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FEDERAL REVENUE AND FAMILY INCOME SHIFTS DUE TO MAJOR PROPOSED CHANGES IN STUDENT LOAN POLICY

This week and next, federal lawmakers will consider a comprehensive overhaul of the terms and conditions associated with over $68 billion in new federally guaranteed student loans distributed each year to more than 10 million students and their families attending over 6,800 institutions of higher education.[1] Changes of this magnitude in federal student loan law were last made over seven years ago and are not scheduled to be considered again until 2012.[2] In the first independent analysis of the pending and major proposed changes in federal student loan policy recently approved by the key United States Senate and House of Representatives Congressional Committees, the New America Foundation finds that, in short, the budget reconciliation process is facilitating creation of bigger, not smaller, federal college aid programs. Federal financial aid growth will be fueled by higher student loan borrower interest rate payments and fees, as opposed to increased general tax revenues, shifted budget priorities, or increased government efficiency. In fact, a significant number in Congress appear ready to undermine government efficiency and prop up guaranteed business and profit for banks and non-profit lenders participating in the federal student loan program.

EXECUTIVE SUMMARY:

1) **The vast majority of proposed federal budget savings from the student loan program over the next five years derive from an infusion of revenue from students and lenders as opposed to reduced government spending.**

Over 88 percent of federal budget savings produced by the principal United States Senate proposal and over 75 percent of savings produced by the principal House of Representatives proposal derive from higher interest rates, higher fees, and redirection of certain student payments from lenders to the government. This approach leaves structurally intact and will even increase the use of a government program deemed inefficient by the Office of Management and Budget (OMB) and Government Accountability Office (GAO).

2) **Over and above required federal budget savings, additional major proposed student loan policy changes would increase borrowing costs for largely middle families in order to pay for increased financial aid to poor students.**

The principal United States Senate proposal would raise the interest rate on parent loans for undergraduate students to 8.5 percent a year, affecting over 800,000 largely middle class families. The resulting increased federal revenue increase would pay for increased financial aid to Pell Grant students from families with a mean income of $15,400 a year. This change alone would transfer approximately $3.9 billion from middle class families to the poor over the next five years. The typical PLUS loan borrower over the course of the next four years would pay an additional $900 in higher interest costs over current rates (but only an extra $225 in higher interest costs over rates scheduled to go into effect July 2006 under current law).

3) **Finally, major proposed changes in Congress would reduce competition among student loan providers. These changes have the potential to drive up future government spending and student costs on college loans. Further, they reduce the likelihood that private lenders will provide financial aid to colleges and universities in exchange for their student loan business.**

According to the OMB, CBO, and GAO, federal spending on the Direct Loan program is between 7.75 and 11 cents less on every dollar borrowed than government spending on a similar private lender alternative loan program. Yet the principal House of Representatives' student loan proposal would double up-front fees paid by students in the Direct Loan program in order to increase federal revenue. In other words, the House of Representatives is poised to make a student loan program that is cheaper for taxpayers more expensive for borrowers. The principal Senate proposal would bar private loan companies from offering colleges competitive financial aid premiums in exchange for entering into "school-as-lender" partnerships.

The Federal Student Loan System

The federal government operates two main student loan programs: (1) the Federal Family Education Loan (FFEL) Program, and (2) the William D. Ford Direct Loan (Direct Loan) Program. Approximately 75 percent of student loan volume is distributed through the FFEL program and 25 percent through the Direct Loan program.[3]

Both the FFEL and Direct Loan program deliver Robert T. Stafford Subsidized and Unsubsidized Loans and Parent Loans for Undergraduate Students in the same amounts, at the same interest rates, and with similar repayment options. There are, however, significantly different student and lender fees associated with each program.[4] Direct Loan student fees are uniform and lower than FFEL student fees, but FFEL lenders may assume those student fees for some students in order to compete with the Direct Loan program and each other.

Colleges are empowered to choose in which of the two student loan programs they want to participate in order to ease the administrative burden that would result from having otherwise to operate two separate loan programs. Thus, for each academic term, students may only borrow from either the FFEL program or the Direct Loan program based on the decision made by their particular college.

The main difference between the FFEL and Direct Loan programs, in addition to student and lender fees, are delivery structures and associated fiscal cost. In the FFEL program, loan capital is supplied by private banks and non-profit lenders. The federal government guarantees those lenders against loss through borrower default, death, or disability. Under the FFEL program, the government also pays an extra federal "special allowance payment" that subsidizes borrower repayments of principal and required borrower interest payments.

In the Direct Loan program, the federal government supplies loan capital raised from United States Treasury auctions. A private contractor, chosen through a competitive bidding process and paid pursuant to a performance-based contract, then issues Direct Loans to students. Instead of guaranteeing lenders against default and subsidizing their student interest payments as in the FFEL program, under the Direct Loan program, the government collects student payments through private contractors.[5] Student payments equal principal borrowed plus an interest rate that is identical to the interest rate paid by FFEL borrowers. The Direct Loan and FFEL programs have similar student default rates.

Federal Student Loan "Savings" and Budget Reconciliation

Since even before the Direct Loan program was created in 1993, a partisan debate over the two student loan programs raged in higher education policy circles. Representatives of the banking industry and their primarily Republican allies supported the FFEL program. Good government activists and their largely Democratic allies argued that the FFEL program is inefficient and that the alternative Direct Loan program is preferable from a fiscal policy standpoint.

The Bush Administration largely has avoided an overt position in this debate. In February 2004, however, President Bush's Fiscal Year 2005 budget stated that "there is evidence of significant cost inefficiencies in the [FFEL] program" and that "significantly lower Direct Loan subsidy rates call into question the cost effectiveness of the FFEL program structure, including the appropriate level of lender subsidies."[6]

One year later, President Bush's Fiscal Year 2006 budget and a supplementary announcement on student loans combined to propose almost $8 billion worth of [FFEL] student loan mandatory spending reductions over a five year period in order to finance a permanent extension of 2001 tax cuts scheduled to expire in 2011 and phase in an increase in maximum Pell Grant funding from $4,050 to $4,500 per recipient over the same five year time period.[7]

In April 2005, Congress followed President Bush's lead and passed its Fiscal Year 2006 Budget Resolution that included reconciliation instructions ordering Congressional Committees to produce legislation generating $34.7 billion in budget savings over the next five fiscal years.[8] Almost 40% of total required savings, $12.7 billion in the House of Representatives and $13.7 billion in the United States Senate, were designated by the Fiscal Year 2006 Budget Resolution to come from student loan and labor programs.[9] The Congressional Budget Resolution assumed, but did not require, that $7 billion of the required savings would come from the federal student loan program with the remainder to come from federal labor programs.

On October 18 and 27, 2005, the key House and Senate Committees approved reconciliation legislation with respect to student loans, an accompanying comprehensive rewrite of the Higher Education Act, and pension reform legislation.[1] Floor action in the

[1] The reconciliation process is significant, because it facilitates relatively fast action by protecting that legislation from the traditional rules of Congressional procedure, including rules that

House of Representatives and United States Senate is expected on both pieces of legislation in November.

Analysis of Proposed Student Loan Budget "Savings"

The Congressional Budget Act of 1974 allows relevant Congressional Committees to produce reconciliation "savings" by reducing government outlays, increasing government revenue inflows, or doing both.[10]

To reduce government spending or outlays substantially for student loans, there essentially are two main options. Either the government can cut outlays to banks and non-profit lenders issuing and administering FFEL student loans or it can cut government benefits to student borrowers. Instead of pursuing either option vigorously, the relevant Congressional Committees chose to raise student loan revenue markedly.

According to an analysis by the New America Foundation detailed in Tables 1 and 2, over 88 percent of federal student loan budget savings produced by the major pending United States Senate proposal and over 75 percent of net savings produced by the major pending House of Representatives proposal derive from higher student loan interest rates, higher student loan fees, and capture of future student payments to lenders that the government requires to be above market-level in otherwise low-interest rate time periods.

TABLE 1: UNITED STATES SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS REPORTED BUDGET RECONCILIATION AND HIGHER EDUCATION ACT LEGISLATION, OCT. 18, 2005

BUDGET SAVINGS	2006-2010
Reduced Government Spending / Outlays	
Prohibiting Growth in "9.5% Loan" Volume:	$1.4 billion
Reduced Portion of Defaulted Federal Loans Insured:	$860 million
Subtotal Reduced Government Spending:	**$2.26 billion**
Increased Federal Revenue	
Student Payments in Excess of the Guaranteed Lender Rate of Return, Which as per the Senate Bill will be Collected by Lenders and "Passed Through" to Federal Government:	$11.2 billion
Higher Interest Rates Paid by Parents on PLUS loans:	$3.9 billion
Mandatory Guarantee Agency Paid 1% Fee:	$1.5 billion
Higher Lender Paid Fee on Consolidation Loans:	$625 million
Subtotal Increased Federal Revenue:	**$17.225 billion**
Interactions Among All Spending Reductions and Revenue Raising Provisions:	$1.4 billion
Aggregate of Small Provisions with Savings Effects, including changes in income protection allowance and disbursement requirements for schools with low default rates:	$486 million
Total	**$21.37 billion**
PERCENTAGE OF BUDGET SAVINGS FROM REDUCED GOVERNMENT SPENDING →	11.6%
PERCENTAGE OF BUDGET SAVINGS FROM INCREASED FEDERAL REVENUE →	88.4%

Note: Percentage distribution assumes Interaction Savings and Small Provision Savings are proportionately distributed between Reduced Government Spending and Increased Federal Revenue.

allow for unlimited debate in the United States Senate. In other words, reconciliation legislation is filibuster-proof and requires only a majority vote to pass. *See* Congressional Budget Act of 1974, P.L. 93-344, 88 Stat. 297-332.

According to the official CBO cost estimate accompanying the Senate Health, Education, Labor, and Pension (HELP) Committee's Budget Reconciliation plan as summarized in Table 1, only two major student loan budget savings policies are proposed to reduce government outlays.[11] The larger of two spending cuts included in the Senate bill, prohibiting growth in "9.5% loan volume," is not new; it is a simple extension on an existing law that only partially responded to a scandal in the student loan program uncovered in August 2004.[12]

The only other spending cut in the Senate Committee reported bill reduces the proportion of defaulted loans for which FFEL lenders are reimbursed. Currently, most lenders are reimbursed for 98 percent of outstanding defaulted volume, although the largest lenders are reimbursed for 100 percent of defaulted volume. The Senate Committee would reduce federal reimbursement for defaulted loans to 97 percent of outstanding volume. In other words, lenders will be guaranteed to receive at least 97 percent of any student loan borrowed principal from either students or federal payments.

TABLE 2: UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON EDUCATION AND WORKFORCE REPORTED BUDGET RECONCILIATION AND HIGHER EDUCATION ACT LEGISLATION, OCT. 27, 2005

BUDGET SAVINGS	2006-2010
Reduced Government Spending / Outlays	
Reduced Funding for Administration of Direct Loans:	$2.2 billion
Prohibiting Growth and Recycling of "9.5% Loans":	$1.8 billion
Reduced Portion of Defaulted Federal Loans Insured:	$915 million
Subtotal Reduced Government Spending:	**$4.92 billion**
Increased Federal Revenue	
Student Payments in Excess of the Guaranteed Lender Rate of Return, Which as per the House Bill will be Collected by Lenders and "Passed Through" to Federal Government:	$11.2 billion
Higher Lender Paid Fees on Consolidation Loans:	$1.83 billion
Mandatory Student Paid 1% Guarantee Fee:	$1.5 billion
Reduced Guaranty Agency Percentage Withholding of Recovered Default Loans:	$560 million
Subtotal Increased Federal Revenue:	**$15.09 billion**
Interactions Among All Spending Reduction and Revenue Raising Provisions:	$301 million
Total	**$20.31 billion**
PERCENTAGE OF BUDGET SAVINGS FROM REDUCED GOVERNMENT SPENDING →	24.6 %
PERCENTAGE OF BUDGET SAVINGS FROM INCREASED FEDERAL REVENUE →	75.4 %

Note: Percentage distribution assumes Interaction Savings and Small Provision Savings are proportionately distributed between Reduced Government Spending and Increased Federal Revenue.

According to a *preliminary* CBO cost estimate summarized in Table 2 and available on the New America Foundation's website, the House of Representatives Education and Workforce Committee's Budget Reconciliation plan is slightly more aggressive than the Senate in reducing government spending on student loans, although it generates more than three-quarters of all budget "savings" from policies that increase federal revenue.

The House Committee plan, for example, ends the ability of student loan providers to recycle existing 9.5% loan payments into new student loans also entitled to a 9.5% rate of return. This additional policy change in the House Committee plan saves $400 million in the form of reduced government spending over the next five years.

However, the single largest cut in government spending included in the House Committee's reconciliation plan can be only characterized as either illusory or reckless. The House Committee dramatically limits by $2.2 billion over five years mandatory spending dedicated to administration of the Direct Loan program, so called Section 458 spending named after its designation within the Higher Education Act of 1965. Presumably, Section 458 costs necessary for administering the Direct Loan program will instead be financed through the annual discretionary budget appropriations process, making the mandatory proposed "savings" an accounting illusion rather than a genuine cut in government spending. Should, however, these costs not be assumed through discretionary appropriations, the federal government's ability to administer the existing Direct Loan program would be severely compromised.

In sum, rather than reduce what President Bush's Fiscal Year 2005 budget deemed "cost inefficiencies" and unnecessary government spending, Congress' once in a decade comprehensive overhaul of federal student loan law instead is on track to increase federal revenue collected from students, parents, and lenders in order to achieve budget "savings."

REDISTRIBUTION OF MIDDLE CLASS INCOME

A political dispute exists between student advocates and federal lawmakers over the nature of the dominant source of increased federal revenue generated by the main Congressional student loan reconciliation proposals. Student advocates claim that it is borrowers who will be responsible for the bulk of additional revenue slated to transfer to the federal government. In contrast, Congressional sponsors claim that same revenue is more properly characterized as coming from lenders' pockets. Regardless, both pending major reconciliation student loan proposals in the House and Senate increase borrowing costs for middle class families, in some cases markedly. These proposed increased costs for middle class borrowers offset the cost of proposed increased financial aid for poor students.

Explanation of the Floor Income Offset

More than three quarters of House Committee's and four fifths of the Senate Committee's proposed increased student loan federal revenue derives from a single source: eliminating the floor on yields associated with repayment of guaranteed student loans to FFEL lenders. Here's how the floor income offset works.

Under the FFEL student loan program, there are two key interest rates. First, there is the interest rate borrowers pay to lenders (i.e. "the student rate") that is determined once a year according to a formula set by law. The current student rate is dependent upon the three-month Treasury bill interest rate.

There is a second interest rate payable to lenders (i.e. "the lender rate") also set by statute, calculated quarterly, and dependent upon the prevailing interest rate for privately traded commercial paper. The lender rate is guaranteed. If the student interest rate on payments to lenders is less than the statutorily assured lender rate, the federal government makes up the difference by providing lenders with a special allowance subsidy payment in order to guarantee the lenders' rate of return.

The student interest rate calculation, however, is set to change on July 1, 2006 from being a variable rate dependent upon the three month Treasury bill to a constant 6.8 percent regardless of other prevailing interest rates.

Under current law, when the student 6.8 percent interest rate is *higher* than the lender quarterly guaranteed interest rate, the lenders will get to keep the excess student payments. For example, if the lender rate in December 2006 is 6.3 percent based on publicly-traded commercial paper interest rates, lenders will collect a 6.8 percent rate of interest from students and *keep* the extra half of one percent interest over and above their federally guaranteed rate of return.

Both Congressional Committees aim to change current law, however, to require that lenders "pass through" any excess student payments to the federal government. Students claim that such excess payments derive from their pockets. Congressional sponsors and lenders describe the excess payments instead as a government-required and student-paid lender subsidy. Regardless, at $11.18 billion over five years, federal capture of excess student payments to lenders is more than enough to meet the Budget Resolution's assumed required "savings" to be produced by the student loan program.

Analysis of Additional Proposed "Savings" and Spending Beyond Reconciliation Requirements

Independent of the Budget Resolution mandate to achieve "savings" from the student loan program, the relevant Congressional Committees also would like to increase government spending on student aid and pay for it with a variety of increased middle class borrower interest rates and fees. Both the House and, to an ever greater degree, the Senate Committees seek to increase borrowing costs for middle and upper income families in order to finance increased student benefits for low income students.

TABLE 3: UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON EDUCATION AND WORKFORCE REPORTED BUDGET RECONCILIATION AND HIGHER EDUCATION ACT LEGISLATION, OCT. 27, 2005	
BUDGET SPENDING	2006-2010
Major Spending Outlays on Student Loans (for either borrowers or lenders' benefit)	
Increased Subsided and Unsubsidized Stafford and PLUS borrowing by Undergraduates and Graduate Students:	$1.6 billion
FFEL origination fee reduction:	$2.3 billion
Subtotal Increased Spending on Student Loans:	**$3.9 billion**
Hurricane Katrina Relief for Higher Education:	$215 million
Total:	**$4.12 billion**

Most significant is the Senate Committee's dramatic proposed increase in borrower interest rates associated with Parent Loans for Undergraduate Students (PLUS). Typically, before families assume a PLUS loan, they borrow federal Stafford loans up to a government set limit that currently is $23,000 over the course of an undergraduate career. For families that have exhausted their Stafford loan eligibility, PLUS loans are available. These loans are supplemental, low-interest, federally insured loans made to parents of undergraduate students in order to help pay for college expenses not covered by other forms of financial aid. Parents do not have to demonstrate financial need for PLUS loans but must have a good credit history. Over 800,000 PLUS loans are issued each year. They disproportionately go to parents with children in high cost, private colleges and universities.

The current interest rate for a new PLUS loan is 6.1 percent. It is scheduled to change to a fixed 7.9% beginning in July 2006. But the Senate Committee proposes instead to increase PLUS loan interest rates to a fixed 8.5%. In other words, beginning in July 2006, the Senate bill seeks to increase PLUS loan interest payments an additional six-tenths of one percent. Average PLUS loan debt equals $9,416 per borrower, per year.

At the current 6.1 percent interest rate, the average middle class borrower will pay $574 in interest a year on their PLUS loan. At the 7.9 percent interest rate slated to take effect on July 1, 2006 under current law, the average borrower will pay $744 in interest a year on their PLUS loan. But at the principal Senate plan's proposed interest rate of 8.5 percent to take effect July 1, 2006, the average borrower will pay over $800 a year in interest on their PLUS loan. Over the course of the next four years, more than 800,000 largely middle class PLUS loan borrowers will pay an average of upwards of $900 in additional interest on their college debt under the principal Senate budget reconciliation plan.[13]

In contrast to the House Committee's proposal, however, the principal Senate plan would establish new spending on grant aid for low income students. The Senate Committee has developed a new $8 billion (over $9 billion in budget authority) grant supplement called the Provisional Grant Assistance Program (ProGAP) that tracks student eligibility with the Pell Grant program. A portion of new ProGAP funds are earmarked for Pell Grant eligible students studying math, science, and foreign languages. It appears the Senate created Pro GAP anew rather simply expanding the existing Pell Grant program in order to avoid budgetary problems that have been associated with the Pell Grant program in the past due to unexpected rising student enrollment and financial need.[14] But substantively, ProGAP is supplemental grant aid for Pell Grant recipients. Nearly half of all Pell Grant recipients have a family income of less than $10,000 a year.[15]

TABLE 4: UNITED STATES SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS REPORTED BUDGET RECONCILIATION AND HIGHER EDUCATION ACT LEGISLATION, OCT. 18, 2005

BUDGET SPENDING	2006-2010
Major Spending Outlays on Grant Aid	
Provisional Grant Assistance Program (ProGAP) for Maximum Pell Grant Recipients:	$6.113 billion
National Science and Mathematics Access to Retain Talent (SMART) Grants:	$1.899 billion
Subtotal Increased Spending on Grant Aid:	**$8.012 billion**
Major Spending Outlays on Student Loans (for either borrowers or lenders' benefit)	
Increased Subsided and Unsubsidized Stafford and PLUS borrowing by Undergraduates and Graduate Students:	$1.86 billion
Direct Loan and FFEL origination fee reduction:	$1.6 billion
Subtotal Increased Spending on Student Loans:	**$3.46 billion**
Hurricane Katrina Relief for Higher Education:	$105 million
Total:	**$11.58 billion**

Thus, the principal Senate plan essentially would establish immediately President Bush's proposed $4,500 maximum Pell Grant. Of the $8 billion in increased grant aid for exceptionally needy students, especially those who study math, science, and foreign languages, the Senate would finance almost half the cost, $3.9 billion, from increased interest rates charged by the government to largely middle class PLUS loan borrowers.

In sum, key Congressional Committees have rejected an approach embraced by President Bush that would cut government spending on lender subsidies in order to finance increased grant aid. Instead, they have pursued an approach that increases the borrowing costs of some students and families in order to finance increased financial aid for other typically more needy students.

ANTI-COMPETITION POLICIES

The Direct Loan program was enacted in 1993 to reduce federal expenditures. The program is cheaper for taxpayers than the FFEL bank guaranteed student loan program for two reasons. First, Direct Loans are funded with federal capital, not private capital, and so are inherently cheaper. The cost of capital for the Direct Loan program is backed by the full faith and credit of the United States as opposed to private capital, which is not as secure. Thus, interest rates associated with federal borrowing through Treasury bonds are always lower than private borrowing associated with corporate bonds. The second reason why the Direct Loan program is cheaper for taxpayers than the FFEL alternative is that while costs like student subsidies, defaults, and collection are very similar between the two programs, the "profit" on Direct Loans from student interest payments accrue to the federal government instead of to private lenders.

It has been over a decade since the Direct Loan program was created. Contemplated savings have been validated by every independent, non-partisan government agency budget estimate. The Office of Management and Budget, the Congressional Budget Office, and the General Accounting Office all have concluded that Direct Loans cost between 7.75 and 11 cents less on every dollar borrowed than government spending on the similar FFEL private lender alternative loan program.[16] Variation in estimated potential savings among these three government agencies is due to the timing of the cost estimates and different estimates of prevailing interest rates. But they all reach the same base conclusion: the Direct Loan program is cheaper for taxpayers. The *Chronicle of Higher Education* summarized GAO's September 2005 finding writing, "Direct lending to college students has cost taxpayers more than originally forecast, but it still costs five times less per loan than [FFEL] guaranteed lending."[17]

Competition Between the two Federal Loan Programs

Despite the different fiscal costs, government officials have maintained two loan programs in order to infuse greater competition into our student loan system and thus provide an incentive for better service to students. In fact, taxpayers, students, and colleges have benefited from two types of competition in the federal student loan program: (1) competition between the Direct Loan program and the FFEL program; and (2) competition among lenders in the FFEL program.

Taxpayers have benefited from the competition *between* the two loan programs. The existence of an affordable alternative has highlighted the large, unnecessary subsidies on FFEL guaranteed loans. As the Bush Administration's budget put it, "significantly lower Direct Loan subsidy rates call into question the cost effectiveness of the FFEL program structure, including the appropriate level of lender subsidies."[18] It is not a coincidence that lender subsidies were cut in 1993 (when Direct Loans were created), and again in 1998 (the year the Direct Loan program was last reauthorized). One independent study estimated that competition between the two loan programs reduced federal costs by $685 million per year, nearly entirely within the FFEL program.[19]

Students and colleges have also benefited from the competition between the programs. As one college president described it, "The competition from direct lending has forced private lenders to improve service, lower some rates and loan origination fees, offer new repayment options, and find creative ways to keep the schools they still have and try to lure others back to the fold."[20] A 1999 independent assessment concluded, "Virtually no one disputes that the operation of an alternative loan program has produced a competition that inspired innovation and service—to the benefit of all borrowers and schools."[21]

As a senior FFEL executive told an industry trade publication in 1998, "[Direct Loans] have introduced some ways of doing business and some delivery mechanisms that made the private enterprise wake up a little bit. To be perfectly honest, as a private enterprise we thought we were doing almost an A-plus job. When we stepped back a little bit, we saw some of the things the Department of Education was doing and we realized we weren't. . . It's been relatively good for the industry, particularly for the recipients in terms of students and schools."[22]

Competition, however, also exists *within* the FFEL guaranteed loan program. Under the FFEL system, students choose their own lender, often with the guidance of their school, creating incentives for lenders to reduce loan fees and interest rates and improve service to schools. In special "school-as-lender" deals, colleges can earn more than $1 million in fees by lending to their own students and then quickly selling those loans to a bank.[23] Current school-as-lender reward fees for colleges reach as high as 8 percent of borrowed volume.[24]

Competition has lead many FFEL guaranty agencies—intermediaries administering the federal guaranty against default—to waive the 1 percent "insurance fee" they may charge students. Finally, students who are unhappy with their initial lender are able to refinance their loans with another lender.

House and Senate Proposals Undermine Competition

Despite the benefits of competition *between* the two programs, the principal House of Representatives' student loan proposal would double up-front fees paid by students in the Direct Loan program in order to increase federal revenue. In other words, the House of Representatives is poised to make a student loan program that is cheaper for taxpayers more expensive for borrowers.

Currently, students pay a 1.5 percent fee to borrow their loans, and they must pay an additional 1.5 percent fee if they fail to make their first 12 payments on time. The House proposal would instead charge a 3 percent fee when students borrow a Direct Loan. It threatens the Direct Loan administrative budget, as explained above, and also therefore, potentially program quality. But most significantly, higher student borrowing fees for Direct Loans as proposed by the House Committee will make the program more expensive *for borrowers* than the FFEL alternative, seriously compromising its effectiveness as a competitor to FFEL lenders.

The House and Senate proposals also threaten competition *within* the FFEL program. The House would eliminate competition among FFEL participants on insurance fees by mandating that all guaranty agencies must collect. No longer would a guaranty agency be able to waive the one percent insurance fee from students in order to attract FFEL business.

The principal Senate proposal would bar private loan companies from offering more colleges financial aid premiums in exchange for entering into "school-as-lender" partnerships. Currently, individual lenders offer universities premiums equal to up to 8 percent of graduate student loan volume for entering into "school-as-lender" arrangements. Under the school-as-lender program, a university in effect acts as a storefront bank. It issues FFEL loans to graduate students and then immediately sells those loans to a private FFEL lender at a premium. Universities put their school-as-lender partner availability out to competitive bid.[25] The premium they receive is unrestricted aid.

The Senate's proposed "school-as-lender" moratorium has cross cutting competitive effects. On the one hand, it inhibits competition *within* the FFEL program that serves to funnel excess government FFEL subsidies to colleges and universities. On the other hand, however, it promotes competition *between* the two loan programs. The Direct Loan program is prohibited statutorily from offering similar "school-as-lender" rewards. Thus, existence of the "school-as-lender" program without a Direct Loan alternative tilts the competition between the two programs in favor of the more expensive FFEL program.

Prior to the reconciliation process, some Congressional leaders had proposed expanding the "school-as-lender" program to Direct Loan schools as well.[26] But neither the House nor the Senate appears poised to adopt that proposal. The House would maintain the "school-as-lender" program as is without a Direct Loan alternative and thus with a competitive imbalance. The Senate would bar growth of the "school-as-lender" program, but not decrease lender subsidy levels that as per operation of the program are admittedly unnecessarily high by an amount equal to as much as 8 percent of graduate loan volume.

If under "school-as-lender" arrangements, private lenders are able to forgo subsidy income voluntarily equal to as much as 8 percent of graduate loan volume and still turn a profit, government spending on graduate student loan subsidies is up to 8 percent unnecessarily high. Government spending on some $12 billion a year in FFEL graduate student loans could be cut without impacting loan availability. But neither chamber of Congress appears interested in cutting government spending on federal student loans.

CONCLUSION

The single largest source of "savings" associated with the budget reconciliation process now pending before Congress is the federal student loan program. Budget savings slated to come from that program derive not from reduced government spending, but instead from enhanced government revenues. In fact, contemplated student loan policy changes generate enhanced government revenue beyond that which is necessary to meet reconciliation savings targets required by the Congressional budget process.

Over and above required federal budget savings, additional major proposed student loan policy changes would increase borrowing costs for largely middle class families in order to pay for increased financial aid to poor students. Major proposed changes would reduce competition among student loan providers and drive up future government spending on student loans and future borrower costs. In short, the budget reconciliation process is facilitating creation of bigger, not smaller, federal college aid programs and threatening to increase inefficiency in the federal student loan program.

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[1] *See* Office of Federal Student Aid, Frequently Asked Questions, http://www.ed.gov/about/offices/list/fsa/resources.html
[2] *See* S. 1614, The Higher Education Act Amendments of 2005; H.R. 609, The College Access and Opportunities Act of 2005.
[3] All data presented are derived from cost estimates prepared by the independent and non-partisan Congressional Budget Office (CBO), unless otherwise noted. *See* Memorandum to Interested Parties, Deborah Kalcevic, Congressional Budget Office, Mar. 2005
[4] *See generally* Federal Student Loans: Terms and Conditions for Borrowers, Adam Stoll, Congressional Research Service, July 2005
[5] *See generally* The Administration of Federal Student Loan Programs: Background and Provisions, Adam Stoll, Congressional Research Service, May 2005
[6] *See* Fiscal Year 2005 Budget of the United States Government, Program Assessment Ratings Tool, page 34 www.whitehouse.gov/omb/budget/fy2005/pma/education.pdf
[7] *See* Budget of the United States Government for Fiscal Year 2006
[8] *See* Fiscal Year 2006 Concurrent Congressional Budget Resolution Conference Report, H.Con.Res 95, H.Rpt. 109-62. *See* http://www.house.gov/budget/fy06legtextar031105.pdf
[9] Ibid.
[10] *See* Congressional Budget Act of 1974, PL 93-344, 88 Stat. 297-332.
[11] *See Reconciliation* RECOMMENDATIONS OF THE SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS, Congressional Budget Office Cost Estimate, Oct. 24, 2005
[12] *See, e.g.*, New York Times, *A Windfall from a Student Loan* Program, Greg Winter, Aug. 27, 2004. To this day, an old statutory and regulatory loophole in the federal student loan program stemming from the 1980s and early 1990s guarantees lenders a government subsidized 9.5% rate of return on a group of otherwise non-descript student loans. Students who hold "9.5% loans" pay an interest rate of approximately 5% today, while the government provides lenders an additional near 4% payment. For other new student loans, banks are guaranteed a far lower rate of return.

Until uncovered in the summer of 2004, a number of student loan providers, led by the Nelnet Corporation, pursued a novel bond-swapping technique designed to take greater advantage of the so-called 9.5% loan subsidy. Until that time, the lenders had been spectacularly successful, growing federal payments from just over $200 million a year to almost $1 billion annually in space of three years.

In October 2004, Congress passed the Taxpayer-Teacher Protection Act prohibiting the 9.5 loan growth technique for the next 15 months. To much criticism, the law did nothing to reduce outstanding liabilities associated with existing 9.5% loans. *See e.g.*, *Student Loan Scam (Cont.)*, Washington Post, Oct. 21, 2005; *see also* New York Times, *Education Secretary Back End to Student Loan Loophole*, Tamar Lewin, July 9, 2005.

[13] *See* Memorandum to Interested Parties, Deborah Kalcevic, Congressional Budget Office, Mar. 2005.

[14] During each of the last four fiscal years, the Pell Grant program has operated with a "shortfall" or deficit due to unexpected rises in student enrollment and financial need. *See* Budget of the United States Government for Fiscal Year 2006.

[15] *See* Federal Pell Grant Program of the Higher Education Act, James Stedman, Congressional Research Service, p. 16, Mar. 2004. http://www.opencrs.com/rpts/RL31668_20040312.pdf

[16] *See* Government Accountability Office, Federal *Student Loans: Challenges in Estimating Federal Subsidy Costs*, Table 3, p 18, Sept. 2005; Budget of the United States Government for Fiscal Year 2006, Appendix, page 371.

[17] Chronicle of Higher Education, *Report Assesses Cost of Direct Loans*, Kelly Field, Nov. 4, 2005.

[18] *See* Fiscal Year 2005 Budget of the United States Government, Program Assessment Ratings Tool, page 34 www.whitehouse.gov/omb/budget/fy2005/pma/education.pdf

[19] Fred Galloway and Hoke Wilson, Educational Policy Institute, "Reframing the Student Loan Costing Debate: The Benefits of Competition," July 2005.

[20] Judith Bailey, President of Western Michigan University, "Direct Lending: A President's Perspective," May 17, 2004 (http://www.aascu.org/leadership/testimony/bailey.htm, last checked on 10/31/2005).

[21] Macro International (1999), *Five-Year Assessment of the Direct Loan program.*

[22] *See* Student Lending Update, *Interview with James Gathard, Senior Vice President for Business Executives for NationsBank Education Loans*, Jan. 13, 1998.

[23] *See* U.S. News & World Report, *Big Money On Campus*, Julian Barnes et al., Oct. 27, 2003

[24] *See* Comments of Walter Cathie, Director of Financial Aid, Widener University, Annual Conference of the National Association of Student Financial Aid Administrators, July 5, 2005, New York City.

[25] *See e.g.*, Chronicle of Higher Education, *Cashing in on Student Loans*, Stephen Burd, Nov. 5, 2004; Boston Globe, *More Colleges Replace Banks for Student Aid*, Marcella Bombardieri, Nov. 26, 2004.

[26] *See* S. 754 & H.R. 1425 , The Student Aid Reward Act of 2005. *See also* New York Times, *The College Aid Crisis*, May 25, 2004.