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Highlights

Highlights of GAO-04-1070, a report to congressional requesters

September 2004

FEDERAL FAMILY EDUCATION LOAN PROGRAM

Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments

Why GAO Did This Study

To encourage lenders to make student loans under the Federal Family Education Loan Program (FFELP), the federal government guarantees lenders a statutorily specified rate of return—called lender yield. Some lenders may issue tax-exempt bonds to raise capital to make or purchase loans; loans financed with such bonds issued prior to 10/1/93 are guaranteed a minimum lender yield of 9.5% (hereafter called 9.5% loans). When the interest rate paid by borrowers is less than the lender yield, the government pays lenders the difference—a subsidy called special allowance payments. In light of the upcoming reauthorization of the Higher Education Act of 1965, we examined special allowance payments for 9.5% loans.

What GAO Recommends

To address the issues identified in this report, Congress should consider changing the yield for loans made or purchased in the future with the proceeds of pre-10/1/93 tax-exempt bonds, and any associated refunding bonds, to better reflect market interest rates.

GAO recommends that Education change its regulations so that 9.5% loans transferred from a pre-10/1/93 tax-exempt bond no longer receive a minimum 9.5% yield. Education agrees that special allowance payments should be reduced, but believes it has limited options to do so. GAO believes that Education has other options it can explore.

www.gao.gov/cgi-bin/getrpt?GAO-04-1070.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Cornelia Ashby at (202) 512-8403 or ashbyc@gao.gov..

What GAO Found

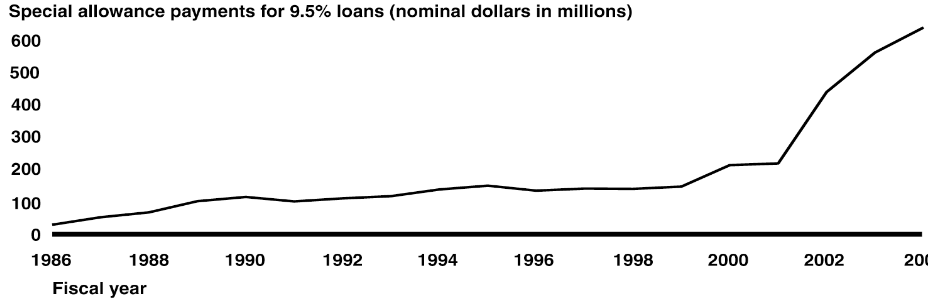
As shown below, special allowance payments for 9.5% loans have risen dramatically in recent years, increasing from $209 million in FY 2001 to well over $600 million as of June 30, 2004. A primary reason for the increase is the sharp decline in the variable interest rates paid by borrowers relative to the minimum 9.5% lender yield.

Another reason for the increase in special allowance payments is the rising dollar volume of 9.5% loans, which increased from about $11 to over $17 billion from FY 1995 to June 30, 2004. Given that current market interest rates are at or near historic lows, lenders have a financial incentive to maintain or increase their 9.5% loan volume and can do so in three ways:

- After paying costs, including payments to bond investors, associated with a pre 10/1/93 tax-exempt bond, lenders can use any remaining money to reinvest in more FFELP loans that, by law, are also guaranteed a minimum 9.5% yield.
- Lenders can issue a new bond, called a refunding bond, to repay an outstanding pre 10/1/93 tax-exempt bond that financed 9.5% loans. Consequently, the refunding bond finances the 9.5% loans and may have a later maturity date than the original bond, allowing lenders to maintain their 9.5% loan volume for a longer time.
- By issuing a taxable bond and using the funds obtained to purchase 9.5% loans financed by a pre-10/1/93 tax-exempt bond, lenders can significantly increase their loan volume. Lenders can use the proceeds from the sale of loans previously financed by the pre-10/1/93 tax-exempt bond to make or buy additional loans, which are also guaranteed a 9.5% yield. Under Education's regulations, loans previously financed by a pre 10/1/93 tax-exempt bond and subsequently financed by (i.e., transferred to) a taxable bond continue to be guaranteed a 9.5% yield.

Some Members of Congress and the Administration have proposed making statutory changes with respect to 9.5% loans, which could save billions of dollars in future special allowance payments. An official representing a leading credit rating agency and some major lenders told us that making changes to the minimum 9.5% yield for loans made or purchased in the future should not affect lenders' ability to make required payments on outstanding tax-exempt bonds.

Special allowance payments for 9.5% loans (nominal dollars in millions)



Source: U.S. Department of Education.