

Statement of Alfred B. Fitt
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before
The Subcommittee on Postsecondary Education,
Committee on Education and Labor
U.S. House of Representatives
May 30, 1979

Mr. Chairman and members of the committee, my name is Alfred Fitt. I am General Counsel of the Congressional Budget Office. I am delighted to be here in response to the chairman's invitation, and on behalf of CBO.

The general topic today is student loans. While there may be some lingering ideological or philosophical objections to the whole concept of helping students by making debtors out of them, the public policy of the United States for the last twenty-one years has been to make it ever easier for college students to secure education loans.

The student loan business in this country is now a gigantic business. This fiscal year alone there will be nearly \$3 billion worth of student borrowing, with practically all of the loan capital supplied or guaranteed by the federal government, and directly or indirectly paid for by federal taxpayers. By this fall, there should be close to \$8 billion in guaranteed student loans outstanding, plus almost another \$5 billion in the National Direct Student Loan program. On-budget federal costs to support student loans are approaching \$1.5 billion annually.

Given such figures, the question for years to come is unlikely to be whether there will be student loan programs.

Rather, the broad question will be how to improve the existing programs.

The present set of mechanisms by which the federal government intervenes in the student loan business has been criticized on a number of grounds, and not just on account of the very large costs involved. Despite frequent amendment of student loan legislation, a loan is not yet available to every student who is qualified for and in need of a loan. Different interest rates are charged to borrowers whose circumstances appear in many cases to be the same. The default rates are disturbingly high. The systems themselves are vexingly cumbersome to all the participants---the borrowers, the lenders, the educational institutions and the state and federal agencies involved.

My testimony this morning will include a brief history of the two major federal student loan programs, and how they work, followed by a discussion of some of the issues the Congress may wish to consider during the current reauthorization cycle. CBO is working on an in-depth analysis of the government's student loan programs. So my statement today should be regarded as preliminary.

The history begins with the National Defense Education Act of 1958. That law authorized the appropriation of \$295 million over the next four years, to provide capital for student loans to be made by colleges, with the institutions putting up \$1 for each \$9 in capital from the federal government. The 1958 law fixed the life of the program at eight years; only borrowers during the first four years were to be eligible for loans in the second four years. The interest rate to be paid by borrowers after they left school was 3 percent, a compromise figure between differing House and Senate versions, but approximately equal to the then Treasury cost of money.

But the program was not stopped in 1966. Though every president since President Eisenhower has recommended a stop, the Congress has instead always reauthorized it and provided increasingly generous annual appropriations, leveling off at about \$310 million in recent years. The accumulated federal capital contribution is now almost exactly \$4 billion, and the one-tenth share put up by institutions means that nearly \$4.5 billion is invested. When the Congress has finished legislating for fiscal year 1980, the likely total in the National Direct Student Loan program will approach \$5 billion.

There are about 3,400 educational institutions who are NDSL lenders, and this academic year, according to

Administration estimates, there will be 874,000 borrowers. The interest rate remains what it was when the law was first passed, zero while in school and 3 percent thereafter.

At the end of June 1978, over \$700 million in outstanding NDSL loans were in default. That sum is more than a sixth of all the capital ever put into the program. The total today probably exceeds three-quarters of a billion dollars, spread among 900,000 or more former students. Some observers have blamed the rising NDSL default on the 1972 decision to allow proprietary institutions to become lenders under the program. But though such institutions now make up 30 percent of all NDSL lenders, their accumulated share of the federal capital is only \$132 million---or less than 3.7 percent---so the great bulk of the default problem remains with the 2,400 non-profit institutions.

After twenty years of depending on colleges and universities to be diligent and expert in collecting the federal money they had lent to their students---with the results I have just mentioned---the U.S. Office of Education this spring has begun a pilot program to take over the defaulted NDSL paper. It is too early to know whether the effort will cost less than the amounts collected.

Viewed in isolation, the NDSL program has much to commend it. The lending decisions are made in financial aid offices, so the availability of the loan---and its size---can depend on informed estimates of need. The borrowing transaction itself is quick, simple and straightforward, with only the student and his institution involved. And of course, a loan at 3 percent is a popular one among those who must borrow for their college expenses.

But NDSL loans are not available universally. There are thousands of postsecondary institutions that do not participate in the program, so their student bodies are excluded from it. Furthermore, those who do participate have shown that overall they are not very good at collecting on those loans when the time comes. The NDSL default rate is 17.4 percent.

Furthermore, some observers question the propriety of the very low interest rate on NDSLs, asserting that not only is so large a subsidy unnecessary---in that it has no apparent effect on the decision to attend---but that it is distributed mainly by chance---that is, that luck more than anything else determines whether a student borrower must pay 3 percent rather than 7 percent for his loan after leaving school.

The counter-argument is made that NDSL monies are reserved for specially needy borrowers. If this is so, the facts to prove it have never been gathered. The statistics on the family income distributions of borrowers under the 7 percent Guaranteed Student Loan Program are neither recent nor comprehensive, so there is a one-hand clapping problem when making comparisons with the income distributions of NDSL borrowers. For the latter, there are statistics showing that a great many colleges make NDSL loans to students from families that cannot fairly be classified as poor. For example, in fiscal year 1977, 41 percent of undergraduate dependent students who got NDSLs came from families with 1975 incomes above \$12,000---when \$12,000 was more than the median income for all American families.

Since all borrowers---NDSL or GSL---pay zero interest while they are students, the difference in interest rates only becomes real after they have left school. But there have apparently never been any studies of comparative incomes of NDSL and GSL borrowers once they enter repayment status. For all that we can tell, the extra subsidy for the NDSL borrower is just a \$100 million a year gift that some young people get after leaving college and others do not.

The much larger Guaranteed Student Loan Program became law in 1965. . The law provided that for states with student loan guaranty agencies, the federal government would cover 80 percent of the state's losses in guaranteeing education loans that students would obtain from banks and other commercial lending institutions. It was hoped that such a shared guaranty would bring private capital to the student loan market, and at an interest rate of 6 percent or less, which would be paid by the federal government for borrowers who came from families with incomes under \$15,000, so long as the borrower was in school.

But the 1965 expectations were not realized. Not all the states joined in, so the federal government became a 100 percent guarantor for lenders in the non-participating states.

Then it soon turned out that the standard 6 percent interest rate was not high enough to attract private capital. It was boosted to 7 percent.

By 1969 it was obvious that 7 percent was insufficient, so in that year Congress legislated a "special allowance", meaning a bonus bringing the effective interest rate up to

a maximum of 10 percent (depending on quarterly fluctuations in government borrowing costs), with the difference above 7 percent payable from the federal Treasury.

Three years later, at the behest of the banks, Congress created the Student Loan Marketing Association---Sallie Mae. The function of Sallie Mae is to provide a secondary market in student loans. In layman's terms, what Sallie Mae does is two things: 1) it buys student loans from banks and other lenders, thereby becoming the owner of the loan and the one responsible for collecting it when due, and 2) it lends money to banks, up to 80 percent of the face value of the student loans made by that bank, with those loans being the collateral to ensure that Sallie Mae will be repaid. In either case, the effect is that the bank's funds are no longer tied up in its student loan portfolio, and the funds received from Sallie Mae can be turned into more student loans or other kinds of investments a bank may want to make.

Sallie Mae is declared by its 1972 enabling legislation to be a "Government-sponsored private corporation". It is owned by stockholders, who put up about \$25 million for their stock, and who must be either financial or educational

institutions. The stockholders control 14 seats on the board of directors, and the President of the United States appoints another seven. In order to enable Sallie Mae to be able to buy student loans, and to lend money against them, it was given 10 years of power to borrow from the federal Treasury, subject to the approval of the Secretary of HEW, but without any statutory limit. The corporation has borrowed about \$1 billion on that basis, and according to the President's fiscal year 1980 budget, will have borrowed \$1.75 billion from the Treasury by October 1, 1980. Thus, about 98 percent of Sallie Mae's current resources have been supplied by the federal government. A year or so from now, the federal share will approach 99 percent.

In 1976 it developed that the maximum 10 percent in combined interest and "special allowance" was too low, so Congress raised the ceiling to 12 percent (averaged over any four consecutive quarters). That same year, the in-school interest subsidy was extended to borrowers with family incomes up to about \$31,000 adjusted gross income. In 1978, the family income ceiling was taken off altogether.

From 1965 through last September, the GSL program totalled about \$13 billion in loans, of which \$5.2 billion had been repaid, another \$1.1 billion in defaulted loans had been

redeemed by the federal government under its guaranty commitment, and \$6.8 billion were still outstanding. In the first six months of this fiscal year---that is, through March 31, 1979---loan dollar volume is running 38 percent ahead of the same period last year, and the number of borrowers is up by 28 percent. (The President had budgeted for increases of 21 and 10 percent, respectively.) On-budget GSL program costs now exceed \$1 billion a year, and the default rate is about 14 percent.

The immediate future of the GSL program is difficult to predict. The high cost of government borrowing in the last few quarters has forced the special allowance against its statutory ceiling, but the actual effects of the formula will not be felt until July---when the combined interest and special allowance must drop to 11 percent, compared to the 13.25 percent rate payable this quarter. If the present ceiling formula is retained, there will be strong downward pressures on the inclination of banks to make new student loans, just when there seem to be extraordinary upward pressures in the demand for such loans.

Viewed originally as an ingenious and inexpensive way to attract private sector capital to the student loan business, the GSL program has gone through piecemeal alterations that

have transformed it into a system much more costly than a direct federal loan program, with the higher costs not rebounding to the benefit of student borrowers, but rather to the benefit of the financial institutions that make the loans.

The transformation occurred in two steps. The first was the enactment of the special allowance, which had the effect of guaranteeing the GSL lenders an interest rate 3.5 percentage points above the Treasury's short-run borrowing costs. Since a loan can be serviced for about 1.0 percentage point, the special allowance arguably means that the government is paying around three times more to the banks than it would cost to run a direct federal student loan program.

When interest rates decline from their current highs, as they no doubt eventually will, the differential paid to GSL lenders under the law will nevertheless remain constant. They will continue to receive \$35 more per year for each \$1,000 of loaned principal than it would cost the government to borrow the same amount.

The second step in the transformation came with the creation of Sallie Mae and its 10-year grant of access to the U.S. Treasury. Put in simplest terms, the existence of

Sallie Mae allows a bank to make a student loan with "private sector" capital and then trade in the loan for Sallie Mae capital. Since Sallie Mae has gotten about 98 percent of its capital from the Treasury, the actual effect of the transaction is that capital borrowed by the federal government replaces whatever "private sector" capital was involved.

Sallie Mae not only injects federal capital into the student loan system through its loan purchase program; it also does so by lending money at bargain rates to banks, who in turn relend that money to students. The 2.5 percentage point differential between a bank's cost of borrowing from Sallie Mae and its return from the federal Treasury for relending that money has the effect of raising the bank's gross rate of return well above the nominal 13.25 percent currently in effect.

Recently, the state direct lending agencies have discovered the advantages of dealing with Sallie Mae. They get their initial capital from public funds, of course, either appropriated or borrowed. After they have loaned out the funds so raised, they can sell the notes to Sallie Mae and relend the proceeds to more students.

Both the state and Sallie Mae profit on the deal, because the borrowing cost of the former is typically less than 7 percent and for the latter, about 10 percent, while the return to each is the familiar 13.25 percent, paid from appropriated federal funds. The state bondholders and the Treasury eventually get paid back as the student borrowers repay their loans. If any of those borrowers defaults--- as surely some will---Congress appropriates enough to cover every penny of defaulted principal and missed interest owed. In all the foregoing, there is no "private sector" capital at all, as that phrase is usually defined, and nothing is at risk: the real burden is squarely and solely on the federal taxpayer.

I want to emphasize that the examples I have just been using are considerably over-simplified. Neither banks nor state lending agencies sell their whole student loan portfolios to Sallie Mae. Lenders and Sallie Mae make various one-time small charges in connection with the papers they pass back and forth. The cost of servicing a student loan may be more---and it may be less---than 1.0 percentage point per \$1,000 of principal per year, i.e., \$10 per year. It depends on whether the borrower is still in school, or in the grace period, or in actual repayment status, and upon the total he has borrowed, for it costs no more to service

a \$2,000 loan (the average size of a GSL this year) than a \$1,000 loan. Finally, unless something is done about the statutory cap on the special allowance, or unless the cost of money immediately and unexpectedly declines, the rates of return for GSL lenders will be lower than in the examples.

But every over-simplification aside, the basic point remains the same: The Guaranteed Student Loan Program, as modified over time, bears no real resemblance to the program originally conceived. Instead of attracting private capital to the student loan market solely on the strength of a federal guaranty against any loss, the Treasury now pays about 13 percent for all capital entering the system, even though the same capital would cost less than 10 percent if the government borrowed it directly. Moreover, about one-sixth of all GSL capital can be traced to the federal government. One federal office loans the money out to Sallie Mae at 10 percent, which passes it on to the GSL lenders at 11 percent, and another federal office pays those lenders 13 percent for relending the government's money to students.

Before turning to a discussion of possible changes in the present system, I want to lay out the assumptions that have guided our analysis.

First, the sole object of federal intervention in the student loan business is to help people pay the cost of attending educational institutions. If the necessary side effects are to stimulate business and profits for banks, or to enable state governments to engage in arbitrage at federal expense, or to provide employment in federal, state, academic and other bureaucracies, so be it. But we must not forget that the side effects are just what the name implies; there is no public policy goal in keeping them.

Second, we do and should care about the cost of the route by which a dollar travels from the public and into the hands of a student borrower. If it costs more for that dollar to travel through the federal Treasury on its way to the student than if it merely travels from depositor to bank to borrower, then all other things being equal, the dollar should take the second route rather than the first---and vice versa.

Third, the particular goals of federal intervention are:

- To assure that all qualified students in need of an educational loan are able to obtain one, and that repayment arrangements are manageable when the borrowers leave school.
- To the extent that student borrowers must be subsidized, to give the subsidies on a fair and explicable basis.

- To structure the program in the most effective and efficient possible manner, so that it is least costly, least vulnerable to abuse, and least complicated for students and the institutions they attend.

There are two quite different cost decisions that Congress makes in connection with student loan programs. The first has to do with the cost of the system itself, which includes the cost of capital, of originating loans and of servicing those loans. It is these system costs with which our analysis is mainly concerned. The second kind of cost decision is with respect to how much of the system costs---whatever they are---should be borne by student borrowers. While the two kinds of decisions are clearly related, they are also clearly independent. The goal for system costs should be to make them as low as possible. The goal for borrower subsidies is another matter; it depends on subjective judgments about which generations should bear what portions of post-secondary education costs, and within generations, how much the college-going group should be subsidized compared to the non-college-going group. My comments today on this second kind of decision will be quite limited.

It appears to us that the student loan system costs under the present arrangements are considerably higher than they need to be, and despite the fact that the federal

government is paying more than is necessary, students are still not assured of being able to obtain the loans they need.

Basically, the system costs are now equal to the government's cost of borrowing all the capital loaned to students, plus 3.5 percent a year on that capital, plus losses from defaults. Since the government's borrowing costs per dollar will not be significantly affected no matter how the student loan programs are structured, the only parts of the system costs worth scrutinizing for possible savings are the 3.5 percent allowance and the default costs.

The real purpose of the 3.5 percent allowance is to reimburse GSL lenders for their origination and servicing costs and to allow a reasonable profit on their activity. But some portion of the allowance, although the amounts are still probably small in a relative sense, is going to finance state arbitrage gains. Even if that issue is ignored, there still remains the question of whether the government could obtain student loan origination and servicing for an annual cost of less than 3.5 percent of the capital in the system.

Our preliminary conclusion is that origination and servicing of the GSL program can be obtained for substantially less than 3.5 percent---that is to say, for less than the \$280 million a year now paid on that account.

Considering origination costs first, they now include for every guaranteed loan the participation of both a lending institution and an educational institution. But since the government is paying all the costs of putting up the capital, the role of the bank in such a loan is actually superfluous. The loan can just as well be originated by the educational institution alone.

Secondly, it is demonstrable that servicing costs are well below 3.5 percent of the capital being serviced. Sallie Mae has servicing contracts with four banking institutions and one state agency. The costs range from about \$11 per year for borrowers who are still in school to a high of \$27 per year for borrowers in repayment status.

If the government were the owner of the student notes, it too could contract out for loan servicing, presumably on terms at least as favorable as those negotiated by Sallie Mae. In short, it would pay \$11 to \$27 a year instead of \$70 a year on the average guaranteed student loan now being made.

The remaining element of the current system cost is the loss from defaults. The long-run costs involved are difficult to estimate with any precision. While claims paid on defaulted GSLs are a known amount---about \$200 million last year---it is impossible to state how much the government will eventually collect from the debtors whose defaults gave rise to the claims, just as it cannot yet be known how much the government will realize from its current effort to obtain payment from NDSL defaulters. But it does seem safe to predict that default losses will decline in proportion to the amount of effort the government---with its superior ability to locate defaulters---puts into the task. Whether there will be a net budget gain from the government's efforts remains to be seen. But so long as the collection responsibility is spread among thousands upon thousands of educational and commercial lending institutions, the default rate is likely to remain at a level most observers would find unsatisfactory.

All the foregoing suggests that it would be useful for the Congress to consider reshaping the system to acknowledge the reality of the government's present role in raising the necessary capital. One possibility would be to federalize Sallie Mae, to have it be the conduit by which the funds would flow to state lending agencies, who would be the retailers, so to speak, in dealing with the educational

institutions that would originate all student loans. There are many other ways in which the system could be restructured to the same end.

I will conclude this statement with a brief discussion of the borrower subsidies in the present student loan systems. As I mentioned earlier, there does not appear to be a sound analytical basis for continuing to have one program with a 3 percent charge and another with 7 percent. Indeed, the differential introduces questions both of fairness and practicality, as well as of cost. The fairness issue arises because the effect of the differential is that students in like circumstances are treated in an unlike fashion. The practicality issue comes about because, with two different interest rates, it is virtually impossible to consolidate loans when---as is often the case---a borrower has both a GSL and an NDSL when he reaches repayment status. Without suggesting what the interest rate ought to be, whether 7 percent or something else, there ought to be just one basic rate.

My second comment grows out of last fall's legislation that extended the in-school interest subsidy to every GSL borrower, irrespective of family income. We cannot yet know

the costs and program implications of that change, but they may turn out to be severe, with costs rising when loans are readily available, and lower income borrowers crowded out when loans are rationed. It is probable that a great many families with liquidity problems in financing their childrens' college costs, but who are fully able and willing to pay, say 7 percent, for the privilege of stretching those costs over time, will arrange to have their children take out the interest free loans. The Congress might well consider adopting an explicit program for such families, with the interest subsidized for those who fell below a stated income level, or who have already qualified for any other need-based aid, and 7 percent loans for those who choose not to supply family income information.

Finally, I want to re-emphasize that the short-run outlook for the GSL program is extremely clouded. When the impact of the special allowance ceiling occurs a month or so from now, you may be asked to turn aside from your deliberations about the long-run shape of student loan programs and do something quickly about the short-run shape.

Mr. Chairman, that concludes my prepared statement.

