

Legislative Information

THE FACTS ABOUT THE FEDERAL FAMILY EDUCATION LOAN PROGRAM (FFELP) VS. THE STAR ACT AND DIRECT LENDING

The new Congress is rushing headlong toward bad policy on student lending as it considers proposals to cut the student loan program on top of the \$12 billion slashed from the program last year as part of the Deficit Reduction Act. The Student Aid Reward (STAR) Act is an example of the bad student aid policy proposals under consideration. The STAR Act would introduce discrimination into the rewarding of need-based aid by awarding government aid to needy students who attend Direct Lending schools only. It would also turn the foundation of the Higher Education Act of 1965 on its head by rewarding need-based aid on criteria unrelated to financial need. The proposed legislation would essentially force schools to leave the FFELP program in favor of the federal government's Direct Lending program by paying taxpayer-funded inducements to the schools that switch.

If enacted, the unintended consequences will be less choices and higher cost loans to the vast majority of our country's college students, with minorities and students from low and moderate income families being hit the hardest.

FFELP vs. The STAR Act and Direct Lending

In the Federal Family Education Loan Program (FFELP), private and non-profit lenders compete to provide federally guaranteed student loans. In 2005-06 FFELP served more than 6.5 million students and parents, lending a total of \$52.5 billion. Since 1965 the program has helped more than 50 million Americans go to college.

Despite FFELP's clear advantages for student borrowers, some members of Congress are focused on damaging the FFELP. Under the proposed STAR Act, the government would offer taxpayer-funded financial incentives to schools that participate in the government-run Direct Lending program. Its purpose is to induce schools to leave FFELP. Essentially, it would have the effect of propping up a program whose market share has shrunk every year since 1998-99.

American families deserve better. They deserve a thoughtful debate about rising college costs. They deserve the lower costs, superior customer service and more expansive loan options that come with competition from private lenders.

Just take a look at the facts:

1) College financial aid experts oppose discrimination.

The National Association of Student Financial Aid Administrators (NASFAA) and the thousands of college financial aid professionals it represents are opposed to the STAR Act. Specifically, NASFAA said: "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."

2) FFELP cost students less than Direct Lending.

The assertion that the STAR Act will actually save the government money is both unproven and highly unlikely. In fact, **FFELP saves students \$700-\$2,000 more than DL** through lower fees upfront and generous repayment incentives. Payment of the government-mandated fees on behalf of borrowers by lenders saves the typical borrower over \$500 at the time students need it most – as they begin each school year. Additional repayment incentives and rebates encourage timely repayment and reduce defaults.

3) Schools prefer FFLEP over direct lending.

Since 1997, **more than 600 schools have dropped out of the Direct Lending Program** because of its inferior service to students and families. The Direct Lending share of annual lending is down to 20 percent and falling. 96 percent of the schools that have left the Direct Lending program identify administrative and service problems as key reasons.

Colleges and universities around the country have recognized the benefits of a competitive marketplace. FFELP offers students more choices and better service - a direct result of innovation and improved technology from lenders competing for student borrowers. Loan providers offer a continuum of services, including financial aid, debt management and default prevention counseling.

4) The Direct Lending Program costs taxpayers money.

The Direct Lending Program has lost taxpayer money every year since 1997, totaling **\$18 billion**. The Direct Lending Program has had to borrow \$105 billion, adding to the national debt, but has only \$89 billion in performing loans to meet its obligations to the U.S. Treasury.

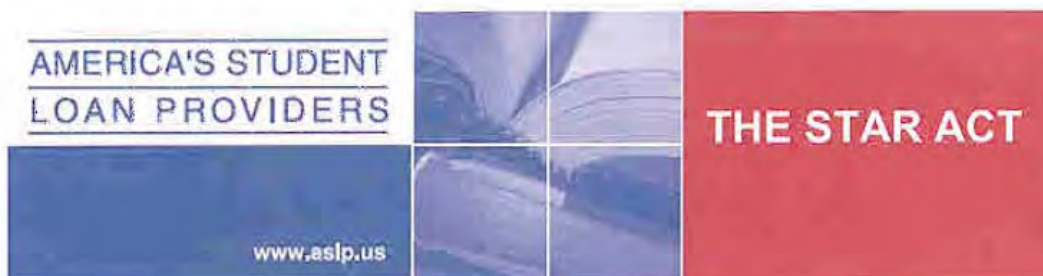
Direct Lending has not “saved” taxpayers a single penny to date. In every year but one since its inception, the program has actually cost more, on a cash basis, than FFELP.

Colleges and universities shouldn't have to choose between inferior service or less financial aid, and taxpayers shouldn't bear the burden of supporting this inefficient government program.

5) FFELP helps minority and low income students.

Since 1997, the majority of historically black colleges and universities that initially chose to use Direct Lending have voluntarily left the program. Yet some politicians still favor the bureaucratic Direct Lending Program, despite its inferior service and track record for American families.

As the new Congress moves forward with its agenda, it should reaffirm its commitment to students - not through cuts to the nation's most relied upon student aid program, but through additional investments to make college more accessible.



Background

There are two major federal student loan programs: The Federal Family Education Loan Program (FFELP) and the Federal Direct Loan (DL) Program. In FFELP, private and non-profit organizations compete to provide federally guaranteed loans to students and parents. FFELP loan providers raise funds in the capital markets to finance student loans. The DL Program borrows funds from the U.S. Treasury.

After the DL Program was created in 1993, Congress gave schools the choice of which loan program best serves their needs. That choice has produced a robust level of competition that has created new benefits for students and families and sparked technological innovations in student aid delivery. More than 83 percent of the nation's schools participate in FFELP, and more than 500 have returned to FFELP.

Increasingly, DL advocates have attempted to turn the discussion of the relative merits of the programs into a debate centered on their belief that FFELP is more "expensive" than direct lending. Federal money would be saved, they argue, by providing "incentives" for schools to switch to the government-run program. Those "savings" could then be used to increase need-based aid for students.

America's Student Loan Providers supports increases in federal need-based aid. However, we oppose approaches like the Student Aid Reward Act because the formula the government uses to measure program costs (and "savings") is seriously flawed. The bill would also be unfair to millions of students.

What is the STAR Act?

The Student Aid Reward Act (H.R. 1425) would require the Secretary of Education to carry out a reward program to encourage schools to participate in the loan program that he or she determines is the "most cost-effective for taxpayers." The sponsors, as well as DL proponents, have asserted all along that the DL Program is "most cost effective"—and that the bill's purpose is to move schools into direct lending.

The bill, as intended by the sponsors, would give schools that switch to the DL Program 50 percent of any "savings" resulting from their participation in the DL Program, with the remaining "savings" being distributed to existing DL schools. These savings must be used for need-based grant aid. Schools that switch to the DL Program must stay for at least 5 years.¹

What is the basis for the belief that the STAR Act will generate savings? Program cost estimates by the Office of Management and Budget and the Congressional Budget Office that make the DL program appear to be less expensive than the FFELP. For many the discussion of program costs begins and ends there, despite mountains of evidence that they do not reflect the true costs of either program.

Truth Is FFELP's Costs and Direct Lending's Are Roughly the Same

There are serious problems with the way CBO and OMB measure the costs of both programs.

First, the score is heavily weighted by interest rate predictions that, historically, have been wrong. In fact, OMB has raised the DL Program's subsidy costs *every year* as actual interest rates have replaced earlier projections. The GAO also concluded in 2004 that the DL program could not accurately estimate future

interest income on student loans, as evidenced by the program's overestimating interest income by 67 percent between 1994 and 2003.

In other words, as PricewaterhouseCoopers and others have pointed out, *the government's inaccurate interest rate projections have had the effect of underestimating the DL Program's costs and overestimating the FFELP's.*

Second, government cost estimates do not include the DL Program's administrative costs. Nor does it account for the more than \$650 million annually in federal taxes paid by the FFELP's loan providers.

So which one is cheaper? It all depends, says the Education Department's Inspector General:

"In any given year either FFELP or [DL Program] total costs ... 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 definitely answer the question of whether FFELP or [DL Program] is more expensive."ⁱⁱ

Finally, these cost estimates, not to mention DL advocates, ignore the program's actual performance.

- Since 1994 the DL Program has received almost \$15.9 billion *less* in fees and interest payments from borrowers than it has paid the Treasury Department in interest.
- The program has \$104 billion in outstanding loans, yet it expects only \$87.5 billion in loans will be repaid. Taxpayers will have to cover this shortfall.

STAR Act Is Bad Financial Aid Policy

ASLP and many financial aid administrators object to the legislation on other grounds. The federal government would for the first time in the history of the Higher Education Act treat low-income students at one college better than those at another for reasons unrelated to financial need. Such a departure would do an enormous disservice to needy students across the country who have made their school choice based on how that school meets their educational objectives—not based on the loan program in which the school participates.

Preserve Choice, Increase Access

While ASLP supports efforts to increase need-based aid for low-income students, we believe the STAR Act cannot deliver on that promise and would severely compromise the current student-aid delivery system. We urge Congress to reject the STAR Act and instead work to strengthen the student loan program and increase access to financial aid.

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ⁱ The total amount of payments to schools, however, cannot exceed the savings attributable to loans made by schools which, after the date the legislation becomes law, switch to the most cost effective program. If the total amount otherwise payable exceeds the amount of savings attributable to schools that switch, payments are distributed first to schools that switch.

ⁱⁱ Separate analyses by the GAO, CBO, CRS and others also challenge the reliability of the DL Program's cost estimates.

Summary of H.R. 5

- On Jan. 17, 2007, the U.S. House of Representatives voted (356 to 71) on H.R. 5, the “College Student Relief Act” introduced by House Education and Labor Committee Chairman George Miller (D-CA).
- The bill would ratchet down student loan interest rates for select borrowers over the next five years. While the original rhetoric was to immediately cut rates in half for all students and parents, the final proposal would only reduce them for a subset of undergraduate students who have unsubsidized Stafford loans. In fact, the 3.4% rate (half of today’s 6.8% rate) would not take effect until July 1, 2011 and would last for only six months before returning to 6.8% on January 1, 2012.
- Specifically, the proposal would be phased in over five years, with interest rates on subsidized Stafford loans to undergraduates going to 6.12% for loans made between July 1, 2007, and June 30, 2008; 5.44% for loans made between July 1, 2008, and June 30, 2009; 4.76% for loans made between July 1, 2009 and June 30, 2010; 4.08% for loans made between July 1, 2010, and June 30, 2011; and 3.4% for loans made on or after July 1, 2011. The rate cut would expire after only 6 months, when loan rates for all new loans would return to 6.8% on Jan. 1, 2012.
- The move to halve student loan interest rates comes with a significant price tag: the CBO estimate the cost to exceed \$7 billion over 5 years.
- New House rules require that increased entitlement spending be offset by other entitlement spending reductions or tax increases. Although there is no requirement that the legislation be paid for by cutting investment in other federal financial aid programs H.R. 5 recklessly proposes to pay for the entire cost of the interest rate reduction with punitive cuts to the Federal Family Education Loan Program:
 - Reducing lender yield by 0.10% with an exemption for small lenders (those lenders that make up the bottom 10% of holdings). Today, lenders are paid a market rate on behalf of borrowers set at the 90 day commercial paper rate plus 2.34 percentage points. Under the new plan, lenders would earn the 90 day commercial paper rate plus 2.24 percentage points.
 - Reducing default insurance from 97 cents for every dollar that is not paid back to 95 cents.
 - Eliminating by July 1, 2007 the exceptional performer designations (which provide a the 2% increase in default insurance for high-performing loan servicers)
 - Doubling the lender origination fee on all loans, from 0.5% to 1% as of July 1, 2007;
 - Reducing payments to guarantors for collections (immediately from 24% to 20% and phased down to 18% in 2008 and then to a level designated by the Secretary in 2010);
 - Increasing the consolidation offset fee from 1.05% to 1.3% for lenders that have more than 90% of the holdings in consolidation loans.
- Last year Democrats rightfully criticized the \$12 billion in cuts to the student loan program. The Deficit Reduction Act was labeled the “Raid on Student Aid.” Surprisingly, H.R. 5 makes \$6 billion in cuts in the same exact manner the \$12 billion was cut last year.
- Not only do cutting interest rates on student loans have no impact on college access, the punitive cuts to FFELP would place the benefits students receive from private lenders in jeopardy.
- The legislation could have drastic unintended consequences, such as an increase in student loan default rates, as lenders assume greater risk and become more selective about where to offer products and services to help students and schools manage their student loan default rates. Today’s national cohort default rate of 5.1% could increase, and each 1% rise in that figure costs taxpayers \$4 billion.

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Student Loan Sunshine Act Summary

The overarching goal of the “Student Loan Sunshine Act” is to ensure student loan borrowers are provided the necessary information and disclosures they need to make informed decisions. To achieve this important goal, the bill takes a number of steps in the right direction. These steps include:

- Requiring that lenders inform students and parents of their federal loan options, including the terms and conditions that are more favorable to the borrower than the terms and conditions of most private education loans.
- Providing lenders with a model disclosure format to be developed by the Secretary of Education.
- Ensuring schools generally use three or more lenders on their preferred lender list and maximize benefits for students.
- Prohibiting lenders and guarantors from providing any gift to school employees or agents in order to secure or maintain business.

All stakeholders should be very concerned, however, that the proposal as written will have potentially dire unintended consequences that will limit consumer choice, compromise personal privacy, impose unmanageable burdens on schools, force borrowers to more expensive borrowing options and significantly disrupt the financial aid process and the ultimate disbursement of funds for borrowers.

Borrower Choice

- The bill effectively ends a student’s ability to obtain a private education loan directly from a financial institution where the private loan is not certified by the school (“direct-to-consumer” loan).
- Borrower options would be severely limited based on the onerous information and notification requirements placed on lenders and schools.
- The vast majority of direct-to-consumer borrowers are either non-traditional students (adults) who are, continuing their education or returning to school after starting their working careers helping finance their children’s education. These students/borrowers typically elect not to go through the financial aid office. In fact, nearly 50% of all Title IV undergraduate students and parents of students attending post-secondary schools did not go through the financial aid office to finance their education in 2005.
- If direct-to-consumer loans are not available and students or their parents make the personal choice not to go through the financial aid office process with the required disclosure of significant private information to the federal government, these students will be forced to borrow through credit cards, lines of credit and more expensive, high risk alternatives.
- Financial aid offices (“FAOs”) could be paralyzed by the additional notification requirements in section of the bill that amends the Truth in Lending Act (the “TILA Amendments”). Already overburdened, they will be swamped with thousands of notifications from direct-to-consumer lenders to which FAOs must respond in a detailed, time-consuming manner before the students can obtain funds from the private lender. This would likely result in a complete disruption of the financial aid process and would compromise the ability of tens of thousands of students to fund their education since federal borrowing limits are inadequate at most

schools. This threat is even more acute because borrowers typically apply for direct-to-consumer loans very late in the process, often just before schools starts.

Privacy

- Many consumers make the free choice of borrowing private education loans to avoid disclosing to the government the very detailed and extensive private and financial information that the government requires with the Free Application For Federal Student Aid (“FAFSA”) in order to secure a federal loan.
- The loan information disclosures would require schools to inform each student or parent of their “remaining options” for federal loans before that student or parent may take out a private loan from a lender with which the school has an “educational loan arrangement”. In order to determine what the student’s or parents “remaining options” are, the school must require the student and parent complete a FAFSA thereby frustrating the student’s/parent’s desire to keep private from the government a significant amount of very personal information.

Reporting

- The new annual reporting requirements will be very onerous for both schools and lenders. While some lenders may be able to accommodate the additional burdens imposed by such detailed annual reporting, financial aid offices may not have sufficient staff or resources to meet the requirements. For schools, the annual report required under Section 153 will include a requirement to provide a detailed explanation of why the school believes each type of loan offered by a lender with whom it has an educational loan arrangement is beneficial to borrowers. Most schools simply do not have the staff to meet such an unnecessary burden. And lenders will be reluctant to assist schools in meeting this requirement for fear of violating the new gift ban requirements.

Disclosure

- The required lender disclosures required by the proposed TILA Amendments are significantly more burdensome than those required for any other consumer loan. For example, they include a requirement to disclose on every loan application *any* complaints (and their resolution) filed with any state or private consumer protection agency. Lenders with millions of customers will naturally be the subject of complaints from customers, many of which may lack any merit. Moreover, this disclosure requirement applies to *every* loan solicitation, marketing or advertisement. Such disclosure requirements will create an undue and unreasonable burden on all lenders without any obvious benefit to borrowers. In fact, more important information such as the basic terms and conditions of the loan may be obscured by such unnecessary and potentially voluminous information.

Preferred Lending List

- Schools should generally have at least three unaffiliated lenders named on their preferred lending lists. However, certain schools may be able to secure the best deal for their students

through an RFP process resulting in a single loan provider. There should be an exception for schools to choose fewer than 3 preferred lenders as long as the school documents that it engaged in a competitive bidding process that involved at least 3 unaffiliated lenders. This approach would be consistent with the ability schools have to select the Direct Loan Program as a sole loan provider. It is noteworthy that schools that select the Direct Loan Program are not required to disclose to students the process they engaged in to make that selection.

- In light of the very burdensome additional reporting requirements, more lenders may elect to bypass the financial aid office by deliberately refusing to be on a school's preferred lender list. This would lead lenders to focus on direct-to-consumer marketing.

Impact of President Bush's Fiscal Year 2008 Budget

The President's fiscal 2008 budget proposes massive cuts of **\$19 billion** over the next five years to the Federal Family Education Loan Program (FFELP). Other student aid programs are also targeted, including Perkins loans, Supplemental Educational Opportunity Grants (SEOG), and Leveraging Educational Assistance Partnerships (LEAP). Cuts in student aid are used primarily to offset the costs of increasing Pell Grants, the new Academic Competitiveness Grants, and raising loan limits for undergraduates after their first two years.

The proposed FFELP cuts would have far-reaching negative consequences for students, schools, and taxpayers. The cuts would reduce competition in the program, increase the cost of loans to students and parents, and would undermine the superior service provided to borrowers and schools under the private-sector based program.

The **\$19 billion** in proposed cuts to FFELP include:

- Reducing the market rate of return paid to lenders by 0.50 percent. Lender payments would be slashed from the commercial paper rate from 2.34 percent to 1.84 percent. Estimated five-year savings: \$12.4 billion.
- Increasing student lender risk share by reducing default insurance from 97 percent to 95 percent (including a 2 percentage point reduction for lenders deemed "exceptional performers"). Estimated 5-year savings: \$1.6 billion.
- Increasing the lender fee on consolidation loans by 50 percent. The lender fee of 0.5 percent paid by lenders on each consolidation loan based on the loan balance would be increased to 1 percent. Estimated five-year savings: \$850 million.
- Reducing guaranty agency default collection payments from 23 cents on each defaulted dollar they collect to roughly 16 cents. Estimated five-year savings is \$2.3 billion.
- Moving guaranty agency account maintenance fees to a unit cost basis based on the number of accounts each agency manages. Agencies currently are paid an administrative fee based on the original principal amount of active loans they have guaranteed. Estimated five-year savings is \$1.6 billion.

Impact

- Lenders would be forced to completely re-evaluate the level of participation and commitment to the program, resulting in substantially fewer lenders participating in the program and reduced competition and service levels.
- The size of the cuts would reinforce a "one-size-fits-all" approach to student lending and would make it more difficult lenders to address the needs of schools for which Direct Lending is not a good solution. This is especially true for smaller, more resource-poor

schools, such as many Historically Black Colleges and Universities and Hispanic Serving Institutions.

- Students and families would be forced to pay more for their loans and taxpayers would carry the burden and cost of higher student loan defaults as lenders would be forced to slash programs designed to prevent defaults. High default rates would place the viability of the entire student aid system at risk.

Impact of Specific Proposals

- The 0.50 percentage point cut to lender yield is unprecedented in size and unsupportable by the economics of the student loan program. FFELP lenders generally make less than ½ a penny on a dollar of student loans. These cuts would virtually eliminate the profitability of the loans and could not be sustained without increasing fees on borrowers, eliminating borrower benefits, and substantially reducing the level of service and investment FFELP lenders provide.
 - A typical undergraduate borrower who borrows \$17,000 can save anywhere from \$700 to over \$1300 from the widely-provided fee reductions and borrower benefits.
- The reduction in default insurance from 97 percent to 95 percent attacks one of the most critical features of the student loan program, ensuring that all students from all schools, regardless of credit worthiness, have access to student loans if they need them. The guarantee is what makes universal access possible. The guarantee was reduced just last year, from 98 percent to 97 percent. This proposal introduces additional default risk into the decision-making process and will harm those schools and students where defaults tend to be higher.
- The collections cuts are bad policy and discourage guaranty agencies from using more successful, but more expensive, collection techniques. The end result will mean higher default costs shouldered by current and future taxpayers.
 - In 2005, the President's budget proposed to cut collections payments to an "average" of 16%, but did not offer specifics for the proposal. The final Deficit Reduction Act enacted a cut to collections, by reducing collections through the Direct Loan consolidation program from 18.5% to 10%. This appropriately aligns incentives for the best types of collections and should result in an average amount of payment that the Department's private collectors receive.
- The lender fee on consolidation cuts further into the consolidation yield, which is already under attack by the proposal to reduce its yield by 0.50 percentage points. Because of the lender-paid annual consolidation offset fee, the yield on a consolidation loan is already 0.75 percentage points below the Stafford loans.
- There are little details available to judge the impact of the reductions in payments made to guaranty agencies. Cuts of this size, however, are likely to affect default prevention and management efforts as well as the outreach and education services that guaranty agencies now provide.