United States General Accounting Office

GAO

Report to Congressional Requesters

October 2003

STUDENT LOAN PROGRAMS

As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined

GAO-04-101

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-04-101, a report to congressional requesters

Why GAO Did This Study

The federal government makes consolidation loans available to help borrowers manage their student loan debt. By combining loans into one 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—and are available to borrowers regardless of financial need.

GAO was asked to examine (1) how consolidation borrowers differ from nonconsolidation borrowers; (2) how federal costs have been affected by recent interest rate and loan volume changes; and (3) the extent to which repayment options—other than consolidation—are available to help simplify and reduce loan repayments.

What GAO Recommends

GAO recommends 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. Options could include targeting the program to borrowers at risk of default and extending existing consolidation alternatives to more borrowers. Education should also consider how best to distribute program costs among borrowers, lenders and the taxpayers. Education agreed with our recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-04-101.

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

On average, consolidation loan borrowers, over the 1987 to 2002 period, had higher levels of student loan debt, higher incomes, and larger loan repayments than did nonconsolidation borrowers. For example, the average student loan debt among consolidation borrowers prior to consolidating their loans was about $22,000 versus about $10,000 for nonconsolidation borrowers. As a group, they defaulted less often on their consolidation loans than borrowers who did not consolidate their loans.

Recent trends in interest rates and consolidation loan volumes have affected consolidations in the Department of Education's (Education) two major student loan programs—the Federal Family Education Loan Program (FFELP) and the William D. Ford Federal Direct Loan Program (FDLP)—in different ways, but in the aggregate, estimated subsidy and administration costs have increased. Subsidy costs for FFELP consolidation loans grew from $1.3 billion for loans made in fiscal year 2002 to nearly $3 billion for loans made in fiscal year 2003. Lower interest rates available to borrowers in fiscal year 2003 increased 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 consolidation loan borrowers pay. Higher loan volumes also added to the estimated subsidy costs. Interest rates and loan volume also affected costs for FDLP consolidation loans, but in a different way. Because the interest rate the government charges borrowers has been somewhat greater than the interest rate that Education pays to finance its lending, consolidation loans have generated a net gain for the government in recent years. Lower rates paid by borrowers and reduced loan volume from recent record highs, however, reduced the net gain to $286 million for loans made in fiscal year 2003, down from $460 million the year before. While administration costs are not specifically tracked for either loan program, available evidence indicates that these costs have also risen.

Alternatives to consolidation, such as the ability to make a single repayment to cover multiple loans and obtain extended repayment terms, now give some borrowers opportunities to simplify and reduce loan repayments, but not all borrowers can use them. As a result, consolidation loans may be the only option for some borrowers to simplify and reduce repayments. Borrowers' repayment choices—whether to obtain a consolidation loan or use other alternatives—have consequences for federal costs. While consolidation loans may remain an important tool to help borrowers, overall federal costs in providing for consolidation loans may exceed federal savings from reduced defaults. An assessment of the advantages of consolidation loans for borrowers and the government, taking into account program costs and how costs could be distributed among borrowers, lenders, and the taxpayers, would be useful for decisionmakers.

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Abbreviations

FCRA	Federal Credit Reform Act
FDLP	William D. Ford Direct Loan Program
FFELP	Federal Family Education Loan Program
HEA	Higher Education Act
HEAL	Health Educational Assistance Loans
IRS	Internal Revenue Service
NSLDS	National Student Loan Data System
SAP	special allowance payment

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

October 31, 2003

The Honorable John A. Boehner
Chairman
Committee on Education and the Workforce
House of Representatives

The Honorable Howard P. "Buck" McKeon
Chairman
Subcommittee on 21st Century Competitiveness
Committee on Education and the Workforce
House of Representatives

For over 2 decades, the federal government has made consolidation loans available to help borrowers cope with large amounts of federal student loan debt. Consolidation loans are designed to help borrowers stay current on loan payments, thereby reducing the government's costs of paying for defaults. Instead of making concurrent repayments on several loans over a period usually limited to 10 years, consolidation loan borrowers can combine their loans and extend their repayment periods beyond 10 years, thereby reducing monthly repayments. Consolidation loans also allow borrowers to lock in a fixed interest rate, unlike most other federal student loans, which carry an interest rate that varies from year to year. Between fiscal year 2000 and 2002, the number of borrowers consolidating their federal student loans nearly doubled to almost 1 million, and the total amount—or volume—of loans being consolidated rose even more sharply, from $12 billion to over $31 billion. Consolidation loans are available under both of the Department of Education's (Education) two major student loan program—the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP)[1]—and, in fiscal year 2002, accounted for about 44 percent of these programs' total loan volume.

[1]Under FFELP, private lenders make consolidation loans to borrowers, with Education guaranteeing lenders loan repayment and a rate of return that is equal to the average 3-month commercial paper rate plus 2.64 percent. As of June 30, 2003, that rate of return was 3.81 percent for consolidation loans made on or after January 1, 2000. Under FDLP, Education uses federal funds to make direct student loans.

The increase in consolidation borrowers and loans has raised congressional interest in the cost of the program for the federal government. Two main types of federal costs are involved. One is "subsidy"—the net present value of cash flows to and from the government that result from providing these loans to borrowers.[2] 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.[3]

For years, consolidation loans were basically the only alternative available to borrowers seeking to reduce the size of their loan repayments. In recent years, however, some repayment options, such as graduated, extended, and income-based repayment plans, have been added to FFELP and FDLP. This change has raised congressional interest in the degree to which these options extend payment relief to borrowers without requiring them to consolidate their loans, and in the potential advantages and disadvantages of the various approaches, both for borrowers and the federal government. In light of the upcoming reauthorization of the Higher Education Act (HEA) (which authorizes the consolidation programs), you asked us to examine several issues concerning consolidation loans. As agreed with your office, we focused our work on answering the following key questions:

[2]The Federal Credit Reform Act of 1990 requires Education to estimate these subsidy costs, using the net present value of cash flows to do so. 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). The background section of the report will describe credit reform in more detail.

[3]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—more specifically, in the 2.64 percent add on paid over and above the 3-month rate on commercial paper.

- How do consolidation loan borrowers differ from nonconsolidation loan borrowers?

- How are federal subsidy and administration costs for consolidation loan programs affected by recent interest rate and loan volume changes?

- To what extent do repayment options other than consolidation loans allow borrowers to simplify loan repayment and reduce repayment amounts?

Our work to answer these questions involved a variety of information sources, including officials from Education's Office of Federal Student Aid and Budget Service, as well as representatives of FFELP lenders. To develop information about student borrowers, we analyzed a sample of student loan data from Education's National Student Loan Data System (NSLDS)—a comprehensive national database of student loans, borrowers, and other information. The sample was a randomly drawn, representative sample that contained records on approximately 4.4 million loans held by 1.4 million students or their parents. The sample constituted 4 percent of the overall NSLDS population of approximately 32 million students.[4] To assess the reliability of the NSLDS data, we reviewed existing information about the sample and interviewed Education officials in Washington, D.C., responsible for performing data accuracy, validity, and integrity tests of NSLDS data. In addition, we performed electronic testing of key variables in our sample for obvious problems in accuracy and completeness. We determined that the NSLDS data were sufficiently reliable for this report. Our analysis on borrower characteristics focused on borrowers in the sample who originated loans from 1987 (the year consolidation loans were made available under the program as it is currently structured[5]) to November 2002. To develop information about the family income of borrowers and their repayment amounts, we analyzed data provided by the Internal Revenue Service (IRS) on family income and Education on loan repayments for a sample of borrowers who

[4]Because we used a sample, there is a sampling error associated with estimates obtained from them. For a 95 percent confidence interval, all percentage estimates reported have sampling errors of plus or minus 1 percentage point or less. All reported estimates other than percentages have sampling errors not exceeding plus or minus 5 percent of the value of those estimates.

[5]The current loan consolidation provisions were enacted by the Consolidated Omnibus Budget Reconciliation Act of 1985 (Pub. L . No. 99-272) and later revised by the Higher Education Amendments of 1986 (Pub. L. No. 99-498). The Student Loan Marketing Association (Sallie Mae) had previously been authorized to make consolidation loans.

entered repayment in 1999. Our analysis of federal costs of consolidation loans is also based in part on interviews with Education officials in Washington, D.C., and a review of relevant analyses prepared by Education. We reviewed the HEA and related Education regulations and other published information to identify the repayment options available to student loan borrowers. We conducted our work from July 2002 through August 2003 in accordance with generally accepted government auditing standards.

Results in Brief

On average, consolidation loan borrowers, during the 1987 to 2002 time period, had higher levels of student loan debt, higher incomes, and larger loan repayments than did nonconsolidation loan borrowers. The average level of student loan debt among consolidation loan borrowers, prior to consolidating their loans, was about $22,000 versus about $10,000 for borrowers who did not consolidate their loans. Consolidation loan borrowers were less likely than nonconsolidation loan borrowers to have attended a proprietary (for profit) school and were more likely to have borrowed while attending graduate/professional school. Most consolidation loans had repayment periods that were longer than 10 years. In addition, consolidation loan borrowers, on average, had twice as many student loans as did nonconsolidation borrowers, and two-thirds of consolidation loan borrowers had loans from more than one lender, compared with about one-third of nonconsolidation loan borrowers. Overall, once they had consolidated their loans, borrowers with consolidation loans defaulted less often than borrowers who did not consolidate their loans.

Recent trends in interest rates and consolidation loan volumes have affected 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 $1.3 billion for loans made in fiscal year 2002 to nearly $3 billion for loans made in fiscal year 2003. Lower interest rates available to borrowers in fiscal year 2003 increased 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. Higher loan volumes in the FFELP program also added to the estimated subsidy costs. 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 Treasury to finance its lending. However, the drop in interest rates that occurred in fiscal year 2003, among other things, reduced the government's estimated net gain to $286 million for loans made in fiscal year 2003, down from $460 million for loans made the year before. A decrease in loan volume from recent record highs also contributed to the reduced gain. Administration costs are not specifically tracked for either consolidation loan program, but available evidence indicates that these costs have risen, primarily reflecting increased loan volumes.

Repayment options, other than consolidation loans, that allow borrowers to simplify loan repayment and reduce repayment amounts—such as the ability to make a single repayment to cover multiple loans and obtain extended repayment terms—are now available to some borrowers under both FFELP and FDLP, but these alternatives are not available to all borrowers. If borrowers have multiple loans from a single lender, they can make one monthly payment to cover all their loans. Many borrowers can also adjust the amount of their monthly payments so that they make smaller monthly payments at the start of repayment and larger monthly payments during later repayment periods for each of their individual loans. Moreover, borrowers with relatively large loan balances can extend their repayment periods beyond a 10-year term, which results in smaller monthly payments. While these alternatives to consolidation have been added, borrowers must meet certain criteria to be able to use them. For example, the ability to make a single payment is limited to borrowers whose loans are currently with a single lender, and the ability to extend repayment periods is, in some cases, limited to borrowers whose total loan balances are above certain limits. For borrowers who cannot use these options, consolidation loans remain the only vehicle under FFELP and FDLP by which they may combine multiple repayments into one and reduce the amount of their monthly repayments. Consolidation loans also allow borrowers to lock in a fixed interest rate for the life of the loan—an option not available to nonconsolidation loan borrowers in either program. The ability to lock in a low interest rate for the life of the loan is one factor that could motivate some borrowers to choose consolidation over other options. Borrowers' repayment choices, including whether to obtain a consolidation loan or use other repayment alternatives, have consequences for federal costs. While consolidation loans may remain an important tool to help borrowers, overall federal costs in providing for consolidation loans may exceed federal savings from reduced defaults.

In this report, we recommend 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 provided Education with a copy of our draft report for review and comment. In written comments on our draft report, Education agreed with our reported findings and recommendations. Education's written comments appear in appendix I. Education also provided technical comments, which we incorporated where appropriate.

Background

Congress created consolidation loans under Title IV of the HEA to help borrowers combine and reduce monthly repayments so as to help decrease federal loan default costs. Consolidation loans are available under Education's two major student loan programs—the FFELP and FDLP. Under FFELP, private lenders make loans to students with Education guaranteeing the lenders loan repayment and a rate of return on the loans they make. Under FDLP, the federal government makes loans to students using federal funds.

FFELP and FDLP Offer Several Types of Loans

In addition to consolidation loans, a number of other types of loans are available under FFELP and FDLP, including subsidized Stafford, unsubsidized Stafford, and PLUS loans. Both subsidized and unsubsidized Stafford loans are variable rate loans that 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. Students can qualify for unsubsidized Stafford loans regardless of financial need. The federal government pays the interest on behalf of subsidized loan borrowers while the student is in school. 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.

Consolidation loans differ from Stafford and PLUS loans in that they enable borrowers who have multiple loans—possibly from different

lenders, different guarantors,[6] and even from different loan programs—to combine their loans into a single loan and make one monthly payment. Consolidation loans are new originations that, in general, do not contribute to increases in outstanding loan balances because they refinance already existing loans.[7] 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 Stafford and PLUS loans. 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 (subsidized and unsubsidized Stafford loans, PLUS loans, and, in some instances, consolidation 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 inclusion in a consolidation loan, including Perkins loans, Health Professions Student loans, Nursing Student Loans, and Health Education Assistance loans[8] (HEAL).

Consolidation loans under FFELP and FDLP accounted for about 44 percent of the $71.8 billion in total new student loan dollars that originated during fiscal year 2002. FFELP consolidation loans comprised about 72 percent of the fiscal year 2002 consolidation loan volume, while FDLP consolidation loans accounted for the remaining 28 percent.

[6]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.

[7]In some cases, according to Education, borrowers' outstanding loan balances may increase if collections costs assessed borrowers are included in the amounts being consolidated.

[8]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.

Federal Credit Reform Act of 1990 Helps Define Federal Costs Associated with Consolidation Loans

The Federal Credit Reform Act (FCRA) of 1990 was enacted to require agencies to more accurately measure the government's cost of federal loan programs and to permit better cost comparisons among and between credit programs, such as FDLP and FFELP. Prior to implementing FCRA, the budgetary cost of a new direct loan or loan guarantee was reported on a cash basis. Thus, loan guarantees appeared to be free in the budget year, while direct loans appeared to be as expensive as grants. As a result, costs were distorted and credit programs could not be compared meaningfully with other programs and with each other. FCRA and the related accounting standards and budgetary guidance, together known as credit reform, were established to more accurately measure the government's costs of federal credit programs.

Subsidy Costs

As part of implementing credit reform, agencies are 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, based on the present value of estimated net cash flows, excluding administration costs.

For FFELP loans, the subsidy cost of a loan guarantee is the net present value, when a guaranteed loan is disbursed, of estimated cash flows such as:

- Payments by the government to lenders to cover loan defaults and interest subsidies. (Interest subsidies include payments to lenders that provide them a guaranteed rate of return on the loans they make as well as payments of interest on behalf of subsidized Stafford loan borrowers who are in periods of deferment).[9]

- Payments by lenders to the government, including origination and other fees, penalties assessed borrowers, and recoveries on defaulted loans. (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 of the loans in their portfolio.)

For FDLP loans, the subsidy cost of a direct loan is the net present value, at the time when the direct loan is disbursed, of estimated cash flows such as

- loan disbursements by the government to borrowers and

[9]Deferment equals a period of time during repayment in which the borrower, upon meeting certain conditions, is not required to make payments of loan principal.

- principal repayments and payments of interest by borrowers to the government.

The subsidy costs of FDLP loans are also affected by the interest Education must pay to Treasury to finance its lending activities.

Administration Costs

Administration costs include all costs directly related to FDLP program operations, including loan servicing, loan system development and maintenance, including computer costs, and the costs of collecting on delinquent loans. For FFELP loans, lenders incur a substantial portion of administration costs. The federal government initially pays many of these costs by paying an allowance to the lenders. These allowances are part of the subsidy cost under credit reform. For FDLP loans, the federal government pays for administration costs directly.

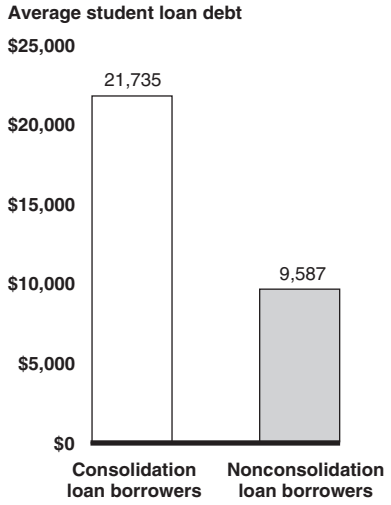
Consolidation Borrowers Had More Debt, Higher Incomes, and Differed in Other Ways When Compared with Nonconsolidation Borrowers

Consolidation loan borrowers differed from nonconsolidation loan borrowers in a variety of ways. On average, consolidation loan borrowers had higher student loan debt, higher incomes, larger annual loan repayments, and longer repayment periods. They were also less likely to have attended a proprietary (or, for-profit) school and were more likely to have borrowed while attending graduate/professional school. In addition, they averaged more student loans from more lenders. Overall, consolidation loan borrowers defaulted less often than borrowers who had not consolidated their loans.

Consolidation Borrowers Had Higher Student Loan Debt and Incomes, Larger Loan Repayments, and Longer Repayment Periods

Borrowers with consolidation loans had a higher average amount of student loan debt than nonconsolidation loan borrowers. Prior to consolidation, the average student loan debt for our sample of consolidation loan borrowers from January 1987 through November 2002 was $21,735, more than twice the average of $9,587 for nonconsolidation borrowers (see fig. 1). While average student loan debt was higher for consolidation loan borrowers, the average student loan debt for both types of borrowers increased over time. Between 1992 and 2002, the average student loan debt increased from $17,420 to $35,339 for consolidation loan borrowers, and from $7,267 to $15,720 for nonconsolidation borrowers.

Figure 1: Average Student Loan Debt of Consolidation Loan Borrowers Prior to Consolidation Compared with Nonconsolidation Borrowers Originating Loans January 1987 to November 2002



Source: GAO analysis of NSLDS data.

Note: Amounts analyzed and reported are in nominal dollars.

Borrowers with consolidation loans had higher average incomes and higher average annual repayments on their student loans than nonconsolidation loan borrowers. In addition, loan repayments comprised a slightly higher percentage of the incomes of consolidation borrowers, with an annual student loan repayment-to-income ratio of 9.4 percent for consolidation loan borrowers and 8.4 percent for nonconsolidation borrowers (see table 1). Not only did consolidation loan borrowers have higher average incomes than nonconsolidation loan borrowers, 39 percent of them had family incomes greater than $50,000, compared with 23 percent of nonconsolidation borrowers with family incomes greater than $50,000.

Table 1: Annual Income and Annual Student Loan Repayment of Consolidation Borrowers Compared with Nonconsolidation Borrowers Entering Repayment in 1999

	Consolidation borrowers	Nonconsolidation borrowers
Average income	$47,150	$32,591
Average annual repayment	$3,355	$2,126
Average student loan repayment-to-income ratio	9.4%	8.4%

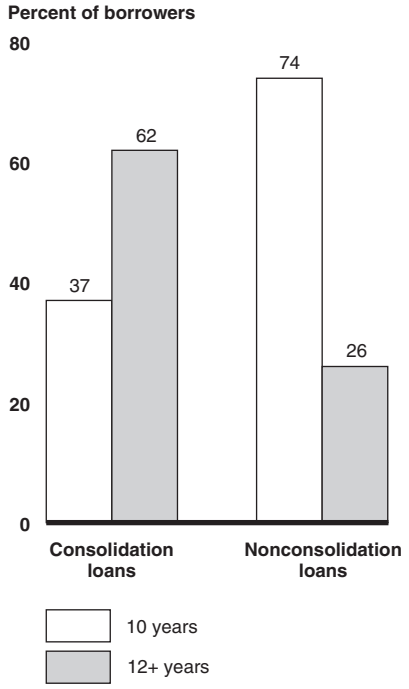
Source: GAO analysis of IRS and Education data.

Note: The annual student loan repayment-to-income ratio was calculated as the average debt burden across five income categories weighted by the number of borrowers in each category.

For the FDLP loans in our sample,[10] consolidation loans tended to have longer repayment periods than nonconsolidation loans. Over 62 percent of consolidation loans had repayment terms of 12 years or more, compared with 26 percent for nonconsolidation loans. The smaller loan balances often carried by nonconsolidation loan borrowers could help explain why a smaller portion of nonconsolidation loans had repayment periods of more than 10 years. For example, under FDLP, many of the repayment plans that allow the extension of repayment periods require a minimum loan balance of $10,000. The repayment periods for loan balances over $10,000 usually vary depending on the amount of the loan, with 30 years being the maximum repayment period for loan balances of $60,000 or more. Since our analysis indicates that nonconsolidation loan borrowers had an average loan debt of $9,587, these borrowers would not qualify for extended repayment periods. However, even when consolidation loan borrowers had the option to extend their repayment term, nearly 4-in-10 (37 percent) of the consolidation loans in our sample had a standard 10-year repayment period (see fig. 2).

[10]NSLDS does not contain information about repayment terms for FFELP loans.

Figure 2: Repayment Periods of Consolidation Loans Compared with Nonconsolidation Loans Originating from January 1987 to November 2002

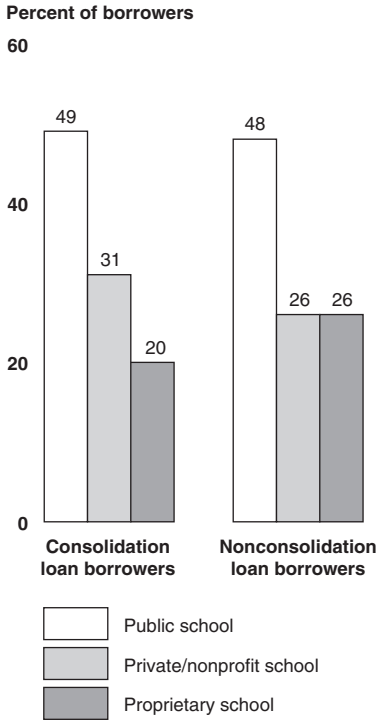


Source: GAO analysis of NSLDS data.

Consolidation Borrowers Were Less Likely to Attend Proprietary Schools and More Likely to Have Borrowed While Attending Graduate/Professional School

Consolidation loan borrowers were less likely than nonconsolidation loan borrowers to have attended a proprietary (or, for-profit) school. Additionally, borrowers with consolidation loans were somewhat more likely to have attended public or private/nonprofit schools than were nonconsolidation borrowers. Overall, 80 percent of consolidation borrowers attended public or private/nonprofit schools and 74 percent of nonconsolidation borrowers attended a public or private/nonprofit school (see fig. 3).

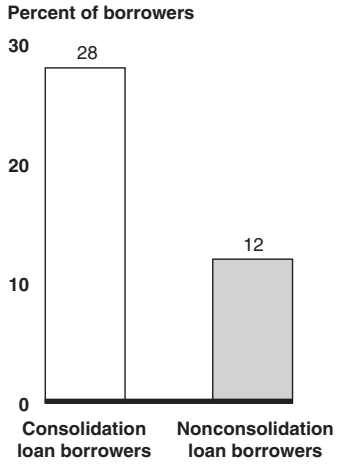
Figure 3: Type of School Attended by Consolidation Loan Borrowers Compared with Nonconsolidation Borrowers Originating Loans, January 1987 to November 2002



Source: GAO analysis of NSLDS data.

Although both consolidation and nonconsolidation loan borrowers tended to borrow prior to graduate/professional school, our analysis indicates that consolidation loan borrowers were more likely than nonconsolidation borrowers to have taken out a student loan while attending graduate/professional school. About 28 percent of consolidation loan borrowers borrowed while they were in graduate/professional school compared with 12 percent of nonconsolidation loan borrowers (see fig. 4).

Figure 4: Percentage of Consolidation Loan Borrowers Who Borrowed for Graduate/Professional School Compared with Nonconsolidation Borrowers Originating Loans, January 1987 to November 2002

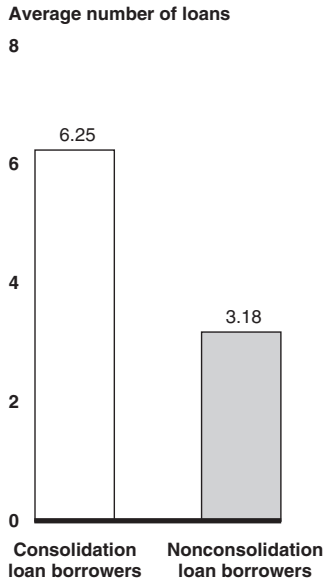


Source: GAO analysis of NSLDS data.

Consolidation Borrowers Had More Loans and Borrowed from More Lenders

Prior to consolidating their loans, consolidation loan borrowers averaged more loans from more lenders than nonconsolidation loan borrowers. Consolidation loan borrowers had taken out an average of about six loans each, nearly twice the average number for nonconsolidation borrowers (see fig. 5). Furthermore, consolidation loan borrowers were more likely to have borrowed from more than one lender. Prior to consolidation, 28 percent of consolidation loan borrowers had loans from three or more lenders compared with 9 percent for nonconsolidation borrowers (see table 2).

Figure 5: Average Number of Loans of Consolidation Loan Borrowers Compared with Nonconsolidation Borrowers Originating Loans, January 1987 to November 2002



Source: GAO analysis of NSLDS data.

Table 2: Number of Lenders of Consolidation Borrowers Compared to Nonconsolidation Borrowers Originating Loans, January 1987 to November 2002

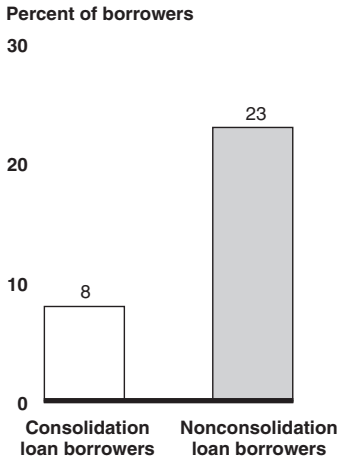
Number of lenders	Consolidation borrowers	Nonconsolidation borrowers
1	37%	69%
2	35%	22%
3 or more	28%	9%
Total	**100%**	**100%**

Source: GAO analysis of NSLDS data.

Consolidation Borrowers Defaulted Less Often

Fewer consolidation loan borrowers in our sample had defaulted on their consolidation loans than nonconsolidation borrowers had defaulted on their loans. The overall default rate for consolidation loan borrowers who had defaulted on their consolidation loans was about 8 percent compared with the overall default rate of 23 percent for nonconsolidation borrowers (see fig. 6).

Figure 6: Percentage of Consolidation Borrowers Who Defaulted on Consolidation Loans Compared with Nonconsolidation Borrowers Who Defaulted on Loans, January 1987 to November 2002



Source: GAO analysis of NSLDS data.

Some consolidation loan borrowers had defaulted on a student loan prior to obtaining their consolidation loan and then subsequently defaulted on their consolidation loan as well. About one-fifth (19 percent) of consolidation loan borrowers had, in fact, defaulted on a loan before they obtained a consolidation loan; of these borrowers, about 23 percent subsequently defaulted on their consolidation loans. Of the approximately four-fifths (81 percent) of consolidation loan borrowers that had never defaulted on a student loan prior to obtaining a consolidation loan, about 5 percent defaulted on their consolidation loan.

Interest Rates and Increased Loan Volumes Have Increased Federal Costs

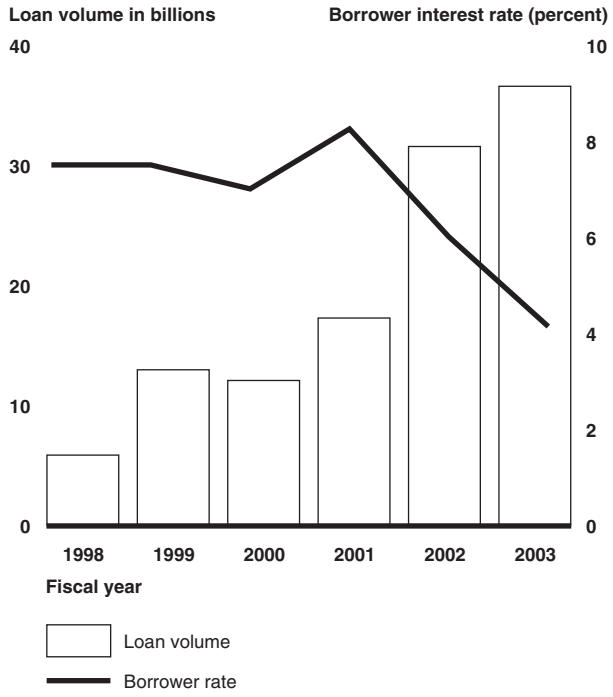
Although recent trends in interest rates and consolidation loan volumes have affected the FFELP and FDLP consolidation programs in somewhat different ways, the net effect has been an increase in estimated subsidy and administration costs for loans made in fiscal year 2003 as compared with loans made in fiscal year 2002. In FFELP, estimated subsidy costs rose from $1.3 billion for loans made in fiscal year 2002 to nearly $3 billion for loans made in fiscal year 2003. These estimated subsidy costs are affected by the amount the federal government must pay to lenders to guarantee them a statutorily established rate of return, which fluctuates over time as interest rates rise and fall. Increased FFELP consolidation loan volume in 2003 also raised costs. For FDLP consolidation loans, the margin of difference narrowed between the interest rate that Education

earned from borrowers and the rate that Education paid to the Treasury to finance direct loans. As a result of this smaller difference, as well as an expected decrease in demand for FDLP consolidation loans compared to prior years, the estimated net interest gain to the government dropped from $460 million in fiscal year 2002 to $286 million in fiscal year 2003. The movement of subsidy costs for loans made in future years will depend heavily on what happens to interest rates and loan volumes. Administration costs are not specifically tracked for either loan program, but available evidence indicates that these costs have also risen.

Borrowers' Rates Have Dropped and Loan Volumes Have Risen

Recent years have seen dramatic growth in loan volume for both consolidation loan programs, along with an overall drop in interest rates for borrowers that correspond to the overall decline in interest rates. From fiscal year 1998 through fiscal year 2002, the volume of consolidation loans made (or "originated") rose from $5.8 billion to over $31 billion. Of the over $31 billion in consolidation loan volume for fiscal year 2002, $22.7 billion was in the FFELP and $8.8 billion was in the FDLP. While FDLP consolidation loan volume for fiscal year 2003 is expected to decrease, FFELP loan volume is expected to increase, resulting in a total consolidation loan volume of over $36 billion for the year. 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. From July 2000 to June 2003, the minimum fixed interest rate for consolidation loans dropped 4 percentage points, with consolidation loan borrowers currently obtaining rates as low as 3.50 percent in the year beginning July 1, 2003. Figure 7 shows the relationship between these two factors. Under these conditions, 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.

Figure 7: Consolidation loan volume increased as borrower interest rates fell



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

Underscoring the potential attractiveness of these loans to potential borrowers, many lenders, including newer loan companies that are specializing in consolidation loans, are aggressively marketing 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.

Effect on Subsidy Costs Varies between Programs

Overall estimated subsidy costs for consolidation loans made in fiscal year 2003 were greater than for consolidation loans made in fiscal year 2002. In light of the differences between how the FFELP and FDLP operate, however, the costs of these two programs were affected in very different ways. For FFELP, the result was a substantial increase in estimated subsidy costs. 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.

Increased Special Allowance Payments to Lenders and Increased Loan Volume Caused FFELP Subsidy Costs to Rise

Estimated subsidy costs for FFELP consolidation loans are expected to increase from $1.3 billion for loans made in fiscal year 2002 to almost $3 billion for loans made in fiscal year 2003. While part of the increase is the result of greater loan volume, the increase is primarily 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.

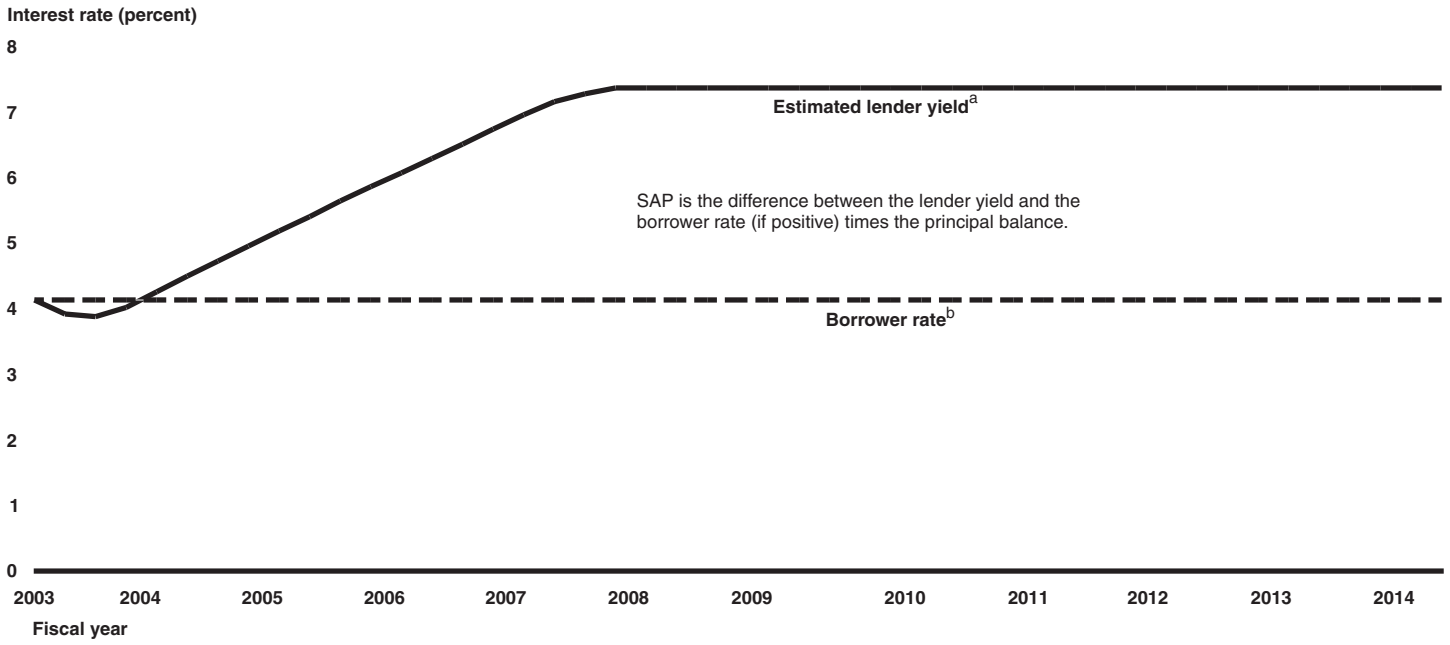
The interest subsidy, which is called a special allowance payment (SAP), is based on a formula specified in law and paid by Education to lenders on a quarterly basis when the "guaranteed lender yield" exceeds the borrower rate. This guaranteed lender yield is currently based on the average 3-month commercial paper[11] interest rate plus an additional 2.64 percent. The amount of the quarterly SAP paid to loan holders equals the difference between the guaranteed lender yield and the borrower rate divided by four and multiplied by the average unpaid principal balance of all loans the lender holds. 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 nearly $3 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. In figure 8, the bottom line shows the fixed borrower rate for a FFELP consolidation loan made in the first 9 months of fiscal year 2003, while the top line shows Education's estimated 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 would therefore receive only the rate paid by borrowers; no SAP would be 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 the figure shows, Education's assumptions would

[11]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.

call for lenders to receive a SAP over most of the life of the consolidation loans made in fiscal year 2003.

Figure 8: Illustration of Estimated SAP Paid to Holders of FFELP Consolidation Loans Originated in Fiscal Year 2003



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

[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 (OMB), 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 July1,1998, and in repayment at time of consolidation.

In point of fact, Education is required to revise these estimates periodically to adjust for changing assumptions about interest rates and loan performance. Subsidy costs estimates for FFELP consolidation loans can vary substantially, depending on how much the guaranteed lender yield rises above the fixed rate paid by borrowers. Education is required to account for such changes in subsidy cost estimates by annually updating, or "reestimating," loan program costs, in accordance with OMB budget

guidance.[12] Any increase or decrease in the subsidy cost estimates resulting from reestimates is reflected in future program budget estimates as appropriate and Education's end of the fiscal year financial statements whenever the reestimated amount is significant. Thus, Education's estimates for both fiscal year 2002 loans and fiscal year 2003 loans are subject to change in the future.

An increase in loan volume also played a role in the subsidy cost increase from fiscal years 2002 to 2003, but to a lesser degree than the higher interest subsidies the government is expected to pay to lenders. On their own, loan volumes can increase subsidy amounts. To illustrate, estimated subsidy costs can be converted into subsidy rates, reflecting the estimated unit cost per loan dollar to the federal government. For example, a $1,000 loan with a federal subsidy cost of $100 would have a subsidy rate of 10 percent. The subsidy rate for FFELP consolidation loans made in fiscal year 2002 was approximately 5.9 percent. Given a fiscal year 2002 FFELP consolidation loan volume of about $22.7 billion, and a subsidy rate of 5.9 percent, federal subsidy costs can be determined by multiplying the loan volume by the subsidy rate ($22.7 billion X 0.059 = $1.3 billion). Viewed in this way, it is clear that even if the subsidy rate remained the same from fiscal year 2002 to 2003, the larger expected FFELP consolidation loan volume of $30.5 billion in fiscal year 2003 would have increased total subsidy costs to $1.8 billion (i.e., $30.5 billion X 0.059 = $1.8 billion), an increase of $0.5 billion from fiscal year 2002. However, the higher interest subsidies the government is expected to pay to lenders, as previously discussed, also increased the subsidy rate for FFELP consolidation loans made in fiscal year 2003. This rate—9.8 percent—coupled with the estimated loan volume of $30.5 billion, resulted in the total FFELP consolidation loan subsidy costs of about $3 billion ($30.5 billion X 0.098).

[12]To estimate the cost of loan programs, Education first estimates the future performance of direct and guaranteed loans when preparing their annual budgets. These first estimates establish the subsidy estimates for the current-year originated loans. The data used for the first estimates are reestimated later to reflect any changes in loan performance and expected changes in future economic 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.

Changing Interest Rates Also Affected FDLP Consolidation Loans

Subsidy costs can occur within FDLP as well, but in a different way. The FDLP consolidation program is a direct loan program and therefore involves no guaranteed yields to private lenders. Still, the program has potential subsidy costs determined in part by the relationship between interest rates Education earns from borrowers—the borrower rate and the rate Education pays Treasury to finance its lending. The government's cost of capital is determined by the interest rate Education pays Treasury to finance direct student loans, which is equivalent to the discount rate.[13] 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 is expected to decline from $460 million in fiscal year 2002 to $286 million in fiscal year 2003.[14]

[13]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.

[14]The subsidy estimates for consolidation loans made in fiscal year 2003 were developed by Education in August 2003. To account for recent changes in interest rates, we asked Education to update its estimates as of August 18, 2003, using a discount rate that we calculated based on the average of daily Treasury rates for various short- and long-term maturities during fiscal year 2003. Because our calculation was as of August 18, 2003, we approximated the Treasury rates through the remainder of the fiscal year based on the August 18, 2003, rates. At the end of fiscal year 2003, when OMB determines the actual discount rates for fiscal year 2003, estimated subsidy costs of the fiscal year 2003 FFELP and FDLP consolidation loans will likely change.

The smaller net gain that is expected to occur in fiscal year 2003 reflects a narrowed difference between the discount rate and the borrower rate. 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 2 percentage points, from 6 percent in fiscal year 2002 to 4 percent in fiscal year 2003. The discount rate, on the other hand, dropped by only 0.95 percentage points. The resulting interest rate spread decreased from 1.1 percent to 0.05 percent (see table 3). In other words, each $100 of consolidated FDLP loans made in fiscal year 2002, will result in $1.10 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 $0.05 more in interest for the government.

Table 3: 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	6.0%	4.90%	1.1%	1.1% x $100 = $1.10
2003	4.0%	3.95%	0.05%	0.05% x $100 = $0.05

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

Note: The discount rate of 3.95 percent is an estimated discount rate on August 18, 2003. The actual discount rate for fiscal year 2003 may be higher or lower, which would reduce or increase the interest rate spread for fiscal year 2003.

While Education revises estimates periodically to adjust for changing assumptions about future interest rates for FFELP consolidation loans, the borrower rate and the discount rate used to derive the subsidy cost for FDLP consolidation loans made in fiscal year 2003 are generally fixed for the life of the loans. As a result, the subsidy cost of FDLP consolidation loans made in any given fiscal year do not vary in the way that subsidy costs for FFELP consolidation loans do.[15]

[15]Subsidy cost estimates for consolidation loans made in fiscal year 2003 will be updated when the actual discount rate for the loans made in fiscal year 2003 is known at the close of fiscal year 2003. Reestimates for interest rates for FDLP consolidation loans would generally not occur due to the fixed discount and borrower rates used for calculating subsidy cost estimates. However, technical reestimates which are made after the close of each fiscal year to adjust for changes in assumptions other than interest rates (e.g., defaults, recoveries, prepayments, and fees), may still occur and could result in changes to the subsidy cost estimates.

Loan volume also played a role in the smaller net gain that occurred in fiscal year 2003. While FDLP consolidation loan volume increased from about $5.4 billion in fiscal year 2000 to about $8.8 billion in fiscal year 2002, Education estimated a decrease in demand for FDLP consolidation loans for 2003, expecting volume to be about $6 billion.[16] The unit cost per loan dollar, or subsidy rate, for FDLP consolidation loans made in fiscal year 2002 was a *negative* 5.2 percent, which resulted in a *negative* subsidy[17]—that is, a "gain"—to the government of $0.052 for each dollar lent (excluding administrative costs). As previously discussed, the difference between the discount rate and the borrower rate narrowed from fiscal year 2002 to fiscal year 2003, which contributed to the increased subsidy rate from a *negative* 5.2 percent to a *negative* 4.8 percent, resulting in a smaller gain, per loan dollar, to the government. Had the subsidy rate remained the same from fiscal year 2002 to fiscal year 2003, the decrease in FDLP consolidation loan volume would have resulted in a reduced gain to the government of about $147 million. The subsidy rate increase from fiscal year 2002 to fiscal year 2003, however, coupled with reduced loan volume, resulted in a reduced gain of $174 million.

Subsidy Costs Are Sensitive to Interest Rate Changes

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. As a measure of how great an effect different interest rate assumptions can have, we asked Education to conduct two additional sets of calculations for fiscal year 2002 FFELP and FDLP consolidation loans. Using the same loan volume and other assumptions of the fiscal year 2002 estimates, Education applied the interest rate assumptions that were used to develop the estimates for the fiscal year 2001 and 2003 consolidation loans. These assumptions differed from those in place in fiscal year 2002, as well as from each other. In general, the interest rate assumptions for fiscal year 2001 were higher than the assumptions used in fiscal year 2002, and future interest rates were expected to decrease. The interest rate assumptions for fiscal year 2003, on the other hand, were generally lower

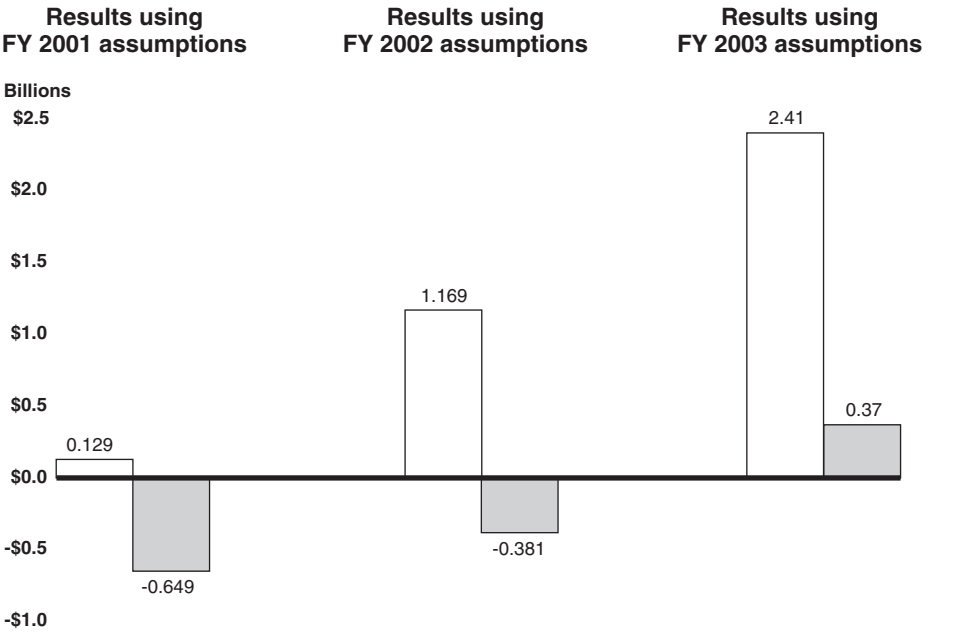
[16]Education's $6 billion estimate was calculated as part of the 2003 Mid-Session Review and based on actual consolidation loan volume for the first two quarters of fiscal year 2003. Actual volume may differ. Further, in July 2003, borrower interest rates decreased from the prior year, which may increase demand for FDLP consolidation loans during the remainder of fiscal year 2003.

[17]Negative subsidies mean subsidy costs that are less than zero. They occur if the present value of cash inflows to the government exceeds the present value of cash outflows.

than the assumptions used in fiscal year 2002, and future interest rates were expected to increase.

Calculating subsidy estimates under these three different sets of interest rate assumptions produced substantially different results. As figure 9 shows, the results of this analysis indicated that for FFELP consolidation loans, the fiscal year 2001 interest rate assumptions would result in estimated subsidy costs totaling $129 million, or about $1 billion less than the estimated subsidy costs under the actual fiscal year 2002 estimates. In contrast, the fiscal year 2003 interest rate assumptions resulted in estimated subsidy costs totaling $2.4 billion, an increase of more than $1.2 billion in subsidy costs, even though the estimate was calculated across the same volume of loans. For FDLP consolidation loans, the analysis indicated that a greater interest rate spread between the discount rate and the borrower rate for the fiscal year 2001 interest rate assumptions, resulted in a net gain to the government totaling about $645 million or about $264 million more than the gain under the actual fiscal year 2002 estimates. In contrast, the fiscal year 2003 interest rate assumptions resulted in an estimated subsidy cost to the government totaling about $370 million, a change of about $751 million. This increase is primarily due to the negative interest rate spread in which the borrower rate used in fiscal year 2003 was less than the discount rate used in the fiscal year 2003 interest rate assumptions.

Figure 9: Illustration of Net Subsidy Costs to the Federal Government for Consolidation Loans Made in Fiscal Year 2002 Using Three Different Sets of Interest Rate Assumptions



FY 2001 assumptions	
Discount rate (FDLP)	5.31%
Lender yield (FFELP)	
-- In FY 2001	7.53%
-- In 10 years	7.36%
Borrower rate	7.75%

FY 2002 assumptions	
Discount rate (FDLP)	4.90%
Lender yield (FFELP)	
-- In FY 2002	4.52%
-- In 10 years	7.36%
Borrower rate	5.63%

FY 2003 assumptions	
Discount rate (FDLP)	5.47%
Lender yield (FFELP)	
-- In FY 2003	4.02%
-- In 10 years	7.36%
Borrower rate	4.13%

Subsidy costs for FFELP loans

Subsidy costs for FDLP loans

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

Note: Results were obtained by applying Education's interest rate assumptions for fiscal years 2001, 2002, and 2003 to the 2002 consolidation loans. Negative subsidy costs for FDLP using fiscal years 2001 and 2002 rates represent a net gain for the federal government.

Administration Costs Also Increase, but 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 total includes approximately $31 million for loan origination, $19 million for loan servicing, and $3 million for loan collection. The $52.3 million does not include overhead costs, which include such expenses as 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 by about $7 million 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 under FFELP, a large portion of 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.

Repayment Options Other Than Consolidation Loans That Allow Borrowers to Simplify Loan Repayments and Reduce Repayment Amounts Exist, but Borrowers' Use of These Options Is Limited by Several Factors

Repayment options, other than consolidation loans, that allow borrowers to simplify loan repayment and reduce repayment amounts are now available to some borrowers under both FFELP and FDLP, but these alternatives are not available to all borrowers. Since consolidation loans were first offered to borrowers, Congress has changed student loan programs in ways that provide borrowers with these loan repayment options. These options include provisions for combining multiple loan payments into one and for restructuring the repayment terms or lengthening the repayment period in order to lower monthly repayment amounts. However, these options are limited, in some cases, to borrowers who have loans with one lender, or whose loan balances meet certain criteria. These options also differ from the consolidation loan program in that they carry a variable borrower interest rate, while consolidation loans allow borrowers to lock in a fixed interest rate. In today's environment, with current low interest rates that are expected to rise over time, the ability to lock in a low fixed rate may affect many borrowers' decisions about which approach to take. Borrowers' choices of whether to use consolidation loans or these other options have a budgetary effect for the federal government. Proposed legislation has been introduced in the 108th Congress that, among other things, would replace the fixed borrower interest rate for consolidation loans with a variable interest rate.

Flexible Repayment Options Similar to Consolidation Are Available to Some Borrowers

Other options, outside of consolidation, now exist for some borrowers to make single payments on multiple loans and reduce their payment amounts—options that were unavailable when Congress first introduced consolidation loans under the FFELP. For example, when Congress created the FDLP in 1993, Education provided FDLP borrowers with the ability to combine payments on multiple FDLP loans into a single payment. Similarly, in 1999, Education promulgated regulations requiring FFELP lenders to combine all of a borrower's FFELP loans into a single account to be repaid under a single repayment schedule. Furthermore, Congress has provided borrowers with a number of repayment plans that give certain FFELP and FDLP borrowers who do not consolidate their loans flexibility to reduce monthly payment amounts in a variety of ways. For example, "graduated" and "income-sensitive" repayment plans introduced in 1992, allow borrowers to make smaller payments early in a repayment period, followed by larger payments in future years. (These plans assume that a borrower's income will increase over the repayment period.) While borrowers who use the FFELP graduated and income-sensitive repayment plans must generally repay their loans over a 10-year period, another repayment plan—"extended"—allows certain FFELP borrowers to lengthen their repayment terms up to 25 years, thus

reducing monthly repayment amounts. Under FDLP, borrowers have similar repayment options, plus additional flexibility to repay loans over longer periods, outside of consolidation. Table 4 summarizes the repayment plans available to borrowers under FFELP and FDLP.

Table 4: Description of Borrower Repayment Plans

FFELP repayment plans		FDLP repayment plans		
Standard	Borrowers make fixed monthly payments of at least $50 for up to 10 years.[a]	Standard	Borrowers make fixed monthly payments of at least $50 for up to 10 years.[a]	
Graduated	Borrowers make smaller payments early in a repayment period, and larger payments later, within certain limits (no repayment can be more than three times greater than any other). Repayment must occur within 10 years.	Graduated	Borrowers make fixed monthly repayments at two or more levels (usually a lower amount for the early years of repayment and a larger amount in the later years) over a period of time that varies with the size of the loan and is the same as for the FDLP extended repayment plan (see below). Borrowers' payments may not be less than the interest due or less than 50 percent, or more than 150 percent, of the monthly repayment required under the standard plan.	
Extended	Borrowers make fixed or graduated monthly repayments of at least $50 for a period of time that varies depending on the amount of the loan. Repayment must occur within 25 years. Extended repayment is limited to new borrowers on or after October 7, 1998, who accumulate (after such date) outstanding loans totaling more than $30,000.	Extended	Borrowers make fixed monthly repayments of at least $50 for a period of time that varies depending on the amount of the loan:	Maximum term:
			Amount:	
			Less than $10,000……	12 years
			$10,000 to $19,999……	15 years
			$20,000 to $39,999.....	20 years
			$40,000 to $59,999…….	25 years
			$60,000 or more..……..	30 years
Income-sensitive	Borrowers' payment amounts may be adjusted annually to reflect changes in a borrower's income. Repayment plan is limited in the amount of adjustment that can be made by statutory requirements that the loan be repaid within the 10-year maximum and that monthly repayments are, at a minimum, sufficient to cover interest.[b]	Income-contingent	Borrowers' payment amounts are based on the total amount of the borrower's loan, income, and family size for a period up to 25 years. Under this repayment plan, borrowers repay based on annual income for up to 25 years with any remaining amount owed on the loan discharged at that time.	

Sources: HEA, Congressional Research Service, and Education.

[a]Because of the variable interest rate for nonconsolidation loans, the loan holder may adjust either the size of the monthly repayment or the length of the repayment period annually. If the change in interest rates would result in a borrower being unable to complete repayment within the 10-year maximum, the loan holder may provide administrative forbearance for a maximum of 3 years (effectively extending the repayment period).

[b]FFELP regulations allow lenders some flexibility to extend repayment up to 15 years through "administrative forbearance" to accommodate the variable interest rates and sensitivity to very low incomes under this repayment plan.

Consolidation loan borrowers, like other FFELP and FDLP borrowers, may choose among the four repayment plans offered under the programs. Borrowers who consolidate under FFELP may—in addition to flexibility offered by the repayment plans—extend their repayment periods up to 30 years by choosing a standard, graduated, or income-sensitive repayment plan. Extending repayment periods, in general, will lower borrowers' monthly repayment amount. Table 5 compares the repayment periods allowed by FFELP under consolidation with those allowed under nonconsolidation.

Table 5: Comparison of Repayment Periods for FFELP Consolidation and Nonconsolidation Loans, by Repayment Plan

	Maximum repayment period for nonconsolidation loans	Maximum repayment period for consolidation loans	
Standard	Up to 10 years	10-30 years depending on outstanding balance of loans:	
		Amount	
		Maximum period	10 years
		Less than $7,500...	12 years
		$7,500 to $9,999……	15 years
		$10,000 to $$19,999…	20 years
			25 years
		$20,000 to $39,999…..	30 years
		$40,000 to $59,999…..	
		$60,000 or more……..	
Graduated	Up to 10 years	10-30 years depending on outstanding balance of loans (see above)	
Income-sensitive	Up to 10 years	10-30 years depending on outstanding balance of loans (see above)	
Extended[a]	Up to 25 years	Up to 25 years	

Sources: HEA, Congressional Research Service, and Education.

[a]Limited to borrowers who accumulate after October 7, 1998, outstanding loans totaling more than $30,000.

Compared with FFELP borrowers, FDLP borrowers have more flexibility to extend the repayment periods for FDLP loans without obtaining a consolidation loan. Under the graduated and extended repayment plans, for example, FDLP borrowers may obtain a repayment period of up to 30 years, regardless of whether they choose a consolidation loan or nonconsolidation option. Table 6 shows the repayment periods available for FDLP borrowers.

Table 6: Repayment Periods for FDLP Consolidation and Nonconsolidation Loans, by Repayment Plan

	Maximum repayment period	
Standard	Up to 10 years	
Graduated	12–30 years depending on loan amount:	
	Amount	
	Maximum period	
	Less than $10,000…..	12 years
	$10,000 to $19,999……	15 years
	$20,000 to $39,999……	20 years
	$40,000 to $59,999……	25 years
	$60,000 or more…..….	30 years
Extended	12–30 years depending on loan amount (see above)	
Income-contingent	Up to 25 years	

Sources: HEA, Congressional Research Service, and Education.

While the options, outside of consolidation, allow some borrowers to make single repayments on multiple loans and reduce their monthly repayment amounts—thus achieving ends similar to consolidation loans—not all borrowers can take advantage of these flexibilities. First, borrowers who obtained FFELP loans from multiple lenders are still faced with making multiple loan payments because lenders are only required to combine borrowers' repayments on the loans they make. Second, borrowers may be required to meet certain eligibility criteria—such as accumulating loans exceeding specified thresholds—to qualify for extended repayment periods. Finally, borrowers who obtained loans under multiple programs—FFELP, FDLP, or other programs—are also faced with multiple payments and may or may not be able to obtain lower monthly repayment amounts. Table 7 compares the extent to which borrowers can combine multiple loan payments into one, lower monthly

repayment amounts, and extend repayment periods under consolidation and nonconsolidation options.

Table 7: Comparison of Borrowers' Options under Consolidation and Nonconsolidation Loans

Composition of borrower's loans	Able to reduce to single payment?	Able to adjust monthly payments through graduated or income-based approaches?	Able to extend the repayment period?
Consolidation loans			
FFELP	Yes	Yes	Yes for all borrowers, with length of period dependent on loan balance.
FDLP	Yes	Yes	Yes for all borrowers, with length of period dependent on loan balance.
Combination of FFELP and FDLP and/or other loans[a]	Yes	Yes	Yes for all borrowers, with length of period dependent on loan balance.
Nonconsolidation loans			
FFELP loans from a single lender	Yes	Yes	Yes, but only for borrowers with loans totaling more than $30,000.
FFELP loans from multiple lenders	No	Yes	Yes, but only for borrowers with loans totaling more than $30,000.
FDLP loans	Yes	Yes	Yes for all borrowers, with length of period dependent on loan balance.
Combination of FFELP and FDLP and/or other loans[a]	No	Varies by type of loan	Varies by type of loan.

Source: GAO analysis.

[a]Other federal student loans eligible for inclusion in a consolidation loan include Perkins loans, Health Professions Student loans, HEA loans, and Public Health Service Act Nursing Student Loans.

Available Options Involve Variable Interest Rates, While Consolidation Offers Currently Attractive Fixed Rate

Another key difference between consolidation loans and other repayment options for nonconsolidation loans is that these other options carry a variable interest rate, while consolidation loans carry a fixed interest rate for the life of the loan. Depending on prevailing interest rates and borrowers' expectations about future interest rates, this difference may affect the decisions that borrowers make regarding whether to obtain a consolidation loan or use other options to combine payments, lower payments, and extend repayment periods. When interest rates are low, as they are now, and are expected to increase in the future, a consolidation

loan that carries a low fixed interest rate may be more attractive to borrowers because a variable rate may exceed the fixed rate during most or all of the remaining repayment period, which could be up to 30 years. However, if rates are expected to decrease in the future, repayment options that carry a variable rate may be more attractive, and borrowers may choose other options over consolidation, hoping to take advantage of lower rates in the future. Since it is difficult to predict interest rates over a lengthy period, borrowers need to be aware of all the risks involved before they make their final decision. Once student loans are consolidated, the interest rate is fixed for the life of the loan and, under current law, borrowers generally cannot reconsolidate their existing consolidation loans to take advantage of lower interest rates. Consequently, borrowers who chose to consolidate their student loans several years ago—and locked in what are now high rates relative to what borrowers can now obtain—are unable to take advantage of the current rate. For example, borrowers who consolidated between February and June 1999, have a locked rate of 8.25 percent.[18] Borrowers who elected to consolidate between July 2002 and June 2003 received a rate of 4 percent, and for 2004, the rate is expected to be about 3.5 percent.

Borrowers' Choices between Fixed or Variable Rate Alternatives Affect Federal Costs

The choices that borrowers ultimately make will have consequences for federal costs. As previously discussed, federal costs for FFELP consolidation loans have recently increased because of the greater difference between borrowers' fixed low interest rate and the variable rate guaranteed to lenders, which is expected to increase in the future. In this situation, were borrowers to choose an alternative option, costs to the federal government would likely be less because a variable borrower rate would increase along with the variable rate guaranteed to lenders and the difference between the two rates would be less. This decreased difference would result in decreased FFELP federal subsidy costs. If circumstances were different, however, federal subsidy costs could increase. For example, if borrowers obtained a consolidation loan with a fixed interest rate at a time when rates were expected to decrease in the future, federal subsidy costs would be lower, than is currently the case, because the borrower rate would likely exceed the rate guaranteed to lenders, and the federal government would not be required to pay a SAP. In such situations, if borrowers were to choose an alternative option with variable borrower

[18]This assumes that the underlying loans being consolidated were Stafford loans disbursed between July 1995 and July 1998 and were in repayment at the time of consolidation.

rates, federal subsidy costs could increase because the borrower rate would decline along with the variable rate guaranteed to lenders. In this case, the decreased difference could result in increased FFELP federal subsidy costs, if SAP payments became necessary.

Borrowers' choices between fixed and variable rate loans and among repayment periods also affect costs to the federal government associated with FDLP loans. A significant driver of FDLP costs, as previously discussed, is the difference between the discount rate and the borrower rate. In general, higher borrower rates will result in Education receiving larger interest payments from borrowers, thus decreasing federal costs. 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. For both programs, federal costs are also affected by the repayment period chosen by borrowers. For example, longer FFELP repayment periods can result in the federal government making special allowance payments to lenders over a longer period of time. For FDLP, longer repayment periods can increase the amount of interest borrowers pay to Education on their loans and increase the amount of interest paid by Education on the amounts borrowed from Treasury.

Proposed Legislation Concerning Consolidation Loans Could Affect Federal Costs

Proposed legislation has been introduced in the 108th Congress that, among other things, would replace the fixed borrower interest rate for consolidation loans with a variable interest rate, which will affect federal costs associated with consolidation loans. In particular, the Student Loan Fairness Consolidation Act of 2003 (H.R. 2504) would eliminate provisions that prevent borrowers who previously obtained a consolidation loan from obtaining a new consolidation loan and replace the current fixed borrower rate with a variable borrower rate for borrowers who refinance their existing consolidation loans as well as for new consolidation loan borrowers. [19] For example, borrowers who obtained a consolidation loan in the past and are paying higher rates of interest would be provided the

[19]Other proposed legislation includes the Consolidation Student Loan Flexibility Act of 2003 (H. R. 942) and the College Loan Assistance Act of 2003 (H.R. 2505). H.R. 942 would, among other things, eliminate a requirement that borrowers certify to having sought and been unable to obtain a consolidation loan from any holders of the outstanding loans the borrower has selected for consolidation. Like H.R. 2504, H.R. 2505 would, among other things, eliminate provisions that prevent borrowers who previously obtained a consolidation loan from obtaining a new consolidation loan.

opportunity to obtain a new consolidation loan at current (lower) borrower interest rates. In addition, in "re-consolidating" their loans, the proposed legislation would replace the current fixed borrower rate with a variable borrower rate. If enacted, the proposed legislation would affect federal costs due to the refinancing of previous consolidation loans and the change from fixed to variable borrower interest rates.

Conclusion

Although additional options to consolidation are now available that give some FFELP and FDLP borrowers opportunities to simplify loan repayment and reduce repayments to more manageable levels, not all borrowers qualify. As a result, many borrowers may find that consolidation loans remain the only option for combining loans and lowering their monthly repayments. While consolidation loans may thus remain 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 for FFELP consolidation loans. Providing for these larger interest subsidies on behalf of a broad spectrum of borrowers, however, 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. 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. Restructuring the consolidation loan program to specifically target 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 changes 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.

Recommendation for Executive Action

We recommend 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. Options 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. 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. If Education determines that statutory changes are needed to implement more cost-effective repayment options, it should seek such changes from Congress.

Agency Comments

We provided a draft of this report to Education for review and comment. In commenting on the draft, Education agreed with our reported findings and recommendation, noting that our work will contribute to the policy discussions related to the reauthorization of the HEA. In addition, Education noted that it was pleased with our conclusion that consolidation loans have advantages for borrowers and may help them avoid default and that improving flexible repayment options for borrowers would provide several benefits. Education also provided technical comments, which we incorporated where appropriate. Education's written comments appear in appendix I.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time we will send copies to the Secretary of Education and other interested parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov

If you or your staff have any questions or wish to discuss this material further, please call me at (202) 512-8403, or Jeff Appel at (202) 512-9915. Other contacts and staff acknowledgments are listed in appendix II.

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

Appendix I: Comments from the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

OCT 27 2003

THE ASSISTANT SECRETARY

Ms. Cornelia M. Ashby
Director, Education, Workforce,
and Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on your draft report, *Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined (GAO-04-101)*. We appreciate that you are providing Members of the Congress with a summary of several complex aspects of student loan consolidation. GAO's work will contribute to the policy discussions related to the reauthorization of the Higher Education Act of 1965, as amended (HEA).

We are pleased with your conclusions that loan consolidation has provided several advantages for borrowers and may have assisted in the significant improvements in default aversion and significant reductions in default that we have achieved over the past few years. We agree that improving the flexible repayment options available to Stafford and PLUS borrowers in the FFEL program would provide several benefits. As we review the HEA for the upcoming reauthorization, we will consider this issue. We also agree with the report's recommendation to assess the advantages of consolidation loans for borrowers and the government in light of program costs and identify options for reducing Federal costs.

We appreciate the analysis and GAO's lengthy work on this engagement. The Department looks forward to working with the education community and the Congress to develop a reauthorization bill that meets the needs of our nation's families.

Additional comments on specific sections of the report are contained in technical comments contained in an e-mail to you. Again, I wish to thank you and your staff for your work on this engagement and look forward to continuing to work with you on these and other important issues.

Sincerely,

Sally L. Stroup

1990 K STREET, N.W. WASHINGTON, D.C. 20006

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

Appendix II: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Susan Chin (206) 287-4827

Staff Acknowledgments

In addition to those named above, Cindy Decker, Ben Jordan, Heather Macleod, Corinna Nicolaou, Stan Stenersen, Vanessa Taylor, and Marcia Carlsen made important contributions to this report.

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