

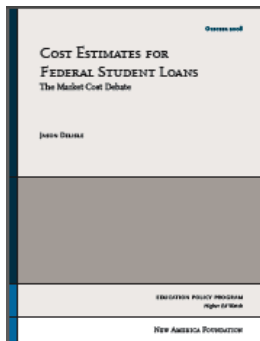
## New America Foundation Releases Report Exposing Spin on Student Loan Costs

Jason Delisle - October 1, 2008 - 11:58am

Is there another round of fighting brewing between the government's two competing student loan programs? Consider recent events:

- In the wake of the credit crunch, more colleges are opting to join the Direct Loan program, driving up its volume as a share of student loans for the first time in well over a decade.
- Recent government efforts to shore up the Federal Family Education Loan (FFEL) program have moved us closer to letting lenders make loans with federal capital (looks a lot like the Direct Lending model to us).
- Democratic presidential candidate Barack Obama has proposed the wholesale elimination of the FFEL program in favor of moving to 100 percent Direct Lending.

The stars appear to be aligning for a renewed debate about which loan program is better for students and cheaper for taxpayers.



Should hostilities be renewed, expect the student loan industry to switch into high gear to try to discredit Office of Management and Budget (OMB) and Congressional Budget Office (CBO) estimates that show that Direct Lending is cheaper for the government to run. In evaluating the loan industry's claims, lawmakers, journalists, and the public should be especially wary of one line of argument that surely will be made. In recent years, the loan industry has put out a number of reports arguing that the private market would assess the costs and risks of the loan programs differently than OMB and CBO (which must abide by government accounting rules) and that this discrepancy explains away any cost advantage Direct Lending is shown to have.

Today, the New America Foundation is releasing an in-depth report examining the lending industry's claims about determining "market costs" for student loans. We have found that trade associations and consulting organizations working on behalf of the student loan industry have twisted a legitimate budgeting concept into a half-truth. In trying to use the market cost concept to discredit government estimates that show subsidizing lenders to make student loans is more expensive than having the government make loans directly, they have made serious errors in their reasoning and methodology, and many of their conclusions are just plain wrong. Making matters worse, the GAO has made similar errors in its own work on the topic.

**Click here for a copy of the issue brief**

To bring more clarity to this debate, our report includes the following:

- A discussion and explanation of the market cost concept for federal student loan programs.
- A detailed analysis and critique of the market cost reports published by government agencies, private consulting companies, and trade associations representing student loan companies.
- An identification and explanation of the major errors and misleading information in the work published on the market cost concept for federal student loans.
- A discussion of student loan cost estimates by Northwestern University's Deborah Lucas and the Congressional Budget Office's Damien Moore that corrects many of the errors made in other market cost work.

We hope this report will correct the record and serve as an important reference for those interested in the student loan cost debate.

OCTOBER 2008

# COST ESTIMATES FOR FEDERAL STUDENT LOANS

The Market Cost Debate

JASON DELISLE

EDUCATION POLICY PROGRAM  
*Higher Ed Watch*

NEW AMERICA FOUNDATION

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## Executive Summary

In an ongoing debate about the relative costs of the federal government's direct and guaranteed student loan programs, some budget experts and private lenders have argued for the use of "market cost" estimates. They assert that official government cost estimates for federal student loans differ from what private entities would likely charge taxpayers to deliver the benefits and services the program provides. A market cost estimate would take such information into account.

Although the market cost concept for federal student loans has merit, the student loan industry has abused and distorted it. As part of an effort to discredit government estimates, which suggest that direct lending costs less than guaranteeing loans, the literature published by student loan companies generally calls for adopting market

cost estimates only for direct loans or incorrectly applies the concept to guaranteed loans so that they appear to cost less than government estimates. Government agencies, including the Government Accountability Office, have added weight to these arguments by using flawed methodology.

Market cost research that correctly applies the concept to both types of federal student loans suggests that the programs cost taxpayers much more than is reported in the federal budget. As such, it is important that policymakers, the media, and the public understand the market cost debate as it relates to the cost-effectiveness of guaranteed versus direct federal student loans. This issue brief aims to provide an explanation of the market cost concept and the public policy debate it has spurred.

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For the last 15 years, interest groups, stakeholders, members of Congress, and budget analysts have debated the costs of the federal government’s primary student loan programs—the Federal Family Education Loan (FFEL) program and the Direct Loan program. (See the text box on page 5 for a description of the programs.) The debate has centered on the relative cost-effectiveness of FFEL guaranteed loans and direct loans, and how those costs should be defined, estimated, and reported in the budget. The relative cost of each program is a key factor for policymakers since both loan programs provide nearly identical loan terms to borrowers, making the lower-cost program a superior policy choice.<sup>1</sup>

Many budget experts and stakeholder groups have argued that official cost estimates for federal student loans reported by budget agencies are inaccurate because they do not reflect “market costs,” or what a private entity would charge taxpayers to fund and administer the same benefits and services that the government provides. Government agencies, private consulting organizations, and student loan trade associations have all weighed in. Their conclusions are confusing, often incorrect, and in many cases intentionally misleading.

Private lenders have called for adopting market cost estimates only for direct loans. However, the principle is equally applicable to FFEL guaranteed loans made by private lenders because both loan types expose the federal government to very similar risks and obligations. Lender trade associations have also incorrectly argued that market cost estimates should be applied so that guaranteed loans appear to cost less than official estimates. Separately, the Government Accountability Office (GAO) has published a paper that makes the same erroneous argument.

The debate over federal student loan costs can be confusing for policymakers, the media, and the general public alike. Arguments over complex technical issues and financial concepts are colored by ideological biases and well-funded lobbying efforts. The market cost issue is no exception. Nevertheless, it is important that policymakers understand the concept and apply it correctly. To that end, this issue brief aims to help all concerned to better understand the debate over market cost estimates for federal student loans. An explanation of the market cost concept and

a description of the current cost-estimating approach used by government agencies precedes a discussion of incorrect or misleading arguments in the existing market cost literature. A brief discussion of work that correctly applies the market cost concept follows.

### **Market Cost Estimates in Theory**

The market cost (sometimes termed “market risk” or “economic cost”) of a government program refers to the price private entities would charge taxpayers to offer the same benefits and services currently funded by the government. In the case of government-subsidized student loans, the market cost reflects the price private entities would charge taxpayers to fund low interest rates for borrowers, the government’s administrative costs, and the subsidies it pays to private lenders, among other things. While private entities do not usually offer benefits and services as generous as those provided by the government, information on the prices that private entities would likely charge for such benefits and services can be found by examining prices for similar assets and services in the private market.

Proponents of the market cost approach argue that the costs of government student loan programs should reflect market values for financial activities that involve risk. Private entities and individuals (i.e., taxpayers) ultimately bear all of the risk associated with loans guaranteed or made by the federal government because taxpayer resources are used for the government’s transactions. Moreover, a student loan entails the same risk whether the federal government or the private market makes it, because the federal government cannot reduce risk.<sup>2</sup> The possibility that the borrower

## Federal Student Loan Programs

The federal government offers several types of student loans to help promote access to higher education. The main programs—Stafford, Parent Loans to Undergraduate Students (PLUS loans), Grad PLUS, and Consolidation—generally carry fixed interest rates for borrowers, provide generous deferment and forbearance terms, and offer flexible repayment plans of up to 30 years. All loans are made through one of two different administrative structures: the direct or guaranteed loan programs. Schools choose which administrative structure their students will use.\*

Under the direct loan program, the federal government raises money in the Treasuries market and lends funds directly to students. Borrowers repay loans directly to the federal government. Private contractors are used to administer loan servicing.

Under the Federal Family Education Loan program (guaranteed loans), private lenders make the loans with two separate subsidies from the federal government: a guarantee against 97 percent of default losses and a guaranteed interest rate. Lenders receive an interest rate payment equal to short-term interest rates (three-month commercial paper), plus 1.79 percentage points (recent legislation changed the rate from 2.34 percentage points). Borrowers make loan payments to lenders at a fixed interest rate set in law. If the borrower interest payments do not cover the lender's guaranteed interest rate in a given financial quarter, the federal government pays the lender an interest rate subsidy, called a special allowance payment, or SAP, to make up the difference. Conversely, if the borrower interest rate payments exceed the lender's guaranteed interest rate, then the lender remits the excess portion of the borrower payment to the federal government.\*\*

\* Federal Education Budget Project, "Student Loans Overview," New America Foundation, [http://www.newamerica.net/programs/education\\_policy/student\\_loan\\_watch](http://www.newamerica.net/programs/education_policy/student_loan_watch).

\*\* Federal Education Budget Project, "Federal Student Loan Subsidy Structure," New America Foundation, [http://www.newamerica.net/programs/education\\_policy/federal\\_education\\_budget\\_project/subsidies](http://www.newamerica.net/programs/education_policy/federal_education_budget_project/subsidies).

will default on the loan, or that interest rates will fluctuate, or that relative asset values will change over time is the same whether it is the taxpayers or lenders in the private market who shoulder such risks. Therefore, cost estimates for risky financial activities undertaken by the government will accurately reflect the value taxpayers assign to the use of their resources only if they reflect the value that private markets assign to the same activity.

### Credit Reform Rules and the Current Cost Estimate Approach

The Federal Credit Reform Act of 1990 changed the method for determining cost estimates for government loans from cash to accrual accounting. Under cash accounting, costs are reflected only when funds are paid in to or out of the Treasury, so future obligations are not fully visible. Thus, direct loans look like a grant in the year that they are made, and guaranteed loans appear to have no cost in the year that they are made. Accrual accounting, on the other hand, reflects the costs of future obligations in the year that they are made, rather than in the year they are paid. Therefore, the accrual accounting approach adopted in 1990 better

reflects the future costs that may occur when the government makes either a direct loan or a guaranteed loan. Furthermore, the costs of each type of loan are more easily compared under accrual accounting.<sup>3</sup>

Credit reform rules specify how budget agencies are to compute loan costs on an accrual basis.<sup>4</sup> It requires student loan costs to be presented as a subsidy rate reflecting the lifetime cost to the government of making a direct loan or guaranteeing a loan in the year that the loan or guarantee is made. The subsidy rate is a percentage cost of the underlying loan, so that a \$1,000 loan that costs the federal government \$100 to make carries a 10 percent subsidy rate. To determine the subsidy rate, credit reform requires that budget analysts estimate the future cash flows associated with the loan to and from the federal government. These cash flows are then discounted to the present using discount rates equal to the interest rate on a U.S. Treasury bond of equivalent duration. Table 1 illustrates how the Congressional Budget Office (CBO) models cash flows for hypothetical \$3,000 guaranteed and direct loans under credit reform rules.

Table 1. Credit Reform Cash Flow for a \$3,000 Stafford Loan

Year	1	2	3	4	5	6	7	8	9	10	11	12
<b>Guaranteed Loan (\$)</b>	<b>In-School</b>											
In-School Interest Payment to Lender	204	204	204									
3% Borrower Origination Fee	-90											
0.5% Lender Origination Fee	-15											
In-School Lender Interest Rate Subsidy	12	26										
Lender Interest Rate Subsidy			39	38	36	33	29	25	20	15	9	3
Guaranty Agency Processing Fee	12											
<b>Net Cash Flow</b>	<b>123</b>	<b>230</b>	<b>39</b>	<b>38</b>	<b>36</b>	<b>33</b>	<b>29</b>	<b>25</b>	<b>20</b>	<b>15</b>	<b>9</b>	<b>3</b>
<b>Net Present Value: \$537</b>												
<b>Subsidy Rate: 17.9%</b>												
<b>Direct Loan (\$)</b>	<b>In-School</b>											
Principal Disbursed	3,000											
1.5% Borrower Origination Fee (Assumes Discount)	-45											
Principal Repayment			-220	-236	-252	-270	-289	-309	-331	-354	-379	-405
Interest Repayment			-200	-185	-168	-151	-132	-111	-90	-67	-42	-15
<b>Net Cash Flow</b>	<b>2,955</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>	<b>-421</b>
<b>Net Present Value: -\$103</b>												
<b>Subsidy Rate: -3.4%</b>												

Source: U.S. Congressional Budget Office, *Subsidy Estimates for Guaranteed and Direct Student Loans*, November 2005, <http://www.cbo.gov/ftpdocs/68xx/doc6874/11-16-StudentLoans.pdf>, p. 24.

Note: This table presents the credit reform cash flows used to estimate the costs for a hypothetical \$3,000 Stafford student loan with a two-year in-school period and 10-year repayment made under the guaranteed and direct loan programs. The loan carries a fixed 6.8 percent borrower interest rate. Positive numbers reflect a cost to the government. Negative numbers reflect a gain.

To estimate the total up-front costs of the loans, cash flows to and from the federal government are discounted to the present using U.S. Treasury bond rates. The guaranteed loan costs the government \$537 and the direct loan earns \$103. The guaranteed loan cash flow for the federal government is composed almost entirely of annual subsidy payments made to the lender that has made the loan to the student. The federal government also receives origination fees from the student borrower and the lender in the year the loan is disbursed. The direct loan cost estimate, even though the loan is the same for the borrower, is based on a very different cash flow. In year one, the cash flow reflects the disbursement of the \$3,000 loan from government and the \$45 origination fee paid by the borrower to the government. During repayment years, the cash flow reflects repayment of principal and interest from the borrower to the government.

## Market Costs vs. Government Estimates

Under credit reform estimates published by the CBO, certain federal student loans made to undergraduate students in both the guaranteed and direct loan programs, earn a return for the government. According to their figures, the average unsubsidized Stafford direct loan made in 2008 carries a negative subsidy rate of 22.2 percent, meaning that the federal government makes 22.2 cents on a net present value basis for each dollar it lends.<sup>5</sup> According to the same estimates, an unsubsidized Stafford loan made under the FFEL guarantee arrangement carries a negative subsidy of 3.8 percent.<sup>6</sup> This is due to the assumption that fees and interest rebates paid by lenders to the federal government under the guarantee arrangement will be greater than any subsidy paid to lenders and student borrowers.

**Table 2. Federal Student Loan Average Subsidy Estimates (CBO March 2008 Baseline)**

Fiscal Year	2008	2009
Unsubsidized Stafford Direct Loans	-22.2%	-23.19%
Unsubsidized Stafford Guaranteed Loans	-3.8%	-0.09%

Despite credit reform estimates that suggest direct loans earn a return, lenders acting in the private market do not make loans with similar benefits to undergraduate students. They deem such loans too risky and generous to be profitable. Similarly, financial institutions do not sell guarantee arrangements to private student lenders like the one the federal government provides in the FFEL program because the arrangements would be unprofitable. Instead, the private market suggests that in order for a loan to earn a positive return (or for the guarantee arrangement to earn a positive return), the government would have to charge much higher fees and provide less generous benefits to borrowers. Consider the differences between the terms of federal student loans and the loans made in the \$17 billion annual private student loan market.<sup>7</sup>

Private loans made to undergraduate students usually carry variable interest rates between 2 and 10 percent-

age points above a short-term interest rate benchmark. In contrast, federal student loans for undergraduates carry a fixed 6.8 percent interest rate for up to 30 years. Lenders providing private student loans always require a credit check, and may require a co-signer. Private lenders can turn away high-risk borrowers or charge them higher rates and fees. Federal student loans, on the other hand, require no credit check and offer loans to all students on the same terms. Federal loans also include generous deferment and forbearance options that are not provided by private lenders.

In sum, estimates made according to credit reform rules suggest that both federal direct student loans and loan guarantees are likely to earn a positive return for the government. If the loans and guarantees were truly profitable, entities would likely provide them at similar terms in the private market. However, private entities consider the loans and guarantee arrangements to be too risky. Differences between loan costs under credit reform and the costs implied by private markets are the essence of the market cost concept.

## Misleading Market Cost Information

Although budget analysts, academics, and student loan interest groups recognize that the government's cost estimates for the student loan programs differ from the market's estimates, much of the published work on the topic includes serious errors that misrepresent the market cost concept. This misinformation is in part the result of lobbying efforts by the student loan industry, but government agencies are also responsible for incorrect interpretations of the concept.

Some reports incorrectly conclude that market cost estimates are relevant only for direct loans and not for guaranteed loans. Others fail to recognize that a market cost estimate for guaranteed loans should make adjustments to credit reform cash flow models to reflect the risky cash flow between the private lender and the borrower. Similarly, the literature argues for estimates that incorrectly reduce the cost of guaranteed loans. On the other hand, some facets of the market cost concept are correctly identified in the existing literature. For example, the literature correctly says that estimates must more accurately account for administrative costs, and that estimates should be based on discount rates that reflect the private market's assessment of risk.

## Why Market Costs Matter for Both Student Loan Programs

Some student loan trade associations argue that market cost estimates should only be applied to direct loans, or that guaranteed loans are unaffected by such estimating techniques. In fact, market cost estimates are equally relevant for estimating the costs of both programs because both types of loans expose the federal government to very similar risks and obligations.

Loans under both federal programs are made to the same populations at nearly identical borrower terms, including interest rates and repayment length. Moreover, the federal government bears similar default and interest rate risk whether it guarantees a loan or makes it directly. In the FFEL guaranteed loan program, the 97 percent default guarantee exposes the government to nearly all of the default costs it would assume in making a direct loan.<sup>8</sup> Additionally, the interest rate subsidy arrangement for lenders in the guaranteed program exposes the government to interest rate risks similar to those it faces when making loans directly.

Despite the similar risks in both loan programs, the mar-

ket cost literature often excludes any discussion of market cost estimates for guaranteed loans. A paper published in 2006 by America's Student Loan Providers, a trade association, focuses entirely on market cost estimates regarding direct loans and dismisses the concept with respect to guaranteed loans.<sup>9</sup> (For other examples of this approach, see the text box on page 10). Douglas Holtz-Eakin, a former director of the Congressional Budget Office, argues in a paper commissioned by student loan companies and trade associations that direct loan cost estimates should include market costs because "in making direct student loans, the Government assumes market risks and uses its powers to pass these risks along to taxpayers."<sup>10</sup> Although Holtz-Eakin's reasoning applies equally to government-guaranteed student loans, he makes no mention of them in this regard.

## The Problem with "Risk-free" Discount Rates

Discount rates are used to estimate the value of a future cash flow from a loan (repayment of principal and interest) in today's dollars by accounting for the time value of money and the effects of risk and uncertainty on the value of a loan. The riskier the loan is, the lower its present value will be which is reflected in cost estimates by using higher discount

### Does the Government Have a Financing Advantage in Treasury Bonds?

Some sources claim that the federal government has a financing advantage over private loan companies that makes student loans profitable when they otherwise would not be. They argue that the government can finance the loans at a lower cost than the private market can by issuing Treasury bonds with below-market interest rates.\* This so-called financing advantage is an accounting illusion.

The federal government is able to borrow at a lower cost because it has the power to tax to cover its obligations. However, the loans it makes with the borrowed funds are not less risky. The lower cost stems from the fact that the risks inherent in the loan have been spread among current and future taxpayers, and are no longer borne by the bondholders, as would be the case in the private market.

Put another way, individuals purchasing Treasury bonds accept lower interest rates on the bonds than they would for corporate bonds, not because the student loan that the bond has financed is less risky than if private entities had made the loan, but because the federal government can compel taxpayers to pay the bondholder regardless of what happens to the student loan. If the loan goes into default, or interest rate changes diminish its value, the federal government will still pay bondholders by raising the necessary revenue. The private market offers bondholders no such guarantee. In essence, Treasury bondholders are insulated from risk—but the risk associated with the loan as valued in the private market is the same whether it is financed by means of corporate bonds or Treasury bonds.

\* Kim Clark, "Student Loans Make Money for Taxpayers," U.S. News and World Report, May 21, 2008.

rates. A higher discount rate makes a future cash flow worth less in today's dollars; a lower discount rate makes it worth more.

However, credit reform rules do not allow for the use of such risk-based discount rates in making federal loan cost estimates. Instead, the rules require the use of U.S. Treasury bond interest rates to discount loan cash flows.<sup>11</sup> Interest rates on Treasury bonds represent a "risk-free" rate that is lower than other securities in the market because the government is not likely to default on its debt given its taxing authority. In short, credit reform and private market techniques for estimating the value of a loan differ because private entities would use a discount rate that reflects an appropriate level of risk, while the government allows only "risk-free" discount rates.

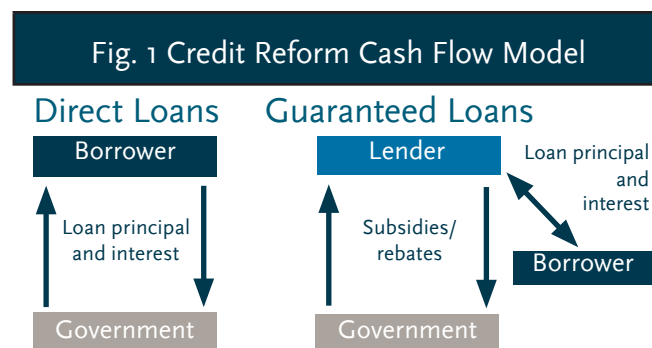
The market cost literature correctly identifies this discrepancy. For example, the paper by America's Student Loan Providers states that "in the case of direct loans, not accounting for risk through the discount rates assures that the budget subsidy amounts overvalue the future cash flows...."<sup>12</sup> And a report by PricewaterhouseCoopers concludes that "a market-based rate should be used to discount the cash flows associated with direct loans and loan guarantees made by the government."<sup>13</sup>

### The Problem with Cash Flow Models for Market Cost Estimates

Appropriate discount rates are not the only major component of a market cost estimate. Estimates should be based on loan cash flow models that reflect risk in a manner similar to those used by the private market. Cash flow models for direct loans under credit reform reflect risk in much the same way that the private market would. But cash flows for guaranteed loans do not. Almost none of the market cost literature identifies this key point. It is perhaps the most significant error in the methodology and reasoning in existing market cost literature.

Direct loan cash flows modeled under credit reform rules reflect the disbursement of the loan to the student and the repayment of the loan with interest over time (see table 1 and figure 1). Because this cash flow treatment accounts for risk in much the same way that the private market would, discounting the cash flow at higher, market-based rates produces cost estimates consistent with the market cost concept. The use of a higher, market-based discount rate reduces the present

value of the future repayment of interest and principal to the government, increasing the cost of the loan. The market cost literature includes a correct interpretation of this concept for direct loans. As the PricewaterhouseCoopers study notes, "[Direct loan] future cash inflows will be worth less (i.e., government costs will increase) because they will be discounted at a higher rate."<sup>14</sup>



On the other hand, guaranteed loan cash flows under credit reform rules are treated very differently. Specifically, guaranteed loan cash flow models do not reflect the loan that has been made to the student borrower because they do not show the disbursement of principal and repayment of interest and principal. Instead, cash flow represents the subsidy payments from the federal government to a lender (see table 1 and figure 1). In one sense, this presentation is accurate because the lender, not the federal government, has made the loan to the student, and credit reform rules are concerned only with cash flow to and from the government. To be consistent with private market cost estimates, however, the cash flow model used in the estimate should reflect the cash flow of the loan that the lender has made to the student. It is this cash flow that exposes the government to default and interest rate risk.

Most of the market cost literature fails to mention this important point, and instead accepts the credit reform cash flow model as an accurate reflection of the risk that the government assumes in each loan program.<sup>15</sup> The literature fails to recognize that although the government's role in each program differs, the risks and obligations the government bears in each program are very similar and that this should be reflected in the cash flow model. This leads to a related error in most of the market cost literature.

The literature argues that higher, market-based discount rates should be applied to the credit reform cash flow for guaranteed loans to produce market cost estimates, which

## Examples of Misleading Market Cost Reports

### PricewaterhouseCoopers, *The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs* (March 2005)

This paper, commissioned by companies that make federal student loans, points out that direct loans and guaranteed loans display very different cash flows under credit reform rules and recognizes that “discount rate changes have asymmetric impacts on the estimated subsidy costs of the two programs due to differences in the timing of their cash flows.” There is no discussion, however, of the fact that the two cash flows are not comparable and that applying a higher discount rate to guaranteed loans produces incorrect results. Instead, the paper concludes, “discounting with the market-based rate would result in higher costs for FDLP [direct loans] relative to FFELP [guaranteed loans].” The paper leads readers to believe that such an outcome is an accurate reflection of market values when, in fact, it is inherently flawed. Logically, market cost estimates should in fact have symmetric impacts on subsidy cost estimates given the similar risks for the government in both types of loans.

### Government Accountability Office, *Federal Student Loans: Challenges in Estimating Federal Subsidy Costs* (September 2005)

In this report, the GAO concludes that “using a risk-adjusted [market] discount rate would have a greater impact on the subsidy cost estimates of FDLP [direct loans] relative to FFELP [guaranteed loans]” and that “this difference would result, in part, because of differences in the amount and timing of cash flows.” While this conclusion is mathematically correct, it is an incorrect interpretation of the market cost concept. Market discount rates should produce similar effects for direct and guaranteed loans because loans under both programs represent similar risks for the federal government. Instead, the GAO’s conclusion is based on the effect of applying a higher discount rate to both the direct and guaranteed loan credit reform cash flows. Discount rates lower than risk-free Treasury rates, however, best reflect the market cost of a guaranteed student loan when the credit reform cash flow model is used.

### America’s Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less* (May 2006)

America’s Student Loan Providers, which represents private lenders making federal student loans, argues in this paper that market-based discount rates should be used to reflect market values for the direct loan program, but not the guaranteed program. The ALSF concludes that market discount rates increase the government’s cost of making a direct loan compared to credit reform rules, reflecting the value that the private market places on the activity. However, the paper incorrectly states in a footnote that the government’s costs for guaranteed loans are unaffected when market discount rates are used. “Because most of the [guaranteed loan] program costs are early in the loans lives (in-school interest payments and defaults), [guaranteed loan] program subsidy estimates are far less sensitive to discount rates and are not affected by the higher rate.” The ALSF erroneously draws this conclusion because it applies the discount rates to the guaranteed loan cash flow as calculated under credit reform rules. It makes no mention of the problems inherent in using this cash flow model and higher discount rates to produce market cost estimates.

would appear to lower the government’s cost for guaranteed loans. This occurs because the guaranteed loan cash flow is composed of deferred payments (interest subsidy payments and in the case of default, a one-time payment) that decrease in value as discount rates increase. However, this methodology is incorrect. A market cost estimate for guaranteed loans that employs the credit reform cash flow model rather than the cash flow between borrower and lender should use discount rates that are *lower* than Treasury rates.<sup>16</sup>

By definition, the market value of the guarantee arrangement is equal to the value of the protection from uncertainty and potential financial loss that the government provides to the lender. Discounting future payments to lenders at risk-free rates implies that the protection provided by the guarantee arrangement is worth only the face value of its payments, minus the risk-free value of money over time. But the private market places a value on the uncertainty of the events that trigger payments under the guarantee (default and interest rate fluctuations) that is in addition

to the face value of the payments themselves. To account for the market value of this uncertainty, the guarantee payments must be worth *more* than the sum of their credit reform cash flow discounted at risk-free rates. This additional value is reflected by discounting the credit reform cash flow at rates *lower* than risk-free rates, which increases the value (cost) of the guarantee.

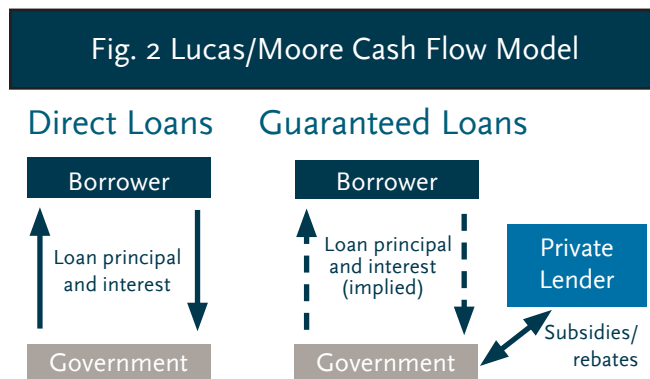
Thus, under credit reform cash flow models, a market cost estimate would account for the increased risk of a 20-year loan versus a 10-year loan by using a lower discount rate, increasing the present value of the guarantee. The error in arguing that higher discount rates reflect greater risk should be clear in this example. An increase in the discount rate reduces the value of the guarantee even though it is worth more because the 20-year loan is riskier. However, most market cost literature incorrectly argues the opposite. According to the GAO, for example, “The student loans would reflect the market’s valuation of the loans, because the expected cash flows would have been discounted using a *higher discount rate* that incorporates risks—such as interest rate risk—that are not included in [the Department of] Education’s subsidy cost model [emphasis added].”<sup>17</sup> (See the text box on page 10 for other examples of this incorrect approach.)

### Guaranteed Loan Cash Flow Adjustments

Northwestern University’s Deborah Lucas and the CBO’s Damien Moore recognize the problems that the credit reform guaranteed loan cash flow model poses for determining a market cost estimate. Their 2007 paper for the National Bureau of Economic Research represents the most complete and robust market cost estimate of the federal student loan programs to date.<sup>18</sup> And their conclusions are quite different than those reached by student loan providers, interest groups, and other government agencies.

In their estimates, Lucas and Moore use a market-based discount rate derived from the private student loan market. To correct for the treatment of guaranteed loan cash flows under credit reform, they model the cash flow as an “implied” loan. The guaranteed loan cash flow is presented as if the government is making a *direct loan* to a student, but with funds it borrows from private banks. Interest rate subsidy payments the government pays to the lender through the guarantee arrangement are treated as financing costs. In other words, the subsidy payments are treated as interest on the funds the government hypothetically borrowed

from the bank to make the direct loan. When compared to credit reform rules, Lucas and Moore’s implied loan technique allows for the risky cash flow from the loan—the principal and interest payments—to be more fully revealed and correctly discounted at a higher, market-based rate. Moreover, it models the risky cash flows for guaranteed loans in a method comparable to that used for direct loans (see figure 2).



Using these techniques for loans issued in the 2006–07 academic year, Lucas and Moore find that both direct and guaranteed loans are more costly than reported by the CBO under credit reform rules.<sup>19</sup> Their work suggests that the average direct loan costs the federal government about \$20 for every \$100 lent (20 percent subsidy) over the life of the loan, instead of earning \$4 (negative 4 percent subsidy) as stated by the CBO in its 2006 baseline projections.<sup>20</sup> Likewise, they suggest that the government’s guarantee arrangement with lenders costs \$31 for every \$100 lent (31 percent subsidy), compared to 12 cents (12 percent subsidy) under credit reform rules as reported by the CBO.<sup>21</sup>

### The Question of Administrative Costs

Under credit reform rules, loan program administrative expenses incurred by the federal government are excluded from cost estimates. Both direct and guaranteed student loan program estimates exclude salary and information technology expenses incurred by the Department of Education. Payments made by the federal government to private contractors that service the direct loan program are also excluded. The Office of Management and Budget estimates that the administrative costs of a direct loan amount to \$1.50 for every \$100 lent (or 1.5 percent) over the life of the loan, in present-value terms. A guaranteed loan costs \$0.37 for every \$100 lent.<sup>22</sup>

While these expenses do not pose risks to the federal gov-

ernment per se, private market estimates for loan program costs would certainly include such administrative costs in valuing both the direct and guaranteed student loan programs. Generally, the market cost literature correctly identifies the different treatment of administrative costs under credit reform and private market estimates. Most reports, however, incorrectly suggest that incorporating administrative costs accounts for a significant share of any cost difference between direct and guaranteed loans. Lucas and Moore demonstrate that administrative costs are in fact only a small fraction of total market costs and do not have much influence on the relative costs of each loan type. The authors find that administrative costs make up \$2.10 of the \$20 it costs to make a \$100 direct loan.<sup>23</sup> In comparison, they show that administrative costs make up \$0.80 of the \$31 it costs to guarantee a \$100 loan.

### More Costly Than We Think

The debate over the cost-effectiveness of guaranteed versus direct federal student loans can be confusing, especially with respect to the market cost concept. Government agencies and stakeholder interest groups have correctly interpreted some aspects of the concept, but they have incorrectly interpreted others. The most problematic of these misinterpretations is the failure to identify the importance of the market cost concept for both direct *and* guaranteed loans. Another problem occurs with the unique treatment of guaranteed loan cash flows under credit reform rules when compared to a private market cost estimate. Despite the misinterpretations in much of the existing literature, some research has been published, such as work by Northwestern University's Deborah Lucas and the CBO's Damien Moore, that correctly applies the market cost concept to both student loan programs, and this research concludes that both direct and guaranteed student loans cost taxpayers much more than is reported in the federal budget. Lucas and Moore's work also demonstrates that guaranteed loans have a higher market cost than direct loans. As the debate continues it is clear that policymakers, the media, and the public are better served by a more critical examination of the existing literature on market cost estimates for these programs.

## Notes

1 While both the direct and guaranteed loan programs provide standard borrower benefits (such as fixed interest rates) as defined by law, private lenders making guaranteed loans have in the past offered additional benefits at their discretion. Supporters of the guaranteed loan program have argued that the program provides better customer service to borrowers than the private contractors who administer the direct loan program.

2 U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Guarantees*, August 2004, <http://www.cbo.gov/ftpdocs/57xx/doc5751/08-19-Credit-Subsidies.pdf>, pp. 4–5.

3 When the credit reform Act of 1990 was debated and adopted, student loans were provided only through the guaranteed program. Thus, the act originally made costs for guaranteed loans and other student aid programs more comparable. In 1992, credit reform helped to make adoption of the direct loan program possible by establishing similar budget treatment for both guaranteed and direct loans.

4 U.S. Congress, *Omnibus Budget Reconciliation Act of 1990*, Public Law 101-508, November 5, 1990, <http://thomas.loc.gov/cgi-bin/bdquery/z?d101:HR05835:@@D&summ2=m&>.

5 The term “unsubsidized” refers to Stafford loans available to all undergraduate students. Students from lower-income families may qualify for more generous “subsidized” Stafford loans, which do not accrue interest while the borrower is in school and may carry lower interest rates; U.S. Congressional Budget Office, *CBO March 2008 Baseline Projections for the Student Loan and Grant Programs*, <http://www.cbo.gov/budget/factsheets/2008b/education.pdf>, pp. 4–5.

6 *Ibid.*, 4.

7 The College Board, *Trends in Student Aid, Trends in Higher Education Series*, 2007.

8 The default guarantee was recently as high as 99 percent for lenders deemed to be “exceptional performers,” or those with good performance records, such as low default rates. Before the exceptional performer status

was discontinued, 18 lenders with exceptional performer status accounted for 90 percent of federal student loan volume.

9 America's Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less*, May 2006, <http://www.usa-funds.org/NR/rdonlyres/48014947-4D17-4021-911A-DE90C5D6986E/4863/WhitePaper2006vFINALfinal.pdf>.

10 Douglas Holtz-Eakin, *Budget-Scoring Barriers to Efficient Student Loan Policy* (prepared for the Consumer Bankers Association, the Education Finance Council, the National Council of Higher Education Loan Programs, Nelnet, and Sallie Mae), December 2006, <http://www.studentloanfacts.org/NR/rdonlyres/65DDECf9-3020-4C6A-8C8F-B568556FEA64/7398/BudgetScoringBarrierstoEfficientStudentLoanPolicy.pdf>, p. 9.

11 Thomas Stanton, *Primer on Credit Reform*, Center on Federal Financial Institutions, 1998, <http://www.coffi.org/pubs/Primer%20on%20Credit%20Reform%20by%20Stanton.pdf>, p. 8.

12 America's Student Loan Providers, *Guaranteed Student Loans Cost Taxpayers Less*, 13.

13 PricewaterhouseCoopers, *The Limitations of Budget Score-keeping in Comparing the Federal Student Loan Programs* (prepared for the Consumer Bankers Association, the Education Finance Council, and the National Council of Higher Education Loan Programs), March 2005, 15.

14 *Ibid.*, 14.

15 U.S. Government Accountability Office, *Federal Student Loans: Challenges in Estimating Subsidy Costs*, GAO 05-874, September 2005, <http://www.gao.gov/new.items/d05874.pdf>, p.10.

16 Deborah Lucas and Marvin Phaup, *The Cost of Risk to the Federal Government and Its Implications for Federal Budgeting* (National Bureau of Economic Research, August 2007), <http://www.nber.org/chapters/c3039.pdf>, p. 27.

17 *Ibid.*, 32.

18 Deborah Lucas and Damien Moore, *Guaranteed vs. Direct Lending: The Case of Student Loans* (National Bureau of Economic Research, November 2007), <http://www.nber.org/chapters/c3038.pdf>.

19 Lucas and Moore make other changes to the credit reform approach that also partially account for the higher costs of both programs. These include changes to the collection costs and rates for defaulted loans and the treatment of consolidation loan default rates, and the inclusion of all administrative costs incurred by the government.

20 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30; and Congressional Budget Office, *CBO March 2006 Baseline Projections of Mandatory Outlays, supplemental data, education, student loans*, March 2006, p. 4.

21 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30; and Congressional Budget Office, *CBO March 2006 Baseline Projections of Mandatory Outlays*, 3.

22 Budget of the United States Government, Fiscal Year 2009 Appendix, 364.

23 Lucas and Moore, *Guaranteed vs. Direct Lending*, 30.

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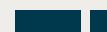
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## **Direct Lending Gains Participants as Troubles Plague Bank-Based System**

By [PAUL BASKEN](#)

*Washington*

Student borrowing through the Education Department's direct-lending program has grown this year by nearly 50 percent, at the same time the bank-based alternative has grown reliant on a federal rescue plan and has become increasingly difficult for government watchdogs to monitor.

The department, in a series of new statistical reports released on Friday, showed that:

- \* Nearly 400 new colleges joined the department's direct-lending program this year, with their students borrowing \$16.4-billion, while student borrowing through the bank-based system of loan companies using federal subsidies dropped 3 percent, to \$30.6-billion.
- \* Lenders using the financial rescue authority approved this year by Congress have collected reimbursement for about 40 percent of total loan volume in the bank-based system, and have claimed future eligibility for much of the remainder.
- \* An [audit](#) by the department's Office of Inspector General cast doubt on the department's claims of only \$258-million in annual improper payments in the bank-based system, saying the system is too complicated and the accounting methodology too flawed for it to have confidence in that number.

The complications and economic uncertainties in the bank-based system are driving colleges over to direct lending, said Roberta L. Johnson, director of student financial aid at Iowa State University and chairwoman of the National Direct Student Loan Coalition.

"There were a lot of schools that were very concerned about having loan funding available," Ms. Johnson said, explaining the growth, to 1,369 colleges participating in direct-lending on September 18 from 975 institutions participating on the same date last year.

The direct-loan program was created in 1993, largely at the insistence of Democrats who argued that the Education Department could supply students with loan money more efficiently than by giving private lenders both a subsidy and a guarantee of repayment in the event the borrower defaults.

Direct lending has remained far smaller than the bank-based system—about a fifth of the size in recent years—as loan companies used their subsidies to give students lower rates and offer colleges more attentive service.

### **Making the Switch**

Those advantages have largely disappeared over the past two years, however, as Congress both slashed the subsidy rates and restricted the ability of banks to provide colleges with loan-processing services and other financial benefits.

One of the financial-aid officials making the switch this year, Harlan Plunkett at MidAmerica Nazarene University, in Kansas, said he had been a staunch defender of the bank-based system. The university reluctantly signed up for direct lending, however, after a series of loan companies announced this summer they were revising or eliminating service on the campus, Mr. Plunkett said.

"In the small amount of time we have participated in direct lending, I have been pleasantly surprised by the direct-loan system," he said. "It has proven to be a wonderful decision in spite of the challenges we faced in" the transition process, he said.

New participants have included both private colleges and large state institutions, like the Indiana University system; Kansas, Michigan, and Pennsylvania State Universities; and Purdue University, Ms. Johnson said. Representatives of some for-profit institutions, however, have expressed fear that joining direct-lending could lead some loan companies to stop offering their students private loans, she said. Many for-profit colleges rely heavily on private loans, which banks issue outside the government system to students who have exhausted their federal-loan limits.

The subsidy cuts in the bank-based system were followed by this year's collapse of the mortgage industry, which constricted all forms of borrowing. The Bush administration and Congress introduced a plan in May that lets private lenders sell the government assets that are based on newly issued loans, giving the companies cash so they can issue new loans to more students.

### **Active Buyback Program**

A total of 10 lenders have sold loan assets to the Education Department under the plan, worth about 40 percent of total volume in the bank-based system, said Dennis M. Cariello, a department lawyer handling the buyback program.

Lenders have submitted paperwork making much of the remaining volume in the bank-based system eligible for the buyback authority, which is also helping to make money available to students by giving nervous outside investors the confidence to purchase student-loan debt, Mr. Cariello said.

The department also continues to get the payments to lenders within two or three days, and hopes to eventually have a system for one-day turnarounds, he said. Some loan companies, especially state-run agencies and other nonprofits, have said they can't take advantage of the buyback plan because they have too little available cash to even begin writing loans.

The department, which originally promised a turnaround time of less than 10 days, realizes the importance to some loan companies of a speedy process, Mr. Cariello said. "When we were originally talking of 10 days, they said, Well, that's 10 days that a bank can go out of business," he said. "If it's a couple hours or no more than 24 hours, well, the economy's in flux, but there aren't too many banks that are going out of business in 24 hours' time."

Despite such concerns among individual lenders, the department still sees no evidence of students unable to find federally subsidized loans. Not a single borrower is known to have tried this fall to use a backup system known as "lender of last resort," Mr. Cariello said.

The Education Department, prodded by Congress, engaged this summer in sometimes-contentious private-sector negotiations that produced expanded lender-of-last-resort protections. The provisions establish a process for giving additional access to federal loan money to any eligible student rejected by at least three private lenders.

"The pieces are in place in case there is a problem," Mr. Cariello said, "but no one has come to us yet, to my knowledge."

## **Growth in Detected Losses**

The audit issued on Friday by the department's inspector general, meanwhile, added to an accumulating body of evidence of the complexity of the bank-based system. The audit cited department estimates that taxpayers lost \$258-million in annual improper payments in the bank-based system in fiscal year 2006 but only \$2-million in fiscal year 2007.

Such variations in the estimation of improper payments, which typically involve a loan company overbilling the department, show both that the department isn't keeping good records and that the system itself is so complicated that the department's failures are understandable, an audit-agency official said. Lawrence A. Warder, the department's chief financial officer, promised in a written response to the audit to put in place a series of suggestions by the inspector general's office for improving the quality of its loss estimates.

The American Council on Education challenged the inspector general's decision to criticize the Education Department's methodology without producing its estimate of annual losses. The bank-based system "is mind-numbingly complex, but it's a pathetically narrow bureaucratic response" for the inspector general to find fault without offering its own suggested method, said Terry W. Hartle, the council's senior vice president for government and public affairs.

An official of the inspector general's office, speaking on the condition he not be identified by name, said the auditing agency felt it could identify flaws in the department's practices, but it did not have the resources to carry out the monitoring and calculations on its own.

John P. Higgins Jr., who retired this past summer as inspector general after 40 years of federal service, said in an interview that the complicated bank-based loan system stood out for its susceptibility to costly waste and abuse.

Because of that complexity, the department essentially pays loan companies that submit the paperwork for subsidies and guarantee reimbursements, with little ability to review any cases that aren't the subject of a complaint, said Robert M. Shireman, executive director of the Project on Student Debt. "It's an honor system," Mr. Shireman said.

The buyback provisions introduced this year for the bank-based system, which required Treasury Department officials to get a closer look at its operations, are causing a new level of awareness within the administration of the complexities and resulting problems, Mr. Shireman said.

That could help accelerate the likelihood that next year Congress will overhaul and consolidate what has now effectively become three separate methods for delivering student-loan money, said Mr. Shireman, a former senior education-policy adviser in the Clinton administration. Such a consolidation could leave private companies with a role, but perhaps more restricted to servicing functions rather than loan ownership, he said.

## Penn State completes Federal Direct Loan Program implementation

Monday, September 22, 2008

University Park, Pa. -- Fall registration marked the successful completion of Penn State's implementation of the federal Direct Loan Program. As of Sept. 7, the Office of Student Aid disbursed \$180 million in federal Direct Loans funds — Stafford, Parent PLUS, and Graduate PLUS — for more than 40,000 undergraduate and graduate students compared to \$137.2 million in Federal Family Educational Loan Program (FFELP) funds in 2007. The University is among the top five institutions with the greatest Direct Loan volume in the country.

One of the Direct Loan programs that experienced the most growth at Penn State was the Graduate PLUS Loan. This fall, 22 percent more graduate students have turned to Direct Loans, rather than rely on private loans, to borrow beyond the maximum Stafford Loan limits to help pay their educational costs.

The University joined the federal Direct Loan Program — in which students and parents borrow their federal loans directly from the federal government rather than from banks or lenders — in summer 2008, to ensure students and parents had access to a secure source of federal loan funds despite unstable market conditions. Dozens of banks and private lenders stopped offering federal loans to students in 2008 due to downturns in the credit markets and cuts in government subsidies. "Having a secure source of government-backed educational loans has brought relief to students and families who were worried about the availability of these loans due to the instability of the credit markets," said Anna M. Griswold, executive director of student aid and assistant vice president for Undergraduate Education.

Nine out of 11 Big Ten institutions participate in direct lending. The number of higher education institutions that participate in direct lending continues to grow. According to the Sept. 2 edition of The Chronicle of Higher Education, more than 300 institutions made the switch to direct lending this year alone. Universities such as Penn State, who switched recently to direct lending, created a 43 percent jump in loans originated through the federal Direct Loan Program.

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*Today's News*

Tuesday, September 2, 2008

## As 'Crisis' Deters Loan Companies, Direct Lending Sees 43-Percent Jump

By PAUL BASKEN

Washington

The Education Department's direct-lending program has seen a 43-percent jump in business already this academic year, after a series of private lenders stopped offering government-backed student loans.

The department, in its first statistical tally for the new academic year, said on Friday that it had originated more than \$10.84-billion in loans at 1,156 colleges as of August 8. At the same time last year, the direct-lending program had originated nearly \$7.55-billion in loans at 851 institutions.

Most students with government-subsidized loans obtain them through private lenders that receive both interest subsidies and federal guarantees of repayment. In direct lending, however, students obtain their loan money from the Education Department. Last year about a fifth of students used this alternative.

Student borrowers can obtain loans directly from the department only if their colleges have signed up for the direct-lending program. Demand for the system had been expected to grow this fall, after a combination of subsidy cuts in the bank-based system and tougher economic conditions led dozens of private lenders to stop offering federal loans, leaving colleges uncertain as to how many bank-originated loans would be available to serve their students.

The largest user of the bank-based system to switch to direct lending this year was Pennsylvania State University, which wanted a secure source of funds for its 43,000 student borrowers after the state-chartered Pennsylvania Higher Education Assistance Agency, a loan company also known as Pheaa, stopped offering federal loans.

Penn State students have already borrowed more than \$100-million in student-loan money through the direct-lending system, and the university is "pretty pleased" so far with the process of drawing the money from the federal treasury, said Anna M. Griswold, the university's executive director of student aid and assistant vice president for undergraduate education.

Private lenders have been fighting the expansion of direct lending since it was established in 1994, arguing that they provide better customer service and discounts beyond the federally mandated minimum prices. But the recent subsidy cuts—imposed by Congress in an attempt to bring the cost of the bank-based system down closer to the cost of direct lending—have led many loan companies to reduce both service levels and the discounts they offer students.

The rush to direct lending may also have been spurred by media reports raising doubts about the ability of banks and other private loan companies to participate in the system of federally guaranteed loans. Such reports often blurred the distinction between federally subsidized loans and higher-cost private loans, which students often pursue after have reached their annual borrowing limits under the federal program.

Private loans are costlier and scarcer this year because of an overall tightening in credit markets, while the federally guaranteed loans remain available to all students at even lower rates than last year.

Loan companies seeking to press Congress to reverse the subsidy cuts in the federal program often encouraged the notion of a crisis in both federal and private lending.

"If you thought there was an asset class that would be OK, it would be federal loans that have a guarantee from the government," Tom Joyce, a spokesman for Sallie Mae, the nation's largest student loan company, was quoted as saying in an article that appeared last March in *The Washington Post*. "But even that market has gone from tremors to earthquakes."

That article, like many others, suggested students seeking federally guaranteed loans would be paying more, without noting that the actual interest rate paid by students has dropped this year to 6 percent from 6.8 percent last year. Such articles instead have focused on the possibility that cash-strapped loan companies might stop offering to reimburse certain fees paid by students. Those fees, however, are usually worth much less to the student than the overall interest-rate reduction mandated by Congress.

*The Post*, in a follow-up article on Sunday, reported that analysts and others found it "surprising" that most students have been able to borrow the money they need for college.

Loan companies realized their warnings could lead some colleges into the direct-lending program, but felt they owed students their best assessment of conditions, said Kevin Bruns, executive director of America's Student Loan Providers, an industry lobby group.

"That was a risk loan providers were willing to take," Mr. Bruns said. "It was a risk we had an obligation to take considering the millions of students and thousands of schools we serve and continue to serve. It would have been gross negligence not to raise alarms."

### **Buyback Program Active**

Congress and the Education Department, hoping to help loan companies stay in the federal program, created a system this summer through which the lenders can sell their loan portfolios to the government. That provides the loan companies with cash so they can issue students more government-backed loans. The loan companies needed the help because economic conditions have left many outside investors unwilling to purchase student-loan debt.

The new loan-purchase program is running well, Education Department officials reported last week, with more than \$1.7-billion distributed to loan companies in the first 12 days of the buyback program. The department also has been able to make the loan purchases and get the money into the hands of the lenders within an average of two or three days, the officials said.

Sallie Mae, saying it was helped by the buyback program, announced last week it was reducing the amount of money it needed to borrow elsewhere to finance its operations.

The Education Department doesn't yet have figures for volume in the bank-based system this year that can be compared to direct-loan tallies, though initial numbers suggest the direct-lending system may be growing to the point at which it could become comparable in size. The bank-based system has issued nearly \$13-billion in loans at 3,230 colleges so far this academic year, according to the department figures provided on Friday. In the previous academic year, private lenders distributed nearly \$55.8-billion in government-subsidized loans at 4,612 participating institutions.

Penn State was the ninth largest user of the bank-based system last academic year, according to Education Department figures obtained last week by the college advisory firm Student Lending Analytics. The figures showed that for-profit institutions accounted for seven of the 10 largest users of the system. The two other nonprofit institutions in the top 10 were Nova Southeastern and New York Universities.

The largest users of the direct-lending system last year were Ohio State University, the University of Minnesota, and the University of Florida.

Ms. Griswold said that she had not seen "any major glitches" with direct lending at Penn State, and that she believed she and her staff can manage direct lending at least as well as bank-originated loans. "Probably better," she said. "When there was a problem" with Pheaa, she said, "getting it resolved took a little bit more effort."

August 13, 2008

## What Student Loan Squeeze?

*There is still money available; here's where to find it.*

By Jane Bennett Clark

Still haven't nailed down your student loans for the coming semester? Worried about your chances of getting money amid reports that student loans have dried up? Fear not. Federal loans, the best and by far the most prevalent student loans, are still available.

As for private loans, which make up a relatively small part of the student-loan universe, students with good credit and a creditworthy cosigner can still get those, too. But expect to pay higher fees and interest rates than in past years. Here's the skinny.

### Stafford Loans: Still Available

A few months ago, the picture for all student loans looked grim. Many lenders, including several big ones, were having trouble financing the federally backed student loans known as Staffords. That represented potential disaster for the six million students who rely on these loans, which offer a fixed interest rate (6.8% or less), flexible repayment and other generous terms.

Lawmakers averted the crisis by giving the Department of Education authority to buy back the loans from lenders or otherwise provide financing for them. The move staunched the flow of lenders out of the student-loan market but didn't stop it altogether. Since last spring, more than 100 private lenders -- most recently Brazos and the Massachusetts Educational Financing Authority -- have suspended some or all of their federal student-loan programs, according to Mark Kantrowitz of [Finaid.org](http://Finaid.org). But other lenders, including big players such as Sallie Mae, PNC and Citibank, have picked up the slack.

The effect of all this drama? For students who attend schools that participate in the federal Direct Lending program, none: Those students borrow directly from Uncle Sam. As for students who borrow their federal loans through private lenders, as most do, those who haven't already lined up a lender should head straight to the financial-aid office, says Kevin Walker, of [SimpleTuition.com](http://SimpleTuition.com), a student-loan comparison site. "Those offices are on the front lines. They know who is making the loans and who isn't."

### Private Loans: Tough to Get

The solution isn't as easy for families who still hope to secure private loans, which some families depend on to fill any gap between federal loans and the cost of tuition. About 30 lenders, including Bank of America and Wachovia, have lately dropped or suspended their private student-loan business, and lenders who remain have tightened their underwriting criteria.

Where once students with poor credit -- say, a FICO score of 620 -- could get one of these loans, it now takes a score of 650 or higher plus a creditworthy cosigner. And borrowing the same amount of money will cost more in interest rates and fees than it did a year ago.

Some lenders are refusing to make any private loans to students who attend community college or career-training schools, where the population tends to be lower-income. "A year ago, probably 75% or 80% of our students were approved for a private loan. Today, the estimate is 25% to 35%," says Harris Miller, president of the Career College Association.

To help students with poor or no credit fill the gap between federal student loans and tuition, lawmakers recently raised the maximum on unsubsidized Stafford loans by \$2,000 annually. Students can now borrow up to \$5,500 for their freshman year, \$6,500 for their sophomore year, and \$7,500 each for junior and senior years. That boost has been especially helpful for students at career colleges, says Miller, because \$2,000 represents the amount they typically borrow in private loans to cover tuition.

For students who still fall short, “institutions will have to look at what they can offer,” says Justin Draeger, of the National Association of Student Aid Administrators. The financial-aid office may have the flexibility to give your strapped student a tuition discount, a bridge loan or a tuition payment plan. Meanwhile, students should scout out grants and scholarships until the last minute, says Miller. “Pursue all the avenues.”

## **PLUS Loans: To the Rescue**

Parents who are willing to borrow to help finance their kids’ education have another great resource: PLUS loans. The parent equivalent of Staffords, these federally backed loans not only offer a fixed rate of 8.5% or less plus flexible repayment terms, but they also let parents of dependent students borrow up to the full cost of attendance.

To get the loans, parents must pass a basic credit test. Standards have always been relatively lenient, but recently they’ve been relaxed even more. At one time, being seriously delinquent on mortgage payments or bills would have been a deal breaker. But the same legislation that raised the limit on Stafford loans leaves the door open to applicants who are no more than 180 days late on repayment of a home mortgage and no more than 89 days late on other debt.

Under the old rules, repayment of PLUS loans had to begin within 60 days of disbursement unless lenders agreed otherwise. Under the new law, you can defer repayment until six months after your student graduates.

Dependent students whose parents don’t pass muster under the new standards have yet another fallback. They qualify for a higher amount of Stafford loans: up to \$9,500 a year for the first year, \$10,500 as a sophomore and \$12,500 as juniors and seniors.

## **Home Equity: Don’t Count on It**

Not long ago, home-equity loans represented a crucial element in college financing, and for good reason. Families could tap the equity in their homes and deduct the interest on up to \$100,000 of the borrowed amount. In recent years, families have tapped as much as \$25 billion annually in home equity to cover education expenses, says Walker.

In areas where housing prices have dropped, however, lenders have frozen or reduced home-equity loans, limited the amount homeowners can take out in new loans, or stopped making the loans altogether. (See *The Home Equity Door Slams Shut*.) Parents who no longer have access to this resource can go with a PLUS loan or call their student’s financial-aid office to discuss other options.

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Aug 4, 2008

## Some averted MEFA problems

### Holy Cross, Becker made loan switch

By Jacqueline Reis TELEGRAM & GAZETTE STAFF  
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All the upheaval in the student loan market has actually benefited Ronald A. Burgess of Florida, a student at Becker College in Worcester.

Like the College of the Holy Cross, Becker switched this summer from the Federal Family Education Loan Program to direct loans, meaning that students looking for federal loans apply directly through the college, not through a third party lender, such as a commercial bank. Advocates, among them U.S. Sen. Edward M. Kennedy, D-Mass., have encouraged schools to move to direct loans as some private lenders stopped offering federal loans.

Becker notified Mr. Burgess, 20, of the switch in mid-June, after the lender he used in his first year had denied his application because of the change.

"I kind of panicked, but I actually did what they told me to do," he said of Becker.

He went to the financial aid office, which counseled him through the application process. He took out two Stafford loans, and he learned that he might want to have his mother or father take out a PLUS loan in his name for the following year. (PLUS loans, unlike Stafford loans — which are in the student's name — can be taken out for the full cost of attending college.) Mr. Burgess will still need a \$4,000 private loan from an outside lender to pay this year's costs, but, thanks to more financial aid, that's less than the \$10,000 in private loans he needed last year, he said.

While his increase in financial aid isn't directly related to Becker's switch to direct loans, the ease of finding a federal loan and the face-to-face guidance is. "I love the way it is now," said Mr. Burgess, a management student who said he had a hard time finding a loan last year.

Holy Cross decided to switch to direct loans after the Massachusetts Educational Financing Authority announced in April that it would not offer federal loans this year, and after Citibank told the school in May that it would not offer federal loans to Holy Cross students. Ninety-eight percent of Holy Cross families had federal loans through MEFA, and Citibank balked when it saw it hadn't done high volume at the college in the past, according to Lynne M. Myers, Holy Cross' director of financial aid.

"We were very uncomfortable with the fact that lenders were leaving," she said. That overrode the benefits the FFELP program had offered in the past, such as lower fees and the possibility of lower interest rates.

"There was a whole past, when the FFELP program was the more attractive option," she said.

But with Citibank's exit and a fear that more banks could do the same, she quickly signed the school up for direct lending.

Some schools, such as Fitchburg State College and Quinsigamond Community College, have been with direct lending for years. Direct lending is more work for a school's financial aid staff, but it also streamlines the process, said Iris P. Godes, Quinsigamond's dean of enrollment management. "It was always a challenge with students who needed a lot of help with the process ... who would forget what lender they had. ... With the direct loan program, you're in complete control."

Quinsigamond tries to make sure students know what they're getting into with a loan. Some sit and watch a video before going through the process while others read about it and take an online quiz. The money gets allocated directly to the school, which sends some to the bookstore to cover those costs. The financial aid staff has been so helpful it even e-mailed Webster resident Jennifer M. Talamini the hours the bookstore was open, she said. "Everything has been made so convenient for me," Mrs. Talamini said.

Some schools, Assumption College for one, have signed up for direct loans as a back-up plan but haven't switched over. "If the market does fall out, at least we've done the paperwork," Linda Mularczyk, Assumption's director of financial aid, said. In the meantime, there are still more than 2,000 lenders offering federal loans, and some of them offer repayment options more attractive than the direct lending plans, she said.

Many of Assumption's families took out federal loans through MEFA in the past, so they had to find a different lender this summer, Ms. Mularczyk said. Tuition deadlines have already passed at the school.

Still other schools, such as Atlantic Union College in Lancaster, are staying away from direct lending. The school has "specific representatives for our lenders ... that we can call for any need and have an almost immediate response for challenges at the school or with a student," Financial Aid Director Sandra Pereira said in an e-mail.

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## Business

Direct Loan Program is an A-plus for students

Dan Murphy, The Examiner

2008-07-23 07:00:00.0

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### **BALTIMORE -**

With student-loan lenders dropping at a fast pace over the past six months, many financial aid offices are dropping them to deal directly with the federal government.

Universities all across the country have been switching to the Direct Loan Program to receive loans directly from the government, rather than a private lender.

"Basically, it eliminates the middleman, which makes the process much easier for everyone involved," said Roberta Johnson, chairwoman of the National Direct Student Loan Coalition.

In the more common Federal Family Education Loan Program, a student borrows money from a bank or other source that is subsidized by the government.

DLP loans come directly from the federal Stafford loan or other federal programs to the university or college, which then passes it along to the student.

In the past six months, several major FFELP lenders have ended or dramatically decreased their programs, leaving schools and students to search for a new way to pay tuition.

Schools such as Towson University, which has used direct loans for more than a decade, said they were able to escape this problem by using the more reliable option.

"We're not having to deal with third-party lenders and whether they will stay in the program or not," said Vince Pecora, Towson's director of financial aid. "In that respect, it is a much more stable program."

That stability is persuading major universities — Penn State, Michigan State and Indiana universities, for instance — to make the switch.

Loyola College in Maryland is one school that previously offered multiple options. Director of Financial Aid Mark Lindenmeyer said that starting in the fall semester, direct loans will be the only ones available.

"Based on all of the problems and issues that have occurred over the past year regarding the college's ability to maintain a recommended lender list, we decided that this was the best move," Lindenmeyer said.

The change will help students by eliminating the search process and simplifying payments.

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*Examiner*



## **Penn State Direct Loan Program has successful summer start**

**Thursday, July 10, 2008**

University Park, Pa. (July 10) – Penn State’s first foray into the direct loan business is off to a healthy start. To date, about 3,000 students or parents have taken advantage of the University’s new Direct Loan program to help pay their summer tuition bills. The first round of disbursements totaled just under \$5 million with anticipated total disbursements to reach \$7.5 million for summer session, according to the University’s Office of Student Aid.

In March, Penn State made public its decision to participate in the Federal Direct Loan Program in response to the ongoing volatility of the nation’s credit markets. In the Direct Loan program, students and parents of dependent undergraduate students borrow their federal loans—Stafford, Graduate PLUS, and Parent PLUS—directly from the federal government rather than from banks or lenders.

“We, along with many other institutions around the country, were concerned and made changes to guarantee the ability of students and parents to borrow federal loans,” said Anna M. Griswold, executive director of student aid and assistant vice president for undergraduate education. “At Penn State, more than 90 percent of our borrowers lost their federal loan lenders since spring, after many banks and private lenders left the student loan business. We knew we had to do something to guarantee the stability of federal loan funds for our students and parents.”

Last year, more than 44,000 Penn State students (and some parents) borrowed \$376 million through federal loan programs. Because the University has one of the largest federal student loan volumes in the country, implementing the Direct Loan program in such a short timeframe was a significant undertaking.

A Direct Loan implementation team was appointed to make sure the program was in place beginning with the summer enrollment period. For months, the implementation team, comprised of staff from the Office of Student Aid, the Office of the Bursar and Administrative Information Systems worked to develop new systems between the U.S. Department of Education and Penn State to transmit and receive federal student loans.

The team, under an extremely short time line, was able to successfully set-up a gateway to transmit and receive data electronically with the U.S. Department of Education and also created new processes among University offices to ensure students and parents would continue to have access to their federal loan funds to help pay their educational expenses.

“Having disbursed our first Direct Loans for summer is a great success. The implementation team will continue its work during the rest of summer in preparation for the next disbursement of loans, which happens on or around the first day of classes this fall semester,” said Griswold. “Now that our participation in the Direct Loan Program will offer a secure source of federal loan funding for our students and parents, we will continue to assist students and families through this new process and remind them of the steps they need to take to secure federal loans for their next semester.”

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## **University decides on direct lending beginning this fall**

St. Thomas is changing its federal student loan process and will require students to borrow from the federal government, not banks, beginning with the fall semester.

St. Thomas, along with many institutions, is concerned by the instability in the student loan markets and has made changes that will guarantee the ability of students to borrow and consolidate their federal loans, said Marla Friederichs, associate vice president for admissions and financial aid.

Changes to the subsidies that banks received for participating in federal student loans and instability in the loan markets have put pressure on the student loan industry. This pressure, along with the resulting loss of revenue for banks, has resulted in many lenders leaving the student loan business. At St. Thomas, more than 50 percent of student loan borrowers have lost their federal student loan lenders over the last few months.

St. Thomas has decided to join the William D. Ford Federal Direct Loan Program. Beginning with the fall 2008 term, all students and parents who wish to borrow in the federal student or parent loan programs will be required to do so through the Direct Loan program.

Here are some important Direct Loan highlights:

**Funding is secure.** Direct Loans go through the U.S. Department of Education, and the funds come directly from the U.S. Treasury.

**Fees and interest rates are more favorable.** Participating in this program is not only more secure, but many of the fees and rates are more favorable. For example:

- Federal Direct Loan fees are the same for all borrowers. When working with private lenders, these fees vary by lender and guarantor.
- Federal Direct Loans have lower origination fees than their private lender counterparts, and that means more money to students up front.
- All funds are received electronically, which means no paper checks and no delays in the disbursement of funds.
- Interest rates for Federal Direct Loans and the Federal Family Education Loan Program are the same for federal student loans; however, they are lower in the Federal Graduate PLUS Loan program.

**Processing is streamlined.** Unlike working with private lenders, direct loans allow students to:

- Borrow from one source – the U.S. Department of Education.
- Complete one electronic application – via the Department of Education Web site.
- Communicate with one entity regarding loan concerns – the Department of Education where these federal loans are made, guaranteed and serviced.

**Consolidation Loans exist.** The program will allow and help students consolidate their student loan debt. Many private lenders in Federal Family Education Loan Program have discontinued doing loan consolidation.

While this change will require all students and parents who wish to borrow in the Federal Stafford or Federal PLUS loan programs to do some work over the summer, the outcome should be well worth the effort, Friederichs said.

In July, St. Thomas will send information directly to students about the process for securing loans through the Direct Loan program. The information will be detailed, thorough and time-sensitive, and Friederichs said it will be critically important for students to read the information and take action to ensure that their loan funds arrive on campus for the fall in a timely manner.

For more information, undergraduate students should go to UST's [undergraduate financial aid Web site](#), and graduate students should go to the [graduate financial aid Web site](#).

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Comments, questions about this Web page can be directed to  
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June 8, 2008

## The right way to help

Recent events have exposed major flaws in the federal approach to student aid. Some of the country's biggest banks have stopped offering loans at community colleges, for-profit universities and other less "competitive" institutions.

The Kentucky Community and Technical College System is among the victims, according to a Lexington newspaper story.

While other lenders will help fill the void, some administrators fear the turmoil may cause students to lose focus or to drop out temporarily, before finding new financial help. Ironically, that's precisely what the federal student loan system was designed to avoid.

Federal Family Education Loan (FFEL), the program some banks are leaving, was designed to ensure that student lending by private financial institutions was risk-free and profitable. However, the recent bank dropouts show that some don't think the student loan market is profitable enough.

To keep private lenders in the market, the government would have to increase subsidies, which are paid for by taxpayers, with money that could be given to students in need.

The Direct Loan Program, the other branch of the federal student loan system, is directly funded by the federal government, thus eliminating the profit needs of private lenders.

Presidential candidate Barack Obama has called for eliminating the FFEL, along with its costly subsidies to private lenders, in favor of mandating that all federal student loans be provided through the Direct Loan Program. That idea should be supported by students, parents and those who care about enlarging the country's educated workforce.

Some argue that private lenders can offer more competitive rates and other incentives to the students they choose to serve, and that ending FFEL would be a mistake. But they don't see the big picture: Without costly subsidies to private lenders, the government could offer lower interest rates and provide loans to more students in need.

Sen. Obama's approach deserves serious consideration.

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June 3, 2008

EDITORIAL

## Banks and Student Loans

Despite the credit crunch, there is little danger that students who need federally backed college loans will not be able to get them. That's partly because of a law signed last month — the Ensuring Continued Access to Student Loans Act — that will help lenders raise money to make new loans. It is also because the federal government offers loans both privately, through lenders that earn subsidies to participate in the program, and publicly, through its direct-lending program.

These programs are not equal. The credit crunch, which has caused banks to tighten lending standards, is new evidence that the direct-lending program is far preferable to its private counterpart. In *The Times* on Monday, Jonathan Glater reported that some of the biggest banks in the country have closed their doors to students seeking loans for community college, which are smaller — and less profitable — than loans for the elite, four-year colleges that the bankers covet.

Those loans are guaranteed by taxpayers' dollars, and with more than 40 percent of the country's undergraduates enrolled in community colleges, those students must be served as fairly and as well as their more affluent counterparts in four-year institutions.

Other lenders are coming to take the community-college business, but some administrators fear the turmoil might cause students to lose focus or to drop out temporarily before securing new loans. The whole point of the subsidized lending program was to prevent this kind of thing from happening. By paying the lenders a handsome subsidy — and guaranteeing the loans against default — the federal government hoped to keep the lenders in place, during good times and bad.

The community colleges that have been jilted by the private lenders need to join the direct-loan system, which allows students to borrow directly from the government through their schools. This would require slightly more administrative work by the schools. But the direct-lending program doesn't experience the kinds of disruptions that were highlighted in Monday's news article. The direct-lending program, which is much less costly, is better for the taxpayers than the private-lending system, which requires a federal subsidy.

In the short run, Congress has ordered its investigative agency, the Government Accountability Office, to review how the loan access law is being enforced. Lawmakers may have to put new requirements on banks that want to continue to receive the subsidy.

The ultimate goal, however, should be to phase out the subsidized system and handle all student loans directly.

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# Ensuring Access to College in a Turbulent Economy

Senate Health, Education, Labor and Pensions Committee  
Field Hearing, Monday, March 17, 2008  
Northeastern University  
Boston, Massachusetts

Statement of  
Eileen K. O'Leary  
Asst. Vice President/Director of Student Financial Services  
Stonehill College  
Easton, Massachusetts

Good morning Senator Kennedy and distinguished panel members. Thank you very much for the opportunity to provide testimony today at this field hearing of the U.S. Senate Health, Education, Labor and Pensions Committee. Your willingness to hold this hearing to bring clarity and calm to the question of federal student loan availability is very much necessary and appreciated.

My name is Eileen O'Leary and I am Assistant Vice President and Director of Student Financial Services at Stonehill College in Easton, Massachusetts where I have worked for nearly 25 years. I have operational and administrative experience with nearly every federal Title IV financial aid program and have counseled thousands of students seeking financial assistance to pay for their dream of earning a college education. I have administered the Federal Pell, ACG, SMART and SEOG programs; the Federal Perkins Loan and Federal Work-Study programs; and I have processed student loans through both the Federal Family Education Loan Program (FFELP) and the Federal Direct Student Loan program (DL). My professional career has been very rewarding and I am grateful to Congress for its ongoing commitment to providing access to higher education. I am especially gratified by your recent bold and definitive action in passing the College Cost Reduction and Access Act of 2007 (CCRAA) in which you chose students over private sector profits, providing the single largest increase to the Pell Grant in recent history, as well as reduced fees and interest rates on student loans and numerous other student benefits such as public service loan forgiveness, TEACH Grants, and the income based repayment option.

Unfortunately, we have arrived at a confluence of events which is being used by some to characterize the federal student loan programs as "in crisis." These events are:

- the crisis in the credit markets resulting from the sub-prime mortgage debacle which may affect the availability of capital for private (non-federal) student loans;
- the credit market situation making unfeasible the financing of federal education loans through the asset-backed securities market, particularly effecting the not-for-profit FFELP lenders; and
- the recent reduction in lender profits in FFELP through CCRAA.

The executive director of the FFELP trade group America's Student Loan Providers has stated in The Daily Beacon that "If conditions continue in the credit crisis, it's not unimaginable that next fall some families will find it difficult to find a *federal student loan*."

Congressman Kanjorski (D-PA), in his March 4, 2008 press release "expressed concern that many lenders will soon decide...to leave the student loan market."

Many media outlets have reported – either through carelessness or misinformation – that there will not be sufficient capital or indeed lenders to provide students with federal student loans going forward. In fact, the

*Wall Street Journal* has reported that students will poor credit “will likely have a harder time getting a government backed federal loan.”

Such blatant fear-mongering and misinformation (whether intentional or not) is unfortunate and may prove extremely harmful to students across the country, just as so many of our high school seniors currently decide not just what college to attend next year, but if they should go to college at all.

Congress, schools and FFELP lenders alike seek to help qualified students get a college education. However, any attempt to foster the belief in a federal student loan crisis is harmful, unconscionable, and counter to the national goal of increasing the number of college graduates. Thus, while citizens need to know the facts, these facts should be clearly stated with no attempt to cause panic or to misinform.

First and foremost, as an experienced financial aid professional, I can state with complete confidence that ***there is no federal student loan crisis - all eligible students can get federal student loans now and will be able to do so going forward.***

***While lenders may be experiencing problems in securing capital or adjusting to the post CCRAA world, this does not translate into problems for students. Students will still be able to obtain federal student loans!***

I do not believe that the HELP Committee’s goal is to ensure the continued viability of every player in the FFELP industry. It is, as the title of this Hearing states, to *Ensure Access to College*. It is all about students - nothing more, nothing less.

I fully realize that the financial markets are in crisis and many FFELP lenders are experiencing major shifts in their methods of securing capital, in their personnel requirements as they operationalize the recent changes to inducement and lender list regulations, and in the economies required under compressed profit margins.

**However, lender difficulties do not translate into an inability for students to get federal loans for which they are eligible.**

Members of the U.S. Department of Education, the FFELP industry, national higher education organizations, and other financial aid administrators concur.

1. Al Lord, Vice Chairman and CEO of Sallie Mae, the largest FFELP lender stated in his March 3, 2008 letter to financial aid directors that while “These issues...have created uncertainty among many who rely on student lending...my purpose in sending this letter is to remove the uncertainty. The capital market disruption is the lenders’ problem; Sallie Mae does not want it to be yours.”
2. JP Morgan Chase bank has announced that it will continue to make federal student loans and is voluntarily cutting interest rates and fees on federally-backed student loans in order to gain greater market share.
3. Mark Kantrowitz, the publisher of Finaid.org, a web site sponsored by Citibank, a FFELP lender, has disseminated a list of lenders who have announced that they are leaving the FFELP program, or temporarily suspending new loan originations. His list of “drop-outs” includes fewer than two dozen lenders, some of whom were simply consolidation companies looking to make fast money – a process that is no longer attractive to students given the change from variable to fixed interest rates on federal student loans. Since over 2000 unique lenders made FFELP loans this year, the loss of a few dozen is inconsequential. Many of the remaining 1900 plus lenders will certainly be willing to take on the added market-share.
4. Mike Reardon, CEO and President of Citibank stated on February 22, 2008, that “...this is an unprecedented and challenging time for the FFELP community. The recent and upcoming legislative changes are significantly impacting how we manage our business. Congress has required us to do more with less and we are rising to the challenge.”

5. C.E. Andrews, President of Sallie Mae has stated on January 29, 2008 that “The changes we have announced reinforce our ability and commitment to provide the right saving- and paying-for-college solutions to our schools, students, and families.”
6. Mike Dunlap, President and CEO of Nelnet wrote to financial aid directors on January 23, 2008, that “Nelnet is a stable business partner because of our financial strength. We have made decisions for the long term and have the capital, cash, and revenue we need to serve you and be successful.”
7. Secretary of Education Margaret Spellings has stated in her recent letter to college presidents that “While a few lenders have chosen or may choose to reevaluate their continued participation in this program, we expect other lenders will actively compete for this loan volume and ensure that a competitive, efficient, and comprehensive FFEL Program continues to provide a variety of lending options, foster innovation, and improve customer service.”
8. Anita Weier of the Capital Times reported that Richard George, president and CEO of Great Lakes Higher Education Guaranty Corporation, has stated that “there should not be any impact on federal Title IV loans” as a result of the “student loan troubles.” Mr. George was further quoted in Weier’s *Student Loans are Safe Here* article that “lenders being affected by the spillover of the sub-prime mortgage loan crisis are largely nontraditional lending companies that have auctioned securitized student loans.”
9. “We’re concerned, as everybody is, because there is turmoil in the financial markets, but so far we haven’t found it in the student loan office...I’m afraid people are panicking with no reason to,” stated Larry Warder of the U.S. Department of Education in that same article.
10. The University of Wisconsin - Madison director of student financial services also stated in the Weier article that student loans will not be much of a problem at her institution. “We are not in a panic mode at all.”
11. The Executive Director of the Iowa College Student Aid Commission, Karen Misjak stated in a March 6, 2008 press release that “Many of our lender partners, both local and national, have stepped up to the plate to ensure that access...remains attainable and affordable.”
12. Joe Belew, president of Consumer Bankers Association in his March 10, 2008 message to financial aid administrators stated that “There have been numerous reports of lenders throughout the country announcing that they will no longer be making Federal Family Education Loans or that they will be reducing or stopping the lending of private education loans. We are writing to let you know that despite a series of negative developments...banks plan to continue making both FFELP and private loans in academic year 2008-2009.” He also elaborated that while some lenders will cease making FFELP loans, “some banks plan to expand their lending in the upcoming academic year to ensure that students have the funds they need.”
13. Dr. Phil Day, President and CEO of the National Association of Student Financial Aid Administrators (NASFAA) in his March 11, 2008 letter to membership stated that “NASFAA is not aware of any student being denied a federal student loan due to market conditions...Even in instances where student loan providers have suspended their loan programs, other loan providers have stepped in to fill any vacancies.”
14. The Project on Student Debt has confirmed that “federal student loans are and will remain widely available to students and families at all income levels.”

Currently, there are about 3500 approved lenders in the Department of Education’s database of eligible FFELP lenders. This means that there are approximately 2 schools for every lender. We also know, based on Department of Education records, that over 2000 unique lenders are defined as “active” since they made loans to students during this academic year. Through media reports as well as lender statements, we can ascertain that fewer than two dozen of these lenders to date have decided to cutback or cease lending activities for next academic year. This is a mere 1% of active lenders. There is no doubt that some of the remaining lenders will see this as an opportunity to increase their market share, and indeed a few have already indicated that they are ready and able to do so. These numbers also tell us that in any given year, all eligible lenders are not necessarily actively participating in FFELP, for unique business reasons unrelated to the current capital market crisis. These past hiatus’ from lending have never caused a panic or lack of FFELP loan availability for students.

I recently conducted an informal survey of Massachusetts colleges, universities and trade schools and every responding financial aid administrator indicated that they have not experienced an inability for their students to

get FFELP loans this year, and expect no change for next year. While a minority have been notified that one or more of their historical lenders will reduce or stop FFELP participation, there are other lenders who have filled the resulting gap. They reported only that some loan terms have changed – not because of the credit crisis, but due to the smaller profit margins resulting from CCRAA. (As you know, the reduction in special allowance payments has resulted in the reduction of some lender-defined benefits enjoyed by some borrowers and instead Congress has moved these excess profits into significantly higher Pell Grants for *all* eligible needy students.)

(It must be noted that we will in all likelihood see a tightening of credit requirements for private, non-federal, alternative loans that are not federally guaranteed. Most typically, students with bad credit will be unable to obtain alternative loans with high interest and exorbitant fees at schools with high default rates and low graduation rates – loans that are not dischargeable, even in bankruptcy or death. I for one do not believe this is a bad thing.)

**We must, however, err on the side of caution and be prepared. In the extremely unlikely event that students at FFELP schools do experience difficulties obtaining their federal student loans, Congress has already established two fail-safe means to insure access.**

First, Congress created the “Lender of Last Resort” option to allow guaranty agencies to secure capital from the government to use to cover any shortfalls of available funding for FFELP loans. While it has never been necessary to resort to this fall-back position to date, the U.S. Department of Education is putting the mechanisms in place to do so if necessary, according to the Secretary of Education, Margaret Spellings. This means that if lenders in general are unable to secure sufficient capital to meet the needs of students, then the Department of Education will insure that capital through the established guaranty agencies across the country.

Second, Congress has already put into place the most efficient and reasonable means of insuring against capital shortfalls in FFELP and disruptions for students. In 1992 Congress created the Federal Direct Student Loan Program (DL). Direct Lending provides the same federal loans to students as does FFELP; however, operationally it is an alternative delivery system for getting students their federal loan proceeds. The capital is not provided by the private lending industry as in FFELP; instead, the federal government provides the loan capital for DL directly from Treasury. There are currently about 1100 schools across the country whose students receive their loan funds through the DL delivery method instead of through FFELP. This accounts for about 20% of all student and parent federal loan volume. In fact, DL has the largest market share of federal student loans of any lender in the country, including the largest FFELP lender, Sallie Mae.

Some FFELP lenders have stated that the Department of Education is not capable of increasing volume in DL if FFELP partially or fully fails. It appears, however, that it is basically the lenders who have this opinion, and that opinion is apparently based on no more than wishful musings. We must remember that at its inception, Direct Lending increased its market share from zero to one third of the market over a two year period, as a new, unproven program with no previous infrastructure. The U.S. Department of Education proved it was extraordinarily capable of handling a large increase in volume then, and one would expect that after fifteen years of improved technology and experience, it could rapidly and smoothly expand from its present market share of 20%. There is no basis in fact to assume that the Department is not fully capable of exceeding its initial success.

One of the efficiencies introduced by the Department over the Direct Lending program’s history is its movement to the Common Origination and Disbursement system, or COD. COD is the system used by every college, university, and trade school in the country to process Pell Grants, ACG, SMART, and the new TEACH grants. Therefore, every school is already up and running on the system necessary to process direct loans. Movement to Direct Lending, if necessary, is not akin to a systems change for schools, but rather an expanded use of the current federal aid delivery system. Direct loans are simply Pell Grants with a promissory note.

Schools who believe their students may not continue to be well-served through FFELP can move quickly into the DL program if they so choose. For a school already approved for Title IV program eligibility, the steps are few and simple: A change to the Program Participation Agreement (an on-line process) to include DL, expansion of use of EdExpress or similar file transfer method for COD, and internal process adjustment and training. After fifteen years of Direct Lending, nearly every enterprise system used by schools are DL processing capable already. A school determined to shift from FFELP to DL has only to make the decision and follow the short-course.

While some acknowledge that the Department, over time, could handle a significant increase in direct loan volume, they have expressed concerns about an ability to do so in the short term. However, I have been advised by the Department that it is capable of doubling direct loan volume immediately, without any system or contractor upgrades since they are currently underutilizing capacity. In addition, over approximately two months, they are confident that direct loan volume could increase to 60% of market share (from the current 20%) with relatively minor accommodations and adjustments. To increase further would require some systems and contractor upgrades. These upgrades, however, could be accomplished relatively quickly.

There has been much misinformation about Direct Lending promulgated by those with a vested interest in its failure. In my experience, and the experience of over 1100 other successful direct loan schools, it is a better alternative to FFELP for many reasons, including the following:

- The Department of Education does not redline students at any schools and provides funds to all eligible students. This is not always the case in FFELP.
- Direct Lending provides a simple, one-stop shopping alternative with great customer service to students and families.
- Direct Lending provides a high level of transparency and simplicity, reducing administrative time and expense.
- The streamlined process is easy for families to understand and navigate.
- While in FFELP borrowers may have multiple loan servicing agents and loans may be sold several times over the life of the loans, Direct Lending maintains a single point of service for the life of the loan.
- Direct Lending provides ease, predictability and reliability of obtaining funds to assist in cash flow predictions at the institutional level.
- Perkins Loans consolidated into Direct Lending do not lose their grace period.
- DL borrowers can change repayment plans at any time without loss of benefits; this is not always true in FFELP.
- Borrowers can take advantage of the new Public Service Loan Forgiveness available only in the DL program.

Stonehill College's experience with Direct Lending can best be expressed in our latest estimated cohort default rate: 0%. The DL servicer is available, helpful, and committed to reducing defaults. They are highly successful, with the cohort default rate in DL lower than in FFELP for every applicable year but one in the last 10 years.

**Finally, I would urge you to work with the Secretary of Education on these issues.**

It is obviously not enough that the Department is *capable* of handling a sudden, significant increase in direct loan volume. It must set the stage now to handle any major influx of schools.

Over the past eight years, the Department has not been actively advancing the Direct Loan Program, allowing a comfortable status quo to evolve. However, in the unlikely event that FFELP does degenerate and more schools decide to move quickly to Direct Lending, the Secretary must be prepared and that preparation should begin immediately.

I would suggest that the Secretary pro-actively inform schools in FFELP of the steps necessary to move to Direct Lending if they so choose. These steps must assume current Title IV eligibility and provide simple and concise instructions for approval and training both on-line and in person. I would advise that the Secretary immediately and conspicuously place these simple instructions on the Department's IFAP web site.

She should re-assemble her team of internal experts to work with new direct loan schools to get them up and running in the shortest time-frame possible to avoid disruptions to students, a method that was highly successful in the beginning of the program. This will allow schools to have a single-point-of-contact at the Department when it has implementation questions.

If needed, both the Lender of Last Resort option and Direct Lending must be fully ready to relieve any FFELP emergency that may evolve, without delays. The Department of Education has certainly proven itself capable of bringing up new programs quickly and efficiently most recently operationalizing both ACG and SMART on short notice. I have no doubt that with pre-planning now, students will see no disruptions in Title IV loan fund disbursements under any required Lender of Last Resort or Direct Loan expansion.

I thank you again for the opportunity to present testimony at this Field Hearing. I urge you to continue to do your good work, insuring access to higher education for all qualified students, regardless of the financial circumstances into which they are born. I would be pleased to answer any questions that you may have.

# Northeastern to alter loan program

## *Funding to come from government*

By Peter Schworm, Globe Staff | March 17, 2008

Northeastern University plans to announce today that it will provide student loans exclusively from the government in an effort to ease students' and parents' anxiety over the availability of loans amid recent tumult in the financial markets.

The move is a major shift for the university and one that could herald a broader change in the source of education loans.

Northeastern officials said the move was prompted by the turmoil in the student loan industry caused by fallout from the subprime lending crisis. A number of commercial lenders and state agencies have announced in recent weeks that they will no longer provide federal education loans because of a deepening credit shortage and reduced government subsidies.

The announcements have stirred widespread concern among college students and parents about landing loans for the fall, but most financial aid specialists say students will not have difficulty securing government-backed loans for the next academic year.

Northeastern officials said they believe moving to the direct-loan program, in which students borrow solely from the US Department of Education, will provide a more stable source of funding and simplify the often-confusing borrowing process.

"It is our responsibility to ensure that every student and parent has a sure and clear path to obtain educational loans, particularly at this important time of year where students are making decisions on college options," said Philomena Mantella, Northeastern's senior vice president for enrollment and student life, in a phone interview yesterday.

Northeastern students borrowed \$126 million last year through federal education loan programs such as Stafford, Perkins, and PLUS. Mantella said she did not anticipate resistance from students who might prefer to choose their own lender.

Since last year's student loan scandal over conflict-of-interest abuses, regulations were introduced that restrict colleges from steering students toward preferred commercial lenders, she added, giving another impetus for the change.

The direct-loan program offers several repayment methods and allows borrowers to switch repayment methods if needed, university officials said. Northeastern, rather than a bank or other lender, will directly disburse the loans.

Seamus Harreys, dean of student financial services at Northeastern University, said borrowing money from the government will provide "safe harbor" from the current turbulence in the financial markets and is "consistently the lowest-cost option."

The direct-loan program provides about one-third of all student loans, he said.

Northeastern follows Pennsylvania State University as the second major university in the country to end its relationship with third-party lenders such as Sallie Mae for federally guaranteed student loans, and instead steer its students toward loans provided directly from the government.

Northeastern's new policy takes effect in July.

The announcement coincides with a Senate field hearing held at the university today. The hearing, hosted by US Senator Edward M. Kennedy, will focus on college costs and access to student loans. Kennedy, chairman of the Committee on Health, Education, Labor, and Pensions, is calling for increased federal loan limits and expanded eligibility to reduce families' reliance on private loans.

"The ability of students and families to pay for college should not be determined by the quarterly earnings of banks and lenders," he said in a statement.

Northeastern's move "will help protect students, as the Direct Loan Program is insulated from disruptions in the private credit markets," he said.

On Friday, House lawmakers urged US Secretary of Education Margaret Spellings to ensure that the direct-loan program is equipped to handle increased demand for federal loans.

Students have increasingly turned to higher-interest private loans in the past decade to handle rising tuition costs. Private loans accounted for 24 percent of all education loans last year, up from 6 percent a decade ago, according to the College Board's latest survey.

But with the credit crunch making it harder to secure capital, some lenders are tightening eligibility or forgoing student loans altogether. About 20 percent of Northeastern students take out private loans, which will not be affected by the new policy.

Students and parents have grown concerned as numerous providers of student loans have backed out of the industry in recent weeks.

Earlier this month, New Hampshire's nonprofit student-loan agency said it will no longer offer private loans, and the Massachusetts Educational Financing Authority, which lent money to 42,000 college students last year, has struggled to secure financing for its loans. The Pennsylvania Higher Education Assistance Agency has also announced it was leaving the federal student loan program.

But the vast majority of commercial lenders remain, and some specialists said colleges are overreacting to the current uncertainty.

The National Association of Student Financial Aid Administrators recently announced it "is not aware of any student being denied a federal loan due to market conditions."

Last week, the Consumer Bankers Association sent a letter to financial aid administrators assuring that banks will continue to make private and government-backed loans.

STATEMENT  
OF

ROBERTA JOHNSON  
DIRECTOR OF FINANCIAL AID  
IOWA STATE UNIVERSITY

BEFORE THE  
HOUSE COMMITTEE ON EDUCATION AND LABOR

ON  
MARCH 14, 2008

Mr. Chairman and Members of the Committee:

My name is Roberta Johnson and I am the Director of Student Financial Aid at Iowa State University in Ames, Iowa. Iowa State University is a land-grant institution with an enrollment of 26,160. Prior to assuming the role of Director of Student Financial Aid at Iowa State University, I served for eighteen years in the assistant director and associate director positions at Iowa State where I was responsible for student loan operations. I have experience in the administration of loans through both the Federal Family Education Loan Program and the Federal Direct Loan Program. Iowa State University entered the Federal Direct Loan Program as a Year One school in 1994.

Iowa State University's loan Federal Direct Stafford and PLUS volume in 2006-07 was \$97.6 million dollars and encompassed over 20,000 separate awards for 14,645 students. Yet we were able to accomplish this with only 2 full-time staff members. One of those staff members also administers the Federal Pell Grant program, Academic Competitiveness Grant, National SMART Grant, and will assume duties for the TEACH Grant program in July.

There were a number of reasons why we moved to Direct Lending in 1994 and why we remain there today – most notably, we are able to provide better customer service to our students and their parents; minimize the amount of staff time spent dealing with tracking down loan funds or changes; and maximize the predictability of receiving funds both for our students and our institution. Our students and their parents frequently comment on how easy it is to understand the process, that they appreciate always knowing who holds their loan, and that Iowa State University provides prompt courteous service when they have questions about any financial aid program. Before Direct Lending, that was not the case.

I have included in the attached slides a GAO slide that quite accurately depicts what Iowa State University experienced as a participant in the FFEL program, dealing with multiple student loan players and the contrasting graphic showing how the process works today. The Direct Loan Program has been described as Pell with a Prom Note. In fact, any school that is currently administering the Federal Pell Grant, ACG, or National SMART Grant programs is already interfacing the with Department of Education's system for disbursing Direct Loans and other student aid, the Common Origination and Disbursement (COD) system. To participate in the Direct Loan program would require only that they sign up to participate with the Department of Education and that they attach loan information to the files they are already sending to the Department via COD.

In the midst of the current credit crunch and with daily media reports about student loan instability, it is important to help students and their families differentiate between federal and private loans and to reassure them that Stafford Loans, PLUS loans and Grad PLUS loans are available. While there have been reports of certain FFEL lenders leaving the program, temporarily suspending operations, or redlining certain schools due to graduation or default rates, this is not the case in the Federal Direct Loan Program. Direct Loans are funded as

a student entitlement from funds borrowed wholesale from the private sector through the sale of Treasury Securities. There is never a question of capital availability in the Direct Loan Program. This differs from FFEL. In that program lenders are entitled to subsidy and default payments if they choose to make loans to students.

The Direct Loan Program is administered by private sector contractors through competitively let contracts by the Department of Education. These contractors have years of experience administering Direct Loans, and indeed many of them also are servicers for FFELP lenders. Like the FFEL program, the Department's responsibilities are to oversee and govern the administration of both programs.

In 1994, the Direct Loan program was entirely new. In three years it had one third of the market and the program worked smoothly. Today it has 20% of the market thanks to the marketing and taxpayer provided discounts FFEL participants offered and the prohibition against marketing of Direct Loans by the Department. The Department of Education already has the infrastructure to handle an influx of schools into the Direct Loan program.

Mr. Chairman, thank you for the opportunity to appear before you today and for your support, and the support of others on the committee, for Direct Lending. I would be happy to respond to any questions you or the Members of the Committee might have.

[Click here for a copy of the powerpoint presentation.](#)



## **Penn State moves to become a direct loan participant for students**

**Monday, March 10, 2008**

In an effort to provide its students with a stable and predictable source of funding for their federal student loans, Penn State intends to become a direct student loan participant, with money coming from the U.S. Department of Education. The initiative will give the 44,000-plus Penn State students who currently have federal loans a secure source of funding along with a streamlined process for obtaining loans.

Recent reports of instability in the national credit markets -- initially caused by problems with subprime mortgages -- have been compounded by new concerns over capital and bond markets. The turmoil has placed a burden on federal student loan lenders and raised concerns about the accessibility of federal student loan funding.

A little more than a week ago, the Pennsylvania Higher Education Assistance Agency (PHEAA) announced that it will no longer serve as a lender for federal Stafford Loans, a move that directly affects 40,800 Penn State students who use PHEAA as their lender. Some lenders of private student loans also are cutting back on loan services, although Penn State will continue to assist students with suggestions for private loan providers from which to choose.

"We have a responsibility to our students to help them obtain financial aid that allows them access to a Penn State education," said Penn State President Graham Spanier. "Given the circumstances we believe that affiliating with the federally guaranteed Direct Student Loan Program will enable our students to continue their education without worrying about where their federal student loans will be coming from."

Penn State as a direct loan participant will provide students a simple process for receiving loans. As a participant in the program, Penn State -- rather than a bank or other lender -- will be afforded the maximum capability to ensure timely disbursement of student loans each semester, like hundreds of other colleges and universities that currently participate in the direct loan program. The Department of Education secures the funding directly from the U.S. Treasury, so instability in financial markets does not affect this source of funding for student loans.

In addition, the Direct Loan Program offers students a number of repayment plans not available from the loans made through other lenders. Recent legislation provides students in Direct Lending with a new partial forgiveness program for those who enter public service during their repayment period. This loan is easy to receive with a single point of contact. Students also will have on-line access to their loan account information all day, every day.

PHEAA, as a federal loan guarantor, will continue to originate and service student loans, but intends to turn over lending to private banks and other lenders.

"Penn State has had a long-standing and collaborative relationship with PHEAA. The University will maintain that cooperation in relation to PHEAA's continuing services," said Al Horvath, Penn State vice president for Finance and Business.

Penn State's Office of Student Aid will provide further information to all students in the coming weeks about the Federal Direct Student Loan Program and Penn State's participation. Student aid programs, such as Pell Grants and state grants, are not affected by the changes. Students in the Pell Grant program will actually see an increase in their grant for next year.

"Removing the uncertainty for our students and letting them know their loans will be funded is an assurance we need to provide," said Anna Griswold, assistant vice president and executive director of Student Aid for the University. "We think Penn State students will find this program to be simple and easy to understand; they will join their peers at many of the Big Ten schools and other flagship universities who have been receiving their loans through the Direct Loan Program for over a decade."

*A list of frequently asked questions related to the Direct Loan Program, and accompanying answers that should help families understand how this program will serve their student, can be found at <http://live.psu.edu/story/29429>.*

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