



## RELIABLE AND EFFICIENT STUDENT LOANS: Questions and Answers

February 19, 2010

### Direct Loans General

*Q. Is it prudent for the federal government to make loans, rather than use private-sector lenders?*

A. The government-guarantee program (FFEL) and direct lending are both public-private partnerships. The Direct Loan program provides loans to students directly from the Treasury and then administers these loans through competitively-awarded performance-based contracts with private companies. This approach costs taxpayers less than FFEL, a program in which politically-set subsidies are paid to banks to originate and service student loans. Direct Loans are also more reliable for schools and students. Unlike FFEL lenders, the Direct Loan Program has experienced no problems during the credit crunch.

*Q. Hasn't the competition between FFEL and Direct Loans improved both programs?*

A. The Direct Loan program uses private sector competition where it matters most: servicing and collection of the loans. Experienced, private companies will get more business if they keep defaults down and keep schools and borrowers satisfied.

*Q. In FFEL, there are agencies that help prevent defaults. With those agencies eliminated, will default rates increase under direct lending?*

A. No. In the past, default rates for similar types of schools in the Direct Loan and FFEL programs have been comparable. The Department of Education will continue to use experienced, private sector companies to collect and service the loans. Furthermore, the new servicing contracts provide the companies with a financial incentive to keep defaults and delinquencies at a minimum.

*Q. FFEL lenders and guaranty agencies have played an important role in outreach to families seeking information about financial aid and college. Will this disappear?*

A. The Administration has proposed that funds be provided to states to continue these types of important outreach activities.

## Capacity and timing

*Q. Traditionally, more schools have been enrolled in the FFEL program. Is there enough capacity in the Direct Loan program to assume the FFEL program's volume?*

In a November 2009 report, the Department's independent Inspector General found that the Department and its contractors have the capacity to handle 100% of the anticipated student loan volume. In addition to system readiness, the IG found that the Department has the resources to assist schools in making the transition.

*Q: Isn't it too late to make the shift to Direct Lending for this fall?*

The switch generally takes only two to five weeks, and most schools -- more than 95% of loan volume -- are either already set up to make direct loans or are taking steps to get ready. More than 2000 schools are now in the Direct Loan program, more than double the number just three years ago. Independent surveys show that schools are finding the switch much easier than anticipated. Some examples:

"I can say that we feel 100 percent positive about the transition and we are glad that we made the change."- Scott Weltjen, Director of Financial Aid, Erie Community College, New York

"We got the transition work done with our regular staff, during normal operating hours, while keeping on top of regular work. It was hard to believe that something this big could be this easy."-Rick Shipman, Michigan State University

"I will not minimize that we have had a few minor issues, but resolving each one of them has been very doable. Most of the issues were due to the fact that we couldn't believe the process could be as simple as it is. Staff thought it really had to be more complex."-Lois Kelly, Director of Financial Aid at California Polytechnic State University

"It's wonderful to have a one-stop center for managing the loan programs with friendly, knowledgeable staff ready to assist you with any questions. . . I cannot imagine processing loans any other way."-Sherry Cwirko, DePaul University

*Q: Why not extend ECASLA, so that lenders are more likely to remain in the FFEL program?*

ECASLA was a temporary program. With enough capacity now in the Direct Loan Program, ECASLA is no longer needed to make sure that students will have access to FFEL loans. The Direct Loan program will offer better, more reliable service to students and schools at a lower cost to taxpayers.

*Q. When is the drop-dead date for passing SAFRA or at least extending ECASLA?*

Obviously it would be best to give schools certainty about a switch as soon as possible, but there is no drop-dead date because the Direct Loan program is fully available and will remain fully available. In the absence of congressional action, lender-of-last-resort programs in FFEL will also remain available if lenders are not making loans.

## **Cost and finance**

*Q. Why is it that it costs less to make the loans directly rather than guaranteeing the loans?*

In either system, essentially the same loans are made to the same students at the same schools, with the government carrying the risk of default. The main difference is that the government's cost of acquiring the funds to lend is lower than what we have to guarantee to banks to make the same loans. That is the primary reason that Direct Loans are cheaper: the government's lower cost of borrowing. In addition, the guaranteed loan program is designed around a wasteful and unnecessarily complicated structure that includes many entities – including lenders, guaranty agencies, and secondary markets – and often pays them more than is justified.

*Q. By charging interest is the government profiting off student loans?*

Federal student loans offer below-market rates that do not increase even when rates increase in the economy. That is a major benefit to borrowers. In addition, the federal government provides deferments for unemployment and economic hardship, disability discharges, income-based repayment, forgiveness for public service, additional benefits for veterans and other valuable benefits. The taxpayer cost of these benefits is partly covered by the borrower payments on the loans. Reducing the interest payments – or handing them over to banks that take no real risk – leaves less money for these borrower benefits.

*Q. But doesn't direct lending lead to increased government borrowing? Isn't it better to keep it off the balance sheet?*

A. Guaranteed through FFEL or made through Direct Lending, the federal government is taking the risk on all student loans and the loans are on the balance sheet. Because we don't have to subsidize the banks, direct lending reduces the deficit and, over the long term, reduces the federal debt.

*Q. The federal budget doesn't show billions of dollars of payments to lenders in recent years. Where are the Direct Loan "savings" coming from?*

A. Government-guaranteed returns do not always show up in the form of a check from the Treasury. When the government takes virtually all of the risk on a loan but lets the lender keep the borrower payments, the "subsidy" is just as real as a direct payment from taxpayers. Estimates from the Congressional Budget Office show these unnecessary subsidies to total \$80 billion over the next ten years. In periods of low interest rates, the reduced subsidies will show up as revenues from borrower payments; in periods of higher interest rates they will be government payments of interest that will not need to be paid to lenders.

## **Jobs**

*Q. Lenders have alleged that there are thousands of jobs at stake. Does the switch to direct lending eliminate jobs?*

The Department of Education's contract for private sector loan servicing requires that the processing be done in the United States. As a result, we are already seeing thousands of loan servicing jobs that had been sent overseas return to this country. Furthermore, federal loan volume is growing by tens of billions of dollars, increasing the demand for loan servicing—jobs that remain in America if those loans are made through direct lending rather than FFEL. The future American jobs at stake far outnumber the domestic student loan origination jobs that remain in the faltering student loan industry today. In addition, jobs would be created by the programs funded by savings these billion of dollars through direct lending. For example, financing school construction creates jobs for carpenters, electricians, plumbers and others. Support for innovative education programs helps to employ educators and to improve the productivity of other workers. While work at lending institutions will shift as a result of the legislation, the net domestic jobs impact will in all likelihood be positive.

## **Lender alternative**

*Q. Lenders have developed an alternative to the Obama Administration's proposal. What's wrong with that approach?*

Some lenders have proposed an approach in which they would originate the loans and then transfer them to the government for a fee of \$75 per loan. The lender would then service the loan under contract with the Department of Education. According to the Congressional Budget Office, this approach would cost \$13 billion more over ten years than direct lending. That \$13 billion would be sufficient to fund over two million maximum Pell Grants over the next ten years. That is two million more students who could receive the maximum Pell Grant award, enabling them to go to college. The lender proposal would also undermine the performance-based nature of the proposed DL servicing contracts, which call for lenders to receive additional volume for keeping defaults down and customer satisfaction high. Instead of using competition to create incentives for performance, the lender proposal sets fees based on congressional mandates—continuing to deliver billions of dollars in unnecessary subsidies to banks.