated with a school, or to any individual in exchange for applications, application referrals, or application processing rights, a specified volume or dollar amount of loans, or the placement of a lender that uses the agency's loan guarantee on a school's list of recommended or suggested lenders; and
 - Payments or other benefits to a school or any organization directly or indirectly affiliated with a school not specifically tied to loan applications, loan referrals, or application processing rights;
 - Payment of entertainment expenses for school employees or employees of organizations directly or indirectly affiliated with a school, including private hospitality suites, tickets to shows or sporting events, meals, alcoholic beverages, and any lodging, rental, transportation or other gratuities related to any social activity sponsored by the guaranty agency or a lender participating in the agency's program.
- For these purposes, an organization, directly or indirectly, affiliated with a school is defined as a school-affiliated organization in section 682.200. Applications include the Federal Application for Financial Aid (FAFSA) and master promissory notes. Other benefits include, but are not limited to, preferential rates or access to a guaranty agency's products and services, computer hardware at below market rental or purchase cost, contributions to institutional scholarship funds, printing and distribution of college catalogs and other non-counseling or non-student financial aid related materials at reduced or no cost, and the placement of guaranty agency employees or contractors at the school except on an occasional, short-term emergency basis.
 - Assess additional costs or deny benefits otherwise provided to schools and lenders participating in the agency's program on the basis of the lender's or school's failure to agree to participate in, or provide a specified volume of loan applications or loan volume; to the agency's program.

A guaranty agency is not prohibited from providing —

- Assistance to a school that is comparable to that provided by the Department of Education to a school in the William D. Ford Direct Loan Program, as identified by the Secretary in the Federal Register;
- Staffing services to a school on an occasional, short-term, emergency basis;
- Reasonable costs for light meals and refreshments associated with guaranty agency sponsored training of program participants and secondary school personnel and with workshops and forums customarily used by the agency to fulfill its responsibilities under the Act;
- Reasonable costs of receptions that are scheduled training, meeting or conference events if those events are open to all training, meeting or conference attendees;

- Travel and lodging costs that are reasonable as to cost, location, and duration to facilitate the attendance of school staff in training that they would otherwise not be able to undertake, or to participate in the activities of an agency's governing board, a standing official advisory committee, or in support of other official activities of the agency;
- Toll-free telephone numbers for use by schools or others to obtain information about FFEL program loans, or for use by schools to electronically submit applicant loan processing information or student status confirmation data; and
- Payment of Federal default fees in a non-discriminatory manner.³⁸⁰

Student Aid Reward Proposals

Background

From 1998 to 2007, the Direct Loan Program's market share decreased from 34 percent to about 20 percent.³⁸¹ Concurrently, the number of FDLP schools declined by almost 200 to fewer than 1,100.³⁸² Some of the reasons for this shift of institutions from Direct Loans to FFELP were, according to the GAO:

- Difficulties fulfilling certain program requirements.
- Reduced or no loan origination fees offered by FFELP lenders.
- An increasing interest by schools in entering the student loan business as lenders.³⁸³

Although the postsecondary community at large was aware that a number of schools were moving out of Direct Loans, no efforts were made to change the direction of the shift until 2003.

2003-2004 Direct Loan Reward Legislation

S. 1793 and H.R. 4370

In the fall of 2003, Sen. Edward Kennedy (introduced S. 1793, the "College Quality, Affordability, and Diversity Improvement Act of 2003," which included a financial incentive to persuade **all** schools to participate in FDLP through the "Direct Loan Reward Program."

³⁸⁰ Ibid.

³⁸¹ U.S. Department of Education, Budgets for Fiscal Years 1999-2008.

³⁸² Education Finance Council, *EFC Weekly*, Nov. 18, 2002 and U.S. Office of Management and the Budget, *Fiscal Year 2008 Budget of the U.S., Analytical Perspectives*, February 2007, p. 76.

³⁸³ United States Government Accountability Office, GAO, Report to Congressional Requesters, *More Oversight Is Needed for Schools That Are Lenders*, GAO-05-184, January 2005, p. 2.

Specifically, the bill encouraged schools to participate in the Direct Loan Program by:

- Providing new institutions that signed up to participate in Direct Loans with a financial reward payment if they agreed to participate in FDLP for five years from when the first payment was made.
- Requiring that reward payments be used to award students Federal Supplemental Educational Opportunity Grants and also stipulating that schools would not be required to provide any matching funds.³⁸⁴

The amount of a financial reward payment would be:

- In the case of the first year of participation in the Direct Loan Reward Program, an amount equal to 50 percent of the savings to the Federal Government generated by the institution's participation in Direct Loans rather than FFELP.
- In the case of the second through fifth years of participation, an amount equal to 10 percent of the savings to the Federal Government generated by the institution's participation Direct Loans rather than FFELP.³⁸⁵

The bill also required that the program be cost-neutral, as follows:

- The Secretary would be prohibited from making financial reward payments that, in the aggregate, exceeded the Federal savings resulting from implementation of the Direct Loan Reward Program; and
- In calculating the Federal savings, the Secretary would determine any Federal savings on loans made to students at institutions of higher education that participated in the Direct Loan Reward Program and compare it to the Federal cost of an equivalent type and amount of loan volume made under FFELP.³⁸⁶

Views in Support

While never explicitly citing concerns about the declining school participation in the Direct Loan Program, Senator Kennedy said in a statement accompanying S. 1793:

For every \$1 borrowed through the Direct Loan program instead of the traditional private bank FFEL program, taxpayers save 14 cents. The bill offers schools that choose to participate in the Direct Loan program a percentage of federal savings, and earmarks that reward for campus-based financial aid.

³⁸⁴ S. 1793, Oct. 28, 2003, Sec. 104.

³⁸⁵ Ibid.

³⁸⁶ Ibid.

And the bill ensures that this new Direct Loan Reward Program creates no net cost to the federal government, by triggering its implementation: the Reward Program only takes effect once enough private bank FFEL schools state an intention to switch to Direct Lending. Most of the savings from that switch will go to taxpayers, but some will go to Direct Loan schools and students with financial need attending those schools.³⁸⁷

Views in Opposition

Congressman John Boehner issued a press release sharply criticizing S. 1793 as follows:

U.S. House Education & the Workforce Committee Chairman John Boehner (R-OH) today criticized higher education legislation offered by Senate Democrats that calls for a costly expansion of former President Bill Clinton's faltering direct student loan program, a move that could mean less money for other student aid programs and upset the careful balance between direct and traditional lending that has resulted in the lowest student loan interest rates in history for U.S. students under President George W. Bush. ...

And resources that could be better spent strengthening Pell Grants for needy students would instead be used to coax schools to stay in a faltering loan program most schools don't even like. ...

The troubled direct student loan program, touted by Clinton as a good deal for students and taxpayers, has cost \$4.6 billion more than expected to date, based on data published earlier this year by the Office of Management & Budget (OMB). Schools have been steadily and voluntarily dropping out of the direct loan program for years, favoring the guaranteed loan program in which the private sector, not the federal government, is the source for student loans. ...³⁸⁸

The Kennedy proposal was taken up by Congressmen Tom Petri, R-Wis., and George Miller in the spring of 2004 with the introduction of companion legislation, H.R. 4370, "The Direct Loan Reward Act" in the House. Their bill was identical to the Kennedy legislation except that it directed institutions to use the Direct Loan Rewards to supplement their students' Pell Grants.³⁸⁹

Neither legislative proposal was passed during the 108th Congress and since neither bill was reported, no official CBO estimates were developed.³⁹⁰

³⁸⁷ Senator Edward Kennedy, "Statement of Senator Edward M. Kennedy on the Introduction of the College Quality, Affordability, and Diversity Improvement Act of 2003," Oct. 28, 2003.

³⁸⁸ U. S. House of Representatives, Committee on Education and the Workforce, Press Release, Oct. 28, 2003.

³⁸⁹ H.R. 4370, May 17, 2004, Sec. 2.

³⁹⁰ Democratic Staff, Education and the Workforce Committee, "'Direct Lending' over 'FFEL,'" July 21, 2005, p. 1.

2005-2006 Student Aid Reward Legislation

H.R. 1425 and S. 754

In April of 2005, Senators Kennedy, Richard Durbin, D-Ill., and Gordon Smith, R-Ore., along with Representatives Petri, Miller and others introduced a new iteration of the “Reward” legislation, slightly altered and now entitled the Student Aid Reward Act of 2005 or STAR. The bills were identical to each other and to their predecessors in most respects, but did include some changes to terminology, payment requirements and to the types of students that could receive grants.

For example, rather than stating outright that there would be a reward for schools that moved to Direct Loans, the legislation would provide financial incentives to institutions that “participate in the student loan program under this title that is most cost-effective for taxpayers and that, on the date of enactment of the Student Aid Reward Act of 2005, participated in the student loan program that is not most cost-effective for taxpayers.”³⁹¹

Instead of permitting schools to use their rewards solely for Federal Supplemental Educational Opportunity Grants, the new legislation stipulated that institutions must use the rewards for supplements to Pell Grants and for need-based grants to graduate students.³⁹²

Finally, the bills clarified that all schools participating in the program would be eligible for rewards, although new recruits to the “most cost-effective program” would receive preferential treatment in the event there was a shortfall in funding.³⁹³

Below is a synopsis of the STAR measures:

The bills encouraged **all** institutions of higher education to participate in the Student Aid Reward Program by:

- Providing institutions participating in the “most cost-effective” loan program with a financial reward payment if they would agree to participate in the program for five years from when the first payment is made.
- Requiring that reward payments be used to award students a supplement to their Federal Pell Grant and to award need-based grants to lower- and middle-income graduate students.
- Stipulating that each school participating in the program would be eligible for rewards, although new recruits to the most cost-effective program would receive preferential treatment in the event there was a shortfall in funding.

³⁹¹ S. 754, April 11, 2005, Sec. 2.

³⁹² Ibid.

³⁹³ Ibid.

The amount of a financial reward payment would be not less than 50 percent of the savings to the federal government generated by the institution's participation in the "most cost-effective" loan program.

The bills also required that the program would be cost-neutral, as follows:

- The Secretary would be prohibited from making financial reward payments that, in the aggregate, exceeded the federal savings resulting from implementation of the Student Aid Reward Program.
- In calculating the federal savings, the Secretary would determine any federal savings on loans made to students at institutions of higher education that participated in the "most cost-effective" loan program and compare it to the federal cost of an equivalent type and amount of loan volume made under the "least cost-effective" loan program.³⁹⁴

Neither bill was enacted during the 109th Congress, and because neither bill was reported, no official CBO estimates were developed. Preliminary CBO estimates showed that the STAR Act could save the federal government \$12.3 billion over the ensuing 10 years.³⁹⁵

Views in Support

Congressional Opinions

According to Senator Kennedy:

Under current law, there are two parallel federal student loan programs that provide essentially the same loans and interest rates to students, but one costs billions of dollars more each year than the other.

In the first program, the Federal Family Education Loan program, the federal government guarantees and subsidizes loans issued to students by Sallie Mae and other lenders. These loans bear virtually no risk for the lenders, who are guaranteed against default and receive a very profitable rate of return. In fact, some of these lenders are guaranteed a 9.5 percent subsidized rate of return on loans that are already guaranteed against default.

In the second program, the Direct Loan Program, loans are issued directly from the U.S. Treasury. The loans are serviced and collected through contracts with private companies, but there is no middleman making the loans.

The Direct Loan Program is much, much less expensive for taxpayers, because it provides loan capital at a lower rate, eliminates middlemen as lenders, and avoids billions of dollars in unnecessary subsidies to lenders.

³⁹⁴ Ibid.

³⁹⁵ *Student Lending*, Jan. 3, 2006, p. 5.

According to President Bush's 2006 education budget, student loans made through the more expensive program cost \$11 more for every \$100 in loans than the same loans made with U.S. Treasury funds. Yet, colleges and students have no incentive to use the more efficient program. In fact, lenders from the less efficient program often offer rewards to colleges to persuade them to use the less efficient, more expensive program.

Our Student Aid Reward Act encourages colleges to choose the less expensive of the government's student loan programs.³⁹⁶

According to a press release from Congressman Petri's office:

His bill would encourage colleges and universities to use the Direct Loan Program by promising them most of the federal government's savings in the form of increased Pell Grants for low-income students — potentially increasing Pell Grants by \$1,000 per eligible student.

Loans provided by both programs are identical to students, but that the banks' subsidies in the guaranteed student loan program amount to several billion dollars.

If his Direct Loan Reward Act were enacted, some \$17 billion could be "transferred" from bank subsidies to lower-income students receiving Pell Grants during the next 10 years. According to the Congressional Budget Office, if all schools switched to Direct Loans, the increase in student aid would be at least \$60 billion over 10 years at no cost to the taxpayers.³⁹⁷

Other Supporting Opinions

The National Direct Student Loan Coalition came out in favor of the STAR Act and explained its support in this manner:

The plan is simple: The STAR Act encourages colleges to use the less expensive of the federal government's student loan programs.

Currently, there are two main student loan programs that provide essentially the same loans and interest rates to students, but one costs billions more annually than the other. In the first program, loans are issued from U.S. Treasury funds, and private companies are contracted to service and collect student loan payments.

In the second program, the federal government underwrites and subsidizes loans issued by private lenders and banks. These loans bear virtually no risk for private banks, yet have an assured rate of return and are guaranteed against default by the government.

³⁹⁶ Senator Edward M. Kennedy, Press Release, March 15, 2005.

³⁹⁷ Congressman Thomas Petri, Press Release, March 15, 2005.

The first program is much less expensive, because it secures loan capital at a lower rate, eliminates the middleman, and cuts out billions in unnecessary subsidies to banks.

According to President Bush's 2006 education budget, student loans made through the more expensive program cost \$11 more for every \$100 lent than the same loans made with U.S. Treasury funds. (Figure includes administrative costs.)

According to the Congressional Budget Office, the STAR Act would provide in excess of \$12.3 billion in additional funds for college scholarships over the next 10 years — at no additional cost to taxpayers. These savings would provide an additional \$1,000 per Pell Grant recipient each year.

Moreover, because the Student Aid Reward Act supports and makes use of increased efficiency in the student loan program, it creates no additional cost for taxpayers, according to CBO.³⁹⁸

The American Association of Collegiate Registrars and Admissions Officers, the State Public Interest Research Groups' Higher Education Project and the U.S. Student Association jointly wrote a report that promoted the Student Aid Reward Act and also estimated what each postsecondary institution in the country would gain if all schools transferred to FDLP. They said:

Congress has the opportunity this year, however, to increase student aid funding by billions of dollars at no additional cost to taxpayers. Bipartisan legislation is pending in Congress that would increase federal student aid for those colleges and universities that utilize the more economically efficient of the two federal student loan programs. The Student Aid Reward (STAR) Act, introduced in March 2005, would increase student aid funding by redirecting the subsidies currently going to student loan companies to needy students. ...

Below are other findings of the report:

- The Student Aid Reward Act could generate \$4.4 billion in new federal money next year, based on the savings of all colleges and universities switching into the more cost effective Direct Loan program.
- At least \$3 billion of this money could be used to increase federal student aid funding at all colleges and universities across the country. This student aid increase would be available at no additional cost to taxpayers.

³⁹⁸ National Direct Student Loan Coalition, Web Posting at <http://www.altrue.net/site/ndslc/section.php?id=11340>, as accessed Feb. 26, 2007. Note: The site has since been updated to reflect the 2007 re-introduction of the STAR Act and the link now reflects this more recent information.

- This \$3 billion increase would be enough to give each Pell Grant recipient almost \$600 more in additional grant aid a year, which is six times the proposed increase in the Pell Grant maximum for next year in the FY06 federal budget.³⁹⁹

Views in Opposition

Congressional Opinions

The leadership of the House Education and Workforce Committee published extensive negative comments on the STAR legislation, which read in part:

Since its inception in 1993, the Federal Direct Loan Program (FDLP) has consistently failed to fulfill its expectations of improved service and financial savings. ...

Proponents of expanding the federal role in student lending have suggested American taxpayers should begin providing schools with extra money to remain in the Direct Loan Program — an apparent admission that Direct Lending can't compete with the more efficient private sector unless taxpayers fork over hundreds of millions in additional money. Americans deserve the facts about the student loan programs before Congress asks them to pay even more. ...

Since the creation of the Direct Loan Program, proponents have claimed it would generate profits for the government because the federal government can borrow money more cheaply than the private sector, and a net profit would be earned over time as students repaid loans with interest. Despite these claims that FDLP would earn a profit, the Office of Management and Budget (OMB) and Department of Education (ED) have consistently been forced to “re-estimate” the subsidy costs associated with FDLP. Those subsidy re-estimates have shown that FDLP has never earned the profits it promised or any profits at all, and in fact has shown a net cost to American taxpayers, as was pointed out by the Government Accountability Office (GAO) in a March 2004 study.

One of the primary reasons for the cost re-estimates is that OMB has consistently overestimated the amount the government will receive in any given year from borrower repayments or origination fee payments. For example, according to the GAO, from FY 1995 through FY 2003 the Department underestimated (overestimated) borrower interest payments by 67 percent, origination fee payments by 5 percent, and default collections by 44 percent. All of these factors have resulted in FDLP costing more than expected.

³⁹⁹ American Association of Collegiate Registrars and Admissions Officers, State Public Interest Research Groups' Higher Education Project, U.S. Student Association, “Easy Money, How Congress Could Increase Federal Student Aid Funding at No Additional Cost to Taxpayers,” May 2005, p. 2.

Questions are growing about hidden costs associated with Direct Lending — costs that exist but don't show up on the federal government's balance sheet because of accounting procedures. According to President Bush's FY 2006 budget request, from 1992 through 2004 cumulative private sector-based, Federal Family Education Loan Program (FFELP) re-estimates have reduced subsidy costs by \$7 billion. In FDLP, subsidy costs have increased by \$5 billion. That represents a \$12 billion swing in subsidy costs, with FDLP costing more than expected and FFELP costing less. ... ⁴⁰⁰

Other Opposing Opinions

The National Association of Financial Aid Officers came out in opposition to the STAR initiative. Its reasoning was:

While NASFAA consistently champions additional funding for needy students, it is opposed to creating tensions based on the loan program in which an institution participates. Many perceived that this proposal could force schools to abandon their preferred loan program in order to acquire additional grant funding for their needy students. Some suggested that the STAR legislation might place different types of institutions and the FFEL and Direct Loan programs in opposition of each other.

The comments NASFAA members provided on the STAR Act led the NASFAA Board to vote to oppose this legislation. This was done in light of the fact that the STAR proposal, as currently drafted, does not promote fairness and equity to all student borrowers or to the schools that they attend. The NASFAA Board felt it was necessary to clarify its position on this issue and believes this position is in keeping with its guiding principles.⁴⁰¹

The Consumer Bankers Association was among the many student loan trade associations that came out in opposition to the STAR measure. The group asserted that:

The "Student Aid Reward Act" raises serious fiscal and consumer issues, and would make students, schools and taxpayers losers if enacted, said Consumer Bankers Association President Joe Belew.

The bill seeks to induce educational institutions to terminate their participation in the private sector Federal Family Education Loan Program (FFEL) by paying them funds based on savings estimated to be produced by substituting government-financed and administered Direct Student Loans.

⁴⁰⁰ Excerpted from U. S. House of Representative, Committee on Education and the Workforce, *Fact Sheet: Exposing Direct Lending Myths*, March 15, 2005.

⁴⁰¹ National Association of Student Financial Aid Administrators, *News from NASFAA*, Web Posting at <http://www.nasfaa.org/publications/2005/greauthorizationrecommendations070805.html>, accessed Feb. 20, 2007.

Belew said the bill, jointly introduced today by Senator Edward Kennedy (D-MA) and U.S. Rep. George Miller (D-CA) “is an attempt to pay schools to abandon the student loan program that they have determined works best for themselves and for the students they serve.”

The funds that would be used for the inducement payments to the schools would come from the estimated savings derived from substituting Direct Loans for FFEL loans on the campuses involved. “There is a high probability,” Belew said, “these savings will never materialize, but after the inducement payments are made to the schools, there will be nothing for taxpayers to do about it.”⁴⁰²

S. 3593

In the summer of 2006, Senator Kennedy, along with Senators Hilary Clinton, D-N.Y.; Christopher Dodd, D-Conn.; Tom Harkin, D-Iowa; Joseph Lieberman, D-Conn.; and Schumer, introduced S. 3593, “The Student Debt Relief Act Of 2006.”⁴⁰³ Among numerous other provisions, the bill would establish a student aid reward program with provisions identical to those in S. 754.⁴⁰⁴

The legislation was not enacted during the 109th Congress. Following the 2006 election, Senator Kennedy indicated that the STAR legislation would be among the legislative priorities for the Health, Education, Labor and Pensions Committee in the 110th Congress.⁴⁰⁵

2007 Student Aid Reward Legislation

Following up on his stated intentions to re-introduce the STAR Act, Senator Kennedy in early 2007 included the legislation in two bills, S. 359 and S. 572, the latter of which was co-sponsored by Senator Gordon Smith. Concurrently, Representatives George Miller and Thomas Petri introduced identical companion legislation in the House, H.R. 1010.

The 2007 iterations of the STAR measure were identical to the 2005-2006 versions. Highlights of the earlier bills and of various views are outlined above.

As of February 2007, there had been no action on the legislation.

⁴⁰² CBA News Release, as quoted in National Council of Higher Education Loan Programs, *Afternoon Briefing*, March 16, 2006, no page numbers.

⁴⁰³ S. 3593, June 28, 2006, Sec. 3.

⁴⁰⁴ *Ibid.*

⁴⁰⁵ U. S. Senate, Senator Edward Kennedy, Press Release, “Kennedy Announces HELP Committee Priorities for 110th Congress,” Nov. 16, 2006.

5. CONSOLIDATION LOANS

This chapter examines trends in FFELP and FDLP consolidation loan volume and outlines the terms and conditions for the loans. Also included are sections on borrower benefits, default rates and summaries of salient consolidation loan studies and policy issues.

TRENDS

Consolidation Loan Volume

FFELP consolidation volume has mushroomed from \$3 billion in fiscal year 1995 to a projected \$32 billion in FY 2008, after reaching a peak of \$72 billion in fiscal 2005. Direct Loan consolidation has expanded rapidly as well, with a FY 1995 volume of only \$300 million and an estimated \$5 billion in FY 2008, after a high of about \$19 billion in fiscal 2006.⁴⁰⁶

Table 14 illustrates program growth. For the three fiscal years 2006-2008 combined, consolidation volume is expected to approach \$160 billion.

TABLE 14. FFELP and FDLP Consolidation Loan Volume 1987-2008⁴⁰⁷

Fiscal Year	FFELP (millions)	FDLP (millions)
1987	\$263 ⁴⁰⁸	N/A
1988	\$642 ⁴⁰⁹	N/A
1989	\$684 ⁴¹⁰	N/A
1990	\$820 ⁴¹¹	N/A
1991	\$1,120 ⁴¹²	N/A
1992	\$1,365 ⁴¹³	N/A
1993	\$1,492 ⁴¹⁴	N/A
1994	\$2,018 ⁴¹⁵	N/A
1995	\$3,117	\$329

⁴⁰⁶ Unless otherwise referenced, U.S. Department of Education, *Budget Appendices*, Fiscal Years 1997-2008.

⁴⁰⁷ Ibid.

⁴⁰⁸ U.S. Department of Education, *Guaranteed Student Loan Programs Data Book FY 1988*, p. 18.

⁴⁰⁹ U.S. Department of Education, *Guaranteed Student Loan Programs Data Book FY 1989*, p. 29.

⁴¹⁰ U.S. Department of Education, *Guaranteed Student Loan Programs Data Book FY 1990*, p. 30.

⁴¹¹ U.S. Department of Education, *Guaranteed Student Loan Programs Data Book FY 1991*, p. 32.

⁴¹² U.S. Department of Education, *Federal Student Loan Programs Data Book FY 1992*, p. 40.

⁴¹³ U.S. Department of Education, *Federal Student Loan Programs Data Book FY 1993*, p. 45.

⁴¹⁴ Ibid.

⁴¹⁵ U.S. Department of Education, *Federal Student Loan Programs Data Book FY94-FY96*, Table 20.

<http://www.ed.gov/finaid/prof/resources/data/fslpdata94-96/index.html>, accessed Feb. 21, 2007.

Fiscal Year	FFELP (millions)	FDLP (millions)
1996	\$4,266	\$803
1997	\$3,836	\$1,333
1998	\$3,234	\$2,431
1999	\$4,720	\$8,006
2000	\$5,695	\$5,369
2001	\$9,255	\$7,760
2002	\$22,693	\$8,845
2003	\$34,935	\$6,657
2004	\$35,947	\$7,782
2005	\$53,956	\$15,685
2006	\$72,010	\$19,347
2007 (est.)	\$26,853	\$4,466
2008 (est.)	\$31,882	\$4,996

Factors Affecting Consolidation Volume

From 1986 to 1998, consolidation volume was relatively modest. A number of circumstances have contributed to the massive growth during the past decade:

- The implementation in 1995 of the Federal Direct Consolidation Loan Program, which actively sought FFELP market share through price benefits.
- Price incentives targeted at consolidation borrowers under both loan programs.
- Significant focus on consolidation of defaulted loans.
- Finally, and most importantly, the unprecedented low, fixed rates on most consolidation loans during the period 2001-2006.

TERMS AND CONDITIONS OF CONSOLIDATION LOANS

From 1995 to 2006, the Direct Loan Consolidation Program was excluded from the statutory requirement that mandates parallel terms and conditions for FDLP and FFELP. That policy was reversed when the Higher Education Reconciliation Act altered the statute to require equivalent terms between the two programs, unless otherwise specified in law.⁴¹⁶

⁴¹⁶ Public Law No. 109-171, Feb. 8, 2006, Sec. 8009.

As a result, all in-school consolidation was prohibited for both programs. The new law also prohibited married couples from consolidating and eliminated certain types of re-consolidation. Thus, except for the income contingent repayment option, all previous FDLP regulatory consolidation benefits are no longer available if they have no statutory FFELP counterpart.⁴¹⁷

Below are summaries of key terms and conditions pertaining to consolidation loans. Unless otherwise specified, these terms apply to both FFELP and Direct Loans.

Loans Eligible for Consolidation

The following loans may be consolidated under FFELP and Direct Loans^{418 419}:

Under FFELP:

- Stafford and PLUS loans, and some existing Consolidation loans.
- Defaulted Stafford, PLUS, and Consolidation loans, if the borrower has made satisfactory arrangements to repay the loans or agreed to repay the loan under an income-sensitive repayment plan.
- Perkins Loans.
- Direct Loans.
- Health Professions Student Loans.
- Certain Nursing Loans.
- Health Education Assistance Loans.

Under Direct Loans:

- Direct Stafford and PLUS loans.
- A FFELP loan for which the borrower has been unable to obtain a consolidation loan from a FFELP lender or has been unable to obtain a FFELP consolidation loan with income-sensitive repayment terms acceptable to the borrower.
- Defaulted FFELP (under certain circumstances) and FDLP Stafford and PLUS loans, if the borrower has made satisfactory arrangements to repay the loans or agrees to repay the loan under income contingent repayment.
- Perkins Loans, only if another eligible FFELP or Direct Loan program loan is included in the consolidation.
- Health Professions Student Loans, only if another eligible FFELP or Direct Loan program loan is included in the consolidation.
- Certain Nursing Loans.

⁴¹⁷ Ibid.

⁴¹⁸ *The Higher Education Act of 1965* (as amended), Sec. 428C(a)(3)(B) and Sec. 428C(a)(4).

⁴¹⁹ Public Law No. 109-171, Feb. 8, 2006, Sec. 8009 and CFR 685.220 as amended.

- Health Education Assistance Loans.
- An existing FFELP consolidation loan that has been submitted to the guaranty agency for default aversion, for purposes of obtaining an income contingent repayment plan.
- An existing FFELP consolidation loan for which an FFELP borrower has filed an adversary complaint in a bankruptcy proceeding seeking to have the Federal Consolidation Loan discharged, for purposes of obtaining an income contingent repayment plan.

Loan Limits

Because the purpose of consolidation loans is to combine a borrower's loans and, depending on the outstanding balance, extend the repayment period on the underlying loans, there are no annual or overall aggregate loan limits. The statute, until an error occurred in the 1998 Amendments, required that consolidated student loans under section 428C of the Act be counted against the aggregate Stafford loan limits for the underlying loan programs. Despite this inadvertent repeal, regulations still require that Stafford loans included in consolidation loans be counted against aggregate Stafford loan limits.⁴²⁰

Consolidation Loan Interest Rates

Since 1998, the maximum consolidation rate has been a **fixed** rate, based on the weighted average rates of the borrower's underlying loans, **rounded up** to the nearest one-eighth of 1 percent, with a cap of 8.25 percent.⁴²¹ Borrowers who took out Stafford and PLUS loans prior to July 1, 2006, have underlying loans with **variable** rates. Thus, when these borrowers consolidate, the new **fixed** consolidation rate is the average of the **variable** rate in effect on their loans during the year they consolidate.

As student loan interest rates declined during the early and mid-2000s, reaching a record low repayment rate of 3.37 percent in 2004-2005, fixed-rate consolidation loans, not surprisingly, became an extremely popular student loan refinancing tool. This ability of borrowers to lock in low rates for up to 30 years has become a major expenditure item for the federal government, as the projected cost of the growing consolidation loan volume has increased by billions of dollars during the past several years.⁴²²

Table 15 outlines the historic consolidation loan interest rates based on the 91-day T-Bill rates, which until 2006, were used for setting the rate on the underlying variable-rate Stafford and PLUS loans.

⁴²⁰ Archived *Higher Education Act of 1965* (as amended), Sec. 428C(a)(3)(B)(ii) and 34 CFR, 682.204(j).

⁴²¹ *Higher Education Amendments of 1998*, "Conference Report to Accompany H.R. 6," Sept. 26, 1998, Sec. 416.

⁴²² U. S. Department of Education, *FY 2008 Budget Appendix*, pp. 338 and Congressional Budget Office, "The Cost of the Consolidation Option for Student Loans," May 2006, pp. vi and vii.

As illustrated in the table, during 2006-2007, Stafford borrowers who received their original variable-rate loans after July 1, 1998, but before July 1 2006, and who consolidate during their grace period, are able to lock in a 6.625 percent interest rate for the duration of the repayment period — up to 30 years. Because many lenders offer price incentives on consolidation loans, the actual rate may be even lower.⁴²³ Borrowers in repayment with loans disbursed during that period, or borrowers who wish to consolidate loans that were originally disbursed prior to July 1, 1998, can expect slightly higher consolidation loan rates.

TABLE 15. Historic Consolidation Loan Fixed Rates for Various Cohorts of Loans for Stafford and PLUS Borrowers Who Received Their Original Loans After July 1, 1998, but Before July 1 2006⁴²⁴

Consolidation Loans Made During:	Base 91-day T-Bill Rate	Rate for Stafford Loans Consolidated During In-School, Grace and Deferment Period	Rate for Stafford Loans Consolidated During Repayment	Rate for PLUS Loans Consolidated
1998-99	5.16%	7.00%	7.50%	8.25%
1999-2000	4.62%	6.375%	7.00%	7.75%
2000-01	5.89%	7.625%	8.25%	8.25%
2001-02	3.69%	5.50%	6.00%	6.875%
2002-03	1.76%	3.50%	4.125%	4.875%
2003-04	1.12%	2.875%	3.50%	4.25%
2004-05	1.07%	2.875%	3.375%	4.25%
2005-06	3.00%	4.75%	5.375%	6.125%
2006-07	4.84%	6.625%	7.25%	8.00%

As mentioned previously, the 2006 HERA changed Stafford and PLUS loan interest rates from **variable** to **fixed**, but made no change to the consolidation rate, which remains fixed, based on the weighted average of the underlying loans, rounded up to the nearest one-eighth of 1 percent. Thus, the maximum consolidation rate for these fixed-rate loans is 6.875 percent for Stafford loans, 8 percent FDLF PLUS loans and 8.25 percent for FFELF PLUS.

It is also noteworthy that the current interest rate structure makes it advantageous for a PLUS borrower with either a variable-rate or a fixed-rate FFELF loan to consolidate in a high interest rate environment because the **maximum** rate for a variable-rate PLUS loan

⁴²³ A few examples: http://www.wachovia.com/personal/page/0,,325_496_8297,00.html, <http://www.educationalloancompany.com/consolidation.htm>, accessed Feb. 21, 2007.

⁴²⁴ Based on bond-equivalent rates of 91-day T-Bills auctioned at the final auction held prior to June 1 of each academic year. U.S. Department of Education, various interest-rate documents, accessed on Feb. 2, 2007 through <http://www.fp.ed.gov/PORTALSWebApp/fp/intrates.jsp>.

is 9 percent (8.5 percent for a fixed-rate FFELP PLUS loan), whereas the **maximum** rate for a consolidation loan is only 8.25 percent. For example, a PLUS borrower paid 8.99 percent in interest in 2000-01, but if that borrower had consolidated, the rate would have dropped to 8.25 percent.

Minimum Balance Requirements

All minimum balance requirements for consolidation loans were eliminated in the 1993 Student Loan Reform Act. Borrowers with a balance below \$7,500 cannot extend their repayment period beyond 10 years, however.^{425 426}

FFELP Single Holder Rule

From 1986 to 2006, the FFELP consolidation program included a requirement that borrowers must consolidate with a holder of their loan or loans, unless the holder(s) did not offer consolidation loans.⁴²⁷

Over the years, this “single holder” provision was relaxed somewhat. For example, borrowers were able to consolidate with another lender if they had loans from multiple lenders (as long as one of them was an FFELP or FDLP loan) or were unable to obtain income-sensitive repayment terms from their current holder(s).⁴²⁸

In 2005, the Administration’s FY 2006 budget proposals as well as the House and Senate initial reauthorization proposals (H. R. 609 and S. 1614), proposed to completely strike the single holder rule. The Administration explained its recommendation as follows:

Currently, borrowers wishing to consolidate may face complicated procedures and limited choices. The Administration proposes to eliminate all barriers to consolidation or reconsolidation, including the statutory provision limiting a borrower’s ability to choose their consolidation lender.⁴²⁹

The single holder rule was repealed in June 2006 through a provision in the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery.⁴³⁰ Consequently, borrowers are now able to consolidate with their lender of choice.

⁴²⁵ Public Law No. 103-66, Aug. 10, 1993.

⁴²⁶ *Higher Education Act of 1965* (as amended), Sec. 428C(c)(2).

⁴²⁷ *Higher Education Amendments of 1986*, “Conference Report to Accompany S. 1965,” Sept. 22, 1986, p. 127.

⁴²⁸ *Higher Education Amendments of 1998*, “Conference Report to Accompany H.R. 6,” Sept. 26, 1998.

⁴²⁹ U. S. Department of Education, *Fiscal Year 2006 Budget, Summary and Background Information*, February 2006, p. 60.

⁴³⁰ Public Law No. 109-234, Sec. 7015(a), June 15, 2006.

Borrower Fees

No upfront borrower fees may be levied on a consolidation loan.⁴³¹

Maximum Repayment Period

Consolidation borrowers may choose from the full range of payment choices available under regular repayment plans: standard, graduated, extended and income-based.⁴³² Depending on the outstanding balance of the underlying loans, borrowers have up to 30 years to repay their consolidation loans under each repayment plan. Please see Table 9 on p. 58 for details on repayment plans.

Cost to Borrowers of Various Repayment Plans

Table 16 illustrates the costs to borrowers of various consolidation repayment options under FFELP and FDLP. As is the case with any consumer debt, the longer a borrower takes to repay the loan, the higher the interest costs.⁴³³

TABLE 16. Projected Consolidation Repayment Costs for a Borrower With \$20,000 in Stafford Subsidized Loan Debt at an Interest Rate of 6.875% and an Initial Income of \$30,000 Under Various Repayment Options^{434 435}

Consolidation Repayment Options	Length of Repayment	Monthly Payment	Total Amount Paid	Interest Paid
<i>FFELP/FDLP Standard Repayment</i>	20 years	\$154	\$36,855	\$16,855
<i>FFELP/FDLP Extended Repayment</i>	NA	NA	NA	NA

⁴³¹ *Higher Education Act of 1965* (as amended), Sec. 428C(c)(5) and Sec. 438(c)(2).

⁴³² *Higher Education Act of 1965* (as amended), Sec. 428C and Sec. 455(g).

⁴³³ Indebtedness figure based on averages from Baum, Sandy and O'Malley, Marie, *College on Credit: How Borrowers Perceive Their Education Debt*. Results of the 2002 National Student Loan Survey, Washington, D.C.: Nellie Mae Corporation, 2003, p. v.

Salary data based on projected average starting salary for Liberal Arts Bachelor Degree recipients in 2007. See, for example, http://money.cnn.com/2007/02/08/pf/college/lucrative_degrees_winter07/index.htm?postversion=2007020813, accessed Feb. 14, 2007.

⁴³⁴ For FDLP Loans:

https://loanconsolidation.ed.gov/loancalc/servlet/common.mvc.Controller?controller_task=startCalculator, accessed Feb. 26, 2007. The data for income-contingent repayment assume repayment at an interest rate of 6.875 percent and annual income growth of 5 percent. For FFELP Loans: USA Funds, Online Calculators, <http://www.usafunds.org/borrowers/index.html>, accessed Feb. 21, 2007.

⁴³⁵ Although the underlying rate is assumed to be 6.8 percent, the statute mandates that the consolidation loan rate be rounded to the "nearest higher one-eighth of 1 percent." *Higher Education Act of 1965* (as amended), Sec. 427A(1)(3).

Consolidation Repayment Options	Length of Repayment	Monthly Payment	Total Amount Paid	Interest Paid
<i>FFELP/FDLP Graduated Repayment</i> ⁴³⁶	20 years	\$115, initial two years, \$162 remaining years	\$37,665	\$17,665
<i>FDLP Income Contingent Repayment</i>	14 years 10 months	\$171 initial, \$194 final payments.	\$32,290	\$12,290
<i>FFELP Income Sensitive Repayment</i> ⁴³⁷	21 years	\$150, year 1. \$150, for years 2-21.	\$37,847	\$17,847

LOAN CONSOLIDATION STUDIES AND REPORTS

2003 GAO Consolidation Cost Study

In 2002, the GAO was asked to review and report on certain consolidation components, particularly as they relate to federal costs, borrower status, indebtedness levels and other loan data. In the congressional request, it was noted that:

It is important for us to know who now is benefiting from the Consolidation Loan program in order to determine if federal subsidies are being directed properly. Therefore, we are requesting that you conduct a study addressing the following issues for both the Federal Family Education Loan Program and the Federal Direct Loan Program:

- What are the characteristics of the consolidation loan borrower, including indebtedness level, repayment status at time of consolidation, number of previous loans and number of previous loan holders?
- What are the federal costs associated with this program?
- How many borrowers are in default at the time they choose to consolidate?
- How many borrowers, who were in default prior to consolidation, again fall into a default situation while they are in the consolidation program?
- What is the average pay off timeframe for consolidation loan borrowers?⁴³⁸

The GAO published a response to some of these questions in 2003, together with recommendations. Below are excerpts:

⁴³⁶ Graduated Repayment: Two years reduced payments (Numbers are rounded up.)

⁴³⁷ Income Sensitive Repayment Assumptions: Six percent of monthly pre-tax income is allocated to repayment.

⁴³⁸ U.S. House of Representatives, "Letter to David M. Walker, Comptroller General from Rep. Boehner and Rep. McKeon," June 3, 2002, as reported in Education Finance Council, *EFC Exchange*, June 14, 2002.

- [Based on GAO analysis of NSLDS data] consolidation loan borrowers differed from non-consolidation loan borrowers in a variety of ways. On average, consolidation loan borrowers had higher student loan debt, higher incomes, larger annual loan repayments, and longer repayment periods. They were also less likely to have attended a proprietary (or, for-profit) school and were more likely to have borrowed while attending graduate/professional school. In addition, they averaged more student loans from more lenders. Overall, consolidation loan borrowers defaulted less often than borrowers who had not consolidated their loans.⁴³⁹
- Although recent trends in interest rates and consolidation loan volumes have affected the FFELP and FDLP consolidation programs in somewhat different ways, the net effect has been an increase in estimated subsidy and administration costs for loans made in fiscal year 2003 as compared with loans made in fiscal year 2002. ... Administration costs are not specifically tracked for either loan program, but available evidence indicates that these costs have also risen.⁴⁴⁰

2004 GAO Consolidation Cost Study

In 2004, a GAO representative testified before Congress on the spiraling cost of the consolidation programs. These are excerpts from the testimony:

- Recent years have seen a drop in interest rates for student loan borrowers along with dramatic overall growth in consolidation loan volume. From July 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.50 percent as of July 1, 2003. From fiscal year 1998 through fiscal year 2003, the volume of consolidation loans made (or “originated”) rose from \$5.8 billion to over \$41 billion. The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many borrowers to consolidate their variable-rate student loans at a low, fixed rate.
- Recent trends in interest rates and consolidation loan volume have affected the cost of the FFELP and FDLP consolidation loan programs in different ways, but in the aggregate, estimated subsidy and administration costs have increased. For FFELP consolidation loans, subsidy costs grew from \$0.651 billion for loans made in fiscal year 2002 to \$2.135 billion for loans made in fiscal year 2003. ...FDLP consolidation loans are made by the government and thus carry no interest rate guarantee to lenders, but changing interest rates and loan volumes affected costs in this program as well. ... The drop in loan volume and interest rates that occurred in fiscal

⁴³⁹ United States General Accounting Office, GAO, Student Loan Programs, “As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined,” GAO-04-101, October 2003, p. 9.

⁴⁴⁰ Ibid., p. 17.

year 2003, contributed to cutting the government's estimated net gain from \$570 million in fiscal year 2002 to \$543 million for loans made in fiscal year 2003. Administration costs are not specifically tracked for either consolidation loan program, but available evidence indicates that these costs have risen, primarily reflecting increased overall loan volumes.⁴⁴¹

2004 GAO Study of Consolidation Borrower Characteristics

In 2004, the GAO published a study that examined various characteristics of the consolidation population. These were the key findings:

- As a group, FFELP borrowers were less likely than FDLP borrowers to default on a student loan prior to consolidation .
- Both FFELP and FDLP borrowers who had defaulted prior to consolidation were more likely to default on their consolidation loan than borrowers who did not default prior to consolidation.
- Between 1998 and 2002, an increasing share of both FFELP and FDLP underlying loan volume was consolidated into FFELP; a decreasing share of underlying loan volume was consolidated into FDLP.
- Defaulted loans, whether from FFELP or FDLP, were much more likely to be consolidated into FDLP.
- For consolidation loans made in fiscal years 1995 to 2001, FDLP borrowers had higher default rates than FFELP borrowers for four of the seven fiscal years.
- Both FFELP and FDLP borrowers who have defaulted prior to consolidation are more likely to default on their consolidation loan than borrowers who did not default prior to consolidation.
- A higher percentage of consolidation loan volume under the FDLP income contingent repayment plan is in default compared with loan volume in other FDLP repayment plans.⁴⁴²

As a result of these findings, the GAO recommended that “Education consider the type of schools consolidation borrowers attended in developing the risk categories for the department’s budgetary cost estimates.”⁴⁴³

⁴⁴¹ GAO, Testimony Before the Committee on Education and the Workforce, House of Representatives, Student Loan Programs, “Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs,” Statement of Cornelia M. Ashby, Director, Education, Workforce, and Income Security Issues, March 17, 2004, pp. 2-3.

⁴⁴² GAO, Student Consolidation Loans, “Further Analysis Could Lead to Enhanced Default Assumptions for Budgetary Cost Estimates,” August 2004, Highlights, p.3.

⁴⁴³ Ibid., p. 10.

2004 Private Sector Study of Consolidation Costs

In 2004, two major student loan trade associations — the National Council of Higher Education Loan Programs and the Consumer Bankers Association, as well as Sallie Mae — sponsored a study that reviewed the costs to the taxpayer of consolidating loans at a fixed rate.

Entitled “The Fiscal and Social Costs of Consolidating Student Loans at Fixed Interest Rates,” the study found that:

- The shift from an annually adjusted variable interest rate to a fixed rate produces both significant inequities among students and large long-term costs for taxpayers. The inequities derive from the fact that the long-term cost of a student’s loans, once those loans are consolidated, depends on the year in which he or she happens to consolidate them;
- A borrower who consolidated her loans in 2000 pays annual interest of 8.25 percent, compared to another borrower consolidating today [2003] at 3.5 percent;
- A borrower consolidating \$22,000 in student loans (the average amount consolidated, according to the General Accounting Office) will pay a total of \$30,622 over 20 years, including \$8,622 in interest, if he consolidated in 2003; if he had consolidated the same loans three years earlier, he will have to pay \$44,991, including \$22,991 in interest;
- From 1992 to 2003, the interest costs owed by borrowers consolidating \$22,000 in student loans ranged from \$8,622 to \$25,505, depending only on the year in which the student left school and consolidated the loans.⁴⁴⁴

Furthermore:

The current interest rate cycle will drastically expand the cost of the current loan consolidation program. Focusing on the loans provided under the Federal Family Education Loan (FFEL) program, the principal student loan program:

- Interest rates fell sharply from 2000 to 2003: The Treasury bill rate fell from 5.9 percent to 1.1 percent, the commercial paper rate fell from 6.3 percent to 1.1 percent, and the average rate on consolidated student loans fell from 8.25 percent to 3.5 percent;
- The volume of fixed-rate consolidation soared as interest rates fell, increasing from \$6.6 billion in 2000 to \$34.9 billion in 2003; ...

⁴⁴⁴ Kevin A. Hassett and Robert J. Shapiro, “The Fiscal and Social Costs of Consolidating Student Loans at Fixed Interest Rates,” March 9, 2004, p. 3.

- The FFEL loans consolidated in FY 2003 will cost taxpayers \$6.3 billion in interest rate subsidies over the lifetime of the loans, with a comparable cost required for loans consolidated in FY 2004.⁴⁴⁵

2005 GAO Letter Pertaining to Consolidation Loan Interest Rates ⁴⁴⁶

In 2005, in response to a request from Congress, the Government Accountability Office reaffirmed its prior position that consolidation loan costs had risen due to increases in volume and low interest rates. The GAO then went on to explain the impact of projected interest rates on consolidation costs and concluded:

In closing, the Department of Education's proposal to change from a fixed to a variable rate the interest charged to borrowers on consolidation loans, as well as its other consolidation loan reform proposals included in the President's Budget for Fiscal Year 2006, is consistent with the recommendation we made in our October 31, 2003, report that the Secretary of Education identify options for reducing federal costs.⁴⁴⁷

After considerable debate in Congress, the HERA did **not** change the consolidation interest rate from a fixed to a variable rate.

2005 GAO Study of FDLP as Sole Provider of FY 2006 Consolidation Loans

In December 2005, the Government Accountability Office published a report outlining the effects of originating all fiscal year 2006 consolidation loans exclusively through the Direct Loan Program. This information was requested by Congressman George Miller, then ranking minority member of the Committee on Education and the Workforce, who asked these questions:

- (1) What would be the estimated budgetary effect of providing consolidation loans exclusively through FDLP in fiscal year 2006?
- (2) To what extent and for what reasons might this estimated budgetary effect change as subsidy costs are re-estimated in future years?
- (3) How might FFELP lenders and borrowers be affected if consolidation loans were made exclusively through FDLP?⁴⁴⁸

⁴⁴⁵ Ibid., pp. 3-4.

⁴⁴⁶ Government Accountability Office, Letter to The Honorable John A. Boehner, Chairman, Committee on Education and the Workforce, House of Representatives. Subject: Consolidation Loan Borrower Interest Rates, Washington, DC, Feb. 25, 2005.

⁴⁴⁷ Ibid., p. 6.

⁴⁴⁸ Government Accountability Office, "Potential Effects of Making Fiscal Year 2006 Consolidation Loans Exclusively through the Direct Loan Program," Dec. 2005, p.1.

GAO's responses to these questions were:

(1) Providing consolidation loans exclusively through FDLP in fiscal year 2006 could yield estimated budgetary cost savings of about \$3.1 billion, based on subsidy cost estimates in the President's fiscal year 2006 budget, but actual savings would remain unknown until all loans made in fiscal year 2006 are repaid. In addition, federal administrative costs, which are not included in subsidy cost estimates, would likely increase and offset estimated subsidy cost savings by about \$46 million over the life of the loans, based on Department of Education (Education) estimates, because FDLP administrative costs are higher than those of FFELP. Tax revenues, which could affect estimated savings, are also excluded from subsidy cost estimates.

The \$3.1 billion estimated savings result from:

- avoiding an estimated subsidy cost of \$2.5 billion for providing a projected volume of \$25.5 billion in FFELP consolidation loans, and
- an estimated gain to the federal government of \$620 million if the projected FFELP consolidation loan volume of \$25.5 billion were made through FDLP rather than through FFELP.

The \$2.5 billion subsidy cost estimate in the President's budget for fiscal year 2006 for FFELP consolidation loans is based in part on the fact that the government-guaranteed yield provided to FFELP lenders was projected to be higher than the fixed interest rate consolidation loan borrowers would pay, resulting in special allowance payments to lenders over the entire life of these loans. ...

(2) The estimated subsidy cost savings from providing consolidation loans exclusively through FDLP could change significantly because of changes in assumptions underlying subsidy cost estimates. Key assumptions include:

- (1) economic conditions, such as interest rates;
- (2) loan performance, such as the portion of loans that default; and
- (3) loan volume.

In estimating subsidy costs for a loan cohort, Education must make assumptions about cash flows that are generated many years in the future. Estimated subsidy costs are periodically revised as new information about the assumptions and actual loan volume and costs incurred are known. As a result, subsequent subsidy cost estimates (i.e., re-estimates) for a cohort of loans could change substantially from initial estimates, and actual costs would remain unknown until all loans made in fiscal year 2006 are repaid and actual interest rates over the life of the loans are known. ...

(3) Although the actual impact on FFELP lenders and borrowers of providing consolidation loans exclusively through FDLP is difficult to predict, major FFELP consolidation loan lenders informed us that it would reduce lender revenues, the total volume of consolidation loans originated, and certain borrower benefits, such as repayment incentives provided by lenders, including lower interest rates, for on-time borrower repayments. These potential impacts could, however, be somewhat offset by such changes as (1) increased earnings for holders of FFELP unconsolidated loans retained as a result of decreased demand for consolidation loans, and (2) lenders providing nonconsolidation loan borrowers alternative repayment options and other incentives to encourage them not to consolidate their loans, as suggested by some FFELP lenders we contacted. Lenders would continue to earn income from loans not consolidated.⁴⁴⁹

2006 CBO Study Concerning Consolidation Loan Costs

In May 2006, the Congressional Budget Office published a paper that outlined the cost to the government of supporting the consolidation loan programs. The CBO found that under certain variable interest rate scenarios borrowers stand to benefit substantially from consolidating. They also estimated that with the advent of fixed-rate Stafford loans in 2006, “new” borrowers will not have much of an incentive to consolidate because there will be no rate advantage for them to do so. Borrowers with variable-rate loans still will be able to take advantage of low interest rate environments. The following are excerpts from the report that touch on those issues:

Of the various provisions included in a federal student loan contract, the option to consolidate individual loans contributes greatly to a borrower’s benefits and the cost of the program to the government and taxpayers. Most of the benefit comes from the fact that consolidation allows a borrower to convert loans with variable interest rates (which will not be issued after June 30, 2006) into one loan with a long-term fixed rate at the currently prevailing variable rate, which is linked to short-term market rates. Borrowers can choose when to consolidate, and they tend to do so when market conditions allow them to lock in long-term loans at the lowest interest rates. ...

For example, the benefit to borrowers averaged \$26 per \$100 in principal for loans consolidated in the 2004 program year, whereas for loans consolidated in 2000, the average benefit was only \$2 per \$100 in principal. ...

The Congressional Budget Office (CBO) estimates that the present value of the cost of the consolidation option has averaged \$4.60 per \$100 of loans originated. That is, the option to consolidate has cost the government (and benefited borrowers) about the same amount as forgiving the repayment of nearly 5 percent of borrowers’ loan principal. Today’s relatively small difference between long- and short-term interest rates implies that if the rules in effect before July 2006

⁴⁴⁹ Ibid., pp. 4-6.

continued, the prospective cost of the consolidation option would be lower than that historic average. In CBO's estimation, the average cost of the option for the 2006- 2015 period would be about \$1.50 per \$100 of the principal amount.

The changes scheduled to take effect in July 2006 fundamentally change the terms of the student loan program, fixing the interest rate on original and consolidated loans at 6.8 percent and 6.875 percent, respectively. Those changes eliminate the possibility of consolidating at a rate below 6.875 percent. Under the rules in effect after July 2006, the average cost of consolidation for the 2006-2015 period will be about 40 cents per \$100 of loans originated, CBO estimates. One important reason for the sharp reduction in cost is that consolidation provides few benefits to borrowers eligible to increase their loan maturity through the extension provision of their existing loans.⁴⁵⁰

CONSOLIDATION LOAN DEFAULT TRENDS

The Department of Education does not calculate separate **cohort** default rates for consolidation loans (Chapter 4 includes information about these rates). Since 2003, however, the federal budget has included consolidation loan default data based on formulas "which reflect projected defaults over the life of a loan cohort."⁴⁵¹

The table below shows the Administration's consolidation loan default rates published in the annual Budget Appendix. FDLP consolidation default rates are markedly higher than FFELP rates.

TABLE 17. Default Rates for FDLP and FFELP Consolidation Loan Borrowers 2003-2008⁴⁵²

Fiscal Year	FFELP	FDLP
2003	15.5%	30.9%
2004	14.5%	28.0%
2005	13.4%	15.5%
2006	13.3%	13.5%
2007 (est.)	13.9%	32.9%
2008 (est.)	13.8%	32.6%

⁴⁵⁰ Congressional Budget Office, "The Cost of the Consolidation Option for Student Loans," May 2006, pp. vi and vii.

⁴⁵¹ U.S. Department of Education, *FY 2007 Budget Appendix*, p. 366.

⁴⁵² U.S. Department of Education, *FY 2005 Budget Appendix*, p. 367, *FY 2006 Budget Appendix*, p. 370, *FY 2007 Budget Appendix*, p. 366 and *FY 2008 Budget Appendix*, p. 337.

POLICY ISSUES

Consolidation Refinancing/Reconsolidation Proposals

To provide more generous options for reconsolidation during the period of very low variable interest rates in the early- to mid-2000s, members of both political parties introduced bills that would have allowed borrowers to refinance already consolidated loans at lower interest rates. In general, the rationale for these proposals was that borrowers who had consolidated their variable-rate loans at relatively unattractive fixed rates ought to have the opportunity to take advantage of the very low T-bill rates. For example, in 2004, Congressman Rob Simmons, R-Conn., stated that:

Interest rates are currently at an all-time low, while college tuitions are at an all-time high. By law, homeowners can refinance their home mortgages; taxpayers can refinance their credit card debt. Sadly, graduates can't refinance their student loans. That's wrong and that's why I've asked the Chairman of the House Education committee to hold a hearing to study ways in which students and graduates can refinance student loans at the best rates possible.⁴⁵³

And, also in 2004, Congresswoman Rosa DeLauro, D-Conn., said:

At a time when young people and families are looking to start out on their own, to make a life for themselves, they are finding instead that they are burdened with massive debts that limit their professional opportunities and reduce their quality of life. ... We have serious challenges before us in the coming decades, when budget cuts in so many areas are imminent. We need to maintain and improve the Federal government's commitment to higher education so that we can continue to give every motivated student the opportunity to grow and contribute to our society.⁴⁵⁴

2005 Refinancing Proposals

The consolidation loan refinancing issue surfaced again in 2005, this time with strong bipartisan support. The Administration's FY 2006 Budget recommended allowing reconsolidation with the caveat that borrowers would have to pay a 1 percent origination fee "in recognition of the financial advantage of reconsolidation."⁴⁵⁵

Shortly after the release of the FY 2006 Budget, Senator Edward Kennedy introduced a higher education bill that also included a provision for reconsolidation. S. 371 would have allowed refinancing **only** of Direct Consolidation Loans, at the prevailing fixed rate as determined by the Secretary and only if "the interest rate on such borrower's Federal

⁴⁵³ Congressman Rob Simmons, News Release, March 18, 2004.

⁴⁵⁴ Congresswoman Rosa L. DeLauro, Press Release, July 22, 2004.

⁴⁵⁵ U. S. Department of Education, *Fiscal Year 2006 Budget Summary and Background Information*, February 2005, p. 9.

Direct Consolidation Loan is not less than the sum of 3.3 percent and the average of the bond equivalent rates of the 91-day Treasury bills auctioned for the previous calendar quarter.”⁴⁵⁶ The option to refinance would be available to the borrower only once.⁴⁵⁷

These proposals were not enacted during the 109th Congress.

2006 Reconsolidation Changes

Until Passage of HERA in 2006, Direct Loan borrowers could reconsolidate their consolidation loans, but there was no interest rate advantage in doing so, because the new rate would be identical to the old rate (the consolidation rate is based on the weighted average of the underlying loans).⁴⁵⁸ FFELP borrowers, by law, were precluded from reconsolidating existing consolidation loans.⁴⁵⁹

HERA instituted parallel terms and conditions for the two programs, which changed the reconsolidation provisions, as explained by the Department of Education:

The changes made to section 428C(a)(3)(B) by the HERA provide that a Consolidation Loan borrower loses eligibility to borrow a FFEL or Direct Consolidation Loan after receiving a consolidation loan, except that:

1. A borrower who receives additional eligible loans after the receipt of the consolidation loan may receive a subsequent consolidation loan;
2. Eligible loans received before or after the consolidation loan was received may be added to the existing consolidation loan during the 180-day period following receipt of that consolidation loan;
3. Eligible loans received prior to the date of the first consolidation loan may be added to a subsequent consolidation loan; and
4. A FFEL Consolidation Loan borrower may obtain a subsequent consolidation loan under the Direct Consolidation Loan program for the purpose of securing an income-contingent repayment schedule if the FFEL lender has requested default aversion assistance from the guaranty agency.^{460 461}

2006-2007 Legislative Proposals

Following passage of HERA, some Democratic lawmakers introduced bills that would alter or repeal the provisions dealing with loan consolidation and reconsolidation. For

⁴⁵⁶ 109th Congress, S. 371, p. 39.

⁴⁵⁷ Ibid.

⁴⁵⁸ 34 CFR, 685.220(b).

⁴⁵⁹ *Higher Education Act of 1965* (as amended), Sec. 428C(a)(3)(B).

⁴⁶⁰ Public Law No. 109-171, Sec. 8009, Feb. 8, 2006.

⁴⁶¹ U. S. Department of Education, “Enactment of the Higher Education Reconciliation Act of 2005, Loan Issues,” (Enclosure to DCL GEN-06-02 and FP-06-01), March 10, 2006, p. 2.

example, in 2006, Sen. Hillary Clinton proposed to allow refinancing of FFELP consolidation loans for a fee, and refinancing of FDLP loans without additional cost.

Senator Kennedy recommended that the HERA provisions restricting reconsolidation be repealed.

Both proposals were reintroduced early in 2007. As of February 2007, no action had been taken on these measures.⁴⁶²

Consolidation Counseling Proposals

In some instances, student loan consolidation may not benefit the borrower. For example, a lower interest rate might not offset the increase in the amount of interest paid over the life of a loan. Furthermore, borrowers should be made aware that it is generally to their advantage to repay the loan early, if possible. Borrowers also may lose certain benefits when they consolidate.

To help borrowers navigate these issues regarding loan consolidation, many organizations and lawmakers have proposed stepped up counseling efforts. For example, a group of student loan providers suggested that:

To assure that borrowers get appropriate counseling, Congress should review the effectiveness of counseling currently received by consolidation loan borrowers and consider enacting specific and detailed counseling requirements for consolidation loans that would assure that borrowers are fully informed on these subjects. At a minimum, borrowers should be required to contact their current loan holder before their application for consolidation is completed so that they can compare the benefits they might be foregoing against those offered by consolidation.⁴⁶³

Current Consolidation Counseling Offered by Student Loan Providers

Current law explicitly exempts consolidation loans from the counseling requirements that are required for other types of student loans.⁴⁶⁴ Nevertheless, some guarantors and lenders, as well as the Department of Education have voluntarily increased their efforts to counsel borrowers about the advantages and disadvantages of consolidation. There are, however, no uniform standards or requirements for consolidation counseling.

⁴⁶² 109th Congress, S. 3255, Sec. 4, S. 3259, Sec. 6, 110th Congress, S. 359, Sec. 11, S. 511, Sec. 4.

⁴⁶³ Letter from Joe Belew, Consumer Bankers Association; Brett Lief, National Council of Higher Education Loan Programs; Mark Powden, Education Finance Council; Rose DiNapoli, Sallie Mae to the Honorable Ralph Regula, U.S. House of Representatives, Dec. 6, 2001.

⁴⁶⁴ *Higher Education Act of 1965* (as amended), Secs. 433(a) and (b).

2006 Legislative Proposals

The 2006 House reauthorization bill, H.R. 609, would have streamlined consolidation counseling by mandating that borrowers must be given information about:

- The effects of consolidation on total interest to be paid, fees to be paid, and length of repayment.
- The effects of consolidation on a borrower's underlying loan benefits, including loan forgiveness, cancellation, and deferment.
- The ability of the borrower to prepay the loan, pay on a shorter schedule, and to change repayment plans.
- The fact that borrower benefits may vary among different loan holders.
- The tax benefits for which borrowers may be eligible.
- The consequences of default.
- The fact that simply applying for a consolidation loan does not obligate the applicant to agree to take the consolidation loan.⁴⁶⁵

The 2006 Senate reauthorization legislation, S. 1614 also included some consolidation counseling requirements. The bill:

- Provided for general consolidation counseling by schools during the exit interview that is substantially similar to the requirements of the House bill.
- Provided that lenders must provide consolidation borrowers with counseling about the implications of including a Perkins Loan in a consolidation loan.⁴⁶⁶

These legislative initiatives were not enacted during the 109th Congress.

2007 Legislative Proposals

In early 2007, Senator Clinton reintroduced her 2006 Student Borrower Bill of Rights Act, which included the requirements recommended in the 2006 H.R. 609 (above) and also mandated that borrowers who consolidate a federal loan with a private loan be given the following information:

- That the consolidation or reconsolidation loan would be a private loan, not a Federal loan.
- A description of the benefits and protections the borrower would lose by consolidating a federal loan with a private loan.
- That consolidation is available within the federal loan program.⁴⁶⁷

⁴⁶⁵ 109th Congress, H. R. 609.

⁴⁶⁶ 109th Congress, S. 1614.

⁴⁶⁷ 110th Congress, S. 511, Sec. 5

6. PRIVATE STUDENT LOANS

This chapter focuses on the role and history of private student loans, as well as current borrowing trends, lender participation, borrower characteristics and private student loan terms and conditions.

ROLE AND HISTORY OF PRIVATE LOANS

Students finance their postsecondary education by means of family contributions, federal loans, grants and work-study, state grants, institutional grants and loans and, sometimes, outside scholarships. When these sources of funding do not add up to the full amount needed, some students turn to private loans.

Other students may not have a pressing financial need and may bypass need-based financial aid resources in favor of a private loan. Thus, paradoxically, for some individuals, private student loans are a resource of necessity, whereas for others they serve as a resource of convenience.

History

Private student loans predate federal loans. Prior to the passage of the Higher Education Act in 1965, some private lenders were already engaged in making loans to students or their parents, but, by all accounts, it was not until the 1980s that private — or alternative loans, as they were then called — emerged as a real presence in the student loan marketplace. According to a student loan publication:

By January 1982, the number of alternative loan programs in existence was large enough to warrant the establishment of newsletter reporting on them, “The Alpine” published first under the auspices of the Alternative Loan Program Task Force of the National Council of Higher Education Loan Programs and the Massachusetts Higher Education Assistance Corporation.⁴⁶⁸

Despite some growth in the early 1980s when PLUS loan interest rates were very high, alternative loan volume stagnated for a number of reasons. Chief among these reasons are the subsequent lowering of PLUS rates, the emergence of a federal supplemental loan for students program — known as ALAS— and a lack of cost-effective funding.⁴⁶⁹ As a result, private loans were but a small component of student loan offerings during the 1980s.

Private loan volume continued to be modest well into the 1990s, perhaps because Congress expanded federal loan eligibility substantially with the passage of the 1992

⁴⁶⁸ Freeman, Ernest T. and Thomas D. Parker, “The Prospect for Family Education Loans,” in Joseph Marr Cronin and Sylvia Quarles Simmons (eds.), *Student Loans: Risks and Realities*. Dover, DE: Auburn House Publishing Company, 1987, pp. 120-121.

⁴⁶⁹ Ibid.

Higher Education Amendments, which created a new **unsubsidized** Stafford loan component, with many of the same terms and limits as other Stafford loans. In addition, the removal of the \$4,000 borrowing cap from PLUS loans meant that qualified parents could borrow unlimited amounts, as long as they did not exceed college cost minus aid.⁴⁷⁰

During the mid 1990s, the rapidly escalating cost of college, combined with the nimbleness of lenders in devising new products targeted to specific borrower populations, resulted in new opportunities for private loans, which in turn, led to substantial increases in volume.

HERA may stem the growth of private loans somewhat, because graduate and professional students now are able to borrow under the PLUS loan program. These students also will see some increases to their unsubsidized Stafford loan limits. Counteracting those changes, however, undergraduate borrowers may seek increased access to private loans, because HERA increased subsidized Stafford limits only for freshmen and sophomores by a modest amount, and there was no change to the limits for juniors or seniors. Aggregate undergraduate borrowing limits also were not increased.⁴⁷¹

BORROWING TRENDS

No definitive data exist on private loan volume. Various entities collect at least some data on these loans, but no central database captures all volume on a regular basis, as is the case with federal loans.⁴⁷² Moreover, the definition of a private loan is somewhat vague. The College Board, for example, uses the term “non-federal” loans for loans from private lenders and state-sponsored “private” loan programs.⁴⁷³ The NCES studies define “private sources loans” as commercial or private source loans, which do not include loans from family or friends.⁴⁷⁴

Despite these limitations in methodology, the College Board, has collected what is currently the most comprehensive annual volume assessment for non-federal student loans. As illustrated by Figure F, non-federal loan volume has increased tenfold during the past decade and now stands at more than \$17 billion. During the same period, federal loan volume (not including consolidation) more than doubled to almost \$70 billion.⁴⁷⁵ Although the total amount of private student loans still is only about a quarter of federal loan volume, some have speculated that private loans will be poised to overtake federal student loan volume within a decade.⁴⁷⁶

⁴⁷⁰ Pre-1992 version of *Higher Education Act* (as amended), Sec. 428B(b)(1).

⁴⁷¹ Public Law No. 109-171, Sec. 8005, Feb. 8, 2006.

⁴⁷² For examples, please see Catherine A. Wegmann, Alisa F. Cunningham, Jamie P. Merisotis, *Private Loans and Choice in Financing Higher Education*, The Institute for Higher Education Policy with support from The Education Resources Institute, July 2003, p. 7.

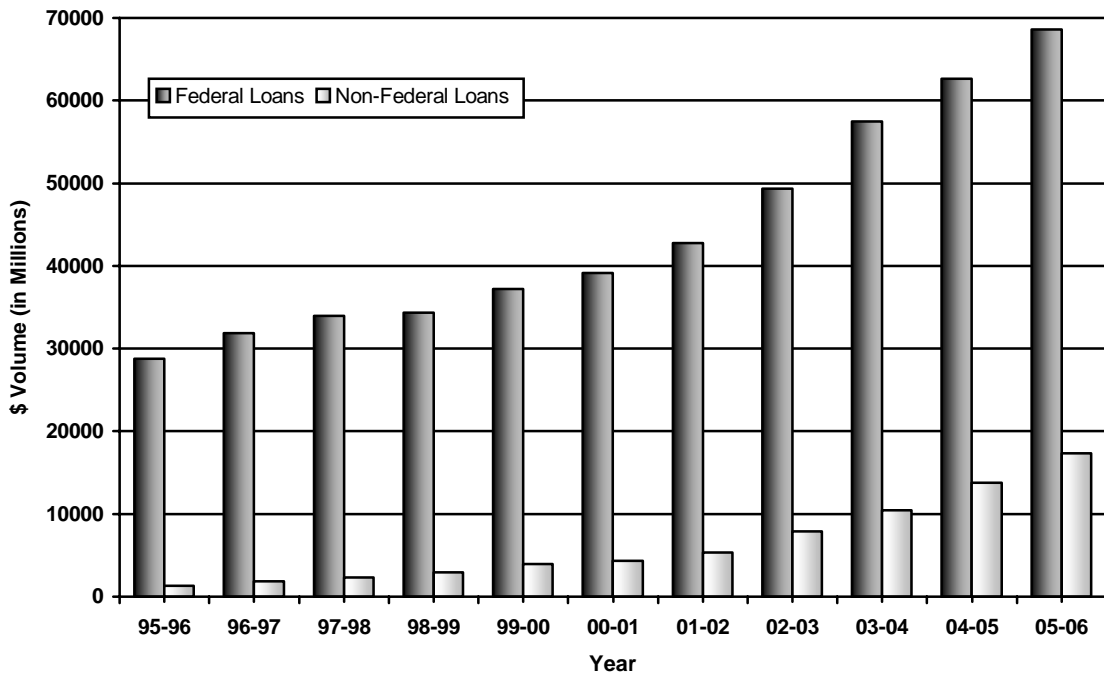
⁴⁷³ College Board, *Trends in Student Aid*, October 2006, p. 26.

⁴⁷⁴ U.S. Department of Education, National Center for Education Statistics, *Student Financing of Undergraduate Education: 1999–2000*, Statistical Analysis Report, July 2002, p. 210.

⁴⁷⁵ College Board, *Trends in Student Aid*, October 2006, p. 6.

⁴⁷⁶ See <http://www.finaid.org/loans/privatestudentloans.phtml>, accessed Dec. 27, 2006.

FIGURE F. Distribution of Federal and Non-Federal Student and Parent Loan Volume (Current Dollars) ⁴⁷⁷



TERMS AND CONDITIONS OF PRIVATE LOANS

For federal student loans, borrowers know most terms in advance. They know, for example, that Stafford loans are not based on creditworthiness and they are informed upfront about annual limits and maximum fees and rates. Borrower benefits, such as lower rates and fee reductions, may vary from lender to lender, but the general terms are pre-established. Federal student loan borrowers also are entitled to in-school interest subsidies (Stafford subsidized loans), deferments, grace periods and a rehabilitation program, should the loan go into default.

Such is not the case for private student loans. Interest rates and fees are based, not on a formula, but on variables, such as field of study, type of institution and, because of the risk involved, almost always on the creditworthiness of the borrower or the co-signer. Typically, the only “subsidy” is embedded in the price of the product, and that subsidy tends to be based on creditworthiness. Thus, borrowers with lower credit scores/ratings, who are aiming for relatively non-lucrative careers, are apt to be turned down altogether or pay a much higher price for their private loans than would be the case for borrowers with stellar credit scores and high-income future job prospects.

There is, however, one major point of similarity between federal and private loans. As a 2003 private loan report explains:

⁴⁷⁷ College Board, *Trends in Student Aid*, October 2006, p. 6.

Both private loan products and federal student loans can be used only to help students finance their postsecondary educations and can be certified (approved and verified from the college’s financial aid office) only up to a certain amount. For private loans this amount often is either a set dollar amount or the cost of attendance minus aid, whichever is less.⁴⁷⁸

Both for-profit and nonprofit lenders offer hundreds of competing private loan products that are constantly changing in response to market pressures. Thus, the table below, which outlines some current terms for private loans, should be viewed as a snapshot in time, not as a definitive description of current terms.

TABLE 18. Comparison of Selected Terms and Conditions for Federal Loans and a Sampling of Private Loans for Undergraduates⁴⁷⁹

LOAN PROGRAM	CUMULATIVE LOAN LIMITS	MAXIMUM REPAYMENT PERIOD	INTEREST RATES	FEES
<i>FFELP/FDLP Subsidized Stafford</i>	\$23,000	10-30 Years	Fixed 6.8%	Up to 3% ⁴⁸⁰
<i>FFELP/FDLP PLUS</i>	Cost Minus Aid	10-30 Years	Fixed 7.9%-8.5%.	Up to 4%
<i>TYPICAL Private Loan X⁴⁸¹</i>	\$250,000	15 Years	Prime + 0-8% ⁴⁸²	0-10%
<i>TYPICAL Private Loan Y</i>	\$120,000	20-25 Years	LIBOR+ 3-6.75% ⁴⁸³	0%
<i>TYPICAL Private Loan Z</i>	Cost Minus Aid	15 Years	LIBOR + 2.8% fixed LIBOR + 1.6% variable Variable capped at 12%	3.75-7.0%

PRIVATE LOAN BORROWER CHARACTERISTICS

The most recent comprehensive research on the characteristics of private student loan borrowers is based on information from the 2003-2004 National Postsecondary Student Aid Study, which has been compiled and analyzed by The Institute for Higher Education Policy.

⁴⁷⁸ Catherine A. Wegmann, Alisa F. Cunningham, Jamie P. Merisotis, *Private Loans and Choice in Financing Higher Education*, The Institute for Higher Education Policy, with support from The Education Resources Institute, July 2003, p. 7.

⁴⁷⁹ *Higher Education Act of 1965* (as amended), Secs. 428 and 428B. and <http://www.finaid.org/loans/privatestudentloans.phtml>, accessed Feb. 26, 2007.

⁴⁸⁰ Under HERA, Stafford borrower fees will be gradually reduced to a maximum of 1 percent.

⁴⁸¹ These lenders are not identified and are chosen as typical lenders from <http://www.finaid.org/loans/privatestudentloans.phtml>. No endorsement is implied. Accessed Feb. 26, 2007.

⁴⁸² Prime is the Prime Lending Rate as published in the *Wall Street Journal*. This is the rate banks charge their most creditworthy customers.

⁴⁸³ LIBOR is the three-month average of the London Interbank Offered Rate. LIBOR is the average interest rate paid on deposits of U.S. dollars in the London market.

Undergraduate Borrower Characteristics⁴⁸⁴

Dependent Undergraduates

Dependent undergraduates who borrowed private loans in 2003-2004 tended to have these characteristics:

- The majority were:
 - From families with incomes greater than \$60,000.
 - Attending college full time.
 - In their first two years of college.
 - Working part time while enrolled.
- About three-quarters attended four-year institutions (public or private not-for-profit).
- Twenty percent of dependent private loan borrowers did not borrow Federal Stafford loans.
- Sixty-three percent had borrowed a subsidized Stafford loan, and 37 percent had borrowed an unsubsidized loan.
- About two-thirds also had borrowed the maximum possible amount under the Federal Stafford Loan program (subsidized and unsubsidized loans).⁴⁸⁵

Independent Undergraduates

Independent undergraduates who took out private loans in 2003-2004 tended to have these characteristics:

- The majority were:
 - From families with incomes less than \$30,000.
 - Attending college full time.
 - In their first two years of college.
 - Working full time or part time while enrolled.
- Only about one-third attended four-year institutions (public or private not-for-profit).
- Twenty-five percent of independent private loan borrowers did not borrow federal Stafford loans.
- Seventy percent had borrowed a Stafford subsidized loan, and 67 percent had borrowed an unsubsidized loan.

⁴⁸⁴ Catherine A. Wegmann, Alisa F. Cunningham, Jamie P. Merisotis, *Private Loans and Choice in Financing Higher Education*, The Institute for Higher Education Policy with support from The Education Resources Institute, July 2003, pp. 34-44.

⁴⁸⁵ Institute for Higher Education Policy, *The Future of Private Loans, Who is Borrowing and Why*, December 2006, p. 17.

- About one-half had borrowed the maximum possible amount under the Federal Stafford Loan program (subsidized and unsubsidized loans).⁴⁸⁶

Graduate Borrower Characteristics

Professional Students

- Of professional students who borrowed private loans, 63 percent were pursuing law degrees, 22 percent were pursuing degrees in medicine, and 14 percent were enrolled in other health sciences programs.
- The majority were:
 - From families with incomes less than \$20,000.
 - Not working.
 - Attending a private not-for-profit institution.
 - Attending full time.
- Only 8 percent of professional student private loan borrowers did not borrow Federal Stafford loans.
- Ninety percent had borrowed a subsidized Stafford loan, and 90 percent had borrowed an unsubsidized loan; and
- Ninety percent had borrowed the maximum or the exceptional maximum possible amount under the subsidized and unsubsidized Federal Stafford Loan program. ⁴⁸⁷ (According to IHEP: “Some medical students are awarded exceptional maximum amounts of Stafford loans, which may point to one reason why these students constitute a smaller proportion of professional private loan borrowers than those in law degree programs.”⁴⁸⁸)

Graduate Students

- Of graduate students who obtained private loans, the largest proportions were pursuing other master’s degrees (27 percent), MBA degrees (17 percent), education-related master’s degrees (17 percent), and other master’s of science degrees (16 percent).
- The majority were:
 - From families with incomes less than \$30,000.
 - Working full or part time while enrolled.
 - Attending a private not-for-profit institution.
 - Attending full time.
- Twenty-eight percent of graduate student private loan borrowers did not borrow Federal Stafford loans.

⁴⁸⁶ Ibid., p. 18.

⁴⁸⁷ Ibid., p. 24.

⁴⁸⁸ Ibid., p. 28.

- Sixty-seven percent had borrowed a subsidized Stafford loan, and 68 percent had borrowed an unsubsidized loan.
- Sixty-three percent had borrowed the maximum or the exceptional maximum possible amount under the subsidized and unsubsidized Federal Stafford loan program.⁴⁸⁹

LENDER PARTICIPATION

There is no official tally of private student loan providers. An industry publication, *The Greentree Gazette*, regularly lists the top 100 or so lenders of private loans, and a financial aid Web site, *finaid.org*, provides similar information online. Below is a table that outlines the top 25 **federal** student loan originators for 2005, as compiled by the Department of Education. With only one exception, all these lenders also provide **private** loan products.

TABLE 19. Lender Participation in Private Student Loans⁴⁹⁰

FFELP LENDER	FFELP ORIGATION RANKING	PRIVATE LOAN PROVIDER?
<i>SLM Corporation — Sallie Mae</i>	1	Yes
<i>Citibank Student Loan Corporation</i>	2	Yes
<i>Bank One (Now Chase)</i>	3	Yes
<i>Bank Of America</i>	4	Yes
<i>Wells Fargo Bank</i>	5	Yes
<i>JPMorgan Chase</i>	6	Yes
<i>First Union National Bank (now Wachovia)</i>	7	Yes
<i>College Loan Corp</i>	8	Yes
<i>U S Bank</i>	9	Yes
<i>Access Group</i>	10	Yes
<i>EdAmerica</i>	11	Yes
<i>Pittsburgh National Corp. (PNC)</i>	12	Yes
<i>Northstar Guarantee</i>	13	Yes
<i>Suntrust Bank</i>	14	Yes
<i>Education Lending Group (Student Loan Xpress)</i>	15	Yes

⁴⁸⁹ Ibid., p. 25.

⁴⁹⁰ U.S. Department of Education, “*Top 100 Originators - FY05 and FY04*”, at <http://www.fp.ed.gov/PORTALSWebApp/fp/pubs.jsp>, and <http://www.finaid.org/loans/privatestudentloans.phtml>, accessed Feb. 22, 2007.

FFELP LENDER	FFELP ORIGINATION RANKING	PRIVATE LOAN PROVIDER?
<i>Citizens Bank</i>	16	Yes
<i>Pennsylvania Higher Education Assistance Authority</i>	17	Yes
<i>College Foundation, Inc.</i>	18	Yes
<i>National Education Loan Network (NELNET)</i>	19	Yes
<i>National City Bank</i>	20	Yes
<i>South Carolina Student Loan Corp.</i>	21	Yes
<i>Brazos Group (Educational Funding Services, Inc. (EFSI))</i>	22	Yes
<i>Kentucky Higher ED Student Loan Corp.</i>	23	Yes
<i>Illinois Student Assistance Commission (IDAPP)</i>	24	Yes
<i>Nova Southeastern University</i>	25	No

7. STUDENT LOAN INDEBTEDNESS

In recent years, student loan indebtedness has become the focus of extensive attention. To provide an overview of debt burden issues, this chapter gathers information from a number of different sources and summarizes:

- Data on student loan indebtedness trends for undergraduate and graduate students.
- Undergraduate and graduate borrower characteristics.
- The potential socio-economic impact of borrowing.
- Potential options for ameliorating the impact of debt burdens.

INDEBTEDNESS TRENDS

Several different surveys keep track of indebtedness trends, and although they may differ somewhat in terms of methodology, the trends are clear: college students are indeed borrowing more now than they did in the past.

Undergraduate Borrowers

- By the time they received a bachelor's degree, nearly two-thirds of **undergraduate** students at four-year colleges and universities have student loan debt (65.6 percent in 2004). In 1993, less than one-half of four-year graduates had student loans.⁴⁹¹
- Over the past decade, average debt levels for graduating seniors with student loans more than doubled from \$9,297 to \$19,200 — a 108 percent increase (58 percent after accounting for inflation).⁴⁹²
- One-fourth of graduating borrowers in 2004 carried more than \$25,000 in student loan debt (not including parent borrowing).⁴⁹³
- The 2002 National Student Loan Survey found that undergraduate student loan debt had increased significantly since 1997. The average undergraduate debt [in 2002 current dollars] was \$18,900, up 66 percent from \$11,400 five years earlier.⁴⁹⁴
- The 2002 study further established that students attending private four-year colleges borrowed most (average \$21,200), followed by those who attended public four-year colleges (average \$17,100). Vocational/technical

⁴⁹¹ National Center for Education Statistics (NCES), National Postsecondary Student Aid Study (NPSAS), 1993 and 2004 undergraduates, Data Analysis System (DAS), http://nces.ed.gov/das/library/tables_listings/nedrc_table.asp?sbj=student%20aid, Table 149, accessed Feb. 23, 2007.

⁴⁹² Ibid.

⁴⁹³ Project on Student Debt, *Quick Facts about Student Debt*, p. 2. Calculations by the Project on Student Debt from the National Center for Education Statistics (NCES), National Postsecondary Student Aid Study (NPSAS), 2004 undergraduates, Data Analysis System (DAS).

⁴⁹⁴ Baum, Sandy and O'Malley, Marie, *College on Credit: How Borrowers Perceive Their Education Debt. Results of the 2002 National Student Loan Survey*, Washington, D.C.: Nellie Mae Corporation, 2003, p. v.

school students averaged \$15,000. Students who had attended public two-year institutions took out an average of \$8,700 in student loans [all current dollars].⁴⁹⁵

Graduate Borrowers

- Information about graduate students compiled by NCES show that during the 2003-2004 school year, 70 percent of **all** graduate students who had completed their education indicated that they had borrowed for their undergraduate and/or graduate education, ranging from a low of 46 percent for doctoral candidates (except education) to a high of 95 percent for medical students.⁴⁹⁶
- The 2003-2004 NCES data further reveal that graduate students who had completed their education and who had borrowed for either their undergraduate or graduate education had accumulated an average of \$42,500 in debt, ranging from a low of \$28,200 for master's degree candidates enrolled in education to a high of \$125,900 for medical students.⁴⁹⁷

Parent Borrowers

According to the Project on Student Debt:

In 2004, the parents of 15.3 percent of graduating seniors took out federal PLUS loans: 12.3 percent at public four-year institutions, 21 percent at private four-year institutions. Their average PLUS debt was \$17,709: \$14,056 at public institutions, \$21,984 at private institutions. (These data are for dependent students only and do not include other forms of debt, such as home equity loans, that parents may take on to help pay for college.)⁴⁹⁸

Annual Student Borrowing in Relationship to Other Aid

Undergraduates

The Education Department's *Condition of Education 2006* offered a comparison of loans as a percentage of total aid for three cohorts of borrowers over time. To further illustrate differences among types of students and institutions, the report also included data on dependency status, income and type of institution.

⁴⁹⁵ Ibid.

⁴⁹⁶ NCES, *Student Financing of Graduate and First-Professional Education: 2003-04*, Statistical Analysis Report, June 2006, p. 96.

⁴⁹⁷ Ibid.

⁴⁹⁸ Project on Student Debt, *Quick Facts about Student Debt*, p. 1. Calculations by the Project on Student Debt from the National Center for Education Statistics (NCES), National Postsecondary Student Aid Study (NPSAS), 2004 undergraduates, Data Analysis System (DAS).

As shown in the table below, which is a summary of NCES data, loans have increased as a percentage of the total aid package since 1992-93, although growth appears to have leveled off since 1999-2000 across most cohorts. Independent undergraduates and students at public four-year schools tended to carry the highest percentage of loans in relationship to other aid across the three cohort years. Students at private institutions as well as independent students, borrowed higher annual amounts than did other students, however.

TABLE 20. Average Annual Amount of Federal, State, Institutional, and Private Loans (In Constant 2003-2004 Dollars) for Aided Full-Time/Full-Year Undergraduates and Loans as a Percent of All Aid⁴⁹⁹

Borrower Characteristics	1992-93	1999-2000	2003-2004
<i>All Borrowers</i>			
<i>Average Loan Amount</i>	\$4,600	\$6,000	\$6,200
<i>Loans as % of Aid</i>	33.7	40.6	41.2
<i>Dependent</i>			
<i>Average Loan Amount</i>	\$4,100	\$5,400	\$5,600
<i>Loans as % of Aid</i>	32.2	39.6	39.1
<i>Independent</i>			
<i>Average Loan Amount</i>	\$5,200	\$7,500	\$7,500
<i>Loans as % of Aid</i>	36.5	43.1	46.0
<i>Public 4-year</i>			
<i>Average Loan Amount</i>	\$4,200	\$5,500	\$5,800
<i>Loans as % of Aid</i>	38.3	48.3	46.9
<i>Private Non-Profit 4-Year</i>			
<i>Average Loan Amount</i>	\$5,100	\$6,900	\$7,200
<i>Loans as % of Aid</i>	30.7	35.9	35.8

⁴⁹⁹ NCES, *The Condition of Education 2006*, June 2006, p. 211. Does not include Parent Loans and Credit Card Debt. Loans as % of aid include aided students with no loans.

Graduate and Professional Students

The Department of Education also publishes reports on the financing of graduate education and, as shown in the table below, from 1992 to 2003, there has been an increase in both annual loan amounts as well as in loans as a percentage of all aid.

TABLE 21. Average Annual Amount of Federal, State, Institutional, and Private Loans (In Constant 2003-2004 Dollars) for Aided Full-Time/Full-Year Graduate Students and Loans as a Percent of All Aid⁵⁰⁰

Borrower Characteristics	1992-93	1999-2000	2003-2004
<i>All Graduate Borrowers</i>			
<i>Average Loan Amount</i>	\$14,512	\$18,342	\$21,500
<i>Loans as % of Aid</i>	51.8	52.7	62.8
<i>Master's Students</i>			
<i>Average Loan Amount</i>	\$10,688	\$16,218	\$16,400
<i>Loans as % of Aid</i>	38.5	50.5	61.7
<i>Doctoral Students</i>			
<i>Average Loan Amount</i>	\$11,920	\$15,444	\$20,200
<i>Loans as % of Aid</i>	26.6	21.1	31.2
<i>Professional Students</i>			
<i>Average Loan Amount</i>	\$18,210	\$22,084	\$27,500
<i>Loans as % of Aid</i>	76.4	78.6	81.1

BORROWER CHARACTERISTICS

Undergraduate Borrowers

According to the National Center for Education Statistics, during school year 2003-2004, undergraduate borrowers, regardless of whether they were full-time or part-time, dependent or independent, had these demographic characteristics:

- **Gender.** There were no major differences in borrowing patterns: 33 percent of males borrowed, vs. 36 percent of females.
- **Race.** Blacks, whites and American Indians borrowed at a higher rate (43, 35, and 32 percent respectively) than did Hispanic and Asian students (30 and 25 percent).
- **Age.** More students in their mid- and late-twenties borrowed during the year (40 percent) than did younger and older students (34 and 21 percent, respectively).

⁵⁰⁰ NCES, *Student Financing of Graduate and First-Professional Education: 2003-04*, Statistical Analysis Report, June 2006, p. 48, p. 66, p. 78 and p. 92. NCES, *Student Financing of Graduate and First-Professional Education: 1999-2000*, Statistical Analysis Report, June 2002, p. 82 and p. 97. Does not include Parent Loans and Credit Card Debt. Loans as % of aid include aided students with no loans.

- **Dependency Status.** More dependent than independent students borrowed (38 percent vs. 32 percent).
- **Dependent Family Income.** There were no major differences in the borrowing levels by income, except that students with incomes over \$100,000 borrowed less frequently than their peers.
- **Institution Type.** Students at private for-profit schools and private non-profit four-year institutions borrowed more frequently than did students at public four-year colleges (73 percent, 56 percent and 45 percent respectively).⁵⁰¹

Graduate Borrowers

According to NCES, during school year 2003-2004, full-time/full-year master's, doctoral and first-professional graduate borrowers had these demographic characteristics:

- **Gender.** Females tended to borrow more frequently than males, except for first-professional students who borrowed at similar rates.
- **Race.** Blacks borrowed at a higher rate, except in first-professional programs where whites and Hispanics borrowed at the higher rates.
- **Age.** There was no clear pattern of age-specific borrowing across the three types of graduate study.
- **Field of Study.** Engineering students borrowed at lower rates than did students with other majors in master's and doctoral degree programs. Education, social science and business majors all borrowed at substantially higher rates. For professional students, only theology students borrowed at a relatively low rate (less than 50 percent). Medical and law students all borrowed at very high rates (more than 80 percent).
- **Marital Status.** A slightly higher percentage of unmarried graduate students borrowed. That was true across all three disciplines.
- **Family Income.** Except for master's degree students, borrowers with incomes over \$50,000 borrowed at a lower rate than their lower-income peers, and lower-income borrowers borrowed at a substantially higher rate. In the case of master's degree students, that trend was reversed, and individuals with incomes of less than \$5,000 borrowed the least of that cohort.
- **Citizenship.** Citizen students tended to borrow at higher rates than non-citizens, except for master's degree students.⁵⁰²

⁵⁰¹ NCES, *Student Financing of Undergraduate Education: 2003-04*: Statistical Analysis Report, June 2006, pp. 84-85. Does not include Parent Loans and Credit Card Debt.

⁵⁰² NCES, *Student Financing of Graduate and First-Professional Education: 2003-04*, Statistical Analysis Report, June 2006, pp. 70-72.

SOCIOECONOMIC IMPACT OF BORROWING

As a result of the rapid increases in college debt burdens, researchers have begun to focus on the socio-economic impact of student loan borrowing. Although the data still are relatively scant, some interesting answers to questions concerning debt burdens are beginning to emerge. Below are summaries of findings from currently available published studies.

Do Students Feel Burdened by Debt?

The National Student Loan Survey, published in 2003, found that:

An increased number of borrowers feel more burdened by their education debt, with about a quarter of the borrowers perceiving themselves as having significant problems. Those who say they feel burdened by their education debt increased to 55% from 50% in 1997. Fifty-four percent also say they would borrow less if they had to do it over again, up from 45% in 1997. However, compared to previous surveys, the same low percentage of borrowers - about 15% - say the benefits are just not worth the difficulty of making payments.

For the first time, we are seeing a difference in perception of burden between low-income student borrowers and others. Students who came from low-income families (defined as Pell Grant recipients) report feeling more burdened by their debt than did non-Pell recipients, when controlling for all other factors. This is a change from previous studies when there was no significant difference in attitudes between low-income and non-Pell recipients.

African-American borrowers express greater perception of burden, even with lower debt-to-income ratios, and less satisfaction that the benefits of borrowing were worth it.⁵⁰³

Among graduate students, 63 percent indicated that they were “very burdened” by their debt payments. For law and medical school graduates that percentage was a much higher 75 percent.⁵⁰⁴

Furthermore, when looking at the issue of indebtedness from the perspective of “would you do it over again?” NASLS showed a significant change over time:

The proportion of borrowers saying they would borrow **less** if they had it to do over again has increased considerably over time; the percentage who claim to be experiencing more hardship than anticipated was significantly higher in 1997 and 2002 than in 1987 and 1991; and the 59% in the current survey who believe the

⁵⁰³ Baum, Sandy and O'Malley, Marie, *College on Credit: How Borrowers Perceive Their Education Debt. Results of the 2002 National Student Loan Survey*, Washington, D.C.: Nellie Mae Corporation, 2003, p. vii.

⁵⁰⁴ *Ibid.*, p. 16.

benefits outweigh the costs was significantly lower than the 66% - 74% who gave this positive response in earlier surveys.⁵⁰⁵

Finally, it is important to note that:

... Responses to questions about the access and choice benefits of education loans have been consistently positive over time and this year, borrowers were strikingly less likely than in earlier surveys to blame loans for preventing them from staying in school or from going on to graduate school [In 1987, 41% and 55%, respectively, compared to 2002, 29% and 42%, respectively].⁵⁰⁶

Does Student Loan Debt Lead to Postponement of Consumer Purchases?

Conventional logic would dictate that students with high debts would postpone major consumer purchases, such as a house or a car. Indeed, the NASLS findings indicate that a growing proportion of borrowers have delayed such purchases:

- In 1987, 23 percent of respondents indicated that they had delayed buying a home because of student loan debt; that number jumped to 38 percent in 2002;
- Concomitantly, in 1987, only 17 percent indicated that they had delayed buying a car because of student loans; that figure also increased — to 30 percent — in 2002.⁵⁰⁷

These data were further clarified, as follows:

In past NASLS surveys, multivariate analysis revealed no impact of debt levels on the probability of homeownership. However, in 2002 the probability of owning a home decreases by a small but statistically significant amount — approximately 0.2 percentage points for each \$1,000 of education debt. In other words, an additional \$5,000 of debt reduces the probability of owning a home by about 1% ...;

Borrowers over the age of 31 are much more likely to own homes, with the home ownership rate of those 31 and younger 21%, compared to 42% for those 32 and older. Surprisingly, Pell does not have a significant impact on the probability of home ownership among NASLS respondents.

African-American borrowers and those who identified themselves as members of a group other than white, African American, or Asian/Pacific Islander are less likely than others to own homes, as are those who did not complete any degree.

⁵⁰⁵ Ibid., p. 29.

⁵⁰⁶ Ibid.

⁵⁰⁷ Ibid. p. 27.

The results on home ownership are, however, notable, particularly because of the contrast with earlier NASLS findings. Certainly, they signal a need to be vigilant about the impact of further increases in student debt levels.⁵⁰⁸

Does Student Loan Debt Foster Avoidance of Public Service Careers?

The State Public Interest Research Groups' Higher Education Project examined indebtedness and career choice by focusing on "the issue of unmanageable debt as it pertains to college graduates entering two critical public service careers: teaching and social work." The authors considered:

Average starting salaries of teachers and social workers nationally and by state and estimated what percentage of these new public servants would carry unmanageable student loan debt. "Unmanageable" means that their loan payments would have a measurable and burdensome impact on their lives and would likely hinder their ability to pay for basic necessities.⁵⁰⁹

The results:

Factoring in high debt levels, the congressional fixed 6.8% interest rate for federal student loans, and low starting salaries, we found that 23% of public four-year college students graduate with too much debt to manageably repay their loans as a starting teacher. Thirty-seven percent (37%) of public four-year college graduates have too much debt to manage as a starting social worker.

Graduates of private four-year colleges face even more significant debt burdens. Thirty-eight percent (38%) of private four-year college students would face an unmanageable debt burden as a starting teacher. Fifty-five percent (55%) of private college graduates would face serious repayment challenges as a starting social worker.⁵¹⁰

An important caveat regarding the results: The PIRG study considered debt levels of all graduates of four-year institutions, not just those entering the teaching and social work fields.

Does Student Loan Debt Lead to Delay in Major Life Events?

According to the NASLS Study, the answer is a qualified "yes." As the table below illustrates, during a 15-year period, an increasing percentage of borrowers indicated that they had delayed both marriage and childbearing.

⁵⁰⁸ Ibid., p. 26.

⁵⁰⁹ State PIRGs' Higher Education Project, "Paying Back, Not Giving Back: Student Debt's Negative Impact on Public Service Career Opportunities," April 2006, pp. 4-5.

⁵¹⁰ Ibid.

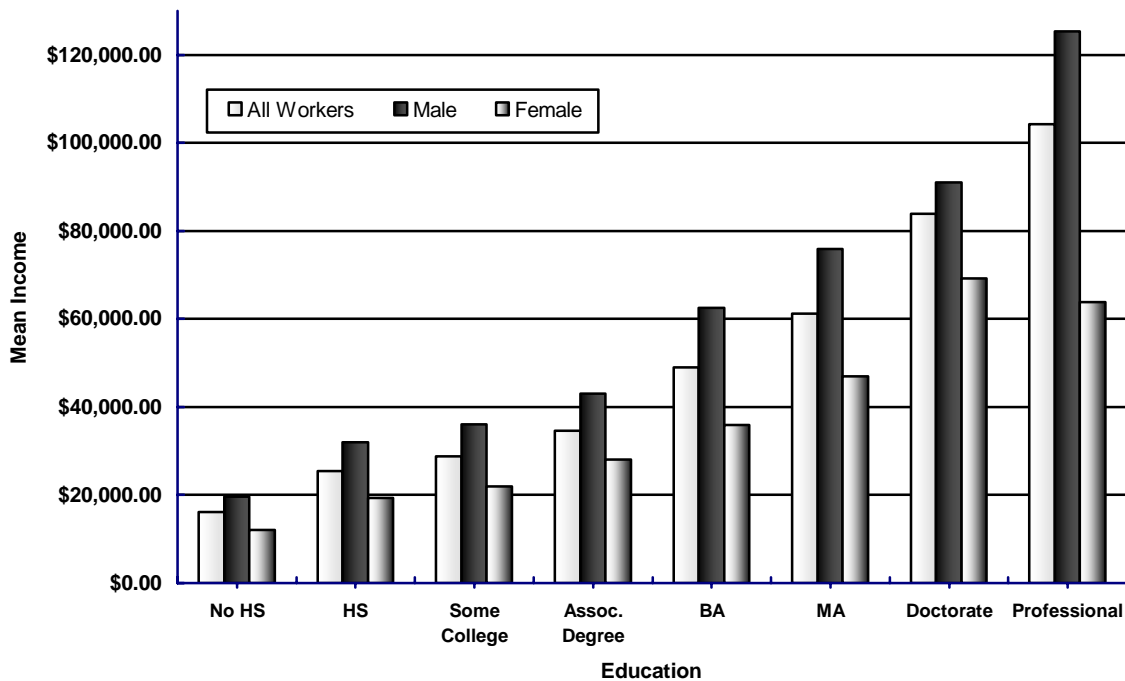
TABLE 22. Percentage of NASLS Survey Respondents Who Indicated They Delayed Marriage and Child-Bearing⁵¹¹

Life Event	1987	1991	1997	2002
<i>Delayed Marriage</i>	9%	7%	15%	14%
<i>Delayed Child-Bearing</i>	12%	12%	22%	21%

EDUCATION AND ANNUAL INCOME

The Census Bureau collects data on educational attainment and estimates annual income on the basis of these and other data. As the figure below shows, the higher the level of education, the greater the annual earnings, with professional degree recipients earning more than high school graduates by a factor of five to one. It is also noteworthy that males earn more than females in every educational attainment category.

FIGURE G. Mean Income in 2003 by Educational Attainment and Gender for All Workers, 18 Years and Over⁵¹²



⁵¹¹ Ibid., p. 27.

⁵¹² U.S. Census Bureau, *Current Population Series*, "Educational Attainment in the United States: 2004," <http://www.census.gov/population/www/socdemo/education/cps2004.html>, Table 8, accessed Feb. 24, 2007.

POTENTIAL OPTIONS FOR LOWERING DEBT BURDENS

As debt burdens rise, concerns about negative consequences gain in importance. To forestall an indebtedness crisis, numerous proposals have been put forward to ease the upward pressure on borrowing for postsecondary education. The proposals include:

- Increasing need based grant aid.
- Promoting financial literacy programs.
- Enhancing and expanding borrower loan counseling.
- Modifying repayment terms to take into account the higher debt burdens.
- Creating new deferments.
- Creating new loan forgiveness programs.
- Expanding the use of education tax incentives.
- Expanding the use of income-sensitive/contingent repayment.
- Reducing borrower fees.
- Decreasing borrower interest rates.
- Establishing incentives to control tuition.

Policy-makers are currently debating many of these options, and components of some were enacted as part of the Higher Education Reconciliation Act.⁵¹³

⁵¹³ See, for example, 110th Congress, H.R. 5 and S. 359, as well as Public Law No: 109-171, Secs. 8008 and 8009, Feb. 8, 2006.

8. APPENDICES

APPENDIX A. FEDERAL STUDENT LOAN BASICS

Unless otherwise noted, this description of the federal student loan programs applies to both the FFELP and the Direct Loan Program. The information is compiled from the Higher Education Act of 1965 and regulations.

Types of loans

FFELP and FDLP both provide four different loan options:

- Subsidized Stafford loans.
- Unsubsidized Stafford loans.
- PLUS loans for parents and graduate/professional students.
- Consolidation loans.

Depending on their financial need, students may be eligible for subsidized or unsubsidized Stafford loans or a **combination** of the two. Parents and graduate/professional students may qualify for PLUS loans. Consolidation loans are available to both Stafford and PLUS borrowers.

Eligibility Criteria and Terms

The table below provides details on eligibility criteria and other terms of federal student loans.

TABLE 23. FFELP and FDLP Loan Terms

Program	Eligibility Criteria	Who Pays In-School, Grace and Deferment Periods Interest?	Are the Loans Need-Based?
<i>Subsidized Stafford Loans</i>	At least half-time undergraduate and graduate students.	The federal government.	Yes.
<i>Unsubsidized Stafford Loans</i>	At least half-time undergraduate and graduate students who are: a. Dependent borrowers who are ineligible for subsidized loans and those who are eligible for less than the full amount of such loans. b. Dependent borrowers whose parents are unable to get a PLUS	The borrower.	No.

Program	Eligibility Criteria	Who Pays In-School, Grace and Deferment Periods Interest?	Are the Loans Need-Based?
	loan. c. Independent borrowers.		
<i>PLUS Loans</i>	Parents of dependent undergraduate students and graduate/professional students.	The borrower.	No, but the borrower may not have an adverse credit history.
<i>Consolidation Loans</i>	Borrowers with loans from all categories above can combine multiple federal education loans into one new loan and extend payment up to 30 years on large balance loans.	The government, if underlying loan is subsidized; the borrower, if it is not.	No.

Details of Borrower Eligibility

As outlined above, federal student loan eligibility varies according to whether the borrower is dependent, independent, a graduate student or a parent.

A **dependent** student is defined as a student who is **not**:

- An individual who is at least 24 years old by December 31 of the award year.
- An orphan or ward of the court.
- A veteran of the U.S. Armed Forces.
- An individual serving on active-duty status in the military for purposes other than training.
- A graduate or professional student.
- A married person.
- An individual with legal dependents other than a spouse.

An **independent** student is someone who meets **any one** of the criteria above. A student also can be considered independent if the school's financial aid administrator documents the status based on professional judgment of the student's unusual circumstances.

A **graduate** student is an individual who is enrolled in a program or course above the baccalaureate (bachelor's degree) level at an institution of higher education, and who is not receiving aid as an undergraduate student for the same period of enrollment.

A **parent** borrower must be the parent of a dependent undergraduate student.

Students must be enrolled at least half time in a degree or certificate program in order to qualify for a federal student loan.

Loan Limits

Please see Table 3 on p. 51.

Applying for a Loan

Subsidized and Unsubsidized Stafford Loans

Federal student aid eligibility is based predominantly on financial and other information collected by the federal government through the Free Application for Federal Student Aid, which, in paper format, can be obtained from high schools, financial aid offices or the federal government. An online version can be accessed at www.fafsa.ed.gov.

After the information supplied by the student and parents on the FAFSA is processed by a government contractor, the results are reported to the student's school or directly to the student on the FAFSA Web site. Using these results, the school produces a financial aid package, which typically includes a mix of grants, loans (subsidized and/or unsubsidized) and work-study. The student accepts or declines the package, including any loans. If the loan is accepted, the student signs the promissory note and submits it to the lender of his or her choice (in the case of FFELP) or school (in the case of FDLP), after which the loan is disbursed at the appropriate time.

PLUS Loans for Parents and for Professional and Graduate Students

Parents file a separate application for a PLUS loan and, in some cases, do not need to complete a FAFSA. All PLUS borrowers must demonstrate that they do not have an adverse credit history in order to qualify for the program.

Beginning July 1, 2006, graduate and professional students also are eligible for PLUS loans under the same terms and conditions as those of parent borrowers, but with the added requirement that applicants for these loans must complete the FAFSA. Furthermore, graduate and professional students must have applied for the maximum amount for which they are eligible under the Federal Stafford Loan program before applying for a PLUS loan.

Consolidation Loans

Consolidation borrowers do not need to file a FAFSA. Currently, borrowers cannot consolidate while in school, but can opt to consolidate during their grace period (if applicable) or after entering repayment. Both borrowers in good standing as well as those in default are eligible to apply for a consolidation loan. The application does not involve any credit checks.

Maximum Interest Rates

Please see Table 4 on p. 53.

Maximum Loan Fees

Please see Table 6 on p. 56.

Repayment Options

Repayment terms differ somewhat among FFELP, FDLP and Consolidation loans. For details about the options available to borrowers, please see Table 9 on p. 58.

Delinquency and Default

A student loan is deemed delinquent if a scheduled payment is not received by the due date of the first missed payment that is not later made. That date is established by the lender under guidelines promulgated by the Secretary.⁵¹⁴

A student loan is considered in default if the borrower in repayment fails, despite vigorous collection efforts on the part of lenders, servicers and guarantors, to make a scheduled payment, **and** this payment delinquency lasts for 270 days.⁵¹⁵

Delinquency and default set the following actions in motion (FFELP-specific actions are noted as appropriate):

- The borrower's delinquency and default are reported to national credit bureaus.
- To bring a delinquent loan back in paying status, lenders and guarantors initially undertake the following default prevention activities:
 - First, the lender exercises due diligence by making concerted efforts to get the loan back into repayment by contacting, or attempting to contact the borrower if the borrower's whereabouts are not known, and endeavoring to bring the loan current.
 - Second, in FFELP only, if, after two months, the lender is still unable to move the loan back into repayment, the guarantor of the loan responds to a default aversion assistance request from the lender. The guarantor then uses all available resources to attempt to assist the lender in bringing the loan out of delinquency, including skip-tracing, more-frequent-than-required borrower contacts, debt-management programs, and counseling.⁵¹⁶

⁵¹⁴ 34 CFR, 682.411(b).

⁵¹⁵ 34 CFR, 682.200(b).

⁵¹⁶ *Higher Education Act of 1965* (as amended), Sec. 428I.

- If after these efforts, a default nevertheless occurs, the lender, in FFELP, submits a claim to the guarantor of the loan. If the claim is valid, the lender is reimbursed, in most cases, for 97 percent of the unpaid principal of the loan.
- The FFELP guarantor now owns the loan and files for reimbursement of the claim from the Department of Education. If ED approves the validity of the claim, the guarantor is reimbursed for up to 95 percent of the accrued principal and interest on the loan. Depending on the guarantor's default prevention performance, the rate of federal reinsurance may fall to 85 percent or 75 percent.
- After default, the guarantor, whether directly or through collections contractors, continues to attempt to collect on the loan. After an FDLP default, the loan is assigned to ED's collection contractors for attempted collection.
- FFELP lenders and guarantors share in the costs of loan defaults, while in the Direct Loan Program, the federal government bears the entire risk of default. Lenders currently pay 1-3 percent of the cost of default, and guarantors pay an additional 5-15 percent depending on their overall default rates.

Default rates have declined significantly over the past decade, as illustrated in Figure E on p. 71.

APPENDIX B. THE DEPARTMENT OF EDUCATION AND STUDENT LOANS

Brief History of ED

The 1979 Department of Education Organization Act established a U.S. Department of Education.⁵¹⁷ This new entity contained functions from the Education Division of the U.S. Department of Health, Education and Welfare along with other selected education programs from HEW, the U.S. Department of Justice, U.S. Department of Labor, and the National Science Foundation.⁵¹⁸

According to the law, some of ED's goals are to "improve the management of Federal education activities; and increase the accountability of Federal education programs to the President, the Congress, and the public."⁵¹⁹

⁵¹⁷ Public Law No. 96-88.

⁵¹⁸ U.S. Department of Education, National Center for Education Statistics, *1998 Digest of Education Statistics*, Chapter 4, Federal Education Legislation, p. 390, <http://nces.ed.gov/pubs99/1999036.pdf>, accessed Feb. 24, 2007.

⁵¹⁹ U.S. Department of Education, "Our Mission," <http://ed.gov/Welcome/mission.html>, accessed Feb. 24, 2007.

ED Duties

ED is responsible for managing well over 200 education programs, of which nine are classified as direct student financial-assistance programs administered by the Federal Student Aid Office, known as FSA. Several other student assistance programs — for example, Robert Byrd Honor Scholarships and Fulbright Scholarships — are under the control of the Office of Postsecondary Education.⁵²⁰ OPE also oversees policy development for the federal student assistance programs.

The nine programs overseen by FSA will distribute more than \$90 billion in direct aid (excluding consolidation loans) to more than 11 million students and parents in fiscal year 2008.⁵²¹ In addition to disbursing aid to students and schools, ED:

- Oversees the management of outstanding FFELP and FDLP loan portfolios.
- Performs lender, guarantor and school oversight.
- Supervises collection efforts on defaulted loans.

Total federal administrative costs (not limited to student loan administrative costs) for the Department were about \$1.3 billion for fiscal 2007, compared with \$807.8 million in fiscal 1997.⁵²²

According to budget information, during fiscal 2007 ED employed 4,177 full-time equivalent employees, compared with 4,479 FTEs in fiscal 1997.⁵²³ In addition, the Department hires many private contractors to perform its administrative functions. Employees working for those contractors are not included in ED's FTE data.

The size and scope of ED's duties place a considerable demand on the Department's resources and its ability to hold the government and taxpayers harmless from fraud, waste and abuse. To protect the federal fiscal interest, ED is under constant scrutiny by its Inspector General, the General Accounting Office, and congressional watchdog committees.

Scope of Student-Loan Programs

The FFELP and FDLP are by far the largest of the programs administered by ED. Based on the estimated combined outstanding volume of loans at the end of fiscal 2008, the Department will be responsible for administering a combined student loan portfolio of more than \$500 billion, **excluding** defaulted loans (ED does not publish comprehensive data on outstanding defaults). As indicated in Table 24, the Direct Loan portfolio (also

⁵²⁰ U.S. Department of Education, <http://web99.ed.gov/GTEP/Program2.nsf>, accessed Feb. 26, 2007.

⁵²¹ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 52.

⁵²² *Ibid.*, p. 78 and *Fiscal Year 1999 Budget Summary and Background Information*, p. 87.

⁵²³ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 78, and *Fiscal Year 1999 Budget Summary and Background Information*, p. 87.

excluding loans in default), which ED must actively manage from origination through repayment, accounts for \$109.2 billion, or about 21.5 percent, of this amount. Consolidation loans from both programs total more than half of all outstanding loans.⁵²⁴

TABLE 24. Distribution of Estimated End of Fiscal Year 2008 Balance of \$506 Billion in Outstanding FDLP and FFELP Loans (excl. Defaulted Loans)⁵²⁵

Loan Program	FDLP	FFELP
	Amount (billions)	Amount (billions)
<i>Stafford Subsidized</i>	\$27.1	\$79.7
<i>Stafford Unsubsidized</i>	\$21.4	\$71.1
<i>PLUS</i>	\$6.6	\$19.5
<i>Consolidation</i>	\$54.1	\$227.0
Total	\$109.2	\$397.3

ED Service Initiatives

The Department of Education has initiated several efforts to streamline its service components. Some of these efforts have been targeted at the FDLP exclusively, but others have been more broadly directed. Below is a synopsis of noteworthy service improvements.

Online Entrance and Exit Counseling

Emulating initiatives in the FFELP, the Department of Education has established Web-based entrance- and exit-counseling modules for Direct Loan Program borrowers. Direct Loan schools may, however, still use their own counseling materials, if they so choose.^{526 527}

Direct Loan Servicing Web Site

Online access for students to their FDLP accounts represents another attempt by ED to expand borrower services. According to a progress report issued by the Department's student aid office, the site:

⁵²⁴ U.S. Department of Education, *Fiscal Year 2008 Budget, Appendix*, pp. 340, 343, 344.

⁵²⁵ Ibid.

⁵²⁶ U.S. Department of Education, <http://www.dlservicer.ed.gov/exitcounseling/ecec-main.asp>, accessed Feb. 24, 2007.

⁵²⁷ U.S. Department of Education, *Volume 2 - FSA Handbook: School Eligibility and Operations*, p. 2-109, <http://www.ifap.ed.gov/IFAPWebApp/currentSFAHandbooksYearPag.jsp?p1=2006-2007&p2=c>, accessed Feb. 24, 2007.

Now allows borrowers to update their demographic data, provides both summary and detailed financial information for each account, provides a detailed history of all payments made to a borrower's account, and allows borrowers to change their repayment plans or payment due dates. It also allows borrowers to request and determine eligibility for forbearance or deferments.⁵²⁸

Common Origination and Disbursement Initiative

In 2001, the Department announced plans to implement a Common Origination and Disbursement (COD) process that includes a Common Record (CR) format. This method of processing data, which is not confined to Direct Loan schools, became mandatory for all Title IV schools during the 2005-2006 school year.⁵²⁹ According to ED, this technological effort is improving service by:

- Re-engineering the current processes and systems for delivering and reporting Pell Grants and Direct Loans from two processes and systems into one common origination and disbursement process and system.
- Giving schools the option of reporting campus-based student level data.
- Providing schools with a standard record format that supports student level data exchange with other trading partners, at their option: FFELP partners, state grant, prepaid tuition, and scholarship agencies; and alternative loan partners.
- Increasing accountability and program integrity by monitoring and informing schools of their progress in reporting records according to the existing 30-day reporting requirements.
- Using a standard language for e-business and the Internet called XML.⁵³⁰

The Common Origination and Disbursement system first became operational in April 2002.⁵³¹

Electronic Processing of Student Aid Applications

Although not limited to FDLP borrowers, the government's push to encourage borrowers complete their student aid applications online has yielded positive results. According to ED:

⁵²⁸ U.S. Department of Education, Student Financial Assistance, *Performance Plan Progress Report*, 3rd Quarter Fiscal Year 2000, no page numbers.

⁵²⁹ U.S. Department of Education, *Frequently Asked Questions About Common Origination and Disbursement (COD)*, <http://ifap.ed.gov/eannouncements/attachments/1222CODFAQ.pdf>, accessed Feb. 24, 2007.

⁵³⁰ U.S. Department of Education, *Common Origination and Disbursement, An SFA Integration and Modernization Project for Federal Pell Grant and Direct Loan Processing*, July 20, 2001, pp. 2-3.

⁵³¹ U.S. Department of Education, General Manager: FSA School Channel, *Summary: Common Origination and Disbursement (COD) Release 1.0*, April 29, 2002.

The Free Application for Student Aid (FAFSA) on the Web continues to receive recognition as a government Internet site that rises above the ordinary. In April 2000, *Federal Computer Week* named FAFSA on the Web as one of the 10 top government Web sites for bringing the federal government closer to the public and making it easier to work with agencies. In June 2000, FAFSA on the Web was announced as a recipient of an E-Government 2000 Pioneer Award. This award recognizes e-government best practices that increase productivity, reduce cost, and improve quality, timeliness, and accuracy of services provided to the public.⁵³²

Overall, the number of electronic student aid applications has grown substantially and for the 2006-2007 school year, 94 percent of applicants filed electronically.⁵³³

Electronic Signatures

The Electronic Signatures in Global and National Commerce Act, enacted in 2000, provides that electronically signed documents are deemed legally binding.⁵³⁴ The Department of Education moved rapidly to implement this law, and in July 2001, announced the rollout of an electronic signature process for student loans. According to ED:

The Department's Office of Student Financial Assistance (SFA) has put in place the first electronic signature option for conducting business with the federal government. The feature allows borrowers in the Federal Family Education Loan (FFEL) and William D. Ford Federal Direct Loan Programs to "sign" for their loan on-line using their unique department-issued Personal Identification Number (PIN), rather than having to print a signature page, sign by hand, and send through the mail. ...

Enabling borrowers to sign master promissory notes electronically for their student loans was the last obstacle to building a completely paperless student loan process. Electronic filings are faster than paper and reduce errors. ...

The e-sign option is available to lenders in the Federal Family Education Loan (FFEL) program, as well as to applicants borrowing through the Federal Direct Loan Program.⁵³⁵

⁵³² Department of Education, Student Financial Assistance, *Performance Plan Progress Report*, 3rd Quarter Fiscal Year 2000, no page numbers.

⁵³³ Advisory Committee on Student Financial Assistance, "Summary of FAFSA Processing Statistics January 1, 2006-July 6, 2006," (6-month report), <http://www.ed.gov/about/bdscomm/list/acsfa/edlite-4proginfo.html>, accessed Feb. 26, 2007.

⁵³⁴ Public Law No. 106-229, June 30, 2000.

⁵³⁵ U.S. Department of Education, News Release, July 6, 2001.

Schools, Financial Partners and Student Portals

The Schools Portal, launched in March 2001, was designed to deliver on one Web site a number of electronic resources targeted at the needs of financial aid administrators. The portal offers information for both FDLP and FFELP institutions and can be customized by users.⁵³⁶

The Financial Partners Portal was unveiled in 2002, soon to be followed by a Students' Portal. Both Web sites provide a wealth of information and electronic tools for FFELP providers and students.⁵³⁷

APPENDIX C. LENDER REVENUES AND EXPENDITURES

This section provides details about the sources of lender income on student loans, the history and mechanics of the federal lender subsidy known as the "special allowance" and the mandatory payments lenders are required to make to the federal government.

Lender Revenues

A FFELP lender's income stream consists primarily of interest payments made by the borrower or the federal government and federal special allowance payments.

A lender's net income includes all income streams less all costs associated with making and servicing the loan, which include the expenses associated with:

- Raising funds to make the loans.
- Servicing the loans.
- Delinquency and defaults.
- Mandatory payments to the federal government, such as origination fees, loan fees, excess interest payments and rebate fees.
- Other administrative expenses.⁵³⁸

Loan-servicing functions include:

- Originating loans.
- Maintaining contact with borrowers.

⁵³⁶ U.S. Department of Education, *SFA Community Announcements*, Student Financial Assistance, April 30, 2001, <http://www.ifap.ed.gov/eannouncements/0430faaaccessonweb.html>, accessed Feb. 24, 2007.

⁵³⁷ <http://www.fp.ed.gov/PORTALSWebApp/fp/index.jsp>, accessed Feb. 24, 2007.
<http://studentaid.ed.gov/PORTALSWebApp/students/english/index.jsp>, accessed Feb. 24, 2007.

⁵³⁸ The "net income" explanation has been paraphrased and expanded from U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Dec. 18, 2001, p. 3.

- Counseling borrowers about repayment options.
- Converting loans to grace periods, deferment periods and repayment.
- Tracking deferments and forbearances.
- Billing for payments.
- Taking steps to prevent defaults if loans become delinquent.

Interest Payments

For subsidized Stafford loans, the federal government pays interest, called the interest subsidy, to FFELP lenders on behalf of borrowers during the in-school and grace periods and during deferment.⁵³⁹

During the repayment phase, the borrowers pay all interest to either their FFELP lender or to the Secretary, in the case of Direct Loans. The borrowers also pay all interest on unsubsidized loans and on PLUS loans. Consolidation loan interest is always paid by the borrowers during repayment, but paid by the government during deferment if the underlying loans were subsidized.⁵⁴⁰

Special Allowance

To ensure a return that is comparable to that of private lending products, lenders receive a special allowance subsidy paid by the federal government.⁵⁴¹

History of Special Allowance

Special allowance payments have been authorized by statute since the 1960s. The payments are based on formulas that vary according to student loan type, the date the loan was made and the source of loan capital (taxable or tax-exempt). The payments are made for each of the three-month periods ending March 31, June 30, Sept. 30, and Dec. 31.

Before 1977, a committee composed of the Secretary of Health, Education, and Welfare, the Secretary of the Treasury, and the Director of OMB decided the level at which lender special allowance should be set. Since 1977, the special allowance has been established by using formulas established through legislation rather than by a committee's determination.⁵⁴²

⁵³⁹ *Higher Education Act of 1965* (as amended), Sec. 428(b).

⁵⁴⁰ *Higher Education Act of 1965* (as amended), Sec. 428B, Sec. 428C and Sec. 428H.

⁵⁴¹ *Higher Education Act of 1965* (as amended), Sec. 438(a).

⁵⁴² U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Dec. 18, 2001, p. 2 and pp. 120-121.

Each formula applies to loans disbursed during a specific time period. Consequently, there currently are more than a dozen SAP formulas, each of which may apply to loan portfolios that include up to 12 different interest rates.⁵⁴³

The following table presents a summary of FFELP lender special allowance formulas, from the 1960s to the present.

TABLE 25. HISTORIC SPECIAL ALLOWANCE FORMULAS⁵⁴⁴

YEAR	STAFFORD	PLUS	CONSOLIDATION LOANS	TAX-EXEMPT LOANS
1965	Maximum special allowance was established at 3%.	N/A	N/A	N/A
1977	Statutory 91-day T-Bill rate minus borrower interest rate + 3.5%, rounded to nearest 1/8 of 1%, with a cap of 5% over borrower rate.	N/A	N/A	N/A
1979	SAP cap was eliminated.	N/A	For loans made prior to 10/1/1981: Statutory 91-day T-Bill rate minus interest rate + 3.5%, rounded to nearest 1/8 of 1%.	N/A
1981	Average 91-day T-Bill rate minus interest rate + 3.5%. SAP rounding was eliminated.	SAP was paid when average 91-day T-Bill minus interest rate + 3.5% exceeded the borrower rate.	Same as Stafford.	SAP was halved for certain loans made with tax-exempt financings, but quarterly SAP could not be less than 9.5% less the interest rate divided by four. ⁵⁴⁵

⁵⁴³ For specific information on current special allowance formulas, please see <http://www.fp.ed.gov/PORTALSWebApp/fp/intrates.jsp>, accessed Feb. 24, 2007.

⁵⁴⁴ Unless otherwise noted, the rates are based on U.S. Department of Education and the U.S. General Accounting Office, *Final Report Regarding the Findings of the Study Group on the Feasibility of Using Alternative Financial Instruments for Determining Lender Yield Under the Federal Family Education Loan Program*, Jan. 19, 2001, pp. 120-121 and U.S. Department of Education, Federal Student Aid, "Federal Family Education Loan Program Special Allowance Rates for the Quarter Ending December 31, 2006," January 2007, p. 2.

⁵⁴⁵ *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(B).

YEAR	STAFFORD	PLUS	CONSOLIDATION LOANS	TAX-EXEMPT LOANS
1987	Average 91-day T-Bill minus interest rate + 3.25%. ⁵⁴⁶	SAP was paid only if the calculated PLUS interest rate exceeded 12%. Otherwise same as Stafford. ⁵⁴⁷	Same as Stafford.	N/A
1992	Average 91-day T-Bill minus interest rate + 3.1%.	SAP was paid only if the calculated PLUS borrower rate exceeded 10%. ⁵⁴⁸ Otherwise same as Stafford.	Same as Stafford.	N/A
1993	N/A	N/A	N/A	The special treatment of loans funded with new tax-exempt financings was repealed for loans made with the proceeds of tax-exempt obligations issued after Oct. 1, 1993.
1995	Average 91-day T-Bill minus interest rate + 2.5% in school, grace or deferment; 91-day T-Bill minus interest rate + 3.1% in repayment.	Average 91-day T-Bill minus interest rate + 3.1%.	Average 91-day T-Bill minus interest rate + 3.1%.	N/A
1998	Average 91-day T-Bill minus interest rate + 2.2% in school, grace or deferment; 91-day T-Bill minus interest rate + 2.8% in repayment. ⁵⁴⁹	Average 91-day T-Bill minus interest rate + 3.1%, subject to a limitation that SAP will be paid only during the reference year (July 1-June 30) if, on June 1 prior to that year, the 91-day T-Bill rate + 3.1% exceeds 9.0%. ⁵⁵⁰	Average 91-day T-Bill minus interest rate + 3.1%, subject to a limitation that special allowance is paid only when T-Bill + 3.1% exceeds borrower rate. ⁵⁵¹	NA
2000	3-month commercial paper rate minus interest rate + 1.74% in-school, grace or deferment; 3-month CP minus interest	3-month CP minus interest rate + 2.64%, subject to a limitation that SAP will be paid only during the reference year if, on	3-month CP minus interest rate + 2.64% subject to a limitation that special allowance will be paid only when the CP	The special treatment of loans funded with legacy (pre-October 1993) tax-exempt financings was repealed on a

⁵⁴⁶ Ibid.

⁵⁴⁷ Higher Education Act of 1965 (as amended), Sec. 438(b)(2)(C)(i).

⁵⁴⁸ Higher Education Act of 1965 (as amended), Sec. 438(b)(2)(C)(ii).

⁵⁴⁹ Higher Education Act of 1965 (as amended), Sec. 438(b)(2)(H).

⁵⁵⁰ Ibid.

⁵⁵¹ Higher Education Act of 1965 (as amended), Sec. 438(b)(2)(H)(vi).

YEAR	STAFFORD	PLUS	CONSOLIDATION LOANS	TAX-EXEMPT LOANS
	rate + 2.34% in repayment. ⁵⁵²	June 1 prior to that year, the 91-day T-Bill rate + 3.1% exceeds 9%. ⁵⁵³	rate + 2.64% exceeds borrower rate. ⁵⁵⁴	temporary basis for loans made with the proceeds of tax-exempt obligations issued after Oct. 1, 1993, except for loans that were recycled . ⁵⁵⁵
2006	Same as 2000. ⁵⁵⁶	3-month CP minus interest rate + 2.64%. ^{557 558} The limitation that SAP will be paid only during the reference year (July 1-June 30) if, on June 1 prior to that year, the 3-month CP + 2.64% exceeds 9%, was repealed.	Same as 2000.	The ability to refund, transfer and recycle loans funded with legacy tax-exempt financings was completely prohibited for loans made with the proceeds of tax-exempt obligations, except that the HERA permitted small (less than \$100,000,000 in holdings) non-profit lenders to continue to take advantage of recycling until 2010. ⁵⁵⁹

History of Special Allowance for Tax-Exempt Issuers

The General Accountability Office outlined the history of special allowance for tax-exempt issuers as follows:

To finance loans, some lenders, specifically state agencies and state-designated authorities, may issue tax-exempt bonds to raise capital to make or purchase loans, thereby providing other lenders with more funds to make more loans. Investors who buy these bonds receive interest income that is exempt from federal taxation. ...

Concerned that the lender yield for loans financed with tax-exempt bonds did not adequately reflect the lower costs associated with tax-exempt financing, Congress

⁵⁵² *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(I).

⁵⁵³ *Ibid.*

⁵⁵⁴ *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(I)(vi).

⁵⁵⁵ *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(B)(vi).

⁵⁵⁶ *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(I). [New].

⁵⁵⁷ *Ibid.*

⁵⁵⁸ Public Law No: 109-171, Sec. 8006 repealed old Sec. 438(b)(2)(I)(vii) dealing with the PLUS special allowance provision.

⁵⁵⁹ Public Law No: 109-171, Sec. 8013, Feb. 8, 2006.

reduced the yield in passing the Education Amendments of 1980. To do so, Congress reduced the special allowance payments to be paid on loans financed with tax-exempt bonds to one-half of that otherwise payable. At the same time, however, Congress guaranteed that the lender yield for loans financed with tax-exempt bonds would be no less than 9.5 percent. ...

Several years later, in passing the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the one-half special allowance payment and minimum 9.5 percent yield provision for loans financed with tax-exempt bonds issued on or after October 1, 1993. ...⁵⁶⁰

The GAO and ED further elaborated upon these changes:

In 1980, in a double-digit interest rate environment, the special allowance for FFELP loans funded with tax-exempt obligations was reduced to one-half the special allowance paid on loans funded with taxable obligations, subject to a floor of 9.5 percent.

In the low interest rate environment of the early 1990s, this special treatment for tax-exempt funding was repealed, but the repeal did not apply to obligations “originally issued” before the effective date. This “grandfather” clause has been interpreted to permit serial refinancings of then-outstanding tax-exempt obligations to qualify for the floor of 9.5 percent.⁵⁶¹

Thus, due to the 1993 language, certain student loans that were financed with tax-exempt bonds issued before October 1993 continued to receive a minimum return of 9.5 percent. According to a 2004 GAO report:

There are primarily three ways — referred to as recycling, refunding, and transferring — that a lender can slow the decrease in, maintain, or increase its 9.5 percent loan volume.

- First, after paying costs associated with a pre-October 1, 1993 tax-exempt bond (such as payments of interest and principal to bond investors), lenders can reinvest, or recycle, any remaining money earned from 9.5 percent loans to make or purchase additional loans that, under the law, are also guaranteed a minimum 9.5 percent lender yield. Using this method, lenders are able to slow the decrease in, maintain, or slightly increase their 9.5 percent loan volume.
- Second, lenders can issue a new bond, called a refunding bond, to repay the principal, interest, and other costs of an outstanding pre-October 1,

⁵⁶⁰ United States Government Accountability Office, Federal Family Education Loan Program, *Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, September 2004, pp. 1-4.

⁵⁶¹ U.S. Department of Education and the U.S. General Accounting Office, *Final Report Regarding the Findings of the Study Group on the Feasibility of Using Alternative Financial Instruments for Determining Lender Yield Under the Federal Family Education Loan Program*, Jan. 19, 2001, p. 78.

1993 tax-exempt bond. Based on how the HEA has been interpreted, 9.5 percent loans originally financed with a pre-October 1, 1993 tax-exempt bond, but subsequently financed by a refunding bond, continue to carry the government guaranteed minimum yield for lenders of 9.5 percent. Moreover, the refunding bond may have a later maturity, or payoff, date than the original bond. Using this method, lenders can maintain their 9.5 percent loan volume.

- Third, under Education regulations, a lender can significantly increase its 9.5 percent loan volume by issuing a taxable bond and using the proceeds to purchase 9.5 percent loans financed by a pre-October 1, 1993 tax-exempt bond. The lender then uses the cash available from the pre-October 1, 1993 tax-exempt bond to make or buy additional loans, which are guaranteed the minimum 9.5 percent yield. Under regulations issued in 1992, the loans transferred to the taxable bond continue to be guaranteed the minimum 9.5 percent lender yield, so long as the original bond is not retired or defeased. (At the time the regulation was promulgated, Education anticipated that interest rates would rise, resulting in a higher lender yield for loans financed with taxable bonds than for loans financed with tax-exempt bonds. Education believed that if the 1992 regulation was not promulgated, lenders would have had an incentive to transfer loans from tax-exempt bonds to taxable bonds in order to obtain a higher yield, thus resulting in higher special allowance payments for the government.)
- As a result of recycling, refunding, and transferring, the overall dollar volume of 9.5 percent loans has increased from about \$11 billion in fiscal year 1995 to over \$17 billion at the end of the third quarter of fiscal year 2004. While the dollar volume of 9.5 percent loans presently accounts for only about 8 percent of all outstanding FFELP loan volume, these loans account for 78 percent of all special allowance payments made to FFELP lenders thus far in fiscal year 2004.⁵⁶²

In response to fiscal and political concerns, Congress passed legislation in 2004 that, on a temporary basis, prohibited the practices of refunding and transferring of the 9.5 percent tax-exempt loans.⁵⁶³

In 2006, Congress made these prohibitions permanent and also included “recycled loans” in the overall repeal of the guaranteed 9.5 percent return on these legacy tax-exempt loans. This action effectively ended the 9.5 return for tax-exempt issuers. Until 2010, certain small nonprofit tax-exempt lenders are permitted to continue the practice of recycling, however.⁵⁶⁴

⁵⁶² United States Government Accountability Office, Federal Family Education Loan Program, *Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, September 2004, pp. 1-4.

⁵⁶³ Public Law No. 108-409, Oct. 30, 2004, Sec. 2.

⁵⁶⁴ Public Law No. 109-171, Feb. 8, 2006, Sec. 8013.

The Mechanics of Calculating Special Allowance Payments

Formula

For Stafford loans in repayment made with taxable funds after Jan. 1, 2000, special allowance is calculated by:

- Determining the average of the bond-equivalent rates of the quotes of the 3-month commercial paper (CP financial) rates in effect for each of the days in a given quarter.
- Subtracting the applicable borrower interest rates from the average bond-equivalent rate.
- Adding 2.34 percent (1.74 percent for in-school loans, grace period loans or loans that are in deferment) to the resulting percentage.
- Dividing the resulting percentage by four.⁵⁶⁵

Example

Using the above formula, if the average CP rate is 5.22 percent, and the borrower's interest rate is 7.14 percent⁵⁶⁶, special allowance for a Stafford loan in repayment is calculated as follows:

5.22% minus 7.14%	=	minus 1.92%.
Minus 1.92% plus 2.34%	=	0.42%, the annual special allowance.
0.42% divided by 4	=	0.105%, the quarterly SAP paid to lenders.

Different formulas apply for loans in deferment or grace period, PLUS loans, consolidation loans and some legacy loans financed with tax-exempt funds.

Lender Expenditures

Origination Fee

Regardless of whether lenders pass the fee on to Stafford and PLUS borrowers, they must pay the Secretary the current statutory amount of the origination fee.

⁵⁶⁵ Higher Education Act of 1965 (as amended), Sec. 438(b)(2)(I).

⁵⁶⁶ Based on end-of-year 2006 actual data,

<http://www.ifap.ed.gov/ffelspeccrates/attachments/SAPmemo01042007.pdf>, accessed Feb. 28, 2007.

Loan Fee from Lenders

As a result of provision in the 1993 Budget Reconciliation legislation, lenders are charged a “Loan Fee from Lenders,” which is payable to the federal government. This fee amounts to 0.5 percent of the principal amount of the loan.⁵⁶⁷

Lender Interest Rebate Fee

On consolidation loans, lenders are charged an “Interest Payment Rebate Fee,” which is payable to the federal government. This fee, also instituted in 1993, totals 1.05 percent of the principal plus accrued interest on each consolidation loan, calculated on an annual basis.⁵⁶⁸

Recapture of Excess Interest

The HERA included a provision that requires lenders to rebate excess interest received from borrowers when the borrower rate exceeds the quarterly SAP rate. This requirement applies only to **new** loans made on or after April 1, 2006.

The new statute also incorporated a complex methodology used to calculate the “special allowance support level,” which serves as the basis for the calculation of excess interest.⁵⁶⁹

Risk Sharing

Lenders are, in most cases, not fully insured for the student loans in their portfolios. Currently, they have to pay for 1-3 percent of defaults on loans made after July 1, 2006, and for 1-2 percent of defaults for loans made prior to that date. This practice is known as risk sharing. There is no risk sharing with the private sector in the Direct Loan Program, because the federal government bears the entire cost of defaults.⁵⁷⁰

Lenders eligible for 1-percent risk sharing are called Exceptional Performers. To qualify as an Exceptional Performer, lenders and servicers must maintain a compliance performance rating each year of 97 percent or higher on all servicing requirements for each loan.⁵⁷¹ As of January 2007, 18 lenders and student loan servicers, including many of the larger providers, were designated as Exceptional Performers.⁵⁷²

⁵⁶⁷ *Omnibus Budget Reconciliation Act of 1993*, “Conference Report to Accompany H.R. 2264,” August 4, 1993, p. 58.

⁵⁶⁸ *Ibid.*, p. 60.

⁵⁶⁹ *Higher Education Act of 1965* (as amended), Sec. 438(b)(2)(I)(v).

⁵⁷⁰ *Higher Education Act of 1965* (as amended), Sec. 428(b)(1)(G).

⁵⁷¹ *Higher Education Act of 1965* (as amended), Sec. 428I(a).

⁵⁷² U. S. Department of Education, <http://www.fp.ed.gov/PORTALSWebApp/fp/exceptional.jsp>, accessed Feb. 24, 2007.

APPENDIX D. THE 2001 ALTERNATIVE MARKET MECHANISMS STUDY

Background

In conjunction with the 1998 Higher Education Amendments, a congressional committee stated that:

Currently, the Federal Family Education Loan (FFEL) program is a market-based program with private sector participation. However, to a large extent lender returns are set through a political process rather than a market process. This is disturbing for two reasons. First, if lender yield is set too low, private capital will become unavailable, and the student loan programs will collapse. Second, if the rate of return is set too high, the Federal Government forgoes savings that could be put to better uses or returned to the taxpayer.⁵⁷³

To assist Congress in evaluating alternatives to the method of setting lender returns, the 1998 Amendments directed the Secretary and the Comptroller General to convene a study group to identify “not fewer than 3 different market mechanisms for use in determining lender yields on student loans while continuing to meet the other objectives” of FFELP and FDLP.⁵⁷⁴

The legislation also specified 14 criteria intended to form the basis for the study group’s evaluation:

1. The cost or savings of loans to or for borrowers, including parent borrowers.
2. The cost or savings of the mechanism to the federal government.
3. The cost, effect and distribution of federal subsidies to or for participants in the program.
4. The ability of the mechanism to accommodate the potential distribution of subsidies to students through an income contingent repayment option.
5. The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants.
6. The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower.
7. The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders.
8. The effect on program integrity.
9. The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans.
10. The availability of loans to students by region, income level and by categories of institutions.

⁵⁷³ House Report No. 105-481, 105th Congress, 2d Session, pp. 154-155 (1998).

⁵⁷⁴ *Higher Education Act of 1965* (as amended), Sec. 801(b).

11. The proposed federal and state role in the operation of the mechanism.
12. A description of how the mechanism will be administered and operated.
13. Transition procedures, including the effect on loan availability during a transition period.
14. Any other areas the study group may include.⁵⁷⁵

The study group consisted of representatives of the Department of the Treasury, the Office of Management and Budget, the Congressional Budget Office, entities making FFELP loans, other entities in the financial-services community, other participants in the student loan programs and other individuals designated by GAO and Education. There were 27 members in all.⁵⁷⁶

The 2001 Draft Report

From March to December 2000, the study group met four times. Due to the diverse backgrounds of the more than two dozen members of the group, it was agreed early in the process that, as proposed by ED and GAO, the group would not attempt to agree on a specific market mechanism model, but would submit a series of options for the consideration of Congress.⁵⁷⁷

The study group's draft report was published in January 2001 and contained five market mechanism alternatives:

- **Adjustments to the Current System.** This model “would involve the least change from the current FFELP. Information would be collected from current market transactions for use in determining the appropriate level of lender yield, which the Congress or some independent entity would still set through statute or regulation.”⁵⁷⁸
- **Loan Origination Rights Auction Model.** Lenders would be “bidding for the right to originate loans (either for the right to procure a certain volume, with which they could originate loans at any school, or for the right to originate loans at particular schools). A lender's bid might consist of a specific yield level, so the yield would be directly determined by this mechanism. Alternatively, the bid might consist of a dollar amount for the right to originate loans, with the lender's yield on these loans set outside the process.”⁵⁷⁹
- **Loan Sale Model.** Under this model, “the government or a government-designated entity would originate loans. Private lenders would then bid in an auction to purchase these loans after they have been originated. Again,

⁵⁷⁵ *Higher Education Act of 1965* (as amended), Sec. 801(c).

⁵⁷⁶ U.S. Department of Education and the U.S. General Accounting Office, *Draft, Alternative Market Mechanisms for the Student Loan Program*, Jan. 18, 2001, pp. 76-79.

⁵⁷⁷ U.S. Department of Education, *Notes from Meeting of March 1, 2000, Market Mechanisms for Student Loans*, (Student Loan Study Group 2-Section 801 Study), p. 2.

⁵⁷⁸ *Ibid.*, p. 9.

⁵⁷⁹ *Ibid.*

the lender yield would be set outside the process, and lenders' bids to purchase these loans would determine their net yield."⁵⁸⁰

- **Federal Funding Model.** According to this model, "lenders would have the opportunity to borrow funds from the federal government to make FFELP loans. They would borrow either at a predetermined interest rate or at an interest rate determined by some type of bidding process. The lender's yield would still be set by the Congress, but by changing lenders' funding costs, this model would determine the net yield for lenders."⁵⁸¹
- **Market-Set Rate Model.** Under this model, "lenders and borrowers would negotiate their own interest rates and perhaps other loan terms. Regulatory limits, such as a limit on the range of interest rates a lender would be allowed to offer, could be imposed. This process would set both the lender yield and the borrower interest rate."⁵⁸²

Although the report was intended to present an impartial view of the options for change, the draft report, as submitted by ED and GAO, included a statement favorable to Direct Loans:

FDLP gave students and schools a choice and improved the student aid delivery system. FDLP gives schools more control over the loan process by offering one set of procedures, fast and reliable delivery of funds, less paperwork, electronic loan processing, and a customer service emphasis. ... FDLP has achieved billions in savings for students and taxpayers.⁵⁸³

The draft report also included additional views, submitted by members of the FFELP community, which presented the following recommendations:

Any serious consideration of market-based mechanisms must start with a disciplined examination of the policy goals that underpin the federal student loan programs. The study group should not only evaluate new market mechanisms against these objectives, but also should assess the current guaranteed loan program's track record in achieving national policy goals. This discovery process could demonstrate that more could be lost than gained by a precipitous move to an auction system that radically alters the diverse incentive structure that drives FFELP loan providers to serve all eligible borrowers at ever increasing levels of service and price benefits. ...⁵⁸⁴

⁵⁸⁰ U.S. Department of Education and the U.S. General Accounting Office, Draft, *Alternative Market Mechanisms for the Student Loan Program*, Jan. 18, 2001, p. 9.

⁵⁸¹ Ibid.

⁵⁸² Ibid.

⁵⁸³ Ibid., p. 23.

⁵⁸⁴ U.S. Department of Education and the U.S. General Accounting Office, Draft, *Alternative Market Mechanisms for the Student Loan Program*, January 18, 2001, Appendix VIII, USA Group, "Student Loan Auctions: Issues and Implications," April 2000, p. 5.

Experimentation with massive restructuring of the FFEL Program could threaten its viability. Any major changes must be weighed against the strength of the existing program. The best decision for Congress may be to do nothing rather than continuing the turmoil that has kept program participants on edge for the past 10 years. Constant upheaval is costly and eventually wears down loan providers, financial aid administrators, and others who are involved in the loan programs. Competitive pressure and the technological revolution of the 1990's have brought significantly reduced borrowing costs for students, their families and taxpayers. This is a good thing. It should be encouraged.⁵⁸⁵

Responses to Draft Market-Mechanism Models

In conjunction with publishing the draft report, the Department and the GAO asked for comments on the five market-mechanism models. Eight entities responded. The predominant sentiment among respondents was a strong reluctance to alter the current FFELP model. For example, one school representative warned that:

A real potential for discrimination and denial of access to funds exists even in the current program for students who take out smaller loans for shorter academic programs. This potential could be amplified by a change to a market-based model. Uniform terms and conditions for all students must remain as a fundamental policy.⁵⁸⁶

A consultant for the American Association of State Colleges and Universities, who also was a study group member, maintained that:

During Study Group discussion of options, it appeared to be very difficult to retain all of the following advantages of the current FFELP for students and institutions if one eliminated the current "one-size-fits-all" gross return to lenders:

- Students now have the benefit of interest rates set by Congress that are the same for all borrowers, whether high risk or low risk.
- Guaranteed student loan volume is driven by the demand of eligible students, not an annual decision by Congress or the Executive Branch. Eligible lenders can make guaranteed loans to all eligible students attending institutions participating in the FFELP who apply for a loan. Eligible lenders have an entitlement to the federal guarantee and special allowance payments.

⁵⁸⁵ U.S. Department of Education and the U.S. General Accounting Office, Draft, *Alternative Market Mechanisms for the Student Loan Program*, Jan. 18, 2001, Appendix VII, Richard Pierce, et. al., "Today's Competitive Loan System Is Already Filled With Market Mechanisms," May 2000, p. 4.

⁵⁸⁶ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Appendix IX, Comment from Nancy Broff, General Counsel to the Career College Association, Dec. 18, 2001, p. 132.

- Lenders must compete for market share. Institutions and borrowers can choose among lenders on the basis of lenders' service without regard to any annual limit on how much each lender has the right to lend in FFELP.
- Under the current legislative structure, the FFELP is a mandatory program, does not require an annual appropriation of either loan capital or subsidy, and does not compete for funding with the discretionary student aid programs.⁵⁸⁷

In the same vein, the Oklahoma Lender Advisory Council emphasized that:

None of the models described in the alternative market mechanism report seriously address ways of gathering more credible information on which to base lender yield. Instead, models described appear to have great potential for causing interruption to the delivery of loan funds and services to students by virtue of the degree of radical change required by the respective models. The current model for delivery of loan funds to students and the objectives and integrity of the FFEL program are functional and intact; therefore why change them?⁵⁸⁸

These negative views of the models presented in the draft report were echoed by the media. For example, *The Chronicle of Higher Education* reported that:

Most members of a study group asked by Congress to consider ways to inject mechanisms into the guaranteed-student loan program have reached a similar conclusion: It may be best to leave the system alone.⁵⁸⁹

Education Daily also reported about the work of the group:

College and student groups generally oppose most of the options because they might spur further consolidation in the loan industry, reducing competition and lowering the incentives and quality of service that students receive.⁵⁹⁰

The 2001 Final Report

The final Market Mechanism Study Report was slated to be released on May 15, 2001, but was not submitted to Congress until Dec. 18, 2001. It was almost identical to the draft

⁵⁸⁷ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Appendix XV, Comment from Patricia Smith, Consultant for the American Association of State Colleges and Universities, Dec. 18, 2001, p. 146.

⁵⁸⁸ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Appendix XIII, Comment from Oklahoma Lender Advisory Council, Dec. 18, 2001, p. 140.

⁵⁸⁹ *The Chronicle of Higher Education*, "Unpalatable Options and a Shift in Political Tides Hobble Campaign to Restructure Loan Program," Feb. 23, 2001, p. A30.

⁵⁹⁰ *Education Daily*, "Little Agreement on Injecting Markets Into Loan Program," Jan. 23, 2001, p. 3.

report and contained the five market-mechanism options outlined above. The final report included no official statements expressing a preference for either loan program.⁵⁹¹

APPENDIX E. FUNCTIONS AND FINANCING OF FFELP GUARANTORS

The Guaranteed Student Loan Program (now FFELP) enacted in 1965 was based on the premise that the program would be a public/private partnership: Private lenders would offer loan capital and a nationwide network of state or private nonprofit guarantors would back the loans. Guarantors would also serve as loan administrators, and the Department of Education would reinsure the loans and oversee the performance of the guarantors and lenders.⁵⁹²

The number of guarantors has decreased from 46 in 1990 to 35 today through mergers and consolidations. In addition, many guarantors outsource at least some of their functions. Thus, the number of state or nonprofit private entities that perform all guarantor functions in-house has also declined.^{593 594}

In 1998, Congress created authority for guarantors to enter into Voluntary Flexible Agreements with the Secretary. Under VFAs, guarantors can opt to alter their traditional role and funding.⁵⁹⁵ Five agencies currently have such agreements, which are discussed in greater detail later in this chapter.

Over the years, the role of guarantors has evolved considerably, both through legislative fiat and through guarantor initiatives. The summaries below describe both the statutory and non-statutory activities of guarantors.

Mandatory Guarantor Functions

The Higher Education Act of 1965 mandates that guarantors perform the following tasks:

Student Loan Insurance

A federal student loan made with private capital is guaranteed against default because students generally have no credit history and cannot provide collateral, thus making the loan very risky for lenders. Guarantors minimize lender exposure by insuring from 97 to 99 percent of the loan principal against default. The guarantors' Federal Reserve Fund is, in turn, reimbursed by the Secretary for this service, but only for 95 percent, 85 percent or 75 percent of the principal, based on the guarantor's default prevention performance.⁵⁹⁶

⁵⁹¹ U.S. Department of Education and the U.S. General Accounting Office, *Alternative Market Mechanisms for the Student Loan Program*, Dec. 18, 2001.

⁵⁹² U.S. Department of Education, Office of Postsecondary Education, *FY 1988 Guaranteed Student Loan Programs Data Book*, p. 29.

⁵⁹³ U.S. Department of Education, Office of Postsecondary Education, *FY 1990 Guaranteed Student Loan Programs Data Book*, p. 43.

⁵⁹⁴ U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 82.

⁵⁹⁵ *Higher Education Act of 1965* (as amended), Sec. 428A.

⁵⁹⁶ *Higher Education Act of 1965* (as amended), Sec. 428(b)(1)(G) and Sec. 428(c)(6).

Thus, guarantors are responsible for paying part of the cost of a defaulted loan. This less-than-100-percent reimbursement system is known as risk sharing.

Loan Status Management

Guarantors are obligated to keep track of a loan from origination through repayment.⁵⁹⁷ As part of that function, they are able to assist borrowers, schools and lenders by providing information on loan accounts and borrower status.⁵⁹⁸

Default Prevention Activities

Each guarantor must follow stringent statutory and regulatory guidelines as they work with lenders, schools, and students to prevent defaults. Most guarantors have developed default aversion plans that include a host of activities, such as more-frequent-than-required borrower contacts, debt-management programs, and counseling. These efforts are initiated as soon as the borrower has missed a few payments.⁵⁹⁹

These default prevention activities have contributed to the relatively low cohort default rates in FFELP during the past decade, with a 2004 rate of only 5.1 percent.⁶⁰⁰ In addition, according to an NCHHELP survey, “during federal fiscal year 2004, default prevention efforts averted \$33 billion in potential student loan defaults. On average, guaranty agencies prevented student loan default on more than \$9 of every \$10 of seriously past due student loan accounts.”⁶⁰¹

Collecting on Defaulted Loans

The collection process is carried out by guarantors in a manner designed to provide the borrower with reasonable and affordable repayment options based on the borrower’s income and ability to pay.⁶⁰² For fiscal 2008, guarantors are expected to net more than \$5.3 billion in collections on defaulted loans.⁶⁰³

Loan Rehabilitation

A student loan default carries many negative consequences for the borrower. Guarantors offer defaulted borrowers the option to rehabilitate their loans by making at least nine “reasonable and affordable payments.” These payments must be made within 20 days of the due date during 10 consecutive months.

⁵⁹⁷ *Higher Education Act of 1965* (as amended), Sec. 422B(d)(1).

⁵⁹⁸ *Higher Education Act of 1965* (as amended), Sec. 428(k)(1).

⁵⁹⁹ *Higher Education Act of 1965* (as amended), Sec. 422(l).

⁶⁰⁰ U.S. Department of Education, “Briefing on National Default Rates,” Sept. 19, 2006.

⁶⁰¹ National Council of Higher Education Loan Programs, *2005 Guaranty Agency Survey*, no date, p. 1.

⁶⁰² *Higher Education Act of 1965* (as amended), Sec. 422B(d)(3).

⁶⁰³ U.S. Department of Education, *Budget Appendix*, Fiscal Year 2008, p. 338.

Borrowers who successfully rehabilitate receive the added benefits of having the default notation removed from their credit reports.⁶⁰⁴

Gatekeeping

Effective school and lender oversight is important to the overall accountability of the FFELP. Currently, guarantors monitor more than 5,000 schools (not including direct loan institutions) and about 3,200 lenders across the country to ensure that the public-policy purposes and regulatory requirements of the FFELP are met.^{605 606}

Program integrity has increased markedly, as poor-quality schools with high default rates and lenders with unprincipled lending practices have been excised from the program. Since 1991, more than 1,050 schools have lost eligibility due to excessively high default rates.⁶⁰⁷

Lenders of Last Resort

The statute directs guarantors to act as lenders to borrowers who are otherwise unable to obtain subsidized Stafford loans.⁶⁰⁸

Student and Family Counseling and the College Access Initiative

Guarantors are an important source of unbiased information about financial aid and postsecondary assistance for families and students. Consequently, during the past several decades, many guarantors have established extensive counseling programs to help families and individuals resolve issues related to postsecondary education information, financing and credit management.⁶⁰⁹

College Access Initiative

The HERA built upon this existing counseling framework by incorporating new information distribution tasks into the statute through a “College Access Initiative” under which guarantors:

Shall undertake such activities as are necessary to promote access to postsecondary education for students through providing information on college planning, career preparation, and paying for college. The guaranty agency shall publicize such information and coordinate such activities with other entities that

⁶⁰⁴ *Higher Education Act of 1965* (as amended), Sec. 428F.

⁶⁰⁵ *Higher Education Act of 1965* (as amended), Sec. 422B(d)(1).

⁶⁰⁶ As documented in NCHelp, *Daily Briefing*, March 29, 2006, no page numbers and U.S. Department of Education, *Fiscal Year 2008 Budget Summary and Background Information*, p. 82.

⁶⁰⁷ U.S. Department of Education, “Briefing on National Default Rates,” Sept. 13, 2006.

⁶⁰⁸ *Higher Education Act of 1965* (as amended), Sec. 428(j).

⁶⁰⁹ *Higher Education Act of 1965* (as amended), Sec. 422B(d)(1).

either provide or distribute such information in the States for which such guaranty agency serves as the designated guarantor.⁶¹⁰

By the beginning of 2007, the College Access Initiative was in its final implementation phase and had established a mission, a workgroup and a new information sharing Web site *going2college.org* with state-specific college-planning, preparation and financial aid information for students and families.

According to information from NCHELP, the mission of the initiative is to:

- Link students and families, especially those from groups underrepresented in higher education, to information and resources that enhance access to college and other higher education programs so they can learn about the college planning process, and the help available to succeed.
- Promote the economic health and well-being of states' residents and communities.⁶¹¹

A workgroup of guarantors under the auspices of NCHELP is assisting in the implementation of the College Access Initiative by:

- Sharing information and developing best practices.
- Working with an advisory committee of college access experts.
- Working with the access community to learn more about existing programs and to increase awareness about guaranty agency materials and programs.
- Developing resources and forums to help agencies expand their outreach activities to reach a broader number of students, families and organizations.
- Creating a central location for students, families and educators to visit — so agencies can display and promote a comprehensive listing of the programs and services in their state.⁶¹²

Training and Information Dissemination for Financial Aid Officers and Lenders

Guarantors provide extensive hands-on training of lenders and financial aid professionals. They also review, interpret and disseminate information to schools and lenders about the requirements of student loan statutes and regulations.⁶¹³

⁶¹⁰ Public Law No: 109-171, Sec. 8023, Feb. 8, 2006.

⁶¹¹ National Council of Higher Education Loan Programs (NCHELP), College Access Initiative Work Group, College Access Initiative, Presentation at Federal Student Aid Conference, Oct. 30 – Nov. 2, 2006, <http://fsaconferences.ed.gov/conferences/2006presentations.html>, accessed Dec. 27, 2006.

⁶¹² Ibid.

⁶¹³ *Higher Education Act of 1965* (as amended), Sec. 422B(d)(1).

Application Verification

Guarantors validate the eligibility of students borrowing under the FFELP by authenticating the information on all loan applications.⁶¹⁴

Non-Statutory Guarantor Functions

Loan Disbursement

Guarantors frequently arrange to transmit students' loan proceeds to schools on behalf of lenders.

Innovation in Technology

During the past decade, guarantors have, individually and jointly with institutional and lender colleagues, worked to position the FFELP at the forefront of the technology revolution. (Please see Appendix F for a discussion of service improvements, including technological advances.)

Scholarships and Loan Forgiveness Programs

Many guarantors also provide scholarships to postsecondary students, usually on the basis of financial need. Some guarantors also provide opportunities for loan forgiveness, usually designed to help fulfill identified state occupational needs.

Standard Guarantor Financing Model

Brief History

The first state guarantors acted as bona fide insurance companies. Like such organizations, student loan guarantors maintained reserve funds to ensure that they would always have the resources to pay lender claims.⁶¹⁵ This model, with some modifications, was adopted in 1965 on the federal level and, for the most part, has been carried forward to the present. Since 1965, there have, however, been a number of changes to the insurance responsibilities of guarantors and to the scope of their duties.

At the inception of the guaranteed loan program in 1965, many guarantors' reserve funds were financed with seed money from the federal government. In addition, many states contributed to the reserves of state guaranty agencies. Private, nonprofit guarantors could receive contributions from other sources to bolster reserves, which generally were set at certain specified levels, depending on corporate, state or federal rules.⁶¹⁶

⁶¹⁴ Ibid.

⁶¹⁵ Lumina Foundation for Education, Inc., *Dream, Recollections from 40 Years of Opening Doors to Higher Education for Students and Families*, 2001, p. 9.

⁶¹⁶ Ibid.

From 1965 to 1990, guarantors paid all lender claims. After the 1990 financial collapse of the then-largest guarantor in the country, the Higher Education Assistance Foundation, lenders and the federal government were extremely concerned about the financial soundness of the remaining guarantors. Thus, to reassure lenders that their defaulted loans would always be insured, the 1992 Higher Education Amendments provided that the Secretary would take over as guarantor-of-final-resort in the event of agency insolvency.⁶¹⁷

Because of this action, guarantors could no longer claim to be the ultimate insurers of student loans, although they still were required to keep reserves at a certain level of their outstanding obligations, or risk termination of their guarantee agreements with the Department.⁶¹⁸

This lessening of fiscal liability was employed by the Clinton Administration as justification for repeated attempts to transform guarantors into “fee-for-service” federal contractors.⁶¹⁹

Continuing the movement toward diminishing guarantor fiscal autonomy, so-called “recalls” of reserves also were enacted periodically during the past two decades, generally to reduce the federal budget deficit or to “pay for” other higher education program expansions.⁶²⁰ As a result, several disputes arose about the ownership of guarantor reserves. These disputes led to court cases that predominantly held that the reserves belong to the federal government.⁶²¹

Both the 1993 Student Loan Reform Act and the 1998 Higher Education Amendments reinforced that the federal government, not guarantors, owned the reserve funds.⁶²²

Finally, a decision in 2000 by the Congressional Budget Office to “score” the reserves held by guarantors as federal assets further confirmed the federal government’s ownership of these funds.⁶²³

The 1998 Funding Model

The 1998 Higher Education Amendments clarified both the ownership of guarantor reserve funds and the functions of guarantors. In terms of the latter, guarantors moved from statutory and regulatory rigidity toward a set of functions that emphasized

⁶¹⁷ *Higher Education Act of 1965* (as amended), Sec. 432(o).

⁶¹⁸ *Higher Education Act of 1965* (as amended), Sec. 428(c)(9).

⁶¹⁹ U.S. Department of Education, *Annual Budgets*, Fiscal Years 1997, 1998, 1999, 2000 and 2001.

⁶²⁰ See, for example, *Higher Education Act of 1965* (as amended), Sec. 422(d) and (h).

⁶²¹ See, for example, *Education Assistance Corporation v. Cavazos*, 902 F.2d 617, 627 (8th Cir. 1990).

⁶²² *Higher Education Act of 1965* (as amended), Sec. 422(g) and Sec. 422A(e).

⁶²³ Congress of the U.S., Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, January 2000, p. 85.

incentives for default aversion over default collections and a focus on goals rather than processes.

In terms of funding, the legislation established a Federal Student Loan Reserve Fund, known as the Federal Fund, owned by the federal government and administered by guarantors. The Federal Fund included all of the “old reserves.”⁶²⁴ Although the federal government owns the Federal Fund, guarantors must manage the fund to ensure that they meet a minimum reserve level of 0.25 percent of outstanding loans, or face potential termination.⁶²⁵

The 1998 amendments also created a new Agency Operating Fund, which guarantors own and manage “in accordance with prudent investor standards.”⁶²⁶

The new financing structure established a rational relationship between the guarantors’ cash flows and loan management activities. The report accompanying the House reauthorization legislation explained the changes as follows:

The new guarantor-financing model included in the Committee bill reflects a reformed administrative and financing structure that will achieve several goals of the Committee. First, the model provides incentives for greater efficiencies on the part of guaranty agencies since certain funds will now be the property of each individual agency. This is a major contrast to current law that dictates that all funds held by a guaranty agency belong to the Federal Government and are subject to recall at any time by Congress, thereby eliminating any incentive for guaranty agencies to operate more efficiently and produce savings.

Second, the model increases the current risk sharing for defaults from 98% to 95% which will cause all agencies to use their best efforts to prevent defaults. This provision addresses an often-heard criticism of the FFEL Program that 98% risk was not sufficient to have any impact on the practices of guaranty agencies. Third, the model decreases funds retained on defaulted loans from 27% to 24%. This provision also addresses an often-heard criticism that guaranty agencies have an incentive to allow loans to default due to the high collection retention rate. The combination of increased risk and lower retention rates should result in improved default prevention activities and greater collection efforts in the event of default in order to offset the lost revenues from both of these provisions. These changes should silence the criticism of these two aspects of the FFEL Program.⁶²⁷

⁶²⁴ *Higher Education Act of 1965* (as amended), Sec. 422A.

⁶²⁵ *Higher Education Act of 1965* (as amended), Sec. 428(c) (9)(c).

⁶²⁶ *Higher Education Act of 1965* (as amended), Sec. 422B.

⁶²⁷ 105th Congress, Second Session, House of Representatives, Report No. 105 481, April 18, 1998, pp. 213-

Sources and Uses of Funds

To perform their statutory obligations, guarantors rely on a variety of funding sources that flow into either the Federal Fund or the Agency Operating Fund. The sources and uses of the two funds are outlined below.

Federal Fund Revenue Sources⁶²⁸

- **Assets from the pre-1998 Reserve Fund.**
- **Reinsurance reimbursements from the federal government.**
 - Guarantors are reimbursed by the Secretary at 75 to 95 cents on the dollar on the insurance payments they have made to lenders. The reinsurance payment is 95 percent if the guarantor maintains an annual default rate of less than 5 percent of all its insured loans in repayment during the prior fiscal year; 85 percent if the annual default rate is between 5 and 9 percent; and 75 percent if the rate goes above 9 percent. This annual default rate is frequently referred to as the “trigger rate.”⁶²⁹
 - For example, if \$100,000 of a guarantor’s portfolio is in repayment at the end of a given fiscal year, and the guarantor experiences only \$1,000 in defaults during the subsequent year, the trigger rate is 1 percent, and the guarantor is entitled to 95-percent reinsurance on the defaulted lender claims. If, on the other hand, the guarantor records \$6,000 in defaults, the trigger rate is 6 percent, and the guarantor is eligible to receive only an 85-percent reimbursement.
 - Reinsurance payments include payments for loans in default and bankruptcy as well as other claims.⁶³⁰ The practice of not paying guarantors 100 per cent on each defaulted dollar is known as risk sharing.
- **Default Fees paid by borrowers or other non-federal sources.**
 - Following the passage of HERA, a 1-percent mandatory federal default fee was instituted for FFELP guarantors to be paid into guarantors’ Federal Funds, either by borrowers or through non-federal means. Many guarantors currently waive this fee for borrowers.⁶³¹
- **The part of default collections on a loan that represents funds previously expended by guarantors through risk sharing.**
- **Investment earnings on the fund.**

⁶²⁸ *Higher Education Act of 1965* (as amended), Sec. 422A(c) and 34 CFR, 682.419(b).

⁶²⁹ *Higher Education Act of 1965* (as amended), Sec. 428(c)(1).

⁶³⁰ 34 CFR, 682.419(b).

⁶³¹ *Higher Education Act of 1965* (as amended), Sec. 428(b)(1)(H) and 428H(h) as amended by *Public Law No. 109-171*, Feb. 8, 2006.

Permitted Uses of the Federal Fund⁶³²

The Federal Fund may be used for:

- **Payment of insurance claims to lenders.**
 - In general, lenders are entitled to receive from 97 to 99 percent of the principal on each defaulted loan depending on when the loan was made.⁶³³ Like guarantors, they share part of the risk of default.
- **Transfer of default aversion fees to the Agency Operating Fund.**
 - This fee is equal to 1 percent of the total unpaid principal and accrued interest on the loan at the time a default aversion-assistance request is submitted to the guarantor by the lender. A guarantor is eligible for the fee on “any loan on which a claim for default has not been paid as a result of the loan being brought into current repayment status by the guaranty agency on or before the 300th day after the loan becomes 60 days delinquent.”⁶³⁴
- **Payment of the Secretary’s share of collections on defaulted loans.**
 - For each dollar collected on defaulted loans, guarantors must remit 77 cents to the Secretary, and deposit into the Federal Fund the part of default collections that represents funds expended by guarantors through risk sharing. The remainder is placed in the Operating Fund.⁶³⁵
- **Other uses as permitted in regulations.**
 - The regulations permit a number of uses of the Federal Fund not specified above. Examples include the transfer of account maintenance fees (see below) to the Operating Fund if directed by the Secretary, refunding payments made by or on behalf of a borrower on a discharged loan, and the catchall “any other purpose authorized by the Secretary.”⁶³⁶

Agency Operating Fund Revenue Sources⁶³⁷

- **A loan processing and issuance fee paid by the Secretary.**
 - The fee is currently equal to 0.4 percent of the total principal amount of insured loans.⁶³⁸

⁶³² *Higher Education Act of 1965* (as amended), Sec. 422A(d) and 34 CFR, 682.419(c).

⁶³³ *Higher Education Act of 1965* (as amended), Sec. 422A(b)(1)(G) as amended by Public Law No. 109-171, Feb. 8, 2006.

⁶³⁴ *Higher Education Act of 1965* (as amended), Sec. 428(l).

⁶³⁵ *Higher Education Act of 1965* (as amended), Sec. 428 (c)(6).

⁶³⁶ 34 CFR, 682.419(c).

⁶³⁷ *Higher Education Act of 1965* (as amended), Sec. 422B(c) and 34 CFR, 682.423(b).

⁶³⁸ *Higher Education Act of 1965* (as amended), Sec. 428(f).

- **An account-maintenance fee paid by the Secretary.**
 - The fee is paid on the basis of 0.10 percent of the original principal amount of outstanding loans insured by the guarantor.⁶³⁹
- **A default aversion fee paid from the Federal Fund.**
 - This fee is equal to 1 percent of the total unpaid principal and accrued interest on the loan at the time a default aversion assistance request is submitted to the guarantor by the lender. A guarantor is eligible for the fee on “any loan on which a claim for default has not been paid as a result of the loan being brought into current repayment status by the guaranty agency on or before the 300th day after the loan becomes 60 days delinquent.”⁶⁴⁰
- **A portion of the proceeds of collections on defaulted loans.**
 - As noted above, for each dollar collected on defaulted loans, guarantors must remit 77 cents to the Secretary, and deposit into the Federal Fund the part of default collections that represents funds expended by guarantors through risk sharing. The remainder is placed in the Operating Fund.⁶⁴¹
- **The guarantor’s share of the payoff amounts on rehabilitated or consolidated defaulted loans.**
 - When a defaulted loan is rehabilitated or consolidated, it leaves the guarantor’s portfolio. As a reimbursement for the administrative work performed by the agency to bring the loan out of default (the collection costs), the guarantor currently may retain 18.5 percent of the outstanding balance of a rehabilitated loan and 10 percent on the balance of a consolidated defaulted loan.
 - Effective October 1, 2009, a guaranty agency must remit directly to the Secretary the entire amount of the collection charge with respect to each defaulted loan that is paid off with excess consolidation proceeds. For any federal fiscal year beginning on October 1, 2009, the term “excess consolidation proceeds” is defined as the proceeds of consolidation of defaulted loans received by the guarantor to pay defaulted loans that exceed 45 percent of the agency’s total collections on defaulted loans in the given federal fiscal year.⁶⁴²

⁶³⁹ *Higher Education Act of 1965* (as amended), Sec. 458(b) as amended by Public Law No. 109-171, Feb. 8, 2006.

⁶⁴⁰ *Higher Education Act of 1965* (as amended), Sec. 428(l).

⁶⁴¹ *Higher Education Act of 1965* (as amended), Sec. 428 (c)(6).

⁶⁴² 34 CFR, 682.401(b)(27) and 34 CFR, 682.405(b)(1)(iv) and paraphrased from Public Law No. 109-171, Feb. 8, 2006.

*Permitted Uses of the Agency Operating Fund*⁶⁴³

The Agency Operating Fund may be used for:

- **Costs associated with loan application processing.**
- **Expenses related to loan disbursement.**
- **Costs connected with enrollment- and repayment-status management.**
 - This category includes activities that are directly related to ascertaining the student's enrollment status, including prompt notification to the lender of the status, as well as auditing of the promissory note to ensure that it conforms with federal student loan requirements.
- **Expenses related to default aversion activities.**
 - This category encompasses guarantor activities that are directly related to providing collection assistance to the lender on a delinquent loan.
- **Costs associated with default collection activities.**
- **Payments for school and lender training expenses.**
- **Expenses linked to financial aid awareness and related outreach activities.**
- **Payments related to compliance monitoring (school and lender reviews).**
- **Costs associated with other student financial aid-related activities as selected by the guarantor.**

VFA Guarantor History and Financing Models

Below is a description of the evolution and details of the Voluntary Flexible Agreement alternative to the traditional guarantor funding model.

Brief History

Prior to 1998, student loan guarantors functioned under a unified set of legislative and statutory rules. Duties and responsibilities, both operational and financial, generally applied to all sectors of the guarantor community.

During the 1998 reauthorization debate, differences of opinion arose over the appropriate role for student loan guarantors. The majority of guarantors promoted a new funding model — discussed above — that would settle the long-standing issue of ownership of guarantor reserve funds, create a new funding structure, provide incentives for default aversion and focus on performance over process.

⁶⁴³ *Higher Education Act of 1965* (as amended), Sec. 422B(d) and 34 CFR, 682.423(c).

Some guarantors chose to advance legislation that would enable them to create “Voluntary Flexible Agreements” with the Secretary. Under these agreements, guarantors would be able to shed both their loan guarantee role and their responsibility for the federal reserves. As described by *The Chronicle of Higher Education*:

American Student Assistance of Massachusetts, EDFUND of California (which operates the FFEL program on behalf of the California Student Aid Commission), and the Great Lakes Higher Education Guaranty Corporation said they had established the National Association of Student Loan Administrators to “reinvent the role of the guarantee agency.”

Specifically, they said they generally embraced the Clinton Administration’s plan for a “fee-for-service” model that would strip guarantee agencies of their traditional role in reimbursing lenders for defaulted loans. Instead, the government would reward the agencies for performing duties that would help students and otherwise enhance the loan program.⁶⁴⁴

The House Committee report accompanying the reauthorization legislation stated:

The Committee intends that this [VFA] authority be used to test new and innovative methods for carrying out the types of activities currently required of guaranty agencies under the Higher Education Act in order to find more efficient and effective means of managing the FFEL Program.⁶⁴⁵

The Senate reauthorization report expressed a similar view:

The purpose of these [VFA] agreements is to provide the authority to experiment with new and innovative methods for carrying out the types of activities currently required of guaranty agencies. The committee looks forward to working closely with the Department to ensure that this authority is effectively and appropriately utilized.⁶⁴⁶

The VFA Legislation

The enacted legislation called for a new statutory authority that would allow up to six guarantors to form separate agreements with the Department of Education during 1999-2001, with no limitations on the number of participants thereafter.⁶⁴⁷ Under the terms of a VFA:

⁶⁴⁴ *The Chronicle of Higher Education*, “Rift Among Guarantee Agencies Grows as 3 Split off to Form a New Association,” Jan. 23, 1998, p. A32.

⁶⁴⁵ U.S. Congress, House of Representatives, “House Report No. 105-481,” *Higher Education Amendments of 1998*, April 17, 1998, p. 126.

⁶⁴⁶ United State Congress, Senate, Senate Report No. 105-181, *Higher Education Amendments of 1998*, May 4, 1998, p. 51.

⁶⁴⁷ *Higher Education Act of 1965* (as amended), Sec. 428A.

- The Secretary may waive or modify a limited number of guaranty agency requirements, but not any requirements pertaining to student loan terms and conditions or terms related to lender default payments.
- Until the 2006 passage of HERA, the Secretary could also, subject to limitations, waive the prohibitions on inducements by guarantors if it were deemed consistent with the law, although no such waiver was ever granted. HERA, however, repealed the ability of the Secretary to grant such a waiver and also rescinded the authority to waive the new federal default fee that guarantors must now deposit in their Federal Funds.⁶⁴⁸

The original statute closely circumscribed VFA functions to include only the following:

- Administration of the loan insurance function.
- Monitoring insurance commitments.
- Default-aversion activities.
- Review of default claims made by lenders.
- Payment of default claims.
- Collection of defaulted loans.
- Adoption of acceptable internal systems of accounting and auditing.
- Timely and accurate data collection and reporting as required by the Secretary.
- Monitoring of institutions and lenders.
- Informational outreach to schools and students in support of access to higher education.⁶⁴⁹

Furthermore, under a VFA, the Secretary may alter the federal subsidies paid to VFA agencies, but only to the extent that any new fee structure is cost-neutral.⁶⁵⁰

The VFA must also include information about:

- How an agency intends to use any net revenues that may accrue.
- What the performance standards and criteria will be.
- What will be the consequences if a VFA fails to meet its goals.
- How a VFA may be terminated.⁶⁵¹

Finally, it is important to note that a VFA must provide for uniform lender participation and must not inhibit a borrower's choice of lender.⁶⁵²

⁶⁴⁸ *Higher Education Act of 1965* (as amended), Sec. 428A(a) as amended by Public Law No. 109-171, Feb. 8, 2006.

⁶⁴⁹ *The Higher Education Act of 1965* (as amended), Sec. 428A(b).

⁶⁵⁰ *Ibid.*

⁶⁵¹ *Ibid.*

⁶⁵² *Ibid.*

VFA Financing Models

Although the VFA legislation was enacted in 1998, the selection process was not completed until late in the year 2000, and the Secretary of Education finished signing the agreements in March, 2001.^{653 654}

The four entities that participated initially were American Student Assistance, California Student Aid Commission, Great Lakes Higher Education Guaranty Corporation, and Texas Guaranteed Student Loan Corporation.

Although different in certain respects, some of these VFAs shared some common characteristics:

- They placed the Federal Fund in a federal escrow account.
- They intended to reward successful default aversion to a greater degree than under the traditional guarantor model.
- They intended to reduce the reliance on income from default collections.
- They received funds directly from the federal government to pay lenders' default claims.
- They were not subject to risk sharing (currently at least 5 percent of all defaults) or minimum reserve requirements (currently 0.25 percent of outstanding loans).⁶⁵⁵

The following table outlines the basic components of each of the four original VFAs.

TABLE 26. Elements of the Four Original Voluntary Flexible Agreements⁶⁵⁶

VFA ELEMENT	GREAT LAKES	CSAC	TEXAS	ASA
<i>Fee Structure</i>	Concept of one performance-based fee in lieu of all other fees. Some current fees still are technically in place, however.	Same as current fee structure with new fees added.	Same as current fee structure with new fees added and only retention fee lowered.	Loan processing and issuance fee retained. Other fees are changed.
<i>Return of Reserves</i>	Places the Federal Fund into an escrow account.	Not mentioned.	Places the Federal Fund into an escrow account.	Places the Federal Fund into an escrow account.
<i>Default-Aversion</i>	No specific activities are mentioned, but	Default Aversion Laboratory, which	No specific activities are	Partnerships with lenders. Otherwise,

⁶⁵³ Higher Education Act of 1965 (as amended), Sec. 428A(a)(3).

⁶⁵⁴ Information about terms and conditions of each VFA may be found at U.S. Department of Education, Voluntary Flexible Agreements, <http://www.fp.ed.gov/PORTALSWebApp/fp/proj2.jsp>, accessed February 25, 2007.

⁶⁵⁵ Ibid.

⁶⁵⁶ Ibid.

VFA ELEMENT	GREAT LAKES	CSAC	TEXAS	ASA
<i>Activities</i>	some earnings are tied to default aversion.	includes "new" methods of delinquency-servicing, early-withdrawal counseling, and consolidation to avoid defaults.	mentioned, but some earnings are tied to default aversion.	no specific activities are mentioned, but some earnings are tied to default aversion.
<i>Collection Costs Received by Guarantor</i>	Actual costs.	Collection retention may be increased based on performance.	19.5%-23% based on performance for regular loans. 18.5% to 20% for consolidated or rehabilitated loans.	18.5 percent of the amount collected by ASA.
<i>Insurance Premiums</i>	If collected, goes to the escrowed Federal Fund.	Not mentioned.	If collected, goes to the escrowed Federal Fund.	Not mentioned.
<i>Property (Non-Liquid Assets)</i>	The Department agrees that it will not assert dominion or control over Great Lakes' property or revenues derived therefrom during the term of the VFA.	Not mentioned.	Not mentioned.	Not mentioned.
<i>Payment of Claims</i>	The agency will receive funds directly from ED for payment of default claims.	Not mentioned.	The agency will receive funds directly from ED for payment of default claims.	The agency will receive funds directly from ED for payment of default claims.
<i>Waiver of regulatory Guarantor Collections Requirements</i>	Yes.	Yes.	No.	Yes.
<i>Waiver of regulatory Lender Due Diligence Requirements</i>	Partial.	Yes.	Not mentioned.	Not mentioned.
<i>Outreach Efforts</i>	No.	Yes.	No.	Yes.
<i>Reinsurance /Risk sharing</i>	Assumed 100% - No risk sharing.	Not addressed.	100% - No risk sharing.	100% -No risk sharing.
<i>Minimum Reserves</i>	Exempt.	No Exemption.	Exempt.	Exempt.

Current Status of VFAs

As of early 2007, all four original VFAs were still operating under their respective agreements. In 2004, they were joined by the Colorado Student Loan Program.

Auguring a potential change to VFAs, the Administration's 2008 Budget proposed eliminating all VFA agreements.⁶⁵⁷ As of February 2007, no action had been taken on this proposal.

APPENDIX F. FFELP SERVICE INITIATIVES

FFELP providers have focused on the following service-related issues during the past decade:

- Paperwork simplification and standardization.
- Common rules and operating procedures for program participants.
- Electronic signatures.
- Student counseling.
- Electronic data exchanges.
- Electronic loan-processing methods and standards.

These improvements in student loan processes are the result of cooperative efforts among FFELP participants that have contributed to the overall streamlining and enhanced efficiency of the FFELP.

Key service initiatives are outlined below.

Applications, Promissory Notes and Other Common Forms

Prior to 1998, the FFELP could not match the simplicity of the FDLP's single-application loan origination process. In addition to completing the Free Application for Federal Student Aid to determine their need for financial aid, FFELP borrowers were also required by law to complete a separate student loan application and promissory note. Although most providers combined the loan application and promissory note, borrowers still had to answer redundant questions and were frequently confused about the status of their various student aid applications.

The 1998 Higher Education Amendments reduced the complexity of the FFELP application process. Borrowers now complete just the FAFSA to establish eligibility for all federal student aid **and** apply for FFELP loans. They also can apply for loans for multiple years by completing a Master Promissory Note, which can be in either paper or

⁶⁵⁷ U.S. Office of Management and the Budget, *Fiscal Year 2008 Budget of the U.S., Analytical Perspectives*, February 2007, p. 377.

electronic format. These changes erased some of the key differences between FFEL and Direct Loans at the front end of the student loan process.⁶⁵⁸

The 1998 legislation also mandated standardization of numerous other forms, resulting in improved efficiency and administrative uniformity.⁶⁵⁹

The Common Manual

As noted above, during the 1980s and early 1990s, many institutions were dissatisfied with FFELP guarantors' differing guidelines and criteria for administration of the program. The Direct Loan Program's single set of standards was viewed as a positive contrast to the FFELP patchwork of requirements.

To address this concern, 23 guarantors adopted the *Common Manual* in early 1996. The project was so successful that the number of participants grew to encompass all guarantors by the end of that year.⁶⁶⁰

According to its authors, the *Common Manual: Unified Student Loan Policy* is:

Designed to help train new financial aid and student loan personnel and to assist the experienced officer in finding answers to questions about federal regulations and guarantor policy.

Where possible, the guarantors that have participated in the development and distribution of this manual have agreed to adopt uniform policies. In a few cases, some guarantors have policies that are different from the uniform policies outlined in this manual. Places in this manual where such exceptions exist include a cross reference to appendix C, which details guarantor-specific policies.⁶⁶¹

The *Common Manual* provides student loan program background information, describes administrative policies applicable to participating schools and lenders, cites regulations and the law and supplies active links to those materials in the electronic versions. It also includes reference materials, federal and agency contacts, as well as a history of the federal loan programs.⁶⁶²

ELM Resources

In the early 1990s, a group of FFELP lenders implemented an additional effort to provide streamlined services to schools. This initiative, ELM Resources, was "established ... by a

⁶⁵⁸ *Higher Education Act of 1965* (as amended), Sec. 483(a)(1).

⁶⁵⁹ *Higher Education Act of 1965* (as amended), Sec. 432(m).

⁶⁶⁰ Common Manual Guarantors, *Common Manual, Unified Student Loan Policy*, March 2005, pp. 1-3.

⁶⁶¹ Common Manual Guarantors, *Common Manual, Unified Student Loan Policy*, July 2006, p. 1.

⁶⁶² *Ibid.*

group of FFELP providers who wanted to improve loan processing for their customers.”⁶⁶³

ELM, which is organized as a mutual-benefit corporation, has attracted a sizable constituency, comprising guarantors, lenders and hundreds of schools. The essential thrust of the organization is as follows:

ELM is a cooperative venture allowing participants in the FFELP industry to deliver student loans to their school customers through a single data channel from multiple platforms. Lenders provide state-of-the-art technical services at a reduced cost, while meeting the needs of their customers.

Schools demand simple, streamlined processes that alleviate the difficulties inherent in dealing with multiple FFELP providers with differing systems. ELM allows its members to meet those demands while keeping their own costs to a minimum.⁶⁶⁴

CommonLine

CommonLine is a process developed by the National Council of Higher Education Loan Program to facilitate the electronic processing of Federal Family Education Loans and alternative loans. According to the *Common Manual*:

CommonLine standardizes electronic loan certification formats, response files, disbursements, change transactions, and error messages.

The goal of CommonLine is to simplify the loan origination, disbursement, and change process for schools by:

- Establishing common formats used by all participants.
- Allowing schools to use just one school-based software system to communicate with all CommonLine participants.
- Allowing schools to use their current software systems to communicate with organizations with which they currently have no electronic connection.

The Origination Standards Advisory Team data exchange standards have been adopted by virtually all participants in the FFELP community for support of the delivery of FFELP and alternative loans. The entire FFELP industry has standardized origination processing around these specifications.⁶⁶⁵

⁶⁶³ ELM Resources, <http://www.elmresources.com/l-about.php>, accessed Feb. 25, 2007.

⁶⁶⁴ Ibid.

⁶⁶⁵ Common Manual Guarantors, *Common Manual, Unified Student Loan Policy*, July 2006, p. 583.

Other uniform-standards initiatives include the Common Account Maintenance and Common Claim Initiative processes.⁶⁶⁶

National Student Clearinghouse

The National Student Clearinghouse, a not-for-profit corporation, was launched in 1993 as the National Student Loan Clearinghouse. The founding entities included a cross-section of schools and student loan industry representatives who wished to improve loan services for colleges and universities, guarantors, lenders and the federal government.⁶⁶⁷

According to the Clearinghouse's Web site:

- The Clearinghouse serves the nation's educational community, specifically more than 2,800 colleges, enrolling 91% of US college students, and scores of high school districts nationwide, by:
 - Maintaining an electronic registry containing more than 75 million student records, more than any other single source.
 - Providing secure and accurate online verifications to more than 10,000 verifying entities each year, including most major employers, student service providers, insurance companies, credit issuers, the U.S. Department of Education, and others.
 - Performing over 100 million electronic student record verifications annually.

Examples of services are:

- Core Service: The Clearinghouse provides enrollment status and deferment information for financial aid students on behalf of its member institutions to guaranty agencies, lenders, servicers and the Department of Education. Participating in our Core Service allows institutions to automate their deferment and enrollment processing, ensuring greater reporting accuracy and reduced loan default rates. All state and national guarantors and most lenders and servicers participate in the Clearinghouse;
- EnrollmentVerify: Through EnrollmentVerify, the Clearinghouse processes all the enrollment verification inquiries received by participating colleges and universities using the information that they already provide;
- DegreeVerify: On average, each college and university completes 1,000 degree verifications per year for every 5,000 enrolled students. Participating in DegreeVerify frees schools from the administrative burden

⁶⁶⁶ Ibid.

⁶⁶⁷ National Student Clearinghouse,

http://www.studentclearinghouse.org/about/pdfs/Clearinghouse_profile.pdf, accessed February 25, 2007.

of verifying degrees for employers, background search firms and recruiters.⁶⁶⁸

Electronic Signatures

Members of the FFELP community were quick to adopt procedures that allow borrowers to take advantage of the electronic-signature process. Some providers made e-signature of education loan applications available to borrowers as soon as the Electronic Signatures in Global and National Commerce Act took effect on July 1, 2001.⁶⁶⁹

Lenders have several options for structuring their electronic signature process: Some use the Department of Education's Personal Identification Number process; others have developed authentication processes that are PIN-less.⁶⁷⁰

Common to both methods is the emphasis on enhancing service to borrowers through simplification, quicker loan turnaround and less paperwork for both student and schools.

Mapping Your Future

In 1996, guarantors, assisted by lenders and servicers, began another collaborative venture, Mapping Your Future, a nonprofit, public-service organization, for the purpose of providing financial and counseling information to schools and students. According to the sponsors:

During the past years, Mapping Your Future has served students and their families, school financial aid professionals, and others in the financial aid industry in a number of ways, always keeping in mind the original mission of the organization. Volunteers and professional staff have worked together to counsel students and families about career, college, financial aid, and financial literacy choices through a state-of-the-art Web site.

Through the web site, Mapping Your Future offers many early awareness, college preparation, career planning, default prevention, and financial fitness tools and services. One of the premier services offered by Mapping Your Future is Online Student Loan Counseling. Because of its national collaborative nature, Mapping Your Future has been able to help students in the country and around the world.

Through the years, Mapping Your Future has served millions of students and their families as well as thousands of middle school and high school counselors and college financial aid professionals.⁶⁷¹

⁶⁶⁸ Ibid.

⁶⁶⁹ See, for example, <http://www.tgslc.org/newsroom/news/2001/press011025.cfm>, accessed Feb. 25, 2007.

⁶⁷⁰ See, for example Sallie Mae, Press Release, "Sallie Mae's E-Signature Program Goes Live; Numerous School and Industry Partners Adopt the Process," March 12, 2002, and http://www.salliemae.com/get_student_loan/apply_student_loan/understanding/loan_application/electronic_signatu_re.htm, accessed Feb. 25, 2007.

⁶⁷¹ Mapping Your Future Web site: <http://sponsors.mapping-your-future.org/about/history.htm>, accessed

Furthermore, Mapping Your Future:

- Offers students and parents one place on the Web where they can get general college, career, and financial aid information and access to state information through each of the sponsoring agencies.
- Provides free Online Student Loan Counseling and related services to schools and students, enabling students at various schools to receive consistent information about loan management.
- Provides accurate, up-to-date debt management counseling and default prevention information through the joint effort and expertise of MYF professional staff, guaranty agency staff, and school financial aid professionals from around the country.
- Enhances delivery of services to schools and students in their area.
- Enables students to complete counseling anytime, anywhere,(for example, prior to coming to campus, or by students studying abroad).
- Provides customized school-specific information, as well as electronic confirmation files.
- Maintains a high level of privacy and security for both students and financial aid professionals.⁶⁷²

The Meteor Project

Another service-improvement initiative sponsored by the student loan community is the Meteor Project. Spearheaded by the National Council of Higher Education Loan Programs, the Project was formally launched in September 2002. This effort is an attempt by “participants in the Federal Family Education Loan Program (FFELP) ... to work together to create an information network to provide aggregated financial aid information to their customers.”⁶⁷³

According to the sponsors, Meteor is designed to offer these benefits to financial aid professionals:

- The ability to access timely, student-specific financial aid information from multiple sources.
- Provision of a one-stop, common, online customer service resources for schools.
- Enhancement of the ability of participants to provide Web capable products.⁶⁷⁴

February 25, 2007.

⁶⁷² Ibid.

⁶⁷³ National Council of Higher Education Loan Programs, <http://www.nchelp.org/pages/page.cfm?id=27>, accessed Feb. 25, 2007.

⁶⁷⁴ National Council of Higher Education Loan Programs, <http://www.nchelp.org/pages/page.cfm?id=22>, accessed Feb. 25, 2007.

The Meteor project initially will provide information only about FFELP loans. Over time, the sponsors' vision is that Meteor will include information about FDLP, Perkins loans, Pell grants, state grants and alternative loans.⁶⁷⁵

⁶⁷⁵ Ibid.



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