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STUDENT LOAN PROGRAMS

Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs

Statement of Cornelia M. Ashby, Director
Education, Workforce, and Income Security Issues

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss issues related to consolidation loans and their cost implications for taxpayers and borrowers. Consolidation loans, available under the Department of Education's (Education) two major student loan programs—the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP)—help borrowers manage their student loan debt. By combining multiple loans into one loan and extending the repayment period, a consolidation loan reduces monthly repayments, which may lower default risk and, thereby, reduce federal costs of loan defaults. Consolidation loans also allow borrowers to lock in a fixed interest rate, an option not available for other student loans. Consolidation loans under FFELP and FDLP accounted for about 48 percent of the $87.4 billion in total new student loan dollars that originated during fiscal year 2003. FFELP consolidation loans comprised about 84 percent of the fiscal year 2003 consolidation loan volume, while FDLP consolidation loans accounted for the remaining 16 percent.

Two main types of federal cost pertain to consolidation loans. One is "subsidy"—the net present value of cash flows to and from the government that result from providing these loans to borrowers. For FFELP consolidation loans, cash flows include, for example, fees paid by lenders to the government and a special allowance payment by the government to lenders to provide them a guaranteed rate of return on the student loans they make. For FDLP consolidation loans, cash flows include borrowers' repayment of loan principal and payments of interest to Education, and loan disbursements by the government to borrowers. The subsidy costs of FDLP consolidation loans are also affected by the interest Education must pay to the Department of Treasury (Treasury) to finance its lending activities. The second type of cost is administration, which includes such items as expenses related to originating and servicing direct loans.

My testimony today will focus on two key issues: (1) recent changes in interest rates and consolidation loan volume and (2) how these changes have affected federal costs for FFELP and FDLP consolidation loans. My comments are based on the findings from our October 2003 report for this Committee, Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined (GAO-04-101, October 31, 2003). Those findings were based on review and analysis of data from a variety of sources, including officials from Education's Office of Federal Student Aid and Budget Service, and representatives of FFELP

lenders; a sample of student loan data extracted from Education's National Student Loan Data System (NSLDS)—a comprehensive national database of student loans, borrowers, and other information; relevant cost analyses prepared by Education; and statutory, regulatory and other published information. For this testimony, we updated our numbers to reflect recent estimates made by the Department of Education. Our work was conducted in accordance with generally accepted government auditing standards.

In summary:

- Recent years have seen a drop in interest rates for student loan borrowers along with dramatic overall growth in consolidation loan volume. From July 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.50 percent as of July 1, 2003. From fiscal year 1998 through fiscal year 2003, the volume of consolidation loans made (or "originated") rose from $5.8 billion to over $41 billion. The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many borrowers to consolidate their variable rate student loans at a low, fixed rate.

- Recent trends in interest rates and consolidation loan volume have affected the cost of the FFELP and FDLP consolidation loan programs in different ways, but in the aggregate, estimated subsidy and administration costs have increased. For FFELP consolidation loans, subsidy costs grew from $0.651 billion for loans made in fiscal year 2002 to $2.135 billion for loans made in fiscal year 2003. Both higher loan volumes and lower interest rates available to borrowers in fiscal year 2003 increased these costs. Lower interest rates increase these costs because FFELP consolidation loans carry a government-guaranteed rate of return to lenders that is projected to be higher than the fixed interest rate paid by consolidation loan borrowers. When the interest rate paid by borrowers does not provide the full guaranteed rate to lenders, the federal government must pay lenders the difference. FDLP consolidation loans are made by the government and thus carry no interest rate guarantee to lenders, but changing interest rates and loan volumes affected costs in this program as well. In both fiscal years 2002 and 2003, there was no net subsidy cost to the government because the interest rate paid by borrowers who consolidated their loans was greater than the interest rate Education must pay to the Treasury to finance its lending. However, the drop in loan volume and interest rates that occurred in fiscal year 2003, contributed to cutting the government's estimated net gain from $570 million in fiscal year 2002 to $543 million for loans made in fiscal year 2003. Administration costs are not specifically tracked for either

consolidation loan program, but available evidence indicates that these costs have risen, primarily reflecting increased overall loan volumes.

In our prior report, we recommended that the Secretary of Education assess the advantages of consolidation loans for borrowers and the government in light of program costs and identify options for reducing federal costs. Education agreed with our recommendation.

Background

Consolidation loans differ from other loans in the FFELP and FDLP programs in that they enable borrowers who have multiple loans—possibly from different lenders, different guarantors,[1] and even from different loan programs—to combine their loans into a single loan and make one monthly payment. By obtaining a consolidation loan, borrowers can lower their monthly payments by extending the repayment period longer than the maximum 10 years generally available on the underlying loans. Maximum repayment periods allowed vary by the amount of the consolidation loan (see table 1). Consolidation loans also provide borrowers with the opportunity to lock in a fixed interest rate on their student loans, based on the weighted average of the interest rates in effect on the loans being consolidated rounded up to the nearest one-eighth of 1 percent, capped at 8.25 percent. Borrowers can qualify for consolidation loans regardless of financial need. Loans eligible for inclusion in a consolidation loan must be comprised of at least one eligible FFELP or FDLP loan, including subsidized and unsubsidized Stafford loans, PLUS loans,[2] and, in some instances, consolidation loans. Both subsidized and unsubsidized Stafford loans, and PLUS loans are variable rate loans. Other types of federal student loans made outside of FFELP and FDLP, which may carry a variable or fixed borrower interest rate, are also eligible for

[1]State and nonprofit guaranty agencies receive federal funds to play the lead role in administering many aspects of the FFELP program, including reimbursing lenders when loans are placed in default and initiating collection work.

[2]Both subsidized and unsubsidized Stafford loans are available to undergraduate and graduate students. The interest rates borrowers pay on these loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 8.25 percent. To qualify for a subsidized Stafford loan, a student must establish financial need. The federal government pays the interest on behalf of subsidized loan borrowers while the student is in school. Students can qualify for unsubsidized Stafford loans regardless of financial need. Unsubsidized loan borrowers are responsible for all interest costs. PLUS loans are variable rate loans that are available to parents of dependent undergraduate students. The interest rates on these loans adjust annually, based on a statutorily established market-indexed rate setting formula, and may not exceed 9 percent. Parents can qualify for PLUS loans regardless of financial need.

inclusion in a consolidation loan, including Perkins loans, Health Professions Student loans, Nursing Student Loans, and Health Education Assistance loans (HEAL).[3]

Table 1: Consolidation Loan Repayment Periods, by Loan Amount

Amount	Maximum term (years)
Less than $7,500 (FFELP)	10
Less than $10,000 (FDLP)	12
$7,500 to $9,999 (FFELP)	12
$10,000 to $19,999	15
$20,000 to $39,999	20
$40,000 to $59,999	25
$60,000 or more	30

Source: Higher Education Act, Congressional Research Service, and Education.

The Federal Credit Reform Act (FCRA) of 1990 helps define federal costs associated with consolidation loans and was enacted to require agencies, including Education, to more accurately measure federal loan program costs. Under FCRA, Education is required to estimate the long-term cost to the government of a direct loan or a loan guarantee—generally referred to as the subsidy cost. Subsidy cost estimates are calculated based on the present value of estimated net cash flows to and from the government that result from providing loans to borrowers.[4] For FFELP consolidation loans, cash flows include, for example, fees paid by lenders to the government[5] and a special allowance payment by the government to lenders to provide them a guaranteed rate of return on the student loans they make. For

[3]Perkins Loans are fixed rate loans for both undergraduate and graduate students with exceptional financial need. Perkins loans are made directly by schools using funds contributed by the federal government and schools; borrowers must repay these loans to their school. The Health Professions Student Loans and Nursing Student Loans are fixed rate loans for borrowers who pursue a course of study in specified health professions. The HEAL program provided loans to eligible graduate students in specified health professions. HEAL was discontinued on September 30, 1998.

[4]Present value is the value today of the future stream of benefits and costs, discounted using an appropriate interest rate (generally the average annual interest rate for marketable zero-coupon U.S. Treasury securities with the same maturity from the date of disbursement as the cash flow being discounted).

[5]For consolidation loans, FFELP loan holders must pay, on a monthly basis, a fee calculated on an annual basis equal to 1.05 percent of the unpaid principal and accrued interest on the loans in their portfolio.

FDLP consolidation loans, cash flows include borrowers' repayment of loan principal and payments of interest to Education, and loan disbursements by the government to borrowers. Unlike FFELP, FDLP involves no guaranteed yields or special allowance payments to lenders because the program is a direct loan program. The subsidy costs of FDLP consolidation loans are also affected by the interest Education must pay to Treasury to finance its lending activities. Another type of cost pertaining to consolidation loans is administration, which includes such items as expenses related to originating and servicing direct loans.[6]

In estimating loan subsidy costs, Education first estimates the future economic performance (net cash flows to and from the government) of direct and guaranteed loans when preparing its annual budgets. These first estimates establish the subsidy estimates for the current-year originated loans. The data used for the first estimates are reestimated in later years to reflect any changes in actual loan performance and expected changes in future performance. Reestimates are necessary because projections about interest and default rates and other variables that affect loan program costs change over time. Any increase or decrease in the estimated subsidy cost results in a corresponding increase or decrease in the estimated cost of the loan program for both budgetary and financial statement purposes.

Borrowers' Rates Have Dropped, and Loan Volume Has Risen

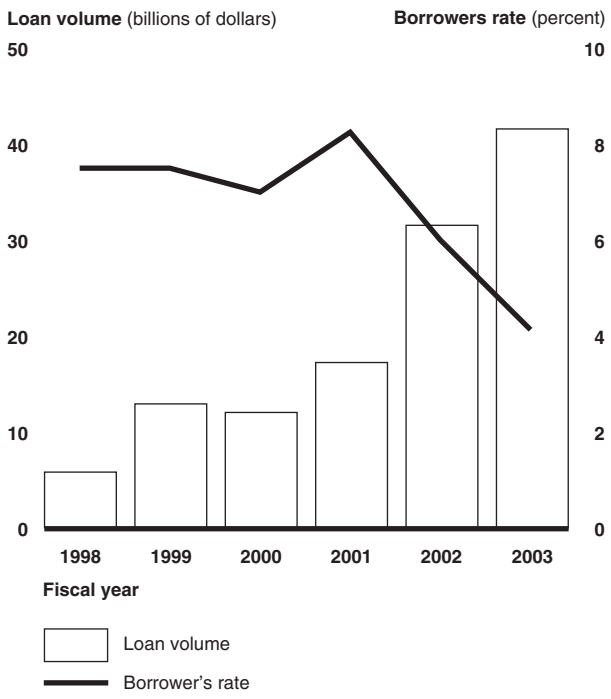
Recent years have seen a drop in interest rates for student loan borrowers along with dramatic overall growth in consolidation loan volume. From July 2000 to June 2003, the interest rate for consolidation loans dropped by more than half, with consolidation loan borrowers obtaining rates as low as 3.50 percent as of July 1, 2003. From fiscal year 1998 through fiscal year 2003, the volume of consolidation loans made (or originated) rose from $5.8 billion to over $41 billion. Over four-fifths of the fiscal year 2003 loan volume is in FFELP. While overall volume rose in 2003, the trends differed by program. FDLP consolidation loan volume for fiscal year 2003 decreased, but loan volume in the larger FFELP increased, resulting in total consolidation loan volume of well over $41 billion.

The dramatic growth in consolidation loan volume in recent years is due in part to declining interest rates that have made it attractive for many

[6]Under FFELP, a large portion of the administration cost is borne by the private lender. The federal government pays many of these costs in its subsidy payment to lenders—specifically, in the 2.64 percent add on paid over and above the 3-month rate on commercial paper.

borrowers to consolidate their variable rate student loans at a low, fixed rate. Figure 1 shows the relationship between these two factors. When interest rates are low, some borrowers may find it in their economic self-interest to consolidate their loans so that they can lock in a low fixed interest rate for the life of the loan, as opposed to paying variable rates on their existing loans, regardless of whether they need a consolidation loan to avoid difficulty in making loan repayments and avert default.

Figure 1: Consolidation Loan Volume Increased Dramatically as Borrower Interest Rates Fell from Fiscal Year 2001 to Fiscal Year 2003



Source: GAO analysis based on data provided by Education's Budget Service.

Underscoring the potential attractiveness of these loans to potential borrowers, many lenders, including newer loan companies that are specializing in consolidation loans, have aggressively marketed consolidation loans to compete for consolidation loan business as well as to retain the loans of their current customers. Their marketing techniques have included mass mailings, telemarketing, and Internet pop-ups to encourage borrowers to consolidate their loans. This increased marketing effort has likely contributed to the record level of consolidation loan volume.

Changes in Interest Rates and Loan Volume Affect FFELP and FDLP Costs in Different Ways, but in the Aggregate, Estimated Costs Increased

While the estimated future costs for consolidation loans can vary greatly from year to year, low interest rates and recent loan volume changes have resulted in substantial increases in overall costs to the federal government. However, in light of the differences between how FFELP and FDLP operate, the subsidy costs within these two programs were affected in very different ways. For FFELP, the result was a substantial increase. For FDLP, the result was a narrowing of the net difference between the estimated interest payments paid by consolidated loan borrowers to Education and the costs paid by Education to Treasury to finance direct loans.

FFELP Subsidy Costs Affected by Increased Special Allowance Payments to Lenders and Increased Loan Volume

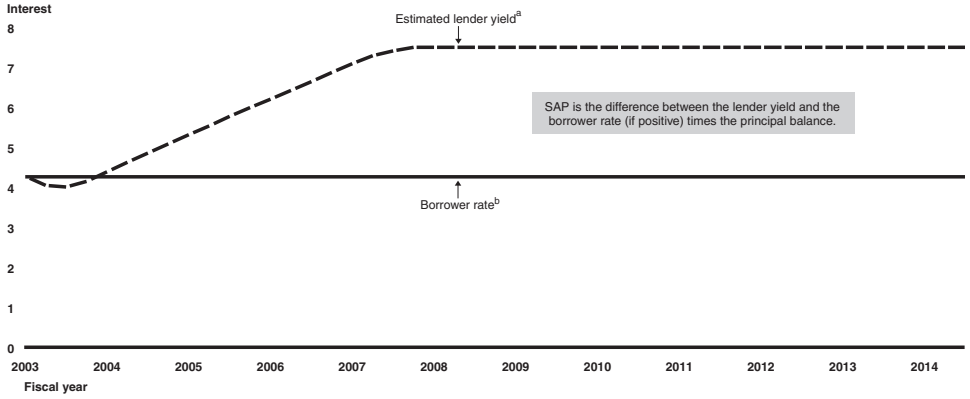
Estimated subsidy costs for FFELP consolidation loans rose from $0.651 billion for loans made in fiscal year 2002 to $2.135 billion for loans made in fiscal year 2003. The increase is largely due to the higher interest subsidies the government is expected to pay to lenders to ensure they receive a guaranteed rate of return on student loans and the result of greater loan volume. The interest subsidy, which is called a special allowance payment (SAP), is based on a formula specified in law and paid by Education to lenders on a quarterly basis when the "guaranteed lender yield" exceeds the borrower rate. This guaranteed lender yield is currently based on the average 3-month commercial paper[7] interest rate plus an additional 2.64 percent. When this guaranteed yield is higher than the amount of interest being paid by borrowers, Education makes up the difference. If the borrower's interest rate exceeds the guaranteed lender yield, Education does not pay a SAP, and the lender receives the borrower rate.

Education's estimate of $2.135 billion in subsidy costs for FFELP consolidation loans made in fiscal year 2003 is based on the assumption that the guaranteed lender yield will rise over the next several years, reflecting Education's assumption that market interest rates are likely to rise from the historically low levels experienced in fiscal year 2003. The effect of this rise is shown in figure 2, where the bottom line shows the fixed borrower rate for a FFELP consolidation loan made in the first 9 months of fiscal year 2003, and the top line shows Education's estimated

[7]Commercial paper is short-term, unsecured debt with maturities up to 270 days. It is issued in the form of promissory notes, primarily by corporations. Many companies use commercial paper to raise cash for current transactions and many find it to be a lower-cost alternative to bank loans.

values for the guaranteed lender yield over time. In fiscal year 2003, market interest rates were such that the guaranteed lender yield established under the SAP formula was actually below the borrower rate. Lenders, therefore, received only the rate paid by borrowers; no SAP was paid. However, in future years, when the guaranteed lender yield is expected to increase and be above the borrower rate, Education would have to make up the difference in the form of a SAP. As figure 2 shows, Education's assumptions would call for lenders to receive a SAP over most of the life of the consolidation loans made in fiscal year 2003.

Figure 2: Illustration of Estimated SAP Paid to Holders of FFELP Consolidation Loans Originated in Fiscal Year 2003



Source: GAO analysis based on data provided by Education's Budget Service.

[a]The estimated lender yield, which is based on the average 3-month commercial paper rates, as provided by the Office and Management and Budget, does not vary much after fiscal year 2007 since the projected commercial paper rates do not vary much after fiscal year 2007. The actual lender yield could vary from these projections depending on future interest rates.

[b]This borrower rate is for a consolidation loan originated from October to June of fiscal year 2003 and whose underlying loans are Stafford loans disbursed after July 1, 1998, and in repayment at time of consolidation.

An increase in loan volume also played a role in the subsidy cost increase from fiscal years 2002 to 2003. However, the effect of the increased loan volume was not as large as that of the higher interest subsidies the government is expected to pay to lenders in the future.

FDLP Loans also Affected by Changing Interest Rates

Subsidy costs can occur within FDLP as well, but in a different way. FDLP's consolidation program is a direct loan program and, therefore, involves no guaranteed yields to private lenders. Still, the program has potential subsidy costs if the government's cost of borrowing is higher than the interest rate borrowers are paying. The government's cost of

borrowing is determined by the interest rate Education pays Treasury to finance direct student loans, which is equivalent to the discount rate.[8] The difference between borrowers' rates and the discount rate—called the interest rate spread—is a key driver of subsidy estimates for FDLP loans. When the borrower rate is greater than the discount rate, Education will receive more interest from borrowers than it will pay in interest to Treasury to finance its loans, resulting in a positive interest rate spread—or a gain (excluding administrative costs) to the government. Conversely, when the borrower rate is less than the discount rate, Education will pay more in interest to Treasury than it will receive from borrowers, which will result in a negative interest rate spread—or a cost to the government.

For FDLP consolidation loans made in fiscal years 2002 and 2003, no such negative interest rate spreads were incurred in either year, based on the methodology Education uses to determine these costs. In both years, borrower interest rates for FDLP consolidation loans were somewhat higher than the discount rate, resulting in a net gain to the government. However, while Education continued to benefit from lending at interest rates higher than its cost of borrowing for FDLP consolidation loans made in fiscal year 2003, the size of this benefit declines from $571 million in fiscal year 2002 to $543 million in fiscal year 2003.

The smaller net gain that occurred in fiscal year 2003 reflects both a decrease in the loan volume and a narrowed difference between the discount rate and the borrower rate. Loan volume in fiscal year 2003 was $6.7 billion, a decrease from $8.8 billion in fiscal year 2002. In fiscal year 2003, this difference narrowed in part because borrower rates dropped more than the discount rate. The borrower rates for FDLP consolidation loans dropped 1.2 percentage points, from 6.3 percent in fiscal year 2002 to 5.1 percent in fiscal year 2003. The discount rate, on the other hand, dropped by only 0.88 percentage points, from 4.72 percent in fiscal year 2002 to 3.84 percent in fiscal year 2003. The resulting interest rate spread decreased from 1.59 percent to 1.22 percent (see table 2). In other words, each $100 of consolidated FDLP loans made in fiscal year 2002, will result in $1.59 more in interest received by Education than it will pay out in interest to the Treasury. A similar loan originated in fiscal year 2003, however, will generate only $1.22 more in interest for the government.

[8]While the discount rate is the interest rate used to calculate the present value of the estimated future cash flows to determine subsidy cost estimates, it is also generally the same rate at which interest is paid by Education on the amounts borrowed from Treasury to finance the direct loan program.

Table 2: Interest Rate Spread for FDLP Consolidation Loans Originated in Fiscal Years 2002 and 2003

Fiscal year	Borrower rate	Discount rate	Interest rate spread	Estimated interest payments for each $100 of loans
2002	6.31%	4.72%	1.59%	1.59% x $100 = $1.59
2003	5.06%	3.84%	1.22%	1.22% x $100 = $1.22

Source: GAO analysis of data provided by Education's Budget Service.

Administration Costs also Increase, Mainly because of Loan Volume

Loan volume affects administrative costs, in that cost is in part a function of the number of loans originated and serviced during the year. As a result, when loan volume increases, administration costs also increase. Education's current cost accounting system does not specifically track administration costs incurred by each of the student loan programs. Consequently, we were unable to determine the total administration costs incurred by consolidation loan programs or any off-setting administrative cost reductions associated with the prepayment of loans underlying consolidation loans. However, based on available Education data, we were able to determine some of the direct costs associated with the origination, servicing, and collection of FDLP consolidation loans. For fiscal year 2002, these costs totaled roughly $52.3 million. This does not include overhead costs, which include costs incurred for personnel, rent, travel, training, and other activities related to maintaining program operations. For fiscal year 2003, the estimated costs for the origination, servicing, and collection of FDLP consolidation loans is projected to increase to $59.5 million. While we similarly were unable to determine Education's administration costs directly related to FFELP consolidation loans, they are likely to be smaller than for FDLP consolidation loans. This is because a large portion of FFELP administration cost is borne directly by lenders, who make and service the loans. The special allowance payments to lenders, which rise and fall as interest rates change, are designed to ensure that lenders are compensated for administration and other costs and provided with a reasonable return on their investment so that they will continue to participate in the program.

Concluding Observations

As the discussion of both FFELP and FDLP loans shows, interest rates have a strong effect on whether subsidy costs occur and how large they are. The movement of subsidy costs for consolidation loans made in future years will depend heavily on what happens to interest rates. As we have shown, subsidy cost estimates for FFELP consolidation loans can increase

substantially, depending on how much the guaranteed lender yield rises above the fixed rate paid by borrowers, which, in turn, requires the federal government to pay subsidies to lenders. Conversely, if borrowers obtained consolidation loans with a fixed interest rate at a time when rates were expected to decrease in the future, federal subsidy costs could be lower, than is currently the case, because the borrower rate could exceed the rate guaranteed to lenders, and the federal government might not be required to pay lender subsidies. For FDLP consolidation loans, allowing borrowers to lock in a low fixed rate might result in decreased federal revenues if the variable interest rates on those loans borrowers converted to a consolidation loan would have otherwise increased in the future. The exact effects of FDLP consolidation loans, however, depend on a number of factors, including the length of loan repayment periods, borrower interest rates, and discount rates.

We noted in our prior report[9] that borrowers' choices between obtaining a fixed rate consolidation loan or retaining their variable rate loans can significantly affect federal costs. While consolidation loans may be an important tool to help borrowers manage their educational debt and thus reduce the cost of student loan defaults, the surge in the number of borrowers consolidating their loans suggests that many borrowers who face little risk of default are choosing consolidation as a way of obtaining low fixed interest rates—an economically rational choice on the part of borrowers. If borrowers continue to consolidate their loans in the current low interest rate environment, and interest rates rise, the government assumes the cost of larger interest subsidies. Providing for these larger interest subsidies on behalf of a broad spectrum of borrowers may outweigh any government savings associated with the reduced costs of loan defaults for the smaller number of borrowers who might default in the absence of the repayment flexibility offered by consolidation loans.

In our October 2003 report, we also discussed the extent to which repayment options other than consolidation loans allow borrowers to simplify loan repayment and reduce repayment amounts. We found that other repayment options that allow borrowers to make a single payment to cover multiple loans and smaller monthly payments are now available for some borrowers under both FFELP and FDLP, but these alternatives are not available to all borrowers. In that report, we concluded that restructuring the consolidation loan program to specifically target

[9]GAO-04-101.

borrowers who are experiencing difficulty in managing their student loan debt and at risk of default, and/or who are unable to simplify and reduce repayment amounts by using existing alternatives, might reduce overall federal costs by reducing the volume of consolidation loans made. In addition, making the other nonconsolidation options more readily available to borrowers might be a more cost-effective way for the federal government to provide borrowers with repayment flexibility while reducing federal costs. An assessment of the advantages of consolidation loans for borrowers and the government, taking into account program costs and the availability of, and potential change to, existing alternatives to consolidation, and how consolidation loan costs could be distributed among borrowers, lenders, and the taxpayers, would be useful in making decisions about how best to manage the consolidation loan program and whether any changes are warranted.

In our October 2003 report, we recommended that the Secretary of Education assess the advantages of consolidation loans for borrowers and the government in light of program costs and identify options for reducing federal costs. We suggested options that could include targeting the program to borrowers at risk of default, extending existing consolidation alternatives to more borrowers, and changing from a fixed to a variable rate the interest charged to borrowers on consolidation loans. We also noted that, in conducting such an assessment, Education should also consider how best to distribute program costs among borrowers, lenders, and the taxpayers and any tradeoffs involved in the distribution of these costs. Furthermore, if Education determines that statutory changes are needed to implement more cost-effective repayment options, we believe it should seek such changes from Congress. Education agreed with our recommendation.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the Committee may have.

GAO Contact and Acknowledgments

For further contacts regarding this testimony, please call Cornelia M. Ashby at (202) 512-8403. Individuals making key contributions to this testimony include Jeff Appel, Susan Chin, Cindy Decker, and Julianne Hartman-Cutts.

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